(916) 445-4588

April 21, 1982

Dear Mr.

We have reviewed the contentions and analysis in your March 17, 1982, letter and have set forth below our conclusions on the two points you raised.

1. In determining the date of change in ownership, upon the exercising of an option to buy, does the date relate back to the initial date of the option itself?

Generally, upon the exercising of an option to purchase realty, the rights of the purchaser will relate back to the date of the option and take priority over most other rights that arose subsequent to the date of the option. Seeburg v. El Royale Corp. (1942) 54 Cal.App. 2d 1, 4, 128 P.2d 362; Utley v. Smith (1955) 134 Cal.App. 2d 448, 450, 285 P.2d 986, and see Miller & Starr, Current Law of California Real Estate §2:31. Uniformly, though, courts have refused to apply relation back to cut off the rights of bona fide purchasers without notice of the option who intervened between the creation and the exercising of the option. Utley v. Smith 134 Cal.App. 2d at 450, D-K Investment v. Sutter (1971) 19 Cal.App. 3d 537, 96 Cal.Rptr. 830. Indeed, the concept of relation back has had little force outside the realm of settling competing claims between the optionee and an intervening purchaser from the optionor.

Moreover, for tax purposes, the holding period of acquired property does not relate back but begins the day following the exercise of the option. Helvering v. San Joaquin Fruit & Inv. Co. (1936) 297 US 496; Rev. Ruling 54-283, 1954-2 Cum. Bulletin 177; see also California Real Estate Sales Transactions (1967) §7.4. The courts have consistently held that until the option is exercised the optionee does not actually own the asset; therefore, there is no relation back. Blick v. Commissioner (1959) 271 F.2d 928.

Under California law, no cases have challenged the federal concept and two State Board of Equalization rulings have accepted the denial of relation back upon the exercising of an

option with respect to the holding period. Appeal of Charles H. and Norma L. Andrews, SBE 6/21/71 and Appeal of Holzworth, SBE 12/12/67.

Therefore, under the facts in our case, since the basis for denying relation back centered on the determination that the optionee did not acquire the property until he exercised the option, the date of change in ownership should be the date of the exercising of the option.

2. May the concept of "economic compulsion" permit relation back in this case?

A recognized departure to the denial of relation back upon the exercising of an option has developed when, because of the nature of the agreement, the purported "lease" is, in reality, a conditional sales contract under which the "optionee" is economically compelled to complete the transaction. (See Mt. Mansfield Television, Inc. v. United States (1964) 239 F.Supp. 539; Oesterreich v. Commissioner of Internal Revenue (1955) 226 F.2d 798 & Norman P. Van Valkenburgh (1967) ¶67, 162 P-H Memo TC). In these cases, the courts have refused to view the sale as taking place upon the exercising of the option. Instead, the agreement is viewed as transferring the property at the date of the "option" subject to the condition subsequent of continued payments. Realistically, the purchaser is compelled to "exercise" his option and complete the transaction in order to retain his sizable investment. (See generally, P-H Federal Taxes ¶11,839)

The courts, though are not actually applying relation back. Rather, they are recognizing that from its inception the agreement was intended by the parties as a sale of the property. Consequently, the courts give effect to these intentions. This problem has arisen almost exclusively in the area of claimed rent deductions by the lessee/purchaser. In denying these deductions for rental payments, the courts have reasoned that the payments were non-deductible capital expenditures spent as acquisition costs. These conclusions rested on an analysis of the ultimate intentions of the parties, as evidenced by the provisions of the lease agreement and giving effect to the circumstances existing at the time the agreement was executed. (P-H Federal Taxes ¶11,839). In each case the court has concluded that the intentions were to in fact have a lease with an option to purchase or that the option was a sham to permit invalid rental deductions as part of a conditional sales contract. (See the numerous cases cited in P-H Federal Taxes ¶11,839 and 11,840). In the former situation the courts give effect to the stated intentions and in the latter the courts give effect to the actual intentions. But in all cases the courts focus upon the intent at the date of the agreement.

Economic compulsion has been utilized only in cases where the method of the transaction did not comport with the actual intentions of the parties. It is a sword used against the taxpayer who attempts to disguise a conditional sale as a lease with an option to purchase. The theory has not been extended to consideration of subsequent changes in circumstances such as in our present case. Economic compulsion is used to align the method of the transaction with the actual intentions of the parties at the time the agreement was made. It is not designed to remedy subsequent changes, foreseen or not. The purpose is only to prevent fraud through manipulation of the purchase arrangement.

Therefore, in this case, since there is no argument that the parties intended to enter into a conditional sales contract instead of the present option agreement, economic compulsion has no application. Moreover, in the event such an argument is subsequently raised, economic compulsion would still be inapplicable. If a conditional sales contract can be proven, no question as to the date of change in ownership remains. If the parties fail to show such a conditional sale, they are back to the present circumstances. In both cases economic compulsion is improper.

Very truly yours,

Glenn L. Rigby
Assistant Chief Counsel

GLR:jlh

cc: Mr. Gerald F. Allen

bc: Mr. Gordon P. Adelman
Mr. Robert H. Gustafson
Legal Section

Mr. Verne Walton

February 6, 1985

Eric F. Eisenlauer

Option to Lease

This is in reply to your memo to Richard Ochsner in which you ask whether the Option to Lease (the "Option") attached thereto created a taxable possessory interest as of the date of the Option. The parties to the Option are the Regents of the University of California (the "Optionor"), and Sickels, O'Brien and Associates, California General Partnership, (the "Optionee"). The property subject to the Option consists of approximately 24 acres of land adjacent to the University of California in La Jolla. The property is currently improved with several old barns, a tack house, an office and a single family residence. The Optionee entered into the Option for the purpose of evaluating the feasibility of developing the property and to obtain all required governmental approvals for the development and construction of a proposed conference center and office building, a commercial center, condominiums, and single family residences before being committed to a long term (50 year) ground lease. Since the date of the execution of the Option on September 1, 1983, the Optionee's initial proposed plans for development of the property have been disapproved by the San Diego City Council and the Optionee is currently in the process of redesigning its plans and going back to the San Diego City Council again to gain approval of the revised plans. If the approvals cannot be obtained, the Optionee will not exercise the Option and lease the property for the 50 year term and will never have any rights of possession or use of the property and will gain no economic benefit from the Option or the property. If the Optionee exercises the Option at a date prior to the end of its three year term, it will be entitled to a refund of a pro rata portion of the Option price, which amounts to $43,750 per month (see paragraph 2(a) of the Option).

Possessory interests are defined by Revenue and Taxation Code Section 107. The courts have held that in determining whether a possessory interest in nontaxable, publicly owned real property exists within the meaning of

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Section 107, the factors of exclusiveness, independence, durability and private benefit must be weighed on a case-by-case basis. Wells National Services Corporation v. County of Santa Clara (1976) 54 Cal.App.3d 579, 583. Similarly, Property Tax Rule 21(a) (18 Cal. Admin. Code § 21) provides in relevant part that a

> "['p]ossessory interest' means an interest in real property which exists as a result of possession, exclusive use, or a right to possession or exclusive use of land and/or improvements...and which may exist as the result of:
>
> "(1) A grant of a leasehold estate...or any other legal or equitable interest of less than freehold, regardless of how the interest is identified in the document by which it was created, provided the grant confers a right of possession or exclusive use which is independent, durable, and exclusive of rights held by others in the property."

Possession is defined by Rule 21(c) to mean: "(1) Actual possession, constituting the occupation of land or improvements with the intent of excluding any occupation by others that interferes with the possessor's rights, or (2) constructive possession, which occurs when a person although he is not in actual possession of land or improvements, has a right to possession and no person occupies the property in opposition to such right." The factor of exclusiveness or exclusive use is defined by Rule 21(e) (18 Cal. Admin. Code § 21) to mean "the enjoyment of a beneficial use of land or improvements, together with the ability to exclude from occupancy by means of legal process others who interfere with that enjoyment."

Had the parties to the Option executed the lease contemplated by the Option, there is no doubt that a taxable possessory interest would have been created. Here, however, the parties have executed only the Option. Typically, such an instrument is merely an irrevocable offer to [lease] certain property which remains open for a specified period of time. Warner Brothers Pictures v. Brodel (1948) 31 Cal.2d 766. It is essentially a sale of the right to enter into a lease and normally no lease or rights to possession or exclusive use come into existence until the right is exercised.

A review of the Option in question indicates that that is the case here. By its terms, the Option does not give the Optionee any right to possession, exclusive use, or occupancy of the property. To the contrary, paragraph 6(b) of the Option states: "During the option period no demolition, construction or development work may be performed on the subject property except as permitted by paragraph 9...." Paragraph 9 of the Option does grant the Optionee certain limited rights of access to the property during the term of the Option in order to "conduct surveys, soils tests and such other planning work and feasibility studies as may be necessary or desirable in connection with Optionee's development on the [p]roperty" and to construct a fence and repair some of the existing improvements on the property. The Optionee also may use an existing building on the property as a project office, but only if it enters into a separate lease for such use. This provision indicates that the parties intended that the Optionee would not occupy, possess or use the property unless a separate lease was entered into. The rights given the Optionee under paragraph 9 of the Option are typical of those given in any option to lease, i.e., those of allowing a prospective lessee certain limited access to property in order to facilitate a determination of whether he wishes to lease the property. Without such provisions, the Optionee's entry on the property could be considered a trespass. Moreover, the terms of the Option do not preclude the Optionor from enjoying its full rights of possession of the property as owner. It, therefore, does not appear that the Optionee has recieved a right of possession or exclusive use of the subject proeprty within the meaning of Property Tax Rule 21.

The concept of taxable possessory interests in California developed from the concern that private parties making valuable use of government lands with potentially no tax liability would gain unfair advantage over persons using private land who paid their full share of property tax. See People v. Shearer (1866) 30 Cal. 645. The Optionee has received no such benefit here. It is true that the development and operation of the property as contemplated in the lease would constitute a valuable use of the property, however, the Optionee does not have the right to develop and operate the property unless and until it exercises the Option. That will only occur if and when all government approvals necessary for the development of the property have been obtained.

In a somewhat analogous situation, if the Option were to purchase instead of lease, the Option would not be treated as a disguised sales contract unless there was economic compulsion to complete the transaction when the Option was created (see LTA 80/147 dated October 7, 1980, a copy of which is attached). It seems clear that no economic compulsion could exist until the required governmental approvals were obtained so that no disguised sales contract (and right to beneficial use of the property) could be deemed to exist before that time. For the same reasons, the Option here should not be treated as a disguised lease.

Based on the foregoing analysis, it is our opinion that no taxable possessory interest was created by the Option.

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Attachment

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