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June 21, 1990

No. 90/45

TO COUNTY ASSESSORS:

HOSPITAL SUPPLIES AND INVENTORIES

This letter responds to continued questions and discussion on the proper categorization of certain tangible hospital property as either supplies or inventory. Let us first review the criteria for categorizing subject hospital property.

The legal guidelines for categorizing certain tangible personal property as either inventory or supplies are set forth in Revenue and Taxation Code Section 129, and further clarified in California Administrative Code Rule 133. Here is the relevant wording from those code sections.

Revenue and Taxation Code Section 129 states:

> "'Business inventories' shall include goods intended for sale or lease in the ordinary course of business...."

California Administrative Code Rule 133 states in relevant part:

> "(c) SERVICE ENTERPRISES. Property held by a person in connection with a profession which is primarily a service activity such as medicine, law, architecture or accountancy is not 'business inventories' held for sale or lease even though such property may be transferred to a patient or client incidental to the rendition of the professional service...."

Hospital industry representatives have argued that paragraph (c) of Rule 133 does not apply to hospitals because hospitals are not a "service enterprise." In order to support the argument that a hospital is not a service enterprise, hospital representatives have indicated the following:

(1) Hospitals are not licensed to practice medicine—doctors are.
(2) Doctors, generally, are not employees of the hospital.
(3) A large segment of the hospital staff, including nurses, are considered "nonprofessional."
(4) There are many departments within a hospital that are "nonmedical."

Industry representatives conclude that a hospital is distinctly separate from the medical profession and as such is not a service enterprise.

We disagree with the logic set forth by hospital industry representatives. It is the position of the Board of Equalization that the public generally perceives hospital property as property held in connection with the medical profession. A hospital provides doctors and their patients with the use of all types of equipment, a medically controlled environment, and support staff. Lacking hospitals, a doctor would have to own and maintain all of the aforementioned items within his/her own office. Such a situation, of course, is inefficient and cost prohibitive. As a result, the hospital becomes, in essence, an extension of the doctor's own office. It matters not that the doctor's name may be missing on the hospital door; he/she is there to practice the art and science of medicine, with the approval of the hospital owners, according to rules mutually agreed upon. A hospital, by virtue of such an agreement, is in the business of providing an environment for professional care and service. Since the service environment is provided for a professional, in order to practice a profession, we conclude that property held by a hospital is used in connection with the medical profession. Therefore, hospital property falls within the definition of Rule 133(c), Service Enterprise. Any such property transferred to a patient or client incidental to the rendition of the professional service would not be eligible for the business inventory exemption.

Part of the argument against a hospital qualifying as a "profession" relies on the logic that a hospital has "nonprofessionals" and enclaves within the hospital that are "nonmedical." We are not persuaded by the argument. To discount a hospital as a profession for such reasons would be akin to discounting a CPA firm as nonprofessional because it has a large clerical staff that takes up a portion of the office space. A hospital, as with any other professional operation, will of necessity have some nonprofessionals and nonprofessional areas. But a hospital, as well as other professional businesses, is considered in its entirety. Rule 133(c) even addresses such a situation by inserting the word "primarily," which Webster's Dictionary defines as meaning "essentially." The hospital is primarily a medical entity--a service enterprise for professionals--regardless of the nonprofessionals and the various nonmedical enclaves. The dedicated, nonmedical enclaves are discussed later in this letter.

In addition to the previous logic that Rule 133(c) should be applied to hospitals, consider also that Rule 133(c) applies to property used "...in <u>connection</u> with a profession...." (Emphasis added.) The word "connection" means <u>affiliated with</u>, <u>association</u>, or <u>relationship</u>, indicating that only some kind of relationship or affiliation with a profession be maintained. In our opinion hospital property is clearly connected with the medical profession.

It is inappropriate to discount Rule 133(c) because it refers to "...a person...." Revenue and Taxation Code Section 19 defines a "person" as including "...any person, firm, partnership, association, corporation, company, syndicate, estate, trust, business trust, or organization of any

kind." Based on the Section 19 definition, a hospital, for the purposes of Rule 133(c), would be considered a person.

A more difficult point of concern regarding interpretation of Rule 133(c) has to do with the word "incidental." Is an item incidental to the rendition of the professional service or not? In our opinion, the primary reason for a patient to be in the hospital is to be provided a medically approved environment in which the doctor can repair damage, ease pain, and attempt to make patients well. Incidental to the primary purpose is the receipt and consumption of various medical supplies, splints, sutures, casts, food, medicine, I.V. solution, etc. The patient is in a hospital for professional help, not to buy certain items of property which are administered incidental to the professional service being provided. Neither the hospital nor the doctor is serving the patient primarily to sell items such as sutures or bedpans.

Considering the hospital as a professional service enterprise dictates that tangible personal property which may transfer to a patient is not held for sale in the ordinary course of business. Such property is transferred to a patient incidental to the rendition of a professional service and is properly categorized as a supply item.

For property of a medical nature that transfers to a patient there is, however, one exception to the supply item categorization stated in the previous paragraph. One type of item that can feasibly be considered an inventory item would be a tangible piece of property of a significant nature that becomes affixed to and/or permanently attached to a patient. Attachment can be internal or external, if the item of property does not change its composition, and the item is not anticipated to be returned or discarded at a later date. The intent associated with the piece of property must be that it remain with the person for his/her lifetime and become in essence, a part of the body. Though it could be taken off periodically (as a prosthesis) for a specific reason, the intent is still for the property to remain a part of the body. In our opinion property of a significant nature that will transfer to a patient as described in this paragraph would be considered inventory. Our opinion rests on the logic that the property's permanence and significance would combine to make it more than property transferred incidental to the rendition of the professional service. When an item of property becomes a critical part of the body, that person loses the option on what he/she may do with subject property. As such it is difficult to consider such an item as "incidental." Hence, the item should rightfully be considered inventory when transferred from the hospital to the patient.

Examples of inventory items would include, but not be limited to, prosthesis, pacemakers, hip joints, pins, and artificial body parts and organs. Examples of what would <u>not</u> be inventory would include, but not be limited to, medicine, I.V. fluid, casts, splints, wraps, crutches and bone screws.

The opinion stated in this letter, that certain items of a patient permanent nature could qualify as inventory, within guidelines identified in the previous paragraphs, is a change from our former position. Our former position that even patient permanent property would not qualify as inventory was stated orally and put in writing on at least one occasion to the San Luis Obispo County Assessor. Our change is based on current practices within the medical profession.

We previously alluded to the fact that certain areas within a hospital are designed for nonmedical use. If the hospital has dedicated square footage for a specific activity not related to professional care, and available to nonpatient customers, then those areas of a hospital typically provide nonprofessional service enterprises. For portions of a hospital providing nonprofessional services, tangible personal property transferred to customers in the ordinary course of business would qualify as business inventory, subject to the inventory exemption. Food sold in the cafeteria, drugs sold at the pharmacy counter, and goods sold in the lobby gift shop are such examples.

A hospital's accounting practice, including methods of invoicing for property disbursement, is not determinative when categorizing personal property for property tax purposes. Hospital accounting practices are promulgated by government, insurance, and industry regulations which do not directly relate to property tax law.

I hope this letter is helpful when categorizing certain hospital property as inventory or supplies. If you have questions regarding this letter, please contact the Business Property Technical Services Section of this division at (916) 445-4982.

Sincerely,

Verne Walton, Chief
Assessment Standards Division

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