STATE OF CALIFORNIA

190.0150

BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)))	DECISION AND RECOMMENDATION
D--- R--- C--- INC.	))	No. SS AA 17-096959-010
Petitioner	)	

The Appeals conference in the above-referenced matter was held by John Frankot, Staff Counsel on September 3, 1993 in Hollywood, California.

Appearing for Petitioner:

J--- M. L---
Attorney at Law

R--- D. R---
President

N--- P---
Vice President

J--- N---
Controller

Appearing for the
Sales and Use Tax Department:

Joseph Cohen
District Administrator

Forrest Paisley
Supervising Tax Auditor

Wendy Wang
Senior Tax Auditor

Protested Items

The protested tax liability for the period October 1, 1988 through September 30, 1991 is measured by:

	Item	State, Local and County
A.	Fabrication labor and profit factor deemed to be part of the cost of the fixtures subject to tax in accordance with subsection (b)(2)(B) of Regulation 1521	$317,682
B.	Additional taxable measure on sales of equipment to chain stores under lump-sum contracts.	13,049
C.	Additional taxable measure on sales of equipment to hospitals under lump-sum contracts.	394,111
D.	Additional taxable measure on sales of equipment (special systems) under lump-sum contracts.	335,193
E.	Additional taxable measure on sales of equipment (sound systems) under lump-sum contracts.	13,360
F.	Credits on sales of equipment to the U.S. Government originally reported as sales of fixtures under lump-sum contracts.	-106,232
	Totals	$967,163

Petitioner's Contentions

1. Petitioner contends that the systems it installs consist primarily of fixtures, not machinery and equipment.

2. Petitioner contends that it is not a manufacturer of any of the component parts of the systems it installs.

3. Petitioner contends that even if the systems it installs consist primarily of machinery and equipment, most sales should be allowed as sales for resale.

Summary

Petitioner sells and installs communications systems, security and fire alarm systems, and other electronic devices in various types of buildings (e.g., retail stores, supermarkets, and hospitals). Pictures or written descriptions of some of the systems are attached as Exhibit A.

With few exceptions installation contracts are lump sum, and some over-the-counter sales are made. Petitioner acquires materials and component parts without tax, from unrelated vendors, and reports tax "... as the jobs had been completed progressively"[1]. Component parts are installed in various ways depending on the type of system involved, the nature of the component, and the aesthetic preferences of customers. Petitioner does not manufacture any component parts. According to petitioner, components can be installed in various ways: behind, flush or surface mounted to, walls, ceilings, or floors; placed on a shelf or table, physically attached in some cases; or attached to a rack or control panel. Components are usually linked by hard wiring and conduit.

According to the auditor's comments "....many components of the systems are incidentally attached to the realty and they are not designed for the building, hence, they are not essential to the fixed works."

Lump sum installation contract sales are categorized in the audit as follows:

(1) Paging and music systems for retail chain stores (Audit Item B);

(2) Nurse call systems for hospitals (Audit Item C);

[1]See audit schedule 12, page 2, "Types of Transactions", last paragraph. I assume that this means that petitioner reports tax on the cost of materials and fixtures as they are withdrawn from inventory and committed to jobs.

(3) Special systems, such as security monitoring systems for office and bank buildings (Audit Item D); and

(4) Sound systems (Audit Item E).

The auditor allowed credit for the costs petitioner reported on a system installed for the U.S. Government under a lump sum contract (Audit Item F).

Petitioner performs shop and installation labor on components and systems. Shop labor typically includes assembly and mounting of components on custom made control panels, and to racks, panels or similar items, prior to final installation.

The Sales and Use Tax Department (Department) conducted a routine audit, and calculated petitioner's tax liability based on petitioner's retail selling prices of fixtures, machinery, and equipment, rather than on petitioner's costs. The Department contends that under Sales and Use Tax Regulation 1521[2] petitioner should be considered a retailer of fixtures, machinery, and equipment. At the Appeals Conference, the Department noted that Regulation 1521(c)(8) provides the best available guidelines regarding classification (as fixtures, or machinery and equipment) of the systems and components that petitioner installs, and that no Sales and Use Tax Annotations or other Board-published authorities specifically cover the classification issues involved in this Appeal.

Petitioner protested the Department's audit. Petitioner contends that the items at issue in this Appeal are properly classified as "fixtures" for sales and use tax purposes. Petitioner contends that its cost of fixtures is the correct measure of tax under Regulation 1521.

Petitioner contends that it was improper for the Department to reclassify some of the components it installs as machinery and equipment. Petitioner contends that each system is a fixture in its entirety, and components should not be considered machinery and equipment, regardless of the method of installation.

Petitioner states that its systems are directly related to the efficient and safe use of structures for their intended purposes, and in some cases are legal prerequisites to occupancy (e.g. a security/fire alarm system). Petitioner states that it generally is anticipated that systems will remain in place as long as the realty is used for its intended purposes, and that components are useful only to the extent that they enable systems to provide the desired functions (e.g. fire warning, communications, etc).

[2]All further references to Regulations are to Sales and Use Tax Regulations.

Petitioner states that Regulation 1521, Appendix B, provides that burglar and fire alarms are fixtures, and Appendix C provides that fire alarm systems are not machinery and equipment, noting that petitioner's security systems are merely sophisticated burglar and fire alarms. Petitioner argues that under Regulation 1521, "machinery and equipment" refers to property employed in income-producing activities conducted by the occupant of a structure, and is not intended to refer to property necessary to enable the structure to be utilized for the income-producing activity.

Petitioner contends that property tax definitions of fixtures, machinery and equipment can be utilized for sales and use tax purposes, and that extensive guidance on the definition of fixtures is provided by Property Tax Regulation 122.5. Petitioner cites C.R. Fedrick Inc. v. Board of Equalization (1988) 204 Cal.App.3d 252 and Overhead Electric Company Inc. v. State Board of Equalization (1991) 227 Cal.App.3d 1230, noting that in both cases courts concluded that it was appropriate to refer to property tax rules for purposes of distinguishing between fixtures, and machinery and equipment, for sales and use tax purposes.

Petitioner contends that its systems are properly classified as "fixtures" under Property Tax Regulation 122.5, which defines that term as follows:

> "an item of tangible property, the nature of which was originally personalty, but which is classified as realty for property tax purposes because it is physically or constructively annexed to realty with the intent that it remain annexed indefinitely."

According to petitioner, Property Tax Regulation 122.5 provides that the important elements in deciding whether an item is a fixture or personal property include:

> (1) The manner of annexation;
>
> (2) The adaptability of the item to the purpose for which the realty is used; and
>
> (3) The intent with which the annexation is made.

Petitioner states that under Property Tax Regulation 122.5 an item must be physically or constructively annexed, and it must be intended to remain annexed indefinitely, to be considered a fixture, and that its systems meet this definition.

Petitioner states that each component of each system is either physically or constructively annexed to realty; that annexed items cannot be removed without damage to themselves or the realty or, even if they can be removed without causing damage, there is no intent that they will

be; and, that unattached items are constructively annexed because they are generally not useful by themselves, and because they are designed specifically to interact with physically annexed components which cannot be used properly without the constructively annexed items. Petitioner asserts that each system must be specially designed for the structure in which it is installed.

Petitioner further contends that even if some components were correctly reclassified, the Department acted arbitrarily in doing so, i.e., the Department has failed to explain why individual items have been reclassified.

The Department states that the auditor considered the following factors in distinguishing equipment from fixtures:

> (1) The equipment is not physically attached to the building through permanent connections, and
>
> (2) The equipment is not designed or modified for the building, and it does not become a permanent part of the realty.

The Department concludes that many components of petitioner's security systems are equipment, not fixtures, because they are incidentally attached to realty, not designed for the buildings in which they are installed, and not essential to the fixed works.

Audit Item A is being protested on the grounds that the Department improperly considered petitioner a manufacturer of fixtures. The Department assessed tax on 80% of petitioner's shop labor, plus markup, as taxable fabrication labor, based on available information. Petitioner states that all components are purchased from outside vendors, ready for installation. Shop labor, other than testing, generally involves fabrication of custom control panels, and attachment of components to equipment racks, panels, or similar assemblies for convenience or to satisfy aesthetic preferences of customers. Petitioner states that it is improperly classified as a manufacturer particularly with regard to items attached to racks or similar assemblies for aesthetic reasons only. In any event, petitioner considers the 80% fabrication labor factor excessive and unsupported by the facts.

In the alternative, petitioner contends that even if the Department is correct in classifying some items as machinery and equipment, and even if petitioner is a manufacturer of fixtures in some instances, petitioner did not make retail sales when its customer (e.g., a prime contractor) was not the owner of the property where the system was installed. Petitioner contends that in such cases it made sales for resale, and should be entitled to a refund of any taxes paid on cost or otherwise.

The Department denied any claim of sales for resale, stating that unless petitioner can show that the prime contractors or subcontractors reported and paid the tax due, no resale allowance is

warranted.

Analysis and Conclusions

1. Petitioner contends that the systems it installs consist primarily of fixtures, not machinery and equipment.

Regulation 1521 defines a "construction contract" as a contract to erect, construct, alter or repair any building or structure, project, development, or other improvement on or to real property. The term does not include a contract for the sale and installation of tangible personal property, such as machinery and equipment.

Regulation 1521 provides for three categories of tangible personal property installed by construction contractors in the performance of construction contracts:

> (1) Materials: Means and includes construction materials and components, and other tangible personal property incorporated into, attached to, or affixed to, real property by contractors in the performance of a construction contract and which, when combined with other tangible personal property, loses its identity to become an integral and inseparable part of the real property.
>
> (2) Fixtures: Means and includes items which are accessory to a building or other structure and do not lose their identity as accessories when installed.
>
> (3) Machinery and Equipment: Means and includes property intended to be used in the production, manufacturing or processing of tangible personal property, the performance of services or for other purposes (e.g., research, testing, experimentation) not essential to the fixed works, building, or structure itself, but which property incidentally may, on account of its nature, be attached to the realty without losing its identity as a particular piece of machinery or equipment and, if attached, is readily removable without damage to the unit or to the realty. "Machinery and equipment does not include junction boxes, switches, conduit and wiring, or valves, pipes, and tubing incorporated into fixed works, buildings, or other structures, whether or not such items are used solely or partially in connection with the operation of machinery and equipment, nor does it include items of tangible personal property such as power shovels, cranes, trucks, and hand or power

tools used to perform the construction contract.

Under Regulation 1521, for lump sum construction contracts (not involving the United States Government) construction contractors are considered consumers of materials, and retailers of fixtures, machinery, and equipment installed in the performance of construction contracts. The measure of tax for fixtures is either the contract price or, if the contract does not set a price, the cost price of the fixture to the contractor. If the contractor manufactures the fixture, the cost price is determined by reference to sales of similar fixtures to other contractors; or, by reference to cost amounts stated in the contractor's records; or, by determining an aggregate cost composed of materials, labor, overhead, and profit (see Regulation 1521(b)). For construction contracts with the United States Government, construction contractors are considered consumers of materials and fixtures, and retailers of machinery and equipment, installed in the performance of those contracts.

The law for ascertaining whether an item is a fixture or personal property is well settled. Petitioner is correct in contending that property tax guidelines can be applied in sales and use tax cases. Classification of property as an improvement to realty depends on: (1) the manner of its affixation to the realty; (2) its adaptability to the use and purpose for which the realty is used; and (3) the intent with which the annexation is made (San Diego T.& S. Bank v. San Diego (1940) 16 Cal.2d 142). For tax purposes, the controlling intent is not subjective intent, but objective intent as manifested by the physical facts surrounding the annexation (Bank of America v. County of Los Angeles (1964) 224 Cal.App.2d 108).

Intent is regarded as the crucial and overriding factor, with affixation and adaptability as subsidiary ingredients relevant to the determination of intent (Seatrain Terminals of California, Inc. v. County of Alameda (1978) 83 Cal.App.3d 69). As summed up by the California Supreme Court in Crocker National Bank v. City and County of San Francisco (1989) 49 Cal.3d 881 at 887-888: "...the test reduces itself to whether a reasonable person would consider the item to be a permanent part of the property, taking into account annexation, adaptation and other objective manifestations of permanence." (Citations omitted)

Sales and Use Tax Annotation 190.2130[3] provides as follows:

> "**Security Systems.** The sale and installation of a security system utilizing electronic sensors, digital computer, and master control panel with integrated wiring for detection of forced entry, fire, smoke, etc., constitutes a construction contract. 2/22/71."

[3]All further references to Annotations are to Sales and Use Tax Annotations.

This Annotation is derived from an opinion rendered by Tax Counsel regarding security systems designed for residences and "other customers". Tax Counsel considered the listed components as fixtures, and the integrated wiring as materials.

I believe that the items pictured or described in Exhibit A, except for nurse call stations, are properly classified as fixtures. Affixation is generally by bolts, nails, and similar means, to realty. Electrical components are connected by permanent wiring. Any unattached tangible personal property which is a necessary, integral, or working part of physically annexed items is considered to be constructively annexed to the realty. Petitioner's systems are generally adapted to serve basic functions (security, fire protection, etc) of the buildings where they are installed. Annotation 190.2130 supports classification of security system components as fixtures. And, the intent of petitioner's customers in making the installations, based on the physical facts and outward appearances, is to make permanent improvements to real property.

In order to make an article a permanent accession to realty, its annexation need not be perpetual. It is sufficient if the article appears to be intended to remain where fastened until worn out, until the purpose to which the realty is devoted has been accomplished, or until the article is superseded by another article more suitable for the purpose (San Diego T.& S. Bank, supra, at p. 151). Even if petitioner's systems were subsequently replaced by newer, state-of-the-art units, or became unnecessary and were removed, they would nonetheless be considered "permanent" improvements based on the intent with which they were installed.

A purchaser of a building would expect, absent special circumstances, to acquire title to built-in security monitoring systems, fire alarm systems, sound systems, or paging systems, along with title to the building. Removal of the systems would reduce the value of the realty considerably, and in many instances the installation of replacement systems would be necessary to the continued use and occupancy of the property for its intended purposes.

I conclude that a reasonable person, taking into account the manner of annexation, the adaptability of the items to the use and purpose for which the buildings are used, and other objective manifestations of permanence, would consider the systems that petitioner installs (other than nurse call stations) permanent parts of the buildings where installed.

Nurse call stations are properly classified under Regulation 1521(c)(8), second paragraph, as machinery and equipment. They are generally affixed such that removal would not cause damage. Neither the call stations nor the facilities in which they are installed appear to be designed or modified for each other. And, it seems clear that the intent of the parties, as ascertained by the physical facts and outward appearances, is not to make permanent improvements to real property.

In the prior audit, the auditor commented that petitioner performed installations of "complete

hospital intensive care monitoring systems." I assume that the term "nurse call stations", as used in this Appeal, does not include those systems. In any event, insufficient evidence is on hand to make a proper classification of "complete hospital intensive care monitoring systems."

I note that audit schedule 12C-1, "Evaluation of Equipment Sales to Hospitals Under Lump Sum Contracts Based on 6 Sample Contracts", lists alarm, paging, and other types of systems, in addition to nurse call stations. Only nurse call stations are considered machinery and equipment. Other systems, such as fire and alarm systems, should be classified as fixtures.

A reaudit should be conducted to reclassify the items that petitioner installs to "fixtures", except for nurse call stations, which should be classified as "machinery and equipment." The taxable measure for fixtures manufactured by petitioner, if any, should be determined in accordance with Regulation 1521(b)(2)(B), and petitioner should be provided clear explanations of the Department's reasons for classifying it as a manufacturer in each instance. For contracts with the United States Government, Regulation 1521(b)(1) should be followed.

2. Petitioner contends that it is not a manufacturer of any of the component parts of the systems it installs.

As regards sales taxation of fixtures installed by construction contractors, labor that occurs prior to attachment to realty is properly included in the value, and thus the sales price, of the object that is ultimately attached (Coast Elevator Co. v. State Board of Equalization (1986) 186 Cal.App.3d 206).

Petitioner is a manufacturer, under Regulation 1521(b)(2), when it creates or assembles fixtures or machinery and equipment by a combination of fabrication labor (shop or jobsite), and materials and components purchased from outside vendors or supplied by customers. In contrast, petitioner is not manufacturing fixtures when components are installed directly in realty, or items presently annexed to realty.

According to the audit comments, petitioner fabricates security racks and other items classified as fixtures by the Department (see Schedule 12, page 4). Assuming that these items are produced by petitioner from raw materials and components, the Department is correct in considering petitioner a manufacturer of fixtures, and in applying Regulation 1521(b)(2)(B) to calculate audited taxable measure for audit item A.

Regulation 1521(b)(2)(B) should also be applied to calculate audited taxable measure for any fixtures manufactured by petitioner that are included in audit items B through E, after reclassification in accordance with Analysis and Conclusions item number 1, above.

Petitioner contends that even if it did manufacture fixtures, the Department's calculations of taxable measure under Regulation 1521(b)(2)(B) are incorrect. The auditor examined

petitioner's records and, based on the available information and a discussion with petitioner's shop supervisor, decided to use certain factors to calculate taxable fabrication labor, overhead, and profit. As part of the reaudit process, petitioner should be allowed a reasonable opportunity to provide more accurate calculations of shop labor, overhead, profit, etc, includible in taxable measure under Regulation 1521(b)(2)(B). The Department should make adjustments as warranted.

3. Petitioner contends that even if the systems it installs consist primarily of machinery and equipment, most sales should be allowed as sales for resale.

Construction contractors are retailers of the fixtures, machinery, and equipment which they install in the performance of construction contracts (when the contract is with the United States Government, construction contractors are consumers of fixtures). Tax applies to contractors' sales of fixtures (Regulation 1521(b)(2)(B)(1)), and machinery and equipment (Regulation 1521(b)(2)(C)(1)), installed in the performance of construction contracts. Construction contractors cannot avoid liability for sales or use tax on fixtures furnished and installed by taking a resale certificate [Regulation 1521(b)(6)].

No sales for resale occurred in this case because resale certificates were not accepted by petitioner, nor could they be effective to relieve petitioner's burden to report and pay tax on sales of fixtures, under Regulation 1521.

However, if petitioner can show that others (e.g., prime contractors) actually reported some or all of the sales or use taxes due on petitioner's contracts, relief will be allowed to the extent of the tax so reported to the state.

Recommendation

The Department should perform a reaudit that addresses the following points:

(1) The systems that petitioner installs should be reclassified as fixtures, with the exception of nurse call stations, which are properly classified in the audit as machinery and equipment. Other systems (fire, security, etc.) installed at hospitals should be considered fixtures. Audited taxable measure should be recalculated in accordance with Regulation 1521. Petitioner should be considered a consumer of fixtures installed in the performance of its contracts with the United States Government.

(2) Petitioner should be allowed an opportunity to provide more accurate information relevant to the calculation of Audit Item A. Adjustments should be made as warranted.

(3) Petitioner should be allowed an opportunity to show that some or all of the sales or use taxes due on its contracts were reported to the state by others. Relief should be allowed to the extent of taxes paid to the state by others.

John Frankot, Staff Counsel Date

W/Exhibit A