

STORAGE NAME: h0395.rpp
DATE: January 7, 2000

**HOUSE OF REPRESENTATIVES
COMMITTEE ON
REAL PROPERTY & PROBATE
ANALYSIS**

BILL #: HB 395
RELATING TO: Ad Val Tax Exemption/Capital Lease
SPONSOR(S): Representative Patterson
TIED BILL(S): None

ORIGINATING COMMITTEE(S)/COMMITTEE(S) OF REFERENCE:

- (1) REAL PROPERTY & PROBATE
- (2) COMMUNITY AFFAIRS
- (3) FINANCE & TAXATION
- (4) GENERAL GOVERNMENT APPROPRIATIONS
- (5)

I. SUMMARY:

Certain entities are granted exemptions from ad valorem taxation on property they own which is used for an exempt purpose. It is unclear under current law whether an entity that leases property pursuant to a capital lease¹ qualifies as an "owner" for purposes of exemption from ad valorem taxation.

This bill provides that "[f]or purposes of determining if property is 'owned' by an exempt entity, property owned by the entity under a capital lease shall be deemed to be owned by the entity." This means that property leased to an entity under a capital lease will be considered owned by that entity (lessee) when determining the applicability of existing tax exemptions to owners. This bill also provides a definition of "capital lease."

This bill has no fiscal impact on the state. The fiscal impact of this bill on local government is unclear. Interested parties have provided conflicting estimates of the fiscal impact. See "Fiscal Impact & Economic Impact Statement" for further information.

¹A lease is a contract where the owner of property (lessor) surrenders possession of the property to another (lessee) for a set period of time, but retains legal title to the property. A capital lease is a form of lease that is substantially similar to a sale of the property.

II. SUBSTANTIVE ANALYSIS:

A. DOES THE BILL SUPPORT THE FOLLOWING PRINCIPLES:

- | | | | |
|-----------------------------------|---|-----------------------------|---|
| 1. <u>Less Government</u> | Yes <input type="checkbox"/> | No <input type="checkbox"/> | N/A <input checked="" type="checkbox"/> |
| 2. <u>Lower Taxes</u> | Yes <input checked="" type="checkbox"/> | No <input type="checkbox"/> | N/A <input type="checkbox"/> |
| 3. <u>Individual Freedom</u> | Yes <input type="checkbox"/> | No <input type="checkbox"/> | N/A <input checked="" type="checkbox"/> |
| 4. <u>Personal Responsibility</u> | Yes <input type="checkbox"/> | No <input type="checkbox"/> | N/A <input checked="" type="checkbox"/> |
| 5. <u>Family Empowerment</u> | Yes <input type="checkbox"/> | No <input type="checkbox"/> | N/A <input checked="" type="checkbox"/> |

For any principle that received a "no" above, please explain:

B. PRESENT SITUATION:

Leases

In a lease situation, the lessor owns the asset and, by contract, allows the lessee to use the asset for a specified period of time in return for periodic lease payments. A typical lease is known as an operating lease, and the leased property is returned to the lessor at the conclusion of the lease term.

By contrast, a capital lease is a "contract for the lease of property which possesses the characteristics of a purchase."² The significant difference between an operating lease and a capital lease is the intent of the parties when entering into the lease. In an operating lease, the lessor prices the lease to cover the lessor's investment and expected rate of return, minus the value of the property to the lessor at the end of the term. However, in a capital lease the lessor expects little or no return at the conclusion of the lease term, and thus the lease price is solely based on the lessor's investment and expected rate of return. In an operating lease, possession is returned to the lessor at the end of the lease term; whereas in a capital lease, the lessee often keeps possession of the property at the conclusion of the term because ownership is often transferred from the lessor to the lessee at that time and as a condition of the lease. In general, the periodic payments due under a capital lease are substantially similar to the periodic payments required under a conventional financing arrangement.³ The significant difference between a capital lease and a conventional financing arrangement is that legal title to the property during the term

²Black's Law Dictionary, Sixth Edition.

³Under a conventional financing arrangement, title is transferred to the purchaser at the initiation of the contract. The seller of the property may agree to accept periodic payments in lieu of full payment at the time of sale, or a lender may pay to the seller the sales price in which case the lender agrees to accept periodic payments. The seller or lender accepting periodic payments will usually require that a lien be placed against the property to secure payment.

of the financing is in the name of the lessor/lender under a capital lease, but is in the name of the purchaser/borrower under a purchase money financing arrangement.⁴

A capital lease is a hybrid between outright sale of property, and a traditional lease of property. A capital lease is sometimes referred to as a "lease-purchase." The primary advantages of a capital lease, versus conventional financing to purchase property, are that the lessee (borrower) can obtain 100% financing, and there is greater flexibility for the parties regarding tax benefits.⁵ A proponent of this bill states that "local governments, churches and charitable non-profit groups . . . resort to lease-purchase agreements because of difficulties they experience in obtaining conventional financing."⁶

According to generally accepted accounting principals (GAAP) promulgated by the American Institute of Certified Public Accountants, for a lessee to classify a lease as a capital lease, the lease must meet one of the following criteria:⁷

1. The lease transfers ownership to the lessee by the end of the lease term
2. The lease contains a bargain purchase option⁸
3. The lease term is equal to 75% or more of the estimated economic life of the leased property,⁹ and the beginning of the lease term does not fall within the last 25% of the total economic life of the leased property
4. The present value (PV) of the minimum lease payments at the beginning of the lease term is 90% or more of the fair market value to the lessor less any investment credit retained by the lessor. This requirement cannot be used if the lease's inception is in the last 25% of the useful economic life of the leased asset. The

⁴See generally, Chapter 14, Accounting for Leases, of Wiley GAAP 2000, by the American Institute of Certified Public Accountants.

⁵ Wiley GAAP 2000 at 515.

⁶Letter from William C. Kelly, CPA, June 24, 1997.

⁷ Wiley GAAP 2000 at 521.

⁸A bargain purchase option is: "A provision allowing the lessee the option of purchasing the leased property for an amount, exclusive of lease payments, which is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable. Exercise of the option must appear reasonably assured at the inception of the lease. GAAP does not offer additional guidance defining 'sufficiently lower,' in which many factors such as time value of money, usage, and technological changes influence whether the option fulfills the criteria for a bargain." Id. at 516.

⁹The estimated economic life of leased property is: "The estimated remaining time which the property is expected to be economically usable by one or more users, with normal maintenance and repairs, for its intended purpose at the inception of the lease. The economic life may be determined by such factors as technological changes, normal deterioration, and physical usage. Judgment on these matters may be influenced by knowledge gained through previous experience. This estimated time period should not be limited by the lease term." Id. at 517.

interest rate, used to compute the PV, should be the incremental borrowing rate¹⁰ of the lessee unless the implicit rate¹¹ is available and lower.

For a lessor to classify a lease as a capital lease, GAAP requires that the lease meet one of the four criteria above and the following two conditions:

1. Collectability of the minimum lease payments is reasonably predictable.
2. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.¹²

Ad Valorem Tax

Local governments¹³ are permitted to impose an ad valorem tax¹⁴ against real and personal property located within the local government's jurisdiction.¹⁵ The Florida Constitution provides: "Such portions of property as are used predominantly for educational, literary, scientific, religious, charitable, or governmental purposes may be exempted by general law from [ad valorem] taxation."¹⁶

Prior to 1988, property that was "used" for exempt purposes (educational, literary, scientific, religious, charitable, or governmental) was exempt from ad valorem taxation regardless of ownership of the property.¹⁷ In 1988, the law was changed to require that property must be "owned" by an exempt entity **and** used for exempt purposes in order to qualify for

¹⁰The incremental borrowing rate is: "The rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term (i.e., a loan term equal to the lease term) the funds necessary to purchase the leased asset. Id.

¹¹The implicit interest rate is: "The discount rate that, when applied to the minimum lease payments, excluding that portion of the payments representing executory costs to be paid by the lessor, together with any profit thereon, and the unguaranteed residual value accruing to the benefit of the lessor, causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the lease property to the lessor at the inception of the lease, minus any investment tax credit retained and expected to be realized by the lessor and plus initial direct costs in the case of direct financing leases." Id.

¹²Id. at 521.

¹³The state is prohibited from imposing an ad valorem tax. Article VII, section 1(a), Florida Constitution.

¹⁴An ad valorem tax is "a tax imposed on the value of property." Black's Law Dictionary.

¹⁵Article VII, section 9, Florida Constitution.

¹⁶Article VII, section 3(a), Florida Constitution.

¹⁷Section 196.192(1), F.S. (1981); Daniel v. T.M. Murrell Co., Inc., 445 So.2d 587 (Fla. 2nd DCA 1984).

exemption from ad valorem taxation.¹⁸ Although one appellate court has, subsequent to the change in law, strictly construed the definition of "ownership" by holding that the owner of leased property for purposes of determining exemption from ad valorem taxation is always the lessor,¹⁹ the Florida Supreme Court has held that an exempt entity lessee may be an "equitable owner" of property which would allow a non-exempt lessor to claim the exemption from ad valorem taxation.²⁰ No reported Florida case has found that an exempt entity holding property pursuant to a capital lease is the "equitable owner" of the property and thereby exempt from ad valorem taxation.

Treatment of Capital Leases under Other Tax Codes

The state sales tax code recognizes a capital lease as a sale of the property at the beginning of the lease term.²¹

C. EFFECT OF PROPOSED CHANGES:

This bill amends s. 196.012, F.S., to define a "capital lease" and provides that property leased to an exempt entity pursuant to a capital lease shall be considered owned by the exempt entity for purposes of qualifying the property for exemption from ad valorem taxation.

A capital lease is defined as follows:

A "capital lease" is a lease which meets at least one of the following criteria:

- (a) Ownership of the property transfers to the lessee at the end of the lease term.
- (b) The lease contains a bargain purchase option, which is a provision allowing the lessee, at his or her choosing, to buy the leased property for a price which is sufficiently lower than the expected fair market value of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured.
- (c) The lease term is equal to 75 percent or more of the estimated useful economic life of the property.

¹⁸Chapter 88-102, Laws of Florida. "The Senate Staff Analysis reflects that this amendment was intended to overrule the effect of such cases as Daniel v. T.M. Murrell Co., 445 So.2d 587 (Fla. 2nd DCA 1984), which held that use rather than ownership of the property controlled the granting of a tax exemption." Leon County Educational Facilities Authority v. Hartsfield, 698 So.2d 526, 530 (Fla. 1997).

¹⁹Mastoianni v. Memorial Medical Center of Jacksonville, Inc., 606 So.2d 759 (Fla. 1st DCA 1992); Ocean Highway & Port Authority v. Page, 609 So.2d 84 (Fla. 1st DCA 1992).

²⁰Leon County Educational Facilities Authority v. Hartsfield, 698 So.2d 526, 529 (Fla. 1997).

²¹F.A.C. 12A-1.071(1)(d); F.A.C. 12A-1.096(10); In re Matter of Farm Credit Leasing Service Corp., 13 FALR 396 (1990).

- (d) At the inception of the lease, the present value of the minimum lease payments is at least 90 percent of the fair market value of the leased property. As used in this paragraph, "minimum lease payments" has the same meaning as is contained in Statements and Interpretations of the Financial Accounting Standards Board in regard to capital-type leases. The interest rate used to calculate the present value shall be the Prime Rate published in the "Money Rates" section of the Wall Street Journal on the same date as the inception of the lease.

Comparison between this bill and generally accepted accounting principals

Sections 196.012(20)(a) and 196.012(20)(b) of this bill are substantially similar to GAAP.

Section 196.012(20)(c) of this bill is different from GAAP. Under GAAP, one of the four possible conditions making a lease a capital lease is that the lease term must equal 75 percent or more of the estimated useful economic life of the property and the beginning of the lease must not fall within the last 25% of the total economic life of the leased property. The similar provision in this bill does not include the requirement that the beginning of the lease must not fall within the last 25% of the total economic life of the property.

Section 196.012(20)(d) of this bill is different from GAAP. Under GAAP, one of the four possible conditions making a lease a capital lease is that the present value of the minimum lease payments must be 90% or more of the fair market value to the lessor less any investment credit retained by the lessor, and the lease cannot commence in the final 25% of the useful economic life of the property. The similar provision in this bill does not include the requirement of subtracting any investment credit retained by the lessor, and does not include the requirement that the lease cannot commence in the final 25% of the useful economic life of the property. Also, under GAAP, the interest rate used in the present value calculation is the "incremental borrowing rate of the lessee unless the implicit rate is available and lower." The incremental borrowing rate is based on the creditworthiness of the lessee, and the implicit rate is based, in part, on the lessor's expected profit ratio. In calculating present value under this bill, the interest rate used in the present value calculation is the prime rate, a fixed published interest rate. A proponent of the bill claims that utilizing a fixed published interest rate, rather than one dependent upon the particular circumstances of the parties, will simplify administration of the tax.²²

Section 196.012(20)(d) of this bill references the "Statements and Interpretations of the Financial Accounting Standards Board." The compiled statements and interpretations of the Financial Accounting Standards Board is commonly known as GAAP.

The requirements in GAAP for a lessor to classify a lease as a capital lease are not included in this bill. The definition of a capital lease includes, with changes, the GAAP requirements for a lessee to determine whether a lease is a capital lease.

²²Telephone conference with William C. Kelly, C.P.A., chief fiscal officer of the Volusia County School Board, on December 27, 1999.

D. SECTION-BY-SECTION ANALYSIS:

See "Present Situation" and "Effect of Proposed Changes".

III. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT:

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

None²³

2. Expenditures:

None²⁴

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

The Florida Association of Counties states that this bill codifies an existing and proper interpretation of the law, and that therefore the fiscal impact on local governments would be "minimal."²⁵

2. Expenditures:

A proponent of this bill claims that capital leases typically have an ad valorem tax "pass-through" provision, whereby any ad valorem tax assessed on the property and against the lessor is passed through to the lessee. If the lessee is a government agency, then a governmental agency is, in effect, paying an ad valorem tax.²⁶ To the extent that a local government is a lessee, and in effect pays ad valorem taxes as a pass-through charge pursuant to a capital lease, this bill may lower local government expenditures.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

Exempt entities: A proponent of this bill claims that a capital lease typically has an ad valorem tax "pass-through" provision, whereby any ad valorem tax assessed on the property against the lessor is passed through to the lessee. The net effect to an otherwise

²³Department of Revenue Bill Analysis for HB-395, November 24, 1999.

²⁴Id.

²⁵Telephone conference with Robert W. McKee, C.P.A., of the Florida Association of Counties, on December 9, 1999.

²⁶Telephone conference with William C. Kelly, C.P.A., chief fiscal officer of the Volusia County School Board, on December 27, 1999.

exempt entity is that the entity may, in effect, pay an ad valorem tax.²⁷ To the extent that exempt entities may, in effect, pay ad valorem taxes as pass-through charges pursuant to capital leases, this bill may lower the costs of capital leases to exempt entities.

Non-exempt entities: This bill may reduce ad valorem taxes on non-exempt lessors that lease property to exempt entities pursuant to a capital lease arrangement. To the extent that a lessor charges property taxes to the lessee pursuant to a "pass-through" clause in a capital lease, there may be no net effect on such lessors.

D. FISCAL COMMENTS:

Because of conflicting reports of how capital leases are currently being treated for ad valorem tax purposes, the fiscal impact of the bill is unclear.

IV. CONSEQUENCES OF ARTICLE VII, SECTION 18 OF THE FLORIDA CONSTITUTION:

A. APPLICABILITY OF THE MANDATES PROVISION:

This bill does not require counties or municipalities to spend funds or to take an action requiring the expenditure of funds.

B. REDUCTION OF REVENUE RAISING AUTHORITY:

This bill does not reduce the authority that municipalities or counties have to raise revenues in the aggregate.

C. REDUCTION OF STATE TAX SHARED WITH COUNTIES AND MUNICIPALITIES:

This bill does not reduce the percentage of a state tax shared with counties or municipalities.

V. COMMENTS:

A. CONSTITUTIONAL ISSUES:

None

B. RULE-MAKING AUTHORITY:

None

C. OTHER COMMENTS:

²⁷Id.

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The Florida Association of Counties states that this bill codifies an existing and proper interpretation of the law, and that therefore this bill represents a “minimal” fiscal impact on local governments. The association does not oppose the bill.²⁸

There is a concern that the bill refers to property being “owned by the entity under a capital lease”. A lessee does not own property under a capital lease, a lessee merely “holds” or “has possession” of the leased property. The bill sponsor has filed an amendment to the bill that addresses this concern.

VI. AMENDMENTS OR COMMITTEE SUBSTITUTE CHANGES:

N/A

VII. SIGNATURES:

COMMITTEE ON REAL PROPERTY & PROBATE:

Prepared by:

Staff Director:

Nathan L. Bond, J.D.

J. Marleen Ahearn, Ph.D., J.D.

²⁸Telephone conference with Robert W. McKee, C.P.A., of the Florida Association of Counties on December 9, 1999.