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In this installment of Audit & Beyond, the authors discuss real estate transfer taxes in California and *731 Market Street*, a case that reexamined the "realty sold" and leasehold concept.

States' real estate transfer taxes add an extra layer of complexity to the already daunting prospect of buying and selling real estate. California, like most states, imposes such a tax, but not at the statewide level. Instead, California Revenue and Taxation Code section 11911 authorizes localities to impose their own real estate transfer taxes "on each deed, instrument, or writing [for] any lands, tenements, or other realty sold within the county."[1] San Francisco — which never misses an opportunity for additional revenue sources — took California up on its offer and imposes a real estate transfer tax on the transfer of real property, using language similar to the state's authorizing statute.[2]

Regarding a traditional transfer of title, the transfer tax is fairly straightforward in California and other states (most of which impose tax on the transfer of real property). Leases, however, are less obvious; many states exempt the transfer of a leasehold,[3] while some states — including California — impose the tax on the transfer of some leasehold interests.

California's authorizing statutes do not explicitly impose transfer taxes on the transfer of properties subject to a lease, but through case law California has imported the "change of ownership" concepts governing leases from the property tax arena and applied them to transfer taxes. In *Thrifty Corp. v. County of Los Angeles*,[4] a lessee corporation challenged its payment of city and county real estate taxes on a parcel of land it had leased for 20 years with an option to renew the lease for an additional 10 years. The lessee asked the court to determine whether a leasehold interest in real property constitutes "realty sold" for purposes of section 11911.

The court first acknowledged that the real estate transfer tax statute does not define "realty sold," but it found that the phrase is similar to the concept of change in ownership. Under Rev. & Tax. Code section 61(c)(1)(C), there is a change of ownership for property tax purposes upon "any transfer of a leasehold interest having a remaining term of 35 years or more (including renewal

[1] Cal. Rev. & Tax. Code section 11911.

[2] S.F. Bus. & Tax. Regs. Code section 1102.

[3] *See, e.g.*, Ga. Code Ann. section 48-6-2(a)(4).

[4] 210 Cal. App. 3d 881 (1989).

options)." The rationale behind the 35-year-or-more lease term creating a change in ownership is that "a tenant with a remaining term of 35 years or more (including options) is deemed to hold the equivalent of the fee interest"[5]: That is, according to the court, a long-term lease is akin to a transfer of ownership and should rightly be fully taxed on the fair market value of the property.

Using the change in ownership concept from property tax purposes as a direct proxy for determining when there is realty sold for transfer tax purposes, the court held that leases "of sufficient longevity" that approximate ownership are subject to the real estate transfer tax. Based on the statutory change in ownership standard, the court therefore held that Thrifty's lease "was not of sufficient longevity to constitute 'realty sold' under section 11911" and that the taxpayer was not subject to the real estate transfer tax.

After *Thrifty* formally imported the property tax change in ownership provisions into the real estate transfer tax context, *McDonald's Corp. v. Board of Supervisors of Mendocino County*[6] refined it. The lessee, McDonald's, originally entered into a 21-year property lease with three renewal options of five years each. After honoring the original lease and exercising the lease's renewal terms, McDonald's and its lessor signed an amended lease. At the time the amended lease was signed, the remaining term of McDonald's lease was 28 years (13 years under the original lease and 15 years under the amended lease).

After McDonald's entered into the amended lease, the taxing authority asserted that the new lease was subject to the transfer tax, contending that the amended lease created a leasehold interest of over 35 years. In response to the taxing authority's assessment, McDonald's paid the real estate transfer tax and filed a refund claim. McDonald's argued that because the original lease did not give McDonald's a right to possession during the period of the amended lease, the amended lease period should not relate back to the original lease in calculating the 35-year period for the imposition of the real estate transfer tax. The board of supervisors argued that the entire period of McDonald's leasehold should be considered when determining whether to impose the real estate transfer tax because the amended lease functioned to extend the original lease.

McDonald's claim for a refund gave the trial court the opportunity to determine how to calculate the real estate transfer tax's 35-year period when an existing lease is amended. The trial court concluded, and the court of appeal affirmed, that "at the time of the amendment McDonald's was not considered the 'owner' of the property for tax purposes because the remaining term of the lease was less than 35 years."[7] At the time McDonald's entered into the amended lease, 13 years remained on the original lease and 15 years were added by the amendment, so McDonald's amended leasehold was for only 28 years. Accordingly, the court held that the real estate transfer tax could not be imposed on the transaction.

731 Market Street

Even with robust case law interpreting the real estate transfer tax's application to leaseholds, *731 Market Street Owner LLC v. City and County of San Francisco*[8] reexamined the "realty sold" and leasehold concept, analyzing whether a locality can impose its real estate transfer tax on the sale of a property subject to an existing leasehold interest with a remaining term of over 35 years. The lessor, 731 Market, owned a commercial building in San Francisco, leasing the ground floor of the building to CVS, an unrelated entity. CVS signed a 45-year lease with 731 Market in 2009. At the time the lease was signed, 731 Market paid the county's and city's real estate transfer tax on the creation of the leasehold estate.

In 2015, 731 Market sold and transferred the commercial building to Jamestown Premier 731 Market, while CVS maintained its lease with the identical terms to the 2009 lease. In connection with this sale, 731 Market paid the real estate transfer tax of $1.6 million on the transfer price. Part of 731 Market's 2015 real estate transfer tax payment included the then-present value of 731 Market's anticipated 41-year lease stream. We

[5] *731 Market Street Owner LLC v. City & County of San Francisco*, 50 Cal. App. 5th 937, 947 (2020).

[6] 63 Cal. App. 4th 612 (1998).

[7] *McDonald's Corp.*, 63 Cal. App. 4th at 617.

[8] 50 Cal. App. 5th at 937.

understand that the remainder of the tax was paid on the value of the lessor's fee interest in the property apart from the value of the leasehold (that is, the unleased portion of the property, for which there was no dispute over the application of the transfer tax).

After paying the transfer tax, 731 Market filed a complaint against San Francisco for declaratory relief and for a partial refund of the real estate transfer tax that it had paid on the leased portion of the property. In its trial brief, 731 Market argued that the 2015 real estate transfer tax should not have included an amount attributable to the lease payments because the 2015 sale did not result in a transfer of the CVS lease, arguing that the transfer of the long-term leasehold interest did not constitute realty sold under the transfer tax ordinance. San Francisco argued, on the other hand, that the real estate transfer tax could apply to both the sale of the underlying property and the transfer of 731 Market's interest in CVS's lease to a new landlord since both property interests constituted realty sold and therefore were separately taxable. The trial court entered judgment for 731 Market and agreed that "no taxable event occurred in 2015" regarding the transfer of the existing lease.[9] The court awarded 731 Market a refund for $286,922, and San Francisco appealed.

The court of appeal began its analysis using the reasoning employed by *Thrifty* and *McDonald's* that because Rev. & Tax. Code section 11911 does not define "realty sold," the court may look to the definitions of change in ownership from the state's property tax provisions. Because the San Francisco real estate transfer tax ordinance also uses the undefined term "realty sold," the court applied the same change in ownership analysis to the local ordinance. After tracing that background, the court agreed that the real estate transfer tax had been validly imposed on the long-term lease that the parties had entered into in 2009.

The court then began its analysis of the 2015 sale of the commercial property and CVS's existing leasehold interest. The court reiterated the now-familiar proposition that the property tax statute interpreting a change in ownership provides that a transfer of property subject to a lease with a remaining term of more than 35 years is not a change in ownership, while the creation of a lease of more than 35 years is a change in ownership.[10] Using that framework, the court held that the 2015 sale of the commercial property did not constitute realty sold to trigger the transfer tax as to the long-term lease because at the time of the transaction, "CVS maintained all the same rights under the original lease, which had a remaining term of more than 35 years."[11] Because CVS maintained the same rights during the property's transfer, "the primary economic value of land encumbered by a lease" and the "beneficial ownership stayed with CVS."[12]

The court's holding is consistent with not only previous case law (*Thrifty* and *McDonald's*), but also a number of authorities in California property tax law, including Rev. & Tax. Code section 62(g),[13] California Code of Regulations section 462.100(b)(2)(A),[14] and an annotation from the Board of Equalization.[15] In particular, the 2009 annotation concluded that when a lease is first created or extended to a term of 35 years or longer and then transferred to a new underlying owner of fee simple interest, there is no change of ownership because the lessee still has a present interest and beneficial use of the property.

Analysis

In affirming the trial court's holding, the court of appeal both rendered the correct decision and added to the growing list of case law interpreting the application of the real estate transfer tax to leaseholds using the change of ownership concept.

[9] *Id.* at 942.

[10] Cal. Rev. & Tax. Code section 61(c)(1)(C).

[11] *731 Market Street*, 50 Cal. App. 5th at 947.

[12] *Id.*

[13] Cal. Rev. & Tax. Code section 62(g) ("Change in ownership shall not include: . . . Any transfer of a lessor's interest in taxable real property subject to a lease with a remaining term (including renewal options) of 35 years or more.").

[14] Cal. Code Regs. tit. 18, section 462.100(b)(2)(A) ("The following transfers of either the lessee's interest or the lessor's interest in taxable real property do not constitute a change in ownership of such real property. . . . Lessor's interest: The transfer of a lessor's interest in real property subject to a lease with a remaining term of 35 years or more, whether to a lessee or another party.").

[15] Cal. Prop. Tax Annotation 220.0326.005 (Dec. 21, 2009).

It should now be clear — if it wasn't before — to both local taxing agencies and property owners that a transfer of property subject to at least a 35-year lease does not result in a change in ownership.[16] Section 62(g)'s exclusion to the change in ownership concept is grounded in the principle that when a property owner sells real property encumbered by a 35-year-plus lease, the seller is not transferring the primary economic value of the land to the buyer. Instead, the lessee — which paid tax on the creation of the long-term lease — retains ownership, keeping a present interest and beneficial ownership of the property during the term of the lease.[17]

While no case law interpreting section 62(g) has directly applied the section to the real estate transfer tax, it is settled law that courts look to the change in ownership statutes when interpreting the application of the transfer tax. Therefore, taxpayers with these facts should assert that a taxing authority cannot impose its real estate transfer tax on the underlying sale of the property because there will be no realty sold during such a transfer.

Finally, given that multiple long-standing precedents clearly telegraphed the outcome in this case, it is important to bring attention to the myopic arguments proffered by the city. First, the city argued that the appellate court decisions in *Thrifty* and *McDonald's* — which are the basis for application of the transfer tax to leases in the first place — should not apply to the subject transaction, which was a fee simple transfer of a building that was partially subject to a long-term lease. But that argument would be reasonable only if the city had included as a corollary that the city should not have received transfer tax on the creation of the long-term lease in 2009 — a necessary concession that the city did not offer. The city also contended, without basis, that there should be a different result when a *lessor's* interest is transferred as opposed to a lessee's — a contention at odds with Rev. & Tax. Code section 61 and 18 CCR 462.100, which are also part of the foundation for application of the transfer tax to leases.

To cap it off, the city argued that the city's ordinance created a conveyance of realty for a long-term lessor's transfer where it reads:

> Any tax imposed pursuant to this ordinance shall not apply with respect to any deed, instrument, or writing which creates, terminates, or transfers a leasehold interest having a remaining term (including renewal options) of *less than* 35 years.[18]

The ordinance, of course, explicitly applies to short-term transfers and is an argument against — not for — the city's position in the case, and it is part of the law the city would have relied on to collect the transfer tax *that it collected* back in 2009. The court — very charitably, to the minds of these authors — summarized its rejection of the city's arguments by noting only that "we find that San Francisco's proposed interpretation of the ordinance is unreasonable and would produce absurd results."[19]

Zealous advocacy has its limits, and it applies to both counsel for taxpayers and for government. Nevertheless, given its charter status, San Francisco may be able to revise its ordinance to reach a different result. But even to the extent that the city has unlimited discretion to impose the transfer tax on events involving real property, the authors hope that it will not write a "heads I win, tails you lose" ordinance in which virtually every event involving leased real property (for example, the creation of a long-term or short-term lease, the termination of a long-term or short-term lease, the transfer of property subject to a lease) becomes an event subject to the transfer tax. But the arguments raised by the city in *731 Market Street* suggest that every position that raises revenue is on the table. ■

[16] *Id.*

[17] *See Dyanlyn Two v. County of Orange*, 234 Cal. App. 4th 800, 814-15 (2015).

[18] *731 Market Street*, 51 Cal. App. 5th at 949 (emphasis in original).

[19] *Id.* at 950.