Akerman Practice Update

TAXATION

June 2011

If You Build It, They Will Come: The Taxation of Leasehold Improvements in Florida

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As a general rule, Florida taxes the periodic payment of commercial rent. However, the Department of Revenue has a long-standing position of asserting that the construction of leasehold improvements by commercial tenants is also subject to the Florida sales and use tax. In the Department's view, the value of constructed leasehold improvements represents rent "in-kind" paid to the landlord because under most lease contracts such improvements become property of the landlord on completion. Consistent with its long-standing view, the Department has taken a hard line. On audit, the Department will assert – almost by reflex – that build-out expenses by a commercial tenant are subject to Florida sales and use tax.

The Department's basis for its long-standing position is found in *Department of Revenue, State of Florida v. Seminole Clubs, Inc.,* 745 So.2d 473 (November 19, 1999). In *Seminole Clubs*, the court addressed the taxation of tenant leasehold improvements made to a golf course. In order to maintain possession of the property, the tenant was required by the lease agreement to (1) pay a cash rent based on annual gross revenues, (2) debit a carry forward balance a percentage of gross annual revenues or (3) expend a fixed percentage of annual gross revenues on capital improvements. The court concluded under these facts that the amount spent on the leasehold improvements was rent "in-kind" subject to Florida sales and use tax since the payments were clearly made in lieu of cash rent.

"[T]he court held that the amounts spent by the tenant for leasehold improvements did not fall under the common sense meaning of the term "rent" and were therefore not subject to tax."

Recently, in *Ruehl No. 925, LLC v. State of Fla., Dept. of Rev.,* Case No. 2009-CA-1503, a retail mall tenant challenged the Department's position that certain of its leasehold improvements were taxable as rent "in-kind" subject to Florida sales and use tax. In *Ruehl No. 925,* the court held that the amounts spent by the tenant for leasehold improvements did not fall under the common sense meaning of the term "rent" and were therefore not subject to tax.

The court in *Ruehl No. 925* distinguished *Seminole Clubs* based on the fact that the terms of the form lease agreements in dispute did not demonstrate an intent by the parties that the amounts spent on leasehold improvements were to be considered in lieu of rent. Moreover, the court made clear that there was no evidence in the form lease agreements in *Ruehl No. 925* (1) that amounts spent on leasehold improvements by the tenant would be credited against periodic rent payments, (2) of any requirement that the tenant spend a fixed dollar amount on leasehold improvements or (3) that amounts paid for periodic rent by the tenant under the lease agreements could be manipulated by the amounts spent for leasehold improvements. In the words of the court, amounts spent by the taxpayer on leasehold improvements were simply an "expense which the tenant had to incur to get the premises in a condition that would be suitable for its intended purposes."

The good news for commercial tenants in Florida is that the facts in *Ruehl No. 925* were not exceptional. Because the terms of the lease agreements in *Ruehl No. 925* were boilerplate in nature, almost any commercial tenant can benefit from the substantive decision in *Ruehl No. 925.* However, reliance on the ruling in *Ruehl No. 925* will generally depend on the facts and circumstances of each case. In addition, the Department has appealed the lower court's holding in *Ruehl No. 925.*

In light of the ruling in *Ruehl No. 925*, taxpayers who are under audit would be wise to protest any assessment premised on *Seminole Clubs*. Likewise, taxpayers who have not been assessed on this issue may wish to consider filing protective claims for refund (assuming tax had been paid on the constructed leasehold improvements) pending final resolution of *Ruehl No. 925.*

For more information please contact a member of our Taxation practice.

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