

# The Economic Substance Doctrine in Florida Property

by Steven M. Hogan

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In this second installment of Florida Tax Today, Hogan outlines how looking through a transaction to discover its substance affects property tax planning.

The author invites comments on how the doctrine can affect state tax principles in other fields as well. Hogan can be contacted at [shogan@ausley.com](mailto:shogan@ausley.com).

### Tax-Exempt Property Use

The Florida Legislature has declared that property owned by tax-exempt entities is "totally exempt" from ad valorem taxation if the property is used exclusively for exempt purposes.<sup>1</sup> If the exempt entity uses its real property predominantly for exempt purposes, the exemption is granted to the "extent of the ratio" that the predominant, exempt use bears to the nonexempt use.<sup>2</sup>

Whether an exempt entity is predominantly using its property for an exempt use is fundamentally a question of substance over

form. Section 196.196 sets forth the criteria to use in making that determination.<sup>3</sup> An inquiry into whether the purportedly exempt entity is actually a nonprofit under chapter 196 requires a similar analysis based on its own statutory factors.<sup>4</sup>

Those concepts are illustrated by *Palm Beach Community Church v. Nikolits*<sup>5</sup> and *TEDC/Shell City Inc. v. Robbins*.<sup>6</sup>

In *Nikolits*, the question before the court of appeal was whether raw land purchased by a church in anticipation of building a new church facility was entitled to an ad valorem property exemption under section 196.196. The court affirmed the trial court's determination that the property was not predominantly used for religious purposes when the church had attempted to sell part of it for private development, and no construction activity on a new church building had begun.<sup>7</sup> The church's plan for future development on the site was not enough to gain an exemption in the present in the absence of actual development activity.<sup>8</sup>

In *Robbins*, the question was whether the property owner was a tax-exempt entity under section 196.195. A development corporation obtained real property from Dade County for no consideration. The land was conveyed under a restrictive deed that required the corporation to build low-income housing in a manner overseen

<sup>3</sup> Fla. Stat. section 196.196 (criteria for determining whether property is entitled to exempt status).

<sup>4</sup> Fla. Stat. section 196.195 (criteria for determining whether an entity is for-profit or nonprofit).

<sup>5</sup> *Palm Beach Community Church v. Nikolits*, 835 So. 2d 1274 (Fla. 4th DCA 2003).

<sup>6</sup> *TEDC/Shell City Inc. v. Robbins*, 690 So. 2d 1323 (Fla. 3d DCA 1997).

<sup>7</sup> *Nikolits*, 835 So. 2d at 1275.

<sup>8</sup> *Id.*

<sup>1</sup> See Fla. Stat. section 196.192(1).

<sup>2</sup> Fla. Stat. section 196.192(2).

by the county. The deed could be enforced to cause the property to revert to the county if any restriction was violated.<sup>9</sup>

For building the low-income housing, the corporation realized some federal tax benefits that were passed along to its shareholders.<sup>10</sup> The court held that the passthrough of those benefits was sufficient to disqualify the corporation from tax-exempt treatment, as section 196.195(3) requires that “no part” of the property can “inure to the benefit” of the shareholders of a purportedly exempt property owner.<sup>11</sup>

These cases illustrate the importance of looking through to the economic substance of the use and ownership of property subject to ad valorem property taxes. The planner should ensure that the entity that owns the property is truly exempt and that the predominant use of the property for exempt purposes is clearly documented.

### Equitable Ownership

The substance-over-form concept reaches its apex in the property tax arena within the concept of equitable ownership. Equitable ownership is a common law doctrine that can convert lessees of real property into owners liable for property taxes. In its most ubiquitous form, the doctrine operates to create ad valorem tax liability for long-term lessees. The equitable ownership doctrine is about which party is on the hook for the property tax bill.

Equitable ownership concepts often arise in the context of long-term leases of real property owned by a governmental entity. Leases between a government landlord and a nongovernment lessee are subject to an additional intangible tax on the lease amount.<sup>12</sup> That tax is effectively a substitute for the ad valorem taxes that government-owned land is normally exempt from. The intangible tax is imposed on those leases at a relatively low 0.05 percent rate.<sup>13</sup>

Recent cases illustrate that concept in action. In *Accardo v. Brown*<sup>14</sup> and *1108 Ariola LLC v. Jones*,<sup>15</sup> the Florida Supreme Court held 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.<sup>16</sup>

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,” a court can find the lessee to be the equitable owner of the real property and improvements for ad valorem tax purposes.<sup>17</sup> That 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 state supreme court rejected that contention and held that the equitable ownership doctrine was not defeated by those criteria.<sup>18</sup>

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.<sup>19</sup> The supreme court concluded that “there is no basis for declining to extend the application of the doctrine of equitable ownership to the underlying land that is subject to

<sup>9</sup> *Robbins*, 690 So. 2d at 1323.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 1325.

<sup>12</sup> Fla. Stat. section 196.199(2)(b).

<sup>13</sup> Form DR-601G, “Governmental Leasehold Intangible Personal Property Tax,” provides practical guidance on how to calculate the amount of tax due under various circumstances under the 0.05 percent rate.

<sup>14</sup> *Accardo v. Brown*, 139 So. 3d 848 (Fla. 2014).

<sup>15</sup> *1108 Ariola LLC v. Jones*, 139 So. 3d 857 (Fla. 2014).

<sup>16</sup> *Accardo*, 139 So. 3d at 857; and *1108 Ariola*, 139 So. 3d at 859.

<sup>17</sup> *Accardo*, 139 So. 3d at 856; and *1108 Ariola*, 139 So. 3d at 860.

<sup>18</sup> *1108 Ariola*, 139 So. 3d at 859-860.

<sup>19</sup> *Accardo*, 139 So. 3d at 851-852.

the perpetually renewable leases.”<sup>20</sup> Therefore, the cases tell us what lease terms are not sufficient to defeat a finding of equitable ownership.

The court did not provide guidance in *Accardo* or *1108 Ariola* on what factors should be weighed in that analysis. Rather, the court explained which factors, if present, will not automatically result in a finding that a lessee is not the equitable owner of a given parcel.

A partial clarification of the factors that matter for the equitable ownership analysis was provided in *Russell v. Southeast Housing LLC*.<sup>21</sup> The question in *Russell* was whether a private company that built housing for the U.S. Navy was the equitable owner of the improvements it created, or whether the U.S. Navy retained the “equitable and beneficial ownership” of the properties.<sup>22</sup> The Third District held that under the facts before it, the Navy was the owner of the entire project.<sup>23</sup>

The court examined the following factors that it found material to the inquiry:

- use of the improvements was limited to military housing (this factor weighed in favor of the Navy’s ownership of the property, but by itself determined little);
- the Navy oversaw the construction (weighed in favor of the Navy’s ownership, but not dispositive);
- the Navy directs the rental of the improvements (weighed in favor of the Navy’s ownership; by itself, it did not determine the issue);
- the Navy controlled access to the improvements (weighed heavily in favor of the Navy’s ownership; an owner would rarely grant a non-owner the power to control access to the owner’s property);
- the Navy supervised operation of the improvements during the lease term (weighed heavily in favor of the Navy’s ownership; the Navy was heavily involved in the operation of the housing business);

- the Navy benefits from revenues paid for use of the improvements and received the “lion’s share” of the profits (weighed heavily in favor of the Navy’s ownership);
- the Navy owns the improvements at the end of the lease (long recognized as an incident of equitable ownership; weighed in favor of the Navy’s ownership); and
- transfer of title occurred in order to accomplish something other than transfer of ownership (the transaction was structured so as to circumvent a federal limitation on payment of housing allowance to a government property owner; this indicated that the ownership in truth was retained by the Navy).<sup>24</sup>

As a result of the court weighing those factors, the Navy was held to be the equitable owner of the improvements.<sup>25</sup>

The *Russell* case is instructive, as it shows what factors may weigh into the determination that a lessee is — or is not — the equitable owner of real property. That analysis is a quintessential exercise in a substance-over-form analysis.

### Conclusion

In the property tax arena, planners are advised to consider whether the nature of the property’s use will affect the ultimate liability for property taxes. A property’s use may result in loss of a charitable exemption, or murky questions of ad valorem tax liability. These economic substance factors must be weighed when considering transactions in Florida. ■

<sup>20</sup> *Id.* at 856.

<sup>21</sup> *Russell v. Southeast Housing LLC*, 162 So. 3d 262 (Fla. 3d DCA 2015).

<sup>22</sup> *Id.* at 263.

<sup>23</sup> *Id.*

<sup>24</sup> *Russell*, 162 So. 3d at 268-272.

<sup>25</sup> *Id.* at 272-273.