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SHOP TALK

Telecoms Face Tough Tax Questions Surrounding Realty Versus Personalty Classifications

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More than any other industry, telecommunications providers face fundamental realty versus personalty classification questions that have serious property tax and sales and use tax implications.[1] Telecommunications providers often install equipment and related items (cabling, conduit, etc.) into or on real property and then use it in the same place for years. This creates a question of whether the equipment should be treated as part of the realty itself or as tangible personal property. Ambiguity over such a foundational classification has a myriad of state tax implications. A taxpayer needs to assess its situation holistically, determine its risks, and identify planning opportunities.

The property tax and sales tax implications of classification as realty or personalty

The distinction between real property and tangible personal property is one of the deepest classifications in the law of property. Besides a host of nontax implications, the question has significant state and local tax implications, especially for property taxes and sales and use taxes. Among the potential stakes of a realty versus personalty classification question are the following:

- *Imposition of property tax:* In many states, property tax is imposed on real property but not personal property. This threshold question of taxability can have huge financial implications.[2]
- *Differing application of property tax:* Even if both real property and personal property are subject to ad valorem taxation, they may be taxed at different rates, they may have different approaches to

depreciation, and they may have different tax collectors. Personal property often will be taxed more advantageously than real property.

- *Sales and use tax on construction of real property versus sale of tangible personal property:* A construction contractor typically is treated as the end-user of any tangible personal property that it installs and is subject to sales and use tax on its purchases. By contrast, a seller of tangible personal property who does not install buys for resale and then collects sales tax from its customer. Having a tax administrator second guess the realty/personalty classification can result in significant assessments or potential refund recovery opportunities.[3]
- *Sales tax on leases of personal property:* If equipment retains its character as tangible personal property, then leases or licenses of the equipment or space on the equipment are potentially subject to sales tax or other transaction taxes.[4]
- *Taxation of equipment and services thereto:* Some states have special exemptions regarding telecommunications equipment or special taxes or exemptions surrounding services to telecommunications equipment. The nature of equipment as realty or personalty can affect such a tax or potential exemptions to the tax.[5]

The common law approach

In the absence of specific statutes or rules defining certain property as personalty or realty, the general common law test of the law of fixtures controls. In most states, this is a three-factor test that is not specific to tax law.

The three factors are (1) physical annexation to the real estate, (2) adaption to the use or purpose to which the real estate is devoted, and (3) the intention of the parties to make a permanent accession to the real estate.

- *Annexation:* The first factor is a question of engineering. It looks at how the equipment is attached to the real property. Aspects considered include the initial installation process, the degree of difficulty to remove the equipment, and whether removal could occur without damaging the equipment or the realty.
- *Adaption:* The second factor is harder to pin down. It looks to the degree to which the equipment is adapted to the current use of the real property. This factor is arguably the weakest[6] and can often be argued in both directions. Clearly the presence of equipment on a parcel of real property will indicate that the equipment is suited to the current use of the realty. But, at least for telecommunications

equipment, often there will be nothing particularly customized or unique about the equipment and the realty that will make the equipment especially suitable to a given parcel.

- *Intent:* The third factor, the intent of the person affixing the equipment to the real estate, is the most important. This is a question not just of that person's stated intent but also of the revealed intent. Clearly any agreements, such as leases or easements, are highly relevant. Consider also the economics of the arrangement. Is it likely that the equipment will remain on the real estate for its entire useful life, or is there a good chance that the equipment will be removed and used again in a different location?

These three factors leave courts, tax administrators, and taxpayers with substantial ambiguity as to how to apply the test for specific situations. The Wisconsin Court of Appeals and the Pennsylvania Commonwealth Court, for example, reached opposite conclusions about the classification of cellular towers under the common law test.[7] The Wisconsin court considered the tower to be personal property based on the tower being on leased property and there being a market for used towers. The Pennsylvania court treated the tower at issue as real property based on its bolting to a concrete pad and the automatic lease renewals pushing the likely lease term to 25 years. This kind of ambiguity and inconsistency is typical for the three-factor test.

Some states have common-law variants on the three-factor test, such as looking at intent as the sole factor, or they have additional factors.[8] As a practical matter, the analysis of the facts surrounding the equipment and its affixation will be similar regardless of the exact formulation of a jurisdiction's common law test.

Special statutory rules can apply (but might not have kept up with technology)

A state is free, of course, to establish its own specific rules instead of the common law test. Such legislation is common on the property tax side of classifications.[9] Special definitions also can be in place for sales and use taxes,[10] although it is not as common.

If a special statutory definition is in place, then the classification issue becomes a question of statutory interpretation. With telecommunications technology evolving rapidly, statutes often do not keep up. Recent New York property tax cases involving fiber optic cables demonstrate this issue. In the 2012 *RCN* case, lines, poles, and other equipment associated with fiber optic cable were found not to be "real property" subject to taxation because fiber lines are not "electrical conductors."[11] In subsequent litigation, other taxing jurisdictions tried to shoehorn fiber optics property into a different part of the definition of "real property" that

applies to property used in the distribution of heat, light, power, gases and liquids. These attempts also failed; they were rejected as a strained reading of the statutory language.[12]

If equipment does not meet the statutory definition of real property, then it is likely to be treated as personal property, as was the case in the New York property tax fiber optic equipment cases. In addition, the existence of a definition for one kind of tax may encourage equipment to be similarly classified for other taxes. For example, a property tax definition could encourage the sales tax administrator to classify the equipment consistent with its property tax treatment.

Taxpayers need to consider realty versus personalty classifications holistically

Fundamentally, taxpayers need to look at realty versus personalty classification questions strategically and holistically. Within a state, care should be taken to consider the most advantageous position overall, instead of focusing on a specific tax type. All too often, this connection is not made in larger companies that separate the sales and use tax function from the property tax function. And across states using the common law test, care should be taken about the basis for realty versus personalty positions. While some inconsistency might be explainable, documents created to buttress a position in one jurisdiction potentially could be used against the taxpayer in another jurisdiction. These kinds of risks cannot be eliminated, but they can be managed proactively.

[1] While this article is framed in terms of the telecommunications industry, its overall approach applies equally to other industries involving equipment with similar ambiguity in the realty versus personalty classification.

[2] *See*, *e.g.*, *In re Level 3 Communications, LLC v. Clinton Cty.*, 144 A.D.3d 115 (N.Y. App. Div. 2016) (finding fiber optic cables to be personal property); *Shenandoah Mobile Co. v. Dauphin Cty. Bd. of Assessment Appeals*, 869 A.2d 562 (Pa. Commw. Ct. 2005) (finding cell towers to be real property).

[3] *See Nokia Siemens Networks US LLC v. Ill. Dep't of Revenue*, 14 TT 10 (Ill. Tax Trib. 2014) (treating taxpayer as construction contractor end-user who could not accept resale certificates to avoid taxation).

[4] *See*, *e.g.*, *All City Communication Co., Inc. v. Wis. Dep't of Revenue*, 661 N.W.2d 845 (Wis. Ct. App. 2003) (upholding sales tax on lease payments for cell tower space); Chicago Dep't of Fin., "Informational

Bulletin: Lease Tax on Cell Towers" (Jul. 2016) (providing safe harbor for Lease Transaction Tax on 40% of the charge for lease payments for cell tower space).

[5] *See*, *e.g.*, 34 Tex. Admin. Code § 3.350(h) (noting that exemption for repair of recording and broadcast equipment tangible personal property does not extend to equipment that has become real property).

[6] *See All City Communication Co., Inc.. v. Wis. Dep't of Revenue*, 661 N.W.2d 845, 852-53 ("[W]e have difficulty discerning the logic behind the test and how it would further the goal of distinguishing real property from personal property.")

[7] *Compare All City Communication Co., Inc. v. Wis. Dep't of Revenue*, 661 N.W.2d 845 (Wis. Ct. App. 2003) (upholding imposition of sales tax by treating the cellular tower as tangible personal property), *with Shenandoah Mobile Co. v. Dauphin Cty. Bd. of Assessment Appeals*, 869 A.2d 562 (Pa. Commw. Ct. 2005) (upholding imposition of property tax by treating the cellular tower as real property).

[8] *See*, *e.g.*, *New England Telephone and Telegraph Co. v. City of Franklin*, 685 A.2d 913 (N.H. 1996) (applying a five-factor test).

[9] *See*, *e.g.*, N.Y. Real Prop. Tax Law § 102(12)(d), (f), (i).

[10] *See*, *e.g.*, *Nokia Siemens Networks US LLC v. Ill. Dep't of Revenue*, 14 TT 10 (Ill. Tax Trib. 2014) (applying the special rule of Ill. Adm. Code tit. 86, § 130.1940(c) to treat telecom equipment as real property such that the taxpayer was subject to use tax as the installer end-user).

[11] *In re RCN N.Y. Communications, LLC v. Tax Comm'n of City of N.Y.*, 95 A.D.3d 456 , 457 (N.Y. App. Div. 2012).

[12] *See In re Level 3 Communications, LLC v. Clinton Cty.*, 144 A.D.3d 115 (N.Y. App. Div. 2016); *In re Level 3 Communications, LLC v. Chautauqua Cty.*, 148 A.D.3d 1702 (N.Y. App. Div. 2017).

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