

WEALTH PRESERVATION AND TAX PLANNING ALERT

www.bergersingerman.com

August 2011

Beware of Potential Sales Tax on Leasehold Improvements

Florida law provides that every person or entity who engages in the business of renting or leasing non-exempt real property in Florida (i.e., the landlord) is deemed to be exercising a taxable privilege in Florida and, therefore, must collect the applicable sales tax from the tenant. Failure to collect the applicable sales tax may result in the landlord having personal liability for that tax, as well as potential criminal exposure (misdemeanor of the first degree). The tenant or person actually occupying, using or entitled to the use of leased property is obligated to pay the sale tax to the tenant's immediate landlord. Florida law further provides that the total consideration subject to this sales tax includes lease payments or credits, whether made directly or indirectly, or other consideration "in kind," furnished by the tenant to the landlord.

The Florida Department of Revenue ("DOR") has taken a hard-line position that these leasehold improvements constructed by tenant pursuant to the lease agreement, which revert to the landlord upon termination of the lease agreement, constitute rental consideration "in kind" as a condition of occupancy and are, therefore, subject to Florida sales tax. The DOR's position is supported by the *Seminole Clubs* case, discussed below.

Seminole Clubs Case

In 1999, the District Court of Appeal of Florida Fifth District in *Department of Revenue, State of Florida, v. Seminole Clubs, Inc.*, 745 So.2d 473 (Fla. 5th DCA 1999), held in favor of the DOR on this issue. In that case, the lease agreement required the tenant to expend a fixed percentage of gross revenues each year on capital improvements, in lieu of rent, and that failure to do so resulted in the tenant having to pay cash rent to the landlord in an amount equal to the "shortfall." In determining the amount of this "shortfall," any capital improvements made by the tenant that exceeded the amount of the required annual improvements would be

carried over from year to year and credited against the amount of the required improvements. Under the lease agreement, the leasehold improvements made by the tenant would revert to the landlord upon termination of the lease. The court concluded that the amount spent by the tenant on leasehold improvements, which were required under the lease agreement, were made "for the privilege of occupancy" and, thus, represented rental consideration (i.e., rent "in kind") which was subject to Florida sales tax.

This case has been the DOR's long-standing basis for its position that the construction of leasehold improvements by the tenant represents rent "in kind" paid to the landlord and, therefore, subject to Florida sales tax. The DOR's current position is that this sales tax on leasehold improvements is payable on or before the 20th day of the month following the month in which the leasehold improvements are completed (not at the end of the lease when the leasehold improvements revert to the landlord).

The DOR's long-standing position has suffered a setback in a recent case, the *Ruehl No. 925, LLC* case discussed below, in which the taxpayer prevailed, albeit on different facts.

Ruehl No. 925, LLC Case

On March 25, 2011, the Circuit Court, Second Judicial Circuit, in *Ruehl No. 925, LLC v. State of Florida, Department of Revenue*, 2009-CA-1503, held in favor of the taxpayer (and against the DOR) on the issue of whether leasehold improvements made by a tenant constitute rental consideration (i.e., rent "in-kind") and, therefore, subject to Florida sales tax. In that case, the two lease agreements in question required the tenant and sole occupant of the lease premises to "totally remodel" the leased premises, although no specific dollar amount

(continued on page 2)

WEALTH PRESERVATION AND TAX PLANNING ALERT

www.bergersingerman.com

August 2011

(continued from page 1)

was designated in the lease for such improvements. These leases provided that the leasehold improvements when installed became and remained the property of the landlord. The tenant paid cash rental payments each month, together with the applicable sales tax, but did not pay any sales tax on the cost of the leasehold improvements. The court, while acknowledging the basic premise that leasehold payments required by a landlord and paid for by a tenant as a condition of occupancy are taxable rental consideration, held that this basic premise did not apply in the instant case for the following reasons:

1. The leases did not state any particular amount that must be spent on the improvements;
2. The leases did not indicate that these improvements were to be completed on a periodic basis. Rather, this was a one-time expenditure made by the tenant in order to put the premises in a condition suitable for the operation of the tenant's business;
3. If the landlord had paid the costs of remodeling, these costs would not be considered rent;
4. There is no evidence in the record to suggest that the requirement in the leases that the tenant pay for the cost of such improvements was an attempt to reclassify what would be rental payments so as to avoid the Florida sales tax;
5. There no evidence in the record to suggest that the amount the tenant spent on improvements for refurbishing the interior of the lease premises was in lieu of rent. Rather, as noted by the court, "it is simply an expense which the tenant had to incur to get the premises in a condition that would be suitable for its intended purposes;" and
6. There was no dollar-for-dollar credit reflected in the lease agreements as was the case in the *Seminole Clubs* case.

This case has been appealed by the DOR to the District Court of Appeal, First District, State of Florida. The DOR, in its initial brief to the court, makes the following arguments:

1. Florida law does not require that the lease fix and recite the dollar amount of all future rent before it is taxable. The DOR states that Section 212.03, Florida Statutes, provides that the "total" rent should be taxed and that this Section makes no exception, exemption or exclusion for amounts that are not fixed at the time of the lease execution.
2. Florida law does not differentiate between periodic rent and one-time expenditures when assessing tax liability. The DOR states that nothing in the tax statute or in the implementing rule suggests a difference between the taxability of monthly, quarterly or other periodic rent payments, and rent payments that are expended in lump sum, and that to suggest otherwise would violate the legislative intent to capture and tax the "total" rental consideration.
3. It is not a prerequisite of taxable rent that an expenditure would be taxable if paid by the landlord. The DOR notes that rent, by definition, is the total consideration furnished by the tenant to the landlord – i.e., stated otherwise, rent is what a tenant or occupant pays, not what a landlord pays.
4. The DOR is not required to prove an attempt at tax avoidance in order to assess a lawful tax. The DOR notes that there is no legal basis for this conclusion and that the DOR is not required to prove attempted tax avoidance or tax evasion in order to assess a lawful tax.
5. The DOR notes that the trial court erred by effectively limiting the taxation of rent "in kind" to the precise facts presented in the *Seminole Clubs* case, involving a dollar-for-dollar credit. Rather, the same reasoning applied in the *Seminole Clubs* case should be equally applicable to the *Ruehl No. 925, LLC* case.

As previously noted, the *Ruehl No. 925, LLC* case is currently on appeal by the DOR. It is not clear whether the DOR will prevail in its

(continued on page 3)

we deliver creative and effective business solutions and counsel

BERGER SINGERMAN

attorneys at law

WEALTH PRESERVATION AND TAX PLANNING ALERT

www.bergersingerman.com

August 2011



(continued from page 2)

appeal. Taxpayers who are under audit on this issue should be aware of this *Ruehl No. 925, LLC* case and should consider filing a written protest of any proposed assessment by the DOR which is based on the *Seminole Clubs* case. Taxpayers who are not currently under audit on this issue should be mindful of these cases and should seek legal advice to determine the appropriate course of action to be taken in light of these cases. ■

The information in this newsletter is of a general nature only and is not intended to be relied upon as, nor a substitute for, specific professional advice. Berger Singerman is not responsible for any loss or damage occasioned to any person in connection with acting on or refraining from action as a result of any material in this publication.

The hiring of a lawyer is an important decision that should not be based solely on advertisements. Before you decide, ask us to send you free written information about our qualifications and experience.

WEALTH PRESERVATION AND TAX PLANNING GROUP

Michael Harris

(561) 893-8717

MHarris@bergersingerman.com

Nick Jovanovich

(954) 712-5144

NJovanovich@bergersingerman.com

Daniel Mielnicki

(561) 893-8705

DMielnicki@bergersingerman.com

Marian Nease

(561) 893-8710

MNease@bergersingerman.com

Sheldon Polish

(954) 712-5132

SPolish@bergersingerman.com

William Shaheen

(561) 893-8732

WShaheen@bergersingerman.com

Alfredo Tamayo

(561) 893-8733

ATamayo@bergersingerman.com