

Memorandum

190.1785

To : Mr. Larry Bergkamp
Supervisor, Public Information
and Administration Section (MIC:44) Date: April 26, 2001

From : Sharon Jarvis
Senior Tax Counsel Telephone: (916) 324-2634
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Subject: I--- W--- S--- LLC
SR --- XX-XXXXXX

I am responding to your memorandum dated January 23, 2001 to Assistant Chief Counsel Janice L. Thurston concerning the above taxpayer. You request a legal opinion regarding whether the walls furnished and installed by I--- W--- S--- (IWS) should be classified as materials, fixtures or tangible personal property. You also express your concern that Annotation 190.1980, upon which the taxpayer relies, may be in conflict with points of discussion in Formal Issue Paper Number 99-006 (March 1999) on the issue of whether a contract for the sale and installation of modular panels is a construction contract or a contract for the sale of tangible personal property.

In its November 14, 2000 letter to the Board, IWS explains its business as follows:

“Our company manufactures and sells prefabricated 4’ [feet] wide wall panels that are the components of a relocatable wall system. For customers in California, we deliver the panels to the jobsite and install them. The panels are placed into floor and ceiling steel channels, screwed into place, and finished off with trim pieces. At a future time, if desired, the customer can demount the walls and reconfigure their placement. We lump-sum bill our customers.

“Occasionally and primarily for out-of-state sales, we manufacture and ship the walls to the customer who arranges for the installation.”

Along with its letter, IWS included one of its advertising brochures. The brochure refers to the walls as both “relocatable walls,” and “modular wall systems.” It states, “because we pre-finish the panels offsite and pre-fit windows and doors, installation is a snap.” Under the subtitle “cost-effective,” the brochure states:

“With pricing as competitive as conventional construction, you also get the added benefit of moving and reusing your walls. Also, there

is a tax savings! Under the modified accelerated cost recovery schedule relocatable walls are depreciated over only seven years. Fixed partition walls are depreciated over 31.5 years....”

Under the subtitle “movable and reusable,” the brochure further states:

“It’s very convenient to add, modify or reuse your walls as your business expands. You won’t experience the usual expense, trouble, and mess of wood and drywall. Panels can be quickly disassembled and relocated without damaging the existing interior. Plus, you can take your walls with you if you move.”

The brochure contains photographs of modular walls that quite obviously appear to be formed of panels placed side by side, and secured to channels that are attached to the ceiling by posts. In the photographs, coving at the bottom of the panels masks any attachment to the flooring. IWS’ website features the same photographs as the brochure.

Discussion

As you know, the application of sales tax to construction contracts and construction contractors is explained in Regulation 1521. A construction contract is defined to include lump sum and other contracts to erect, construct, alter, or repair any building or other structure or improvement on or to real property. (Reg. 1521(a)(1)(A)3.) However, a construction contract does not include a contract for the sale, or sale and installation, of tangible personal property such as machinery and equipment. (Reg. 1521(a)(1)(B)1.) Nor does a construction contract include the furnishing of tangible personal property under what is otherwise a construction contract if the person furnishing the property is not responsible under the construction contract for the final affixation or installation of the property furnished. (Reg. 1521(a)(1)(B)2.)

Thus, it is clear from Regulation 1521(a)(1)(B)2. that when IWS sells its wall panels to a customer who arranges for a third party to install the panels, IWS’ sale of such panels is a sale of tangible personal property. Your question, however, concerns IWS’ contracts to both furnish *and* install the wall panels. As such, the issue is whether the contracts are for improvements to real property (the wall panels become a part of the real property), or for the sale and installation of tangible personal property (the wall panels retain their character as tangible personal property).

For over fifty years the California appellate courts have stated that three criteria must be taken into consideration in determining whether an item constitutes tangible personal property or an improvement to realty: (1) the manner of its annexation to the realty, (2) its adaptability to the use and purpose for which the realty is used, and (3) the intention with which the annexation is made. (E.g., *Crocker National Bank v. City and County of San Francisco* (1989) 49 Cal.3d 881, 886-887; *Specialty Restaurants Corp. v. County of Los Angeles* (1977) 67 Cal.App.3d 924, 933.)

The California Supreme Court concluded that the element of intent is the crucial and overriding factor, with the other two criteria being considered only as subsidiary ingredients relevant to the determination of intent. The court stated that the “intention” with which the annexation of the property is made must be determined by the physical facts or reasonably manifested outward appearances. (*Crocker National Bank v. City and County of San Francisco, supra*, 49 Cal.3d 881, 887.) The court summarized the test, stating:

“[T]he 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.” (*Crocker National Bank v. City and County of San Francisco, supra*, 49 Cal.3d 881, 887-888.)

Applying the three-prong test, the first criterion of the test is the manner of annexation. A careful reading of the case law and the three-prong test indicates that, as a general rule, the manner of annexation is also a critical factor in determining the intent with which annexation is made. Illustrative is the *Crocker* case, where in determining that the electronic data processing equipment in question retained its character as tangible personal property, and was not a fixture (improvement to real property), the court pointed out that the equipment was not physically attached to the building through permanent connections such as by cement, plaster, nails, bolts, or screws, but rather was connected through standardized quick-disconnect plugs that were inserted into the power source. (*Crocker National Bank v. City and County of San Francisco, supra*, 49 Cal.3d 881, 890.) Thus, the annexation generally required by the three-prong test is that the property be attached to the realty in a manner that appears permanent in order to be classified as an improvement to real property and not as tangible personal property. Conversely, items that appear to lack permanence because of the manner in which they are annexed to the property generally are not considered an improvement to real property, but tangible personal property.

IWS’ walls are formed from prefabricated panels in four-foot widths, which are seated in channels attached to the flooring and channels attached to the ceiling by posts. Although the panels are screwed into these channels, the attachment of the channels to the ceiling by a system of posts creates some appearance of impermanence, as does the obvious fact that the walls are formed by the side by side configuration of the four-foot wide panels.

Another factor of the three-prong test, the adaptability of the item to the use and purpose for which the realty is used, relates to the extent to which the item was designed or modified for the realty and the realty was designed or modified for the item. (See *Crocker National Bank v. City and County of San Francisco, supra*, 49 Cal.3d 881, 890.) Illustrative of instances in which the manner of adaptation was of significance are *Southern Cal. Tel. Co. v. State Board* (1938) 12 Cal.2d 127 in which the court classified as fixtures certain central office equipment installed in the telephone company's central offices; *Seatrains Terminals of California, Inc. v. County of Alameda* (1978) 83 Cal.App.3d 69 in which the court similarly classified two 750-ton cranes running on specially installed rails embedded into a wharf; and *Specialty Restaurants Corp. v.*

County of Los Angeles (1977) 67 Cal.App.3d 924 in which the court similarly classified the Queen Mary which was held fast to a pier as a tourist attraction, was incapable of self-propulsion, and was enclosed by a large rock dike. As to these three cases, the court commented that a reasonable person might well consider the various items to be permanent parts of the host real property because "in each case, the realty and the personality were uniquely adapted the one to the other." (*Crocker National Bank v. City and County of San Francisco*, *supra*, 49 Cal.3d 881, 892.) (See also *C. R. Fedrick, Inc. v. State Bd. of Equalization*, *supra*, 204 Cal.App.3d 252, 268.) This is not so with the modular walls at issue, which are pre-fabricated into four-foot panels so that they generally may be used in almost *any* building, without any special adaptation necessary. IWS' panel walls are not specifically designed or modified for the buildings in which they are installed, nor are the buildings specifically designed or modified for them.

In regards to the third criterion, the intention with which the annexation of the property was made, this "intention" must be determined by the physical facts or reasonably manifested outward appearances. This third criterion is deemed by the courts the most important prong of the three-prong test, with the elements of manner of annexation and adaptability to the realty considered subsidiary to the element of intent and to be considered along with all other objective manifestations to determine whether or not the intention is that the walls be permanent.¹ The question is: Would a reasonable person observing IWS' modular walls conclude that they were intended to be a permanent part of the building?

Based upon the clear appearance that the walls are formed from four-foot panels placed side by side and affixed to the ceiling by posts connected to a channel that holds the panels in place, these modular walls are noticeably different and less permanent in appearance than traditional walls, and a reasonable person would conclude that they are intended to be exactly what they are, i.e., modular and relocatable, not permanent. As such, they are correctly classified as tangible personal property.

As an addendum, I note that the California Supreme Court commented in *Crocker* that the criteria of the three-prong test is only a *tool* to use in reaching the proper classification of the property, rather than a definitive measure of how a particular property must be classified, stating that the three factors:

“... are merely a guide for the discovery and analysis of the facts of social and economic life—on which, of course, classification ultimately depends. Here, those facts compel a determination that the equipment did not constitute a permanent part of the building.” (*Crocker National Bank v. City and County of San Francisco*, *supra*, 49 Cal.3d 881, 890.)

¹ However, 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 v. San Diego* (1940) 16 Cal.2d 142, 151.)

This comment by the Court offers further guidance for the classification of modular walls. In today's world, "the facts of social and economic life" are that cost and flexibility are often important considerations when tenants or building owners contemplate changes that they wish to make to the interior space in commercial buildings. As evidenced by the growth in the modular systems furniture business and the Board's review of how tax should apply to sales of such modular systems, culminating in the adoption of new Regulation 1583, interior configurations that can be easily and inexpensively changed are an increasing trend. Such configurations², including modular walls, are a part of a movement towards flexibility and interior changes that may be made without the consequence of permanence. IWS' modular walls, like modular systems furniture, are properly classified as tangible personal property.

SPJ:bb

bc: Mr. David Rosenthal

² An additional way to analyze the issue, since some type of modular wall is generally a part of modular systems furniture (although the walls that are a part of such modular systems furniture are often freestanding and not of ceiling height), is to determine whether the modular walls furnished and installed by IWS are more like traditional walls, which once completed are essentially immovable and are a part of the real property, *or* more like modular systems furniture which, even completed and installed, retain their character as tangible personal property. When viewed from this perspective, IWS' modular walls are much like the walls in modular systems furniture: they are in detachable panels that may be easily moved and reconfigured. Whether they ever *are* reconfigured or not, they *can* be, and that is a part of their advertised attraction, a consideration in their purchase, and one reason to classify them as tangible personal property.

Annotation Coordinator (MIC: 50)

By copy of this memorandum to the Annotations Coordinator, I request that it be annotated. I further request the de^letion of Annotation 190.1980 as outdated.