



## STATE BOARD OF EQUALIZATION

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January 11, 2011

**Re: *Change in Ownership of Lessee-Constructed Improvements***  
***Assignment No.: 10-125***

Dear Mr. \_\_\_\_\_ :

This letter is in response to your request for a legal opinion on the change in ownership consequences of the change in control of the lessor of a self-storage facility located at \_\_\_\_\_ Road, \_\_\_\_\_, APN No. \_\_\_\_\_ x-016 (the Property), which is subject to a ground lease with tenant-constructed improvements on it.<sup>1</sup>

**Facts**

Your clients are the Property's tenant. On October 6, 1982, the owner of the underlying land at issue, \_\_\_\_\_ Company (the Original Lessor), leased the land to D \_\_\_\_\_ and J \_\_\_\_\_ (the Original Lessees), for 50 years beginning November 15, 1982, pursuant to that lease entitled "50-Year Lease, California" (the Original Lease).

On March 16, 1989, \_\_\_\_\_ Realty Corporation (RC), the successor by merger to the Original Lessor, entered into that Amendment No. 1 to Lease Between D \_\_\_\_\_ and J \_\_\_\_\_ and \_\_\_\_\_ Realty Corporation with the Original Lessees.

On April 17, 1989, one of the Original Lessees, J \_\_\_\_\_, assigned his interest in the lease to the other Original Lessee, D \_\_\_\_\_, pursuant to an Assignment of Lessee's Interest filed with the \_\_\_\_\_ County Recorder's Office (the Recorder). D \_\_\_\_\_ reassigned a 50 percent interest in the lease back to J \_\_\_\_\_ pursuant to an Assignment of Lessee's Interest that was never recorded.

On October 9, 1989, D \_\_\_\_\_ died testate and his interests passed in equal amounts to his children, L \_\_\_\_\_ and D \_\_\_\_\_ (L and D \_\_\_\_\_). The Final Order on Waiver of Accounting and Petition for Order of Final Distribution dated May 21, 1997 referred to the interests that passed to each of L \_\_\_\_\_ and D \_\_\_\_\_ as each a "One-fourth (1/4)

<sup>1</sup> This opinion is being requested in connection with a hearing before the \_\_\_\_\_ County Assessment Appeals Board scheduled for March 15, 2011. Both parties are aware that we will be issuing this opinion, have examined and/or provided the facts set forth herein, and were given an opportunity to provide additional information in connection with this letter. The parties anticipate that this opinion will be issued prior to the hearing.

interest in a business association with J \_\_\_\_\_, named \_\_\_\_\_ Personal Storage located at \_\_\_\_\_ Road, \_\_\_\_\_, California."<sup>2</sup>

In 1990, the real estate-related activities of RC were spun off into a new independent company, C \_\_\_\_\_ Corporation (C \_\_\_\_\_), making C \_\_\_\_\_ successor in interest to RC and therefore the new lessor. On March 19, 2001, the Original Lease was amended between C \_\_\_\_\_ F \_\_\_\_\_ 1, LLC, a Delaware limited liability company and successor in interest to C \_\_\_\_\_, and L \_\_\_\_\_, D \_\_\_\_\_, and J \_\_\_\_\_.

After all of the transfers and assignments, the current lessor is C \_\_\_\_\_ F \_\_\_\_\_ 1, LLC (the Lessor), and the current lessees are L \_\_\_\_\_ as to a 25 percent interest, D \_\_\_\_\_ as to a 25 percent interest, and J \_\_\_\_\_ as to a 50 percent interest (the Lessees).

Under the Original Lease, the "premises" rented to the Original Lessees was that certain land as described in Exhibit A to the Original Lease. (Original Lease, Section 1.) Section 1 of the Original Lease provides that the Lessee shall use the premises "exclusively for the construction, maintenance and use of Lessee-owned improvements and related facilities for a mini-storage warehouse operation and parking in conjunction therewith." The Original Lessees constructed the self-storage facility on the land by installing the storage containers (the Improvements).

Section 16 of the Original Lease provides the following:

Upon the expiration or termination of this lease, *Lessee shall deliver to Lessor possession of the premises. Lessee, if not in default hereunder, may, prior to such expiration or termination, remove from the premises any buildings or structures wholly owned by Lessee.* Lessee shall restore the premises to the condition in which they existed at the time Lessee took possession, ordinary wear and tear excepted. Upon the failure of Lessee to remove from the premises all property owned by Lessee, said property shall, at the option of Lessor, become the sole property of Lessor, or, if lessor so elects, Lessor may remove from the premises any property owned by Lessee and restore the premises to substantially the same condition in which they existed at the time Lessee took possession, all at the expense of Lessee. (Emphasis added.)

Section 17 of the Original Lease provides the following:

[I]f improvements on the premises other than those which are owned by Lessor are not removed and premises restored prior to termination date, either by Lessee or by Lessor at Lessee's expense, then this lease, with all terms contained herein, including the payment of rental, may, at Lessor's option, remain in effect until improvements are removed and premises restored.

<sup>2</sup> Pages 32 and 35 of the Final Order. It appears that a Preliminary Change in Ownership Report was not filed with respect to the October 9, 1989 transfers to L \_\_\_\_\_ and D \_\_\_\_\_. In addition, it appears that parent-child exclusion claims were also not filed with respect to these transfers. We render no opinion as to the change in ownership consequences of these transactions.

On September 15, 2005, the Lessor was acquired by P , resulting in a change in control of the Lessor. Because there were 27 years remaining on the lease, which would result in a change in ownership of leased property under the long-term lease rules, at issue is whether the Improvements also constitute leased property subject to reassessment. It is your position that only the land should have been reassessed from the change in control because the Improvements were tenant-owned and therefore were not a part of the lessor's interest that was subject to the change in control.

### **Law & Analysis**

Revenue and Taxation Code<sup>3</sup> section 60 defines "change in ownership" as a single test with three elements as follows: (1) a transfer of a present interest in real property; (2) including the beneficial use thereof; (3) the value of which is substantially equal to the value of the fee interest.

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 taxable real property for a term of 35 years or longer (including renewal options); (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 and do not result in a change in ownership. This Rule tracks sections 61, subdivision (c) and 62, subdivision (g).

Under section 64, subdivision (c)(1), when a legal entity undergoes a change in control, there is a change in ownership of all property owned by that entity. If a lessor undergoes a change in control, included in that property that would undergo a change in ownership as a result of such change in control is any "lessor's interest" subject to a lease with a remaining term shorter than 35 years.

To determine whether there has been a change in ownership of a lessee's "leasehold interest" or a "lessor's interest" under these rules when there is a ground lease and tenant-constructed improvements, it is necessary to determine who owns the improvements; if the improvements are owned by the lessor, then they are subject to the long-term lease rules, and if they are owned by the lessee, they would not be subject to those rules.

The California Supreme Court addressed the issue of ownership of tenant-constructed improvements on land subject to a ground lease for purposes of the change in ownership rules in *Auerbach v. Assessment Appeals Board (Auerbach)* (2006) 39 Cal.4th 153. *Auerbach* involved the Tommy Hilfiger store on Rodeo Drive in Beverly Hills. Each of two grandchildren was the beneficiary of one of two trusts that together held a 50 percent tenancy in common interest in the land. Northern Trust Bank of California, as co-trustee of these two trusts, was the real party in

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<sup>3</sup> All "section" references are to the Revenue and Taxation Code, unless otherwise indicated.

interest in the litigation. Two other trusts that were not involved in the litigation owned the other 50 percent tenancy in common interest along with the grandchildren's trusts, and all four trusts leased the land to Tommy Hilfiger Retail, Inc. (Hilfiger) for 10 years with two five-year extension options. The land was improved with a building. The Hilfiger lease defined the premises being leased as including the improvements, and under a paragraph defining "ownership," the lease provided that all alterations to the premises made by Hilfiger would "be the property of and owned by Lessee [Hilfiger], but considered a part of the Premises." The Hilfiger lease also required Hilfiger to surrender the premises at the end of the lease term "with all of the improvements, parts and surfaces thereof clean and free of debris and in good operating order, condition and state of repair, ordinary wear and tear excepted." (*Id.* at pp. 157-58.) A lease addendum also entitled "Ownership" stated: "During the term of this Lease, the Improvements shall be the property of and owned by Lessee but considered a part of the Premises. The Improvements shall, at the expiration or earlier termination of the Lease, become the property of Lessor and remain upon and be surrendered by Lessee with the Premises." (*Id.* at p. 158.)

In 1999, the grandchildren's grandfather died, which transferred ownership of the trust-owned property to the grandchildren. The grandchildren applied for the \$1 million grandparent-grandchild exclusion and it was granted, but the Assessor applied it to the land and the building, not just the land, on the basis that the trust also owned the improvements. (*Auerbach, supra*, 39 Cal.4th at p. 160.) The parties agreed that the land changed ownership, but disagreed that the building did. Northern Trust, as trustee, appealed and the case eventually went to the California Supreme Court.

The California Supreme Court framed the issue succinctly: "The question here solely concerns who owns the building." (*Auerbach, supra*, 39 Cal.4th at p. 162.) If Hilfiger owned the building, then the building did not change ownership when the grandfather died, but if the trusts owned the building, then it did change ownership because it would have been subject to the long-term lease rules as part of the leased property.

Northern Trust argued that Hilfiger owned the building based primarily upon the fact that the lease designated Hilfiger as the owner. The Court concluded that the provision in the lease that Hilfiger owned the building during the lease term was "not dispositive" for change in ownership purposes. (*Auerbach, supra*, 39 Cal.4th at p. 162.) More importantly, in the view of the Court, the lease provided that the building would revert to the lessor upon lease termination, and the lease made Hilfiger's "ownership" subject to the requirement that Hilfiger surrender the building to the lessor upon lease end and gave the lessor the authority to eject Hilfiger from possession for a breach. (*Ibid.*) Because of this, the Court concluded that, "for purposes of Proposition 13, Hilfiger has a leasehold interest in the building or at most a possessory interest in an estate for years, not ownership of the fee interest. The fee interest in the entire premises, including the building, remains with the trusts." The Court also found that other lease provisions supported this conclusion, namely: (1) the trusts retained the right to sell the premises, including the building; (2) the trusts would be required to pay any increased property taxes caused as a result of the property's sale; (3) Hilfiger was required to remodel or replace the building at its own expense, but obtained rent credits if it constructed a new building; (4) remodeling or rebuilding was subject to the trusts' approval; (5) Hilfiger could not transfer its interest without the trusts' approval; and (6) any eminent domain proceeds belonged to the trusts. (*Auerbach, supra*, 39 Cal.4th at p. 163.)

The Court of Appeals for the Fourth Appellate District also addressed this issue recently in *Phelps v. Orange County Assessment Appeals Board No. 1 (Phelps)* (2010) 187 Cal.App.4<sup>th</sup> 653, review den., 2010 Cal. LEXIS 12265 (Dec. 1, 2010). In *Phelps*, the trustee of a trust challenged the reassessment of a shopping center upon the death of an income beneficiary of the trust. The trust owned the fee title to the shopping center land. The trust derived income from the shopping center tenants. In the 1960s, the trust as lessor entered into a lease with Montgomery Ward as lessee that required the lessee to construct improvements on the unimproved land and to surrender the improvements in good condition upon lease termination. Target Corporation (Target) became the current lessee after Montgomery Ward went bankrupt. Target spent \$7 million in renovations to the main store. Both Montgomery Ward and Target subleased portions of the property to other businesses that constructed improvements at their own expense; these improvements were also considered "owned" by the lessee (or sublessee) for the duration of the lease. The lease required the improvements be surrendered to the trust as lessor upon lease termination.

In 1992, one of the three equal income beneficiaries of the trust died, and his interest transferred to his four children, so the assessor reassessed a one-third interest in the entire property, including the tenant-constructed improvements. The trustee argued that the trust didn't have a present interest in the improvements and therefore the improvements could not have changed ownership along with the land. The Court of Appeal found *Auerbach* "instructive" on the issue of the ownership of tenant-constructed improvements for change in ownership purposes. The court interpreted *Auerbach* as holding that "the provision requiring surrender of the building at the conclusion of the lease demonstrated that the trust held the fee interest in the building," regardless of the lease's designation of ownership. (*Id.* at p. 660.) Based on this, the *Phelps* court held that even though the lease at issue provided that the lessee owned the improvements during the lease term, because the lease required the lessee to surrender the improvements in good condition to the lessor when the lease ended, the trust owned the improvements for property tax purposes.

In your case, it is our opinion that the Lessee owns the tenant-constructed improvements for property tax purposes under *Auerbach* and *Phelps*. Under those cases, it is clear that the key factor in determining whether tenant-constructed improvements belong to a lessor for property tax purposes is whether the improvements must be surrendered to the lessor upon lease termination. Under the Original Lease and all of the amendments, there is no requirement that the Lessee surrender the improvements to the Lessor upon lease termination. In fact, as set forth fully above, Section 17 of the Original Lease charges the Lessee with the duty to remove the improvements upon lease termination. Under that provision, if the Lessee does not remove the improvements, at the Lessor's option the tenancy continues until they are removed. Moreover, Section 16 of the Original Lease requires the Lessee to surrender the *land* in the same pre-lease condition, that is, without the improvements.

As the Supreme Court in *Auerbach* found that the other lease terms supported its conclusion, the other lease terms here support our conclusion as follows: (1) the Lessee is required to pay any property taxes on the Improvements (Original Lease, Section 4.B); (2) any eminent domain proceeds from the taking and damaging of the Improvements belongs to the Lessee (Original Lease, Section 25.B); and (3) the Lessee must advise the Lessor before selling or transferring the Improvements, but need not get the Lessor's prior approval (Original Lease, Section 29), although any assignment of the Lessee's leasehold interest as security for a loan does require prior Lessor approval (Original Lease, Section 30).

Because in our opinion the Lessees own the Improvements for property tax purposes, the change in control of the Lessor did not result in a change in ownership of the Improvements. We render no opinion as to the change in ownership consequences of any of the other transactions that occurred over the years with respect to the Property.

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, and are not binding on any person or public entity.

Sincerely,

/s/ Matthew F. Burke

Matthew F. Burke  
Tax Counsel III (Specialist)

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cc: Honorable  
County Assessor

Mr. David Gau	MIC:63
Mr. Dean Kinnee	MIC:64
Mr. Todd Gilman	MIC:70