maddin hauser
Maddin Hauser Wartell Roth & Heller PC
attorneys and counselors

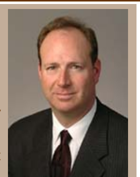
Real E-State

October 2005
Vol. 2 Issue 4

An electronic newsletter for real estate professionals

From the desk of:

The Real e-ditor



In this issue of Real e-State our dedicated staff has a little fun with our Halloween theme. October 31st aside, however, it really does seem that we are heading into some scary times.

Federal Reserve Chairman Alan Greenspan is retiring in January 2006. His policies in regard to the money supply have helped to sustain a buoyant real estate industry, even through some very difficult times here in Detroit. Will his successor guide the nation's monetary policy with as much alacrity?

Hurricanes Katrina and Rita caused widespread devastation in the Gulf region. Whole towns and communities have been uprooted. Substantial damage was inflicted on oil and natural gas facilities. Higher gasoline prices were pinching even before the storms. Wholesale natural gas prices are presently double what they were this time last year. What effect on the economy will higher energy prices have this winter? Just as worrisome, what long range effects will higher energy prices have on the automobile industry in Detroit?

President Bush's support is reported to be eroding, even among his core supporters, and his job approval ratings are the lowest of his Presidency. Other Republican leaders are shrouded in suspicion (Rove) or are under indictment (DeLay). Tax cuts that seemed likely to be permanent before the hurricanes, now may be reconsidered on the Left, while the Right looks for $200 Billion in waste to chop from the budget to pay for storm cleanup.

And consider the major bankruptcy filings in the past several months, including Northwest Airlines, Collins & Aikman, and now Delphi. How will these affect the automobile industry, and what will the ripple affect be through the larger local economy?

Will our future metro Detroit economy look like a Halloween charnel house? Or will new opportunities present themselves to the innovators and risk takers among us? If ever there was a time to be flexible in our outlook and approach to business, as we head into Halloween 2005, this would seem to be the time to be most vigilant for new opportunities (and obstacles). So go ahead, carve the pumpkin early, but guard it against frost!

He who fears being conquered is sure of defeat.

-Napoleon Bonaparte

FOUR SCARY ISSUES FOR REAL ESTATE OWNERS

BY: DANIELLE M. SPEHAR

This time of year when we all fear "things that go bump in the night", we thought it would be useful to briefly highlight some scary issues for real estate owners:

- The Michigan Court of Appeals recently held that a title insurance company was not liable under its title insurance policy to a revocable trust since the trust was not the named insured. The moral of this scary story is that property owners need to get a title insurance endorsement when transferring real estate from their individual names to a trust, even if the trust is revocable.

- Contrary to what may be the common belief amongst builders and realtors, they may be subject to claims under the Michigan Consumer Protection Act ("MCPA"), which allows an award of triple attorneys fees to successful claimants. Michigan courts have held that builders and brokers who fail to claim exemption from the MCPA as an affirmative defense to any MCPA violation claim waive the exemption defense.

- Some corporate tenants have become adamant that a redlined copy of the standard form lease be executed as the final version of the Lease. Their argument is "This way, I'll be able to easily spot the changes whenever I need to refer to the Lease." Unfortunately, Landlords agreeing to do so may be exposing themselves to unnecessary risk. The redline document provides a "paper trail" of what the Landlord and Tenant negotiated. In the event a dispute arises between the parties, the highlighted additions and deletions might lead a judge to draw conclu-

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TIPS TO AVOID THE DEALER PROPERTY TRAP

BY: MICHAEL K. HAUSER

Federal tax rules provide a 20% tax break on sales of "capital" assets (property held for long-term market appreciation), as opposed to sales of "dealer" property (property bought or developed and sold as a business). The tax break is available to individuals, partnerships and "S" corporations (but not "C" corporations) who sell capital assets they have owned for over 1 year. Further, a capital asset seller can defer gain through a § 1031 exchange or installment sale. But each of these techniques are unavailable for "dealer" property.

It is generally presumed that developers and frequent real estate sellers are tainted as "dealers" and will never have capital gain. However, the actual rule is that: capital gains cannot result from "property held primarily for sale to customers in the ordinary course of a trade or business." A taxpayer can incur capital gains for real estate which (1) is held primarily for investment, rental or intended future rental, (2) is not sold as part of an established trade or business, or (3) is not sold within the ordinary course of the taxpayer's business.

"It is generally presumed that developers and frequent real estate sellers are tainted as "dealers" and will never have capital gain."

Planning can make the difference in avoiding dealership status. For example, when feasible, each parcel should be held in a separate entity. Related entities are generally considered distinct "taxpayers" even if they have the same owners. Even if a taxpayer would be a "dealer" if he or she bought and sold properties through a single entity, "dealer" status could possibly be avoided

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LEGAL UPDATE: A JOURNEY THROUGH OUR GHOSTLY PAST

BY: Kasturi Bagchi

In preparing for our year end issue, the Real *e*-State Staff took a stroll down memory lane to see if any proposed laws or pending litigation, which were topics of past editions, have been passed or resolved. Here is a status report:

- As we anticipated in our October 2004 and January 2005 editions, Public Act 357 which accelerates the due date for county real property taxes from December 1st to July 1st is now in full swing. If you are a buyer or seller of real property or a landlord or tenant under a lease, you may wish to reconsider the property tax payment and pro-ration provisions of your purchase agreements and leases in light of the ramifications of the phased-in tax acceleration.

- In our April 2005 edition, we scrutinized the proposed Jobs and Investment Act summary issued by the Governor's office and its possible harmful tax consequences to commercial landlords. The summary of the proposed Act provided that in order to make business tax structure more fair, the Act would eliminate the special property tax treatment of commercial rental property by treating changes in value like all other changes in value are treated for assessment purposes. Without having any more information other than the summary, an official at the Michigan Department of Treasury predicted that the Act would eliminate the treatment of a reduction in the occupancy rate of property as a loss for purposes of calculating taxable value. A legislative analysis of Michigan House Bill 4477 now confirms the anonymous official's prediction. In the analysis, which is available at http://www.michiganlegislature.org, the House Fiscal Agency reports that "under the General Property Tax Act, 'losses' include, among other things, an adjustment in [taxable] value because of a decrease in a property's occupancy rate. However, as a result of the Michigan Supreme Court's ruling in WPW Acquisition v. City of Troy, an "addition" to a property's taxable value could not occur "when the occupancy rate subsequently increases". House Bill 4477, as well as the Senate Bill 0295, proposes to limit the impact of a decrease or increase in a property's occupancy rate on such property's taxable value before December 31, 2001. If the bill is passed, rental property owners can no longer claim a lower taxable value because of a decrease in occupancy.

> **"If the bill is passed, rental property owners can no longer claim a lower taxable value because of a decrease in occupancy."**

- In Glass v. Goeckel, discussed in our July 2005 edition, the Michigan Supreme Court ruled in favor of beach walkers and has reversed the Court of Appeals. In an opinion dated July 29, 2005, the Michigan Supreme Court reasoned that under the public trust doctrine, the state has a longstanding "obligation to protect and preserve the waters of the Great Lakes and the lands beneath them for the public…[Thus]…although the state retains the authority to convey lakefront property to private parties, it necessarily conveys such property subject to the public trust." In determining the scope of the public trust, "Michigan courts have adopted the ordinary high water mark as the landward boundary of the public trust." Consequently, the Goeckels held absolute title only to the ordinary high water mark and the intervening space between the high water mark and the water remains subject to the rights of the public trust.

  Notably, the Supreme Court acknowledged that "the precise location of the ordinary high water mark at any given site on the shores of our Great Lakes remains a question of fact." Furthermore, the Court noted that the public trust doctrine "does not create an unlimited public right to access private land below the ordinary high water mark and "[b]y no means does our public trust doctrine permit every use of the trust lands and waters." Instead, the Supreme Court seeks to limit the intrusion by the public on that shore space between the high and low water marks to "the traditionally articulated rights protected by the public trust doctrine as fishing, hunting, and navigation for commerce or pleasure…[and] activities inherent in the exercise of those rights." Because the public "must have a right of passage" over the intervening shore space in order to fish, hunt or navigate", walking between the high and low water marks of one of our Great Lakes is protected by the public trust doctrine. So next time you go to the beach, be sure and take along your fishing pole!

- Finally, in the no-news-is-good-news category, way back in January 2004, we alerted you to the introduction of Senate Bill 172 which would establish the **Toxic Mold Disclosure Act**. The proposed Act would require the disclosure of mold not only by residential property sellers but also commercial real property sellers and landlords in leasing transactions. The official website for the Michigan legislature indicates that Senate Bill 172 was referred to the Committee on Economic Development, Small Business and Regulatory Reform and has sat there since February 11, 2003.

  Senate Bill 302 introduced in March 2003 for the purpose of repealing the **Land Division Act** has suffered the same fate. The bill was last referred to the Committee on Banking and Financial Institutions on November 10, 2004 and has not progressed.

www.maddinhauser.com
28400 Northwestern Highway
Third Floor, Essex Centre
Southfield, Michigan 48034

Phone: 248-827-1861
Fax: 248-359-6161

If a man harbors any sort of fear, it makes him landlord to a ghost.

-Lloyd Douglas

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sions about the Lease that otherwise could not be gleaned from a clean copy. For example, suppose a lease provides that the Landlord won't be liable for any delays in completing construction, and the Landlord agrees to strike that provision because another part of the Lease provides the Landlord with redundant (but less obvious) protection from liability in that situation. The Tenant later sues the Landlord over construction delays. A judge reviewing the Lease may notice the crossed out provision and conclude that by agreeing to the strike-out, the Landlord was agreeing to accept liability for delays in completing construction. This now places the Landlord in the position of have to convince the judge otherwise.

- Pending legislation in the State of Michigan (HB 4695) may create a new **"mobile home park tenants bills of rights"**. Among other things, the proposed legislation provides for a $10,000 fine for a violation of the Act and states that a park owner shall not "threaten" a park resident with an unlawful eviction in violation of the summary proceedings act.

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if each property is owned through a separate entity. (Note: for an LLC to be a recognized entity for tax purposes, it must have more than one member or it must elect to be taxed as a corporation). It also helps (but is not required) to involve different passive third-party investors in each deal.

Even for taxpayers who are "dealers," each parcel is considered separately to determine if it is dealer property. Taxpayers, *and their brokers and other professionals*, should collect evidence that parcels are held for investment as opposed to sale in the ordinary course of a trade or business. For example, use the term "investment," and avoid the terms "dealer," "development" and "sales," on purchase agreement recitals, when choosing the entity's name, when identifying the entity's business on a tax return, and when stating the entity's purpose on its Articles of Organization or Operating Agreement.

How can a condominium developer or residential community builder who primarily sells in the ordinary course of trade or business avoid the dealership status and incur capital gains? They may be able to divide profits between capital gains (on land appreciation) and ordinary income (on building profits). Assume an LLC buys land, begins development two years later, and then sells the units. Since the LLC engaged in development, the profits would be ordinary income (35% tax). Assume instead the LLC passively held title to the land for investment (as evidenced by the documents mentioned above), while a separate S corporation (with the same owners) obtains government approvals and orders surveys, blueprints and architectural work (as evidenced by having correspondence and payments from the S corporation). Just before development, when the project has appreciated due to market factors and rezoning, the property gets sold from the LLC to the S corporation. The raw land sale could produce capital gain (15% tax) on the pre-development appreciation.

Whether or not this method is viable depends on some critical factors. First, a *business purpose* for the related-party sale is needed, apart from tax motivations. Some sales can be justified on a "segregation of liabilities" theory, if the original title-holder holds other property and does not want to be subject to liabilities related to development. Second, the sale cannot be between two commonly owned partnerships. One entity must be an S corporation. Third, the sale must be at fair market value (taxpayers cannot inflate the capital gain portion).

Here are some other scenarios to consider when trying to avoid dealership status. What if a parcel is tied up with a purchase agreement or option for 2 years, then title will only be held briefly before sale? To get capital gain, one would have to sell the option or the right to purchase, due to the minimum 1-year holding period. What if an investor has held a parcel for 20 years and then teams up with a developer? All of the investor's income will be tainted by the developer, and turned into ordinary income, unless the investor sells the raw land prior to development (and makes some kind of deal with the developer).

For a more thorough discussion, please see Michael Hauser's article "Avoiding Dealer Status to Obtain Capital Gains" in the 2nd Quarter 2005 issue of the Journal of Real Estate Taxation, or contact our office.