



North Carolina Department of Revenue

Beverly Eaves Perdue
Governor

David W. Hoyle
Secretary

December 23, 2011

Memorandum

To: County Assessors

From: David B. Baker, MPA, PPS
Director, Local Government Division

Re: Assessment of Improvements to Leased Property

The property tax treatment of improvements to leased real property has been subject to varying opinions by taxpayers and taxing authorities in North Carolina over the years. This memo is intended to restate and clarify the position of the Property Tax Section of the Local Government Division of the North Carolina Department of Revenue on this issue.

Improvements to leased real property include improvements made by or for a business to real property leased or used by the business. These improvements are almost always used to facilitate the trade or business of the tenant in an occupied space and are most often associated with retail businesses. A determination must be made as to whether these improvements are real property fixtures or personal property fixtures before one can appropriately classify, appraise, and assess this category of property. In order to make this determination, it remains the position of the Property Tax Section that each situation involving these types of improvements must be analyzed independently using a total circumstances test. A total circumstances test involves considering all relevant factors and appropriately weighting the importance of the factors as indicated by the situation under review.

The treatise, 1 James A. Webster, *Webster's Real Estate Law in North Carolina: Possessory Estates and Present Interests in Real Property*, § 2, at 23-36 (Patrick K. Hetrick & James B. McLaughlin, Jr., eds., 4th ed. 1994) (hereinafter "*Webster's*") and court decisions provide guidance on the treatment of these types of improvements under North Carolina law. Chapter 2 of *Webster's* discusses fixtures and provides four criteria that can be used to determine if fixtures have become real property: "(1) Is there an express agreement that the annexed chattel is to be either permanent or temporary? (2) What is the character of the annexation of the chattel to the land – will its severance tear or cause injury to the annexed item or to the realty to which it is attached? (3) What relationship exists between the annexor of the chattel to the land and what relationship exists between the annexor and other claimants – is the annexor's interest in the land a permanent estate since the probability of an intention to annex a chattel permanently to land is in proportion to the permanency of the interest that he claims in the land? and (4)

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What is the nature and purpose of the annexation of the chattel to the land – is it for a “trade,” “agricultural,” “domestic,” or “ornamental” purpose?”

(1) Express Agreement: Some leases may expressly state that the improvements become the property of the landlord at termination of the lease or even upon completion of the improvements, but the fact that those improvements are almost always removed before the next tenant occupies the property indicates that the improvements are usually intended to be temporary.

Lease provisions and treatment of property for financial reporting purposes and income tax purposes can change from day to day. Lease provisions, financial reporting practices, and income tax treatment are factors that may be considered when using a total circumstances test, but they should not be given much weight if the actions of the parties indicate a different intention or actual practice.

Additionally, *Webster’s* discussion of the owner’s intent states: ““Personal fixtures” retain their character as personalty; “real fixtures” are those items which have become in law so inseparably a part of the land as to be deemed a part of the real property. Again, the key factor in determining whether an item has become a fixture, i.e., a real fixture, is the intent of the owner of that item.” The intent of the business in acquiring the assets and putting them in place is for use by the business, and the control of and use of these assets remain with the business (lessee) and not the lessor, regardless of any lease language.

(2) Character of the Annexation: This criteria requires an analysis of the character of the annexation of the improvement: What type of damage to the realty and to the annexed property will result from the removal of the improvements? Retail environments are designed for tenant improvements to be installed and removed on a regular basis, so the damage to the realty is usually negligible or at least expected as part of the business model. The injury caused to the item itself is less important since it is assumed that the next user will not be using the item in most cases (i.e. the damage to the item is irrelevant since it will be removed regardless of the damage caused to the item). The fact that the tenant attached the improvements to the realty in such a way as to accommodate the ability to remove the improvements without significant damage to the realty is also indicative that the improvements did not become real fixtures. However, certain types of improvements, such as structural items or basic construction items such as load-bearing walls, roofs, etc., would likely be considered permanent, regardless of whether installed by the tenant or the landlord.

(3) Relationship of the Annexor: The annexor or tenant has only a temporary interest in the realty. *Webster’s* posits that “... if one has only a temporary interest in the real property, it is reasonably presumable that he does not intend for an attachment to the realty to be more than temporary, to parallel his limited interest in the realty, and thus to remain personalty.” The fact that the vast majority of these improvements are removed when the tenant leaves, is a direct and strong argument against a position that the intent was to make the improvements realty. Of course, a county will have to recognize those situations when the improvements are continued to be used by the landlord after the original tenant has left. At that time, it will have to be considered whether the actions of the landlord in continuing to use the improvements have made those improvements real property. But those situations are the exception and not the norm. And certainly there are some types of tenant improvements that should be assumed to be permanently annexed, such as structural items.

(4) Nature and Purpose of Annexation: *Webster's* discussion of the nature and purpose of chattels annexed to realty includes the following: "...The law allows a tenant who places chattels on leased realty to remove whatever he has affixed to the premises for trade purposes. These chattels are called "trade fixtures" and remain personalty of the tenant." The tenant has paid for the improvements (either directly or indirectly) and the tenant is using the property for trade purposes and is reaping the rewards of that investment. However, continued use of the improvements by the landlord after the tenant has left might be evidence that the improvements have become real property, at that time. Two cases, *Railroad v. Deal*, 90 N.C. 110 (1884) and *Horne v. Smith*, 105 N.C. 322, 11 S.E. 373 (1890), support the concept that fixtures installed to promote trade remain personalty of the tenant.

(Note: Whether the improvements are called personal fixtures, "trade fixtures", or just personal property is not important, as long as it is recognized that they are not real property.)

Listing of Property for Taxation: Businesses should list improvements made by or for the business to real property leased or used by the business. The improvements may or may not be intended to remain in place at the end of the lease, but they must still be listed by the business unless it has been determined that the improvements will be appraised as real property by the county in accordance with the county real property schedules of values. If the business owner has questions about what should be listed, they should contact the appropriate county.

Schedules of Values: Counties should develop their real property schedules of values in such a way that everyone involved in the listing and assessment process, as well as the taxpayer, can readily determine which assets are considered real fixtures and assessed as real property and which assets are considered personal fixtures and should be listed by the business owner and assessed as personal property by the county.

Summary: Reinforcing the long-held position of the Property Tax Section, *Webster's* states that, "Any attempt to place an absolute meaning on the term "real fixtures" must be done with the warning that the facts and circumstances of each particular case must be carefully examined. Nevertheless, "real fixtures" generally consist of things, originally chattels personal, which have been annexed to the land, or to things permanently attached to land, by the owner of the chattels or with his assent, and with the intention to make the annexation permanent. All other annexations are "personal fixtures"." These examinations require the use of a total circumstances test to determine the nature of the assets.

Items of personal property that are determined to have become part of the real property based on a "total circumstances test" or similar analysis should be assessed as real property to the owner of the underlying real property. Counties have a duty to develop their real property schedule of values to make sure that they have the ability to assess real fixtures as real property and personal fixtures as personal property.