

Issue Paper Number 99-039



- Board Meeting
- Business Taxes Committee
- Customer Services Committee
- Legislative Committee
- Property Tax Committee
- Technology & Administration Committee
- Other

Property Tax Rule 133

Business Inventory Exemption

I. Issue

Should the Board authorize publication of proposed amendments to Property Tax Rule 133, Business Inventory Exemption (Section 133, Title 18, of the California Code of Regulations)?

II. Staff Recommendation

Staff recommends that the proposed amendments to Property Tax Rule 133 as shown on Attachment A, "SBE Staff Version," be authorized for publication and submitted to the Office of Administrative Law for publication in the California Regulatory Notice Register.

III. Other Alternative(s) Considered

Adopt California Assessors' Association's (CAA) proposed amendments to Property Tax Rule 133 as shown on Attachment B, "CAA Version". Staff's proposed amendments are compared with the CAA's proposed amendments on the attached matrix, Attachment C.

Issue Paper Number 99-039

IV. Background

Under Government Code section 15606, subdivision (c), the Board is given the authority to prescribe rules and regulations to govern local boards of equalization when equalizing and assessors when assessing. Accordingly, staff was directed to review and revise Property Tax Rule 133. (Section 133, Title 18, of the California Code of Regulations.)

Consistent with this direction, Property Taxes Department and Legal Division staff drafted proposed amendments to Property Tax Rule 133, and disseminated a draft to interested parties.

After receiving comments from interested parties requesting additional changes to the proposed revision, a second draft was prepared. On June 22, 1999, staff held a meeting in Sacramento with interested parties to attempt to reach agreement on the language and issues of the proposed revisions. Consensus was reached on all items except language involving one issue that is identified on the attached matrix (Attachment C).

The remaining unresolved issue is set forth below in the form of a question:

Should oak wine barrels, when used to impart the flavor and aroma enhancing chemical compounds of the oak into wine or brandy, be considered business inventory and, therefore, totally exempt from property taxation; or should the value of the portion of the barrel used for storage be taxable?

V. Staff Recommendation

A. Description of the Staff Recommendation

Staff recommends that the proposed amendments to Property Tax Rule 133 as shown on Attachment A, "SBE Staff Version," be authorized for publication and submitted to the Office of Administrative Law for publication in the California Regulatory Notice Register. Section 219 of the Revenue and Taxation Code provides for the exemption of business inventories and section 129 defines business inventories as follows:

""Business Inventories" shall include goods intended for sale or lease in the ordinary course of business and shall include raw materials and work in progress with respect to such goods."

It has been scientifically proven that particles of chemical components of the oak barrels transfer to the wine or brandy during the aging process, adding flavor, aroma, and color. This enhancement process is the primary purpose for aging the wine or brandy in oak barrels. Therefore, in staff's view, the oak barrels are used as raw material that is incorporated into the wine or brandy and, thus, constitute business inventory. The staff recommendation provides language which clearly specifies that new and used oak wine barrels used to impart the flavor and aroma enhancing chemical compounds of the oak into wine or brandy to be sold qualify for the business inventory exemption.

FORMAL ISSUE PAPER**B. Pros of the Staff Recommendation**

- The staff recommendation is consistent with the existing rule and its application because it grants the business inventory exemption based on the primary use of the property as raw material. This primary use as raw material is demonstrated by the fact that, when the barrel loses its ability to impart the flavor and aroma enhancing chemical compounds to the wine or brandy, then the value of the barrel is substantially reduced.
- The staff recommendation provides clarifying guidance to assessors when applying the business inventory exemption to wine or brandy barrels.

C. Cons of the Staff Recommendation

- The CAA considers the staff recommendation contrary to existing law because it would allow the exemption for portions of the barrel which do not become part of the wine or brandy and, therefore, are not business inventory.

D. Statutory or Regulatory Change

Action by the Board on the attached Property Tax Rule will amend Section 133, Title 18 of the California Code of Regulations.

E. Administrative Impact

The staff recommendation may require the processing of claims for refunds for up to four years by the counties that have wine or brandy barrels eligible for the business inventory exemption under the staff proposed guidelines.

F. Fiscal Impact**1. Cost Impact**

None

2. Revenue Impact

See attached Revenue Estimate.

G. Taxpayer/Customer Impact

None

H. Critical Time Frames

The lien date is January 1 for the assessment year July 1 through June 30. In order for assessors to have this guidance for the processing of the 2000-01 roll, the Property Tax Committee should authorize publication of amendments to the Rule at its meeting on September 1, 1999.

VI. Alternative 1**A. Description of the Alternative**

The Board could adopt the California Assessors' Association's (CAA) proposed amendments to Property Tax Rule 133. Attachment B shows CAA's proposed revisions to the current Rule 133; (comparison to staff's proposed amendments are shown on the attached matrix, Attachment C).

FORMAL ISSUE PAPER

The California Assessors' Association (CAA) agrees that a portion of the oak barrel is incorporated into the wine or brandy; however, the other portion of the barrel is used only as a container and they believe this portion is taxable as personal property.

I. Pros of the Alternative

- The CAA believes their recommendation is more consistent with the law.
- The CAA recommendation provides clarifying guidance to assessors when applying the business inventory exemption to wine or brandy barrels.

C. Cons of the Alternative

- The existing rule does not require exclusive use as business inventory and excludes property as inventory only when the property is primarily used for a disqualifying purpose. Thus, when determining whether the entire property qualifies for the business inventory exemption, if the property is primarily used as business inventory, then the entire property is eligible to receive a total exemption. There is no provision for a partial exemption based on uses other than the primary use that qualifies the property as business inventory.
- The CAA's proposed wording does not provide guidance for allocating the value of the barrel between the storage use and the inventory use.

D. Statutory or Regulatory Change

Action by the Board on the attached Property Tax Rule will amend Section 133, Title 18 of the California Code of Regulations.

E. Administrative Impact

The CAA recommendation may require the processing of claims for refunds for up to four years by the counties that have wine or brandy barrels partially eligible for the business inventory exemption under the CAA proposed guidelines.

F. Fiscal Impact**1. Cost Impact**

None

2. Revenue Impact

See attached Revenue Estimate.

G. Taxpayer/Customer Impact

None

H. Critical Time Frames

FORMAL ISSUE PAPER

The lien date is January 1 for the assessment year July 1 through June 30. In order for assessors to have this guidance for the processing of the 2000-01 roll, the Property Tax Committee should authorize publication of amendments to the Rule at its meeting on September 1, 1999.

Prepared by: Property Taxes Department; Policy, Planning, and Standards Division

Current as of: August 11, 1999

**ATTACHMENT A
SBE STAFF VERSION**

Rule 133. BUSINESS INVENTORY EXEMPTION.

Reference: Sections 129, 219, Revenue and Taxation Code.

(a) SCOPE OF EXEMPTION.

(1) "Business inventories" that are eligible for exemption from taxation under section 129 of the Revenue and Taxation Code include all tangible personal property, whether raw materials, work in process or finished goods, which will become a part of or are themselves items of personalty held for sale or lease in the ordinary course of business. ~~Included in business inventories are containers or container material such as kegs, bottles, cases, twine and wrapping paper, whether returnable or not, if title thereto will pass to the purchaser or lessee of the product to be sold or leased therein. Materials such as lumber, cement, nails, steel beams, columns, girders, etc., held by a licensed contractor for incorporation into real property are eligible for the exemption, providing the real property will not be retained for the licensed contractor's use. Also included are crops and animals held primarily for sale or lease and animals used in the production of food or fiber and feed for animals in either category.~~

~~(2A) The phrase "ordinary course of business" does not constitute a limitation on the type of property which may be held for sale or lease, but it does require that the property be intended for sale or lease in accordance with the regular and usual practice and method of the business of the vendor or lessor.~~

~~(3B) The phrase "goods intended for sale or lease" means property acquired, manufactured, produced, processed, raised or grown which is already the subject of a contract of sale or which is held and openly offered for sale or lease or will be so held and offered for sale or lease at the time it becomes a marketable product. Property which is ready for sale or lease must be displayed, advertised or otherwise brought to the attention of the potential purchasers or lessees by means normally employed by vendors or lessors of the product.~~

(2) "Business inventories" includes:

(A) Containers or container material such as kegs, bottles, cases, twine and wrapping paper, whether returnable or not, if title thereto will pass to the purchaser or lessee of the product to be sold or leased therein.

(B) New and used oak barrels used in the manufacturing process that physically incorporate the flavor- and aroma-enhancing chemical compounds of the oak into wine or brandy to be sold, when used for this purpose. However, an oak barrel is no longer business inventory once it loses the ability to impart the chemical compounds that enhance the flavor and aroma of the wine or brandy. An "oak barrel" used in the manufacturing process is defined as having a capacity of 212 gallons or less. Oak barrels not used in the manufacturing process but held for sale in the ordinary course of business are also considered business inventory.

ATTACHMENT A
SBE STAFF VERSION

(C) Materials such as lumber, cement, nails, steel beams, columns, girders, etc., held by a licensed contractor for incorporation into real property, providing the real property will not be retained for the licensed contractor's use.

(D) Crops and animals held primarily for sale or lease and animals used in the production of food or fiber and feed for animals in either category.

(b) EXCLUSIONS. Property eligible for the "business inventories" exemption does not include:

(1) Property of any description in the hands of a vendee, lessee or other recipient on the lien date which has been purchased, leased, rented, or borrowed primarily for use by the vendee, lessee or other recipient of the property rather than for sale or lease or for physical incorporation into a product which is to be sold or leased. Examples of property excluded from business inventories are office supplies, furniture, machines and equipment and manufacturing machinery, equipment and supplies such as dies, patterns, jigs, tooling or chemicals used to produce a chemical or physical reaction, and contractors' supplies, tools, concrete forms, and other items that will not be incorporated into and become a part of the property. Also ineligible are materials that a contractor is holding to incorporate into real property that will be retained for his own use.

(2) Property being used by its owner for any purpose not directly associated with the prospective sale or lease of that property.

(3) Property actually leased or rented on the lien date.

(4) Property which has been used by the holder prior to the lien date, even though held for lease on the lien date.

(5) Property intended to be used by the lessor after being leased or during intervals between leases even though held for lease on the lien date.

(6) Property in the hands of a lessor who, with intent to enjoy the benefits of the inventory exemption, had leased the property for a period that expired shortly before the lien date but who renewed, extended or renegotiated the lease shortly thereafter.

(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. Property held by enterprises rendering services of a nonprofessional type such as dry cleaners, beauty shop operators and swimming pool service companies is to be regarded as "business inventories" held for sale if such property is delivered to the customer as an item regularly included in the service.

**ATTACHMENT A
SBE STAFF VERSION**

(d) REPAIRERS AND RECONDITIONERS. Persons engaged in repairing or reconditioning tangible personal property with the intent of transferring parts and materials shall be regarded as holding said parts and materials as "business inventories."

(e) AGRICULTURAL ENTERPRISES. Animals, crops and feed held primarily for sale or lease in the ordinary course of business are included in the term "business inventories," as are animals used in the production of food or fiber and feed for such animals.

(1) "Animals used in the production of food and fiber" includes all animals customarily employed in the raising of crops or for the feeding, breeding and management of livestock, or for dairying, or any other confined animals whose products are normally used as food for human consumption or for the production of fiber useful to man. Excluded are animals held by an owner or lessee principally for sport, recreation or pleasure such as show animals, horses kept for racing or horses and other animals kept as pets.

(2) The term "crops" means all products grown, harvested, and held primarily for sale, including seeds held for sale or seeds to be used in the production of a crop which is to be held primarily for sale. It does not include growing crops exempted pursuant to Article XIII, Section 3 (h), of the California Constitution or fruit trees, nut trees, and grapevines exempted by Section 223 of the Revenue and Taxation Code.

(3) The term "food" means property normally considered as food for human consumption.

(4) Feed for animals held primarily for sale or lease or for animals used in the production of food or fiber constitutes "business inventories" subject to exemption. It includes every type of natural-grown or commercial product fed to animals except medicinal commodities intended to prevent or cure disease unless the medicinal commodities are purchased as a component part of feed for such animals.

History:

Adopted November 20, 1968, effective December 21, 1968.
Amended January 7, 1970, effective February 8, 1970.
Amended January 6, 1971, effective February 18, 1971.
Amended February 5, 1975, effective March 20, 1975.
Amended August 20, 1980, effective November 14, 1980.
Amended October 10, 1984, effective February 21, 1985.

**ATTACHMENT B
CAA VERSION**

Rule 133. BUSINESS INVENTORY EXEMPTION.

Reference: Sections 129, 219, Revenue and Taxation Code.

(a) SCOPE OF EXEMPTION.

(1) "Business inventories" that are eligible for exemption from taxation under section 129 of the Revenue and Taxation Code include all tangible personal property, whether raw materials, work in process or finished goods, which will become a part of or are themselves items of personalty held for sale or lease in the ordinary course of business. ~~Included in business inventories are containers or container material such as kegs, bottles, cases, twine and wrapping paper, whether returnable or not, if title thereto will pass to the purchaser or lessee of the product to be sold or leased therein. Materials such as lumber, cement, nails, steel beams, columns, girders, etc., held by a licensed contractor for incorporation into real property are eligible for the exemption, providing the real property will not be retained for the licensed contractor's use. Also included are crops and animals held primarily for sale or lease and animals used in the production of food or fiber and feed for animals in either category.~~

~~(2A) The phrase "ordinary course of business" does not constitute a limitation on the type of property which may be held for sale or lease, but it does require that the property be intended for sale or lease in accordance with the regular and usual practice and method of the business of the vendor or lessor.~~

~~(3B) The phrase "goods intended for sale or lease" means property acquired, manufactured, produced, processed, raised or grown which is already the subject of a contract of sale or which is held and openly offered for sale or lease or will be so held and offered for sale or lease at the time it becomes a marketable product. Property which is ready for sale or lease must be displayed, advertised or otherwise brought to the attention of the potential purchasers or lessees by means normally employed by vendors or lessors of the product.~~

(2) "Business inventories" includes:

(A) Containers or container material such as kegs, bottles, cases, twine and wrapping paper, whether returnable or not, if title thereto will pass to the purchaser or lessee of the product to be sold or leased therein.

(B) A portion of the new and used oak barrels used in the manufacturing process that physically incorporate the flavor- and aroma-enhancing chemical compounds of the oak into wine or brandy to be sold, when used for this purpose. However, an oak barrel is no longer business inventory once it loses the ability to impart the chemical compounds that enhance the flavor and aroma of the wine or brandy. The portion of the barrel that constitutes the container shall not be considered inventory. An "oak barrel" used in the manufacturing process is defined as having a capacity of 212 gallons or less. Oak barrels not used in the manufacturing process but held for sale in the ordinary course of business are also considered business inventory.

ATTACHMENT B
CAA VERSION

(C) Materials such as lumber, cement, nails, steel beams, columns, girders, etc., held by a licensed contractor for incorporation into real property, providing the real property will not be retained for the licensed contractor's use.

(D) Crops and animals held primarily for sale or lease and animals used in the production of food or fiber and feed for animals in either category.

(b) EXCLUSIONS. Property eligible for the "business inventories" exemption does not include:

(1) Property of any description in the hands of a vendee, lessee or other recipient on the lien date which has been purchased, leased, rented, or borrowed primarily for use by the vendee, lessee or other recipient of the property rather than for sale or lease or for physical incorporation into a product which is to be sold or leased. Examples of property excluded from business inventories are office supplies, furniture, machines and equipment and manufacturing machinery, equipment and supplies such as dies, patterns, jigs, tooling or chemicals used to produce a chemical or physical reaction, and contractors' supplies, tools, concrete forms, and other items that will not be incorporated into and become a part of the property. Also ineligible are materials that a contractor is holding to incorporate into real property that will be retained for his own use.

(2) Property being used by its owner for any purpose not directly associated with the prospective sale or lease of that property.

(3) Property actually leased or rented on the lien date.

(4) Property which has been used by the holder prior to the lien date, even though held for lease on the lien date.

(5) Property intended to be used by the lessor after being leased or during intervals between leases even though held for lease on the lien date.

(6) Property in the hands of a lessor who, with intent to enjoy the benefits of the inventory exemption, had leased the property for a period that expired shortly before the lien date but who renewed, extended or renegotiated the lease shortly thereafter.

(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. Property held by enterprises rendering services of a nonprofessional type such as dry cleaners, beauty shop operators and swimming pool service companies is to be regarded as "business inventories" held for sale if such property is delivered to the customer as an item regularly included in the service.

**ATTACHMENT C
ISSUE PAPER MATRIX
DIFFERENCES BETWEEN STAFF AMENDMENTS AND CAA AMENDMENTS**

Staff Proposed Amendment	CAA Differences with Staff Proposed Wording
<p>(2) "Business Inventories" includes:</p> <p>(B) New and used oak barrels used in the manufacturing process that physically incorporate the flavor- and aroma-enhancing chemical compounds of the oak into wine or brandy to be sold, when used for this purpose. However, an oak barrel is no longer business inventory once it loses the ability to impart the chemical compounds that enhance the flavor and aroma of the wine or brandy. An "oak barrel" used in the manufacturing process is defined as having a capacity of 212 gallons or less. Oak barrels not used in the manufacturing process but held for sale in the ordinary course of business are also considered business inventory.</p>	<p>(2) "Business inventories" includes:</p> <p>(B) <u>A portion of the N</u>new and used oak barrels used in the manufacturing process that physically incorporate the flavor- and aroma-enhancing chemical compounds of the oak into wine or brandy to be sold, when used for this purpose. However, an oak barrel is no longer business inventory once it loses the ability to impart the chemical compounds that enhance the flavor and aroma of the wine or brandy. <u>The portion of a barrel that constitutes the container shall not be considered inventory.</u> An "oak barrel" used in the manufacturing process is defined as having a capacity of 212 gallons or less. Oak barrels not used in the manufacturing process but held for sale in the ordinary course of business are also considered business inventory.</p>

BOARD OF EQUALIZATION
REVENUE ESTIMATE

ISSUE #99-039
Property Tax Rule 133, Business Inventory Exemption**Staff Recommendation**

Board staff has proposed amendments for Property Tax Rule 133, Business Inventory Exemption, to specifically state that the exemption applies to oak barrels used to impart the flavor and aroma enhancing compounds of the oak into wine or brandy.

Background, Methodology, and Assumptions

Since April 1996, sales and use tax regulation 1525 has been amended to exempt the sale of new and used oak wine barrels and of new and used oak brandy barrels. It was determined that the primary purpose of these barrels is to impart flavoring into the wine or brandy as it matures. Since, for sales and use tax purposes, oak barrels are a necessary component of the wine or brandy, staff now proposes that the barrels should be exempt from property taxes as business inventory.

Data supplied by five wine-producing counties (Napa, Sonoma, Mendocino, Stanislaus, and San Luis Obispo) indicate that the current assessed value in those counties for oak barrels used for winemaking is about \$182 million. It is likely that the total assessed value statewide for oak wine barrels exceeds \$200 million. We estimate that the current assessed value for oak brandy barrels is \$7 - \$10 million. Therefore, the current property tax revenues received at the 1 percent basic property tax rate are about \$2.1 million.

The estimated claims for refunds, for the four-year period open to statute, resulting from the proposed amendment to Rule 10 would amount to \$8.4 million (\$2.1 million x 4) excluding interest.

Under the California Assessors Association (CAA) proposal, the portion of the barrels that impart flavor and aroma is exempt from property taxes as business inventory but their role as storage containers is taxable. Staff estimates that the value of the storage

function of each barrel is \$20 to \$50. Approximately 1.05 million new and used oak wine barrels are sold each year. Assuming that these comprise 90 percent of all oak wine barrels, the estimated assessed value of the wine barrels as storage containers is:

$$1.05 \text{ million} / 90\% \times [\$20 - \$50] = \$23 \text{ to } \$58 \text{ million.}$$

There are about 150,000 oak brandy barrels statewide. Assuming that the storage value of these barrels is \$20 each, the assessed value of oak barrels used in producing brandy is estimated to be \$3 million (150,000 x \$20).

Revenue Summary

Revenues at the basic one percent property tax rate under current assessment practices for oak barrels used in making wine or brandy are about \$2.1 million annually. Under the staff recommendation, these barrels would be exempt as business inventory. Under the alternative proposed by CAA, a portion of each barrel would be taxable as a storage container. Property taxes at the basic one percent property tax rate for oak wine and brandy barrels under CAA's proposal are estimated to be \$260,000 to \$610,000 [(\$3 million + \$23 million to \$58 million) x 1 percent] annually.

Qualifying Remarks

Claims for refund, for the four-year period open to statute, resulting from the proposed amendment to Rule 10 could exceed \$8.4 million.

Preparation

This revenue estimate was prepared by Aileen Takaha Lee, Statistics Section, Agency Planning and Research Division. The estimate was reviewed by Ms. Laurie Frost, Chief, Agency Planning and Research Division. For additional information, please contact Ms. Aileen Takaha Lee at 445-0840.

Current as of November 10, 1999.