



Mr. Neilon Jennings

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Robert D. Milam

**Inventory Exemption for Goods Held by a Public Utility  
That is a Licensed Contractor**

We have been asked whether a public utility that is a licensed contractor can qualify for the business inventory exemption under Section 129 of the Revenue and Taxation Code. Before dealing with the specific language of the statute, I would like to review the common meanings of the term "business inventory".

According to Webster's New Collegiate Dictionary, the word "inventory", by itself, means an itemized list of current assets. Under this definition, the term includes every item that one owns, for example, to take an inventory is to list every item on hand at some specified date. The word "business" connotes an ongoing enterprise designed to make sales or serve the public. The combination of the two words can have two meanings to the layman:

1. It can refer to all assets on hand in a business enterprise;
2. It can refer to only those assets on hand that are used in the course of the business.

This review is necessary because the Legislature, in adopting Section 129 of the Revenue and Taxation Code, must have adopted one of these two definitions. Of course, a close reading of the section reveals that the Legislature adopted the second meaning:

"Business inventories" shall include goods intended for sale or lease in the ordinary course of business and shall include raw materials and work in process with respect to such goods. (Emphasis added.)

The Board took the position that under Section 129 personal property held by a contractor to be incorporated into

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real property, whether or not that real property was to be sold or leased, could not be eligible for the business inventory exemption. The Board's position was based on the rationale that property to be eligible for the exemption must remain personal property. This position was reflected in our Assessors' Letter dated June 25, 1975, in question B6. This interpretation was challenged in a lawsuit in the Alameda County Superior Court (Case No. 473205-9) in 1978. This case, The Herrick Corp. v. County of Alameda, was decided adversely to the Board. The court held that personal property held by a licensed contractor and to be incorporated into real property could qualify for the business inventory exemption. The judgment was entered on August 31, 1978. The plaintiff argued that the property was held for sale because the personal property was, in fact, sold to a contractor or to the owner of the real property.

At this same time, AB 2352 (Ch. 1394, Stats. 1978) was passing through the Legislature as a measure unrelated to the business inventory exemption. On May 23, 1978, the bill was amended to provide the business inventory exemption to licensed contractors who hold personal property:

...which is incorporated into real property and sold as real property or is incorporated into real property pursuant to a contract to construct such real property. (Emphasis added.)

The word "is" in this version caused problems because it connotes an accomplished fact. According to the analysis of August 9, 1978, prepared by the Senate Revenue and Taxation Committee:

It is this Committee's understanding that the author's intent is to include personal property which will be, rather than is, incorporated into such real property.

To accomplish this, the bill was amended on August 15, 1978, to provide that:

"Business inventories" shall also include goods held by a licensed contractor and not yet incorporated into real property.

This was the final version of the bill, which was signed by the Governor on September 30, 1978, and went into effect on January 1, 1979. On December 5, 1978, in Assessors' Letter No. 78/209, we instructed assessors to allow the exemption for property held for sale or lease by a licensed contractor in the ordinary course of business. However, the letter instructed assessors not to

allow the exemption for materials that a contractor is holding to incorporate into real property where the real property is retained for his own use.

It may be argued that the actual wording of the amendment to Section 129 in AB 2352 indicated that the two common elements that distinguish business inventory, the property must be for sale or lease and it must be held in the ordinary course of business, were intended to be repealed when it comes to contractor's property. Such a construction is not warranted by the legislative history of AB 2352. It is our conclusion that AB 2352 did not in any respect intend to adopt the definition of business inventory as all assets on hand in a business enterprise (referred to on page 1 as definition No. 1) or for that portion of a business enterprise the statute mentions. It follows that in order to qualify for the exemption the property must be held in the ordinary course of business and held for sale or lease.

A public utility is in the business of providing gas or electricity to customers. In furtherance of this business enterprise, it may become a licensed contractor and help construct its own plants. However, this construction activity is not in the "ordinary course" of the utility's business. It could only be in the ordinary course of their business if they were primarily in the business of construction. It cannot be said that the property held for incorporation into real property is in the ordinary course of business for the utility. Furthermore, when such property is incorporated into power plants, it is held for the company's use and not for sale or lease. A public utility, therefore, may not qualify for the exemption merely because it is a licensed contractor.

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Attachments

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