STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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October 21, 1988

Honorable
County Assessor
, California

Attention:

Dear Mr. :

This is in response to your letter to James Delaney in which you request our opinion with respect to the Lease and Option Agreements submitted with your letter in light of State Board of Equalization Letter to Assessors 80/147 "Change in Ownership--Options.". The parties to each agreement are , an Illinois Limited Partnership ("RB") Lessor and Optionor and ("WHS") Lessee and Optionee. Both agreements were entered into on July 18, 1977.

Under the Lease Agreement, WHS leased certain commercial real property in downtown for a period of 301 months commencing December 1, 1977. The total rent payable over the term of the lease was $46,379,167.07. The monthly rent payable in arrears for the first 61 months was $129,166.67; for the next 60 months $137,500; the next 60 months $150,000; the next 60 months $166,666.67; and the next 60 months $187,500. The lease was an absolute net lease with the lessee paying all property taxes, utilities, maintenance, repairs, replacements, insurance, etc.

Under the Option Agreement, WHS paid RB $2 million ($50,000 on December 1, 1977 and the balance January 2, 1978) for an option to purchase the subject property for $15.75 million in December 1987. The $2 million option consideration was nonrefundable and was to be credited against the purchase price in the event the option was exercised. The option was in fact exercised and legal title passed to WHS January 19, 1988.

It appears from the letters of Messrs. and that both parties understood that WHS would make substantial capital improvements to the property and that to date WHS has spent in excess of $10 million on such capital improvements some of which occurred immediately after the agreements were made in 1977.

According to Mr. letter, the property was appraised by the Assessor as of the 1977 lien date at a market value of approximately $18.8 million.

Based on the foregoing, you ask whether a change in ownership occurred at the time the option agreement was made or when it was exercised. This depends upon whether the above described agreements were truly a lease with an option to purchase in which case the change in ownership occurred in 1988 or whether those agreements constituted an agreement of sale between the parties in which case the change in ownership occurred in 1977.

The Board has set forth guidelines for making this determination in Letter to County Assessors entitled "Change in Ownership--Options" dated October 7, 1980 (No. 80/147). The test set forth in that letter is that of economic compulsion. The rationale is that although an optionee has no legal obligation to exercise the purchase option, if it appears at the time the option is granted that the optionee will be economically compelled to do so then the agreement or agreements are properly characterized as an agreement of sale. You will note that LTA 80/147 omits mention of the benefits and burdens of ownership test for determining whether a sale has occurred. Although this test was applied in the letters of Messrs. and , we don't believe it is applicable to determine whether a lease with an option to purchase is in fact an agreement of sale. (See 5 Miller and Starr, Current Law of Cal. Real Estate (1987 pocket supp.) Tax Aspects of Lease Transactions, §§ 35.16, pp. 340,341.)

In applying the economic compulsion test set forth in LTA 80/147, it is necessary to determine whether "significant equity is present at the time the option is originated or it can be determined at the time of origination that equity will be established with certainty within a short period." One example of this provided by LTA 80/147 is where, under a lease with option to purchase, the lessee is paying more than economic rent and the excess is to be applied toward the purchase price if the option is exercised. Since the lessee would lose that equity if he did not exercise the option to purchase, he is economically compelled to exercise the option and the arrangement is properly characterized as a sale from the outset.

Although this case is not identical to the example in LTA 80/147 because no portion of the rental payment is credited against the purchase price on exercise of the option, it is similar in that a payment of $2 million is called for under the option agreement and that amount is to be credited against the option purchase price of $15.75 million if the option is exercised. Moreover, under LTA 80/147, significant equity is also established if the option specifies a selling price that is significantly less than

the current market value. In this case the option specifies a selling price that is more than $3 million less than the current market value of $18.8 million at the time the option was granted. Thus, assuming a market value of only $18.8 million at the time the option could be exercised, WHS would have an equity in the property in excess of $5 million at that time upon exercising the option and paying the balance of the option price of $13.75 million. In fact, the parties anticipated that the property would appreciate in value as evidenced by the increased rental payments over the term of the lease agreed to by the parties. Anticipated value appreciation was apparently justified in 1977 in view of past experience. The parties could, therefore, have reasonably anticipated an equity of considerably more than $5 million in 1987. Since WHS would lose that equity if he didn't exercise the option to purchase, he was economically compelled to exercise it in our opinion.

The alternative to exercising the option (other than defaulting on the lease agreement which is not considered a reasonable alternative) was for WHS to continue as a tenant under the terms of the lease. Economically, this would require WHS to make rental payments in excess of $30 million for the remaining 15 years of the lease. The present value of that obligation amounted to more than $17 million assuming an 8 percent interest rate which is the rate used by the parties in the option agreement. If a higher interest rate is used, the present value of the future rent payments would obviously be lower, e.g., approximately $15 million if 10 percent is used.

When the agreements were made by the parties, therefore, they could reasonably anticipate two alternatives open to WHS ten years hence: Either exercise the option and pay $13.75 million for the full fee simple ownership of the subject real property which would have a market value no less than $18.8 million <u>or</u> continue to pay rent totalling more than $30 million over the remaining term of the lease (the present value of such obligation exceeded $17 million as indicated above). At the expiration of the lease term, the property including at least $10 million in leasehold improvements made by WHS would revert to RB. Simply put, the choice facing WHS was whether to pay $13.75 million for full fee ownership or more than $17 million for fifteen years of ownership.

Through his accountants, WHS apparently believed from the outset that he was economically compelled to exercise the option because according to Mr. 's letter the transactions were treated as a sale for accounting purposes as of 1977. Moreover, WHS's considerable expenditures for capital improvements are consistent with sale treatment.

Based on the foregoing, we are of the opinion that at the time the option was granted it could reasonably be concluded that WHS would be economically compelled to exercise it and that the lease with option to purchase could reasonably be characterized as an agreement of sale.

If you have any further questions regarding this matter, please let us know.

Very truly yours,

Eric F. Eisenlauer

Eric F. Eisenlauer
Tax Counsel

EFE:cb
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cc: Mr. Richard H. Ochsner
Mr. Verne Walton