

220.0345 **Leases.** The purchase by a lessee of the lessor's interest in a lease that originally was and is at the time of purchase for a term of more than 35 years is not a change in ownership. C 3/30/90.



STATE BOARD OF EQUALIZATION

1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)

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Executive Director

(916) 324-6594

March 30, 1990

P.O.

Dear

This is in response to your letter of March 15, 1990 to Mr. _____ in which you request our opinion concerning whether a change in ownership will occur as a result of the proposed transaction described in your letter and set forth below:

Your client entered into a ground lease dated June 1, 1969 by which he, as the tenant, leased certain land (hereinafter the "Land"). The lease had an initial term of 26 years with three renewal options of 23 years each. Thus, counting the renewal options, there was an initial term of 95 years, and there is now a remaining term of 74 years.

The lease also granted the lessee, i.e., your client, an option to purchase the Land before May 31, 1990. Your client now wishes to exercise that option and purchase (in a straight purchase or in an exchange transaction) the entire remaining interest of the lessor in the Land. This will necessarily cause the leasehold interest to terminate.

LAW AND ANALYSIS

Revenue and Taxation Code* section 60 defines "change in ownership" to mean "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest."

Section 61 provides in relevant part that "[e]xcept as otherwise provided in section 62, change in ownership, as defined in section 60, includes, but is not limited to:

*All statutory references are to the Revenue and Taxation Code unless otherwise indicated.

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(c)(1) The creation of a leasehold interest in taxable real property for a term of 35 years or more (including renewal options), the termination of a leasehold interest in taxable real property which had an original term of 35 years or more (including renewal options), and any transfer of a leasehold interest having a remaining term of 35 years or more (including renewal options); or (2) any transfer of a lessor's interest in taxable real property subject to a lease with a remaining term (including renewal options) of less than 35 years."

Section 62 provides in relevant part that "[c]hange in ownership shall not include . . . [¶] (g) [a]ny transfer of a lessor's interest in taxable real property subject to a lease with a remaining term (including renewal options) of 35 years or more."

The rationale behind the foregoing provisions was stated by the Task Force on Property Tax Administration in pertinent part as follows:

The "value equivalence" test is necessary to determine who is the primary owner of the property at any given time. Often, two or more people have interests in a single parcel of real property. Leases are a good example. The landlord owns the reversion; the tenant, the leasehold interest. Suppose the landlord sells the property subject to the lease and the lessee assigns the lease. Which sale or transfer is the change in ownership?

The example illustrates that in determining whether a change in ownership has occurred it is necessary to identify but one primary owner. Otherwise assessors would be forced to value, and account for separate base year values for landlords and tenants on all leases, and for other forms of split ownership. This would enormously complicate the assessor's job.

A major purpose of this third element, therefore, is to avoid such unwarranted complexity by identifying the primary owner, so that only a transfer by him will be a change in ownership and when it occurs the whole property will be reappraised. If the hypothetical lease previously mentioned was a short term lease (the landlord owned the main economic value), the landlord's sale, subject to the lease would count. If, on the other hand, the lease was a long term lease (the lessee's interest was the main economic package), the lease assignment would count. In

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either case, the entire fee value of the leased premises would be reappraised.

The Task Force recommends that its general definition of change in ownership (proposed Section 60 Rev. & Tax Code) should control all transfers, both foreseen and unforeseen. The Task Force also recommends the use of statutory "examples" to elaborate on common transactions. Lay assessors and taxpayers would otherwise have difficulty applying legal concepts such as "beneficial use" and "substantially equivalent." Thus, common types of transfers were identified and concrete rules for them were set forth in proposed sections 61 and 62.

It is important that the specific statutory examples be consistent with the general test. The entire statutory design would be destroyed by providing statutory treatment for specific transfers which are inconsistent with the general test. In that case, the general test would be overruled by the specific rules and the entire statutory design might be held invalid because of the lack of any consistent, rational interpretation of the constitutional phrase, "change in ownership."

Specific Statutory Examples

1. Leases. Leases are a good illustration of the necessity of concrete statutory examples. Both taxpayers and assessors need a specific test--rather than the broad "value equivalence" test--to determine the tax treatment of leases. The specific test, however, must be consistent with the "value equivalence" rule and have a rational basis. Lenders will lend on the security of a lease for 35 years or longer. Thus 35 years was adopted as the concrete dividing line. If the term of a lease, including options to renew, is 35 years or more, the creation of the lease is a change in ownership and so is its expiration. If a lessee under such a lease assigns or sublets for a term of 35 years or more, that is another change in ownership. However, if the lease, including options, is for less than 35 years, the lessor remains the owner and only the transfer of his interest is a change. In all cases, the entire premises subject to the lease in question are reappraised. (Report of the Task Force on Property Tax Administration, January 22, 1979, pages 39-41.) See also, Implementation of Proposition 13, Volume 1, Property Tax Assessment, October 29, 1979, pages 19, 20, 25 and 26.

The Board has interpreted sections 60, 61(c) and 62(g) set forth above in Rule 462 which provides in pertinent part at subdivision (f):

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* * * *

"(2) The following transfers of either the lessee's interest or the lessor's interest in taxable real property do not constitute a change in ownership of such real property.

* * * *

"(B) Lessor's interest:

"(i) The transfer of a lessor's interest in real property subject to a lease with a remaining term of 35 years or more, whether to the lessee or another party.

* * * *

In expressly providing that the transfer of a lessor's interest in real property subject to a lease with a remaining term of 35 years or more to the lessee is not a change in ownership, the foregoing rule reflects the one-owner rationale discussed above and is consistent with the general definition of change in ownership contained in section 60. Since such a transfer would necessarily cause a termination of the leasehold interest by merger, the rule clearly resolves any conflict between the language of section 61(c)(1) regarding termination of a leasehold interest and section 62(g) as applied to such a transfer. Accordingly, since the transfer proposed here falls squarely within the provisions of Rule 462(f)(2)(B), it would not constitute a change in ownership.

The views expressed in this letter are, of course, advisory only and are not binding upon the assessor of any county. You may wish to consult the appropriate assessor in order to confirm that the described property will be assessed in a manner consistent with the conclusion stated above.

Our intention is to provide timely, courteous and helpful responses to inquiries such as yours. Suggestions that help us to accomplish this goal are appreciated.

Very truly yours,



Eric F. Eisenlauer
Tax Counsel

EFE:cb/2414D

cc: Mr. John W. Hagerty
Mr. Verne Walton