

State of California

Board of Equalization

Memorandum

To: Mr. Verne Walton

Date: April 1, 1987

From: Eric F. Eisenlauer

Subject: Change in Ownership of Leasehold Improvements
Following Lease Cancellation – Monterey County

This is in response to your memorandum to Mr. Richard Ochsner dated March 23, 1987 regarding the above-referenced matter. The facts as presented by Mr. Tom Thayer of the Monterey County Assessor's Office are as follows:

The tenant, "Digital" [Redacted] signed a lease on July 15, 1983, with the landlord, R [Redacted] Realty, covering office space in 3 buildings. Building A was fairly complete; it had tenants in place and was considered an office condominium. Buildings B and C were being constructed just for Digital Research. The landlord was to provide the basic shell and Digital was to finish the inside of those buildings. Total cost to Digital was in the neighborhood of \$1.7 million. This lease was called a "net lease" by Digital. Section 7.3 of this lease states, in part, that "all alterations, additions, improvements ... shall at the expiration or earlier termination of the lease become the property of Lessor. . . ."

A sale of the property was planned by the landlord in 1984. Prior to the sale, the parties, on October 25, 1984, executed a new lease, a "gross lease" for the benefit of the new landlord. The new lease provided that the old lease was cancelled and of no further force or effect, however, most of its provisions were identical to the original lease. For example, the lease term commenced on October 1, 1983 as did the original lease term, and the term was for the same time period of twenty years including three extension options of five years each. The new lease also contains the same language regarding possession of leasehold improvements as that contained in Section 7.3 of the original lease part of which is quoted above. The monthly rent under the new lease is \$52,284 and the Lessor pays all expenses including real property taxes except for those over and above such expenses for the Base Year which is defined in the lease as the 1984-85 tax fiscal year (Section 5.3.1 of new lease) whereas under the old lease the monthly rent was \$37,136 and the Lessee paid as additional rent all operating expenses and property taxes paid by the Lessor and then billed to the Lessee (Section 5.3 of old lease).

Digital Research has been assessed each year for its leasehold improvements. Digital now believes that there has been a double assessment on those improvements since the time of the sale of the property in December 1984. Digital contends that ownership to the tenant improvements was transferred from Rusin Realty to the new landlord in December 1984

and that the amount paid for the total property at that time was adequate to cover the value of all improvements.

Based on the foregoing facts, the county asks two questions:

- 1) Would the cancellation of the first lease in October 1984 and subsequent creation of a new lease at that time have resulted in ownership to the tenant improvements being transferred from Digital Research to Rusin Realty?
- 2) For leasehold improvements in general: If a tenant puts in "structural" and "permanent" improvements (such as finishing off a building shell), can the landlord "sell" these improvements to another party if there is no change in the tenant's lease?

Answer to Question 1:

As indicated above, Section 7.3 of the old lease provides essentially that alterations, additions and improvements made by the Lessee shall become the property of the Lessor "at the expiration or earlier termination of the lease." The new lease expressly cancelled the old lease. However, whether such cancellation caused the alterations, additions and improvements made by the Lessee to become the property of the Lessor depends on the intention of the parties (Goodman v. Jonas (1956) 142 Cal.App.2d 775). Such intention must be ascertained from the language of the lease in light of the circumstances surrounding its execution and the object sought to be accomplished by the parties; the lease is to be construed as a whole so as to give effect to every provision, if reasonable possible (Goodman, supra).

Applying the foregoing rules, there is no indication that the parties intended the cancellation of the old lease to effect a transfer of improvements made by the Lessee to the Lessor. All that appears to have been intended was an amendment of the old lease from a "net" lease to a "gross" lease with the Lessee paying the same total amount as before. Had the parties intended a transfer of Lessee improvements to the Lessor, the rental under the new lease logically would have been increased to reflect such an acquisition by the landlord. Such was not the case however. No part of the annual rent increase of \$181,776 is attributable thereto. Rather, under section 5.3.1 of the new lease that amount (\$181,800) is the amount of expense for the Base Year which included all operating costs not billed to Lessee and all real property taxes paid by Lessor which Lessor in turn billed to the Lessee as additional rent under Section 5.3.1 of the old lease. Under the new lease, the Lessee pays to the Lessor as additional monthly rent, the same amount that was previously paid to the Lessor as monthly rent and as additional rent after the Lessor sent a bill for such additional rent.

Also, since the Lessee has been assessed each year for its leasehold improvements, we assume the Lessee must be reporting such improvements on its property statement which would indicate a belief on the Lessee's part that such improvements were not transferred to the Lessor. Accordingly, it is our opinion that the parties did not intend that the cancellation of the old lease was to result in a transfer of the tenant improvements to the Lessor and that no such transfer, therefore, occurred.

Whether the tenant improvements were transferred to the Lessor, however, should not have any significant effect on the Lessee's property tax liability. When the Lessor's interest in the property was sold in December 1984, there was a change in ownership under Revenue and Taxation Code Section 61(c)(2) and Property Tax Rule 462(f)(B)(i) because the remaining term of the lease including renewal options was less than thirty-five years. As a result, Property Tax Rule 462(f) requires that "the entire property subject to the lease is reappraised (i.e., the value of both the lessee's interest and the reversion)." The reappraisal would therefore include the improvements, alterations and additions to the real property made by the Lessee. If such improvements were not transferred to the Lessor as a result of cancellation of the old lease, the Lessee would be obligated for the property taxes on the improvements including the increased taxes resulting from the change in ownership in 1984 because the Lessee was separately assessed for those improvements. In such case, the assessment to the Lessor should not reflect any amount attributable to the tenant improvements. If, on the other hand, the improvements were transferred to the Lessor as a result of cancellation of the old lease, they are properly assessable to the Lessor rather than the Lessee and the Lessee would be obligated to pay the property taxes on such improvements as additional rent to the Lessor pursuant to Section 5.3.1 of the new lease because such taxes are costs in excess of Base Year expenses. As indicated above, however, we don't believe the tenant improvements were transferred to the Lessor as a result of cancellation of the old lease.

Answer to Question 2:

The landlord can legally sell only what he owns. What he owns are the right to receive rent pursuant to the terms of the lease and the reversion or right to possession of the leased property when the lease terminates. If the tenant makes structural and permanent improvements to the leased property, the landlord owns the reversion in such improvements unless the lease agreement provides otherwise. In such a case the landlord can sell his reversion in such improvements.

If there are further questions regarding this matter, please let us know.

EFE:cb
0440D

cc: Mr. Gordon P. Adelman
Mr. Robert H. Gustafson