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Hogan launches his column Florida Tax Today with the first of a two-part series exploring Florida's economic substance doctrine in the sales and use tax realm.

While the economic substance doctrine is well known in the world of federal income taxation,[1] the concept of looking through a transaction's structure to see its substance is less well known in the state tax arena. Fortunately for practitioners in Florida, economic substance principles can be used to plan transactions in a tax-efficient way.

This is the first of two articles analyzing the economic substance doctrine in Florida. This article addresses the concept in the sales and use tax realm, and the second will discuss economic substance principles in the property tax field. I invite comments on how the doctrine can affect state tax principles in other fields as well.

[1] So much so that it is codified in IRC 7701(o).

I. The General Rule: Form Over Substance

Form normally rules over substance in Florida sales and use tax. This is because sales and use tax is an excise tax on a transaction, such as the transfer of tangible personal property or a taxable service between the seller and the ultimate consumer. The tax is an excise tax on the privilege of engaging in the business of selling, using, renting, or storing the property, or in delivering a taxable service.[2]

Because the *transaction* is critical, where it occurs takes on additional importance. Within Florida, each county has the option to levy a discretionary surtax of up to 1.5 percent on top of the 6 percent state tax.[3] A sale in a county with a 1.5 percent surtax will cost more than it would in a county with no surtax.

This also plays out in transactions between states. From Florida's perspective, the key for sales and use tax analysis is whether the transaction occurs within the state.

The sales tax is collected from dealers that sell tangible personal property within Florida.[4] Florida's ability to collect sales tax from dealers outside of Florida is limited to those who have substantial nexus with the state.[5]

The use tax applies to consumers who receive tangible personal property shipments within Florida from dealers who do not collect the sales tax, whether due to the lack of substantial nexus or

[2] *Campus Communications Inc. v. Department of Revenue*, 473 So. 2d 1290, 1293 (Fla. 1985).

[3] Fla. Stat. section 212.055 (discretionary surtax); and Fla. Stat. section 212.05 (state sales and use tax rate).

[4] Fla. Stat. section 212.06(1)(a), (2) (sales tax collectable from dealer; defining the term "dealer").

[5] *Quill Corp. v. North Dakota*, 504 U.S. 298, 312-313 (1992); *Department of Revenue v. Share International Inc.*, 676 So. 2d 1362, 1363 (Fla. 1996) (applying the *Quill* "substantial nexus" test).

through simple neglect.[6] In this way, "the two taxes, sales and use, stand as complements to each other, and taken together provide a uniform tax upon either the sale at retail or the use of all tangible personal property irrespective of where it may have been purchased."[7]

This dynamic lends itself to planning opportunities. For example, in Florida a company that manufactures and installs tangible personal property under a real property improvement contract is both the manufacturer and ultimate consumer of the tangible personal property.[8] Because the manufacturer is the consumer of the items it manufactures, use tax is due on the fabricated cost of manufacturing those items[9] — meaning that the manufacturer has to pay tax on its overhead.[10]

The fabricated cost calculation under the rule is a time-consuming process rife with opportunities for error. Because the sales tax is an excise tax on a particular transaction, this problem can be planned around.

For example, the planner can split the company into two entities: Manufacturing Co. and Installing Co. With this structure, Manufacturing Co. can create and sell the tangible personal property to Installing Co. at a specified price. This price should be an approximation of fair market value to the greatest extent possible. The point is not to understate the cost; rather, the point is to make the cost predictable.

The sales tax will be due on the price Manufacturing Co. charges Installing Co. for the property, because Installing Co. is the ultimate consumer.[11] The planner is well-advised to get a technical assistance advisement memorializing the tax treatment of the reorganization.

II. The 'Supply House' and Public Works

The planning opportunities in sales and use tax are also illustrated by the "supply house" concept. Normally, a contractor performing a real property construction contract must pay tax on its construction materials because it is the ultimate consumer of those materials.[12]

When a tax-exempt entity purchases the construction project from the contractor, it can lower the price of the overall contract by purchasing the construction materials directly. This can take the form of a supply house vendor buying the construction materials for resale to the tax-exempt entity. The supply house vendor furnishes a resale certificate to the seller of the construction materials and receives a tax exemption certificate from the tax-exempt entity upon resale. The contractor then uses those materials in performing the construction contract.

As long as the supply house vendor is not also the contractor, this structure results in a tax-free purchase of the construction materials. This structure is detailed in TAA 94A-061 (1994) and TAA 93A-075 (1993).[13]

This formalism reaches its limit, however, in the case of public works construction contracts. The rules define public works as:

> Projects for public use or enjoyment, financed and owned by the government, in which private persons undertake the obligation to do a specific piece of work that involves installing tangible personal property in such a manner that it becomes a part of a public facility. For purposes of this rule, a public facility includes any land, improvement to land, building, structure, or other fixed site and related infrastructure thereon owned or operated by a governmental entity where governmental or public activities are conducted. The term "public works" is not

[6] Fla. Stat. section 212.06(8) (use tax).

[7] Fla. Admin. Code r. 12A-1.091(4). *See also Scripto Inc. v. Carson*, 105 So. 2d 775, 779 (Fla. 1958) (discussing complementary aspects of sales and use taxes).

[8] Fla. Admin. Code r. 12A-1.051(4).

[9] *Id.*

[10] Fla. Admin. Code r. 12A-1.051(2)(a) (defining fabricated cost); and Fla. Admin. Code r. 12A-1.043 (calculating methods for determining fabricated cost as defined in rule 12A-1.051(2)(a)).

[11] A TAA (technical assistance advisement) issued by the Florida Department of Revenue functions similarly to an IRS private letter ruling. *See* TAA 09A-012 (2009), detailing this type of transaction.

[12] Fla. Admin. Code r. 12A-1.051(4).

[13] These TAAs reference former rule 12A-1.001(3)(a), Fla. Admin. Code, as it applied to tax-exempt religious organizations. This rule, which is no longer in effect, directly addressed the tax-exempt nature of sales to religious organizations. These organizations are still exempt. Fla. Stat. section 212.08(7)(m). The reasoning of the cited TAAs would still apply so long as the exempt organization qualified for and received an exemption certificate under Fla. Admin. Code r. 12A-1.038.

> restricted to the repair, alteration, improvement, or construction of real property and fixed works, although such projects are included within the term.[14]

A governmental entity can purchase materials for use in a public works contract and avoid sales tax in a structure similar to that of the supply house example. As in the supply house structure, the government entity's exempt status does not matter if the materials are purchased by the same vendor that installs them on the project. This means that any sales of construction materials made to a public works contractor, or the contractor's manufacturing of tangible personal property, is taxable if the materials or property are installed by the contractor.[15]

Public works contracts differ from the supply house concept in that the rules establish an economic substance test for whether a purchase is actually made by the government entity in the public works context. To that end, the rule states that:

> A determination whether a particular transaction is properly characterized as an exempt sale to a governmental entity or a taxable sale to or use by a contractor *shall be based on the substance of the transaction, rather than the form in which the transaction is cast*. The Executive Director or the Executive Director's designee in the responsible program will determine whether the substance of a particular transaction is a taxable sale to or use by a contractor or an exempt direct sale to a governmental entity based on all of the facts and circumstances surrounding the transaction as a whole.[16]

The rule goes on to specify criteria that the Department of Revenue may use to determine whether a sale was truly to the government entity, and thereby exempt. These criteria are:

Direct purchase order: The governmental entity must issue its purchase order directly to the vendor supplying the materials the contractor will use and provide the vendor with a copy of the governmental entity's Florida Consumer's Certificate of Exemption.

Direct invoice: The vendor's invoice must be issued to the governmental entity rather than to the contractor.

Direct payment: The governmental entity must make payment directly to the vendor from public funds.

Passage of title: The governmental entity must take title to the tangible personal property from the vendor at the time of purchase or delivery by the vendor.

Assumption of the risk of loss: Assumption of the risk of damage or loss by the governmental entity at the time of purchase is a paramount consideration. A governmental entity will be deemed to have assumed the risk of loss if it bears the economic burden of obtaining insurance covering damage or loss or directly enjoys the economic benefit of the proceeds of that insurance.[17]

The planner is well-advised to document as many of these criteria — and any others that may be relevant — when structuring a public works contract in this manner.[18]

III. Synthetic Leases

Substance decisively rules over form in the case of synthetic commercial lease transactions. Commercial leases are normally subject to Florida sales tax.[19] A synthetic lease — though it may be termed a lease by the parties and treated as such for accounting purposes — is not subject to the commercial lease tax because it is not a real lease.

A commercial lease of real property becomes synthetic when its true purpose is to secure financing.[20] In *Bridgestone*, the hearing officer

[14] Fla. Admin. Code r. 12A-1.094(1)(c).

[15] Fla. Admin. Code r. 12A-1.094(1)(a), (3) (defining "contractor" under the rule; explaining taxable status when contractor installs the property).

[16] Fla. Admin. Code r. 12A-1.094(4)(a) (emphasis added). This adds an element of risk to these types of transactions.

[17] Fla. Admin. Code r. 12A-1.094(4)(b).

[18] TAA 06A-023 (2006) documents an example of how this can go wrong for the planner in several ways at once.

[19] Fla. Stat. section 212.031(1), Florida is unique in imposing tax on commercial leases.

[20] *Bridgestone/Firestone Inc. v. Department of Revenue*, DOAH Case No. 92-2483 (Final Order Nov. 5, 1993). DOAH refers to the Florida Division of Administrative Hearings.

considered whether a sale-leaseback transaction was properly characterized as a commercial lease — and therefore subject to tax — or whether it was truly a vehicle for obtaining financing.

The hearing officer looked through to the economic substance of the transaction to determine that the transaction was not a real lease, but a synthetic one. The hearing officer determined that the lease was really a mortgage, as it was intended to secure financing. The officer analogized to Florida Statutes section 697.01, which extends the definition of mortgage to any instrument executed "for the purpose or with the intention of securing the payment of money."[21]

The hearing officer quoted the Florida Supreme Court's interpretation of section 697.01 as requiring an inquiry into the true nature of a transaction to determine whether it was a mortgage.[22] The quoted portion reads:

> It appears that this court, many years ago, . . . held generally, independent of this statute (s. 697.01), that parole evidence is admissible in equity to show that a deed of conveyance, absolute upon its face, was intended as a mortgage, *and where it is shown that such a conveyance has been executed to secure the payment of money, equity will treat it as a mortgage. The court looks at substance rather than form, makes inquiry and hears evidence beyond the terms of the instrument to the very heart of the transaction so as to determine the intent of the parties* and all admissible evidence bearing upon this broad equitable principle is received and considered by the court, whether written or oral, as it is the intention of equity to promote justice and to prevent fraud and imposition.[23]

The DOR has confirmed the continuing vitality of the *Bridgestone* analysis in the context of synthetic leases in several technical assistance advisements.[24]

IV. Conclusion

The distinction between the form and substance of a transaction under economic substance principles presents a useful tool for planners under Florida law. This article has addressed these concepts in the sales and use tax context. The next installment in our two-part series will address similar issues in the context of Florida property taxes. ■

[21] *Bridgestone*, recommended order, para. 33. The DOR took issue with the hearing officer's interchangeable use of the terms "mortgage" and "financing agreement" in paragraph 33, but did not materially disagree with the analogy otherwise. *Bridgestone*, final order.

[22] *Id.* at para. 34. The department adopted paragraph 34 without objection. *Bridgestone*, final order.

[23] *Bridgestone*, recommended order, para. 34 (quoting *Markell v. Hilpert*, 192 So. 2d 392, 398 (Fla. 1939) (emphasis added)). The DOR adopted paragraph 34 without objection. *Bridgestone*, final order.

[24] *See, e.g.*, TAA 2000(A)-041 (2000) (lease of real property treated as synthetic lease equivalent to a mortgage); and TAA 2003(A)-008 (2003) (lease of aircraft treated as synthetic lease equivalent to a financing agreement). Planners can therefore take advantage of this tool to eliminate tax on synthetic leases used as financing arrangements.