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February 18, 1999

, Esq.

**Re: Request for Advisory Opinion regarding  
Long Term Leases and Change in Ownership**

Dear Mr. :

This is in reply to your letter of January 11, 1999 addressed to Assistant Chief Counsel Larry Augusta in which you request a legal opinion confirming your conclusion that a lease agreement for a term plus extension options of less than 35 years, but with a "conditional lease term extension" ("conditional option") provision which, if the condition were to occur and the option were to be exercised, would result in a total lease term exceeding 35 years, does not, upon execution of the lease, result in a change in ownership of the real property subject to the lease. For the reasons set forth below, we agree with your conclusion that, upon execution, such a lease agreement does not result in a change in ownership. The lessee's right to extend the lease term to a period exceeding 35 years under the conditional option provision should not be included for purposes of computing the lease term because that right is subject to conditions precedent not within the control of the lessee. However, upon the occurrence of any of the stated conditions the lessee's right to exercise the conditional option arises, and, at that time, the term of the conditional option should be added to the lease term remaining. If that total period exceeds 35 years, then a change in ownership results at that time, and the entire property subject to the lease should be reappraised.

### Background

The lease agreement provides for an initial lease term of 20 years, 3 extension options and a conditional option. The first two extension options are each for a period of 5 years. The third extension option is for a period such that when added to the preceding lease term, the overall lease term will not exceed 34 years, 11 months and 29 days. Thus, the initial lease term plus the 3 extension options will total less than 35 years.

The conditional option is for a period such that when added to the preceding lease term, i.e., the initial lease term plus the 3 extension terms, the combined lease term would be 40 years. The conditional option becomes effective on the occurrence of any one of the following events: a change in ownership of the leased property during the period of the initial lease term plus the 3 extension terms, a change in ownership due to a change in the law, or a change in the law that eliminates the grant of such a conditional option as a change in ownership.

### Law and Analysis

Revenue and Taxation Code section 61, subdivision (c) provides, in relevant part, that a change in ownership includes "the creation of a leasehold interest in real property for a term of 35 years or more (including renewal options) . . ." By granting an option, the lessor immediately relinquishes the right to dispose of the property in a manner inconsistent with the option terms. Thus, renewal options are included when computing the lease term, for change in ownership purposes because they transfer to the lessee the absolute right to control the length of the lease term by creating an irrevocable offer which upon acceptance binds the lessor to extend or renew the term of the lease upon the agreed contractual terms. *See, e.g., Palo Alto Town & Country Village, Inc. v. BBTC Company* (1974) 11 Cal.3d 494, 502.

Unlike an unconditional renewal option, the lessee's right to extend the lease term under the conditional option is subject to conditions precedent outside the control of the lessee, and the lessee's right to exercise the option does not arise until the occurrence of any of the three stated events. "A condition precedent is an act or event that must be performed or a certain event that must happen before the promisor's duty of performance under a contract arises." Miller & Starr, *California Real Estate* (2d ed. 1989) §1:131, p. 466. Until that time, the lessor is not under a contractual obligation to extend the lease, and the lessee is not considered to control the length of the term. Therefore, at the inception of a lease agreement that includes a conditional option, the term of the conditional option should not be included when computing the lease term for purposes of change in ownership.

Upon the occurrence of any of the stated conditions, the conditional option in the lease becomes effective; and at that time, the term of the conditional option should be included in computing the entire lease term because the lessee then has a specifically enforceable contractual right to extend the lease term by exercising that option. However, in our opinion, the lease term should be computed by adding the term of the conditional option to the lease term remaining at the time the condition occurs, rather than to the entire original term, because, as discussed above, options are included only when they become effective and subject to exercise by the lessee. Thus, for example, if the original lease term including extension options has 32 years remaining at the time that one of the stated conditions occurs, then the addition of the conditional option

term of 5 years results in a total remaining lease term of 37 years. Because the total period exceeds 35 years then, a change in ownership results at that time, and the entire property subject to the lease should be reappraised.

The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Very truly yours,



Louis Ambrose  
Tax Counsel

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cc:

Mr. Richard C. Johnson (MIC:63)  
Mr. David J. Gau (MIC:64)  
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