
Coates' Canons Blog: What is Exempt Inventory?

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Three times in the past five years North Carolina appellate courts and administrative bodies have wrestled with the question of how to define inventory for purposes of the property tax exclusion created by G.S. 105-275(34). In the first two cases, the courts expanded the inventory exclusion. But this past week the Court of Appeals reversed that trend by concluding that the exclusion does not cover furniture, appliances, and other consumer goods held by a “rent-to-own” business.

Before diving into the most recent inventory exclusion case, *In re: Appeal of Aaron's*, here's a quick summary of how we got to this point.

G.S. 105-275(32a), (33), and (34) create exclusions for “inventories” held by contractors, manufacturers, and retail and wholesale merchants, respectively. G.S. 105-273(8a) defines “inventories” for property tax purposes very broadly. The term covers all “goods held for sale in the regular course of business by manufacturers, retail and wholesale merchants, and construction contractors.” It also covers “packaging materials” involved with the sale (boxes and the like) and raw materials and work in progress held by manufacturers.

Consider Nike, a (terrible, horrible) company that makes and sells shoes. Nike makes many kinds of shoes: running shoes, tennis shoes, basketball shoes, even exploding shoes. (Have I mentioned how much I hate Nike today?) All of those shoes are exempt inventory throughout the entire manufacturing and supply chain and when sold to other wholesalers and retailers. The shoes then become exempt non-business personal property when sold to consumers like you, me, and a generational college basketball talent whose season was ruined by one of those shoes. (Sigh.)

Recent appellate decisions have expanded the inventory exclusion to cover jet planes held for sale by a broker but used for free by third parties (*In re: Corporate Fleet Services*) and tires held by a manufacturer for testing purposes (*In re: Michelin North America*).

The most recent challenge to the scope of the inventory exclusion involved consumer goods owned by the “rent-to-own” business *Aaron's*. The county viewed the sofas, televisions, and washing machines rented by *Aaron's* to consumers as goods held for lease, not for sale, and therefore concluded that the inventory exclusion did not apply. The taxpayer argued that because the lease agreements allowed the customers to purchase the property, that property should be viewed as goods held for sale that are eligible for the inventory exclusion.

After the assessor denied the inventory exclusion for the leased property, the taxpayer appealed to the county board of equalization and review and the state Property Tax Commission (“PTC”). Both ruled in favor of the county. The taxpayer then appealed to the state Court of Appeals, which affirmed the PTC decision and denied the exclusion.

The court rejected *Aaron's* argument that the leases were actually “conditional sales,” basing its conclusion on the fact that the consumers had no obligation to purchase the leased property. The court cited a N.C. Supreme Court decision for the proposition that “[i]f the return of the property is either required or permitted, the instrument will be held to be a lease” rather than a conditional sale.

The court supported its conclusion by pointing out that property in the possession of the consumer under a lease agreement could not be considered to be held for sale by the taxpayer. This reasoning seems to contradict the *Corporate Fleet Services* PTC case mentioned above. In that case, the jets were deemed to be inventory held for sale despite the fact they were regularly used by and under the control of third parties.

The court also noted that very few consumers actually exercised their purchase options under *Aaron's* leases. From 2012

to 2015, the company averaged roughly \$2 billion in annual lease revenue as compared to only about \$35 million in annual retail sales revenue. Those figures make clear that Aaron's consumer goods were held primarily for lease, not for sale.

The reason that an overwhelming majority of Aaron's lease consumers declined the purchase option might have been the premium charged by Aaron's for such purchases. The court cited figures provided by the taxpayer that indicated the purchase price under a lease-to-own agreement was 75% higher than if a consumer purchased the same property from Aaron's through a direct sale. The purchase premium charged to lease-to-own consumers was further evidence that those contracts were truly leases rather than conditional sales.

Because the court's decision denying the exclusion was unanimous, Aaron's does not have an automatic right to appeal to the state Supreme Court. That court could grant a discretionary appeal, but it seems unlikely in a case that does not involve a high-profile or controversial issue. (I think all property tax cases are important, of course, but I have a feeling the N.C. Supreme Court may not agree.)

Assuming this case not overturned on appeal, what guidance does it offer for local tax offices?

First, it affirms the generally accepted belief that property leased to third-parties is not "held for sale" and therefore is not eligible for the inventory exclusion even if there is a possibility that the property might eventually be sold.

Second, it reminds assessors that property tax exclusions should be interpreted narrowly. Taxpayers have the burden of proving they qualify for exclusions, not vice-versa.

Finally, it confirms that PTC decisions are often suspect and should not be viewed as the final determination of legal issues unless and until an appellate court concurs. Although the court in this instance affirmed the PTC, it did so while rejecting the reasoning of the PTC's prior decision in the Corporate Fleet case. An assessor should not shy away from taking action that contradicts an earlier PTC decision if the assessor and their county attorney believe they have solid legal reasoning to support that action.

Links

- www.ncleg.gov/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-275.html
- appellate.nccourts.org/opinions/?c=2&pdf=37635
- www.ncleg.gov/EnactedLegislation/Statutes/HTML/BySection/Chapter_105/GS_105-273.html
- www.marketwatch.com/story/zion-williamson-blows-out-his-shoe-injures-knee-and-nike-gasps-in-horror-2019-02-20
- deadspin.com/zion-williamson-temporarily-activates-his-flying-abililit-1832506609
- www.aarons.com/?gclid=CjwKCAiAkrTjBRAoEiwAXpf9CXkDczEgscJg4TbQBavtaS6gL2ULP-FHdab-vr95Ga6c2gqE2v4dAxoCo6kQAvD_BwE