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April 25, 1980

No. 80/69

TO COUNTY ASSESSORS:

BUSINESS INVENTORY EXEMPTION

Attached to this letter are questions and answers pertinent to the business inventory exemption. The questions have been categorized for easy reference and numbered consecutively within each category.

The major categories are as followes:

A. Administrative
B. Manufacturing
C. Retailing
D. Professional and Service Enterprises
E. Agricultural Enterprises
F. Property Held for Lease

We last published a list of questions and answers on June 5, 1975. Questions and answers that were not on that list are noted with the word "NEW" to the left of the question. In some instances the answers to certain questions have been revised. These revisions are indicated with the word "REVISED" to the left of the answer.

The passage of Assembly Bill 66 (Statutes 1979, Chaper 1150) eliminates the assessment of business inventories as of the 1980 lien date. The 100-percent exemption makes a proper description of business inventory even more important today than in the past.

We hope this material will help promote uniformity of administration. We will appreciate your comments and submission of additional questions.

Sincerely

Verne Walton

Verne Walton, Chief
Assessment Standards Division

VW:do
Attachments

BUSINESS INVENTORY EXEMPTION

QUESTIONS AND ANSWERS

A. ADMINISTRATIVE

1. What is the nature of the business inventory exemption?

   Answer: It exempts from property taxation a designated percentage of the assessed value of personal property which qualifies as inventory under Board Rule 133. The percentage for the 1974-75 thru 1979-80 fiscal years is 50 percent. Beginning 1980-81, such personal property is fully exempt from property taxation.

2. Does the business inventory exemption apply to escaped property enrolled under Sections 531.3, 531.4, and 531.5?

   Answer: Not for property escaping assessment for 1974-75 fiscal year and prior. However, for 1975-76 thru 1979-80 fiscal years the exemption is only denied to escapes to which the penalty in Section 504 is applied.

NEW 3. Upon auditing a taxpayer's 1978-79 return, you find he has willfully underreported machinery and equipment to which the penalty in Section 504 is applied. You also find that inventory was underreported, but not willfully. Would the escaped inventory be eligible for the business inventory exemption?

   Answer: Yes. For the 1975-76 thru the 1979-80 fiscal years the exemption is denied only if the penalty under Section 504 is applied to the escaped inventory. Application of the Section 504 penalty to the machinery and equipment escape would have no bearing on the inventory escape.

REVISED 4. For years prior to 1980-81, if a taxpayer does not return a property statement to the assessor when requested by the assessor and the assessor makes an assessment pursuant to Section 501 of the Revenue and Taxation Code to which the penalty in Section 463 applies, does the business inventory exemption apply to the business inventories so assessed?

   Answer: Yes. Of course for 1980-81 an assessment pursuant to Section 501 would not contain a value for business inventories.

5. Prior to 1980-81, if an assessor makes an assessment on a taxpayer's business inventory pursuant to Section 501 and adds the 10 percent penalty pursuant to Section 463 of the Revenue and Taxation Code for failure to file a property statement, does the business inventory exemption apply before or after the penalty?

   Answer: It applies before the 10 percent penalty is added, thus reducing the penalty. If the assessed value is $1,000 prior to the exemption, the penalty would be $50 ($1,000-50% Exemption = $500 x 10% = $50).

REVISED 6. Does the business inventory exemption apply to inventories assessed on a direct billing program?

   Answer: Yes. Business inventory that was previously included in direct billing estimates must be removed from the assessment for 1980.

7. Prior to 1980-81, does the veteran's exemption apply before or after the business inventory exemption?

   Answer: The veteran's exemption is applied against the property chosen by the veteran. If he chooses to apply it against the inventory, then it is applied first and the business inventory exemption percentage applies to the remainder. For 1980-81 and after, the veteran's exemption will be applied to other than business inventory.

8. Prior to 1980-81, does the welfare exemption apply before or after the business inventory exemption?

   Answer: The welfare exemption applies first, then the business inventory exemption percentage applies to any remainder.

9. Is gold eligible for the business inventory exemption?

   Answer: Gold held by a dealer for sale in the ordinary course of business is eligible. Gold held by individuals or dealers as an investment in anticipation of a price increase is not eligible since it is not held for sale in the ordinary sense.

NEW 10. Does inventory erroneously reported as supplies qualify for the business inventory exemption once it is discovered?

Answer: Yes.

B. MANUFACTURING

1. Do manufacturing supplies qualify for the business inventory exemption?

Answer: Manufacturing supplies, such as nuts, bolts, and screws, that will be incorporated in a product that is to be sold are eligible. Supplies, such as drill bits, that are not physically incorporated into the product are not eligible. Also not eligible are catalysts used to accelerate chemical or physical reaction but which are not intentionally incorporated into the product.

2. Does machinery and equipment that is held for use qualify for the business inventory exemption?

Answer: No.

3. May dies, patterns, jigs, or tools held for use qualify for the business inventory exemption

Answer: No.

4. Are unmined minerals, such as iron ore, subject to the business inventory exemption?

Answer: No. The exemption applies only to personal property.

5. Are parts held by manufacturers so as to perform warranty service on products they sell eligible for the business inventory exemption?

Answer: Yes. Although the parts are not sold outright, they are held for repair of products that are sold. The selling prices of the products will include amounts to cover normal warranty repairs.

REVISED 6. Is sand and gravel held by a licensed contractor for incorporation into a bridge or road bed eligible for the business inventory exemption?

Answer: Yes. Business inventories include all materials held by a licensed contractor which will be incorporated into real property, except those to be incorporated into real property which the contractor is constructing for his own use.

REVISED 7. Is lumber held at the job site by a licensed contractor for incorporation into a building eligible for the business inventory exemption?

Answer: Yes, see answer to B6.

REVISED 8. Is factory-built housing held for sale by the manufacturer eligible for the business inventory exemption?

Answer: If held for sale as individual sections of a building, they would be eligible. They would also be eligible where the manufacturer is also a licensed contractor and assembles the sections at a building site then sells the buildings.

C. RETAILING

1. Assume a retailer goes out of business and moves all of his merchandise to his garage at home. Is that merchandise eligible for the business inventory exemption?

Answer: No. The business has been discontinued, future sales will not be made on a regular basis, and the property is not displayed, advertised, or otherwise brought to the attention of potential purchasers.

NEW 2. Assume a retailer goes out of business due to faulty merchandise. He places the merchandise in storage and attempts to have the manufacturer accept return of the merchandise. Is the merchandise eligible for the business inventory exemption after the retailer ceases to operate the business?

Answer: No. Regardless of the reasons for going out of business, once the retailer has ceased attempts to sell the merchandise, it is no longer business inventory.

3. Is the merchandise in vending machines subject to the business inventory exemption?

Answer: Yes.

4. Do consigned goods that are held for sale qualify for the business inventory exemption?

   Answer: Yes.

5. Is farm or construction equipment, that was previously used by a farmer or contractor, eligible for the business inventory exemption once it is consigned to an auctioneer for sale?

   Answer: Yes, the equipment is held for sale by the auctioneer whose normal business is selling such goods.

6. Farm or construction equipment is held and advertised by a farmer or contractor for sale as a means of disposing of old or excess equipment. Is such equipment eligible for the business inventory exemption?

   Answer: No, it is not held for sale in the normal course of business. Their business is farming or contracting, not selling used equipment.

7. Are trading stamps in the hands of the trading stamp company eligible for the business inventory exemption?

   Answer: Yes, they constitute the transfer of property during the rendition of a service.1/

8. Are trading stamps held by a retailer for distribution with the sale of his goods eligible for the business inventory exemption?

   Answer: No, title to the stamps remains with the trading stamp company; therefore, the retailer cannot "sell" the stamps. They should be treated as a supply item in the retailer's hands.1/

9. Are display items eligible for the business inventory exemption?

1/ Value of trading stamps for property tax purposes, whether in the hands of the trading stamp company or the retailer, is the cost of printing, performation, adding adhesive, and the printer's profit. This was spelled out in an Assessors' Letter dated November 22, 1971.

Answer: Yes, unless they have been altered to the point where it is unlikely they will be sold. An example of a display that is not eligible is a cut-away of a tire showing the interior construction. Such an item would not be sold by the retailer; thus, it is not eligible for the exemption.

10. Are returnable soft drink bottles held by the bottler eligible for the business inventory exemption?

Answer: The answer is dependent on whether or not title passes from the bottler to the retailer. If title passes, then the bottles are eligible. If title doesn't pass, they are not eligible. The determination of passage of title may depend upon the deposit amount, intent of the parties, distinctive shape of the bottle, etc.

11. Are returnable containers such as beer kegs eligible for the business inventory exemption

Answer: The answer depends upon the passage of title as discussed in C10.

NEW 12. Are non-returnable bottles and other containers eligible for the business inventory exemption if title to the containers passes to the purchaser?

Answer: Yes.

NEW 13. Revenue and Taxation Code Section 996 provides that returnable soft drink beverage containers are assessable to the person in possession. Where a retailer is assessed as the one in possession, are the bottles eligible for the business inventory exemption?

Answer: The answer depends upon whether title passes to the consumer. See C10.

NEW 14. Are salesmen's samples eligible for the business inventory exemption?

Answer: Yes, if items are sold from the samples or if the samples are periodically rotated and returned to stock for sale. (See C8.)

NEW 15. Are aircraft as defined in Revenue and Taxation Code, Section 5303 in a dealer's hands eligible for the business inventory exemption?

Answer: No. Property Tax Rule 133(b)(2) excludes personal property from the exemption if the assessment ratio or the tax rate is at a different proportion to value than that applied to real property. Aircraft are subject to an in-lieu tax based upon a 100-percent assessment ratio.

NEW 16. A retailer selling office machines and equipment periodically removes equipment from inventory for use as his office equipment. The equipment is used for a period of time then returned to inventory for sale. The retailer insists the equipment is still for sale even though it is in use and has been removed from display.

Is the equipment eligible for the business inventory exemption while being used as office equipment by the retailer?

Answer: No. The equipment is in use at the consumer level and is not being displayed or otherwise offered for sale.

D. PROFESSIONAL AND SERVICE ENTERPRISES

NEW 1. Goods transfered in the rendition of a professional service are not eligible for the business inventory exemption, while goods transfered in the rendition of a nonprofessional service are eligible. What criteria determines whether a service is professional or nonprofessional?

Answer: Property Tax Rule 133(c) gives examples of medicine, law, architecture, or accountancy as professional services. It lists dry cleaners, beauty shop operators, and swimming pool service companies as examples of nonprofessional services. There are, of course, many services in between that are more difficult to assign to one group or the other.

Following are criteria courts have used to distinguish between a profession or professional service and a non-professional service or enterprise.

A profession is a vocation where the labor and skill is predominantly mental or intellectual, rather than physical or manual. A profession requires knowledge of an advanced

type in a given field of science or learning gained by a prolonged course of specialized instruction and study. A third court defined profession as "a vocation founded upon prolonged and specialized intellectual training which enables a particular service to be rendered."

Examples of profession or professional service: law, ministry, medicine, military service, engineering, chemistry, industrial designing, accountancy, economics, etc.

A non-professional service is generally defined as a vocation requiring skill of a manual or mechanical nature. Courts tend to classify a non-professional service as a business as opposed to a profession.

Examples of non-professional service: Barber, beauty operator, carpenter, plumber, electrician, embalmer, etc.

NEW 2. Are embalming fluids of a mortuary eligible for the business inventory exemption as goods transferred in the rendition of a non-professional service.

Answer: Yes. The skills required of an embalmer are of a manual or mechanical nature.

3. Are medicines that a doctor keeps on hand business inventories?

Answer: No, because they are typically transferred to patients incidental to the rendition of the <u>professional service</u>.

4. Are medicines held by a hospital pharmacy for issuance to patients for a separate charge eligible for the business inventory exemption?

Answer: Yes, they would constitute inventory for sale the same as a druggist's inventory.

5. Is the food held for serving to hospital patients as part of the daily hospital service, not separately billed, eligible for the business inventory exemption?

Answer: No. The meals are incidental to the rendition of the professional service. However, food held for sale in the hospital cafeteria is eligible.

6. An accountant maintains a stock of accounting books which he passes on to his clients as a part of his service. He has a retailer's permit. Do the books qualify as business inventories?

   Answer: No. However, if the accountant regularly bills clients for the books as a separate item in addition to his services, the books would qualify for the exemption.

7. Are clothes hangers and plastic bags held by dry cleaners subject to the business inventory exemption?

   Answer: Yes, because they are delivered to customers regularly as part of the non-professional service performed.

8. Are chlorine tablets held in storage by a swimming pool service company business inventories?

   Answer: Yes, because they are delivered to customers as an item regularly included in the non-professional service.

9. Are replacement parts held in an auto repair shop business inventories?

   Answer: Yes.

10. Are television tubes and electrical parts held in a television repairman's kit subject to the business inventory exemption?

    Answer: Yes.

11. Some companies, such as airlines and bus companies, stock spare parts for use in repairing both their own equipment and equipment belonging to others. Do all or any portion of these parts qualify as business inventories?

    Answer: Yes, if the owner segregates the portion of these inventories held for sale (used to repair the equipment of others) on their records and maintains a supply of such goods for immediate sale and delivery at prices which are both realistic and competitive.

12. Assume that an airline or bus company were to organize a subsidary whose business was to sell spare parts to the parent company. Would the spare parts owned by the subsidiary qualify as business inventories?

    Answer: Yes.

13. Are parts that have already been installed as of the lien date on equipment being repaired by a repair shop eligible for the business inventory exemption?

    Answer: No, they are no longer parts held for sale. Under the legal doctrine of accession, they would become part of the equipment being repaired once they were installed.

14. Is the supply of tickets held by airlines and theaters eligible for the business inventory exemption?

    Answer: No, such items are not held for sale. They only constitute receipts for purchased services.

NEW 15. Are airline "frozen food stuffs" located at an off-site warehouse eligible for the business inventory exemption?

    Answer: Yes, because property held by enterprises rendering services of a non professional type is to be regarded as "business inventories" held for sale or lease if such property is delivered to the customer as an item regularly included in the service. The serving of meals to passangers on aircraft flights is a regular and usual part of the transportation industry.

E. AGRICULTURAL ENTERPRISES

1. Are farm commodities that are being held in storage for future sale by a farmer subject to the business inventory exemption?

   Answer: Yes.

2. Are insecticides, fuel and fertilizer held by a farmer subject to the business inventory exemption?

   Answer: No, because these items are held for use rather than for sale.

REVISED 3. Is baled cotton included in business inventories prior to July 1, 1980?

Answer: No, its tax rate is at a different proportion to value than that applied to real property. (See C15.) Effective July 1, 1980, the statutes setting the tax rate on baled cotton are repealed. Thus, baled cotton reverts back into a general property category. For the 1981 and subsequent lien dates baled cotton will either be taxed the same as other personal property or exempt as business inventory depending on the circumstances involved.

4. Is farm equipment held for sale by the farmer who owns it subject to the business inventory exemption?

Answer: No, isolated sales of used equipment do not constitute a business. However, see C5 regarding equipment consigned to an auctioneer.

5. Are unharvested oranges subject to the business inventory exemption?

Answer: No, unharvested oranges qualify as growing crops. Growing crops are not eligible for the exemption; they are however, exempt as growing crops.

REVISED 6. Do seeds held by a farmer for planting qualify as business inventories?

Answer: Yes, if they are to be used in the production of a crop grown primarily for sale.

7. Are seeds eligible for the business inventory exemption if held for planting in order to produce a crop that will be used as feed for eligible animals?

Answer: No.

NEW 8. Property Tax Rule 133(e)(2) provides that "seed to be used in the production of a crop which is to be held primarily for sale," is eligible for the business inventory exemption. For purposes of the exemption, what does the term "seed" include?

Answer: Webster's dictionary defines "seed" as "the fertilized and ripened ovule of a flowering plant containing an embryo and capable normally of germination to produce a new plant."

NEW 9. Are strawberry plants held for planting by the grower to produce strawberries for sale eligible for the business inventory exemption as "seed used in the production of a crop to be held for sale"?

Answer: No. Strawberry plants do not meet the definition of seed.

NEW 10. Are asparagus roots held for planting eligible as "seed"?

Answer: No. Asparagus roots do not meet the definition of seed.

11. Is feed that is held by a farmer for feeding to animals that are subject to the livestock head-day in-lieu tax eligible for the business inventory exemption?

Answer: Yes.

12. Are commercially prepared by-products, such as sugar beet pulp, almond hulls, and cotton seed hulls, that are held by the farmer and used as feed for livestock subject to the business inventory exemption?

Answer: Yes, if these by-products are fed to animals held primarily for sale or to animals used in the production of food or fiber useful to man.

13. Does medicine that is purchased for mixing in feed for eligible livestock qualify as business inventories?

Answer: No, medicine is classified as business inventories only if it is purchased as a component part of the feed for eligible livestock.

14. Are mink and other commercially-raised fur-bearing animals subject to the business inventory exemption?

Answer: Yes.

15. Are dogs and cats held as pets classified as business inventories?

Answer: No.

16. Are farm animals held for breeding purposes subject to the business inventory exemption?

    Answer: Yes, if their offspring are normally used as food for human consumption or for the production of fiber useful to man.

NEW 17. Are stallions and mares held for the production of offspring eligible for the business inventory exemption as "animals held for the breeding of livestock"?

    Answer: No. Those qualifying for exemption as "animals held for the breeding of livestock" are animals that produce offspring that will be used for food or fiber for human use or consumption.

18. Are show horses and race horses subject to the business inventory exemption?

    Answer: No. Race horses are ineligible since they are subject to an in-lieu fee. Show horses would be eligible only if held for sale in the normal course of business of the owner.

19. Are farm animals that are used to work the farm subject to the business inventory exemption?

    Answer: Yes, if they are used in the raising of crops which are held for sale, or for the feeding, breeding, or management of livestock.

20. Are pack animals used by a guide to pack campers into the mountains eligible for the business inventory exemption?

    Answer: No. However, if the pack animals are held for lease to campers, are directly under the campers' control, and are not otherwise used by their owner, they would be eligible.

21. Are plants grown by nurseries for the production of cut-flowers eligible for the business inventory exemption?

    Answer: No, the plants are not held for sale. Only their products (the flowers) are sold.

NEW 22. Is felled timber lying in the woods on the lien date eligible for the business inventory exemption if it is to be sold as either logs or finished products?

Answer: Yes. The felled timber is inventory eligible for the exemption whether lying in the woods or held in a log deck at the mill. (The Timber Yield Tax is in-lieu of the ad valorem tax on standing timber.)

NEW 23. Are trout in "trout farms" eligible for the business inventory exemption?

Answer: Yes, providing they are being grown for sale or as food for human consumption.

NEW 24. Are oysters being grown in oyster beds eligible for the business inventory exemption?

Answer: Yes, (See E23.)

NEW 25. Are bees eligible for the business inventory exemption?

Answer: Yes. Bees produce honey which is food for human consumption. They also are used in the fertilization of crops.

F. PROPERTY HELD FOR LEASE

REVISED 1. Are goods held for lease eligible for the business inventory exemption?

Answer: Yes, if the property is not actually out on lease on the lien date and is not <u>used</u> by or <u>intended to be used</u> by the lessor for some purpose other than the prospective sale or lease of that property. Also, the property while on lease must be removed from the premises of the lessor and under the control of the lessee.

2. Are linen supplies that are leased to customers eligible for the business inventory exemption?

Answer: Yes, if not out on lease on the lien date. (See F1.)

3. Is ski rental equipment held for short-term rentals eligible for the business inventory exemption?

Answer: Yes, if not out on lease on the lien date. (See F1.)

4. Are vending machines held in the owner's hands that are normally placed on site to dispense food eligible for the business inventory exemption?

   Answer: No, unless the machines are held for rent. Placing them on site does not constitute a rental. Sharing of the receipts with the site owner constitutes payment for use of the site.

REVISED 5. Are coin-operated pool tables, shuffle boards, etc., eligible for the business inventory exemption?

   Answer: Yes, but only when held for sale or rent. Most vending machine transactions involve a machine owner paying a site owner for the use of the site, rather than the site owner paying the vendor a rental for the equipment. Only in the later instance would a "rental" of the equipment occur.

6. Are items eligible for the business inventory exemption if held for lease by a person who has himself leased the items from someone else?

   Answer: Yes. The determining factor is the status of the items on the lien date; i.e., they are held for lease in the normal course of business.

7. A taxpayer is in the business of leasing property to others. He purchases some of the items he holds for lease and self-constructs others. Are the items in the process of being constructed eligible for the business inventory exemption?

   Answer: Yes. Raw material, work in process, or finished goods are all eligible if they will become part of or are themselves items of personalty held for sale or lease.

REVISED 8. Are boats held for rental purposes eligible for the business inventory exemption if, on the lien date, the rental operation is closed for the winter?

   Answer: Yes. Even though the boats are not "held for rent" on the lien date due to the operations being closed for the winter, they are still eligible for the exemption since they are held for rent in the normal course of business. (See F1.)

REVISED 9. Are horses held by a riding stable for rent on an hourly or daily basis eligible for the business inventory exemption?

Answer: Yes, provided the horses are removed from the stable's place of business and not directly under the owner's control during the rental period. Also, provided the horses were not or are not used by the owner while not being rented. (See F1.)

10. Are tools, etc., held by a short-term rental business eligible for the business inventory exemption?

Answer: Yes, if not out on rent on the lien date.

11. Are merry-go-rounds and other amusement rides eligible for the business inventory exemption?

Answer: No, the purchase of a ticket does not give the purchaser control of the equipment, nor the right to remove it from the premises.

NEW 12. Are golf carts held for short term rental eligible for the business inventory exemption?

Answer: No. Assuming that the golf carts are only available for use on the golf course, the golf carts would not be eligible for the exemption. We have held that to qualify as a lease, the property must be under the control of the lessee during the period of the lease. We doubt if the normal golf cart rental would qualify under these quidelines as the lessee has very little control over where he can operate the cart. (See F1.)

NEW 13. Are cable television converters held for sale or lease by a cable company eligible for the business inventory exemption?

Answer: Yes.

NEW 14. Are the supplies of motor fuels held by a rental operation eligible for the business inventory exemption where the fuels will be provided to a customer with the rental of a machine?

Answer: Yes. The fuel supplies are eligible whether billed separately or included in the rental charge.

NEW 15. Are the supplies of motor fuels held by an equipment operator eligible for the business inventory exemption where the fuels are consumed by the operator's equipment during the performance of a job?

Answer: No. The fuels are neither supplied to the customer nor are they delivered to the customer in the performance of a non-professional service.