



## STATE BOARD OF EQUALIZATION

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E. L. SORENSEN, JR.  
 Executive Director

April 30, 1999

Dear Mr. :

This is in response to your January 11, 1999, letter to Ms. Kristine Cazadd. You advised that \_\_\_\_\_ was providing consulting services to U \_\_\_\_\_, and you inquired as to whether or not the total parts inventory maintained by U \_\_\_\_\_ ("USW" or "Operator") was subject to property tax assessment:

The taxpayer maintains a parts inventory for two purposes:

- (1) Repairs to those turbines/windmills owned by U \_\_\_\_\_; and
- (2) Repairs to turbines/windmills owned by partnerships, some of which reflect a nominal minority ownership interest (usually 1%) by U \_\_\_\_\_

The taxpayer computed the ratio of owned windmills to windmills owned by partnerships, and reported the resulting percentage of the parts inventory on-hand at each lien date as assessable.

County, however, regarded the total parts inventory to be subject to assessment and issued escape assessments for 1992-93 through 1995-96.

As hereinafter set forth, in our view, USW is using the parts in the course of its business, the operation of windpower facilities, not holding them for sale and selling them in the ordinary course of business, and hence, the parts are not eligible for the exemption.

Per your letter, in part:

A copy of the "Operations and Maintenance Agreement" (Agreement) between U \_\_\_\_\_ ("USW" or the "Operator") and W \_\_\_\_\_ Partners \_\_\_\_\_, a California Limited Partnership (the "Partnership") is enclosed. The following are excerpts from the agreement:

- (A) USW and PG&E have entered into the Power Purchase Agreements, which require that USW construct and operate wind generation facilities in the \_\_\_\_\_ Pass area of California and provide that the electric power generated thereby will be sold to PG&E.
- (C) The Partnership has been formed for the purpose of constructing, installing and operating wind generation facilities...

- (E) The Partnership desires to have the right to sell all power produced by the Windplant to PG&E under the Power Purchase Agreements...
- (F) The Partnership desires that the Operator operate and maintain the Windplant on the terms and conditions set forth herein.

According to the Agreement:

- (1) Engagement of the Operator. The Partnership hereby engages the Operator to operate and maintain the Windplant and perform certain duties, all as set forth in this Agreement. The Operator accepts such engagement and agrees to perform in accordance with the terms and conditions hereof.
- (3) Operations and Maintenance Duties
- (a) Duties. On behalf of, and as an independent contractor of the Partnership, and in consideration of the fees payable to the Operator under Section 9 hereof, the Operator hereby agrees to operate and maintain the Windplant in accordance with the terms of this Agreement and in order to maintain the Windplant in good working order capable of performing in accordance with the standards set forth herein. Subject in all cases to..., the operation and maintenance responsibilities of the Operator shall include, but not be limited to:
  - (i) operation and maintenance of the Windmills and all other equipment, safety systems, controls, instruments and machinery constituting the Windplant, including replacement or, at the Operator's option, repair, of all Parts (ownership of, and title to, any replacement Parts to be vested in the Partnership);
  - (iii) Hiring, training, administration and supervision of a workforce necessary to perform operations, maintenance and inspection work in accordance with this Agreement;
  - (iv) provision of all services, tools, equipment and materials required to make such repairs or replacements as may be necessary to maintain all portions of the Windplant in good working order and capable of operation in accordance with the standards set forth in this Agreement;
  - (v) establishment and performance of a program of regular preventive maintenance;
  - (vii) performance of periodic overhauls of equipment forming part of the Windplant as recommended by the manufacturer thereof;

(9) Fees.

- (a) As full consideration for all services, materials and other items to be provided or performed by the Operator under this Agreement (except as otherwise provided herein), the Partnership shall pay to the Operator a fee with respect to each Payment Period in an amount equal to the percentage of Gross Revenues for such Payment Period set forth in the table below...

<u>Payment Period</u>	<u>Percentage of Gross Revenues</u>
Ending on or before December 31, 1990	10
Ending on or after June 30, 1991	15

- (b) Except as provided in Subsection 5 (a) hereof and Section 10 hereof, all repairs, replacements or modifications of the Windplant which are required to be made by the Operator hereunder shall be made at the Operator's sole cost and expense in consideration of the compensation provided in Subsection 9 (a) hereof, and no claim shall be had by the Operator against the Partnership for any additional compensation in respect of such repairs, replacements or modifications.

- (11) Ownership and Risk of Loss. The Partnership shall have all risk of loss with respect to the Windplant and each Windmill at the Windplant.

(14) Limitation of Liability; Assignment of Warranties.

- (b) The Operator hereby assigns to the Partnership all manufacturer's warranties that the Operator has received or shall receive with regard to any Parts or materials provided to and used by the Operator under this Agreement. The Partnership shall assign to the Operator any claim under a warranty with respect to any Part that the Operator has repaired or replaced....

Property Tax Rule 133 (a) states, in part:

- (1) "Business inventories" that are eligible for exemption from taxation under section 129 of the Revenue and Taxation Code include all tangible personal property ...which... are themselves items of property held for sale or lease in the ordinary course of business...
- (2) The phrase "ordinary course of business" does not constitute a limitation on the type of property which may be held for sale or lease, but it does require that the property be intended for sale or lease in accordance with the regular and usual practice and method of the business of the vendor or lessor.

- (3) The phrase "goods intended for sale or lease" means property acquired, manufactured, produced, processed, raised or grown which is already the subject of the contract of sale or which is held and openly offered for sale or lease or will be so held and offered for sale or lease at the time it becomes a marketable product. Property which is ready for sale or lease must be displayed, advertised or otherwise brought to the attention of the potential purchasers or lessees by means normally employed by vendors or lessors of the product.

Rule 133 (b) states, in part:

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

- (1) Property of any description in the hands of a vendee, lessee or other recipient on the lien date which has been purchased, leased, rented, or borrowed primarily for use by the vendee, lessee or other recipient of the property rather than for sale or lease or for physical incorporation into a product which is to be sold or leased.

Rule 133 (a) (1) requires that property be held for sale or lease in the ordinary course of business. Initially, there is a question as to whether USW as an operator of windpower facilities is in the business of selling parts. Paragraph 9 (b) of the Agreement provides that all repairs, replacements, or modifications are to be made at Operator's sole cost and expense. This provision contradicts the claim that parts are being held for sale and sold. Rule 133 (a) (2) continues on to define ordinary course of business by reference to the regular and usual practice and method of the business, of the vendor or lessor and, pointedly, contemplates a person whose main endeavor is the sale or lease of property. Here, Operator's main endeavor is the operation of the windpower facilities, to produce continual power output, and USW uses the parts in that operation. The provision of Rule 133 (a) (2) is emphasized in Rule 133 (a) (3), which identifies goods held for sale as "Property which is ready for sale or lease...displayed, advertised or otherwise brought to the attention of the potential purchasers or lessees by means of normally employed by vendors or lessors of the product." Such is not the case here. In contrast to Rule 133 (a), Rule 133 (b) (1) excludes from the term business inventories property purchased primarily for use by the purchaser.

In our view, USW is using the parts in the course of its business, the operation of windpower facilities. Such is specifically recognized by the parties in Paragraph 14 (b) of the Agreement: "The Operator hereby assigns to the Partnership all manufacturer's warranties ...received... with regard to any Parts or materials provided to and used by Operator under this Agreement." And warranty claims as to Parts and their use are the responsibility of the Operator. Such is further indicated by Paragraph 9 of the Agreement, wherein (a), as full consideration for all services, materials and other items, Operator receives a percentage of gross revenues. Consistent therewith, Paragraph 9 (b) provides that all repairs, replacements, or modifications are to be made at Operator's sole cost and expense, in consideration of its "other" compensation. Such is not consistent with a conclusion that Operator is in the business of selling parts or that the parts are "held for sale", as the rule contemplates. Thus, the parts are excluded from the term business inventories by Rule 133 (b) (1).

Such is also not consistent with a conclusion that the Partnership is purchasing parts. In addition to the above, while at the end of the Agreement the Partnership will take back possession and the operation of the windpower facilities in their present state, including parts added by Operator that are still working, it would not receive any parts used in the operation of the wind-power facilities over the course of the Agreement but replaced by Operator because they were no longer useable.

Over the years, staff has distinguished between goods transferred in the rendition of a professional service and goods transferred in the rendition of a nonprofessional service. Per the April 25, 1980, letter to Assessors No. 80/69, Business Inventory Exemption:

D. PROFESSIONAL AND SERVICE ENTERPRISES

- NEW 1. Goods transferred in the rendition of a professional service are not eligible for the business inventory exemption, while goods transferred in the rendition of a nonprofessional service are eligible. What criteria determines whether a service is professional or nonprofessional?

Answer: Property Tax Rule 133 (c) gives examples of medicine, law, architecture, or accountancy as professional services. It lists dry cleaners, beauty shop operators, and swimming pool service companies as examples of nonprofessional services. There are, of course many services in between that are more difficult to assign to one group or the other.

Following are criteria courts have used to distinguish between a profession or professional service and a non-professional service or enterprise.

A profession is a vocation where the labor and skill is predominantly mental or intellectual, rather than physical or manual. A profession requires knowledge of an advanced type in a given field of science or learning gained by a prolonged course of specialized instruction and study. A third court defined profession as "a vocation founded upon prolonged and specialized intellectual training which enables a particular service to be rendered."

Examples of profession or professional service: law, ministry, medicine, military service, engineering, chemistry, industrial designing, accountancy, economics, etc.

A non-professional service is generally defined as a vocation requiring skill of a manual or mechanical nature. Courts tend to classify a non-professional service as a business as opposed to a profession.

Examples of non-professional service: barber, beauty operator, carpenter, plumber, electrician, embalmer, etc.

Arguably, the operation of windpower facilities could be viewed as the providing of a professional service, in the nature of engineering, etc.. In that event, parts transferred in the rendition of the operation of the facilities would not be eligible for the exemption.

Alternatively, were it concluded that operation of windpower facilities constituted the providing of a nonprofessional service, such that parts transferred in the rendition of the operation of the facilities could be eligible for the exemption, it is questionable whether the parts are being sold under the Agreement herein.

Where goods have been transferred in the rendition of a nonprofessional service, staff has stated in letter No. 80/69:

9. Are replacement parts held in an auto repair shop business inventories:

Answer: Yes.

10. Are television tubes and electrical parts held in a television repairman's kit subject to the business inventory exemption?

Answer: Yes.

11. Some companies, such as airlines and bus companies, stock spare parts for use in repairing both their own equipment and equipment belonging to others. Do all or any portion of these parts qualify as business inventories?

Answer: Yes, if the owner segregates the portion of these inventories held for sale (used to repair the equipment of others) on their records and maintains a supply of such goods for immediate sale and delivery at prices which are both realistic and competitive.

Mr.

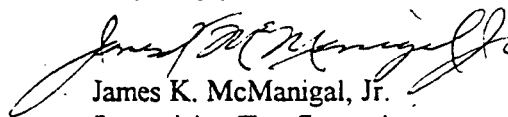
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Thus, while such parts can be eligible for the exemption, it is contemplated that they are held for immediate sale and delivery at prices which are realistic and competitive. Such is not the case here. Again, per section 9 (b) of the Agreement, replacements made by Operator are made at Operator's sole cost and expense. This does not indicate that the parts are held for sale and delivery, that any prices are attributed thereto, that Operator is selling the parts, or that the Partnership is purchasing any parts.

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 the facts set forth herein, and are not binding on any person or public entity.

Very truly yours,



James K. McManigal, Jr.  
Supervising Tax Counsel

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PROPERTY WORKS