

Taxable Status of Leasehold Improvements For or By Tenants

As a result of the Appellate Division decision in the Matter of Flah's of Syracuse, Inc. v. James H. Tully, Jr. et al, 89 AD 2d 729, and based upon the New York State Sales and Use Tax Law (section 1101(b)(9)) and Regulations (section 527.7(a)(3)), the following explains and illustrates the taxable status of leasehold improvements made for or by tenants.

In order to qualify as a capital improvement, an addition or alteration to real property must:

- 1) substantially add to the value of the real property, or appreciably prolong the useful life of the real property;
- 2) become part of the real property or be permanently affixed to the real property so that removal would cause material damage to the property or article itself; and
- 3) be intended to become a permanent installation

Additions or alterations to real property for or by a tenant of such property will be presumed to be temporary in nature for purposes of the third condition stated above, unless a contrary intention is demonstrated. A specific lease provision which states that: 1) immediately upon installation, title to such installation vests in the lessor, and 2) the addition or alteration becomes part of and remains with the premises after the termination of the lease, will be recognized as a demonstration of contrary intention (i.e., an intention of permanence). A provision granting the lessor the right to require removal of the improvement will not negate this demonstration of intention of permanence; nor will a provision which states that the improvement becomes the property of the lessor upon expiration of the lease or upon termination of the tenancy.

In the absence of a lease provision, other factors such as the nature of the installation, or written agreements other than a lease provision may be considered in determining the intention of the parties with respect to the permanence of the installation. Factors which may indicate that a tenant installation is not intended to be permanent include: 1) a lease provision requiring that the leased premises be restored to their original condition at the termination of the lease; 2) the rental of the installed property from a third party (someone other than the lessor of the premises).

The question of the intended permanence of installations by or for tenants frequently arises with respect to trade fixtures. Trade fixtures are articles of personal property which a tenant places upon, or annexes to, leased real property for the purpose of carrying on a trade or business. Trade fixtures do not include items which are common to the maintenance and operation of structures in general, such as central air conditioning and heating systems or other plumbing. Trade fixtures which are affixed to real property may be removed by a tenant where removal would not cause substantial injury to the real property to which they are attached, except where there is a lease provision in effect prohibiting such removal. Therefore, having failed to satisfy the criterion of intended permanence, such removable trade fixtures are not considered to become part of the real

property, nor to constitute capital improvements. It should be noted that where a lease provision prohibits removal of a trade fixture, such trade fixture will not constitute a capital improvement unless it satisfies the three statutory criteria for a capital improvement as set forth above.

Two Advisory Opinions of the Tax Commission which deal with trade fixtures are Beaman Corporation (TSB-A-82(32)S) and Pet Crematory Service of America, Inc. (TSB-A-83(21)S).

The following examples will help to illustrate the position stated above:

Example 1 - A retailer operating in a leased building installs a new store front on the building. The lease provides that title to such improvement vests in the lessor immediately upon installation, and that the improvement becomes part of the premises, and remains with the premises when the lease is terminated. Such lease provision establishes that the installation is intended to be permanent.

Example 2 - Assume the same facts set forth in example 1 with an additional lease provision granting the lessor the right to require the lessee to remove the installation when the lease is terminated. The provision vesting title to the improvement in the lessor remains the determining factor in establishing that the installation was intended to be permanent, despite the additional provision which gives the lessor the right to require that the installation be removed.

Example 3 - A tenant contracts for the installation of water supply pipes to run underground from the city water main into his leased building. The nature of the installation establishes the intent of a permanent installation, thereby qualifying the installation as a capital improvement.

Example 4 - 'A' leases a building from 'B'. 'A' later requests permission to install escalators in the building. 'B' grants permission in writing, specifying the escalators are to remain with the premises after the termination of the lease. This written agreement establishes that the installation is intended to be permanent and therefore qualifies as a capital improvement.

Example 5 - A tenant builds a closet and installs kitchen cabinets on the leased premises. A provision of his lease requires that the premises be restored to their original condition when the lease is terminated. As a result of this provision, the installations cannot be intended as permanent and therefore do not qualify as capital improvements.

Example 6 - A tenant installs a water softener in his plumbing system. He rents the water softener from someone other than the lessor of the premises. The water softener is not intended to be a permanent installation and therefore does not qualify as a capital improvement.

Example 7 - 'X' leases a building from 'Y'. 'Y' agrees to install an air conditioning system for 'X' and, pursuant to a lease provision, 'Y' retains title to the installation. The installation of the air conditioning system is a capital improvement to real property.

Example 8 - 'A' operates a department store on premises leased for a period of 10 years. In the second year of the lease 'A' contracts for the construction of a five story parking garage on property owned by the lessor. The lease does not provide for the transfer of the installation to the lessor. However, the nature of the installation establishes the intention of permanence and therefore qualifies the garage as a capital improvement.

Example 9 - 'A' operates a business on leased premises. Local fire laws require the operator of the business to provide a sprinkler system. The lease does not provide for the transfer of the installation of such system to the lessor. Both the nature of the installation and the fact that the sprinkler system is common to the maintenance and operation of any business activity determine the installation qualifies as a capital improvement.