



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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December 3, 2001

JAMES E. SPEED
Executive Director

Re: *Revenue and Taxation Code Section 110*
Full Cash Value; Fair Market Value

Dear Mr. _____ :

This is in response to your September 11, 2001, letter to Mr. Larry Augusta wherein you requested an opinion regarding property tax assessment issues associated with the capitalized cost of personal property reported to a county assessor in California. Specifically, you inquire concerning a taxpayer's purchase of six rolling tire gantry cranes from a foreign supplier pursuant to a purchase agreement that set forth the terms and conditions of the transaction, one of which emphasized timely delivery and another of which provided for a contract price and for liquidated damages in the event of untimely delivery. For the reasons hereinafter set forth, in our opinion, liquidated damages are not part of the consideration paid for a property, and the liquidated damages provision does not result in a discount from the purchase price but rather, is an amount contractually agreed to as an estimation of actual damages to be recovered by the taxpayer in the event the contractor breached the agreement. Thus, the purchase price would be \$36,000,000, not \$33,000,000.

Description of the Problem According to Your Letter

For several reasons a critical component of the transaction was the timeliness of the delivery of the cranes to the taxpayer. Rapid changes in the container shipping business has meant that larger cranes must be installed more quickly in order to accommodate the wider vessels that are becoming more common in commercial long-distance oceanic shipping. After the cranes are ordered they usually require approximately two years for design, fabrication, testing, delivery and installation. Crane customers are willing to pay more to expedite this processing order to be able to service the larger vessels more economically.

Because of these circumstances, crane purchasers insert language into their agreements that emphasizes that "time is of the essence", and price adjustments to reflect an earlier or later delivery date are used to ensure performance by the supplier/manufacturer. The purchase agreement for the subject cranes contained language that emphasized the importance of timely delivery.

The agreement also imposed a graduated downward price adjustment on the seller for each calendar day the cranes were delivered after the negotiated date that the cranes were to be in operation. The downward price adjustment was capped at a maximum of 10% of the stated purchase price, as follows:

"Article III, Contract Price

Section 3.3, Adjustment of base price:¹ Contractor and E agree that, in the event that the work contemplated hereunder is not completed within the time required, it would be impracticable and extremely difficult to determine or fix E's actual damage and that the E would be entitled to liquidated damages on the basis of 0.15 percent of the Contract price of the delayed Cranes(S) for each and every calendar day the execution of said work may exceed the time allowed for that purpose, provided always that the amount of liquidated damages does not exceed 10 percent of the contract price of the delayed Equipment. Contractor agrees to all of the other terms of the liquidated damages provision set forth in this Contract."

(Underlined emphasis added.)

In the case of the subject property, the supplier failed to deliver cranes by the agreed upon date and triggered the graduated price reduction. Because the equipment was not delivered until well after the 100 days delay stated in the contract, the full 10% adjustment was triggered and the purchase price was reduced from \$36,000,000 to \$33,000,000.

Your Analysis

Assessors' Handbook Section 504, Chapter 4, page 58 states, in part:

"Discounts/Adjustments

"X X X

¹ "a Delayed delivery:" is missing here.

"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.¹¹⁹ (Discounts between related parties may require further examination.) These types of adjustments to purchase price are allowable for property tax assessment purposes.

X X X"

Based upon your analysis of the above-quoted paragraph,² phrase-by-phrase or line-by-line, in your view, Article III, Section 3.3 is a discount which should result in a reduction in the purchase price from \$36,000,000 to \$33,000,000.

Analysis

Revenue and Taxation Code Section 110 defines "full cash value" or "fair market value" as follows:

110. (a) Except as is otherwise provided in Section 110.1, "full cash value" or "fair market value" means the amount of cash or its equivalent that property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other, and both the buyer and the seller have knowledge of all of the uses and purposes to which the property is adapted and for which it is capable of being used, and of the enforceable restrictions upon those uses and purposes.

As Assessors' Handbook Section 504 states, there are instances in which adjustments to what would otherwise be considered to be "full cash value" or "fair market value" are allowed for assessment purposes, including quantity discounts and cash discounts. Thus, as you have pointed out, Assessors' Handbook Section 504 states that discounts offered by a seller are a normal part of supply and demand in the process of setting market value.

As defined in Black's Law Dictionary, Seventh Edition (1999) at pages 477 and 478, "discount" means:

² Neither this nor any other discussion in Assessors' Handbook Section 504 deals with liquidated damages, as liquidated damages was not an issue that the Board directed staff to include at the time the handbook was prepared and adopted.

discount, n. 1. A reduction from the full amount of value of something, esp. a price....

X X X

cash discount. 1. A seller's price reduction in exchange for an immediate cash payment. **2.** A reduction from the stated price if the bill is paid on or before a specified date.

functional discount. 1. A supplier's price discount given to a purchaser based on the purchaser's role (such as warehousing or advertising) in the supplier's distributive system. •This type of discount typically reflects the value of services performed by the purchaser for the supplier. If a functional discount constitutes a reasonable reimbursement for the purchaser's actual marketing functions, it does not constitute unlawful price discrimination and does not violate antitrust laws.

2. A supplier's price discount based on the purchaser's relative distance from the supplier in the chain of distribution. •For example, a wholesaler or distributor usu. receives a greater discount than a retailer.

X X X

trade discount. 1. A discount from list price offered to all customers of a given type - for example, a discount offered by a lumber dealer to building contractors. **2.** The difference between a seller's list price and the price at which the dealer actually sells goods to the trade.

volume discount. A price decrease based on a large-quantity purchase. - Also termed *bulk discount*; *quantity discount*.

In our view, Article III, Section 3.3 does not provide for a "discount", as "discount" is defined above. Rather, it provides for damages in the event of the contractor's untimely performance under the agreement, "liquidated damages" in lieu of actual damages, liquidated damages on a per-day basis but not to exceed 10 percent of the contract price. As indicated, Article III, Contract Price, states in part:

Section 3.3, Adjustment of base price: a Delayed delivery. Contractor and E agree that, in the event that the work contemplated hereunder is not completed within the time required, it would be impracticable and extremely difficult to determine or fix E's actual damage and that the E would be entitled to liquidated damages on the basis of 0.15 percent of the Contract price of the delayed Crane(S) for each and every calendar day the execution of said work may exceed the time allowed for that purpose, provided always that the amount of liquidated damages does not

exceed 10 percent of the contract price of the delayed Equipment. Contractor agrees to all of the other terms of the liquidated damages provision set forth in this Contract.

Article V. Delays, Extensions of Time, states, in part,

5.3 Liquidated Damages:

- a. If the Contractor fails to complete the work covered by the Contract Documents, or any portion thereof, in accordance therewith, within the time for completion stipulated, or within the time for such completion as extended, the Contractor shall and will pay to E the sum stipulated in the Contract, for each and every calendar day the time consumed in the execution of said work may exceed the time allowed for that purpose, which said sum is agreed upon, fixed and determined by the parties hereto, as the liquidated damages that E will suffer by reason of said delay and default. It is expressly understood that it will be impracticable and extremely difficult to determine or fix the actual loss that E will suffer by reason of delay in the performance of the work hereunder. E may deduct and retain the amount of such liquidated damages out of any money which may be due or become due the Contractor.

As defined in Black's Law Dictionary, Seventh Edition (1999) at page 395, "liquidated damages" means:

liquidated damages. An amount contractually stipulated as a reasonable estimation of actual damages to be recovered by one party if the other party breaches. •If the parties to a contract have agreed on liquidated damages, the sum fixed is the measure of damages for a breach, whether it exceeds or falls short of the actual damages.

Thus, it seems clear that contractor and E , in including sections 3.3 and 5.3 in the agreement, intended to provide for liquidated damages, as that term is defined, to be recovered by E in the case of the contractor's untimely performance, not for any "discount" or "discounts" because of contractor's sale or because of E 's purchase of the cranes.

Consistent therewith, in ABI, Inc. v. City of Los Angeles (1984) 153 Cal. App. 3d 669 the California district court of appeal defined "liquidated damages" as a sum which contracting

parties agree will be forfeited upon a breach. Thus, Article III, Section 3.3, Adjustment of Base Price, a Delayed delivery, provides for damages (Article V, Section 5.3, Liquidated Damages) to be recovered by taxpayer if contractor breached the agreement, not for a discount which would permit an adjustment to "full cash value" or "fair market value" for assessment purposes. Being damages for breach of agreement, amounts thereof are not deductible from "full cash value" or "fair market value" for purposes of section 110 and assessment of property, and the full cash value or fair market value of property does not change depending on whether a liquidated damages provision is invoked. Thus, in our opinion, the purchase price of the cranes would be the price contracted for, \$36,000,000, not \$33,000,000.

We find support for our conclusion in the 1972 sales and use tax case of Southern California Edison Co. v. State Board of Equalization (1972) 7 Cal. App. 3d 652. In that case, plaintiff utilities sought refunds of sales tax reimbursement and use taxes paid with respect to purchases of electrical equipment made from 1956 to 1959. The applicable "value" standards for the Sales and Use Tax Law were and are Revenue and Taxation Code sections 6011, "Sales Price, and 6012, "Gross Receipts":

6011. "**Sales price.**" (a) "Sale price"³ means the total amount for which tangible personal property is sold or leased or rented, as the case may be, valued in money, whether paid in money or otherwise, without any deduction on account of any of the following:

X X X

6012. "**Gross Receipts.**" (a) "Gross receipts"³ mean the total amount of the sale or lease or rental price, as the case may be, of the retail sales of retailers, valued in money, whether received in money or otherwise, without any deduction on account of any of the following:

X X X

In that case, by late 1965, plaintiffs had entered into settlement agreements with the manufacturers of equipment under which the manufacturers were to pay so-called "voluntary price adjustments" to the plaintiffs in exchange for the plaintiffs' dismissing pending treble damage actions against the manufacturers based upon the manufacturers' price-fixing activities. The plaintiffs then claimed that their taxes were subject to re-computation and refund, as appropriate, based on the "adjusted" prices of their purchases.

³ Compare to the similar Section 110 definition of "full cash value" or "fair market value" for property tax purposes, supra: the amount of cash or its equivalent that property would bring if exposed for sale in the open market.

December 3, 2001

Page 7

The California Supreme Court, in reversing the decision of the trial court to allow a refund, held that so-called "voluntary price adjustments" arrived at in settlement of antitrust litigation did not entitle the plaintiffs to a tax refund measured by the so-called "inflated" portion of the sales prices. The Supreme Court observed that the payments in the case, although termed "voluntary price adjustments," were in no way distinguishable from other payments, by way of settlement or judgment, which might be received by a purchaser of goods from the seller as a result of litigation arising out of the sales transaction.

In our opinion, liquidated damages in lieu of actual damages are not distinguishable from payments, by way of settlement or judgment, which might be received by a purchaser of goods from the seller as a result of litigation arising out of the sales transaction or as the result of other contractual provisions in the sales agreement designed to preclude litigation. Neither are liquidated damages part of the consideration paid for a property, nor are they a discount from the purchase price. The full cash value or fair market value of a property does not change depending on whether a liquidated damages provision is invoked.

The views expressed in this letter are only advisory in nature. They represent the analysis of the legal staff of the Board based on present law and facts set forth herein. Therefore, they are not binding on any person or public entity.

Very truly yours,

/s/ James K. McManigal, Jr.

James K. McManigal, Jr.
Tax Counsel IV

JKM:lg

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cc:

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