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May 24, 2005

Re: Synthetic Lease Agreement –Determination of Owner

Dear Mr. _____ :

I am responding to your January 10, 2005 fax to Senior Tax Counsel Anthony Epolite in which you request an advisory opinion concluding that, in the case of a “synthetic lease” of California real property, the lessee is considered to be the owner of the leased property for California property tax purposes and is liable for payment of property taxes assessed to the leased property. For the reasons discussed below, we conclude that under the terms of the “synthetic lease” agreement you have provided, the lessee would be considered the owner of the property.

Factual Background

In your letter, you describe the “synthetic lease” as a financing agreement used to convey a security interest in real property in exchange for capital. You provided a copy of a “synthetic lease” (“Synthetic Lease”) between BANK _____, as Agent Lessor for the Lessors and CORPORATION as Lessee and a copy of a Participation Agreement setting forth the terms on which loans will be made to acquires the land together with any improvements thereon. According to the terms of the Lease, on the initial funding date the Existing Owner is to convey the subject property to the Agent Lessor, and the Agent Lessor is then to demise the land and any improvements thereon to the Lessee. The Lessee agrees to lease, for the benefit of the Lessors, the Agent Lessor’s interest in the subject property for the term of the Agent Lessor’s interest. The Existing Owner is defined as the _____ Land Company, the Agent Lessor is defined as Bank _____, New York Branch and the Lessors are defined as, collectively, each of the persons that are or may from time to time become identified as a “Lessor” party to the Participation Agreement. The Participation Agreement names Bank _____, New York Branch as a Lessor. The Lease recites that the Lease Term is for a period of 78 months with a Renewal Term of one year as set forth in the Participation Agreement.

Article 7.1 of the Synthetic Lease provides that:

7.1 OWNERSHIP OF THE PROPERTY. The parties hereto intend that (i) for financial accounting purposes with respect to Lessee, Agent Lessor, the Lessors and the Lenders (A) this Lease will be treated as an "operating lease" pursuant to Statement of Financial Accounting Standards No. 13 (FASB 13), as amended, (B) Agent Lessor will be treated as the owner and lessor of the Property and (C) Lessee will be treated as the lessee of the

Property, but (ii) for federal, state and local income transfer and other tax purposes and for purposes of bankruptcy, insolvency, conservatorship and receivership law (including the substantive law upon which bankruptcy, conservatorship, insolvency and receivership proceedings are based), creditor's rights and other commercial law purposes (A) this Lease will be treated as a financing arrangement, (B) Lessors and Lenders will be treated as lenders making loans to Lessee in an amount equal to the sum of the Lessor Contributions and the outstanding principal amount of the Loans, which loans are secured by the Land and the Property, and (C) Lessee will be treated as the owner of the Land and the Property and will be entitled to all tax benefits ordinarily available to an owner of land and property like the Land and the Property for such tax purposes.

Article XX, paragraphs 20.1 and 20.2 of the lease provide, in relevant part, that the Lessee has an option to purchase the property “at a price equal to the Termination Value plus all accrued and unpaid Capitalized Interest and Basic Rent plus any Supplemental Rent due and owing on the date of purchase.” The “Termination Value” is defined as “an amount equal to the sum of (i) the aggregate outstanding principal of the Notes, accrued and unpaid interest on the Notes and any other amounts due under the Credit Agreement, plus (ii) the aggregate outstanding amount of the Lessor Contributions, and all accrued amounts due on account of the Lessor Yield, plus (iii) other amounts owing to the Participants under the Operative Agreements.” “Capitalized Interest” is defined as “an amount equal to Lessor Yield or Interest on the Loans which has been capitalized pursuant to Section 2.7 of the Participation Agreement and Section 2.3(b) of the Credit Agreement, respectively. “Basic Rent” is defined as “the sum of (I) the Notes Basic Rent and (ii) the Lessor Basic Rent, calculated as of the applicable date on which Basic Rent is due.” Notes Basic Rent is defined as interest due on loans and Lessor Basic Rent is defined as Lessor Yield payable on any Payment Date under the Participation Agreement. Paragraph 20.2

Article XXI, paragraph 21.1 provides that if the Lessee does not exercise the purchase option, the Lessee may elect to have the property remarketed. If the Lessee so elects, the Lessee agrees to pay to Agent Lessor the Maximum Residual Guarantee Amount, Construction Period Maximum Recourse Amount, or Permitted Lease Investment Balance. Agent Lessor shall either remarket the property itself or direct the Lessee to conduct the remarketing. If so directed, Lessee will act as exclusive broker to the Agent Lessor and offer the leased property for sale to a third party buyer not affiliated with the Lessee for the highest price available in the open market. The Agent Lessor may not reject a bid if it is greater than or equal to the difference between the Maximum Residual Guarantee Amount, Construction Period Maximum Recourse Amount, or Permitted Lease Investment Balance. If the property is remarketed and sold, the proceeds will be distributed in accordance with the Participation Agreement and any excess will be returned to the Lessee.

Applicable Law and Analysis

Revenue and Taxation Code section 60¹ defines a “change in ownership” 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 order to identify the owner of the property among the parties to a synthetic lease for property taxation purposes, it must be determined

¹ All section references are to the Revenue and Taxation Code unless stated otherwise.

whether the execution of the synthetic lease constituted a transfer from the Agent Lessor to the Lessee of the present beneficial interest in the property with a value substantially equal to the value of the fee interest.

Section 61 describes certain types of transfers that result in a change in ownership. Subdivision (c)(1) of that section provides, in relevant part, that a change in ownership includes “the creation of a leasehold interest in taxable real property for a term of 35 years or more (including renewal options) . . .” Conversely, a lease with a term of less than 35 years does not result in a change in ownership. Under its provisions, the Synthetic Lease has a term of 78 months plus a renewal term of 12 months for a total of 90 months or 7 years and 6 months. Thus, if the Synthetic Lease is a true lease there was no transfer resulting in a change in ownership at the time of its execution.

A true lease is an agreement under which an owner gives up possession and use of property for valuable consideration for a fixed term at the end of which the owner has an absolute right to retake, control or convey the property. A financing lease is a type of purchase agreement whereby the seller (vendor) accepts periodic payments for the purchase price while retaining title to the property for security purposes. Possession of the property transfers to the lessee without full legal title until payment of the purchase price or on a predetermined date. (Miller & Starr, *California Real Estate 2d*, section 2:42.) Attorney General's Opinion No. CV 78-58 (November 3, 1978), provides guidance in distinguishing true leases from agreements that are denominated as leases but are actually purchase financing agreements. The opinion identifies the elements as follows:

Basically, a true lease provides exclusive possession of property for a limited period of time, while a finance lease provides the transfer of complete ownership at some future point in time. A finance lease is usually intended if at the time of entering into the agreement (1) the parties have a fixed intention to buy and sell, and (2) the entire obligation to pay arises, payments being on a deferred basis, or (3) the “lessee” is under an economic compulsion to exercise the “purchase” option. . . .

The opinion concludes that, the “true owner” of the property subject to a financing lease is considered to be the lessee; even though legal title to the property remains in the lessor for purposes of security. Conversely, in a true lease arrangement, the lessor is considered to be the “true owner” of the property.

The Synthetic Lease satisfies the elements for a finance lease identified in the Attorney General’s Opinion. First, Paragraph 7.1 indicates that the parties had a fixed intention to buy and sell at the time of entering into the agreement. That paragraph provides that the Synthetic Lease is considered to be an operating lease for financial accounting purposes only and that for taxation and legal purposes it will be treated as a financing arrangement and the Lessee will be treated as the owner of the property. Secondly, the Lessee is either obligated to pay the entire purchase amount or is economically compelled to exercise the purchase option under the provisions for the disposition of the property at the end of lease term. As described above, the Lessee has the option of purchasing the property by repaying the Lessor in full for the amount financed with interest and yield. If the Lessee does not elect to exercise the option, then the Lessee agrees to pay the Lessor a guaranteed amount to be offset by proceeds from a sale of the property to a third party. If the proceeds from a sale to a third party exceeds the guaranteed amount, the Lessee

retains the difference. In our view, these provisions demonstrate that the parties intended the Synthetic Lease to be a conditional sale of the property to the Lessee in which the Lessor would receive the full purchase price for the property at the end of the lease term.

Based on the foregoing, we conclude that the Lessee is the owner for California real property tax purposes and the lessor holds only bare legal title.

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. Therefore, they are not binding on any person or public entity.

Very truly yours,

/s/ Tim Treichelt

Tim Treichelt
Senior Tax Counsel

TT:jlh

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