SECTION V

ACCOUNTING FOR APPRAISERS

Asset Accounting for Appraisers

The first question that any competent personal property appraiser should ask concerning a discussion of accounting is, "What is accounting and why should an appraiser know anything about the subject?" Accounting, according to the practitioners, is an activity undertaken to accurately measure the historical performance of a business entity. Accounting is a system that measures business activities and reports the information in the form of financial statements such as the balance sheet, income statement and depreciation schedules.

The most important reason to understand this subject is so that we can recognize the manner in which the information is organized. In the appraisal of real property for example, there is an active market and a readily available source of sales data that will assist the appraiser in determining value. The personal property appraiser, with the exception of motor vehicles and other similar consumer goods, does not have this ready market to assist in the valuation of the subject property. The auditor/appraiser must be able to gain information such as useful life and historical cost from the accounting records of the taxpayer.

The appraiser must also be aware that most business property is acquired by a business which expects to use the equipment for its entire useful economic life. We will find very few companies anxious to trade equipment just to have the newest model available.

For these and other reasons, anyone interested in pursuing a career in the valuation of personal property should have a strong foundation in accounting principles. We will also find many similarities in methodology between the accountant and the appraiser.

The Accounting Profession

The American Institute of Certified Public Accountants (AICPA) is the national professional organization of CPA's. A CPA is a professional accountant who earns this title through a combination of education, experience and a written national examination.

The accounting profession can be divided into two major areas, public accounting and private accounting. Private accountants work for a single business and perform tasks such as auditing, tax planning and preparation, and management consulting. Public accountants work for the general public and perform services such as general accounting, cost accounting, budgeting, systems design, and internal auditing.

There are guidelines that accountants follow in maintaining financial records for businesses. These guidelines are referred to as the Generally Accepted Accounting Principles (GAAP) and are established by the Financial Accounting Standard Board (FASB). The guidelines and principles are used by accountants to maintain accounting records such as the general ledger, balance sheet, and income statement. We will discuss each of these as we go through this section.

Basic Accounting Concepts and Principles

The term generally accepted accounting principles is a very broad statement that covers all the principles, concepts and methods used and recognized by accountants. Below are a few of these principles and concepts.

The Entity Concept: This is the most basic concept in accounting and states that an accounting entity is an organization or part of an organization which is set apart from any other organization. Examples of entities are: individuals, sole proprietorships, partnerships and corporations.

The Reliability Principle: States that accounting records and statements must be based on the most reliable data available. The data must be verifiable and capable of being confirmed by any independent observer.

The Cost Principle: States that assets should be recorded at the actual cost paid at the time of acquisition. The actual cost is also sometimes called the historical cost. The actual cost or historical cost may not be the original historical cost of the asset. We will discuss the difference later in this section.

The Going-Concern Concept: Assumes that an entity will remain in operation long enough to use the assets for their intended purpose. The market value of an asset may change over the life of the asset and many times will be different than the actual or historical cost of the asset.

The Stable-Monetary-Unit Concept: Assumes that the dollar's purchasing power is relatively stable. This concept ignores the effect of inflation in the accounting records, therefore the cost of an asset many times does not equal its fair market value.

The Matching Principle: Requires accountants to match expenses against revenues or to subtract the expenses from the revenues in order to determine the net income or loss.

Understanding these principle and concepts will help the appraiser better understand how accountants maintain the financial records and why. It is always important to remember that accounting records are maintained for reasons that may have no relationship to the fair market value of the assets. There are times when the cost data recorded and maintained does not represent the fair market value of the assets. The appraiser must be able to recognize the differences and make adjustments when warranted.

Basic Accounting

The basic accounting record is the Account. This is a record of the changes that have occurred for a particular asset, liability or equity during a certain time period. The accounts are grouped together in a single book called the ledger. The terms like "booked the asset" "audit the books" and "keeping the books" refers to recording, review and maintaining the ledger. A company will normally have a "chart of accounts" which will list all the accounts found in the general ledger and with a number assigned to each account. These accounts are divided into three major groups represented by the accounting equation below:

A=L+C or assets = liabilities + capital.

Assets are normally divided into the following accounts:

Cash
Notes Receivable
Accounts Receivable
Prepaid Expenses
Land
Building
Equipment, Furniture and Fixtures

Liabilities are normally grouped into two major categories:

Note Payable
Accounts Payable

Capital or Owner's Equity is made up of the following:

Capital
Withdrawals
Revenues

The information from these accounts is used to develop the financial statements of the business. The primary financial statements are the (1) balance sheet, (2) income statement, (3) statement of owner's equity, (4) statement of cash flows and (5) depreciation schedules.

BALANCE SHEET

A balance sheet is an accounting report indicating the assets, liabilities, and capital accounts of a business as of a specific date. The balance sheet is usually prepared annually in conjunction with the business' fiscal year. The balance sheet centers around the accounting equation.

Assets

There are several kinds of assets. Current assets include cash or other accounts that can be easily converted to cash. The cash account is not of interest to the auditor as far as taxation, however these assets may indicate the financial condition of a business when compared to the business' liabilities. Comparing cash and prepaid expenses to notes payable and salaries expense may give the appraiser insight into an economic obsolescence contention by the taxpayer. Other than cash itself, current assets may include accounts receivable, inventory, and prepaid expenses. The inventory section is where the auditor would commonly find inventories of supply items that should appear on the listing form. Such inventories are usually of items located in store rooms or storage cabinets and do not include items at desks or other work stations which are also taxable.

Assets not quite as liquid as current assets may be in the form of investments that generally include stocks and bonds owned by the taxpayer. Investments are not taxable in North Carolina.

Those assets, which we are interested in as appraisers, are fixed assets. In the fixed assets section of the balance sheet, the appraiser will find accounts for land, buildings, furniture and fixtures, machinery and equipment, computers, and vehicles. In North Carolina, we will focus on the personal property component of fixed assets. GAAP requires accountants to report the balance of fixed assets at the lower of cost or market. You will find that accountants capitalize fixed assets at cost rather than market since accountants are not appraisers.

The figures found for fixed assets on the balance sheet reflect the acquisition cost of the assets. The accumulated depreciation represents a write-off of acquisition cost to expense during the period the asset has been owned. The difference between those two figures represents what accountants call book value. Sometimes, an accountant may attempt to be an appraiser and post the net book value figure to the listing form. This is unacceptable since net book value rarely represents fair market value as of the lien date of January 1. Personal property items appearing on the balance sheet may not be categorized in the same manner as reported on the listing. However, the total cost of all taxable items in the balance sheet should equal the total cost reported on the listing form.

Another type of asset found on the balance sheet is intangible assets. Intangible assets are not taxable in North Carolina.

Liabilities

Liabilities are also found on the balance sheet. Liabilities are usually classified as either current, short-term liabilities, or long term liabilities. Current liabilities include accounts payable, reserves for payroll taxes and accrued wages. Long-term liabilities may include items such as mortgages and notes payable.

Capital Accounts (Net Worth) (Owner Equity)

The net worth equity, or capital section of the balance sheet identifies the capital stock, common stock and retained earnings.

An example of how the three parts of a balance sheet work together in the A=L+C equation is the home you might have. The home itself is the asset. The amount owing on the mortgage is a

Balance Sheet VALLEY HARDWARE STORE December 31, 2006					
Assets			LIABILITIES AND NET WORTH		
CURRENT ASSETS			CURRENT LIABILITIES		
Cash On Hand		3,000	Accounts Payable (Net Due)		40,000
Bank Balances		80,000	Accounts Payable (Past Due)		
Marketable Securities					
Accounts Receivable - Customers			Notes Payable - Banks		70,000
Accounts - Current	20,000		Notes Payable - Merchandise		
Accounts - Past Due			Notes Payable - Other		
Total	20,000		Reserve - Federal Taxes		
Less Revenues			Reserve - Other Taxes		
Notes Receivable - Customers					
		20,000	ACCRUED EXPENSES		
INVENTORY			Salaries & Wages	140,000	
Raw Material	30,000				
Work in Process					
Finished Stock					
Office supplies					
Store supplies					
		30,000	Total Current Liabilities		250,000
OTHER CURRENT ASSETS					
			Mortgage Payable		90,000
			Long Term Notes		30,000
Total Current Assets		133,000			
FIXED ASSETS					
Land	80,000		TOTAL LIABILITIES		370,000
Buildings	212,000				
Furniture & Fixtures	109,602		NET WORTH		
Computers			Capital Stock		
Machinery & Equipment	1,261,531		Preferred	424,000	
Leasehold Improvements			Common	225,000	649,000
			Paid in or Capital Surplus		
Total	1,663,133		Retained Earnings		90,812
Less Depreciation	692,321				
OTHER ASSETS		970,812			
Loans and Advances					
			Total		
Prepaid Expenses	6,000		Less Treasury Stock		
			Stockholders Equity		
		6,000			
			NET WORTH		739,812
TOTAL ASSETS		1,109,812	TOTAL LIABILITIES & NET WORTH		1,109,812

liability. The amount you have paid is the capital or net worth. The depreciation on the home would be accounted for in a contra-asset account called accumulated depreciation. We will see accumulated depreciation again in a later section.

INCOME STATEMENT (Statement of Cash Flows, Statements of Operations)

Profit and Loss Statement (Income Statement)		
INCOME	Year Ending 12-31-2006	
Sales		$ 195,256
Total Income		$ 195,256
COST OF SALES		
Inventory to Begin	$ 25,000	
Merchandise Purchased	$ -	
Total	$ 25,000	
Less Inventory at End	$ 11,000	
Cost of Sales		$ 14,000
GROSS PROFIT		$ 181,256
EXPENSES		
Advertising	$ 500	
Auto & Trucks	$ 100	
Bad Debts	$ 500	
Depreciation	$ 1,000	
Discounts and Allowances	$ 50	
Freight, Express, Delivery	$ 1,000	
General and Miscellaneous	$ 1,000	
Heat, Light, Power and Water	$ 1,200	
Insurance	$ 300	
Interest	$ 50	
Laundry and Cleaning	$ 265	
Legal and Accounting	$ 500	
Office Expense, Printing and Postage	$ 500	
Repairs	$ 100	
Rent	$ 12,000	
Tools Expense	$ 1,200	
Store Supplies Used	$ 680	
Office Supplies Used	$ 960	
Salaries and Wages - Employees	$ 10,000	
- Officers	$ 40,000	
Taxes: F.I.C.A.	$ 2,500	
General	$ 3,000	
State Sales	$ 1,250	
Unemployment	$ 4,000	
Telephone and Telegraph	$ 1,000	
Travel and Entertainment	$ 600	
	$	
	$	
Section 179 Assets	$ 18,000	
	$	
	$	
Total Expenses		$ 102,255
Net Operating Profit or Loss		$ 79,001
OTHER INCOME		$ -
Total		$ 79,001
OTHER EXPENSES		$ -
TOTAL NET PROFIT OR LOSS		$ 79,001

The income statement is a financial statement that summarizes the amount of revenues earned and expenses incurred by a business over a period of time. The period of time is usually the business' fiscal year, but may be for a different period, such as one month. There are several items relating to taxable property that can be found in the income statement.

DEPRECIATION SCHEDULE

Possibly the most useful document to the appraiser is the taxpayer’s depreciation schedule. Here the appraiser will find acquisition year and cost of capitalized fixed assets, which are the tools necessary to appraise the property. The depreciation schedule is used by accountants to calculate the measured expense to be taken within a certain revenue period. The matching principle or theory in accounting requires that expenses are to be recognized in the same period in which revenues are earned. This period is ordinarily one year. In other words, if an asset is expected to have a life of six years then the expense of that asset should be taken against the revenues earned in that six year period. The accountant calculation of life may be different than that of the appraiser.

The accountant measures the asset’s life by IRS standards. These standards may allow rapid write off. With a rapid write off, a greater expense is taken. This reduces net income and therefore, reduces the business’ income tax liability. When allocating this expense, or capitalized cost, several methods are available to the accountant.

Valley Hardware Store									
Depreciation Schedule			31-Dec-06						
Office Furniture & Fixtures									
Kind of Property	**Date Acquired**	**Cost or Basis**	**Salvage Value**	**Cost less Salvage**	**Method Used**	**Rate or Life**	**Accum Dep 31-Dec-05**	**2006 Depr Expense**	**Accum Dep 31-Dec-06**
File Cabinet	1997	$ 500		$ 500	SL	8	$ 500	$ -	$ 500
Artwork	2001	$ 1,000		$ 1,000	SL	8	$ 625	$ 125	$ 750
Vacuum	2001	$ 180		$ 180	SL	8	$ 113	$ 23	$ 135
Stereo	2002	$ 1,500		$ 1,500	SL	8	$ 750	$ 188	$ 938
Desk	2003	$ 1,600	$ 100	$ 1,500	SL	8	$ 563	$ 188	$ 750
Furniture	2003	$ 2,500		$ 2,500	SL	8	$ 938	$ 313	$ 1,250
Lamp	2003	$ 100		$ 100	SL	8	$ 38	$ 13	$ 50
Shredder	2003	$ 250		$ 250	SL	8	$ 94	$ 31	$ 125
Desk Set	2004	$ 100		$ 100	SL	8	$ 25	$ 13	$ 38
Adding	2004	$ 50		$ 50	SL	8	$ 13	$ 6	$ 19
Register	2004	$ 500		$ 500	SL	8	$ 125	$ 63	$ 188
Desk	2004	$ 2,000	$ 100	$ 1,900	SL	8	$ 475	$ 238	$ 713
Television	2005	$ 395		$ 395	SL	8	$ 49	$ 49	$ 99
Computer	2005	$ 2,500	$ 100	$ 2,400	SL	8	$ 300	$ 300	$ 600
Computer	2006	$ 2,500	$ 100	$ 2,400	SL	8	$ -	$ 300	$ 300
Sofa	2006	$ 1,670	$ 20	$ 1,650	SL	8	$ -	$ 206	$ 206
Display	2006	$ 500		$ 500	SL	8	$ -	$ 63	$ 63
10 Desks	2006	$ 300	$ 100	$ 200	SL	8	$ -	$ 25	$ 25
10 Chairs	2006	$ 100	$ 25	$ 75	SL	8	$ -	$ 9	$ 9
10 File Cabinets	2006	$ 300	$ 100	$ 200	SL	8	$ -	$ 25	$ 25
Table	2006	$ 2,000		$ 2,000	SL	8	$ -	$ 250	$ 250
Equipment	2006	$ 10,000		$ 10,000	SL	8	$ -	$ 1,250	$ 1,250
Sold Display	2006	$ (1,000)		$ (1,000)	SL	8	$ -	$ (125)	$ (125)
Total		$ 29,545	$ 645	$ 28,900			$ 4,606	$ 3,550	$ 8,156

Fixed Assets

The fixed assets of a business entity are those physical assets generally referred to as the property, or the plant & equipment of the operation. We can further define this subject area as the machinery, equipment, furniture & fixtures.

To be classified as a fixed asset the property must meet all of the following criteria:

1. The asset is acquired for use in the business and is not held for resale

2. The asset is long term in nature, which basically means that the asset will not be consumed during a period of less than one accounting cycle.

3. The asset must possess physical substance. While assets such as copyrights and patents are assets of a company, they have no physical substance and are therefore not classified as fixed assets.

Property acquired by a business and meeting the stipulations above, is **Capitalized** by the business. Businesses usually set a **capitalization threshold**. This threshold is a dollar amount used to determine if an asset will be capitalized and placed on the depreciation schedule or treated as an expensed item and the entire cost written off against the revenues for the current year. Any asset costing more than the threshold is capitalized while items costing less than the threshold are expensed. Expensed items are still taxable and should be listed, but are not found on the depreciation schedule. One of the basic tenets of accounting requires the matching of revenues and expenses. Property acquired by a business that is expected to perform a task for a certain period of time must have a portion of the purchase price matched with the income it produces. If a business did not try to match these revenues and expenses, every time there were major increases in capital assets, the company would show a loss. Conversely, any time a company chose not to buy any new property, they would have to pay increased income taxes.

Cost

The cost of an asset is defined as the cash or cash equivalent price of what is given up in order to obtain the new asset. There can be several different costs that must be included in the capitalized cost of an asset. By industry practice, cost should include any and all costs associated with obtaining the property and bringing it to its anticipated useful purpose. These costs can include, but are not limited to, any combination of the following:

Invoice Cost
Freight
Sales and Excise Tax
Insurance while in transit
Special wiring and foundations
Cost of test runs
Interest During Construction

Cost Apportionment (Depreciation)

In order to match the revenues and expenses of a business entity, the accountant must allocate a portion of the capitalized cost of an asset to the accounting period for which the use of the property is benefited. There are several methods available to the accountant to make this allocation. On the next few pages, we will examine a few of the most popular methods of accounting depreciation.

Straight Line Method

The straight line method assumes the asset will lose its utility on a uniform and even basis. To calculate the annual charge to income for depreciation, the accountant will use the following formula:

$$\text{Annual depreciation} = \frac{\text{Cost - Salvage Value}}{\text{Useful Economic Life}}$$

The following table demonstrates the depreciation of an asset having a cost of $6,500, a salvage value of $1,500 and a useful economic life of five (5) years.

Year#	Book Value	Depreciation Expense	Accumulated Depreciation	Net Book Value
1	6,500	1,000	1,000	5,500
2	5,500	1,000	2,000	4,500
3	4,500	1,000	3,000	3,500
4	3,500	1,000	4,000	2,500
5	2,500	1,000	5,000	1,500 *

* Salvage Value

Decreasing Charge Methods

The theory behind the use of the decreasing charge methods is that the asset is likely to suffer greater maintenance and repair costs in the later years of its economic life. In order to match revenues and expenses, the accountant should allocate a larger portion of the asset cost in the early years of use. The two most common methods for making this allocation are the Sum-of-the-years-digits and the Double Declining Balance.

Although the amount of depreciation calculated each year will vary when using the decreasing charge methods, the method of arriving at net book value does not change. In other words, you always begin with the beginning book value, subtract the calculated depreciation expense for that year and the result is the net book value for that year. Net book value will be the beginning book value for the next year. The accumulated depreciation column is always a running total of the depreciation expense column.

Double Declining Balance Method

This method allocates the depreciation charge by (A) calculating a straight line depreciation rate, (B) doubling this rate, (C) applying the rate to the cost of the asset less any accumulated depreciation, yet (D) stopping the depreciation at salvage value. In our example, the depreciation schedule would appear as follows:

$$\frac{100\%}{5 \text{ (Life Years)}} = 20\%$$

$$20\% \times 2 = 40\%$$

Year #	Book Value	Factor	Depr. Exp.	Accum. Depr.	Net Book Value
1	6,500	.40	2,600	2,600	3,900
2	3,900	.40	1,560	4,160	2,340
3	2,340	.40	840 *	5,000	1,500
4	1,500	.40	-0-	5,000	1,500
5	1,500	.40	-0-	5,000	1,500

*You do not depreciate below salvage value

Sum of the Years Digits

Under this method the years in an asset's life are totaled. This sum becomes the denominator of a series of fractions used in allocating depreciation to the periods in the asset's service life. The numerators of the fraction are the years in the asset's life in reverse order. This method would produce the following depreciation schedule:

Year	Book Value	Fraction	Basis*	Depr. Exp.	Accu. Depr.	Net Book Value
1	6,500	5/15	5,000	1,667	1,667	4,833
2	4,833	4/15	5,000	1,333	3,000	3,500
3	3,500	3/15	5,000	1,000	4,000	2,500
4	2,500	2/15	5,000	667	4,667	1,833
5	1,833	1/15	5,000	333	5,000	1,500 **
15						

* Cost - Salvage Value
** Salvage Value

Activity Methods - Units of Production

In some industries, such as mining, it may be more practical to allocate depreciation to units of production rather than to an estimated life. For instance, if an asset costing $11,500 and salvage value of $1,500 was purchased to produce an estimated 100,000 widgets and 24,000 widgets were produced within a given year, the depreciation calculation for that particular year would appear as follows:

Cost	=	$11,500
Less salvage		- 1,500
Depreciable Base		$10,000 / 100,000 = .10/widget

Year's production =	24,000
Amount of depr./widget	x .10
Year's depreciation	$ 2,400

There are many other methods of depreciation in use by the accounting community. Many of these methods are used for income tax depreciation and have little value for the personal property appraiser. It would benefit the appraiser to make a study of the various regulations covering income tax methods such as those listed:

ACRS - Accelerated Cost Recovery Property
MACRS - Modified Accelerated Cost Recovery Property
CLADR - Class Life Asset Depreciation Range
Section 179 Expensed Property

CASE PROBLEM

ACCOUNTING DEPRECIATION PROBLEM

A new machine is purchased and installed by AAA Company. The machine has a total cost of $5,000.00, a useful economic life of 5 years and a salvage value of $500.00.

1) Prepare a straight-line depreciation schedule for the above asset.

2) T or F: Accountants typically depreciate assets similarly to property tax appraisers and therefore the net book value that accountants arrive at may be used as fair market value for property tax purposes.

3) T or F: As long as the asset is in use above, the taxpayer should list it. Even if the asset is fully depreciated for accounting purposes and has a net book value of zero.

4) T or F: If the asset is disposed of, but it remains on the depreciation schedule, the taxpayer should list the asset for property taxes for the listing period following disposal.

5) The accountant should list which amount for this asset on the listing form.

a) $5,000
b) $500
c) Whatever the net book value is at the time of listing.
d) If the taxpayer says it is inventory, it doesn't need to be listed.

Repairs, Replacements and Betterments

Expenditures for those repairs and replacements necessary to maintain an asset in a normal good operating condition are considered as repairs. These items do not appear in the asset accounts but do appear in the expense accounts. Repairs may include such items as painting, roof repair, machine reconditioning and replacement of small parts.

Extraordinary repairs and replacements are major expenditures intended to extend the life of the asset beyond the original estimated life years. These items are treated as a reduction of accumulated depreciation, thereby increasing net book value.

Betterments are defined as those expenditures for replacements of assets or portions of assets with improved or superior assets or portions of assets. This replacement is usually intended to make the asset better, more efficient or more productive, but will not necessarily extend the life of the asset. Betterments should be recorded as an addition to the asset bettered and included in the depreciation base.

CASE PROBLEM

Machinery & Equipment Appraisal
The Cost Approach

An analysis of Glasco Corp. accounting records reflects the following expenditures for the year 2000 which have not been capitalized by Glasco and reported for property tax purposes in 2001.

Expense Journal

l. $ 7,000 - Replace broken chains in overhead hoist
2. 4,000 - Repair motor in boiler
3. 700 - Repair brick kiln damaged by fork lift
4. l25,000 - Rebuild inside brick kiln walls as required every l0 years by OSHA
5. l,400 - Replace worn belts on conveyor system
6. 3,600 - Repairs (general)
7. 6,800 - Increase electrical voltage for additional boiler system
8. 5,000 - Freight for shipping boiler equipment

In your opinion, should any of the above costs be capitalized rather than expensed, and therefore reported for property tax purposes? If so, which items? _______________
____
____
____

Inventories

Nature of Inventories

The term inventories is a designation for goods that are held for sale in the normal course of business, as well as for goods that are in production or are to be placed in production. Practically all tangible items fall into this classification at one time or another. Gasoline, oil, and automotive supplies are included in the inventory of a service station; crops and livestock are included in the inventory of a farmer; machinery and equipment are included in the inventory of a manufacturer producing such items for sale.

Repeal of the Property Tax on Inventories

Inventories held for sale in the regular course of business by manufacturers, retail and wholesale merchants, and goods held by contractors to be furnished in the course of building, installing, repairing, or improving real property are exempt from property taxes in North Carolina. Below is a history of the changes that took place from 1985 until current.

History:

THE LAWS APPLICABLE IN DEFINING INVENTORIES OF BOTH "MANUFACTURERS" AND "RETAILERS AND WHOLESALERS" WHICH WERE EFFECTIVE AS OF JANUARY 1, 1986 ARE AS FOLLOWS:

1. G. S. 105-273(8a)
   "Inventories" means goods held for sale in the regular course of business, raw materials, goods in process of manufacture or processing, and other goods and materials that are used or consumed in the manufacture or processing of tangible personal property for sale or that accompany and become a part of the property as sold. The term does not include fuel used in manufacturing or processing.

2. (10a) "Manufacturer" means a taxpayer who is regularly engaged, at a manufacturing or processing plant, mill, or factory in this State, in the mechanical or chemical conversion or transformation of materials or substances into new products for sale. The term does not include delicatessens, cafes, cafeterias, restaurants, and other similar retailers that are principally engaged in the retail sale of foods prepared by them for consumption on or off their premises.

3. (13a) "Retail Merchant" means a taxpayer who is regularly engaged in the sale of tangible personal property, acquired by a means other than manufacture, processing, or producing by the merchant, to users or consumers. For the purpose of the classification in G.S. 105-277(i), the term includes a manufacturer who holds property for sale that it did not manufacture or who holds finished goods for sale at a location other than its establishment.

4. (19) "Wholesale Merchant" means a taxpayer who is regularly engaged in the sale of tangible personal property, acquired by a means other than manufacture, processing, or producing by the merchant, to other retail or wholesale merchants for resale or to manufacturers for use as ingredient or component parts of articles being manufactured for sale. For the purpose of the classification in G.S. 105-277(i), the term includes a manufacturer who holds property for sale that it did not manufacture or who holds finished goods for sale at a location other than its establishment.

5. G.S. 105-163.02(e) "Establishment" means a mill or plant in North Carolina at which manufacturing operations are performed, and which constitute an economic unit at a single physical location or site, unless otherwise indicated herein. The word "establishment" includes along with a manufacturing plant all sites in North Carolina where raw materials and/or partially manufactured goods are stored away from the manufacturing plant for use in such manufacturing plant. Two or more plants engaged in different steps of a manufacturing process constitute an establishment if goods must move through each plant before becoming a finished product even though the plants are at different sites in North Carolina. Two or more plants having a common ownership in North Carolina located at different sites and producing the same class or type of products may be deemed at the option of the taxpayer to be a single establishment for the purposes of this Division.

1989 - All poultry and livestock inventories exempted.

Effective January 1, 1989, G.S. 105-275 was amended by adding a new subdivision (37) which exempts from ad valorem taxation all poultry and livestock, and feed used in the production of poultry and livestock, whether or not held for sale.

1992 - Contractors' inventory exempted.

Effective January 1, 1992 G.S. 105-273(8a) was amended by adding "and contractors and (ii) goods held by contractors to be furnished in the course of building, installing, repairing, or improving real property".

Effective January 1, 1992 G.S. 105-273(5a) was added which states, "Contractor means a taxpayer who is regularly engaged in building, installing, repairing, or improving real property."

Effective January 1, 1992 G.S. 105-275(32a) was added which adds "inventories owned by contractors" to the list of exempt properties under G.S. 105-275.

1994 Current Statutes Considering Inventories

The following types of inventories are exempt from property tax in North Carolina.
1. G.S. 105-275(32a) Inventories owned by contractors

2. G.S. 105-275(33) Inventories owned by manufacturers
3. G.S. 105-275(34) Inventories owned by retail and wholesale merchants.

THE LAWS APPLICABLE IN DEFINING INVENTORIES OF BOTH "MANUFACTURERS" AND "RETAILERS AND WHOLESALERS" WHICH ARE CURRENTLY IN EFFECT ARE AS FOLLOWS:

G.S. 105-273

1. (5a) "Contractor" means a taxpayer who is regularly engaged in building, installing, repairing, or improving real property.

2. (8a) "Inventories" means (i) goods held for sale in the regular course of business by manufacturers, retail and wholesale merchants and contractors, and (ii) goods held by contractors to be furnished in the course of building, installing, repairing, or improving real property. As to manufacturers, the term includes raw materials or supplies that are consumed in manufacturing or processing, or that accompany and become a part of the sale of the property being sold. The term also includes a modular home as defined in G.S. 105-164.3(21b) that is used exclusively as a display model and held for eventual sale at the retail merchant's place of business. The term also includes crops, livestock, poultry, feed used in the production of livestock and poultry, and other agricultural or horticultural products held for sale, whether in process or ready for sale. The term does not include fuel used in manufacturing or processing, nor does it include materials or supplies not used directly in manufacturing or processing. As to retail and wholesale merchants, the term includes, in addition to articles held for sale, packaging materials that accompany and become a part of the sale of the property being sold.

3. (10b) "Manufacturer" means a taxpayer who is regularly engaged in the mechanical or chemical conversion or transformation of materials or substances into new products for sale or in the growth, breeding, raising, or other production of new products for sale. The term does not include delicatessens, cafes, cafeterias, restaurants, and other similar retailers that are principally engaged in the retail sale of foods prepared by them for consumption on or off their premises.

4. (13a) "Retail Merchant" means a taxpayer who is regularly engaged in the sale of tangible personal property, acquired by a means other than manufacture, processing, or producing by the merchant, to users or consumers.

5. (19) "Wholesale Merchant" means a taxpayer who is regularly engaged in the sale of tangible personal property, acquired by a means other than manufacture, processing, or producing by the merchant, to other retail or wholesale merchants for resale or to manufacturers for use as ingredient or component parts of articles being manufactured for sale.

What are exempt inventories?

Exempt inventories are "(i) goods held for sale in the regular course of business by manufacturers, retail and wholesale merchants, and contractors, and (ii) goods held by contractors to be furnished in the course of building, installing, repairing, or improving real property." Also included, beginning in 2006, are modular homes as defined in G.S. 105-164.3(21b) used exclusively as display models and held for eventual sale at the retail merchant's place of business. Modular homes are discussed in more detail later in this manual.

The legislature enacted G.S. 105-275(32a), (33) and (34) to exclude "inventory", which was defined in relevant part as "goods held for sale in the regular course of business". The legislature did not exclude all goods held for sale, but only those held for sale in the regular course of business.
The following are examples of goods held as inventory which are not exempt.

1. Leased equipment.

2. Leased vehicles or rental vehicles.

3. Supplies used in providing a service.

4. Spare parts.

There have been three recent cases which have helped answer the question of what are exempt inventories. The Moore Buick-Pontiac, Inc. case out of Onslow County was concerned with the taxability of rental cars. In its decision the North Carolina Property Tax Commission employed a "two prong" test to determine if the property was exempt.

> **The first prong consisted of determining whether the Taxpayer had bargained away his absolute right to possess and control the property; if so, the property could not be said to be "held for sale". The second prong involved an examination of all surrounding facts and circumstances to determine whether the property, if it was held for sale, was held for sale in the regular course of business by a retail merchant.**

The second case was R.W. Moore Equipment Company, Inc. out of Wake County. This case concerned heavy equipment which was leased out by the owner. The North Carolina Property Tax Commission ruled (and the courts have agreed) that the equipment was not exempt inventory and further stated the following:

> **"Inventories", as that term is commonly employed and under the definition set out in G.S. 105-275(33) and (34), is a term clearly distinguishable from capital assets used in a trade or business. A given item (e.g. a drill press, a truck, or a bulldozer) may be either inventory or a capital asset, depending on the use made of that asset by the owner. Indeed, most taxable capital assets start out as someone's (not-taxable) inventory.**

The third case is Cone Mills, Inc. out of Guilford. This case concerns machinery and equipment which had been used by the taxpayer for manufacturing purposes and then removed from production and held for sale or disposition. The North Carolina Property Tax Commission ruled (and the courts have agreed) that the equipment was not exempt inventory and further stated the following:

> **To resolve this question we ask: What was the primary purpose for which taxpayer acquired the property? If the taxpayer acquired the equipment and machinery for the primary purpose of using it in the manufacture of textiles, then the equipment and machinery are not goods held for sale in the regular course of business by a wholesale merchant. If the taxpayer acquired the property for the primary purpose of resale, then the property would be excluded from ad valorem taxation.**

The key point is that not all inventory is exempt and the burden is on the taxpayer to prove that he is entitled to an exemption. Copies of the decisions from the three cases above are available from the Ad Valorem Tax Division upon request.

Case Problem

Inventory

Which of the following would not be considered inventory and exempted from property taxes.

1. Goods held for sale at a clothing outlet.
2. Raw materials used in the production of a product.
3. A contractor's materials and goods sold when making service calls.
4. Drill bits and oil used in a tool and die shop.
5. Cars owned by a car dealer used as a demonstrator.
6. A wrecker running a dealer tag, owned by a car dealer, used for service calls.
7. Medical supplies used in the providing medical care in a doctor's office.
8. Singlewide mobile homes for sale on a dealer’s lot.
9. Rental movies on DVD.
10. Furniture held rent to own that is also for sale while being rented.
11. Computer software that is capitalized on the taxpayer’s books.
12. Equipment owned by a manufacturer after it is no longer being used.
13. Paper or plastic bags used to bag groceries at a grocery store.
14. Modular homes on the dealer’s lot used as an office.