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STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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September 5, 1995

BURTON W. OLIVER
Executive Director

**Re: Application of Business Inventory Exemption to
Linen Service and Rental Agreements**

Dear Mr.

This is in response to your letter to Richard Ochsner, Assistant Chief Counsel, dated July 18, 1995.

You request an opinion related to the applicability of the business inventory exemption related to the business of your client, A Services Group, Inc. (the "Company"). Your question relates to the tax status of linens not in possession of the Company's lessee/customer.

You provide some detail of the workings of the Company. For purposes of this opinion letter, we can consider that the subject linens are in either one of two places: on the premises of the lessee or on the premises of the lessor, the Company. While on the premises of the lessee, the linen is considered to be "in service"; it is either in use, used and ready to be picked up for cleaning or delivered and ready for use. These linens are clearly not "business inventory".

While on the premises of the lessor, the linen can be considered to be "circulating" and is either in the process of being cleaned, soiled and scheduled to be cleaned, cleaned and scheduled for delivery, or in transit in the Company's delivery vehicles to and from the lessee's facility. It is your contention that the linen on the premises of the lessor is held for lease in the ordinary course of business and is exempt from tax as business inventory.

¹The terms "in-service" and "circulating" are used in the document, "Audit Conclusions" described below.

Law and Analysis

As you are aware, applicable business inventory exemption provisions are set forth in Revenue and Taxation Code sections 129 and 219 and Property Tax Rule 133.² There is also a Letter to County Assessors (LTA No. 91/68), Inventory Exemption for Linen Rentals, a copy of which is attached hereto. Revenue and Taxation Code section 219 provides that business inventories are exempt from tax. Section 129 defines the term "business inventories" and provides in pertinent part that:

"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. . . .

"Business inventories" shall not include any goods actually leased or rented on the lien date nor shall "business inventories" include business machinery or equipment or office furniture, machines or equipment, except when such property is held for sale or lease in the ordinary course of business. "Business inventories" shall not include any item held for lease which has been or is intended to be used by the lessor prior to or subsequent to the lease. . . .

Property Tax Rule 133 was promulgated pursuant to the Board of Equalization's authority set out in Government Code section 15606, subdivision (c) and further defines some of the terms used in section 129. Subdivision (b) of Property Tax Rule 133 provides:

Exclusions. Property eligible for the "business inventories" exemption does not include:

. . . .

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

In the case at hand, it is the Company's argument that the linens on the lessor's premises on the lien date should be considered "business inventory." The Company argues that the linens are not actually leased or rented on the lien date if they are not on the lessee's premises.

²Code citations are to the Revenue and Taxation Code unless otherwise specified. Property Tax Rules are set out in Title 18, California Code of Regulations.

A contrary view is expressed in a recommendation submitted in an Assessment Appeals Board in a document entitled Audit General Information, Findings and Conclusions (Audit Conclusions).³ That argument is basically that, on the lien date, the circulating linens, i.e., the linens not on the lessee's premises, are all committed to customers with current Linen Service Agreements; that these linens are, in effect, "actually leased" and thus, outside the statutory definition of business inventory.

Both the Company and the Audit Conclusions cite LTA 91/68 in support of their contrary positions. The LTA provides in pertinent part:

It is Board staff's opinion that:

1. Linens in the possession of the lessee or renter are not eligible for the inventory exemption, regardless of the quantity of linens specified by the contract.
2. If the lessee has a contractual right to a specific quantity of linens, and under the contract has a right to control the use of the linens, the specified quantity of linens is not eligible for the inventory exemption. The quantity of linens specified would be committed to lease.
3. If the lessee has a contractual right to specific linens, and under the contract has a right to control the use of the linens, the specified linens are not eligible for the inventory exemption. The specified linens would be committed to lease.

The Company appears to agree that linen in the possession of the lessee or renter is not eligible for the exemption. It is a factual question as to whether a contract provides for a "specific quantity of linens" or "specific linens." It is the county assessor that makes this factual determination. The Company has submitted what it termed a typical contract for our review. That contract is signed September 5, 1991 by lessee Ingleside Hospital and the Company.

³The Company has submitted for our review a four page document pertaining to an Assessment Appeals Board hearing conducted on September 9, 1994.

Our review of this contract indicates that there is no agreement as to a specific quantity of linen. Clause One states:

That COMPANY agrees to rent and service and HOSPITAL agrees to accept and use all of its normal requirements for linen and related items. (Emphasis added.)

Our reading of this clause is that there is no agreement to a specific quantity.

Our review of the contract further indicates that the lessee does not have a contractual right to specific linens. Exhibit "A" of the rental agreement states:

COMPANY will place into service, pick-up . . . and deliver . . . those items commonly referred to in the trade as "Standard hospital surgical, obstetrical and household linen rental items", being those generally provided and interchangeable with the other hospital linen rental accounts in the area, and listed below. (Emphasis added.)

Again, our opinion is that this shows that the lessee does not have a contractual right to specific linens.

We note that it is the county assessor who has the responsibility to make a final determination. There may be additional information related to the contracts not provided herein which would lead the assessor to a different conclusion as to contractual rights.

The next portion of the LTA is applicable herein. The LTA continues:

Except for the circumstances described above, linens held for sale or lease in the ordinary course of business would normally include linens held by the lessor which are intended to be exchanged for linens held by the lessee on the lien date.

To ensure that the meaning of this paragraph is clear, we will consider it phrase by phrase. The phrase "Except for the circumstances described above" clearly refers to the three conditions described in the prior paragraphs wherein the linens are either in possession of the lessee or subject to specific contractual rights; based on our reading of the contractual material submitted and on the facts which indicate that the linens are not in possession of the lessee, the linens under discussion herein do not fall within any of these conditions.

The next phrase, "linens held for sale or lease in the ordinary course of business", uses language from the statutory definition of "business inventories". Section 129 provides in pertinent part that:

"Business inventories" shall include goods intended for sale or lease in the ordinary course of business "

If we substitute the term "business inventories" for the LTA phrase "held for sale or lease in the ordinary course of business", the meaning of the LTA paragraph is: Linen business inventories normally include linens held by the lessor which are intended to be exchanged for linens held by the lessee on the lien date (except when there are specific contractual rights as described above). Based on this analysis, it is clear that the LTA provides that linens on the premises of the Company are business inventories and exempt from tax if the contracts between the Company and its lessees are non-specific as discussed herein.

An LTA does not have the legal authority of a statute or regulation. LTAs are issued by the State Board of Equalization pursuant to its authority set out in Government Code section 15606, subdivision (e) which provides that the Board shall "Prepare and issue instructions to assessors designed to promote uniformity throughout the state and its local taxing jurisdictions in the assessment of property for the purposes of taxation. . . ." If a county assessor disagrees with the analysis or conclusion set out in an LTA or opinion letter in matters where he or she has primary authority, the county assessor is not bound by the analysis, conclusions or opinions therein.

In summary, it is our opinion that for companies in the business of providing and servicing linens and related items, business inventories include those items on the premises of the lessor on the lien date if those linens are not subject to certain specific contractual obligations described herein. Analysis of a particular contract with regard to these contract terms and factual determinations are to be made by the county assessor.

The views expressed in this letter are, of course, only advisory in nature. As stated above, they are not binding upon the assessor of any county. You may wish to consult the Los Angeles County Assessor in order to confirm that the described property will be assessed in a manner consistent with the conclusions stated above.

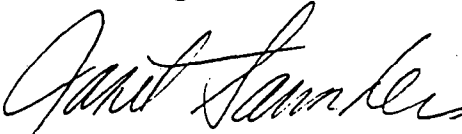
Mr.

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.September 5, 1995

Our intention is to provide timely, courteous and helpful responses to inquiries such as yours. Suggestions that help us to accomplish this goal are appreciated.

Sincerely,



Janet Saunders
Tax Counsel

JS:jd
precednt/genexemp/95006.js

Attachment

cc: The Honorable Kenneth P. Hahn
Los Angeles County Assessor
Mr. John Hagerty, MIC:63
Mr. Richard Johnson, MIC:64
Ms. Jennifer Willis, MIC:70



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GRAY DAVIS
 Controller, Sacramento

BURTON W. OLIVER
 Executive Director

No. 91/68

September 27, 1991

TO COUNTY ASSESSORS:

INVENTORY EXEMPTION FOR LINEN RENTALS

In our letter to assessors 80/69, on page 14, section F, question 2, we provided the following advice:

"Are linen supplies that are leased to customers eligible for the business inventory exemption?"

"Answer: Yes, if not out on lease on the lien date."

This answer is based on California Revenue and Taxation Code Section 129 which states in part:

"'Business inventories' shall include goods intended for sale or lease in the ordinary course of business"

"'Business inventories' shall not include any goods actually leased or rented on the lien date"

In separate letters to the Monterey County Assessor (May 1990) and the Sacramento County Assessor (June 1990), we advised that if a supply of linen stock is "committed" to service a lease, the linens would be "out on lease" and none of the committed stock would be eligible for the business inventory exemption. This would apply regardless of whether the lessee or lessor has possession of the linens. Although these letters were written to individual assessors, they have apparently been given wide distribution.

After further consultation with our legal staff, we have reviewed the position we took in the letters to Monterey and Sacramento Counties and believe it should be clarified.

A typical contract for linen service specifies an initial quantity of linens to be delivered to the customer (lessee). Depending on actual usage and seasonal demands, the quantity of linens held by the customer may be adjusted up or down from the original contract amount.

Pursuant to the contract, the lessor periodically, as often as daily, exchanges clean linens for soiled linens. The customer always has possession of a specific supply of linens, which consists of clean linens, soiled linens, and linens in use. The lessor has an obligation to replace soiled linens with clean linens on a periodic basis.

The typical contract does not require the lessor to maintain any supply of linens beyond the linens actually in the customer's possession, so the number of linens kept by the lessor is entirely at the discretion of the lessor.

It is Board staff's opinion that:

1. Linens in the possession of the lessee or renter are not eligible for the inventory exemption, regardless of the quantity of linens specified by the contract.
2. If the lessee has a contractual right to a specific quantity of linens, and under the contract has a right to control the use of the linens, the specified quantity of linens is not eligible for the inventory exemption. The quantity of linens specified would be committed to lease.
3. If the lessee has a contractual right to specific linens, and under the contract has a right to control the use of the linens, the specified linens are not eligible for the inventory exemption. The specified linens would be committed to lease.

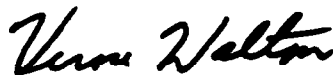
Except for the circumstances described above, linens held for sale or lease in the ordinary course of business would normally include linens held by the lessor which are intended to be exchanged for linens held by the lessee on the lien date.

The example given in the Sacramento letter involved a restaurant with one tablecloth on the table, two other tablecloths on the restaurant premises, and the linen supply company has three other tablecloths either en route or at the linen plant. The letter to Monterey County covered a similar circumstance.

The conclusion in the letters to Sacramento and Monterey Counties did not consider the contract terms between lessor and lessee. It would be inappropriate to rely on these letters to Sacramento and Monterey Counties since the conclusions reached in those letters were not based on all relevant facts.

If you have any questions or comments on this matter, please contact our Business Property Technical Services Unit at (916) 445-4982.

Sincerely,



Verne Walton, Chief
Assessment Standards Division

VW:sk