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November 7, 2016

Hon. Charles W. Leonhardt
 Plumas County Assessor
 1 Crescent Street
 Quincy, CA 95971

Re: *Change in Ownership – Option Agreements*
Assignment No.: 16-156

Dear Mr. Leonhardt:

This is in response to your request for our opinion regarding the change in ownership consequences of the Option Contract for Sale and Purchase of Real Property (the Option) executed between D and G (Seller) and E, Trustee of the E's Trust (Trust or Buyer). Specifically, you ask whether a change in ownership occurred on the date the Option commenced or on the date the Option was exercised. As explained below, based on the information provided, it is our opinion that the Option provided a purchase option to the Trust, which resulted in a change in ownership of the real property when the option was exercised.

Facts

On October 10, 2006, two neighboring property owners, Buyer and Seller, entered into a purchase option for property located in Lake Almanor, California. (Option, p. 1.) The Option described the terms by which Buyer could acquire the property from Seller on or after January 1, 2012, by exercising the option during the time period that is 30 days on either side of the fifth anniversary of the commencement date.¹ (Option, sec. 1, p. 1.) Seller retained possession of the property throughout the option period. (Option, sec. 6, subd. (E), p. 4.)

At the time the Option was created, Buyer estimates the property's fair market value was approximately \$1 million to \$1.2 million. (June 3, 2015 email from E to W (June 3 Email).) Based on the contract's timeline, parties established a purchase price of \$1.4 million. (*Ibid.*) Section 4 of the Option laid out the following schedule of non-refundable payments that were to be made from Buyer to Seller over the Option period and were to be credited against the purchase price:

Initial Option Deposit (due within 30 days of Commencement Date)	\$150,000
Second Option Deposit (due one year from Commencement Date)	\$150,000
Third Option Deposit (due two years from Commencement Date)	\$150,000

¹ According to the Option, the "commencement date" is the date the last party signs the agreement (Option, sec. 2, p. 2). While we were not provided with verification, the Amendment to the Option, *infra*, suggests the commencement date was October 10, 2006.

Fourth Option Deposit (due three years from Commencement Date)	\$150,000
Fifth Option Deposit (due four years from Commencement Date)	\$150,000
Final Balance Due (if exercised, due January 2012)	\$650,000

(Option, sec. 4, p. 3.)

In fall 2011, the parties negotiated the First Amendment to Option Contract for Sale and Purchase of Real Property (the Amendment). The Amendment extended the option period an additional three years beyond its original date, making the period to exercise the option October 10, 2014 (+/- 30 days). (Amendment, sec. 1, p. 1.) Furthermore, effective on the Amendment date and through the end of the option period, Buyer was made responsible for all major maintenance and upkeep of the property, while Seller continued to be responsible for payment of property taxes, association dues, and water and utility costs. (Amendment, sec. 4, p. 2.) The Amendment acknowledged Seller's receipt of \$750,000 in option deposits, and extended the option period for three years in exchange for additional option deposits of \$25,000 due on or before November 1 of 2011, 2012, and 2013, which would also be credited against the purchase price. (Amendment, sec. 2, p. 2.)

In fall 2014, Buyer exercised the option and concluded the sale at the contracted price of \$1.4 million, less \$825,000 of option payments already made. (June 3 Email; April 22, 2016 email from E to Chuck Leonhardt.) Buyer believes the home was worth approximately \$800,000 at the close of sale. (*Ibid.*) However, Buyer felt Trust "had no choice but to conclude the sales transaction at the contracted price or walk away and lose all of [] the Option payments made to date." (Apr. 21, 2016 email from E to Chuck Leonhardt.)

Law & Analysis

Article XIII A, section 2 of the California Constitution requires the reassessment of real property upon a "change in ownership," unless an exclusion applies. A change in ownership is defined in Revenue and Taxation Code² section 60 as "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."

In the case of a purchase option, a change in ownership generally occurs when the option is exercised. (See Property Tax Annotation (Annot.)³ 220.0445 (Oct. 7, 1980).) Exceptions may occur, however, when an agreement is not truly an option, but is actually a form of a sales contract. (*Ibid.*) In these cases, a change in ownership usually occurs when the option was created. (*Ibid.*) This difference arises because a change in ownership occurs on the date a contract becomes specifically enforceable, and entering into a purchase option obligates only the selling party while entering into a sales contract creates a mutual obligation. (See Assessors' Handbook section 401, *Change in Ownership* (Sept. 2010) (AH 401) p. 6; see also Annots. 220.0130 (Aug. 10, 1987) and 220.0132 (Nov. 19, 1980).) Because of the variability of option provisions and the subjectivity of option analysis, each option must be individually

² All further statutory references are to the Revenue and Taxation Code, unless otherwise specified.

³ Property tax annotations are summaries of the conclusions reached in selected legal rulings of State Board of Equalization counsel published in the State Board of Equalization's Property Tax Law Guide. (See Cal. Code Regs., tit. 18, § 5700 for more information regarding annotations.)

analyzed, taking into consideration both the phrasing of the contract and the intent of the parties. (See backup letter to Annot. 220.0445, *supra*, p. 2.)

As stated in AH 401, economic compulsion may be a test for determining whether an option to purchase actually constitutes a sales agreement. (See AH 401, p. 6; see also Annot. 220.0445, *supra*; see also backup letter to Annot. 220.0446 (Oct. 21, 1988) p. 3.) If an option agreement is actually a sales contract, a change in ownership will result at the time the option is created. (*Id.*) You ask how to apply AH 401 to the facts presented, as Buyer appeared to be economically compelled to complete the transaction, but the change in ownership appears to have occurred at the time the option is exercised, rather than when it was created. We believe that the proper reading of AH 401 is that the date of change in ownership is generally the date the option is exercised, unless economic compulsion exists at the time the option is created, in which case both parties are, in effect, mutually obligated to complete the contract, similar to a sales agreement. In this case, however, we believe economic compulsion did not exist at the time the option was created.

As mentioned above, Buyer states it made substantial non-refundable payments toward the purchase price and thus felt economically compelled to complete the transaction at the *end* of the option period. At the time the option was created, Buyer made an initial, non-refundable option deposit of \$150,000, equivalent to less than ten percent of the purchase price. While a significant sum, we do not consider this amount to rise to the level of economic compulsion.

Economic compulsion may also exist if the option specifies a selling price that is significantly less than the current market value, or if it can be determined at the time the option is created that equity will be established with certainty within a short period. (See AH 401, p. 6.) Here, the option was created in 2006, with Buyer originally unable to exercise the option until 2012.⁴ The parties set the selling price at the anticipated market value, not at a lesser value. Additionally, equity was not established within a short period of time, because although the option was negotiated in a favorable real estate market, where economic outlook was positive and an increase in the property's market value appeared likely, the original option period lasted for approximately five years, during which time the market value appears to have declined. Thus, significant equity could not have been established within a short period of time, further suggesting that economic compulsion was absent at the time the option was created.

Most importantly, for a change in ownership of real property to occur, the beneficial use of that property must be transferred. (See Rev. & Tax. Code, § 60.) We have previously found it proper to characterize purchase options in which significant non-refundable payments were made toward a potential purchaser's equity in the property as a sale from the outset, because the purchaser would lose that equity if the option to purchase was not exercised. (See Annots. 220.0445, 220.0446, *supra*.) However, this has always been within the context of a lease with an option to purchase, where the potential purchaser was also a lessee of the property, and thus had beneficial use of the property. (See *ibid*; see also backup letter to Annot. 220.0440 (Apr. 21, 1982) pp. 2-3.) Here, Buyer made a defined stream of non-refundable payments toward the property's equity during the option period, and had invested approximately 54 percent of the purchase price by the end of the initial option period. However, Seller retained possession of the

⁴ This was later renegotiated to 2014, with an agreement to potentially change the exercise date based on Seller's personal or health circumstances. (See Amend., secs. 1 & 4, pp. 1, 2.) However, for purposes of this analysis, we are only evaluating the circumstances at the time the option was created.

property throughout the entire option period, and thus retained beneficial ownership. Buyer did not obtain beneficial use of the property until the date the option was exercised. Therefore, in this instance, we believe the change in ownership occurred upon the *exercise* of the purchase option in 2014 and not upon the option's *creation*. This is when the agreement became specifically enforceable and when Buyer obtained beneficial ownership.

You also state that the Option appears similar to a conditional sales contract. In a conditional sales contract, in which the seller agrees to convey title to real property to the buyer upon the satisfaction of specified conditions set forth in the contract, a change in ownership occurs when the buyer satisfies the conditions and is entitled to receive legal title. (AH 401, p. 6; see also Annot. 220.0635 (Oct. 17, 1980).) Here, the Option does require Buyer to satisfy certain conditions, including making a series of non-refundable payments to Seller and paying the final balance of the purchase price within 30 days of notifying Seller of Buyer's intention to exercise the Option. (Option, secs. 1 & 9, pp. 1-2, 5.) This notice and final payment required to exercise the Option is equivalent to satisfying the conditions of a conditional sales contract. Thus, while the Option shares similarities to a conditional sales contract, we do not believe categorizing it as such would change our conclusion.

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.

Sincerely,

/s/ Amanda Jacobs

Amanda Jacobs
Tax Counsel

AJ/yg

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cc: Mr. Dean Kinnee (MIC:63)
Mr. David Yeung (MIC:61)
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