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## How Fair Market Rent Lease Renewals Can Impact Pennsylvania Realty Transfer Taxes

by Jonathon M. Grosser and Tyler W. Mullen

In a case decided in October, *Saturday Family LP v. Commonwealth of Pennsylvania*, 2016 WL 6069482 (Pa. Cmwlth. 2016), the Commonwealth Court of Pennsylvania addressed whether renewal options must be considered when calculating the full term of a lease for realty transfer tax purposes where the lease includes a mechanism for determining fair market value rent at the time of renewal. After hearing arguments from both sides, and examining the Tax Reform Code of 1971 and accompanying administrative regulations (collectively, the Tax Code), the court held that a renewal term need not be included in calculating the full term of a lease where the rental amount for the renewal term is based upon the fair market value rent at the time of renewal, even if the lease otherwise provides a mechanism for determining fair market value. The *Saturday Family* case clarifies certain points regarding realty transfer taxes as applicable to long-term leases with renewal options, and helps inform practitioners who draft such leases.

As a general principle, transfers of real estate are subject to Pennsylvania’s realty transfer tax. The Tax Code provides that a lease “for a term of thirty years or more” constitutes a transfer of title to real estate sufficient to trigger Pennsylvania’s realty transfer tax. 72 P.S. § 8101-C. The statutory language, however, raises the question of whether renewal options should be calculated in determining the overall term of a lease. Administrative guidance in the Tax Code further provides:

In determining the term of a lease ... it shall be presumed that a right or option to renew or extend a lease will be exercised if the [parties] cannot renegotiate the rental charges for the renewal or extension period unconditionally. [The parties] cannot renegotiate a rental charge unconditionally if it is fixed at a set amount ... or a method of establishing the rental charges is established. Renewals or extensions at the option of the lessee at fair rental value at the time of the renewal or extension are not included in determining the term of a lease.

61 Pa. Code § 91.193(b)(24)(v). Thus, the general rule mandates that options to renew a lease count toward the overall lease term if the rental charge for the renewal is fixed or a method of calculating the rental charge is established at the outset. The exception to the general rule occurs when the renewal rate is determined based on fair rental value at the time of renewal. But what about cases where, prior to entering a lease, the parties agree that renewal rent will be based on fair market rent, as determined by a mechanism established at the outset? Such a situation seemingly includes both a pre-established mechanism component and a fair market value component. The Commonwealth Court examined precisely this issue in *Saturday Family*.

In *Saturday Family*, the landlord and tenant entered into a ground lease for a period of 29 years and 11 months, with the tenant having an option to renew for up to six periods of five years each. The parties did not pre-establish a rental amount for the renewal terms but agreed on a detailed, hierarchical method of calculating the renewal rent, which essentially included a fair market value calculation. Fair market value rent would be determined at the time of renewal by looking (i) to similar parcels in the county, then (ii) if the parties could not agree, by appointing separate appraisers, then (iii) if the parties still could not agree, by appointing a third appraiser, and finally (iv) if the parties still could not agree, by petitioning the Court of Common Pleas.

The landlord and tenant (the Appellants) argued that the renewal options were “at the option of the lessee at fair market value rent determined at the time of the extension – the exact circumstance in which the [Tax Code] exclude[s] renewal options [when] determining the term of a lease.” *Saturday Family* at \*3. The Commonwealth, however, argued that the lease contained “a comprehensive, systematic, and binding method” for calculating the rental charge negotiated prior to execution of the lease. *Id.* at \*4.

After examining the Tax Code according to the canons of statutory interpretation, the court conclusively sided with the Appellants and explained that no realty tax may be imposed in circumstances like those presented. The court stated that “[t]he mere fact that the [lease] establishes a mechanism for determining the fair market value rent in the event that [the parties] cannot agree on a fair market value rent does not alter the salient fact that the [lease] provides that renewal periods shall be at fair market value rent.” *Id.* at \*5.



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The takeaway from *Saturday Family* is clear, and it is informative to practitioners drafting long-term leases. The certainty provided by *Saturday Family* enables attorneys to more accurately advise clients with respect to realty transfer tax issues and also to save clients resources by understanding the rules established by the Commonwealth Court. If a lease will continue for a term of 30 years or more should a renewal option be exercised, then as long as the parties ultimately agree to charge a fair market rent upon renewal, the renewal periods need not be considered when calculating the overall term. A sophisticated mechanism for arriving at fair market rent does not change the analysis, even if the parties negotiate the mechanics prior to entering into the lease agreement.

Although *Saturday Family* could eventually be appealed to the Pennsylvania Supreme Court, the law surrounding realty transfer taxes in the context of long-term leases is now clearer. Practitioners would be well advised to follow developments in the case going forward. ■