SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based only on the provisions contained in the legislation as of the latest date listed below.)

BILL: SB 1990

SPONSOR: Senator King

SUBJECT: Ad Valorem Taxation

DATE: March 30, 2000 REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Cooper	Yeatman	CA	Favorable
2.			FR	
3.				
4.				
5.				

I. Summary:

The bill provides that property leased under a capital lease to an exempt entity is deemed owned by the entity, and thus exempt from ad valorem taxation. This bill also maintains a property tax exemption for property leased from a governmental agency if the agency continues to use the property exclusively for educational purposes.

This bill amends ss. 193.012 and 196.198, of the Florida Statutes.

II. Present Situation:

Leases

In a lease, 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."[1] 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

[1] Black's Law Dictionary, Sixth Edition.

under a conventional financing arrangement. The significant difference between a capital lease and a conventional financing arrangement is that legal title to the property during the term 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.[2]

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.[3]

According to generally accepted accounting principles (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:[4]

1. The lease transfers ownership to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option.[5]
3. The lease term is equal to 75% or more of the estimated economic life of the leased property,[6] 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 tax 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 interest rate, used to compute the PV, should be the incremental borrowing rate[7] of the lessee unless the

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

[3] Wiley GAAP 2000 at 515.

[4] Wiley GAAP 2000 at 521.

[5]A 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.

[6]The 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.

[7]The 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.

implicit rate[8] 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.[9]

Educational Property Tax Exemption

Section 3(a) of Article VII of the State Constitution specifies that portions of property "used predominantly for educational, literary, scientific, religious, or charitable purposes may be exempted by general law from taxation." Chapter 196, F.S., implements these exemptions.

Section 196.192, F.S., requires property be "owned and used" by an exempt entity to qualify for an exemption from ad valorem taxes. (Prior to 1988, property need only be "used" for exempt purposes to qualify for the exemption. The State Constitution does not require ownership as a condition for the exemption.) This provision further qualifies that "each use to which the property is being put must be considered in granting an exemption from ad valorem taxation, including any economic use in addition to any physical use."

To the extent that an exempt entity using property leased to them for an exempt purpose is the equitable owner of such property, holding "all the benefits and burdens of ownership" of the leased property, the property qualifies for an ad valorem tax exemption. *Leon County Educ. Facilities Auth. v. Hartsfield*, 698 So.2d 526, 530 (Fla. 1997) and *Robbins v. Mt. Sinai Medical Center, Inc.*, 1999 WL 1144791 (Fla. App. 3 Dist.)

Because exemptions from taxation results in an uneven distribution of the tax burden, statutes granting such tax relief are strictly construed against the exemption. *Miami Battlecreek v. Lummus* 192 So. 211 (Fla. 1939) and *Sebring Airport Authority v. McIntyre*, 642 So.2d 1072 (Fla. 1994)

School districts have expressed an interest in entering into a long-term lease/leaseback agreement with private investors on property currently owned and used by the district for educational purposes. The investors will become eligible for federal income tax credits based upon the prepayment of business expenses associated with the lease transaction and other factors. The districts estimate a net benefit equal to 5 - 10% of the appraised value of the leased property. If this financial arrangement is agreed to, it is not clear if school districts would retain "all the benefits and burdens of ownership," and thus remain eligible for the property tax exemption.

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[8]The 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.

[9]Id. at 521.

III. Effect of Proposed Changes:

Section 1 creates subsection (20) of s. 193.012, F.S., to provide that property leased to an entity pursuant to a capital lease shall be considered owned by the entity for purposes of determining if the property qualifies for exemption from ad valorem taxation.

Subsection (20) of s. 193.012, F.S., defines a "capital lease" as 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 allows the lessee, at his or her option, to buy the leased property for a price which is sufficiently lower than the expected fair market value of the property on the date the option becomes exercisable such 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.
- (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.

Paragraphs (a) and (b) of s.196.012(20), F.S., are substantially similar to GAAP.

Paragraph (c) of s. 196.012(20), F.S., differs from GAAP in that it 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.

Paragraph (d) of s. 196.012(20), F.S., differs from GAAP in that it 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.

Paragraph (d) of s. 196.012(20), F.S., references the “Statements and Interpretations of the Financial Accounting Standards Board,” which is commonly known as GAAP.

Section 2 amends s. 196.198, F.S., to maintain a property tax exemption for property leased from a governmental agency if the agency continues to use the property, pursuant to a sublease or other contractual agreement with the lessee, exclusively for educational purposes.

Section 3 provides an effective date of upon becoming a law.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

Article VII, section 18(b), of the Florida Constitution provides:

> "Except upon approval of each house of the Legislature by two-thirds of the membership, the legislature may not enact, amend, or repeal any general law if the anticipated effect of doing so would be to reduce the authority that municipalities or counties have to raise revenues in the aggregate, as such authority exists on February 1, 1989."

However, laws of insignificant fiscal impact ($1.5 million) are exempt from this provision.

While the Legislative Impact Conference has not estimated the recurring annual fiscal impact on all counties and municipalities, the impact of this bill is likely to be insignificant. Therefore, it is exempt from the constitutional mandates restriction.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

To the extent that lessors or lessees not previously exempt will become exempt from ad valorem taxes as a result of this bill, local governments will collect less tax revenue.

B. Private Sector Impact:

This bill may reduce property 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.

C. Government Sector Impact:

To the extent that a local government is a lessee, and pays property taxes as a pass-through charge pursuant to a capital lease, this may result in lower expenditures for capital leases.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Amendments:

None.