OWNERS FOR TAX PURPOSES ONLY: THE EQUITABLE OWNERSHIP DOCTRINE AND AD VALOREM TAXATION OF LONG-TERM LEASEHOLD INTERESTS

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The equitable ownership doctrine is a common law concept that can convert lessees of real property into owners that are liable for property taxes. In its most ubiquitous form, the doctrine operates to create ad valorem tax liability for long-term lessees.[1] The equitable ownership doctrine is about which party is on the hook for the property tax bill.

The Florida Supreme Court addressed this doctrine in the spring of 2014 through two companion cases: *Accardo v. Brown*, 139 So. 3d 848 (Fla. 2014), and *1108 Ariola, LLC v. Jones*, 139 So. 3d 857 (Fla. 2014). The court held in both cases that a lessee can be converted into an owner of real property or improvements for ad valorem tax purposes even though a tax-exempt government entity holds a fee simple interest in the underlying realty.[2] These cases reaffirm an odd result of the equitable ownership doctrine: Land that would otherwise be tax-exempt in the hands of a government entity can be placed on the ad valorem tax rolls through a government entity's lease of the land to a nonexempt entity.[3] This means that governments can take nonrevenue-producing property and gain one revenue stream through lease payments, and a second revenue stream through ad valorem taxation via the equitable ownership doctrine. The potentially disruptive impact of this dynamic cannot be understated.

The *Accardo* and *1108 Ariola* decisions also create a unique problem for lessees of land owned by government entities. Such lessees may find themselves taxed twice, once on the value of the lease itself through the intangible tax, and again on an ad valorem basis with regard to the underlying property. Practitioners representing lessees of government lands should recognize this issue and help their clients plan accordingly.

Taxation of Leases from Government Entities

Commercial leases are generally subject to commercial rental tax under F.S. §212.031. The tax applies to leases between "government landlords," where a government entity owns

the underlying realty, and non-government lessees.
The normal tax rate is equal to the sales and use tax rate, with a base rate of 6 percent that local governments may increase through discretionary surtaxes.[3]

Leases between a government landlord and a non-government lessee are subject to an additional "intangible" tax on the lease amount.[4] This tax is effectively a "substitute" for the ad valorem taxes that government-owned land is normally exempt from.

Section 196.199 codifies the intangible tax methodology.
This section provides a special methodology for taxing leases of government property when the lessee primarily uses the land for residential or commercial purposes. Section 196.199(2)(b) reads:

Except as provided in paragraph (c), *the exemption* [from tax on government property] *provided by this subsection shall not apply to those portions of a leasehold or other interest defined by s. 199.023(1)(d), Florida Statutes 2005* , subject to the provisions of subsection (7). *Such leasehold or other interest shall be taxed only as intangible personal property pursuant to chapter 199, Florida Statutes 2005, if rental payments are due in consideration of such leasehold or other interest* . All applicable collection, administration, and enforcement provisions of chapter 199, Florida Statutes 2005, shall apply to taxation of such leaseholds. If no rental payments are due pursuant to the agreement creating such leasehold or other interest, the leasehold or other interest shall be taxed as real property. *Nothing in this paragraph shall be deemed to exempt personal property, buildings, or other real property improvements owned by the lessee from ad valorem taxation*.[5]

A ny property falling into the definition of a "leasehold or other interest" as defined by the 2005 version of §199.023(1)(d) is subject to intangible tax on the rental payments given in consideration for the interest.[6]

The reference to the 2005 version of §199.023(1)(d) is a purposeful acknowledgement that the 2005 definition applies to this levy of tax. In 2006, the Florida Legislature repealed §199.023 in its entirety as part of the general repeal of the annual intangible tax.[7] The same chapter of the Laws of Florida that repealed §199.023 *added* language to §196.199 specifying that the 2005 version of §199.023 should be used to determine whether a leasehold is subject to intangible tax under Ch. 199.[8]

As the survivor of the general repeal of §199.023, §199.023(1)(d) (2005) still provides the definition used to determine whether leases of government property qualify as intangible personal property subject to the intangible tax. The section reads:

> *(d) Except for any leasehold or other possessory interest described in s. 4(a), Art. VII of the State Constitution or s. 196.199(7), all leasehold or other possessory interests in real property owned by the United States, the state, any political subdivision of the state, any municipality of the state, or any agency, authority, and other public body corporate of the state, which are undeveloped or predominantly used for residential or commercial purposes and upon which rental payments are due .*[9]

L eases that fit within this definition are subject to the intangible property tax rate, which is set at the relatively low rate of. 05 percent.[10]

Accardo* and *1108 Ariola

The issue in both *Accardo* and *1108 Ariola* was whether the language of §196.199(2)(b) provides the exclusive manner for taxing leases of government property. The statute states that leases from government entities "shall be taxed *only as intangible personal property*. "[11] The lessees argued in both cases that the statute eliminated the possibility of using the equitable ownership doctrine to hold them liable for paying ad valorem taxes on the underlying property.[12]

Importantly, neither case frames the issue as an either/or proposition. The cases do not stand for the proposition that a lessee found to be the equitable owner of the underlying realty must pay ad valorem taxes in lieu of the intangible tax. Instead, the cases stand for the proposition that a lessee found to be the equitable owner of the real property is the owner "for ad valorem tax purposes" only.[13] This does not mean that a finding of equitable ownership automatically erases the lessee's liability for intangible tax under §196.199. The question of whether *Accardo* and *1108 Ariola* create a new tax liability in the form of ad valorem taxation on top of the intangible tax is open for interpretation and further litigation.[14]

The issue before the court in both *Accardo* and *1108 Ariola* was whether the particular circumstances of the lessee's interest in the underlying properties gave rise to ad valorem tax liability under the equitable ownership doctrine.[15] The key to this question is whether the leasehold interests at issue solely constitute " *leasehold or other possessory interests* in real property owned by [government entities], which are undeveloped or predominantly used for residential or commercial purposes and upon which rental payments are due."[16]

The test of whether a lessee is the equitable owner of property it leases from a government entity sounds deceptively simple. The cases hold that if a lessee "holds virtually all the benefits and burdens of ownership," then a court can find the lessee to be the equitable owner of the real property and improvements for ad valorem tax purposes.[17] T his common law standard provides little practical guidance for what benefits and burdens may convey equitable ownership.

In *1108 Ariola*, the petitioner taxpayers argued that the leases were outside the scope of the equitable ownership doctrine because they "have neither the opportunity to acquire legal title to the improvements nor the right to perpetual renewal of their leases." The court rejected this contention and held the equitable ownership doctrine was not defeated by these criteria.[18]

Similarly, in *Accardo*, the leaseholders contested the application of the equitable ownership doctrine to their leases because they had no right to acquire legal title; they had to make rental payments; the leases were on county property; they were obligated to make improvements on the property; and the leases were for less than 100 years despite being perpetually renewable.[19] The court concluded "there is no basis for declining to extend the application of the doctrine of equitable ownership to the underlying land that is subject to the perpetually renewable leases."[20] The cases, therefore, tell us what lease terms are *not sufficient* to defeat a finding of equitable ownership.

The court did not provide specific guidance in *Accardo* or *1108 Ariola* on what factors should be weighed in performing this analysis.[21] The court, instead, explains which factors, if present, will *not automatically* result in a finding that a lessee is *not* the equitable owner of a given parcel. This leaves plenty of room for further litigation on other factors that might impact the analysis.

It must be noted that the survey of potential lease terms in the cases is incomplete. The court implies in a footnote to *Accardo* that the decision does not directly address the question of whether lessees can be deemed the equitable owners of the *underlying land* through leases that are not perpetually renewable.[22] The leases addressed by the court in *Accardo* all contained perpetual renewal provisions. This led the court to hold that "[u]nder the perpetual leases, the interest of the petitioner taxpayers *in the underlying land* is not materially different from their interest in the improvements. The taxpayers hold 'virtually all the benefits and burdens of ownership' of *both the improvements and the land*. "[23]

Accardo left open the question of whether a lease without a perpetual renewal term can grant a lessee equitable ownership in the land itself. This question was not resolved in *1108 Ariola*, either. Instead, the *1108 Ariola* decision held that equitable ownership of improvements to real property — not the land itself — could be granted through leases that did not contain perpetual renewal terms or purchase options.[24] The question of whether a lessee can become the equitable owner of the underlying realty if a lease is not perpetually renewable or lacks a purchase option, therefore, remains open.

The decisions also suggest that the useful life of improvements to real property may impact the equitable ownership analysis. In *1108 Ariola*, the court cited its prior decision in *Gay v. Jemison*, 52 So. 2d 137 (Fla. 1951), in which the lessee was found liable for payment of sales tax on materials used to build improvements to real property because "the 'probable useful life of the buildings' would not exceed the term of the leasehold."[25] Though the court noted that the petitioners did not rely on the useful life of the improvements in their arguments, the court certainly took notice of the relative life of the improvements as compared to the length of the lease to hold that the lessees were the owners of the improvements.[26]

This concept was also raised by the court in *Accardo*. The court quoted a decision by the Court of Federal Claims, *Wright Runstad Props. Ltd. P'ship v. United States*, 40 Fed. Cl. 820 (1998), in support of its holding that a lessee can hold a property interest sufficient to subject it to ad valorem tax liability. The quoted passage from *Wright* reads: "[W]here the lease term is perpetual *or will outlast the useful life of the capital improvement for which the special assessment is levied, the lessee may be responsible for the assessment since he or she is the sole beneficiary of the improvement*. "[27]

The *Wright* case addressed the question of whether the U.S. General Services Administration (GSA) was subject to liability for paying a special assessment levied by the city of Seattle, Washington, due to its status as lessee of space in an office building.[28] The GSA's landlord sued to force the GSA to pay the special assessment under the terms of its lease. The lease term in question required the GSA to pay additional rent "for its share of 'increases in real estate taxes' levied on [the landlord's] property."[29] The question before the court was whether the special assessment was a real estate tax that the lessee had to pay under the terms of the lease.[30]

The Court of Federal Claims engaged in a lengthy discussion of when a lease that obligates a lessee to pay real estate taxes also obligates the lessee to pay special assessments.[31] The court in *Wright* found that the general rule was that such lease

provisions *did not apply* to special assessments.[32] However, an exception to the rule has been found when the lease is perpetual or when the lease term is longer than the useful life of the capital improvement financed by the special assessment.[33] In such cases, the lessee is the sole beneficiary of the improvement and is, therefore, liable for paying it under a tax clause in a lease.[34]

It is significant that the court found the useful life of an improvement persuasive in the context of an equitable ownership analysis. The significance of this concept is underlined by its appearance in both *Accardo* via the citation to *Wright*, and in *1108 Ariola* via its discussion of *Gay*.[35] Practically, attorneys facing equitable ownership issues in the future may be able to argue that a lease that does not capture the entire useful life of an improvement does not convey an equitable ownership in the full value of that improvement.

Potential Course of Future Litigation

The court's reaffirmation of the equitable ownership doctrine may create incentives for government entities to convert their land into taxable property through leases to private entities. Depending on the extent of the lessee's dominion over the property — in exercising or bearing "virtually all the benefits and burdens of ownership" — property owned by government entities in fee simple can be converted into property on the ad valorem tax rolls. A government body could be incentivized by these decisions to lease out its property in hopes of collecting additional tax revenues. Though this might be a far-fetched scenario at the moment, the legal framework reaffirmed by *Accardo* and *1108 Ariola* has made this potential revenue-raising maneuver plausible.

The equitable ownership concept is ripe for litigation in the future. The number of government leases to private lessees has grown as Florida has developed. Those private lessees may now find themselves liable for ad valorem taxes on the improvements to the land or the underlying realty itself. Without clear guidance on how much ownership is enough to trigger the equitable ownership doctrine, this will be fertile ground for future litigation.

[1] The doctrine has also been applied to hold lessees liable for other taxes as well. In the case of *Gay v. Jemison*, 52 So. 2d 137 (Fla. 1951), a private contractor leased real property for a term of 75 years from the U.S. government to build housing for military personnel. The question before the court was whether the private contractor or the U.S. government was the ultimate owner of the improvements. If the private contractor was the owner, then the contractor had to pay sales tax on its purchase of materials to

construct the improvements. *Id*. at 138. The court held that the private contractor — though a lessee — bore the burden of the tax because the improvements would not become tax-exempt "part[s] of public works or projects owned by the United States Government." *Id*. The lessee, therefore, became the owner of the improvements even though the U.S. government owned the property in fee simple.

[2] *Accardo*, 139 So. 3d at 857; *1108 Ariola*, 139 So. 3d at 859.

[3] For this to occur, the factors relevant to determining equitable ownership would have to be present in the lease transaction. Not every lease will qualify for such treatment, though some assuredly will.

[4] Fla. Stat. §212.031(1)(a), (c) (tax on commercial leases); *see also* Florida Department of Revenue, *Commercial Rental Standard Industry Guide*, Publication No. GT-300122P at 9 (March 6, 2014) (explaining the tax rates applied to commercial leases).

[4] Fla. Stat. §196.199(2)(b),

[5] Fla. Stat. §196.199(2)(b) (emphasis added).

[6] *See id.*

[7] Ch. 2006-312, §1, Laws of Fla. (2006) (repealing §199.023 and other sections of Ch. 199).

[8] Ch. 2006-312, §9, Laws of Fla. (2006) (amending §196.199(2)(b)).

[9] Fla. Stat. §199.023(1)(d) (2005) (emphasis added).

[10] The Government Leasehold Intangible Personal Property Tax Return form (Form DR-601G) provides practical guidance on how to calculate the amount of tax due under various circumstances under the rate of. 05 percent.

[11] Fla. Stat. §196.199(2)(b) (emphasis added).

[12] *See 1108 Ariola,* 139 So. 3d at 860, *reh'g den.* (May 22, 2014); *Accardo*, 139 So. 3d at 852, *reh'g den.* (May 22, 2014).

[13] *Accardo*, 139 So. 3d at 857; *1108 Ariola*, 139 So. 3d at 860.

[14] Further development of this argument is beyond the scope of this article.

[15] *Accardo v. Brown*, 63 So. 3d 798, 799 (Fla. 1st DCA 2011). The leasehold interests in both cases are unique, but the singular nature of the chain of title to the property at issue is not central to the holdings. The First District opinion in *Accardo* provides an excellent discussion of the unique chain of title at issue. The United States was the original title holder, and ultimate title was finally vested in the county governments of Santa Rosa and Escambia counties. No private landowner was ever involved in the chain of title for the properties.

[16] *Accardo*, 139 So. 3d at 851.

[17] *Id*. at 856; *1108 Ariola*, 139 So. 3d at 860.

[18] *1108 Ariola*, 139 So. 3d at 859-860.

[19] *Accardo*, 139 So. 3d at 851-852.

[20] *Id*. at 856.

[21] This is not a criticism of the court's reluctance to engage in drawing bright lines in this area. The author has observed that courts drawing bright lines often leave fuzzy edges that are racked with their own sets of ambiguities. *See* Steven M. Hogan & Jennifer S. Ivey, *What Every Entrepreneur Should Know About Taxation of Internet Commerce*, 18 J. of Internet L. 3, 14 (Sept. 2014) (discussing the ambiguities that have abounded in taxation of Internet and mail-order sales since the U.S. Supreme Court drew a bright line on the issue in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)). Drawing bright lines is a difficult business.

[22] *Accardo*, 139 So. 3d at 852 n.2 ("The petitioner taxpayers point out that some of the subleases are not perpetually renewable, but they do not make an argument that is specific to those leases.").

[23] *Accardo*, 139 So. 3d at 856 (emphasis added) (quoting *Leon Cnty. Educ. Facilities Auth.*, 698 So. 2d at 530).

[24] *1108 Ariola*, 139 So. 3d at 858.

[25] *Id.* at 860 (quoting *Gay v. Jemison*, 52 So. 2d 137, 138-39 (Fla. 1951)); *s ee also* note 1 discussing *Gay*.

[26] *1108 Ariola*, 139 So. 3d at 860.

[27] *Accardo*, 139 So. 3d at 855 (emphasis added) (quoting *Wright*, 40 Fed. Cl. at 825. This quotation was made in the court's discussion of a case from the First District that addressed equitable ownership of leasehold interests on Navarre Beach. In that case, *Ward v. Brown*, 919 So. 2d 462 (Fla. 1st DCA 2005), the First District quoted *Wright* in support of its holding that lessees were equitable owners of real property and subject to ad valorem taxation).

[28] *Wright*, 40 Fed. Cl. at 821.

[29] *Id*. at 824.

[30] *Id*.

[31] *Wright*, 40 Fed. Cl. at 825.

[32] *Id*.

[33] *Id*.

[34] *Id*.

[35] Though the discussions in both cases are outside of the holding and technically dicta, the court clearly found the issue significant enough to include in each opinion.

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