



STATE OF CALIFORNIA

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April 11, 2002

Honorable Kenneth D. Stieger, Assessor
County of Sacramento
Sacramento County Administration Center
700 H Street, Room 3720
Sacramento, CA 95814-1284

Attention: _____, Sr. Auditor-Appraiser

Re: **The Inclusion of a Sales Tax Component in
Determining the Economic Cost of Property.**

Dear Ms. _____:

This is in reply to your letter dated October 9, 2001 to Mr. David Gau of the Board's Property Taxes Department regarding your questions of including a sales tax component when determining the economic cost of property. Please excuse the delay in responding, as previously scheduled Board matters have occupied our time.

As discussed further below, it is our opinion that sales tax should be included as a component of cost in determining the market value of manufacturing equipment when new companies, during the first three (3) years of operation, receive the benefits of the sales tax exemption provided by Revenue and Taxation Code section 6377. On the other hand, when the Legislature has enacted a statutory sales tax exemption for consumers of a specific type of equipment (i.e., farm equipment and machinery), sold at a similar trade level (i.e., Revenue and Taxation Code section 6356.5), sales tax should not be included as a component of cost in determining the market value of such equipment receiving the benefits of that sales tax exemption.

Factual Background

In your letter, you posed the following questions as modified:

1. If a new business in California received an exemption of the state portion of the sales tax on the purchase of manufacturing equipment, pursuant to the provisions

of Revenue and Taxation Code section 6377,¹ should sales tax be included as a component of cost when using the cost approach to value that property?²

2. Given the passage of AB 426 in 2001, providing for an exemption of the state portion of the sales tax on the purchase of farm equipment and machinery, should sales tax be included as a component of cost when using the cost approach to value that property?

Law and Analysis

As to the assessment of personal property generally, it has been the Board's position that typical, and valid, cost components of tangible personal property include sales tax or use tax, as the case may be. As stated in Assessors' Handbook Section 504 (AH 504), *Assessment of Personal Property and Fixtures*, revised June 2000, at page 52:

Valid Cost Components

A property's recorded purchase price does not necessarily reflect all costs required to estimate value for assessment purposes, nor does it necessarily exclude costs which do not contribute to value. In other words, not all costs contributing to value are booked and not all costs booked contribute to value. . . .

It is important to be aware of all cost components. Rule 6 and Rule 10 define these costs as including labor, material, entrepreneurial services, interest on borrowed or owner-supplied funds, freight or shipping costs, installation costs, sales or use tax, and "other costs typically incurred in bringing the property to a finished state (or to a lesser state if unfinished on the lien date)."¹⁰⁷

Direct and Indirect Cost

Cost for assessment purposes may be thought of as *full economic cost*. Full economic cost should include all market costs, both direct and indirect, necessary to purchase or construct equipment and make it ready for its intended use. Costs which add value, direct and indirect, associated with manufacturing the equipment and/or making it ready for its intended use should be included in the full economic cost. Not all costs add value; for example, relocation costs are not costs contributing to the assessable value of the property. *Direct costs*, or "hard" costs, are expenditures for the labor, materials, and direct factory overhead required to construct the property whether purchased in the form of raw materials or a finished product. *Indirect costs*, or "soft" costs, include expenditures other

¹ Unless otherwise indicated, all statutory references are to the Revenue and Taxation Code.

² In your letter, you originally posed the following as your first question: If a company received a sales tax rebate from a state-sponsored incentive program on the purchase of certain equipment, should the assessor include sales tax as a component of cost when using the cost approach to value that property? Upon researching this matter, we discovered the partial sales tax exemption provided by Revenue and Taxation Code section 6377.

¹⁰⁷ Except personal property leased for a period of six months or less (Rule 10(c)) and for certain liquefied petroleum gas tanks as provided by Rule 153.

than labor and material necessary to make the equipment ready for its intended use.

The following listing illustrates typical costs which should be included in full economic cost, that is, those costs typically incurred in bringing the property to a finished state. Some of the more common items are discussed in more detail in the pages following the table. These costs may be equal to, or more than, the cost to put the equipment in place.

And, at page 53 of AH 504:

Table 4A	
Typical Valid Cost Components	
<u>PURCHASED EQUIPMENT</u>	
<u>DIRECT COSTS</u>	<u>INDIRECT COSTS</u>
<ul style="list-style-type: none"> • Purchase price including sales tax, freight, trade-in allowances, and installation less discounts--(with all features & attachments)¹⁰⁸ 	<ul style="list-style-type: none"> • Unbooked sales/use tax,¹⁰⁹ freight-in,¹¹⁰ installation, etc.

And, at page 54 of AH 504:

Purchase Price

Normally, a recent purchase price is the best evidence of the value of an asset. The Revenue and Taxation Code permits the assessor to presume fair market value from property's full purchase price (less allowable discounts), but does not bind the assessor to rely upon it.¹¹¹

And, at page 55 of AH 504:

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 cost are elements of that value.¹¹⁴ These elements should be included in full economic cost since they are part of value when they are paid. However, if these costs would have been

¹⁰⁸ Purchase price total consideration whether money or otherwise; section 110.

¹⁰⁹ *Xerox Corporation v. County of Orange* (1977) 66 Cal. App. 3d. 746; *County of San Diego v. Assessment Appeals Bd. No. 2* (1983) 140 Cal. App. 3d. 52.

¹¹⁰ *Xerox Corporation v. County of Orange* (1977) 66 Cal. App. 3d. 746; *County of San Diego v. Assessment Appeals Bd. No. 2* (1983) 140 Cal. App. 3d. 52.

¹¹¹ *Dennis v. County of Santa Clara* (1989) 215 Cal. App. 3d 1019.

¹¹⁴ *Xerox Corp. v. Orange County* (1977) 66 Cal. App. 3d 746.

applicable to a similar consumer using the equipment at a similar *trade level*, they may be assessable even when not paid.¹¹⁵ The costs apply at the same rate that would apply to that similar consumer whether actually paid or not.

However, there are exceptions to the general rule. Equipment rented to federal instrumentality's and aircraft used by common carriers (neither of which are subject to sales tax), for example, are valued without sales tax as an element of value. The reason in both cases is that the consumer (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.¹¹⁶

Copies of pages 52 through 55 of AH 504 are enclosed for your information and review.

In sum, cost for assessment purposes is full economic cost, which includes all market costs, both direct and indirect, as defined, and which includes sales tax or use tax. And as indicated on page 55 of AH 504, as quoted above, sales and use tax is a component of the full economic cost of property whether actually paid or not. However, if these costs would have been applicable to a similar consumer using the equipment at a similar trade level, such costs may be assessable even when not paid. The costs apply at the same rate as those that apply to a similar consumer, whether or not actually paid.

QUESTION 1—If a new business in California received an exemption of the state portion of the sales tax on the purchase of manufacturing equipment, pursuant to the provisions of Revenue and Taxation Code section 6377, should sales tax be included as a component of cost when using the cost approach to value that property? **YES, SALES TAX SHOULD BE INCLUDED AS A COMPONENT OF COST AS THE EXEMPTION IS NOT AVAILABLE TO ALL SIMILAR CONSUMERS OF THAT EQUIPMENT AT A SIMILAR TRADE LEVEL.**

As noted in Footnote 2 of this letter, further research of this matter disclosed that a partial sales tax exemption on the purchase of manufacturing equipment is available to a limited category of consumers under section 6377.³ This partial exemption is generally available to qualified persons (i.e., corporations or other business entities),⁴ for the first three (3) years of operation, that commence a new trade or business⁵ in California on or after January 1, 1994, on the state portion of the sales tax on the purchase of manufacturing equipment.

¹¹⁵ 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.

¹¹⁶ See the Sales and Use Tax Law for more information regarding sales tax requirements.

³ Enclosed is a copy of Sales and Use Tax Regulation 1525.2, which further details this sales tax exemption.

⁴ Qualifying businesses are those described in Codes 2011 to 3999 of the 1987 Standard Industrial Classification Manual published by the United States Office of Management and Budget. For more information, see the U.S. Census Bureau's website at www.census.gov/epcd/naics/nsic2ndx.htm#S3.

⁵ A new trade or business is one which a qualified person (or any related person) has not engaged in within the preceding 36 months inside the state or which is classified in a different division of the SIC Code than that persons' (or any related person's) current or prior trade or business activities in the state. (Revenue and Taxation Code section 6377(b)(6)(A)(ii).) Section 6377 makes a distinction between persons engaged in a trade or business inside the state and those that are not. Persons engaged in business wholly outside of the state who commence a

This exemption is intended to reduce the start-up costs of consumers who begin certain types of new businesses within a given time period and would not be available to the same company in the future, once it no longer qualified as a new business in California (i.e., after three years). Further, the exemption is not available to the same types of existing businesses in the State. As a result, as the partial sales tax exemption is not applicable to a similar consumer using the manufacturing equipment at a similar trade level, the sales tax should be included as a component of cost when using the cost approach to value that property.

In your letter, based upon the information received from the taxpayer, you assumed that the company was receiving a sales tax “rebate” from a state-sponsored incentive program on the purchase of certain equipment. We would like to take this opportunity to note the distinction recognized between a sales tax or similar rebate and a purchase discount or rebate. 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 seller rebates—represents the amount received by the seller, as well as the cost to all buyers at that consumer level for that product. A sales tax rebate, on the other hand, may not be offered by the seller as part of the transaction between buyer and seller. Receipt of the tax rebate generally requires applying for the rebate, outside of the transaction between buyer and seller, and meeting the qualifications of the program. Thus, a sales tax rebate that requires the buyer to apply and qualify is distinguishable from a purchase discount or rebate offered directly by a seller of the property, since it is not available to all consumers at a similar trade level.

QUESTION 2—Given the passage of AB 426 in 2001, providing for an exemption of the state portion of the sales tax on the purchase of farm equipment and machinery, should sales tax be included as a component of cost when using the cost approach to value that property? **NO, SALES TAX SHOULD NOT BE INCLUDED AS A COMPONENT OF COST AS THE EXEMPTION IS AVAILABLE TO SIMILAR CONSUMERS OF THAT EQUIPMENT AT A SIMILAR TRADE LEVEL.**

Distinguishable from the sales tax exemption question above, AB 426 provides for a sales tax exemption on all qualified sales and purchases of farm equipment and machinery used primarily in producing and harvesting agricultural products. AB 426 enacted Revenue and Taxation Code section 6356.5, among other statutes, to provide for this partial sales tax exemption. Section 6356.5 broadly defines those activities which qualify for this exemption, creating a circumstance in which the exemption would be available and applicable to similar consumers using the equipment at a similar trade level. Hence, consumers engaged in the producing and harvesting of agricultural products and who purchase farm equipment and machinery for such purposes at a similar trade level will be exempt from the state portion of the sales tax and, as such, this portion of the sales tax should not be included as a component of cost for owners of such equipment. A Letter to Assessors discussing AB 426 will be issued by the Board's Property Taxes Department in the next few weeks, further describing the implications of this legislation.

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

Very truly yours,

/s/ Anthony S. Epolite

Anthony S. Epolite
Tax Counsel

ASE:eb

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Enclosures

cc: Mr. David Gau, MIC:63
Chief, PPSD, MIC:64
Mr. Charlie Knudsen, MIC:62
Ms. Jennifer Willis, MIC:70