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State Controller, Sacramento

March 25, 2003

VIA FACSIMILE
ORIGINAL TO FOLLOW

JAMES E. SPEED
Executive Director

RE: Interpretation of Property Tax Rule 10

Dear Mr. :

This is in reply to your letter dated December 16, 2002 to Assistant Chief Counsel Kristine Cazadd related to the amount of a quantity discount that can be considered under Property Tax Rule 10, subsection (d), when valuing property of a lessor which is out on lease for more than six months.

Rule 10, subsection (d) provides that, when property is leased for a period of more than six months, the property should be valued at the fair market value price that a customer at the same trade level as the lessee would pay for that property. Under the concept of full economic cost, as described in subsection (b) of Rule 10, such a price would be adjusted for any appropriate quantity discount that a customer at the lessee's trade level would receive. Unless a lessor can demonstrate that the particular lessee of its property is leasing more than one item of property, however, it would be inappropriate to consider a quantity discount when determining the full economic cost of the property in question. In other words, it cannot be assumed that a lessee is leasing multiple items of property such that the purchase of a like number of that same property would result in a quantity discount.

In your letter, you had mentioned the applicability of Rule 10, subsection (e) to this question. Under the rules of statutory construction, the provisions of subsection (e) of Rule 10 would not apply to an analysis of personal property leased for a period of more than six months under subsection (d) of the rule. A basic tenet of statutory construction is that a statute should be construed, if possible, so that effect is given to all of its provisions, so that no part will be inoperative or superfluous, void, or insignificant. These same concepts can be applied to the analysis of a regulation. Here, subsection (e) of Rule 10 specifically applies (1) to personal property acquired from internal sources (2) which is self-consumed or used. Additionally, the last sentence of the subsection (as referenced in your letter), which provides for a discount as large as that given to a manufacturer's biggest wholesale or retail customer, only applies to

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manufacturers who are their own largest customers. The provisions of subsection (e) therefore have a very limited application. Based upon the rules of statutory construction then, the provisions of subsection (e) of Rule 10 are inapplicable to lessors who lease property to third parties.

Detailed information about trade level adjustments with an allowance for quantity discounts is found in Assessors' Handbook Section 504 (AH 504), *Assessment of Personal Property and Fixtures*, pp. 60-69, attached. See also a February 18, 2003 opinion letter (attached), which discusses the allowance for quantity discounts in a situation where the property is not subject to a trade level adjustment under Rule 10.

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
Senior Tax Counsel

Attachments

ASE:eb

Prec/persprop/03/05ase.doc

cc: Mr. David Gau, MIC: 63
Mr. Dean Kinnee, MIC:64
Ms. Mickie Stuckey, MIC:62
Mr. Harold Hale, MIC:61
Ms. Jennifer Willis, MIC:70
Ms. Kristine Cazadd



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JAMES E. SPEED
Executive Director

February 18, 2003

RE: *The Classification and Valuation of Security/Fire Alarm Systems, Including the Treatment of Volume Discounts and Trade Level Adjustments*

Dear Mr. _____ :

This is in reply to your letter dated August 12, 2002 to Assistant Chief Counsel Kristine Cazadd related to the valuation of company-owned security systems, which are owned and used by the security company, but installed at the premises of the company's customers.

As discussed in detail below, it is our opinion that (1) the alarm systems in question are fixtures and (2) whether company-owned or customer-owned, the company is the consumer of these alarm systems. Regarding your specific questions, the alarm systems owned by the company should be valued at their full economic cost. Full economic cost recognizes that discounts, such as quantity discounts, offered by sellers are a normal part of establishing market value. Thus, when valuing the company-owned alarm systems, the quantity discounts received by the company should be excluded from the full economic cost of the property for assessment purposes. Finally, trade level adjustments cannot be used when valuing the company-owned alarm systems. As Property Tax Rule 10 only applies to personal property, the trade level adjustments authorized by that rule cannot be utilized to value fixtures.

Factual Background

As detailed in your letter, _____ Security Systems, Inc. (the "Company") is engaged in the business of providing security and fire monitoring services, including the installation of burglar and fire alarm systems ("alarm systems") at customers' premises. These alarm systems include devices that monitor the site which send signals to the Company's monitoring center. While alarm systems are occasionally sold outright to customers in conjunction with the sale of monitoring services, most customers do not acquire title to these systems and, thus, the Company retains ownership of the systems installed.

Company-owned alarm systems are recorded on the Company's books at the cost that the Company paid for them. This cost is generally lower than the manufacturer's suggested retail price, because the Company purchases these items from unrelated manufacturers at a volume discount. According to your letter, and based upon our discussions with various assessors'

offices, questions have arisen as to whether (1) a trade level adjustment should be made for the Company's cost of these items and/or (2) the Company-owned alarm systems should be valued at the cost that a customer would incur if it had purchased the system. Additionally, questions have arisen as to whether the volume discounts received by the Company are relevant and should or should not be recognized and considered when determining the full economic cost of the property, as individual customers would not be entitled to such a discount.

Based upon the above, you posed the following questions:

1. How should these alarm systems, that are owned by the Company but installed on customer premises and leased to the customer, be valued?
2. In determining the full economic cost of the Company-owned alarm systems, should the property be valued at the Company's actual cost, which would recognize the volume discount received by the security company, or should the property be valued at the non-discounted price available to the security company's individual customers?
3. Is it appropriate to make a trade level adjustment for the installed systems?

Law and Analysis

I. COMPANY-OWNED ALARM SYSTEMS

Before addressing the questions below, a threshold issue of how the alarm systems are classified must be addressed. In our view, the property in question, alarm systems, are considered fixtures, as personal property that has been annexed to the real property of the Company's customers. As alarm systems are similar to telephone systems, Assessors' Handbook Section 504 (AH 504) (October 2002), *Assessment of Personal Property and Fixtures*, states that telephone system "components integrated into the structure are physically annexed, generally having permanence (intended to be annexed indefinitely), and are therefore structure items."¹ As a result, we conclude that alarm systems should be classified as fixtures under Property Tax Rule 122.5, the same as telephone systems.

QUESTION 1: How should these alarm systems, that are owned by the Company but installed on customer premises and leased to the customer, be valued?

ANSWER: At full economic cost.

Since the Company is providing security and fire monitoring services, the devices constituting the alarm system are, in effect goods transferred in the rendition of a nonprofessional service.² As stated in your letter, without a connection to the Company's monitoring service, an alarm system would have little, if any, utility to an individual customer.

¹ AH 504, page 18.

² Property Tax Rule 133, subsection (c), exempts as business inventory "[p]roperty held by enterprises rendering services of a nonprofessional type . . . if such property is delivered as an item regularly included in the service."

Therefore, whether Company-owned or customer-owned, the Company is the consumer of the alarm systems.³

For purposes of property tax assessment, the alarm systems, with the Company as the consumer of such systems, should be valued at their full economic cost to the Company. Full economic cost recognizes that discounts, such as quantity discounts, offered by sellers are a normal part of establishing market value. Thus, when valuing the Company-owned alarm systems, the quantity discounts received by the Company should be excluded from the full economic cost of the property for assessment purposes.

QUESTION 2: In determining the full economic cost of the Company-owned alarm systems, should the property be valued at the Company's actual cost, which would recognize the volume discount received by the security company, or should the property be valued at the non-discounted price available to the security company's individual customers?

ANSWER: At the Company's actual cost with the volume discount.

Cost for assessment purposes is considered "full economic cost."⁴ The full economic cost of property should include all market costs, both direct and indirect, necessary to purchase or construct the property and to make it ready for its intended use. Of course, a property's recorded purchase price does not necessarily reflect all of the property's cost required to estimate its value for assessment purposes. Likewise, a property's purchase price may reflect costs which do not contribute to the property's value for assessment purposes. In other words, for purposes of determining a property's full economic cost and, thus, its cost for assessment purposes, not all costs contributing to value are booked and not all costs booked contribute to value.

Normally, an asset's recent purchase price is the best evidence of its value. Revenue and Taxation Code section 110 permits the assessor to presume fair market value from a property's full purchase price less allowable discounts. An asset's purchase price may reflect discounts due to the quantity purchased.⁵ For example, a seller may offer discounts that escalate based upon the quantity purchased, exceeding the discount which may be offered in smaller orders.

Such discounts 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 the recognition of a discount, such as a quantity discount, represents the amount received by the seller as well as the cost to the buyer. This type of adjustment to the purchase price of property is allowable for property tax assessment purposes. For this reason, such discounts, including quantity discounts, are excluded from the full economic cost of property for property tax assessment purposes. Assuming that the Company here is a consumer that typically receives quantity discounts due to the amount of property purchased, it is appropriate to reflect such a discount when determining the full economic cost of the property.

³ See the discussion below regarding customer-owned alarm systems.

⁴ See the discussion of full economic cost beginning at page 53 (Chapter 4) of AH 504.

⁵ See the discussion of Discounts/Adjustments beginning at page 60 (Chapter 4) of AH 504.

As stated above, the alarm systems at issue are considered fixtures. Therefore, in addition to the quantity discounts discussed above, the full economic cost of the alarms systems should also include labor and other costs associated with the installation of these systems.⁶

QUESTION 3: Is it appropriate to make a trade level adjustment for the installed systems that are considered fixtures?

ANSWER: No. The Board did not include fixtures in Rule 10.

In November 1999, the Board's Property Tax Committee amended Property Tax Rule 10 (Rule 10), *Trade Level for Tangible Personal Property*, regarding the use of trade level adjustments in valuing personal property. One of the issues for the Committee's consideration at that time was the applicability of the rule to fixtures, by changing the name of the rule and by adding the following to the end of subsection (a) of the rule: "Trade level adjustments shall also be considered when appraising personal property affixed to real property."

The Property Tax Committee, however, did not accept staff's recommendation regarding the application of Rule 10 to fixtures. The following is an excerpt from the minutes of the Committee's meeting with respect to its consideration of Rule 10:

The Committee voted to recommend that the Board adopt staff's modified version of Rule 10 with the following exceptions:

1. Do not adopt staff's proposed change [to add "*Fixtures*"] to the title of the rule. The title of the rule will continue to be, *Trade Level for Tangible Personal Property*.
2. Do not adopt staff's proposed language in subdivision (a) [of Rule 10] that states, "Trade level adjustments shall also be considered when appraising personal property affixed to real property."

On November 19, 1999, with a majority of the Board Members present and voting, the Board adopted the Committee's recommendations above.

For purposes of property tax assessment, the alarm systems at issue are fixtures. The proposed addition to subsection (a) of Rule 10 would have specifically allowed for the use of trade level adjustments when valuing fixtures. However, this language was not adopted and is not part of the rule. The rejection of this addition to the rule clearly results in the conclusion that trade level adjustments cannot be used when valuing fixtures and that trade level adjustments may only be used when valuing personal property. Therefore, trade level adjustments cannot be used when valuing the Company-owned alarm systems.

⁶ See Table 4A, *Typical Valid Cost Components*, at page 54 (Chapter 4) of AH 504 for typical costs that are included in the full economic cost of bringing property to a finished state.

II. Customer-owned Alarm Systems

Alarm systems that are not Company-owned (i.e., those alarm systems that customers purchase and hold title) are also valued in the manner discussed above, because the systems have no utility without the service connection. Based upon our inquiry to you as to why a customer would hold title to an alarm system, you responded as follows:

Company has only a very small portion of revenue (and customers) involved in outright sales--the large majority of their revenue comes from their service contracts and lease customers. Company's typical business model is not to sell the equipment but to lease it--only in a minority of cases is the equipment sold. Of the outright sales, most of the customers are residential, and largely consist of two types--(1) the very large custom installation where the monthly service fee (which varies very little for residential customers) is simply inadequate to justify to Company the cost of the system. In that case, Company will require a much larger upfront fee and the customer then typically wants to own it [the system] for paying that amount. (2) For a small number of residential owners, the owner wants to own because they simply don't lease or borrow, etc. This is not an economic decision, but is based upon their personality trait. There is no difference in the price of the service or maintenance fee whether they own or lease.

Of the business customers, unlike the residential, there are few set pricing plans--the jobs tend to be more custom and individually negotiable. Sometimes businesses will pay the higher upfront fee, take title, and have a lowered monthly service fee from the customary fee.

With respect to where to value the equipment: (1) the equipment is used by Company to provide the security and fire protection/monitoring services. Without the service contract and being activated by Company, the equipment will not function for its intended purpose. (Of course, technology being what it is, I'm sure some people could figure out how to tamper with the system to get it to work even if shut off by Company--like some unauthorized uses of cable channels).

(2) The assets are being valued as a mass asset. No individual consumer would own all of that equipment--only a company providing security/monitoring services would hold all of that equipment and in that quantity. To say that Company could sell all of that equipment for the same price it has made a few isolated sales is unrealistic. The most likely buyer would be another company who would buy the entire mass asset. Even if Company could sell all of its owned equipment to individuals, it would be highly unlikely to achieve the price reflected by the few who wanted to buy (most do not want to buy), and in any event there would be extra marketing and other selling costs, and time delays before all could be sold.

Assuming the foregoing facts, the ultimate consumer of the alarm systems is the Company, even when an alarm system is customer-owned. The situations that you described above in which alarm systems are customer-owned are based upon economic rationales,

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customers believing that they are gaining value by acquiring the alarm system, either by: (1) the lowering of monthly service fees, (2) the acquisition of title justifying the amount of the upfront fees paid with installation, or, (3) the acquisition of title avoids entering into a lease. In other words, customers who have acquired title, have some perceived or actual benefit from the acquisition of title. Regardless of the customer rationale however, these alarm systems really have no utility without being connected to the Company's monitoring service. As a result, whether Company-owned or customer-owned, the Company is always the consumer of the alarm systems.

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. You may wish to contact the County Assessor's Office and Sacramento Assessor's Office to ascertain whether it is in agreement with the analysis and conclusions set forth herein.

Very truly yours,

/s/ Anthony S. Epolite

Anthony S. Epolite
Tax Counsel

ASE:tr

prec/persprop/03/03ase

prec/fixtures/03/02ase

cc:

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