

## Memorandum

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

**Date:** May 27, 2009

**From:** Matthew F. Burke  
Tax Counsel

**Subject:** *Change in Ownership - Lease Extensions*  
**Assignment No. 09-047**

This is in response to your memorandum dated March 11, 2009, requesting our opinion on the change in ownership consequences of extensions of long-term leases.

You ask whether the mere extension of a leasehold that was originally for a term shorter than 35 years, to a new leasehold period of 35 years or longer, results in a change in ownership. It is our opinion that this *would* result in a change in ownership.

In addition, you ask whether the mere extension of a leasehold that was originally for a term of 35 years or longer, at a time when the remaining term on such leasehold is less than 35 years through the mere passage of time, to a new leasehold term once again with a term 35 years or longer results in a change in ownership. It is our opinion that this *would not* result in a change in ownership if there were no other material changes in the terms of the lease made by the lease extension.

Recently we requested that two Property Tax Annotations that address this issue, 220.0332 (July 13, 1981; December 9, 1988) and 220.0351 (December 24, 1991), be deleted. In those Annotations and their back-up letters, we concluded that the extension of a leasehold that was originally for a term of 35 years or longer, at a time when the remaining term was less than 35 years, to a new leasehold term once again 35 years or longer, *would* be a change in ownership. As explained below, we no longer hold this opinion and request that these Annotations be deleted. This memorandum is to replace the deleted Annotations with new written guidance on the matter.

### LAW & ANALYSIS

Revenue and Taxation Code<sup>1</sup> section 60 defines "change in ownership" as a single test with three elements as follows:

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<sup>1</sup> All "section" references are to the Revenue and Taxation Code, unless otherwise indicated.

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.<sup>2</sup>

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. The creation of a leasehold interest in real property for a term of 35 years or longer (including renewal options);<sup>3</sup> and
2. The termination of a leasehold interest in real property which had an original term of 35 years or longer.

To interpret section 61, subdivision (c), the Board promulgated Property Tax Rule<sup>4</sup> 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, in relevant part, that a change in ownership includes:

1. The creation of a leasehold interest in real property for a term of 35 years or longer; and
2. The termination of a leasehold interest that had an original term of 35 years or longer.

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

1. The creation of a leasehold interest in real property for a term shorter than 35 years; and
2. The termination of a leasehold interest which had an original term shorter than 35 years.

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<sup>2</sup> We refer to the three elements from the three-part test as set forth in 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, and in section 60, as "present interest," "beneficial use," and "value equivalence." "Beneficial use" is regularly referred to as "beneficial ownership" and the courts refer to the holder of the beneficial use as the beneficial owner. See *Reilly v. City and County of San Francisco* (2006) 142 Cal.App.4<sup>th</sup> 480, 489.

<sup>3</sup> 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.

<sup>4</sup> All "Property Tax Rule" or "Rule" references are to title 18 of the California Code of Regulations.

The interpretation of sections 60 and 61, subdivision (c), as set forth in Rule 462.100, is consistent with the recommendations of the Task Force Report. 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.4<sup>th</sup> 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 recommended 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. ...

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),<sup>5</sup> 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), and Rule 462.100, must be consistent with section 60. (*Pacific Southwest Realty*, 1 Cal.4<sup>th</sup> 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 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.)

### **Lease Extensions**

As a primary matter, we note that nowhere in the Task Force Report, section 61, subdivision (c), or Rule 462.100, are lease extensions specifically addressed. In our opinion, the change in ownership consequences of lease extensions are properly analyzed by reference to the Task Force Report and the Legislature's intent in section 60. As the Task Force Report states, the three-prong test is to control *all* transfers. The specific issue is the change in ownership consequence when a leasehold term is extended by mutual agreement between the parties to a term 35 years or longer. Our answer depends upon whether the leasehold term was originally or at one time already 35 years or longer. As explained below, if the leasehold term was originally or at one time already 35 years or longer, and a reassessment already occurred upon the lease's original creation or original extension to 35 years or longer, in our opinion the extension of the term back to 35 years or longer does not result in a change in ownership. However, if a leasehold term has at all times been under 35 years, the first extension of the leasehold term to 35 years or longer *does* result in a change in ownership. In our opinion, these conclusions are consistent with the Task Force Report, section 60, Rule 462.100, and case law interpreting the change in ownership rules as applicable to lease transactions.

### **Lease Extensions – Under/Over**

We first address the situation where a lease extension is made to a leasehold that has always been under 35 years and which was never reassessed. We refer to this as the "under/over"

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<sup>5</sup> Section 62, subdivision (g), provides that a transfer of a lessor's fee interest in the underlying property subject to a lease with a remaining term of 35 years or longer does not result in a change in ownership. This is because the lessee is still considered to be the primary owner of the property when the new owner takes the property subject to the long-term lease. This section is not relevant for the purposes of the issues we address in this memorandum.

situation—the lease was never 35 years or longer (under), and was then extended to 35 years or longer (over). Consistent with section 60, Rule 462.100, and section 61, subdivision (c) (by implication), in this situation the lessee has a present interest in the property and has the beneficial use of the property, but has never had the value equivalence. Only the first two parts of the section 60 three-prong test are satisfied. Thus, there is no resulting change in ownership when the lease is executed.

When the lease is first entered into, the lessor is still the owner of the leased premises for property tax purposes and thus there is no change in ownership. When the parties agree to extend the leasehold term to 35 years or longer for the first time, value equivalence is transferred from the lessor to the lessee for the first time. In our opinion, a change in ownership must result because all three parts of the section 60 three-prong test are satisfied. Because the lessee has obtained the third element – value equivalence – the lessee becomes the owner of the leased premises for property tax purposes. At that time, ownership for property tax purposes shifts from the lessor to the lessee and consequently the property undergoes a change in ownership, consistent with section 60.

It is immaterial that the present interest and beneficial use may have transferred to the lessee years earlier when the lease was first entered into, because it is only upon the extension when all three elements for a change in ownership are met by the lessee. In other words, since a change in ownership had not yet been captured upon the transfer of the present interest and beneficial use, it would be appropriate and necessary to capture it upon the lease extension once the value equivalence transfers.

### **Lease Extensions – Over/Under/Over**

The under/over situation is contrasted, however, with the situation of lease extensions when the leasehold term was originally or at one time already 35 years or longer. We refer to this as the "over/under/over" situation—the lease was at one time 35 years or longer (over), dropped below 35 years (under) through the mere passage of time, and then is extended by the parties back to 35 years or longer (over). Consistent with section 60, and under section 61, subdivision (c), and Rule 462.100, subdivision (a)(1)(A), the property underwent a change in ownership when the lease was first entered into or first extended to 35 years or longer. When the lease was first entered into, the lessee obtained a present interest and the beneficial use, and while the leasehold term is 35 years or longer, the lessee has the value equivalence. Thus, the lessee has become the owner of the leased premises for property tax purposes. Once the leasehold term drops below 35 years, the value equivalence shifts to the lessor; however, 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 lessor does not become the

"owner" of the leased premises for property tax purposes.<sup>6</sup> When the lease drops down to a term of less than 35 years through mere passage of time and only the value equivalence shifts to the lessor, the lessee remains the owner for property tax purposes and, in our opinion, will continue to be the owner for property tax purposes unless and until the lease expires or the lessor otherwise transfers its underlying fee interest in the property.

If the lessor and lessee subsequently enter into a lease extension at any time while the remaining leasehold period is under 35 years, the value equivalence once again transfers to the lessee. However, the lessee has at all times retained a present interest in and the beneficial use of the property upon which a change in ownership has already been made, and which made the lessee the owner for property tax purposes. A present interest in and the beneficial use of the property were transferred to the lessee at the beginning of the lease, and have remained with the lessee at all times. Thus, no change in ownership occurs.

To this end, in our opinion it is crucial to recognize that when such a lease for a term of 35 years or longer is first created, or when the term is first extended to 35 years or longer, the change in ownership based upon the transfer of all three elements has already been captured. At that time, the lessee becomes the owner of the leased premises for property tax purposes. Thus, when only the value equivalence is transferred in a later extension, there has not been a correlative transfer of the present interest and beneficial use which have not been previously captured by a change in ownership. Therefore, we are of the opinion that upon such a lease extension, there is no change in ownership.<sup>7</sup>

While it could be argued that the lease extension in this situation is a "creation" of a leasehold interest in real property for a period of 35 years or longer within the meaning of section 61, subdivision (c), and Rule 462.100, subdivision (a)(1)(A), and thus results in a change in ownership under those provisions, we disagree. In our opinion, that interpretation is inconsistent with a proper application of section 60. The creation of a leasehold period for a term of 35 years or longer was already captured as a change in ownership when such long-term lease was first entered or first extended to 35 years or longer.

This opinion is contrary to the Legal Department's prior written guidance on this issue as set forth in our July 13, 1981 and December 9, 1988 back-up letters to Annotation 220.0332, and in our December 24, 1991 back-up letter to Annotation 220.0351. It is our opinion that those letters did not adequately support their conclusion on this issue. For example, in those

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<sup>6</sup> This position is consistent with the Task Force Report, which stresses the need to determine at any given time who the primary economic owner of the property is for a proper application of the change in ownership rules to leases and other split ownership situations. This position is also consistent with a proper application of the other lease transaction provisions in section 61, subdivision (c), and Rule 462.100. For example, if a 40-year lease were to drop to 30 years through mere passage of time, a transfer by the lessor of its fee interest in the property subject to the 30-year lease results in a change in ownership under section 61, subdivision (c), and Rule 462.100, subdivision (a)(2)(A). To be consistent with section 60, as required, in such situation the lessor has transferred the fee value to the purchaser of the fee interest. This could only be the result if the value equivalence necessarily shifted from the lessee to the lessor when the lease term dropped below 35 years through the mere passage of time; otherwise, the lessor would not have the "value equivalence" to transfer to the purchaser of the fee interest.

<sup>7</sup> This opinion, however, may not be interpreted to suggest that a lease extension under this specific situation could be entered into with the intent of avoiding a reassessment upon a sale of the underlying fee interest in the property by a lessor. In our opinion, such a transaction would be subject to the step transaction doctrine. See *Shuwa Investment Corp. v. County of Los Angeles* (1991) 1 Cal.App.4<sup>th</sup> 1635.

annotations, we concluded that an extension of a lease term in the over/under/over situation is a "creation" of a leasehold interest for a term of 35 years or longer (and thus a change in ownership under section 61, subdivision (c) and the Rule), without any analysis of the present interest or beneficial use elements. As well, we failed to recognize the fact that the lessee has at all times retained a present interest in and beneficial use of the property.

### **Substantial Lease Modifications**

Nothing in this opinion is intended to be inconsistent with our opinion with respect to the change in ownership consequences in situations where a lease extension is coupled with other significant modifications or amendments to the lease. It is our longstanding opinion that if there are such significant modifications or amendments to a lease, the lease may be deemed terminated within the meaning of section 61, subdivision (c), and Rule 462.100, subdivisions (a)(1)(C) and (b)(1)(C). If the lease is deemed terminated, a new lease will be deemed created and such lease will be deemed to include the terms of the original lease, as amended or modified. This new lease creation may or may not cause a change in ownership depending upon its new leasehold duration. (See Property Tax Annotation 220.0325 (May 10, 1989).) For purposes of the discussion in this memorandum, it is assumed that the lease extensions are entered into without any other amendments or changes to the lease that would rise to the level of being a "substantial modification."

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