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Beyond the Façade:

New Rules Regarding Historic Preservation Incentives

by Phil Feola and Kate Myers

On August 17, President George W. Bush signed into law the Pension Protection Act of 2006, which significantly affects the federal tax incentives for conservation easement donations.

The easement legislation is a response to findings by the Internal Revenue Service of widespread abuse in the donation of conservation easements, especially with respect to historic façade easements. Rather than abolish the program, this new law has modified it so as to impose higher standards for donors, easement-holding organizations, appraisers and easement promoters. While the legislation relates to all types of land conservation easements, this article focuses upon its effect on historic preservation conservation easements.

Historic Preservation Easements and Tax Benefits

Although landowners donate easements because they want to ensure the protection of land, scenic views and/or historic resources, tax benefits frequently provide a welcome financial incentive for donation. Such tax benefits enable donors to claim charitable contribution deductions for federal income, estate, and gift tax purposes based on the value of a conservation easement donated. In this context, the term "conservation easement" is used to describe both the protection of land and the preservation of buildings. Whereas easements may be restricted to a specific time frame (i.e., a certain number of years), only gifts of perpetual easements qualify a donor for tax benefits. To determine the value of an

easement donation, the landowner has the property appraised at its fair market value with and without the easement restrictions. The difference between these appraisals gives the landowner the easement value for charitable donation purposes.

Unfortunately, significant abuse of these tax incentives has occurred. Conservation easements gained in popularity and a *Washington Post* series pointed out the abuses of landowners using easement donations as a tax shelter. The appraisers hired by these often-wealthy landowners sometimes inflate the value of the land being placed under development restrictions in order to generate a larger tax deduction. In response to the *Post* series, Senator Chuck Grassley, chairman of the Committee on Finance, and Senator Max Baucus, ranking member, issued a press release in December of 2004: "It's ridiculous for people in Georgetown to take tens of thousands of dollars in charitable tax deductions for agreeing not to put aluminum siding on their million-dollar brick houses when local laws and regulations already prohibit such activity," said Grassley. "I want to continue the important goal of historic preservation while ending the abuse."

Meanwhile, the IRS began to investigate charitable deductions taken for both land conservation easements and historic preservation (or façade) easements that protect historic buildings. The investigation revealed systematic abuses that were so rampant that some talked of imposing retroactive penalties for donors who claimed exaggerated deductions for façade easements as well as the appraisers and easement-holding organizations that participated in these transactions.

Façade easements within historic districts listed in the National Register of Historic Places were of specific concern to the IRS. To many, granting tax benefits within historic districts was unnecessary because the property was already "protected." The donor should not receive a tax break because he was not giving up any rights to the property. In essence, the donor would receive a charitable deduction for promising not to harm something that is already protected under historic preservation law. The counter-argument by preservation advocates is that local land use laws are not perpetual like easements and can be modified, changed and sometimes revoked by various methods. Further, some historic preservation laws have a procedure whereby a property owner can alter, or even demolish, a building in such an historic district.

In light of these countervailing considerations, the new legislation achieves a compromise insofar as it allows for the continuation of façade easement donations but requires that any such donation be conditioned on the property owner giving up significant property rights; e.g., the right to change the appearance of a building protected by historic preservation laws. The new law retains the eligibility for tax deductions for historic preservation easements, but requires that the easement encompass more of the building than just the front façade. Further, it holds the donors, donee easement groups and others involved in the transaction more accountable for their actions by imposing stricter standards and penalties.

Special Rules for Property Within Historic Districts

The new law imposes new rules on charitable contributions of easements on certified historic buildings in registered historic districts. These new rules, principally, determine the types of certified historic structures that qualify, the extent of protection provided, the role of easement-holding organizations and appraisers and the consequences for those property owners donating an easement on a building for which they have received rehabilitation tax credits.

Types of Structures and How Much to Protect

One new provision in the legislation limits charitable deductions to certified historic structures defined as a building, structure, or land area that is individually listed by the National Park Service on the National Register of Historic Places (National Register) or a building (but not a structure or land area) located in a National Register historic district.

Moreover, the front façade and the entire exterior of the building (including the front, sides, rear, as well as a restriction on the height of the building) now must be protected by the easement. The legislation also precludes any change in the exterior that would be inconsistent with its historic character. Previously, such an easement usually protected just the front of the building, and the terms of the façade easement permitted the property owner to make alterations of the façade upon consent from the easement-holding organization.

Qualified Preservation Organization

Under the new legislation, the organization receiving the conservation easement donation must enter into a written agreement with the donor certifying, under penalty of perjury, that the donee is a "qualified" organization. This new definition of "qualified" requires that an organization, in addition to being not-for-profit, must designate preservation of historic places as part of its mission and maintain the resources and commitment to manage and enforce the easement. Such clarification in the law is important because easement-holding organizations have great responsibility. The holding organizations provide for the protection without having to buy the property outright by monitoring properties in perpetuity to make sure easement directives are followed, enforcing easements if necessary and mandating certain upkeep.

Qualified Appraisal

Another legislative change is that to justify the charitable contribution, the taxpayer now has to include a "qualified appraisal" for donated property with a claimed deduction of more than $5,000. The appraisal must include photographs of the entire exterior and a thorough description of all development restrictions. "Qualified appraisers" receive particular scrutiny as they must demonstrate they are qualified under the new law and under any new Treasury regulations or guidelines that may follow. Until regulations are issued, the IRS has provided "transitional guidance" in IRS Notice 2006-96. To crack down on overvaluation abuse, the legislation lowers the threshold of what can be considered a "substantial" and "gross misstatement of value." Such misstatements subject appraisers to new penalties of up to 125% of their fee and disbarment from working on federal tax matters.

Rehabilitation Tax Credits

For property owners who have taken advantage of Rehabilitation Tax Credits under Section 47 of the Internal Revenue Code within the past five years, the new law reduces the deduction for an easement contribution on the same property. The deduction allowed under this section shall be reduced by an amount that bears the same ratio to the fair market value of the contribution as the sum of the credits over the course of the preceding five years or the fair market value of the building on the date of the contribution.

Added Incentive

A final provision in the legislation deals with incentives to encourage contributions of real property easements to charities. The legislation raises the deduction limitation for certain non-cash capital gain donations, including donations of qualified historic preservation easements, from 30% to 50% of adjusted gross income with an extended carry-over provision from five to 15 years. Though these provisions only apply to qualified contributions made after December 31, 2005 and before January 1, 2008, preservation organizations are encouraging Congress to make these provisions permanent.

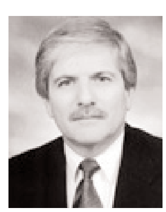
Conclusion

By the passage of these reforms, Congress has recognized the importance of preservation easements and the role of federal tax incentives toward encouraging donation in this arena. No doubt the new legislation brings greater challenges, and requires more thought and care, for all parties involved in these transactions. However, this new legislation should be considered a welcomed change that tightens the process while preserving the importance of the easement program.

In the wake of the recent eminent domain decision, *Kelo v. New London*, 545 U. S. 469 (2005), it will be interesting to see how preservation easements hold up when a municipality threatens to destroy easement-protected historic buildings in the name of economic development.

For more information on the legislation discussed in this article, please refer to the following Web sites:

IRS http://www.irs.gov/charities/article/0,,id=161145,00.html
Notice 2006-96 http://www.irs.gov/irb/2006-46_IRB/ar13.html
Land Trust Alliance http://www.lta.org/publicpolicy/tax_incentives_updates.htm
National Trust for Historic Preservation http://www.nthp.org/legal/easements/



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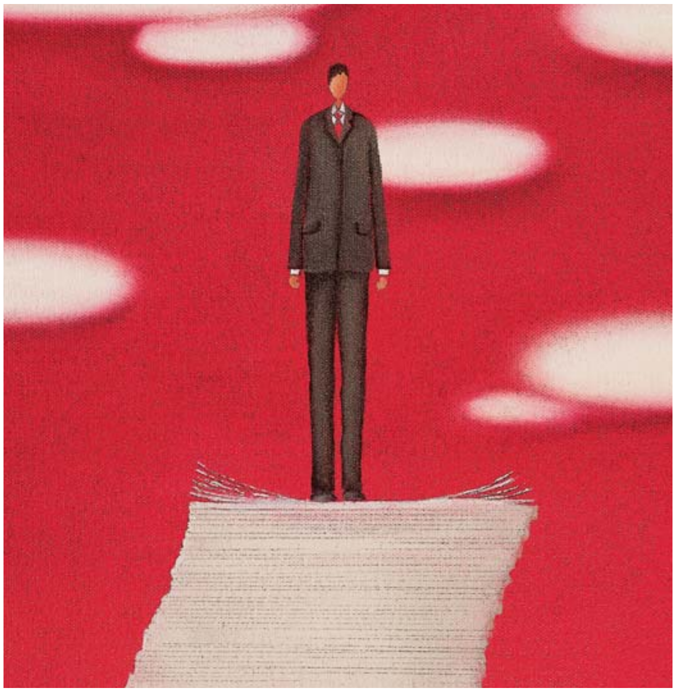

The Redesign of Title Insurance Policies

ALTA's New 2006 Forms

by Yemi Oladeinde and Susan Michelich

On June 17, 2006, the American Land Title Association ("ALTA") adopted new owner's and loan title insurance policy forms for use in nearly all real estate transactions. Title companies are currently rolling out these new forms to comply with ALTA's June 2007 deadline. This article summarizes the key changes and their likely effect on owners, lenders and title insurance companies.

The 2006 forms have the same basic structure and components as the previous forms: insuring clauses (now called "Covered Risks," "Exclusions from Coverage," "Conditions"), Schedules A and B, and endorsements. The forms primarily streamline and simplify language and reformat insuring clauses and exclusions in response to judicial interpretation of these sections. They also expand policy coverage, revise definitions and delete certain conditions.

Covered Risks

In the 2006 forms, the most obvious change is a dramatic increase in the number of Covered Risks. In the owner's policy, the list has more than doubled. Some of the additional items, however, were implicitly covered by exceptions to the Exclusions in past forms. Since some courts have excluded from coverage matters not set forth in the insuring clauses, ALTA expressly identified many exceptions from the Exclusions in the 1992 forms (the forms that are the most prevalent today) as Covered Risks in the 2006 forms. For example, the 1992 forms generally exclude from coverage losses arising from certain governmental regulations, with certain exceptions, such as when a notice for the enforcement of a regulation has been recorded prior to issuance of the policy. The 2006 forms now list this exception as a Covered Risk. Other Covered Risks are more detailed versions of what was in prior forms and do not necessarily expand coverage.

The most notable additions include the following:

Survey Coverage and Encroachments on Adjoining Land: Covered Risk 2(c) in both forms insures against certain circumstances affecting title, such as encroachments, that would be disclosed on a survey. Some courts have held that this survey coverage is not provided in earlier ALTA forms. The definition of "encroachments" now includes existing improvements located on the insured property that encroach onto adjoining land. If a survey discloses encroachments, however, the title company might add a Schedule B survey exception to remove this coverage.

Electronic Transactions: Covered Risks 2(a)(iv) and 2(a)(vi) in both forms expressly provide coverage for defects of title caused by failed electronic filings, recordings or indexing in public records, as well as other risks posed by the use of "electronic means authorized by law."

Creditors' Rights: Covered Risk 9(a) in the owner's policy and 13(a) in the loan policy add affirmative creditors' rights coverage for any preceding transactions. Covered Risk 9(b) in the owner's policy and 13(b) in the loan policy, concepts that were previously addressed in exceptions to Exclusions in prior versions of ALTA policies, provide creditors' rights coverage if the instrument of transfer in the present transaction constitutes a preferential transfer under creditors' rights laws due to failure to timely record or failure to give notice. Both forms continue to exclude from coverage claims that the present transaction is a fraudulent conveyance or transfer, or a preferential transfer for any reason not expressly identified in the Covered Risk section. Since these Exclusions are extensive, owners should still consider obtaining an ALTA 21 endorsement to insure over the Exclusions.

"Gap" Coverage: Covered Risk 10 of the owner's policy and Covered Risk 14 of the loan policy provide "gap coverage," covering defects in title during the gap, if any, between the "Date of Policy" (as designated in Schedule A) and the date of recording of the deed or other instrument of transfer.

Thus, if the closing occurs prior to recordation and the policy is dated as of closing, owners and lenders are automatically covered for any period between closing and recordation.

Exclusions

The "Exclusions from Coverage" section of the forms has been modified to reflect the fact that certain exceptions to Exclusions are now Covered Risks. In addition, some Exclusions have been deleted as unnecessary. The mechanics' lien Exclusion in the loan policy, for example, was deleted because ALTA decided that the 2006 policy adequately limits the mechanics' lien coverage within Covered Risk 11(a) and by the "post-policy" Exclusion 3(d). ALTA also added an Exclusion to both the owner's and loan forms that excludes coverage for real estate tax liens created during any "gap" between the Date of Policy and recordation.

Conditions

The "Conditions" section sets forth defined terms and the rights and obligations of the parties. The most notable changes are to the definitions of "Unmarketable Title" and "Insured" in both policy forms and the newly added definition of "Indebtedness" in the loan policy.

Past forms covered losses due to unmarketability of title as of the Date of Policy; however, the revised definition of "Unmarketable Title" in the 2006 forms extends coverage to title matters that would release a lessee or lender (not just prospective purchasers) under a contractual provision requiring the delivery or existence of marketable title.

The revised definition of "Insured" expressly includes successors resulting from mergers, consolidations, conversions and other similar corporate restructurings. It also includes grantees as long as there is no consideration and the grantee is either wholly owned by or wholly owns the named insured or an affiliated entity.

The definition of "Indebtedness" in the loan form incorporates a much broader range of costs and amounts associated with loans, including construction loan advances and other principal disbursements made subsequent to the Date of Policy. However, lenders may still desire endorsements in construction loan transactions because this change does not cover loss of priority for post-policy disbursements.

Other Key Revisions Include:

Revised Claim Administration Procedures: The "Proof of Loss" provision no longer requires the insured claimant to provide sworn proof of loss within 90 days of discovering the facts giving rise to the damage. Instead, if the title company is unable to determine the amount of loss, it may require the claimant to provide a signed proof of loss. This change allows the insured more flexibility if it learns of a defect that is insured against, but has not yet experienced a loss.

Extent of Title Company's Liability If Unsuccessful in Litigation: If the title company chooses to litigate a claim rather than pay under the policy and is unsuccessful, the amount of insurance for which the title company is liable increases by 10%. Additionally, the insured has the right in such circumstances to have the loss determined either as of the date the claim is made or the date it is settled and paid.

Arbitration: The insured or the title company may now require arbitration of claims in which the amount of insurance is less than $2,000,000, as opposed to the $1,000,000 threshold in the 1992 forms. Also, arbitration must be pursuant to the ALTA arbitration rules.

Choice of Law: There is now a provision specifying that applicable law for disputes is the jurisdiction in which the insured property is located.

In addition to revising the Conditions, ALTA deleted some Conditions that existed in prior forms. The table on page 12 briefly summarizes the deleted Conditions and the practical implications for insured parties.

Endorsements

Endorsements are another significant component of title insurance policies, as they typically add coverage or modify certain Conditions. Along with rolling out the 2006 policy forms, ALTA released a list of endorsements that have been revised to conform to the 2006 forms. These are designated with an "-06" to distinguish them from prior versions, and will be used in conjunction with the new owner's and loan policies forms. There are a few new endorsements, such as three new ALTA Endorsement 9 series endorsements. In general, the substance of the endorsements remains the same.

Conclusion

It seems likely that reaction to these policy changes will be positive, but owners and lenders requiring title insurance should familiarize themselves with the new forms to determine what forms and endorsements to request in order to obtain title policy coverage best suited for the particular transaction.

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Avoiding the Unexpected

ERISA Risks in Real Estate Leasing

by Kurt L.P. Lawson

When negotiating leases, landlords and tenants typically focus on rent, extension options, pass-throughs and permitted uses, among other common provisions. But they must also consider the effects of pension and employee benefit laws, particularly if either party is an employee benefit plan, or related to one. This article briefly describes the rules that limit the types of contracts into which plans and related parties may enter, and identifies ways to avoid, or at least manage, lease drafting risks.

The prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code of 1986 ("Code") prohibit specific transactions, including leases, between the assets of a plan and persons with certain specified relationships to the plan (referred to as "parties in interest" in ERISA and below).

Affected Parties

A party in interest includes any fiduciary or administrator of a plan, any employer whose employees are covered by a plan, any union that represents those employees, any person who provides services to a plan (including a landlord, depending on whether and to what extent it provides services along with the bare right to occupy space), and various related parties.

Investment funds must be particularly vigilant. Generally, if plans collectively own 25% or more of any class of interests in a fund, the fund's assets are treated as plan assets unless the fund is a registered investment company or the interests are debt or are publicly traded. Assets held for plans in separate accounts of insurance companies and bank collective investment funds also typically are plan assets. So, for example, if a plan leases space through a company that it owns or a fund in which many benefit plans invest, then the lease will involve plan assets and will be subject to the prohibited transaction provisions unless an exemption applies.

The broad definition of party in interest means that large plans can have hundreds of them, and their identities can change frequently. Plan assets also may be difficult to identify at any single moment. As a result, leases that are potential prohibited transactions happen all the time.

An otherwise prohibited lease is permitted "if no more than reasonable compensation is paid therefor" and the overall terms are reasonable, including the right of the plan to terminate the lease without penalty on reasonably short notice. Whether the compensation and other terms are "reasonable" depends on all the facts and circumstances, and therefore are subject to second-guessing. Also, if the landlord is a fiduciary of the plan, generally it cannot receive any more than the direct expenses it incurs in operating and maintaining the space.

The Pension Protection Act of 2006 created a new exemption for certain transactions with parties in interest that only provide services to a plan, but the exemption does not apply to the furnishing of “facilities” by or to a plan, and therefore is not likely to be helpful.

Consequences of Violations

The consequences of entering into a prohibited lease transaction can be severe. Unless an exemption applies, ERISA requires a fiduciary that causes a plan to enter into the lease, and the party in interest itself, to reimburse the plan for any losses suffered as a result of the lease. Similarly, the Code requires the party in interest to pay a 15% excise tax on the amount involved (that is, all rent) for each year the lease continues. The 15% rate can increase to 100% if the prohibited transaction is not promptly corrected.

Techniques for Reducing Risk

What can be done to reduce the risk of accidentally entering into a prohibited lease transaction? A number of approaches are commonly used alone or in combination:

REOCs

Plans that invest in real estate often do so through a real estate operating company (REOC). In general, a REOC has at least 50% of its assets invested in real estate that is managed or developed and that the REOC has the right to manage or develop (directly or through independent contractors supervised by the REOC), and is not owned by a single plan or group of related plans.

Properties such as office buildings are considered “managed” as long as they are subject to multiple, relatively short-term leases and have substantial common areas the owner is responsible for maintaining. By contrast, properties subject to long-term leases under which substantially all management activities are the responsibility of the tenants are not considered managed. Because of its active management of real estate, a REOC is not considered a mere investment conduit that needs to be regulated, but rather is a business enterprise in its own right. Thus, assets held by the REOC are not considered plan assets and are not subject to the prohibited transaction rules.

QPAMs

Plans that invest or lease space in real estate often do so under the direction of a qualified professional asset manager (QPAM). A QPAM is a registered investment advisor, bank or insurance company that satisfies certain size and other requirements and is independent of the employer sponsoring the plan.

Because of its expertise and independence, a QPAM can make decisions that are not thought to need as much oversight. Thus, leases under the direction of a QPAM generally are exempt from the prohibited transaction rules unless they involve someone either closely related to the QPAM or in a position to hire or fire the QPAM. Leases of office or commercial space to the employer of the employees covered by the plan or to the QPAM itself also generally are exempt from the prohibited transaction rules if, among other things, the space is suitable for use by different tenants and does not exceed a certain percentage of the rentable space at the property.

Several other exemptions provide similar relief in situations not covered by the QPAM exemption.

Several other exemptions provide similar relief in situations not covered by the QPAM exemption, including transactions involving real estate held by insurance company pooled separate accounts, bank collective investment funds and funds managed by qualified “in-house asset managers.”

Contractual Representations

Parties that are not plans and are leasing space sometimes require the other party to represent that it is not a plan or an entity (such as an investment fund) acting on behalf of a plan or, if it is, that one or more of the above exemptions applies. Similarly, parties that are plans often require the other party to represent that it is not a party in interest to the plan or, if it is, that its relationship to the plan is such that one or more of the above exemptions applies. Contracts should provide that these representations are true on the effective date, and should include a covenant that the representation will remain true throughout the term of the lease, with appropriate remedies for default.

Conclusion

Leases can violate the prohibited transaction rules of ERISA and the Code if the parties are not careful. Nevertheless, various exemptions and techniques can be used to reduce the likelihood of a lease deal turning into a prohibited transaction.

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New Texas Franchise Tax

Casting a Wider Net

by Laura Hannusch and Benjamin McReynolds

As of 2007, real estate companies doing business in Texas are working through the effect of important legislation that may impact decisions on which business entities will most effectively minimize taxes. While it is common practice in most states to form limited liability companies to hold real estate assets, in Texas the vehicle of choice has been limited partnerships. This is because the existing tax (the "Franchise Tax") hits limited liability companies at the same rate as corporations but exempts limited partnerships. The new regime (the "Margin Tax"), enacted in May 2006 by House Bill 3 ("HB3"), eliminates most previous exemptions.

Although HB3 does not take effect until January 1, 2008, the Margin Tax will be calculated on income generated in 2007. The challenge facing companies is this: which of HB3's changes will become effective and how will those changes affect the calculation of income? Because HB3 will result in most limited partnerships and limited liability companies that own real estate being taxed equally, limited liability companies could become the entity of choice in Texas. But with the uncertainty surrounding HB3, the prudent choice is to continue using limited partnerships, at least for now.

Application of the Margin Tax

HB3 makes significant changes to the Franchise Tax by expanding the definition of "taxable entity" to include nearly every entity that enjoys limited liability protection and shifting the tax base from earned surplus to adjusted total revenue. The old Franchise Tax allowed real estate companies to reduce their state tax liability by forming a limited partnership with a 1% corporate general partner, the only entity subject to taxation. Under the new regime, most limited partnerships will be subject to the Margin Tax.

The Margin Tax includes a number of exceptions for entities such as sole proprietorships, general partnerships whose only partners are natural persons, insurance companies, nonprofits, certain trusts, estates of natural persons, certain family limited partnerships, REITs and REMICs. Smaller entities that owe less than $1,000 in tax annually or have $300,000 or less in total annual revenues also are exempt.

In addition, the Margin Tax exempts "passive" activities. This exemption (and an important carve-out) affects the real estate industry significantly. A general or limited partnership or trust is considered passive if 90% or more of its gross income in any given year is classified as passive income, such as dividends, interest, royalties, and, importantly, gain from the sale of real property and securities. Royalty interests and non-operating working interests in mineral rights also are classified as passive income. Section 171.0003(b) of the Margin Tax specifically excludes rent from the list of passive income. Because gain from the sale of real property, however, is considered passive income, the limited partnership may continue to be the preferred entity for holding real estate.

Although the Margin Tax will strip the partnership of many tax exemptions, the limited partnership may avoid the tax in the year property is sold if gains from the sale are 90% of the entity's income. This provision may result in sellers pushing closings into the first quarter of the following year, when the amount of rent collected is low (i.e., under 10% of the entity's income), to allow sellers to take advantage of this exemption.

Another key difference between the Franchise and Margin taxes relates to how each is calculated. Whereas the Franchise Tax is based on an entity's earned surplus or capital, the Margin Tax will be calculated on an entity's "taxable margin." The calculation of taxable margin begins with "total revenue," which is based primarily on amounts reported on IRS Forms 1120 (for corporations) and 1065 (for partnerships), less deductions for bad debt and foreign royalties. Taxable margin is capped at 70% of total revenue, which effectively provides an automatic 30% "standard deduction."

An entity may elect to forgo the 30% deduction and calculate its taxable margin by taking advantage of either (a) the Cost of Goods Sold ("COGS") deduction, or (b) the total compensation deduction. The COGS deduction encompasses certain enumerated costs of acquiring or producing real or tangible personal property sold in an entity's ordinary course of business (i.e., "goods," not intangible property or services). The Margin Tax contains a detailed list of expenses that are not deductible, such as selling costs, idle facility expenses, interest costs and officers' compensation. The COGS deduction also does not apply to the cost of renting or leasing equipment, facilities or real property not used for production of goods, bidding costs allocable to contracts awarded, or costs of operating a facility located on property owned or leased by the federal government. As for the total compensation deduction, wages, salaries, stock options and other income paid to an entity's officers, directors, owners, partners and employees are included. Deductible wages, however, are capped at $300,000 for any single person. The compensation deduction includes all benefits to the extent those benefits are deductible for federal income tax purposes. This deduction will not be of use to real estate companies that do not have employees, which is often the case with single-asset or special purpose entities.

After the application of the various exemptions, the tax base is determined, and the revenues collected are apportioned to Texas using a ratio of gross receipts from business done in Texas to business done throughout the United States. The tax rate, 1% for most entities and 0.5% for taxable entities engaged primarily in retail or wholesale trade, is applied to the resulting apportioned margin.

A Controversial Bill

HB3 sparked immediate controversy and will almost certainly be challenged as, among other things, a violation of the Texas Constitution. Within weeks of HB3's passage, Carole Keeton Strayhorn, the Texas Comptroller, requested an opinion from the Attorney General as to whether the Margin Tax required approval of Texas voters in a statewide referendum under Article VIII, Sec. 24(a) of the Texas Constitution. The Attorney General has not yet issued an opinion in response to Comptroller Strayhorn's request.

Election-year posturing aside, the Margin Tax presents important legal issues that the Texas Supreme Court likely will have to resolve in the near future. The Legislature anticipated this challenge by inserting a provision in the statute that gives the Texas Supreme Court exclusive and original jurisdiction over constitutional challenges to the Margin Tax.

Other potential legal challenges loom on the horizon as well. The Margin Tax's 0.5% rate for wholesalers and retailers may spark some in the service industry (already frustrated by their inability to utilize the COGS deduction) to challenge it as violating the equal protection and due process provisions of the U.S. Constitution. Moreover, companies not domiciled in Texas but that have salespeople in the state likely will challenge the Margin Tax if it is construed as an income tax in violation of Public Law 86-272, a federal law that prevents states from imposing a net income tax on companies whose only business activity within the state is the solicitation of orders for the sale of goods.

Legal challenges aside, the legislation will require some modification due to its hasty enactment. HB3 was rushed through the legislative process to meet a deadline set by the Texas Supreme Court in *Neeley v. West Orange-Cove Consolidated Independent School District*, 176 S.W.3d 746 (Tex. 2005) (holding that the state's attempt to "cap" local school property taxes violated the Texas Constitution's procedure for altering property taxes, which can only be done by the local school districts). As a result, the bill contains a number of discrepancies and errors. For instance, the portion of the Margin Tax used to calculate a partnership's total revenue currently refers to a line on IRS Form 165 that lists net revenues, rather than gross revenues, as was likely intended. If not corrected, this would give limited partnerships that own rental real estate an unlimited deduction for their real estate activities. Also, the Margin Tax exempts general partnerships if all partners are natural people but does not address the tax implications if that partnership interest passes to an estate. Many important economic development credits were deleted in the drafting process but will likely find their way back in during the next legislative session.

What Next?

In spite of the confusion surrounding the Margin Tax, what seems most certain is that there will be changes before the law becomes effective in 2008. Because of these uncertainties, and to a lesser degree because of the potential tax savings that may be obtained in the year in which real property is sold, it appears that limited partnerships will continue to be the entity of choice for real estate companies with assets in Texas until those issues are resolved.

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Making Financing Easier (Maybe)...

Revisited

by Robert Herr and Rachel Horsch

In the article "Making Financing Easier (Maybe)," published in our Spring 2004 newsletter, authors Robert C. Herr and Derek S. Van Hoften pointed out the gaps in Assembly Bill 728, which resulted in the bill's failure to accomplish its intended purpose. That article prompted a movement to amend California Civil Code Sections 2985-2985.6, culminating in Senate Bill 504, which passed June 30, 2006. In this article, authors Robert C. Herr and Rachel B. Horsch revisit the gaps created by Assembly Bill 728 by evaluating the effects of the newly enacted Senate Bill 504.

In 2003, the California legislature enacted legislation known as Assembly Bill 728 ("AB 728"), effective January 1, 2004, aimed to encourage more favorable financing from lenders and thereby provide residential developers with some relief from the state's notoriously strict regulatory climate in order to spur development of badly needed housing. Specifically, the bill aspired to help developers pre-sell certain units of attached condominium housing (that is, to enter into binding contracts with buyers before construction has been completed) and retain a larger portion of a buyer's deposit in the event of breach.

However, AB 728 missed its mark. In June of 2006, the California legislature enacted additional legislation known as Senate Bill 504 ("SB 504") to fill one of the two major gaps created by AB 728.

The Original Problem

In California, the sale or lease of subdivisions of five or more units falls under the jurisdiction of the Department of Real Estate (the "DRE"). In the interest of consumer protection, California law requires the issuance of a final public report by the DRE before any subdivision under its jurisdiction may be offered for sale or lease. When substantially all requirements of a final report are met but certain items remain outstanding, the DRE may issue a conditional public report, which permits developers to enter into binding contracts with buyers, subject to the buyers' right to terminate if a final public report materially different from the earlier conditional public report, or no final public report, is issued.

Prior to the passage of AB 728, conditional public reports were valid for a period of six months, with a possible six-month extension. Ostensibly, conditional public reports allow developers to enter into binding contracts while construction is under way and before a final public report has been issued. However, the reality of attached housing—particularly high-rise, "in-fill" housing—is that completion of development and construction often takes more than the 12 months permitted under the prior law. After the one-year period, the conditional public report would expire and buyers could terminate their contracts—not the kind of risk reduction most lenders seek.

In addition, in the event of termination by buyers, sellers would normally look to the liquidated damages clauses in the purchase contracts for their remedy for the buyers' breach. Before adoption of AB 728, Section 1675 of the California Civil Code limited the amount of liquidated damages developers could receive in the event of a breach. Specifically, if the damages did not exceed 3% of the purchase price, they were considered valid unless the buyers established that the amount was unreasonable. Conversely, if the damages did exceed 3%, the provision was presumptively invalid unless the sellers could establish that the amount was reasonable.

To secure favorable financing, developers need to minimize lenders' risk by demonstrating project viability through the existence of binding contracts with buyers. The one-year risk plus difficulty securing a significant portion of the deposit contributed to uncertainty, which, in turn, discouraged lending.

The Original Solution (Almost)

In response to these concerns, California enacted AB 728, amending Section 11018.12 of the Business and Professions Code and Section 1675 of the Civil Code. The bill implemented two major changes to address the difficulties of securing financing for certain developments.

First, for attached residential condominium housing of 25 or more units, it extended the period for conditional public reports to 30 months, with a possible six-month extension, for a total of 36 months.

Second, it introduced a new formula for evaluating liquidated damages clauses for initial sales of units in projects with 10 or more units. Amended Civil Code Section 1675 now provides that when a prospective buyer pays more than 3% of the purchase price as liquidated damages and later breaches, the seller must, within 60 days of the unit's final sale, prepare an accounting of its costs and revenues allocable to the construction and ultimate sale of the unit, including costs related to the buyer's default. The seller must refund to the defaulting buyer any amount exceeding the greater of 3% of the purchase price or the seller's loss resulting from the buyer's default, as calculated by the accounting. In theory, then, sellers could retain more than 3% of the purchase price.

Identifying the Gap

At first glance, extending the total permissible term of conditional public reports from 12 to 36 months appeared to ameliorate somewhat the financing problems outlined above. If developers had more time to complete the project and receive the final public report, there should be less risk of buyers backing out of contracts.

However, AB 728's attempted solution overlooked a separate California law: Civil Code Sections 2985-2985.6. These sections provide criminal penalties for sellers who encumber property under contract for sale where the contract contemplates closing outside of one year. In order to prevent application of the foregoing sections, the DRE required that provisions be included in real property sales contracts requiring a return of a buyer's deposit before the close of one year, unless the buyer agreed at that point to extend the deal. This one-year termination right conflicted directly with the goals of the new 36-month time frame for conditional public reports.

In addition, the new formula for calculating liquidated damages did not provide much relief for developers. To begin with, it imposed on developers the additional burden of performing an accounting of their loss. Second, AB 728's definition of loss neglected to include developers' anticipated profits, which is the traditional method of calculating damages for breach. Instead, developers could only recover "losses" to the extent that the price they received from subsequent buyers was below the developers' actual cost. In other words, developers could not recover their lost profit in the event of buyers' breach. Instead, developers could only recover their out-of-pocket cost, likely to be less than the amount paid by subsequent buyers, resulting in retention by sellers of no more than 3% of the defaulting buyers' purchase price as liquidated damages. In the end, developers were actually in a worse position under the same circumstances than under the prior law.

With the passage of AB 728 many developers began trying to convince the DRE to relax the one-year termination right requirement. Although the DRE may have approved purchase contracts without such one-year terminations, the restrictions in Civil Code Sections 2985-2985.6 remained and developers needed to be aware of the criminal penalties that could arise from violating the Civil Code's one-year limitation.

Filling the Gap (Partially)

SB 504, which passed June 30, 2006 and was effective immediately, amended Civil Code Section 2985 to exclude from its restrictions any contract written pursuant to a conditional public report, thus allowing these contracts to be written and remain fully binding for the full 36-month time frame without subjecting developers to civil and criminal penalties. As a result of this legislation, the promise of AB 728 (that developers would be able to enter into contracts far enough in advance to allow for the long construction period involved in attached projects) is finally achieved.

In the end, developers were in **a worse position under the same circumstances** than under the prior law.

Conclusion

The benefits of the contracts entered into are still limited, however, by the inability of the developer to count on the benefit of its bargain. Although such contracts now remain binding beyond one year, a developer's ability to retain liquidated damages reasonably calculated to cover its risks from market fluctuations continues to be severely hampered by the definition of loss under AB 728.

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ALTA'S 2006 FORMS: A SUMMARY OF DELETED CONDITIONS (story on page 4)

	Provision Deleted from ALTA 1992 Form	Practical Implication of Deletion
Coinsurance (Owner's Policy, § 7(b))	Insured entitled only to a pro rata proportion of any claimed loss under the policy when the amount of title insurance is less than the value of the insured estate or interest.	An insured's claim may no longer be reduced as a result of underinsuring the estate or interest covered by the policy.
Apportionment (Owner's Policy, § 8)	If the policy covers two or more separately used parcels, the insured's recovery is limited to the amount of insurance apportioned to the affected parcel.	When multiple parcels are insured under one title policy, the insured may now claim up to the total amount of insurance, even if only one parcel is affected by the claimed loss.
Subsequent Advances (Loan Policy, § 8(d))	The title company is not liable for most advances made after the date of the policy.	Advances made subsequent to the date of the policy are included in the definition of "Indebtedness." The expanded definition of "Indebtedness" and the deletion of Condition 8(d) increase the insured's protection if there is a loss based on Covered Risks. The 2006 policy does not provide coverage for loss of priority of the mortgage to the extent of the subsequent advances.
Liability Noncumulative (Loan Policy, § 10)	If a loan policy was previously issued to a senior mortgage holder, the amount of insurance in a junior loan policy for the same land is reduced by any amount the title company has to pay under the policy of the senior lender.	Junior lenders no longer risk losing coverage without having received any payment made under the policy.
"Last Dollar" Coverage Issue (Loan Policy, § 9(b))	A payment of the mortgage reduces the amount of insurance coverage, to the extent of the payment.	Payments on a mortgage no longer result in a reduction in the amount of insurance. As a result, according to ALTA, the "last dollar" endorsement is no longer necessary.

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