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From the desk of:

The Real e-ditor

Of this much I am certain. Change is coming! Like Tony in *West Side Story*, I can feel it "just around the corner". But does change bode well or ill for our local economy?

I just returned to the office from a few vacation days in smoke-shrouded Santa Barbara, where wildfires in the rain-parched hills darkened the sky and drizzled a light ash over a wide area. The full moon rose red through the smoke (literally)! When I returned to my desk on Tuesday, I was reminded just how quickly change can befall (and befuddle) the business world. With the recent trip and fall of the credit markets, and a stock market slide in process, an otherwise promising summer now looks worrisome. Lenders are now pulling up commitments and standing on the sidelines to see what will happen next.

But wait, we here in Michigan have been sweating out a weak economy for years. Could it be that the rest of the country is just now catching up to Michigan? Does that mean that maybe, just maybe, we'll lead the way out of the weakness first? Coincidentally, GM reported an unexpectedly high profit for the second quarter. Even bankrupt and flight-cancellation plagued Northwest Airlines posted a slight profit for the second quarter. This summer's UAW labor negotiations with the Detroit Three could, with the right result, signal a new beginning for labor-management relations in our entire area.

We also have a new business tax which the Governor claims will "encourage companies to invest in Michigan". We hope to summarize this new law for our next issue and point out the opportunities it may hold for the future of Michigan. But even the new MBT is not in final form, as a "cleanup bill" is expected this fall to deal with glitches and unintended consequences which, undoubtedly, will be found in the coming weeks. Other revenue enhancements appear to still be on the table, such as a service tax and the "ticket tax" we keep hearing about.

So clearly, change is here and more change is coming. The only question is, will our area benefit or suffer from the changes? Stay tuned to future issues of *Real* e-*State* for answers.

Steven D. Sallen
Editor-in-Chief

APPELLATE COURT APPLIES NO NONSENSE APPROACH IN FORECLOSURE PROCEEDINGS

BY: KASTURI BAGCHI

On May 15, 2007, the Detroit News reported that there was one foreclosure filing for every 614 Michigan households during the month of April, thereby awarding Michigan with the dubious distinction of being the state with the tenth highest foreclosure rate in the nation. The good news is that the April foreclosure rate was much lower than in January, creating a sense that the worst may be over. What's the bad news? On the same day that this Detroit News article was published, the Michigan Court of Appeals revealed its no nonsense approach to handling foreclosure proceedings in *Sweet Air Investment, Inc. v. Kenney*, No. 265691 (May 15, 2007), which may be a source of concern to Michigan mortgagors.

In *Sweet Air*, the mortgagor purchased 66 continuous acres consisting of three different tax parcels. The property was improved by an 8,000 square foot main house, 5 outbuildings, dog kennels, and a caretaker's home. The mortgagor resided at the main house, located at 300 Marr Lake Road (the "Main Parcel") and used the property to raise show dogs. The caretakers resided at the caretaker's home, located at 750 Marr Lake Road (the "Caretaker Parcel"), which was connected to the Main Parcel only by a bridge. When the mortgagor defaulted on a loan secured by all 66 acres, the lender instituted foreclosure proceedings and received a sheriff's deed at the sale. The lender then quitclaimed all 66 acres to Sweet Air Investments which then sought possession of the property and commenced eviction proceedings.

In spite of the public policy goal of insuring redemption rights, the ruling in Sweet Air suggests a literal approach in applying the [law] as well as a reluctance to favor mortgagors who have waited too long to object to foreclosure proceedings.

The mortgagor sought protection under MCL 600.3224 arguing that the Main Parcel and the Caretaker Parcel were distinct parcels separately occupied by the mortgagor and the

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AVOIDING AN UNINTENDED RELEASE OF A PERSONAL GURANTOR IN A COMMERCIAL LEASE

BY: DANIELLE M. SPEHAR

Getting the principal of a commercial tenant to sign a personal guaranty for a lease is like pulling teeth. Because the negotiation process can be difficult, many landlords rely on a standard guarantee clause that often states the guarantor remains liable despite any modifications, extensions, or renewals of the lease, to avoid asking the principal to execute a new guaranty when the existing lease expires and a new lease is signed. Unfortunately, this may not be a sound business practice. Without the guarantor's consent to become liable under the new lease, you may end up inadvertently releasing the guarantor from further liability under the guaranty.

In a recent Ohio Court of Appeals case, *Samsel Rope & Marine Supply Co. v. Gray*, a landlord learned this lesson the hard way. The facts of the *Samsel* case were quite typical. The tenant's principal signed a personal guaranty of the tenant's obligations under a 1985 lease. The guarantor died in 1994 and the tenant's assets were assigned to a new principal. The lease was scheduled to expire by its terms on August 31, 1995, but provided the tenant with an extension option.

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TAX STRATEGY AND CONDO CONVERSIONS

BY: MICHAEL K. HAUSER

The marketplace has dictated that some apartment buildings are more profitable if converted to condominiums. Apartment building owners face a dilemma – if they sell their building intact to a condominium converter, they will pay capital gain tax (15-25%), but will not share in the profits from individual condominium sales. If they do the conversion themselves, maximizing their economic profit, then the conventional wisdom is that they will pay tax at ordinary income rates (up to 35%) on individual unit sales. This increased tax load could outweigh the additional profits of conducting the conversion.

This article briefly explores three methods of enabling an apartment owner to reap condominium conversion profits without losing capital gains tax rates.

In tax terms, "dealer" means a taxpayer who holds property primarily for sale to customers in the ordinary course of a trade or business. Dealers in real estate pay ordinary income tax because their real estate sales are like an auto dealer's car sales, just profits in the everyday operation of a business. However, rental properties are deemed to be held for use in the rental business, not held for sale. Since rental properties are held for a business/investment use, their sale produces capital gain. Typically, the sale of rental properties produces a substantial amount of capital gain because, even if economically the sale is a break-even, the taxpayer's basis in the property is low due to years of depreciation deductions which reduce the cost basis for tax purposes.

Example: assume Fred buys an apartment building for $2 million. He owns it for 10 years and deducts $800,000 in depreciation, leaving him with $1.2 million of basis left. If the building were sold for $2.7 million, Fred would have $1.5 million in capital gain ($700,000 economic gain taxed at 15% and $800,000 recovery of past depreciation taxed at 25%). This translates to $305,000 in tax. Assume instead Fred converts the building and enters the everyday business of selling condominiums as inventory, ultimately selling them all (net of costs) for $3 million, an extra $300,000. Fred now has $1.8 million of ordinary income taxable at 35%, resulting in tax of $620,000. Thus, Fred actually loses $15,000 on the conversion – though he gets an extra $300,000 in profits, his tax bill goes up by $315,000.

PRE-CONVERSION SALE TO 50%-OWNED ENTITY. The easiest method to allow capital gain on the conversion involves selling the building to a 50%-owned entity. In the example above, Fred would sell the building for $2.7 million (its value as a rental building) to Fred-Joe Corp., an entity half-owned by his partner Joe. This new corporation would do the conversion and collect the $300,000 in net conversion profits (taxable at 35%), but Fred's sale would produce $1.5 million of capital gain taxable at 15-25%. Joe and Fred would have to be even-steven shareholders in all respects. Joe must own 50% because a sale of depreciable property between "related entities" produces ordinary income under Section 1239 of the tax code. An aggressive seller could attempt to capture additional conversion profits by taking a high-interest note back from the purchasing entity or by taking a contingent interest "kicker" or participation right in the purchaser's later sale proceeds. The 50%-line could get tested, and possibly crossed, if the seller's "kicker" is considered a disguised form of equity in the new corporation.

PRE-CONVERSION SALE: THE OVER-50% METHOD. An alternative strategy, *which has not been tested in the courts or ruled on by the IRS*, involves selling the building to a corporation with greater than 50%-common ownership, perhaps even identical ownership. The taxpayer's argument is that Section 1239 (described above) does not apply because the property is not depreciable in the hands of the purchaser, since the purchaser is holding the property as inventory for sale to customers (inventory is nondepreciable). Here, it is paramount to prevent the seller from being a "dealer" and yet to ensure that the purchasing corporation is in fact a "dealer" (to make sure the property becomes nondepreciable "inventory"). The new corporation must conduct the conversion (both the legal and business components) and try to sell the units as soon as is reasonably practicable (as leases expire and buyers become available). The sale terms must be arm's length and there must be a business (non-tax) purpose for the sale. There might be a business purpose if (1) there are differences in the ownership percentages; (2) financing is obtained more easily through a new entity; or (3) the new entity provides additional liability protection as between the condominiums and other property retained by the current owner (for example, if the building's parking lot will not be sold with the condominiums, it could be retained by the original owner).

ORDERLY LIQUIDATION. Though the conventional wisdom is that converting an apartment building into condominiums will bar capital gain, actual cases on the subject are mixed. There are cases, most notably *Gangi*, holding that the conversion of apartments into condominiums can be classified as merely the "orderly liquidation" of an investment, with the conversion activities too insubstantial to amount to the everyday "trade or business" of selling condominiums.

Relying on this method is generally frowned upon by practitioners due to its uncertainty, as compared to the pre-conversion sale. However, in the *Parkside* case (571 F2d 1092 (9th Cir. 1977)., the roles were reversed and the IRS argued for the "orderly liquidation" theory since capital asset status was preferable to the IRS for other reasons. The fact that some cases approve of this method, coupled with the fact that even the IRS sometimes argues for this method, indicates that it has some validity in the right circumstances, especially where the pre-conversion sale is not practical. The liquidation strategy can best be employed where (1) the evidence indicates that the taxpayer had a strong rental intent but made the conversion based on unforeseen circumstances which were out of the ordinary course of business; (2) the conversion-related physical renovation work is minimal; (3) the building has relatively few units, and (4) the sales, brokerage and advertising efforts are not excessive or prolonged.

In conclusion, careful advance planning can avoid the heavy tax burden of recognizing all ordinary income on the sale of a depreciated apartment building as condominiums. The pre-conversion sale is generally the preferred method, with 50%-common ownership generally considered safe and above-50% considered aggressive but justifiable. In some cases, the liquidation theory may be adequately supported by the facts.

NOTE: For additional reading on this topic, please e-mail our office to request a copy of additional articles authored by Michael K. Hauser entitled "Avoiding 'Dealer' Status to Obtain Capital Gains" and "Dealer Status and the Condominium Conversion" which appeared in Real Estate Taxation, a WG&L journal.

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The most rewarding things you do in life are often the ones that look like they cannot be done

~ARNOLD PALMER

Court (Continued from Page 1)

caretakers and, therefore, the sale should be set aside. MCL 600.3224 states that "if the mortgaged premises consist of distinct farms, tracts, or lots not occupied as 1 parcel, they shall be sold separately…but if distinct lots be occupied as 1 parcel, they may in such case be sold together." The purpose of MCL 600.3224 is "to protect parties having interests in mortgaged premises by insuring a right of redemption where occupancy and ownership were other than one parcel." MCLA 600.3224(2).

The trial court ruled in favor of the mortgagor and set aside the foreclosure sale. It found that the mortgaged property was made up of two distinct parcels that were occupied separately and the lender should have sold them separately. However, the Court of Appeals reversed the ruling of the trial court because the statute "require[s] the sale of individual parcels or property covered under a single mortgage only when those parcels are in fact physically separated and not interconnected or integrated in their use or occupancy." In this instance the properties were "physically connected and… accessible to each other by a bridge". The court emphasized that in cases where sales were set aside pursuant to MCL 600.3224, the parcels making up the mortgaged property were separated by a mile or were not continuous. The court also found it noteworthy that the Main Parcel and the Caretaker Parcel were purchased and mortgaged as one property. Furthermore, "the caretakers occupy the caretaker's home for the purpose of maintaining the dog kennels and the entire property. This factor makes the Caretaker Parcel an integral part of the Main Parcel and to the functioning of the entire property's current primary use, which is to raise show dogs." Finally, the court noted that forcing separate sales would land lock the Caretaker Parcel from the highway and impair the value of the property as a whole.

The mortgagor also attempted to have the foreclosure set aside for lack of adequate notice but this also was rejected by the Court. Even if the lender did actually fail to provide notice as required by statute, the foreclosure sale would not be set aside because there was no prejudice to the mortgagor. The mortgagor never timely challenged the validity of the foreclosure sale, nor did they make any "effort to redeem or take any action until well after the redemption period had" expired. In fact, the mortgagor did not take any action until eviction proceedings had commenced.

In spite of the public policy goal of insuring redemption rights, the ruling in *Sweet Air* suggests a literal approach in applying the standards of MCL 600.3224 as well as a reluctance to favor mortgagors who have waited too long to object to foreclosure proceedings. Michigan mortgagors should be aware of this and promptly seek legal counsel if they receive notice of foreclosure from their lender.

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In September 1994, the landlord and tenant signed a new agreement by which they agreed to be bound by the terms of the original lease for an extended term ending in 2004.

In 2002, the tenant defaulted. The landlord sued the tenant and obtained a judgment for $513,000. The landlord then sued the guarantor's estate claiming it was liable for those damages under the guaranty. An Ohio appeals court ruled that the guarantor's estate was no longer liable under the guaranty. While acknowledging the guaranty language that stated "no modifications, extension, indulgence, forbearance, or change" granted to the tenant would release the guarantor from the guaranty or diminish his liability under the guaranty, the Court concluded that the guaranty of the 1985 lease covered only extensions or renewals of *that* lease. By entering into a new lease in 1994 as opposed to amending the expiring lease, the landlord and tenant effectively released the guarantor from liability under the guaranty.

While not binding precedent in Michigan, the *Samsel* case provides a basis for caution and a reminder that landlords will need the guarantor's separate consent to become liable for the tenant's obligations under a <u>new</u> lease. In these situations, it is advisable to address the issue head-on as opposed to relying on the language of a guaranty only to be disappointed when trying to enforce the guarantor's obligations after a default of a new lease by the tenant.