
Coates' Canons Blog: Government Property, Private Leases, and Property Taxes

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[UPDATE: S.L. 2018-98 exempts leasehold interests in exempt government property beginning with the 2019 tax year. As of 2019, leases in government property will no longer be taxable to the lessee.]

Which of the following real property is exempt from local property taxes?

1. A building owned by Blue Devil City and used as city police headquarters.
2. A building owned by Blue Devil City that was previously used as city government office space but is now leased to a private law firm.
3. A lot and building owned by the Carolina County Airport Authority Board that is leased for 20 years to Boeing Co. for use as a commercial aircraft maintenance shop.
4. A building owned by the University of North Carolina-Chapel Hill and leased to the Marriott Corporation for 50 years for use as a hotel.

All four properties are owned by governmental units or agencies, which are exempt owners under N.C.G.S. 105-278.1. But generally property is exempt from property taxes only if it is both owned by an exempt organization *and* used for an exempt purpose. Of these four, only example 1 satisfies both the ownership and the use requirements: the building is owned by an exempt organization (a unit of government) and is being used for an exempt governmental purpose. Does that mean that the government property in examples 2, 3 and 4 are taxable?

No. The government property exemption is unique in that it does *not* include a use requirement. *All* government property is exempt from local property taxes regardless of its use. The properties described in examples 2, 3 and 4 are all exempt because they are owned by governmental units or agencies. It does not matter that the properties are used for commercial activities by non-exempt tenants.

Wait, you say. Aren't North Carolina governments subject to a "public purpose" limitation that restricts the expenditure of public funds for commercial activities? (Yes—here's a great post on that issue by my colleague Kara Millonzi.) And isn't there a statute that limits the commercial activities of N.C. governments? (Yes, N.C.G.S. § 66-58.)

But these limitations on government activities have no relevance to the exempt status of government property. N.C. appellate courts have said as much when rejecting separate attempts by local governments to levy property taxes on buildings owned by state universities because (according to the local governments) the use of those buildings allegedly competed with local businesses. See *In re: Appeal of University of North Carolina*, 300 N.C. 563 (1980), and *In re: Appalachian Student Housing Corp.*, 165 N.C. App. 375 (2004).

The simple rule that all government property is exempt from property taxes is complicated by the Machinery Act's treatment of *leasehold interests* in exempt government property. A leasehold interest is the tenant's right to use the leased property for the term described in the lease. Leasehold interests in exempt real property are one of only two types of intangible personal property that is subject to local property taxation in North Carolina. (The other type of taxable intangible personal property is purchased computer software that is either embedded in computer hardware or capitalized for accounting purposes—see N.C.G.S. 105-275(40).)

Examples 2, 3, and 4 involve leasehold interests in exempt real property that are taxable to the law firm, to Boeing, and to Marriott, respectively. The government entity that owns the real property is never taxable, only the tenant that is leasing space from the government entity.

Leasehold interests are further complicated by the process used to value them for property tax purposes. Most assessors

calculate the tax value of a leasehold interest to be the difference between the market rate for similar space and the actual lease rate for the space. If the lease rate equals the market rate, then the leasehold interest has no taxable value. The tenant will owe tax on the leasehold interest only if the lease rate is less than market rate—that is, if the tenant got a sweetheart deal from the government landlord.

For example, assume that in example 2 the law firm is paying Blue Devil City \$50 per square foot for 5,000 square feet of space in the city-owned office building. If the market rate for similar space is \$75 per square foot, then the law firm's leasehold interest has taxable value because the lease rate is less than the market rate for similar space. That taxable value would be the difference between the market rate per square foot and the lease rate per square foot, multiplied by the number of square feet leased by the law firm: $(\$75 - \$50) \times 5,000 =$ a tax value of \$125,000.

Here's the logic behind the Machinery Act's approach to this type of property: if a lease rate for government property is below market rate for similar property, in effect the government landlord is sharing some of its property tax exemption with the tenant and thereby undercutting rival landlords that are not exempt from property taxes. In order to balance the playing field between the government and competing private landlords, the Machinery Act taxes the "discount" being offered to the tenant.

One final wrinkle. We know that the use of leased government property does not affect the property tax obligations of that government. But can the use of leased government property affect the tax obligations of the *tenant*? The Machinery Act makes clear that it does in one instance: as of 2008, a leasehold interest in exempt government property that is used to provide affordable housing for employees of that government is exempt from property tax. N.C.G.S. 105-275(31e). I think the use of leased government property can also be relevant for other exempt organizations, if that use is consistent with the organization's exempt purpose. For example, assume a non-profit community organization leases property from the city and uses that property for charitable purposes. Regardless of the lease rate, that organization's leasehold interest in the city property should be exempt from property tax, just as is all of the organization's other real and personal property that is used for its exempt purpose.

Links

- www.ncleg.net/Sessions/2017/Bills/Senate/PDF/S561v5.pdf
- www.ncga.state.nc.us/gascripts/statutes/statutelookup.pl?statute=105-278.1
- www.ncga.state.nc.us/gascripts/statutes/statutelookup.pl?statute=66-58
- appellate.nccourts.org/opinions/?c=2&pdf=2004/03-908-1.pdf
- www.ncga.state.nc.us/gascripts/statutes/statutelookup.pl?statute=105-275