taxnotes®

state & local

Volume 85, Number 6 ■ August 7, 2017

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Reprinted from *State Tax Notes*, August 7, 2017, p. 601

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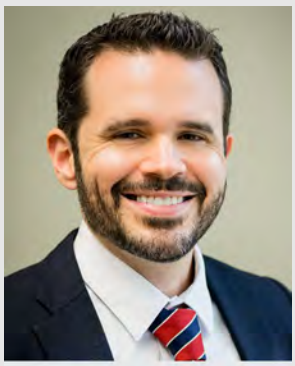

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In this edition of Florida Tax Today, Hogan discusses the state's tax on commercial leases, particularly situations in which related-party transactions could result in an assessment.

Florida is the only U.S. jurisdiction that taxes commercial leases — a situation that often surprises taxpayers.[1] Periodic attempts to repeal the tax have been unsuccessful, though a recently enacted law reduced the tax rate by two-tenths of a percentage point.[2]

A question we frequently get is how to handle "lease" transactions between related parties. Lease is in quotes above because for many of those transactions the landlord and the tenant entities are owned by the same people. Businesses in that position may not even realize that they have created a taxable commercial lease.

Take, for example, a medical practice. The doctors may form a limited liability company to own the real property and the building where the medical practice does business. The doctors may form a professional association (or other entity) to conduct their business. Imagine that in this arrangement, the LLC is owned by the same doctors who own the association. Is the association renting the building from the LLC? Is that a taxable commercial lease? The answer, as is often the case in tax law, is that it depends.

## What Is Rent?

Florida Statutes section 212.031 states that tax is due on "the total rent or license fee charged" for the privilege of "renting, leasing, letting, or granting a license for the use of any real property."[3] To get at the meaning of this section, we must ask the question: What counts as rent that is charged for the privilege of renting real property?

In 1972 the Leon County Circuit Court answered that question in *Seaboard Coast Line Railroad Co. v. Askew*.[4] The *Seaboard* case involved a written lease between a corporation and a wholly owned subsidiary. The lease required the lessee to directly pay the ad valorem property taxes on the real property. The question before the court was whether that property tax payment was taxable rent under section 212.031.[5]

The *Seaboard* court held that because the lessee paid the property taxes for the lessor, such payment was "for account of the owner and for his benefit." Therefore, the payment was rent because it was contemplated by the parties as part of the rental transaction.

[1] *See* Allison Graves, "Yes, Florida Really Is the Only State to Tax Commercial Leases, as Gov. Rick Scott Said," Politifact.com, Mar. 8, 2017.

[2] The state-level rate was lowered from 6 percent to 5.8 percent in the 2017 legislative session. *See* 2017 Fla. Laws Ch. 2017-36, section 21.

[3] Fla. Stat. section 212.031(1)(a), (c).

[4] Case No. 72-15 (Fla. Cir. Ct., 1972). *Seaboard* is often cited in Florida tax decisions, but it is not easily found on most legal databases. Fortunately, the circuit court two blocks from the author's office still has the *Seaboard* file.

[5] The modern version of section 212.031 is materially the same in the way that the statute describes taxable rent as the version in effect in 1972.

Further, the court held that there was no impermissible pyramiding of taxes — that is, imposing tax on a tax — because the payment of the property taxes by the lessee was actually rent. Essentially, the court found that the lessee's payment of the property taxes was a discount on the rental amount that would have otherwise been paid. The court summed up its reasoning by stating: "No tax is imposed upon a tax. A tax is imposed upon a transaction and measured by the rent."[6]

*Seaboard* eventually made its way into the Florida Administrative Code, which now contains a provision stating that "ad valorem taxes paid by the tenant or other person actually occupying, using, or entitled to use any real property to the lessor or any other person on behalf of the lessor, including transactions between affiliated entities, are taxable."[7]

The concept underlying the rule, as articulated in *Seaboard*, is that any amount paid by a lessee for the right to occupy real property is likely to be seen as taxable rent by the state. That concept is the foundation for examining the taxability of related-party commercial leases.

## When Is Rent Paid Between Related Parties?

For related parties, especially entities with a common ownership, the details are critical in determining whether a taxable rental transaction occurred. *Seaboard* teaches that the commercial rental tax is measured by the rent. So the question is whether a taxable rental transaction has occurred, and if so, how much taxable rent has changed hands.

The analysis must start with *St. Johns Trading Co. Inc. v. Department of Revenue*.[8] This was an administrative case that resulted in a recommended order issued by an administrative law judge. The order was adopted in full by the DOR. That means the recommended order is the position of the DOR on the facts presented.[9]

In *St. Johns*, related entities served as the landlord and tenant for several retail stores. The landlord and tenant entities had common ownership. No written lease existed between those entities. The common owners operated other stores that paid rent to third-party landlords. To track the profitability of the stores occupying real property owned by the related landlord, the common owners made book entries in the accounting system tracking rent as intercompany transfers. According to the recommended order, those were merely accounting entries that did not represent actual dollars that would ever be paid. Based on these facts, no taxable rent was found to be paid. Therefore, even if a landlord-tenant relationship existed, the rent charged was zero. Because of that, there was no tax due.

A similar result was reached in *Department of Revenue v. Ryder System Inc.*[10] In *Ryder*, the trial court held that no landlord-tenant relationship existed between related entities and that no rent had been paid between them.[11] The appellate court affirmed the trial court's conclusion that in such circumstances, no tax was due.[12]

When the facts show that rent has been paid between related entities, then the state has the power to tax the amount that changes hands. For example, in *Regal Kitchens Inc. v. Department of Revenue*,[13] the appellate court found that payments between related entities under a written lease were taxable.[14]

The lesson from these cases is that if actual payments are made between related entities that can be characterized as rent, tax may apply to

[6] *Seaboard*, at 3. Pyramiding of the commercial rental tax is prohibited by both the modern version of section 212.031(2)(b) and the version in effect in 1972. The pertinent portion states that "it is the further intent of this Legislature *that only one tax be collected on the rental or license fee payable for the occupancy or use of any such property, that the tax so collected shall not be pyramided by a progression of transactions*, and that the amount of the tax due the state shall not be decreased by any such progression of transactions" (emphasis added).

[7] Fla. Admin. Code r. 12A-1.070(4)(c).

[8] Case No. 84-1652, Florida Department of Administrative Hearings (1984) (final order adopting recommended order issued Jan. 3, 1985).

[9] *See* Fla. Stat. section 120.57 (agency final orders in administrative actions).

[10] 406 So. 2d 1299 (Fla. Dist. Ct. App. 1981).

[11] *Id*. at 1299.

[12] *Id*.

[13] 641 So. 2d 158 (Fla. Dist. Ct. App. 1994).

[14] *Id*. at 161. *Regal Kitchens* also discussed a now-repealed exemption for payments between related parties that serviced debt on which the parties were equally liable. This exemption no longer appears in the regulations. Such payments are now expressly deemed to be taxable rent. *See* Fla. Admin. Code r. 12A-1.070(19)(c).

such payments. The specific circumstances of each transaction will carry the day.[15]

### Who Pays the Tax?

If there is rent between related parties, which one is on the hook for the tax? The answer is both.

Florida law provides that both the lessee and the lessor can be liable for nonpayment of the commercial rental tax. This means the DOR can assess unpaid taxes against either the lessee or the lessor — it depends on which entity gets audited first. The basis for this is found in Florida Statutes section 212.07(8), which states that any lessee who paid taxable rent "and cannot prove that the tax levied by this chapter has been paid to his or her . . . lessor . . . *is directly liable to the state* for any such taxable transactions."[16]

That lessee liability exists despite the lessor's primary duty to register with the state and to remit the tax amounts due.[17] Because of this, commercial lessees must take care to ensure that they can prove tax was paid to the lessor to defend against potential audits.

When advising related entities, remember: The details will carry the day! ■



[15] Technical assistance advisements issued by the department are useful guides for particular situations. Sometimes, the facts indicate that tax is not due. *See* Florida DOR, TAA 04A-032 (May 18, 2004); Florida DOR, TAA 04A-068 (Dec. 21, 2004); and Florida DOR, TAA 05A-039 (Sept. 28, 2005). Sometimes, the facts indicate that tax is due. *See* Florida DOR, TAA 03A-039 (June 22, 2003); Florida DOR, TAA 07A-011 (Apr. 11, 2007); and Florida DOR, TAA 06A-004 (Apr. 11, 2006).

[16] Fla. Stat. section 212.07(8) (emphasis added). The statutory language is mirrored in the department's regulations. *See* Fla. Admin. Code r. 12A-1.070(16).

[17] Fla. Stat. section 212.07(3). *See Schnurmacher Holdings Inc. v. Noriega*, 542 So. 2d 1327, 1329 (Fla. 1989) (the burden is on the lessor to collect the tax, but the lessee has the burden to pay the tax, regardless of whether the lessor collects it).