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Sales tax guidance issued on leasehold improvements

by Marvin Kirsner

The Florida Department of Revenue has published important guidance on the sales tax ramifications of leasehold improvements that are paid for by a tenant.

This guidance sets out the department's position on when the construction of leasehold improvements paid for by the tenant will not be subject to Florida sales tax.

Any building owner, tenant or leasing agent negotiating a lease of Florida real property where the tenant will pay for some or all of the leasehold improvements should take care to follow this guidance to avoid Florida sales tax on the amount paid by the tenant toward the improvements.

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This issue goes back many years when the Florida Department of Revenue began to take the position that sales tax was due where the tenant was required to make any payment for leasehold improvements where the leasehold improvements became the property of the landlord at the end of the lease term.

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The department said such payments by the tenant were rent and subject to sales tax (7 percent in Miami-Dade and 6 percent in Broward and Palm Beach counties).

For example, if a lease of retail space required the tenant to pay for leasehold improvements, and $100,000 in improvements are made, which revert to the landlord at the end of the lease, the department said $6,000 to $7,000 in sales tax would be due from the tenant, depending on the county. If the landlord failed to collect the tax, the landlord was liable.

ADVISORY LETTER

The department's position was

challenged by a mall owner who failed to collect sales tax from its tenant who was required to make leasehold improvements. In December 2011, the First District Court of Appeal in *Department of Revenue v Ruehl No. 925* held in favor of the landlord, finding no evidence in the record to indicate the parties intended the tenant's obligation to make the leasehold improvements was consideration for the lease.

The department did not appeal this case. This resulted in uncertainty on this issue because we did not know whether: (1.) the Department of Revenue would accept the First DCA's decision in *Ruehl* and agree that sales tax would not be due if the landlord and tenant do not intend the value of the improvements to be part of the consideration for the lease; or (2.) whether the department was seeking out a case with stronger facts to indicate the improvements were intended to be rent and litigate this in a new case.

The department appears to have answered this question with a new private letter ruling which says it will follow *Ruehl* if certain conditions are satisfied in the lease. The department said in Technical Assistance Advisement 13A-023 that payments made by a tenant for leasehold improvements will not be subject to sales tax under the following conditions:

- Improvements are made to put the premises in a condition suitable for the operation of the tenant's business,
- There is no requirement to spend a specific or minimum amount of money on the improvements,
- There is no credit given against rental payments,
- The improvements are not explicitly classified as rent, additional rent, rent-in-kind or in lieu of rent and
- There is no evidence there was an attempt to reclassify rental payments to avoid the tax.

NOT BINDING

Each of these conditions will need to be analyzed on a case-by-case basis. For example, assume the value of improvements to be built by a tenant will cost it $100,000, without actually setting out that amount in the lease, and the lease states there is no rent for the first year, but beginning in Year 2 the annual rent is $100,000. In such a case, the department would probably say the value of the improvements was a credit toward the first year's rent even though this is not expressly stated.

Another example might be where the landlord is entitled to use some of the leasehold improvements for its own purposes—say a health-club tenant constructs a fitness facility in a shopping center, and the landlord's employees are entitled to use it without charge.

This guidance is a private letter ruling and is not binding on the department (except to the party who requested it).

A conversation with the author of this ruling indicated this is in fact the department's current position on this issue, but we must remember this is subject to change.

Landlords and tenants in the process of negotiating leases where the tenant will pay for leasehold improvements need to take these guidelines into consideration.

If the parties want certainty, they might want to request their own tax ruling from the Department of Revenue. But this ruling is a welcome change from the earlier position staked out by the department that would have resulted in sales tax on most leasehold improvements paid by the tenant.

Hopefully, the department will issue additional guidance in the future to clarify other details.

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