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In the Zone

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NJ Tax Court Orders Refund of Nonresidential Development Fee, But Not To Developer's or Municipality's Satisfaction

By John L. Grossman

At least one New Jersey court has held, in connection with a refund claim, that the nonresidential development fee imposed by municipalities upon developers is premised upon the equalized assessed value of the building and related site improvements, rather than upon the value of the building, only; the value of the land upon which the development was constructed is not to be included in the calculation. In so doing, the court rejected the developer's argument seeking to limit the fee to a percentage of the building's value. It likewise rejected the municipality's argument seeking to expand the fee to include a percentage of the value of the land.

In *Lowe's Home Centers, Inc. v. Township of Raritan*, Docket No. 008173-2009, a November 3, 2011, unpublished opinion of the Presiding Judge of the Tax Court of New Jersey, the plaintiff (Lowe's) possessed a ground leasehold interest in real property located in Raritan Township. Lowe's constructed a retail store and related site improvements on the property. When the development was planned, a municipal ordinance provided that a developer of a nonresidential development shall pay a development fee equal to two percent of the equalized assessed value for the nonresidential development. The ordinance was consistent with the regulations of the Council on Affordable Housing (COAH), the agency charged with statutory authority to oversee the implementation of municipal affordable housing obligations. The purpose of the ordinance was to fund, in part, the township's obligation to provide low and moderate income housing as required by the *Mount Laurel* doctrine and the New Jersey Fair Housing Act.

The governing ordinance provided that developers shall pay the nonresidential development fee in two installments: (1) 50 percent of the calculated development fee at issuance of building permits, as estimated by the tax assessor prior to the issuance of building permits; and (2) the balance of 50 percent upon issuance of a certificate of occupancy, at which time the fee is recalculated, in view of the fact that the development is complete and an accurate assessment of its equalized assessed value may be made. The developer is then responsible for paying the difference between the fee calculated at certificate of occupancy and the amount paid at building permit.

Lowe's received preliminary site plan approval, a condition of which was to pay the COAH approved nonresidential development fee in accordance with the municipal ordinance. Subsequently, Lowe's received final site plan approval, which incorporated all the conditions of the preliminary site plan approval, including the requirement for payment of the nonresidential development fee. However, the final approval provided that prior to the construction of any of the proposed buildings comprising the Lowe's development, the applicant shall pay one-half of the affordable housing fee for the specific "building." That same approval also provided that, prior to the issuance of a certificate of occupancy for a specific building, the applicant shall pay the remaining one-half of the fee for that "building." This language provided Lowe's with its argument for limitation of the fee.

Lowe's paid one-half of the estimated fee at issuance of the building permit for the project. During construction, the Statewide Nonresidential Development Fee Act became law. This superseded municipal ordinances imposing nonresidential development fees and imposed a uniform, statewide nonresidential development fee of two and one-half percent of equalized value of the "land and improvements" of new nonresidential construction. Based upon the timing of the passage of this Act and of the plaintiff's receipt of a certificate of occupancy, Lowe's was subject to the new fee.

Subsequently, Lowe's applied for a certificate of occupancy for its retail store. The municipal assessor recalculated the nonresidential development fee for the development, including the value of the retail store, the garden center, site improvements and the land under the store. The assessor also raised the fee from the two percent authorized by the municipal ordinance to the two and one-half percent authorized by state law. Lowe's objected, but paid the revised fee under protest; the municipality refused to issue a certificate of occupancy until the fee was paid. Lowe's appealed and ultimately filed a complaint in the Tax Court.

While the Tax Court action was pending, the New Jersey Economic Stimulus Act of 2009 went into effect, placing a moratorium on the collection of the statewide two and one-half percent nonresidential development fee with respect to any project for which site plan approval was issued prior to July 1, 2010, provided that a building permit is issued prior to January 1, 2013. The Lowe's project fell within the moratorium on the

uniform fee. However, under this statute, the moratorium would not apply to a financial or other contribution that a developer made or committed itself to make prior to its effective date. The parties here agreed that the Lowe's project fell within this provision; Lowe's was liable for any financial or other contribution it made or committed itself to make to the township in connection with its development. The extent of the plaintiff's liability, however, was at issue.

Thereafter, Lowe's sought a return of a portion of the nonresidential development fee that it had paid to the township. The plaintiff had paid slightly more than $500,000 as the development fee for the project, $96,000 of which was paid at building permit, the balance of approximately $405,000 was paid under protest at the time of certificate of occupancy. Lowe's sought a return of more than $300,000, contending it had committed to pay only just under $200,000 prior to the effective date of the moratorium. Lowe's further argued the fee was to be calculated on the equalized assessed value of only the retail store building, without consideration of the related site improvements or the land on which the building and site improvements sit. The municipality returned only $100,000 to Lowe's, arguing the plaintiff is liable under the municipal ordinance for payment of approximately $400,000, or two percent of the equalized assessed value of the retail store, associated improvements and the land on which the project sits, as calculated at the time of certificate of occupancy. The municipality, in returning the funds, adjusted for the difference between the statewide two and one-half percent and the municipally-enacted two percent. The municipality contended that prior to the enactment of the moratorium, Lowe's committed to pay the fee in accordance with the terms of the ordinance, requiring the fee to be calculated on the basis of the value of the entire development, not just the building.

The tax court found there to be no dispute that Lowe's obligation to pay the fee was a condition of its land use approvals. Relying upon basic tenets of statutory construction, the court found that Lowe's committed to pay the fee in connection with receipt of its approvals. Addressing the final site plan resolution, which referred to the equalized assessed value of the "building" as the measurement for the fee, the court found that such a definition of the fee is inconsistent with the controlling ordinance, which imposed fees upon the value of developments, not simply buildings. Since the planning board does not have statutory authority to waive or alter the fee as defined by the governing body in the ordinance, the court dismissed any argument that the building was to be the limiting factor. The court also rejected the municipality's argument that the land upon which the retail store and improvements sit is part of the development within the meaning of the ordinance.

Since Lowe's committed to complying with the ordinance at the time of receipt of the approvals, the court concluded that the equalized assessed value placed by the assessor on the retail store and related improvements will serve as the measure of the plaintiff's nonresidential development fee. A refund was ordered consistent with this opinion. As unpublished, this opinion is fact-sensitive and is not binding authority.

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Prevailing Wage Reform Considered by PA General Assembly

By Lauren W. Taylor

A legislative package of various bills has been introduced in the Pennsylvania House of Representatives that would reform the Commonwealth's approach to prevailing wage requirements.

- HB 1329 would increase the prevailing wage rate threshold from the current $25,000 to $185,000. It would also adjust this amount annually based on the Consumer Price Index. The current rate is almost 50 years old and viewed as unreasonable by proponents of the reform bill.
- HB 1271 would clarify the definition of "maintenance work" as it relates to rehabilitation work on roads, highways and bridges. The new definition would exclude the replacement of guide rails and curbs, the repair of pavement by overlaying bituminous material or patching cement surfaces, road widening that does not result in additional lanes, and bridge cleaning and resurfacing. This bill would remedy the actions of the 2008 *Youngwood Borough* Supreme Court case that redefined those activities that have historically been considered maintenance and thus, exempt from the prevailing wage law.
- HB 1367 would require the Department of Labor and Industry to determine the prevailing wage rates for each county by utilizing occupational wage rate data as determined by the Department's Center for Workforce and Analysis as the basis of the determination. The current methodology in determining prevailing wage rates are based on language that is fundamentally vague and often applied in an inconsistent manner. Also, the weight that the statute and regulations currently give to collective bargaining agreements and union wages tend to skew the rates unnecessarily higher than they otherwise would have been if determined under

alternative means. This bill would establish a clear and uniform set of guidelines in determining proper wage rates.

- HB 1191 would exclude political subdivisions or local authorities from the prevailing wage requirements. Municipalities and local authorities would have the option to place themselves under the jurisdiction of prevailing wage requirements by passing an ordinance or resolution.

Reform efforts have been supported by the Pennsylvania State Association of Township Supervisors as well the Pennsylvania Chamber of Business and Industry.

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Federal Enforcement of Stormwater Permits in New Jersey

By Henry L. Kent-Smith

For years, New Jersey has been delegated the authority under the Federal Clean Water Act to manage non-point source stormwater pollutant runoff. Under both the federal Clean Water Act and the Water Pollution Control Act, recent regulatory interpretation has held that "soil runoff" constitutes a pollutant that when discharged into open waters would be a violation of both statutes. Federal authorities have not enforced these types of violations for years. Enforcement was historically left to state authorities, which in New Jersey has been delegated to the local soil conservation districts.

Recently, the federal EPA has stepped up enforcement of the federal Clean Water Act and Water Pollution Control Act for non-point soil runoff pollution. The implications for land developers of this new federal initiative are substantial.

Developers are familiar with the NJPDES Construction Activity Stormwater General Permit (General Permit), which is issued in conjunction with the soil conservation district soil plan approval. Every soil erosion and sediment control plan endorsement is accompanied by the General Permit. Developers and contractors should be well versed with local soil conservation district best management practices, including containment of runoff onsite, soil stabilization and prevention of erosion. The federal requirements pertinent to and part of the General Permit, as found in Attachment B to the Permit, have not been routinely enforced by local soil conservation districts. In particular, Attachment B to the General Permit requires onsite stormwater control and construction waste control measures as part of the Stormwater Pollution Prevention Plan (SPPP). Attachment B also requires a minimum of weekly inspections for soil control measures and operational construction waste control, and these inspections MUST BE DOCUMENTED.

The Stormwater Pollution Prevention Plan requires not just the weekly inspections but the implementation of stormwater BMPs to control soil erosion and prevent offsite stormwater discharge. These BMPs include concrete waste staging areas for the cleaning of all concrete trucks after any onsite pour, soil removal and maintenance of access areas into and out of construction sites to eliminate the transportation of soil erosion materials off site, as well as the regular inspection and maintenance of hay bales, steel fences and other types of measures utilized to maintain stormwater flows and erosion on site and prevent offsite migration. In addition, in areas of acid producing soils (north coastal NJ running parallel to the Delaware River to Salem County) require enhanced soil protection measures, including separate stockpiles, limestone blending and limited exposure to air and rain (30 days).

With the new initiative, federal authorities are now inspecting construction sites to determine compliance with the Stormwater Pollution Prevention Plan, Attachment B onsite stormwater control and the recordkeeping required under Attachment B documenting the stormwater BMP inspections. Because of the heightened federal inspections, developers must be proactive in conducting and properly documenting the SPPP weekly inspections. Keeping meticulous inspection records allows for documentation of any violations and corrective actions taken so that in the event an inspection occurs, the construction manager can provide the federal inspectors with the SPPP and the Attachment B weekly site inspections. This recordkeeping allows the inspectors to assess how BMPs are being implemented, the track record of proactive inspections and remedial actions and the steps taken to properly monitor and control soil erosion and runoff.

The repercussions of failure to comply with Attachment B BMP requirements under the SPPP are significant. At a minimum, Expedited Settlement Offers (ESO) of $15,000 are routine in the face of failure to maintain the Attachment B records. In the event that no records have been kept and there are onsite soil erosion violations, ESOs may not be available and a much larger fine may be assessed.

The ESO fine comes directly out of operational profit for every builder/contractor. Routine weekly soil erosion measure inspections and proper recordkeeping are and should be a normal course of work for all contractors and/or developers. Federal, state and local

authorities and soil conservation districts are often subject to third-party calls and notifications related to potential violations of SPPPs by offsite runoff. Failure to keep records in the face of a third-party complaint may result in even greater fines than the $15,000 ESO. Therefore, construction contractors and developers must be conscious of and committed to the requirement for proper recordkeeping to comply with the Stormwater Pollution Prevention Plan and Attachment B. This should be a requirement in every contractor's scope of work and must include soil stabilization standards related to soil stock piling, as well as staging areas for construction waste, most particularly concrete. By being proactive, developers and contractors can best protect themselves from fines and violation notices: "an ounce of prevention is worth a pound of cure!"

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New OSHA Guidelines for Residential Fall Protection Compliance

By Clair E. Wischusen

On September 22, 2011, the U.S. Department of Labor initiated a temporary compliance assistance program to aid construction companies in the implementation of OSHA's new Residential Fall Protection Directive.

On June 16, 2011, OSHA established a new Compliance Guidance for Residential Construction. Under 29 CFR 1926.501(b)(13), workers engaged in residential construction six feet or more above lower levels must be protected by conventional fall protection (i.e., guardrail systems, safety net systems or personal fall arrest systems) or other fall protection measures allowed elsewhere in 1926.501(b). However, if an employer can demonstrate that such fall protection is infeasible or presents a greater hazard, it may implement a fall protection plan meeting the requirements of 1926.502(k).

However, concerns have been expressed by the construction industry over the hardship associated with compliance in the current housing market climate. In response, OSHA has established a temporary program to ease the industry into compliance.

Effective September 22, 2011, and until March 15, 2012, OSHA has established the following general policy guidance for enforcement of the new residential fall protection directive and for compliance assistance related to that directive:

(1) OSHA will make it a priority for its Compliance Assistance Specialists (CAS) to provide assistance to the residential construction industry. Residential fall protection requests are to be the CAS's highest priority.

(2) During inspections of employers engaged in residential construction that are not complying with the new residential fall protection directive but are following the old directive (STD 03-00-001), the Regional Administrators and Area Directors will take the following actions:

- Area Directors will allow an additional good faith reduction in penalties of up to 10 percent for employers engaged in residential construction. In addition to the safety and health management system good faith determination in Chapter 6 of the Field Operations Manual, the Area Director shall consider examples of attempting to comply in good faith to include: requesting and scheduling an Onsite Consultation visit, ordering protective fall equipment for its employees or performing a documented evaluation of feasible means of abatement. This good faith reduction does not apply in cases of a fatality, catastrophe or serious injury resulting from a fall during residential construction activities.
- Area Directors will allow residential construction employers at least 30 days to correct fall protection violations identified under the new residential fall protection directive. During that time, if such employers are not in compliance at that site or another site, no additional citations or repeat citations shall be issued. This policy does not apply in cases of a fatality, catastrophe or serious injury resulting from a fall during residential construction activities.

(3) All proposed citations under this enforcement policy shall be submitted to the OSHA Regional Office to ensure consistency and clarity.

All of the measures described in this policy apply only to employers that are, at a minimum, following the old directive (STD 03-00-001). If the employer is not complying with either the new or new directive, the Area Director shall issue appropriate citations.

More information can be found at OSHA's Residential Fall Protection web page.

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Proposed Legislation in Pennsylvania

By David H. Comer

Senate Bill No. 1345 proposes to create the "Wireless Broadband Collocation Act," which would regulate wireless telecommunications support structures by, among other things, attempting to streamline the process in connection with applications for modifications and proposed collocations that meet certain requirements.

The proposed act defines the term "collocations" to mean "the placement or installation of new wireless facilities on previously approved and constructed wireless support structures, including monopoles and towers, both self-supporting and guyed, in a manner that negates the need to construct a new freestanding wireless support structure." Additionally, the proposed act defines the term "wireless support structure" to mean "a freestanding structure, such as a monopole, tower, either guyed or self-supporting, or suitable existing or alternative structure designed to support or capable of supporting wireless facilities. The term shall not include any electrical utility pole or tower used for the distribution or transmission of electrical service." The foregoing definitions are used throughout the proposed legislation.

The proposed act would apply to a local governing authority (generally, a municipality or municipal authority) that has adopted zoning ordinances and land use regulations for the placement of wireless support structures by stating that a local governing authority shall not place any additional requirement on the applicant that has the force or effect of:

(1) Regulating the placement of an antenna or related equipment for an existing wireless support structure; provided, however, if the placement of an antenna on an existing wireless telecommunications support structure requires an extension, the placement may be regulated by a local governing authority if the extension would require the wireless support structure to have lighting or the extension exceeds the height limitation of the authority;

(2) Imposing additional costs or operating restrictions on an applicant for the collocation of new wireless facilities unless the support structure is owned by the local governing authority. For the purposes of this section, collocation shall not be deemed an expansion;

(3) Requiring the applicant to provide any sort of justification for radio frequency need; and/or

(4) Acting to prohibit or have the effect of prohibiting the provision of personal wireless services.

The streamlined process of applications would, generally, provide that an "application for collocation or modification of a wireless facility entitled to streamlined processing under this section shall be reviewed for conformance with the local governing authority's applicable site plan and building permit requirements, including zoning and land use conformity, but shall not otherwise be subject to the issuance of additional zoning, land use or special use permit approvals beyond the initial zoning, land use or special permit approvals issued for the wireless support structure or wireless facility. Previously approved wireless support structures and wireless facilities can be modified or accept collocations without additional zoning or land use review beyond what is required by the local governing authority for the issuance of building or electrical permits."

The proposed legislation makes it clear that nothing in the act "may be construed to limit or preempt the scope of a local governing authority's review of zoning, land use or permitting applications for the siting of wireless facilities or wireless support structures or to require a local governing authority to exercise its zoning power, as provided for in the [Pennsylvania Municipalities Planning Code]."

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Restrictive Covenants: A Means To Regulate 'Fracking' in New York?

By Michael I. Slapo

New York State is in the process of allowing oil and gas companies to extract natural gas through the environmentally controversial means commonly referred to as "fracking," or high volume hydraulic fracturing. While local governments throughout New York may attempt to regulate the process through zoning or other means, such regulations may be pre-empted by state laws. The New York Supreme Court's 2011 decision in *Weiden Lake Property Owners Ass'n v. Klansky* (2011 N.Y. Slip O. 51581U (Sup. Ct. Sullivan Co. Aug 18, 2011) suggests, however, another possible alternative: restrictive covenants. The *Weiden Lake* decision upheld the barring of a homeowner's leasing of drilling rights to an oil company due to restrictive covenants running on the land. In *Weiden Lake*, the Property Owners Association (POA) of the Weiden Lake Community, of which the homeowner was a part, argued that each parcel in the community was subject to protective covenants that appeared on the subdivision plat, prohibiting, among other things, "[n]o commercial fishing enterprise or fee based boat launching or **any other commercial uses**…" [emphasis added].

The court found the phrase "any other commercial uses" prohibited all other commercial uses for the entirety of the

community. Further, the court found that, because the homeowner's prior deeds in the chain of title referenced the subdivision plat where such restrictive covenants were contained, the homeowner and the lessee oil company were on record notice of the restrictive covenant against commercial uses. The court found the POA had shown by clear and convincing evidence – namely the clear and unambiguous language of the covenants running with the land and prohibiting commercial use of the homeowner's property, coupled with the record notice to the homeowner – that the POA was entitled to summary judgment declaring the covenants prohibited exploration, drilling, production and marketing of oil, natural gas and other hydrocarbons.

In conclusion, the *Weiden* case makes clear that privately imposed restrictive covenants are an acceptable method to prohibit drilling, including "fracking." It remains to be seen whether a municipality can require such a restrictive covenant as a condition to land use approval due to possible pre-emption by statewide regulation.

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Bill To Establish the Grow NJ Assistance Program Passes in NJ Legislature's Lame Duck Session and Advances to Governor's Desk for Signature

By Jeffrey M. Hall and Daniel V. Madrid

Since the onset of the Great Recession, the executive and legislative branches of the New Jersey state government have sought ways to change the business climate in New Jersey by encouraging development through tax credit legislation. The passage of S3033/A4306 (S3033) on December 15, 2011, proves that the current lame duck session of the New Jersey Legislature is no exception. As we discussed at our recent presentation on the Urban Transit Hub Tax Credit Program (UTHTC program), both branches have undertaken a bipartisan approach to develop new economic development legislation as well as make existing legislation and state incentive programs more workable. Thus, the UTHTC program has been amended substantively three times, with a fourth major revision in pending S3033 now awaiting the Governor's signature. In addition to amending the UTHTC program, this bill establishes the Grow New Jersey Assistance Program (Grow New Jersey).

In brief, S3033 establishes a $200 million tax credit incentive program that encourages the growth of New Jersey companies through capital investment, creation of new jobs and retention of existing jobs. Eligibility requirements would include:

(1) A minimum investment of $20 million in a "qualified business facility" at which no less than 100 full-time existing employees would be retained or 100 new full-time jobs would be created and

(2) The determination by the New Jersey Economic Development Authority (EDA) that the applicant satisfies a "net positive benefit" test.

The cost of the program will be subsumed within the $1.5 billion cap established for the Hub Tax Credit Program and thus could divert some of the remaining credit availability from projects that may be eligible under that program. All applications under the Grow New Jersey program must be filed by July 1, 2014.

The program is open to property owners, tenants and affiliates but is subject to an annual tax credit cap of $4 million. Under the bill, the EDA would be required to establish standards for the construction and renovation of business facilities based on a green building manual prepared by the Department of Community Affairs. Eligible geographical areas would include those traditionally known as "smart growth" areas as well as "vacant commercial office, laboratory, or industrial properties having over 400,000 square feet for at least 1 year or more impacted by UTHTC Program Approval…."

Under the program, an eligible business would receive a base tax credit of $5,000 per job regardless of whether it is a retained or new job. There would be an annual compliance review, and under certain criteria a bonus award of $3,000 would be added to the base tax credit. The per-project benefit cannot exceed the project's total capital investment. As in the UTHTC program, the tax credits would be transferrable through tax credit transfer certificates and subject to nonretroactive forfeiture in the event the business loses eligibility through job attrition.

Notably, the bill also expands the definition of an "urban transit hub" to include NJ Transit rail stations located at an international airport not owned by the Port Authority and, through Assembly Appropriations Committee amendments, expands the eligible areas to include:

(1) Property located **within a one-mile radius** of a rail station if an area is the subject of a Choice Neighborhoods Transformation plan funded by HUD of the federal government and

(2) The site of either an acute care medical facility or a closed hospital located within a one-mile radius of a rail station.

The bill also includes miscellaneous provisions that deal with federal contracts and the Business Retention and Relocations Assistance Grant Program. As of this writing, S3033 is on the Governor's desk for signature. If not signed by the January 10, 2012, recess of the current Legislature, the bill would have to be reintroduced in the new legislative session.

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Foreigners Rush To Invest in U.S. Real Property, But What Are the Tax Issues?

By Jerald David August and Ricardo A. Antaramian

Foreign investment in U.S. real property has increased in recent years, driven in part by the weakness of the U.S. dollar in relation, most notably, to the euro, British pound and Canadian dollar. Despite the recent worldwide economic downturn, declining property values and comparatively low interest rates continue to make U.S. real estate an attractive long-term investment for foreign investors. Before making a substantial investment in U.S. real property, however, foreign persons should fully consider the U.S. tax consequences of their investment, including those that arise when the property is sold and proceeds are repatriated. Individual investors should also account for the transfer tax implications of investments in the United States, whether by direct ownership or through a trust, partnership or corporation, and the transfer tax impacts at death.

For many individual foreign investors, the desired ownership structure to hold title to a U.S. real property is a foreign corporation, generally one organized in a low-tax or tax haven jurisdiction. While this strategy may provide estate tax benefits for nondomiciliary individuals who would otherwise be subject to the U.S. estate tax if they directly owned U.S. real property at death, a closer evaluation weighing the income tax benefits of various ownership structures versus potential adverse estate tax consequences is necessary. Of course, an applicable income or estate tax treaty may have substantial influence on the ultimate form of ownership selected.

In contrast to nonresident aliens investing in U.S. real property, foreign business organizations frequently evaluate whether to make an investment through the formation of a wholly owned U.S. corporate subsidiary or through a U.S. partnership, the interests of which are held through a wholly owned U.S. subsidiary of the foreign entity. The use of a U.S. corporate subsidiary, even if the subsidiary is owned through a U.S. partnership, prevents a foreign investor from being deemed as engaging in a U.S. trade or business. This mitigates exposing the foreign business venture to additional U.S. income tax on business operations conducted from within the United States. The use of a U.S. corporation also avoids the imposition of the branch profits tax under Section 884 on U.S. sourced income (subject to treaty override).

The reach of U.S. income taxation extends to both U.S. citizens and residents on a worldwide basis and to nonresident, noncitizens to the extent of their U.S source income. Because foreign persons are subject to a different taxing regime than U.S. persons, it must be first determined whether a person is a U.S. person under U.S. domestic tax law principles. U.S. persons include citizens and residents, as specifically defined, of the United States as well as domestic corporations and partnerships. (Domestic corporations and partnerships, including entities taxed as partnerships, are those that are organized under U.S. laws.) Thus, foreign persons include nondomestic corporations and partnerships as well as individuals who are not U.S. citizens or residents.

Unless foreign persons are engaged in a "U.S. trade or business" (which is not specifically defined in the Code or the regulations), the tax rate applicable to the foregoing income types, other than income associated with the disposition of a U.S. real property interest, is 30 percent. Where a foreign person is treated as engaged in a U.S. trade or business, income attributable to that activity is subject to the graduated income tax rates for U.S. residents and corporations, as the case may be.

U.S. Trade or Business

It is a factual determination, based on the extent, continuity and substantial nature of the activity, whether a foreign person's investment in U.S. real property is considered a U.S. trade or business. To be a trade or business, an activity must be engaged in for profit and with some regularity and continuity, even if not by the taxpayer personally. In contrast, merely managing or preserving investment assets is not a trade or business activity even if engaged in for profit on a full-time basis. As the nature and scope of the activities grow, however, what may initially begin as merely a passive investment in the United States may later rise to the conduct of a U.S. trade or business.

Also, if a domestic or foreign partnership is engaged in a U.S. trade or business, each partner, including a foreign partner, is treated as engaging in the U.S. trade or business conducted by the partnership. A foreign person, in order to take advantage of cost recovery allowances and other deductions attributable to an investment in real property, including improvements, may file an election to treat the income as effectively connected with a U.S. trade or business.

Foreign Investors With U.S. Real Property

The enactment of Section 897 brought a major shift in the treatment of foreign investors with U.S. real estate holdings. Before the enactment of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), foreign investors in U.S. real property avoided paying U.S. tax on gains realized on the disposition of the property. The realized gains could escape taxation on the basis that the gain was neither "fixed or determinable annual or periodical income" (FDAP) nor effectively connected with a U.S. trade or business. Thus, prior to FIRPTA, a nonresident alien would be subject to U.S. income gain on capital gains from the disposition of U.S. real property interests, per Section 871(a)(2), if, for that year, the individual was present in the United States for at least 183 days or the gain was effectively connected with a U.S. trade or business. Moreover, subject to Section 871(a)(2), capital gain from the sale of stock by a nonresident individual was not subject to U.S. income tax. In addition, a foreign corporation was not subject to tax on capital gain from the disposition of U.S. real property unless an election under Section 881(d) was in effect for the year of sale or the gain attributable to the real property interest was effectively connected income (ECI). Gains from the sale of stock by a foreign corporation owning the stock of a U.S. subsidiary holding U.S. real property also escaped U.S. income taxation if it was not ECI.

Section 897

Congress' enactment of Section 897 in 1980 was designed to eliminate the disparity between the taxation of U.S. and foreign real estate investors with respect to U.S. real property interests. In an effort to remove what was perceived to be an unfair economic subsidy to many foreign investors by failing to tax gains realized on their disposition of U.S. real property interests, Congress leveled the playing field by enacting Section 897, which characterizes a nonresident's U.S. real property gains as ECI. Even though a person, by application of the Code or relevant tax treaty, is not a resident for U.S. income tax purposes, his or her gains, losses and income from interests in real property are nevertheless subject to U.S. taxation in accordance with Section 897 (and corresponding provisions, such as the withholding rules under Section 1445). More specifically, a foreign person's gain or loss from the disposition of a U.S. real property interest (USRPI), as defined in Section 897(c) and the accompanying regulations, is treated as income effectively connected with a U.S. trade or business in which the foreign person is deemed to be engaged during the year of disposition.

Section 897(a) provides that a nonresident alien's or foreign corporation's gain or loss on the disposition of a USPRI is deemed to be effectively connected with a trade or business carried on in the United States even if the property was a wholly passive investment of the taxpayer. The gain or loss is combined with income, gain or loss for the tax year from any business actually carried on by the taxpayer in this country and taxed at regular marginal rates applicable to an individual or a corporation.

Section 897's reach also extends to gain from the taxable dispositions of a domestic corporation's stock if a majority in value of the corporation's asset base over the recent period is comprised of U.S. real property interests. In addition, Section 897 applies to gain on the sale of a foreign corporation's stock, but only if the corporation elects under Section 897(i) to be treated as a domestic corporation and the corporation owns U.S. real property. There are special rules in Section 897 that excuse certain nonrecognition events from causing gain from a U.S. real property interest to be taxed. These rules are complex and require careful evaluation and planning.

U.S. Real Property Interest

In general, a USRPI is one of four classes of interests:

(1) "Any interest in real property" (including an interest in a mine, well or other natural deposit) located in the United States or the Virgin Islands;

(2) An interest in a domestic corporation that is, or was, a U.S. real property holding corporation (USRPHC);

(3) An interest in a foreign corporation that elects under Section 897(i) to be treated as a domestic corporation and that is or was a USRPHC;

(4) A publicly traded interest in a partnership or trust held by a five percent owner.

The term "real property" includes three types of property, including land, improvements, natural products unservered from the land, etc.

Section 897 and Corporations

For corporate transactions, Section 897 contains rules that may affect the outcome of corporate contributions, nonrecognition exchanges and corporate distributions involving USRPIs. Capital contributions of USRPIs to foreign corporations are not subject to the nonrecognition limitations of Section 897(e) because such contributions are not made pursuant to a nonrecognition provision. Instead, Section 897(j) governs these contributions and provides that, subject to the regulations, gain must be recognized on the contribution of a USRPI to a foreign corporation if the contribution is made as "paid in surplus or as a contribution to capital." Certain nontaxable transfers or exchanges of stock in a USRPHC are permitted by special rule. There are also special rules with respect to distributions of USRPIs made by foreign corporations. See Section 897(e) and (d).

Like-Kind Exchanges/Condemnation Acquisitions

Section 897(e)(1) and Temp. Reg. 1.897-6T allow Section 1031 tax-free (partial or wholly) exchanges to qualify for nonrecognition as long as the general criteria under Section 897(e)(1) are met (i.e., a disposition of the interest received would be subject to U.S. tax). U.S. real property and foreign real property are not considered to be of a like kind. Thus, only exchanges of U.S. real property for U.S. real property may qualify for nonrecognition under Section 1031 and be exempted from

the general reach of Section 897(a) by Section 897(e)(1). If U.S. real property under condemnation or threat of same is disposed of by a foreign person, as long as the requirements for nonrecognition of Section 1033 are met (e.g., proceeds from the sale of condemned property are used to acquire U.S. real property similar or related in service or use to the condemned property), nonrecognition should be available.

REITs

Special rules integrate the REIT provisions with FIRPTA (Section 897(h)). In general, any distribution from a REIT to the extent attributable to appreciation in the sale or exchange of a USRPI is subject to FIRPTA. This gain recognition provision does not apply to a not-more-than five percent shareholder of a class of REIT stock regularly traded on an established securities market. Where less than 50 percent of the value of a REIT's stock is owned, directly or indirectly, by foreign persons (i.e., foreign partnerships, estates or trusts at all times during a prescribed testing period), the REIT is described as a "domestically controlled REIT" and the REIT stock is not a USRPHC. Nevertheless, rules similar to Section 897(d) apply to the percentage of foreign-owned shares on the gain realized on distribution of a USRPI by a domestically controlled REIT.

Application to Partnerships, Trusts and Estates

An interest in a partnership, trust or estate is not a USPRI, but Section 897(g) applies a look-through rule for pass-through entities. More particularly, Section 897(g) provides that under the regulations, any money and the fair market value of any property received by a nonresident alien individual or foreign corporation in exchange for all or part of its interest in a partnership, trust or estate, to the extent attributable to USRPIs, are taxable gain or loss under Section 897(a). While the IRS has issued only a narrow set of regulations, its position is that regulations are not required for the IRS to apply Section 897(g). The current regulations apply only to partnerships that satisfy two requirements: (1) at least 50 percent of the value of the partnership's gross assets must, directly or indirectly, be comprised of USRPIs; and (2) at least 90 percent of the value of the partnership's gross assets, again directly or indirectly, must be comprised of USRPIs plus cash equivalents. In such a case, the interest in the partnership is treated as a USRPI for purposes of Section 897(g) but only to the extent the gain on the disposition is attributable to U.S. real property interests (and not cash, cash equivalents or other property). Still, the entire proceeds may be subject to Section 1445 withholding.

In various instances, a USRPI is held by a foreign corporation, perhaps motivated to avoid inclusion of the value of the foreign stock in the taxable estate of a non-resident of the United States. But in many cases there may be a current price to pay with the use of a foreign corporation directly owning U.S. real property. Section 884 imposes a tax of 30 percent on a foreign corporation's effectively connected earnings and profits for the tax year (i.e., earnings and profits that are effectively connected with a U.S. trade or business), but computed with certain adjustments. Specifically, the effectively connected earnings and profits are adjusted depending on how much income is reinvested in U.S. assets. If earnings are invested in U.S. assets, the amount subject to the 30 percent branch profits tax is reduced accordingly; if the earnings are not invested in U.S. assets, the amount on which the 30 percent tax is paid is increased accordingly (but limited to the corporation's accumulated effectively connected earnings and profits).

Other Tax Considerations

Taxation under FIRPTA and the branch profits tax under Section 884 are not the only issues that should be considered when disposing of U.S. real property. Section 1445 is a withholding provision that operates in conjunction with Section 897. Under Section 1445, the purchaser of the house must withhold 10 percent of the amount realized and pay the IRS the amount withheld no later than 20 days after the date of the transfer. Forms 8288 and 8288-A are used for this purpose. The amount withheld may be limited to the extent of the seller's tax liability, but this will require a determination from the IRS as to the amount of the liability. There are exemptions to the withholding requirement, one of which eliminates the withholding requirement if the buyers are individuals and purchase the home for use as a residence. This exception, however, is limited to sales where the amount realized is not more than $300,000.

Disposition of Stock and Other Transactions

As noted previously, certain indirect interests in U.S. real property may also be considered USRPIs. For instance, ownership interests in domestic corporations qualify as USRPI if the corporation qualifies as a USRPHC. A domestic corporation is a USRPHC if the fair market value of its U.S. real property interests is at least 50 percent of the sum of the value of its: (1) U.S. real property interests; (2) interests in foreign real property; or (3) other assets used or held for use in a trade or business. A five-year look-back rule applies to this test. That is, if the foregoing test is met at any time during the five-year period preceding the disposition, interests in the U.S. corporation will be considered a USRPI. While stock in a foreign corporation will generally not be considered a USRPI, for purposes of determining whether a domestic corporation is USRPHC and whether an interest held by it is a USRPI, the definition of USRPI of Section 897(a)(1)(A)(ii) is expanded to include ownership interests in certain foreign corporations. Other special rules apply.

Treaty Issues

U.S. income tax treaties allow the country in which real property is located to tax income and gain associated with the real property. Thus, in the case of real property located in the United States but owned by a resident of a treaty country, the United States may tax any income or gain derived from that property irrespective of whether it is connected with a permanent establishment or fixed base in the United States. The other treaty country, however, should allow for a foreign tax credit to its resident for U.S. taxes paid with respect to the real property (assuming it subjects such income or gains to tax). Some treaties that have been amended because FIRPTA's

enactment takes into account real property held through entities. For example, Article 13 of the U.S.-Denmark Income Tax Convention defines "real property" as including a "U.S. real property interest," that correlates to the FIRPTA definition. For purposes of our example, it is important to note Denmark does not have an income tax treaty with the Bahamas, and the U.S.-Denmark Income Tax Treaty does not treat a Bahamian corporation owned by a Danish individual as a resident for purposes of qualifying for treaty benefits. (This is generally true for entities organized in low-tax jurisdictions with which the United States does not have an income tax treaty.) Only when the jurisdiction in which the foreign corporation is organized has an income tax treaty with both the United States and the country of residence of the foreign individual may treaty benefits be available. For instance, some treaties allow for benefits to be available when the ultimate owner of the entity is a resident in a country with which the United States also has an income tax treaty. Nevertheless, treaties allow the United States to tax income and gains derived from real property located in the United States whether connected with a permanent establishment or fixed base in the United States.

Planning Strategies

Careful thought and consideration of various tax issues, both income and transfer tax, must be taken into account in advising non-resident clients on one or more preferred methods for owning real property in the United States. Part of the planning environment must include consideration of the nonresident's tax residence and whether that jurisdiction has a tax treaty with the United States. Thought must also go into the initial acquisition and funding stage, the financial state and the anticipated sell-off stage. Another factor may be a nonresident's exposure to U.S. estate tax were he or she to pass on while holding an ownership position in a USRPI. When combining ventures, the special nonrecognition rules provided under Section 897 and the regulations take on heightened significance.

Conclusion

The acquisition of U.S. real estate can be a sound economic investment that may, at first glance, appear to be relatively straightforward from a U.S. tax obligation standpoint. Such perception is misleading and erroneous, however. A litany of complex tax rules contains traps for uninformed foreign investors and causes them unwittingly to become subject to higher than desired tax liabilities or worse, violate U.S. tax compliance and reporting requirements. There is also risk of a U.S. estate tax if an untimely death arises and proper planning was not previously taken. As a result, investors and their nontax advisers should be fully informed about the FIRPTA issues discussed in this article (which appears in full in the current issue of the national tax journal *Business Entities*) when contemplating investments in U.S. real property, and they should consult qualified tax professionals prior to making an investment. We at Fox Rothschild would be glad to consult with you upon request on tax planning matters, including the topic addressed here: how nonresidents should structure their investment in U.S. real property.

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Delaware Superior Court Rules on Satisfaction of General Lien on Property Sold at Foreclosure Sale

By Michael J. Isaacs

The Delaware Superior Court recently ruled that general liens on property sold at a foreclosure sale, including those liens senior in priority to the foreclosing mortgage, are discharged from the property at the time of the sale.

On December 7, 2006, the plaintiff, CACH LLC, obtained a judgment lien against Aaron Johnson, Jr., the sole owner of property located in Newark, Delaware. The plaintiff transferred the judgment to the Superior Court and recorded its judgment as a lien on the Newark property on December 21, 2006.

Johnson conveyed the Newark property to himself and his wife as tenants by the entirety on December 19, 2006, the same date on which Johnson and his wife also mortgaged the property with Eastern Savings Bank for $168,000. The deed and mortgage were recorded on December 29, 2006. Accordingly, a title search of the property revealed the general lien in favor of the plaintiff as a first position lien and the Eastern Savings Bank mortgage as a second position lien.

Two years later, Eastern Savings Bank filed a foreclosure action on its mortgage. In April 2009, the property was sold at sheriff's sale to a third-party for $133,000. At that time, the plaintiff's judgment lien was approximately $16,000. The New Castle County Sheriff sent the entire sale proceeds to counsel for Eastern Savings Bank.

The plaintiff brought an action against Eastern Savings Bank alleging misappropriation of funds and unjust enrichment. The Court of Common Pleas granted summary judgment in favor of Eastern Savings Bank. The plaintiff

appealed the decision to the Superior Court.

In its decision, the court noted that 10 Del. C. § 4985 provides that real estate sold at a sheriff sale shall be discharged from all liens except liens created by mortgages. Accordingly, the court ruled that a third-party purchaser at a sheriff sale takes the property unencumbered by judgments against prior owners; even those judgments that have a superior lien position to the foreclosing mortgage unless the judgment is supported by a mortgage.

The court noted that while the foreclosure sale discharged all liens on the property, the proceeds should have been distributed to the lien holders in the order of their priority. As the senior lien holder, the plaintiff was entitled to receive satisfaction of its judgment lien from the proceeds of the sale before the balance of Eastern's mortgage was satisfied. However, as to the third-party purchaser, the general judgment lien was discharged from the property.

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NJ Superior Court Permits Leasing Ban

By Gregory J. Kleiber

The Superior Court of New Jersey has offered some guidance on a question that recurs regularly in representing condominium and homeowners associations: whether an association may ban leasing of units in the community without a unanimous vote. In *Cape May Harbor Village v. Sbraga* (421 N.J. Super. 56), the court considered the appeal of a unit owner from a lower court decision that upheld the right of an association, with a super-majority but not unanimous vote, to prohibit leasing of units in a luxury seaside community. Cape May Harbor Village and Yacht Club is, in the words of the court, "small and exclusive," with just 24 single-family homes (valued above $2.5 million each) and a marina. Although the community had no history of any member leasing out a unit, the Declaration of Covenants and Restrictions expressly permitted leasing when it was adopted in 1995. A unit owner, unable to sell her unit in the current economic climate, began leasing it to tenants. The association promptly proposed and passed, by 20 votes to three, an amendment to the Declaration prohibiting leasing. Litigation ensued, the association prevailed at trial, and Superior Court faced two fundamental issues.

First, the court decided to apply to the case the "reasonableness" standard rather than the more board-friendly "business judgment standard," based on the amendment having been passed after the appellant purchased her unit and on the fact that the leasing ban impacts a basic and valuable property right. However, even applying this more balanced standard, the court ultimately agreed with the lower court that the association's decision was reasonable, given that the ban serves a worthwhile purpose by preserving "the stable residential character of the community" and was not adopted out of spite or malice. In further rejecting the appellant's argument that the amendment should not apply to her because it was adopted after she purchased her unit, the court noted that any purchaser of a unit subject to a Declaration was on notice that the Declaration could be amended by an appropriate majority vote. In its analysis of the reasonableness of the amendment, the court focused in particular on the absence of any prior leasing activity in the history of the community and the admission by the appellant that she was only planning to lease her unit until she could sell it. These unusual factors, together with the small size and elite nature of the community, may limit is applicability to other communities seeking to ban leasing.

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