The Hidden Trap: How Transfer Taxes Can Sneak Up on Lease Transactions

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While most people anticipate encountering transfer taxes when buying or selling real estate, many are caught off guard by state and local transfer taxes that can significantly affect leasing transactions. In many jurisdictions, long-term or high-value leases may be taxed similarly to property transfers. The tax implications of a leasehold interest may exist regardless of whether the lease is formally recorded or not.

This issue becomes even more relevant in commercial real estate, where lease agreements often span decades and grant substantial rights akin to ownership. Failing to account for these hidden tax burdens, particularly those tied to leasehold interests, can lead to unanticipated costs and compliance challenges that disrupt deal structures and investment returns.

In this ***Triple Net*** blog post, we take a closer look at how several states and Washington, D.C. handle leasehold interest taxes. From differing definitions and valuation methods to variations in exemptions and who bears the tax burden, the transfer rules for leasing transactions can be surprisingly diverse. Whether you're an investor, property manager, or a prospective tenant trying to make sense of your financial obligations, understanding the state-specific approaches outlined below is crucial.

California

In California, each county board of supervisors is authorized to impose a documentary transfer tax on any deed, instrument, or writing by which any lands, tenements, or other realty is sold within the county. Cal. Rev. & Tax Code §§ 11911-11933. In addition, California law considers any lease with a term of 35 years or more, including all renewal and extension options, as a "change in ownership" upon a sale of realty because such a lengthy term is the equivalent of a transfer of the fee ownership to the tenant. Cal. Rev. & Tax Code § 61(c). Counties and cities, including charter cities, can set their own rules, some with shorter lease-term thresholds, and

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may also impose additional taxes. Both state and local regulations should be reviewed to determine applicable documentary transfer taxes.

FBT Gibbons Contact: Reach out to Jerry Ruiz if you have specific questions regarding California's transfer tax rules as they apply to your lease agreements.

Illinois

In Illinois, transfer taxes are imposed on the transfer of a "beneficial interest in real property." 86 Ill. Adm. Code 120.20. This includes the transfer (and not the creation) of an interest in ground leases of 30 years or longer, including renewal and extension options. 35 ILCS 200/31-5. In Illinois, unlike other states, (i) this is exclusively applicable to transfers, and (ii) the calculation of the term includes any expired portions. Illinois requires transfer declarations to be completed, which are public records. 35 ILCS 200/31-25, 31-55. It is also essential to consult local regulations, as counties and home rule municipalities have the authority to impose their own transfer taxes.

FBT Gibbons Contact: Reach out to Tim Wieher if you have specific questions regarding lease transfer taxes in Illinois as they apply to your lease agreements.

New Jersey

New Jersey generally does not impose a transfer tax on lease creation or assignment. N.J.S.A. 46:15-5. For leases with a term of 99 years or more, including any renewals or extensions, the state's realty transfer fee (RTF) is due. The RTF is determined based upon the assessed value of the property (in accordance with the municipality's tax records) as of the date of the lease transaction, adjusted by the county percentage level. N.J.S.A. 46:15-5(c), 46:15-7(a), and 46:15-7.1(a).

FBT Gibbons Contact: Reach out to Nicole Taplin if you have specific questions regarding New Jersey's RTF rules as they apply to your lease agreements.

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New York

New York's approach to determining when a leasehold interest is subject to its real estate transfer tax (RETT) involves more than a straightforward evaluation of the lease term. Leases or subleases with terms of more than 49 years (including extensions and renewals) may be subject to RETT if the lease involves major capital improvements and covers most of the property, usually at least 90% of rentable space, excluding common areas. However, even leases for less than 49 years may be taxed if they are coupled with an option to purchase the underlying property. New York bases its RETT calculations upon the present value of future rent payments, plus the value of any purchase option. The consequence for underpayment or failure to timely pay the RETT includes interest and late payment fees that are based on the amount of the applicable RETT. N.Y. Tax Law § 1401 et al.

FBT Gibbons Contact: Reach out to John Glass if you have specific questions regarding New York's RETT rules as they apply to your lease agreements.

Pennsylvania

In Pennsylvania, leases with a potential term of 30 years or more are subject to realty transfer tax unless they fall under specific exemptions within the transfer tax code. Notably, the Pennsylvania Department of Revenue will include the term of any potential renewal options within the determination of the term of transfer tax. 72 P.S. § 8101-C. However, careful drafting of the terms relating to potential lease extensions in accordance with established caselaw can exclude such renewal terms from the calculation and reduce tax liability. Primarily, in order to avoid the extensions being attributable to the calculated lease term, the extension terms must not be automatic, and the rent for such periods must be freely negotiated at the time of the extension in accordance with fair market rates. *Saturday Family LP v. Commonwealth*, 148 A.3d 931, 939 (Pa. Cmwlth. 2016).

FBT Gibbons Contact: Reach out to Leah LaFramboise if you have specific questions regarding Pennsylvania's lease transfer tax rules

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as they apply to your lease agreements.

Virginia

Virginia does not impose a transfer tax on the creation or assignment of a lease. However, Virginia does impose a recording tax if the lease or a memorandum of lease is recorded. VA ST § 58.1-807. If either party to the lease records the lease or a memorandum of lease, there is a recordation tax based upon the consideration or the value contracted. Va. Code Ann. § 58.1-807(A). If the annual rental multiplied by the lease term equals or exceeds the actual value of the property leased, then the recordation tax will be based on the actual value of the property. Va. Code Ann. § 58.1-807(B). Additionally, counties and cities in Virginia may impose a recordation tax equal to one-third of the state recordation tax. Va. Code Ann. § 58.1-814. Certain exemptions from the recordation tax may also apply. Va. Code Ann. § 58.1-811.

FBT Gibbons Contact: Reach out to Carrie Cecil if you have specific questions regarding Virginia's recordation tax rules as they apply to your lease agreements.

Washington, D.C.

In Washington, D.C., recording a lease that lasts 30 years or more (including any renewal options) triggers D.C.'s recordation tax. Although these leases do not convey title, D.C. taxes them in a manner similar to deeds. D.C. Code § 42‑1103(a)(1)(B). The tax applies not only to newly executed leases, but also to assignments or transfers of leases with 30 or more years remaining, particularly where the transaction includes buildings, improvements, or other real property interests. OTR Tax Notice 2024‑02. The tax is assessed against the average annual rent, calculated by capitalizing the average annual rent at a 10% rate and adding any additional consideration paid by the tenant, which amount may not exceed the fair market value of the real property covered by the lease. D.C. Code § 42‑1103(a)(1)(B)(i). If average annual rent is unable to be determined, the calculation becomes more complicated and is based on the greater of (i) 105% of the minimum average annual rent capitalized at a rate of 10%, plus any additional consideration,

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or (ii) 150% of the assessed value of the real property covered by the lease. D.C. Code § 42□1103(a)(1)(B)(ii).

FBT Gibbons Contact: Reach out to Trish Koutsis if you have specific questions regarding Washington, D.C.'s recordation tax rules as they apply to your lease agreements.

Navigating Lease Transfer Taxes: Key Takeaways and Strategies

Although the threshold for taxing long-term leases varies by state, transfer taxes are generally assessed against the party transferring the leasehold interest, typically the landlord, lessor, or assignor. That said, the responsibility for paying the tax can often be negotiated and reassigned through the lease or assignment agreement. Further, careful drafting of leases could help avoid a leasehold interest tax.

Given the complexity and variability of transfer tax rules across different states and municipalities, it is essential for both landlords and tenants to work closely with experienced legal and tax advisors when negotiating long-term lease agreements. By thoughtfully structuring lease terms, while taking into consideration renewal options, improvement obligations, and potential assignment scenarios, parties can often mitigate unexpected tax liabilities and ensure compliance with local regulations.

Please contact the authors or any attorney with FBT Gibbons' Retail and Shopping Center Finance team for assistance in evaluating or negotiating lease terms to address the applicable lease transfer tax rules in your jurisdiction.

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