

Memorandum

To: Mr. Dean Kinnee, Chief
County-Assessed Properties Division (MIC:64)

Date: December 21, 2009

From: Matthew F. Burke
Tax Counsel

Subject: *Change in Ownership – Merger of Leasehold Interest with Underlying Fee Interest Assignment No. 09-086*

This is in response to your memorandum dated May 18, 2009, requesting our opinion on the change in ownership consequences of certain lease transactions.

You ask whether the merger of a leasehold interest with its underlying fee interest results in a "termination" of the lease for purposes of the long-term lease change in ownership rules. It is our opinion that a merger of a leasehold interest with the underlying fee interest in the property must be treated under the change in ownership rules as either: (1) a transfer of the lessor's interest to the lessee, when the lessee purchases the underlying fee interests, and covered by Property Tax Rule¹ 462.100, subdivisions (a)(2)(A) and (b)(2)(A); or (2) a termination of the leasehold, when the property reverts to the lessor upon the lease ending for any other reason deemed a "termination" of a lease under California law, and covered by Rule 462.100, subdivisions (a)(1)(C) and (b)(1)(C).

LAW & ANALYSIS

Revenue and Taxation Code² section 60 defines "change in ownership" as a single test with three elements as follows:

A "change in ownership" means a transfer of [1] a present interest in real property, including [2] the beneficial use thereof, [3] the value of which is substantially equal to the value of the fee interest.³

Section 61, subdivision (c) provides the general rules for determining when certain lease transactions result in a change in ownership. That subdivision provides, in relevant part, that a change in ownership includes:

¹ All "Property Tax Rule" or "Rule" references are to sections of title 18 of the California Code of Regulations.

² All "section" references are to the Revenue and Taxation Code, unless otherwise indicated.

³ We refer to the three elements from the three-part test as set forth in the Task Force Report, and in section 60, as "present interest," "beneficial use," and "value equivalence." We sometimes refer to "beneficial use" as "beneficial ownership" as well, because the courts refer to the holder of the beneficial use to be the beneficial owner. (See *Reilly v. City and County of San Francisco* (2006) 142 Cal.App.4th 480, 489.)

1. The creation of a leasehold interest in taxable⁴ real property for a term of 35 years or longer (including renewal options);⁵
2. The termination of a leasehold interest in real property that was for an original term of 35 years or longer;
3. The transfer of a leasehold interest having a remaining term of 35 years or longer; and
4. The transfer of a lessor's interest subject to a lease with a remaining term shorter than 35 years.

As a counterpart, section 62, subdivision (g) sets forth the lease transaction that *does not* result in a change in ownership, which is any transfer of a lessor's fee interest in the underlying property subject to a lease with a remaining term of 35 years or longer.

To interpret sections 61, subdivision (c), and 62, subdivision (g), the Board promulgated Rule 462.100, which sets forth both the lease transactions that do result in a change in ownership (in subdivision (a) of the Rule), and those lease transactions that do not result in a change in ownership (in subdivision (b) of the Rule).

Specifically, Rule 462.100, subdivision (a) provides that the following transactions *do* constitute a change in ownership:

Transfers of Lessee's Interest:

1. The creation of a leasehold interest in real property for a term of 35 years or longer;
2. The transfer, sublease, or assignment of a leasehold interest with a remaining term of 35 years or longer;
3. The termination of a leasehold interest that had an original term of 35 years or longer; and

Transfer of Lessor's Interest:

4. The transfer of a lessor's interest in real property subject to a lease with a remaining term shorter than 35 years.

⁴ Because all of the change in ownership rules with respect to long-term leases apply only to "taxable" real property, we have chosen throughout this memorandum to omit the word "taxable" when referring to such property. For purposes of this memorandum, it will always be understood that the real property in question is taxable and not exempt.

⁵ Because Property Tax Rule 462.100, subdivision (d), provides that the calculation of a leasehold term always includes the written renewal options, we have chosen throughout this memorandum to omit the "including renewal options" language. For purposes of this memorandum, it will always be understood that a lease term is to be calculated by including such periods.

In addition, Rule 462.100, subdivision (b) provides that the following transactions *do not* constitute a change in ownership:

Transfer of Lessee's Interest:

1. The creation of a leasehold interest in real property for a term shorter than 35 years;
2. The transfer, sublease, or assignment of a leasehold interest with a remaining term shorter than 35 years, regardless of the lease's original length;
3. The termination of a leasehold interest that had an original term shorter than 35 years; and

Transfer of Lessor's Interest:

4. The transfer of a lessor's interest in real property subject to a lease with a remaining term of 35 years or longer, whether to the lessee or another party.

The interpretation of sections 60 and 61, subdivision (c), as set forth in Rule 462.100, is consistent with the recommendations of the "Report of the Task Force on Property Tax Administration" (Task Force Report), submitted to the Assembly Committee on Revenue and Taxation on January 22, 1979. In interpreting the change in ownership provisions of sections 60 et seq., courts have long relied on the explanations and rationales set forth in Task Force Report. (See *Pacific Southwest Realty v. County of Los Angeles* (1991) 1 Cal.4th 155, at pp. 161-162.) The following is the Task Force Report discussion of the present interest, beneficial use, and value equivalence elements of the "change in ownership" test ultimately enacted as the three-prong test of section 60:

Present Interest. ... This element is necessary to protect a variety of inchoate transfers from unintended change in ownership treatment, including future interests, revocable transfers and transfers with retained life estates.

Beneficial Use. Beneficial use is necessary to protect custodianships, guardianships, trusteeships, security interests, and other fiduciary relationships from unintended change in ownership treatment. ...

Value Equivalence. 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. ... [I]n determining whether a change in ownership has occurred it is necessary to identify but one 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.

(Task Force Report, at pp. 39-40 (emphasis in original).)

Accordingly, under the three-part test described above, when two or more persons have an interest in a single parcel of real property, it is necessary to identify the one "primary owner" of the real property. This ensures that a change in ownership occurs only "when the primary economic value of the land is transferred from one person to another." (*Pacific Southwest Realty*, 1 Cal.4th 155, at p. 167.)

The Task Force recommended that its general definition in the three-part test "should control *all* transfers, both foreseen and unforeseen. The Task Force also recommend[ed] the use of statutory 'examples' to elaborate on common transaction," which must be consistent with the general three-part test. (Task Force Report, at p. 40.) In the case of leases, the Task Force recommended that the lessee of a 35-year or longer lease be the primary owner of the property for property tax purposes. The Task Force Report's specific recommended example to elaborate on lease transactions is as follows:

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. ... 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. ...

(Task Force Report, at p. 41.)

Thus, it was the Task Force's clear intent that the "value equivalence" element in lease transactions be determined by reference to the lease duration, and that in its view, this would comport with the three-part test. The Legislature enacted sections 61, subdivision (c), and 62, subdivision (g), to codify this concept, consistent with the Task Force's intent, and the Board subsequently promulgated Rule 462.100 to interpret those codified sections.

When viewing a transaction for change in ownership consequences, our reading and application of section 61, subdivision (c); section 62, subdivision (g); and Rule 462.100 must be consistent with section 60. (See *Pacific Southwest Realty*, 1 Cal.4th 155, at p. 166.) The California Supreme Court has made it clear that the Task Force Report, and the implementing sections, must be read together to determine the Legislature's intent of when a change in ownership occurs for purposes of Proposition 13. (*Id.* at p. 167.) The courts have also been very clear that a transaction only results in a change in ownership if it satisfies all three parts of the three-prong test set forth in section 60 and in the Task Force Report. (*Id.* at p. 162; *Allen v. Sutter County Board of Equalization* (1983) 139 Cal.App.3d 887, 892.) Thus, it is necessary that a change in ownership question be answered by looking at all three prongs, and not just the value equivalence prong. (*Leckie v. County of Orange* (1998) 65 Cal.App.4th 334, 339.)

During the course of a lease, both the lessee and the lessor have a present interest and beneficial use of the property for purposes of the three-prong test. The California Supreme Court has held

that a lessor has a present interest in its property during the lease term, even though it is currently being leased. (*Auerbach v. Assessment Appeals Bd. No. 1* (2006) 39 Cal.4th 153, 162.) The lessor has the present interest in its property in that it can transfer the underlying fee interest for value or can extract rent from it, and the lessor has the beneficial use of the property by enjoying the value of its property represented by rent; the lessee has a present interest and the beneficial use of the property by having the exclusive, present right to physical possession and use of the property during the lease term. (See *Pacific Southwest Realty*, 1 Cal.4th 155, 164-165; *Industrial Indemnity Company v. City and County of San Francisco* (1990) 218 Cal.App.3d 999, 1005-06.)

With respect to value equivalence, however, only one party may have the value equivalence at any one given time. While the lease term is longer than 35 years, the lessee has value equivalence and when the term drops below 35 years, the value equivalence shifts to the lessor. Thus, when a lease is first entered into, the lessee obtains a present interest and the beneficial use, and if the leasehold term is 35 years or longer, the value equivalence also shifts to the lessee. When the leasehold term drops below 35 years, the value equivalence shifts to the lessor. We have consistently taken the position that when a long-term lease for 35 years or longer drops down to a term of less than 35 years through the mere passage of time, although the value equivalence shifts from the lessee to the lessor, there is no change in ownership. This is because the lessee has not also transferred its present interest and beneficial use to the lessor.

Lease Terminations

A lease "terminates" under California law for many reasons. Ordinarily, leases terminate upon the occurrence of the following:

- (a) the expiration of the lease term (Civ. Code, § 1933, subd. 1; 12 Witkin, Sum. Cal. Law (10th ed. 2008) Real Property (herein, Witkin), § 664);
- (b) the destruction of the premises (Civ. Code, §§ 1932, subd. 2, and 1933, subd. 4; Witkin, § 665);
- (c) certain breaches by the lessee (Civ. Code, § 1931; Witkin, §§ 667, 668);
- (d) certain breaches by the lessor (Civ. Code, § 1932, subd. 1; Witkin, §§ 608, 620, 663 and 666);
- (e) certain illegal uses of the premises by the lessee (Witkin, § 674);
- (f) the lessee's surrender of the estate to the lessor (*Id.*, § 675);
- (g) the lessee's abandonment of the premises (*Id.*, § 676);
- (h) foreclosure of a senior mortgage (*Id.*, § 677);
- (i) notice given pursuant to the lease or statute (*Id.*, §§ 678-680); and
- (j) the mutual agreement of the parties (Civ. Code, § 1933, subd. 2).

In all of the above cases, upon the "termination" of the lease, the property reverts back to the lessor. However, a lease will also "terminate" as a matter of law when a lessee acquires the underlying fee interest in the leased property from the lessor during the course of the lease, and, obviously, the property does not revert back to the lessor. Civil Code section 1933 provides that a lease "terminates" when a lessee acquires the underlying fee interest in the leased property from the lessor.⁶ Thus, as a matter of law, it is unquestionable that a lease "terminates" when, during the course of a lease, a lessee buys its lessor's underlying fee interest and the lease is no longer in effect as a result. At issue, however, is whether a lease "termination," as that word is used in the long-term lease statutes and regulations, occurs when a lessee acquires the underlying fee interest from the lessor, or when a lessor acquires the lessee's interest prior to the expiration of the leasehold term (by mutual agreement of the parties, either for consideration or not, or surrender, abandonment, or otherwise).⁷

Lessee's Acquisition of Lessor's Underlying Fee Interest

In our opinion, when a lessee acquires the underlying fee interest from the lessor while the remaining lease term is 35 years or longer, the applicable change in ownership rule is Rule 462.100, subdivision (b)(2)(A), which provides that the transfer of a lessor's interest subject to a lease with a remaining term of 35 years or longer, "*whether to the lessee or another party*," does not constitute a change in ownership of the leased property. (Subdivision (b)(1) covers transfers of a lessee's interests, and subdivision (b)(2) covers transfers of a lessor's interest.) In our opinion, the language "whether to the lessee or another party" in subdivision (b)(2)(A) clearly and unambiguously covers a lessee acquiring its lessor's underlying fee interest.

The result reached in subdivision (b)(2)(A) is consistent with an analysis of such a transaction under the three prongs of section 60. When the lease was first created or extended to a term 35 years or longer, the lessor transferred to the lessee a present interest, beneficial use, and value equivalence, all three prongs. When the lessor's interest is acquired by the lessee while the lease term remains 35 years or longer, ownership does not change because the lessor cannot transfer value equivalence to the lessee because he does not have it. This is because the value equivalence was already transferred to the lessee at the creation of the lease or extension of the lease term to 35 years or longer. Thus, an acquisition by the lessee of the lessor's fee interest does not include the value equivalence. Clearly, the transfer of the lessor's underlying fee interest is a transfer of a present interest and of beneficial use, but the lack of value equivalence means that not all three prongs are transferred in such a transaction, and hence there is no change in ownership.

Similarly, in our opinion, when the lessee acquires the underlying fee interests from the lessor while the remaining lease term is shorter than 35 years, the applicable change in ownership rule

⁶ Civil Code section 1933 states that "[t]he hiring of a thing terminates: ... 3. By the hirer acquiring a title to the thing hired superior to that of the letter." It is commonly understood that this subdivision 3 covers the situation of a lessee acquiring the underlying fee interest in the leased property from the lessor.

⁷ When the same person holds both the lessor's and lessee's interests, the estates are deemed to have "merged" if that was what was intended. (See *Summit Industrial Equipment, Inc. v. Koll/Wells Bay Area* (1986) 186 Cal.App.3d 309.) We use the term "merger" herein generally to refer to both situations of a lessee acquiring the lessor's underlying fee interest and a lessor acquiring the lessee's tenancy interest, and generally refer to the leasehold tenancy and the underlying fee interests merging as a "merger of leasehold interests."

is Rule 462.100, subdivision (a)(2)(A), which provides that the transfer of a lessor's interest subject to a lease with a remaining term shorter than 35 years does constitute a change in ownership of the leased property. (Subdivision (a)(1) covers transfers of a lessee's interests, and subdivision (a)(2) covers transfers of a lessor's interests.)

While subdivision (a)(2)(A) does not contain the same "whether to the lessee or another party" language found in its parallel provision in subdivision (b)(2)(A), it is our opinion that it applies nonetheless because it is the only subdivision of Rule 462.100 that specifically covers transfers of lessor's interests when the remaining lease term is shorter than 35 years, and because it is consistent with an analysis of such a transaction under the three prongs of section 60. If there are less than 35 years left remaining on a lease, the lessor has value equivalence. Opposite to the situation above, this is because the value equivalence is not transferred to the lessee upon the creation of a lease with a term less than 35 years.⁸ Thus, an acquisition by a lessee of the lessor's fee interest includes the value equivalence, and a change in ownership will occur. If the lessor transfers its underlying fee interest to anyone, including the current lessee, while the remaining lease term is less than 35 years, it transfers (i) a present interest in the property in that it transfers the ability to transfer the property for value and the ability to extract rent from it, (ii) the beneficial use of the property in that it transfers the ability to enjoy the value of the property represented by rent, and (iii) the value equivalence.

We note that if the remaining term of a lease is 35 years or longer and the lessee's acquisition of the lessor's fee interest were treated as a "termination" of the lease under the rules, subdivision (a)(1)(C) provides that it would constitute a change in ownership of the leased property, the opposite result obtained under subdivision (b)(2)(A), which clearly and unambiguously covers the transfer of a lessor's interest to its lessee. This direct conflict in result, and the fact that subdivision (a)(1)(C) falls under the header of transfers of "lessee's interests," support the conclusion that these transactions are not to be treated as lease terminations under the long-term lease rules.

In Annotation 220.0348.005 (November 30, 2004), we noted the apparent conflict between Rule 462.100, subdivisions (a)(1)(C) and (b)(2)(A), and concluded that the rule set forth in subdivision (b)(2)(A), that a transfer of a lessor's interest subject to a leasehold interest with a remaining term of 35 years or longer, whether to the lessee or to another party, *does not* constitute a change in ownership, is an exception to the general rule that a "termination" of such a leasehold interest *would* constitute a change in ownership. This is because section 61, which provides the *termination* rule in subdivision (c), states that it applies "[e]xcept as otherwise provided in Section 62," which provides the *transfer of a lessor's interest* rule in subdivision (g).

In Annotation 220.0345 (March 30, 1990), we reached the same conclusion reached here, that a transfer of a lessor's fee interest to a lessee while the remaining lease term is still 35 years or longer, which results in a termination of the lease under California law, must be treated as a transfer of the lessor's interest subject to such a long-term lease under section 62, subdivision (g), rather than a "termination" of the leasehold interest under section 61, subdivision (c).

⁸ In addition, if the lease term were originally 35 years or longer, but has a remaining lease term of shorter than 35 years through the mere passage of time, while the lessee would have originally had the value equivalence upon the lease creation, the value equivalence would have shifted back to the lessor at the time the lease term dropped below 35 years.

Lessor's Acquisition of Lessee's Interest During the Lease Term

In our opinion, all other transactions that result in a termination of a lease, whether upon the natural expiration of the lease term, or prior to the expiration of the lease term, and where the leased property reverts to the lessor, are to be governed by the "termination" provisions of Rule 462.100, subdivisions (a)(1)(C) and (b)(1)(C). Thus, under subdivision (a)(1)(C), if the lease "terminates" under California law for any of the reasons discussed above and the leased property reverts back to the lessor and the lease had an original term of 35 years or longer, the termination would constitute a change in ownership of the leased property *regardless of when the termination occurs*. Similarly, under subdivision (b)(1)(C), if the lease "terminates" and the leased property reverts back to the lessor, if the lease had an original term shorter than 35 years, the termination would not constitute a change in ownership of the leased property.

The results reached in these subdivisions are consistent with an analysis of such transactions under the three prongs of section 60. If the lease had an original term of 35 years or longer, and the lease term remaining is still 35 years or longer, if it terminates and the leased property reverts back to the lessor, the termination results in a transfer to the lessor of the value equivalence and the lessee's present interest and beneficial use, so the termination would result in a change in ownership because all three prongs are satisfied. If the lease had an original term of 35 years or longer, and the lease term remaining is shorter than 35 years, the value equivalence transferred to the lessor when the lease term dropped below 35 years, and then the termination and reversion results in a transfer to the lessor of the lessee's present interest and beneficial use. Again, all three prongs are satisfied and are therefore consistent with subdivision (a)(1)(C) that a change in ownership results. (See Annotation 220.0326 (February 15, 1990), wherein we opined that if a lessor were to buy out its lessee while there were 26 years left on a 54-year lease, a merger of leasehold interests would occur, which would result in a termination of a leasehold interest in property that had an original term of 35 years or longer, and thus would constitute a change in ownership under section 61, subdivision (c), and the predecessor to Rule 462.100, subdivision (a)(1)(C).)

On the other hand, if the lease had an original term shorter than 35 years, the termination and reversion would never constitute a change in ownership because the lessee never acquired value equivalence and as a result would not have it to transfer back to the lessor. All three prongs can never be satisfied, and this is consistent with subdivision (b)(1)(C) that a change in ownership does not result.

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cc: Mr. David Gau MIC:63
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