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The Frustrations of Fixtures: The Impact of Real Property/Tangible Personal Property Classification Questions on State and Local Taxes

The dividing line between tangible personal property and real property is a foundation of state tax systems. This threshold inquiry can determine a number of critical distinctions, including:

- Whether a person selling and installing property is an end-user subject to use tax or a retailer required to collect sales tax from the customer;
- Whether leasing of the property is potentially subject to sales and use taxes;
- Whether and how ad valorem property taxes are imposed; and
- Whether real property transfer tax applies to a sale or long-term lease of the property.

Most of the time the correct classification is readily apparent, but borderline cases present recurring challenges: Within a building, equipment may have some degree of affixation, often for electricity or for bracing. At what point does the equipment become part of the realty? On the land itself, structures can present similar issues: How much affixation; how much permanence is enough to be considered real property?

Answering these questions is a fact-intensive inquiry. It presents significant risks for taxpayers because of the foundational nature of the real property/tangible personal property divide. If a taxpayer gets the classification wrong, it can face an entirely different tax burden, often with limited scope for refund of taxes it may have wrongly paid.

The common law test for fixtures considers physical affixation, suitability to the real estate, and the intent of the parties. The distinction between real property and tangible personal property—sometimes called the law of fixtures—is an old common law doctrine that can apply in a variety of contexts. There may be a question of what property a tenant can remove when a lease ends, or whether a creditor with a security interest can take possession of a particular piece of equipment. If the property causes injury, the same common law test may be relevant to determining who may be sued, whether insurance applies, or the applicable statute of limitations.

In the state and local tax context, this common law test will often apply or at least inform the analysis of whether a piece of property has become part of the real estate. It is a subjective, fact-sensitive analysis, and the correct characterization for tax purposes can be debatable. The three elements of the common law fixtures test are as follows:[1]

1. *The physical nature of the property's attachment to the real estate:* This factor is fundamentally a question of engineering. It considers the mechanics of how the property has been connected to the real estate: nails, bolts, wiring, ductwork, etc. It also considers the potential injury to the real estate if the property was removed.
2. *The adaptation to and necessity for the purpose for which the premises are devoted:* This factor weighs the relevance of the property to the real estate on which it may be affixed. If the property is specifically suited to the real estate, that weighs in favor of treating the property as a fixture.
3. *Whether or not it was intended that the item should be considered to be a part of the realty:* Where the other two factors consider the physical nature of the potential fixture and the parcel to which it may be affixed, this third factor considers the intent of the party or parties involved in the potential affixation. It often takes into consideration the terms of the agreement between the parties.

It is sometimes said that the common law fixtures test is fundamentally a question of intent, and that the first two factors are objective manifestations of the parties' intent.[2]

Taxpayers need to consider real property/tangible personal property classification positions and risks. In our practice we repeatedly see questions and disputes about characterization of property as real or personal for purposes of various taxes. Oftentimes a taxpayer has not considered the issue until it is

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raised in an audit. Among the considerations for taxpayers are the following:

Consistency (or lack thereof) across different taxes and jurisdictions. The ubiquity and flexibility of the common law fixtures test poses problems for taxpayers. The distinction between real and personal property is fundamental to many taxes, particularly sales and use taxes, property taxes, and real estate transfer taxes. While a state or locality may be free to codify a different definition of real or tangible personal property with respect to a given tax, often definitions are either omitted entirely or are sufficiently vague that the common law fixtures test still applies or informs the analysis.

The common law fixtures test is so pliable, however, that different tax administrators may reach opposite conclusions when faced with the same or similar facts. Within a given state, a department of revenue might characterize a piece of equipment as an improvement to real estate while the local property tax assessor's office may reach a different conclusion. Depending on applicable local taxes, a municipal or county home rule tax administrator may also need to address the classification of the item as real or personal property.

These positions may be audit positions with little notice to taxpayers. A taxpayer facing this type of uncertainty should carefully consider its approach in light of any available guidance and craft a strategy appropriate to its situation. For example, perhaps the taxpayer can obtain a letter ruling or other favorable guidance from one tax administrator and use it as leverage in seeking to extend the same treatment to a different tax administered by another governmental body.

The ubiquity of the common law fixtures test means that multistate taxpayers also face issues of consistency (or lack thereof) across state lines. For example, a company that sells and installs equipment in multiple states may face the same issue of whether it is a construction contractor or a retailer. Depending on the materiality of the issue, a company might simply assume that the common law test applies and take a uniform position across all the states, or conduct a state-by-state evaluation.

Such an evaluation should consider whether there are statutes or ordinances providing a different test in derogation of the common law test. For example, persons selling and installing security systems often have specific authority in the sales and use tax context.[3] An evaluation also can consider whether the way that fixtures case law (both tax and nontax) has evolved in a given state requires a different result.

Sales and use taxes pose particular risks of unfairness. The nature of sales and use taxes as being imposed on the final end-user of property poses a particular problem in scenarios where property is sold and installed but there is a question as to whether the property is actually becoming part of the real estate.

If property being sold is being installed as a fixture, then the seller is considered to be an end-user—a construction contractor—typically taxed on the cost price of its equipment and supplies. If the equipment being sold remains tangible personal property, however, then the seller is a retailer and should collect sales tax based on its selling price. This difference in the tax base can be significant.

An especially problematic situation can arise where the parties assume that a transaction is a retail sale but the tax administrator treats it as a construction contract with the seller as end-user. For example, a business that sells and installs heavy equipment may have a large customer that provides a resale certificate from its purchasing company. The seller accepts the certificate and does not collect or self-assess tax.

On audit, the state takes the position that the equipment became part of the real estate and the seller really was a construction contractor.[4] Under the state's theory, the resale certificate is useless; the construction contractor should have paid tax on the wholesale price of the installed property.

Or if the seller collected tax as a retailer, while a state often will credit the erroneously collected tax against the seller's use tax liability, conceivably it can take the whipsaw position that the taxpayer has a duty to either hand over the erroneously collected tax to the state or refund it to the customer, and then an additional duty to pay use tax as a construction contractor. Idaho, for example, adopted this harsh position in 2008.[5]

The impact of a tenant relationship on the fixtures test for tax purposes. The common law fixtures test arose out of landlord-tenant issues, and its focus on the parties' intent raises questions about the extent to which a taxing body should be bound by the parties' contractual relationship between themselves. It can seem a strange result if physically identical scenarios are taxed differently because of the presence of a landlord-tenant relationship.

To take an extreme example, a ground lease may provide for the tenant to be able to construct buildings or structures but with an obligation to remove them and restore the premises upon termination of the lease. While such an agreement made by the parties will typically bind them, does that mean that the buildings or structures are not real property for tax purposes? There is authority that the terms of the landlord-tenant agreement are not necessarily controlling on tax administrators or other third parties.[6] Indeed, for property tax purposes, taxing authorities have assessed removable tenant improvements as part of the real estate.[7]

Conclusion. Taxpayers having real property/tangible personal property characterization issues face significant risks because of the vagaries of the common law test and the foundational nature of this distinction in the application of various state and local taxes. It is critical to be aware of these issues and craft a proactive strategy so that a taxpayer can be prepared if an opportunistic tax administrator seeks to impose its tax on the borderline situation. ■

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1 *See, e.g., C.R. Fedrick, Inc. v. State Bd. Of Equal.*, 204 Cal. App. 3d 252, 264-68 (Cal. Ct. App. 1988); *In re of the Application of Nextel of N.Y., Inc. v. Assessor for the Village of Spring Valley*, 771 N.Y.S.2d 853, 861-62 (N.Y. Sup. Ct. 2004); *Shenandoah Mobile Co. v. Dauphin County Bd. of Assessment Appeals*, 869 A.2d 562, 568-69 (Pa. Commw. Ct. 2005); *Hanjin Shipping Co., Ltd. v. Dep't of Revenue*, Wash. Bd. Tax App. no. 07-439 (Feb. 10, 2011).

2 *See, e.g., Sulphur Springs Valley Elec. Coop. v. Tombstone*, 401 P.2d 753, 758 (Ariz. Ct. App. 1965); *Kearbey v. Douglas*, 221 S.W.2d 426, 428 (Ark. 1949); *Crocker Nat'l Bank v. City & County of San Francisco*, 782 P.2d 278, 281 (Cal. 1989); *Wilmington Hous. Auth. v. Parcel of Land*, 219 A.2d 148, 150 (Del. 1966); *Nokomis Quarry Co. v. Dietl*, 333 Ill. App. 3d 480, 484 (Ill. App. Ct. 2002); *Milestone Contractors, L.P. v. Ind. Bell Tel. Co., Inc.*, 739 N.E.2d 174, 178 (Ind. Ct. App. 2000).

3 *See, e.g.*, 23 Va. Admin. Code § 10-210-230 (mandating treatment as end-user if seller of security system equipment also provides monitoring services).

4 *See, e.g.*, Va. Tax Commission Ruling no. 14-83 (May 30, 2014) (treating a seller of mobile office partitions as a construction contractor subject to use tax).

5 *See* Idaho Tax Commission, "Sales Tax Advice for Contractors Who Improve Real Property" (June 20, 2008); *see also* Idaho Tax Commission Decision no. 25481 (March 21, 2014).

6 *See, e.g., United States v. 19.86 Acres of Land*, 141 F.2d 344 (7th Cir. 1944); *Ayrshire Coal Co. v. Prop. Tax Appeal Bd.*, 310 N.E.2d 667 (Ill. App. Ct. 1974); *United States v. 15.3 Acres of Land*, 154 F. Supp. 770 (M.D. Pa. 1957).

7 *See, e.g., Phelps County v. Anderson*, 508 N.W.2d 314 (Neb. Ct. App. 1993); *In re Tax Objections of Hutchens*, 341 Ill. App. 3d 1039 (Ill. App. Ct. 1976).