STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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September 15, 1989

Dear

Re: Reassessment issues

This is in response to your letter of July 31, 1989, to me requesting written confirmation of an opinion I had expressed in a telephone conversation with you concerning the "one-owner concept relating to leases" and the change in ownership implications of the following facts as set forth in your letter of June 20, 1989, to Richard Ochsner:

> Parcel A was originally an unimproved parcel of real property located in San Diego County and owned by Mrs. B. Mrs. B entered into a sixty-year ground lease with the XYZ partnership ("Partnership") with the proviso that Partnership construct a medical condominium office building on the project. This was in fact undertaken. Upon completion of the medical office condominium project, the various condominium units were purchased by eight different doctors ("Doctors"). Under the terms and conditions of the purchase agreement, each of the doctors purchased an interest in the condominium unit, and also entered into a sublease with the Partnership. As such, Mrs. B. was the master lessor under a ground lease, the Partnership was the lessee and sublessor, and the Doctors were each sublessees.
>
> Subsequently, the Partnership became insolvent and through the course of the insolvency proceedings, elected to give up any and all interest it had to the condominium project and transferred its interest to Mrs. B. At that time, the original lease and the subleases to the Doctors had more than forty years to run. It is now the desire of Mrs. B. to enter into a direct lease relationship with the Doctors. However, in order to avoid the complexity of numerous separate leases with each of the Doctors, the parties desire to structure the transaction in such a way that Mrs. B. and the Doctors utilize the original lease between Mrs. B. and the Partnership (however, it would be amended to clean up a number of technical deficiencies in the documents such as an ambiguous cost of living increase provision, and various provisions pertaining to the ongoing

operation of the property). However, in order to avoid the complexity of separate leases for each unit, it is the desire of the Doctors and Mrs. B. to have Mrs. B. act as the lessor under the amended and restated lease, and to designate the condominium owner's association as the lessee under the lease. The condominium owner's association would then enter into a separate sublease agreement with each doctor requiring in essence their payment of their proportional share of the rent each month. In this regard, each of the Doctors both before and after the proposed transaction would retain the same obligations with regard to the payment of rent and satisfaction of their proportional share of leasehold obligations.

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:

* * *

(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:

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

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 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 227-229.) See also, Implementation of Proposition 13, Volume 1, Property Tax Assessment, October 29, 1979, pages 19, 20, 25 and 26.

It is clear under the foregoing that in order to determine whether a change in ownership has occurred where two or more people have interests in a parcel of real property, it is necessary to establish who the primary owner of the property is.

Since the Doctors are sublessees under a sublease with more than forty years to run, they are the primary owners of the land under the one-primary-owner concept discussed above. Thus, although the transfer by the Partnership to Mrs. B is a transfer of a leasehold interest having a remaining term of 35 years or more, it is also a transfer of a lessor's interest in taxable real property subject to a remaining term of more than 35 years under the sublease. Under the one-primary-owner concept, we are of the opinion that this transfer should be treated as a transfer of a lessor's interest under section 62(g) and not as a transfer of a lessee's interest under section 61(c).

Similarly, a termination of the Partnership's leasehold interest would not constitute a change in ownership under the one-primary-owner concept in our opinion, as long as the right to possession of the property by the Doctors is not legally terminated.

If for any reason, however, the right to possession by the Doctors under the sublease legally terminated, there would be a

change in ownership under section 61(c). Such termination of the possession rights of the Doctors could have occurred or could occur as a result of the terms of the lease, sublease or amended and restated lease, or for other reasons. Since we have not seen any of the lease, sublease or amended and restated lease documents and since there may be facts bearing on the transactions of which we are not aware, we express no opinion concerning whether there was a legal termination of the leasehold interest held by the Doctors.

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

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Tax Counsel

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cc: Hon. Gregory J. Smith
San Diego County Assessor
Mr. John W. Hagerty
Mr. Verne Walton