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July 6, 2020

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San Francisco Cannot Impose a Transfer Tax on the Value of an Existing Lease With a Remaining Term of Over 35 Years When the Building is Sold

A recent opinion, *731 Market Street Owner, LLC v. City and County of San Francisco* (Cal. Ct. App., June 18, 2020, No. A154369) 2020 WL 3285962 ("*731 Market Street Owner*"), issued by a California Court of Appeal in San Francisco provides some relief to San Francisco building owners. The Court confirmed that the City and County of San Francisco (the "City") cannot impose a transfer tax on the value of an existing lease with a remaining term of over 35 years when there is a sale of the building subject to the lease. While this result may not come as a surprise, it is noteworthy that this result came only after a five-year legal battle between the City and the building owner.

Generally speaking, a transfer tax is a fee imposed by a local municipality on the transfer of land or real property from one person (or entity) to another. The transfer tax concept dates back over 200 years and was formerly codified under federal law as documentary stamp taxes. In 1968, the federal law was repealed, and California simultaneously enacted an enabling statute that authorized counties (and cities) to impose a transfer tax upon "realty sold." San Francisco has one of the highest transfer tax rates in the State at \$15.00 per \$500.00 of consideration paid (for transactions with a price of \$25 million and above). Neither the State enabling statute nor the transfer tax ordinance adopted by the City define the term "realty sold."

The facts of *731 Market Street Owner* are straightforward. In 2009, 731 Market Street Owner, LLC leased a ground floor retail space to a tenant for a term of 45 years. A memorandum of lease was recorded two years later, in 2011, and the City assessed a transfer tax on the transaction as "realty sold" pursuant to its transfer tax ordinance¹ based on the value of the stream of rental payments due over the lease's life. In 2015, the building was sold to a new building owner, subject to the retail lease. Of note, all terms of the original lease remained unchanged. The same tenant continued to possess the space and still had a remaining term on its lease of more than 35 years. Following demand by the City, 731 Market Street Owner, LLC paid a documentary

transfer tax based on the value of the entire building (including the then-present value of the remaining revenue stream of the retail lease), and unsuccessfully sought a refund of the amount of tax it paid attributable to the value of the retail lease. 731 Market Street Owner, LLC sued, and prevailed in a bench trial. The City appealed.

In the appeal, the parties disagreed on whether the 2015 transaction was a taxable event for purposes of the ordinance as to the 2009 lease - meaning whether the "realty sold" in the 2015 sale included the value of the existing lease (that had already been taxed in 2011 when the memorandum of the lease with a lease term of more than 35 years was recorded). Because neither State law nor the ordinance defined the term "realty sold," the Court analyzed several decisions that interpreted the term "realty sold" in the property tax context and concluded that the term "realty sold" is sufficiently similar to the phrase "change in ownership." In the property tax context, the creation or a transfer of a lessee's interest under a lease with a remaining term of more than 35 years constitutes a change in ownership and triggers reassessment of the underlying property. (See *Thrifty Corp. v. County of Los Angeles* (1989) 210 Cal.App.3d 881, 885-886 ["Many long-term leases do amount to a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest."]; see also *McDonald's Corp. Board of Sup'rs* (1998) 63 Cal.App.4th 612, 617 ["the holder of a leasehold interest with a term of 35 years or more is treated as the owner"].) However, as the Court noted, "unlike the *creation* of a lease of more than 35 years, a *transfer* of property subject to a lease with a remaining term of more than 35 years is *not* a 'change in ownership.'" Based on this analogy, the Court concluded the City could not "double tax" the portion of the property (the leasehold interest) that had not been "sold" for purposes of determining the amount of the transfer tax to be imposed on the sold property.

In coming to its conclusion, the Court rejected the City's argument that *Thrifty* and *McDonald's* are inapplicable because the two cases only "addressed the transfer of a *lessee's* interest, not a *lessor's* interest." In other words, the Court found that there is no substantive distinction in the transfer tax context between a lessor's interest in the revenue stream under a lease with a remaining term of more than 35 years (which the City incorrectly attempted to tax), and a lessee's interest in the same (which was taxed when the lease was entered into based on the same revenue stream). To conclude otherwise, according to the Court, would mean that the City could theoretically impose a transfer tax on the building owner based on a valuation that included the present value of the lessor's interest in a leasable space on day one, and then tax an identical amount the next day when the building owner actually leased out that space.

731 Market Street Owner provides San Francisco building owners with precedential authority for two factual situations. First, the City cannot impose a transfer tax on the value of an existing lease with a remaining term of over 35 years when there is a sale of a building that is subject to the lease. Second, in the transfer tax context, there is no substantive distinction between a lessor's interest and a lessee's interest in a lease. This decision will provide guidance to building

owners in the sale of multi-tenant office buildings where one or more tenants may have leases in the building of more than 35 years (including options). Careful readers of the opinion may also rely on the decision for guidance in other contexts. The City's argument that prior cases carving out a property tax reassessment exemption for a tenant's transfer of its leasehold interest should not apply to an owner selling a building subject to a lease (specifically in San Francisco as a "home rule" charter city) was a very slim reed to pursue an appeal, and demonstrates that the City continues to take aggressive positions in trying to tax business transactions. The Court's comment that the City was wrongfully attempting to tax the same revenue stream multiple times elevated form over substance is likely to be oft-quoted and may be relied upon in other "double tax" situations involving commercial real estate. The decision also reminds us that it is, in fact, well-settled law that "in case of doubt statutes levying taxes are construed most strongly against the government and in favor of the taxpayer." (*McDonald's Corp.*, *supra*, 63 Cal.App.4th at p. 617; *731 Market Street Owner, LLC*, *supra*, 2020 WL 3285962, p. *6.)

If we can be of assistance in answering any questions concerning taxation of commercial real estate, please contact us.



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ⁱ Section 1101 et seq. of the San Francisco Business and Tax Regulations Code (the "ordinance").

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