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Family Limited Partnerships and I.R.C. Section 2036

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Internal Revenue Code ("I.R.C.") Section 2036 requires inclusion of property in a decedent's taxable estate when the decedent had previously transferred such property but retained certain proscribed interests in the transferred property. Under Section 2036(a)(1), inclusion will occur when the decedent retained the possession or enjoyment of, or the right to the income from, the transferred property. Section 2036(a)(2) similarly requires inclusion when the decedent retained the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the transferred property or the income therefrom.

I. The Byrum Decision

In the context of family partnerships and LLCs, commentators have long believed that the decision in *United States v. Byrum*, 408 U.S. 125 (1972), largely protects such entities from attack under section 2036. In *Byrum*, the U.S. Supreme Court considered an arrangement in which the decedent had transferred stock in certain closely held corporations to a trust for the benefit of his children. The decedent retained the right to vote the stock that he had transferred to the trust. The Internal Revenue Service (the "Service") attacked the arrangement under Section 2036(a)(2), but the Supreme Court held that because the decedent was subject to fiduciary duties as a controlling shareholder and director, a power prohibited under Section 2036 had not been retained. The specific result in *Byrum* was later overturned by the enactment of Section 2036(b) (discussed below), but in a series of private rulings issued in the early 1990s, the analysis of the decision was generally held to still apply to family partnerships. Priv. Ltr. Rul. 9546006 (Aug. 14, 1995); Priv. Ltr. Rul. 9415007 (Jan. 12,

1994); Priv. Ltr. Rul. 9310039 (Dec. 16, 1992); Tech. Adv. Mem. 9131006 (Apr. 30, 1991).

However, recent cases have shown that an attack under Section 2036 may now be the Service's best attack on a family limited partnership or LLC. To avoid such an attack, it is highly advisable to ensure that the entity is in fact treated as separate from the personal affairs of the transferor. Funds of the entity and transferor should not be commingled, personal expenses should not be paid by the entity, and the formalities of the governing documents should be followed. In *Estate of Schauerhamer v. Comm'r*, 73 T.C.M. (CCH) 2855 (1997), the court disregarded a family limited partnership under section 2036(a)(1) when that was not the case, finding there was an implied agreement that the decedent could retain the income of the entity's assets. Similar results occurred in *Estate of Reichardt v. Comm'r*, 114 T.C. 144 (2000); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002); and *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002).

II. Reichardt & the Lack of Company Formalities

In *Estate of Reichardt*, for example, the court noted that the decedent had frequently commingled partnership assets and personal funds, deposited partnership income in his personal account, and essentially used the partnership checking account as his personal account. The decedent had also contributed his personal residence to the partnership, but had continued to live in the house without paying rent to the partnership.

As a result, the court found that there was an implied agreement between Mr. Reichardt and his children that he could continue to use and enjoy the partnership property and the income

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therefrom throughout his life, triggering Section 2036(a)(1). It should be noted that the partnership funds used by the decedent were only \$8,000 in 1993 and \$13,000 in 1994. It therefore apparently was not the value of the partnership assets used, but rather the consistent lack of respect for the partnership form, that caused it to be disregarded. The end result was the inclusion in the decedent's taxable estate of the assets that he had transferred to the partnership, without any valuation discounts.

Moreover, in *Kimbell v. United States*, 244 F. Supp. 2d 700 (N.D. Tex. 2003), the Service successfully invoked Section 2036 in a situation in which the decedent held a 99 percent limited partnership interest that carried the right to remove and replace the partnership's general partner. The general partner in turn had unfettered discretion over cash distributions and was expressly relieved of all fiduciary duties under the partnership agreement at issue. On these facts, the court had little difficulty in disregarding the partnership under Section 2036.

III. The "Strangi II" Opinion

More troubling is the Tax Court's recent decision in the remanded case of *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003). In this case, a family limited partnership was formed by a decedent's attorney-in-fact shortly before the decedent's death. The decedent held all of the limited partnership interests, together with 47 percent of the corporate general partner (the balance of which was owned by the decedent's family members and, via a gift, a local community college). The Tax Court initially found that Section 2036(a)(1) was applicable, pointing out various instances in which partnership assets and income were used for the personal benefit of the decedent, and the fact that virtually all of the decedent's assets had been transferred to the entity. Under the decisions noted above, this result was not particularly surprising.

However, of potentially much greater significance is the Tax Court's discussion of Section 2036(a)(2). On this point, the court first found that the decedent had retained control over the beneficial enjoyment of partnership property through his attorney-in-fact, who had been employed by the general partner to manage the partnership, as well as his power to join with other shareholders of the general partner and cause the dissolution of the partnership. The court went on to find that these powers were not adequately limited by any fiduciary duties, in contrast to *Byrum*, largely because the entity did not conduct an active business and had no unrelated owners, essentially disregarding the ownership of the local community college. According to the court, "[i]ntrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the *United States v. Byrum* scenario."

While there were a number of unfavorable facts for the taxpayer in *Strangi*, the ease with which the Tax Court distinguished *Byrum* can certainly be questioned. It is correct that *Byrum* involved a situation in which there were unrelated minority

shareholders and the entities at issue apparently carried on active businesses. However, to simply dismiss the fiduciary duties owed by family members in an investment entity is a surprising conclusion - state partnership and corporate laws have long recognized and imposed fiduciary duties irrespective of whether the parties involved are related or the entity is an investment vehicle, and are largely intended to protect the interests of those holding small interests in the entities. *See, e.g.*, RCW 25.05.165. The Tax Court's position seems essentially to be a return to the analysis in the long-discarded Revenue Ruling 81-253, 1981-2 C.B. 187, in which the Service had held that valuation discounts should not be allowed for family-owned entities in the absence of documented discord among the family members.

IV. Agreement Provision

Also unclear is what effect, if any, would have been given to a provision in the partnership agreement expressly setting forth fiduciary duties, as is done in some family partnership and LLC agreements. The opinion is unclear as to whether such a provision was present in the *Strangi* agreement. While the background discussion indicates that the *Strangi* agreement included a provision that obligated the managing general partner to use its good-faith efforts to manage partnership affairs in a prudent and businesslike manner and to act at all times in the best interest of the partnership, the provision is not addressed in the Tax Court's discussion of fiduciary duties. Presumably the Tax Court would have reached the same conclusion even if an express fiduciary duty provision had been included in the agreement, but inclusion of such a provision would seem to weaken the court's analysis to some degree.

The courts in both *Kimbell* and *Strangi II* also rejected the taxpayer's arguments that the transfers of assets to the partnerships in question were made for adequate and full consideration by virtue of the receipt of partnership interests in return for such transfers. This conclusion is in contrast to the analysis in *Church v. United States*, 85 A.F.T.R.2d (R.I.A.) 804 (W.D. Tex. 2000), *aff'd*, 268 F.3d 1063 (5th Cir. 2001) (unpublished); and *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997). Unlike the decisions in *Kimbell* and *Strangi*, the *Church* and *Wheeler* opinions held that the exception to Section 2036(a) for transfers made for adequate and full consideration did not require the transaction to actually be made between unrelated parties, and a recent commentator has indicated this appears to be the correct statutory construction. *See* Mulligan, "Courts Err in Applying Section 2036(a) to Limited Partnerships," *Estate Planning* 485 (Oct. 2003). Whether the tax court's analysis of Section 2036(a)(2) in *Strangi II* will survive circuit court review (whether appealed directly or used in other cases) is therefore unclear.

V. The "Anti-Byrum" Rule

Section 2036(b) also should be kept in mind, which as noted above was enacted to change the specific result in *Byrum*. Under

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**An Overview of Opportunities (and Pitfalls)
in the Federal Historic Preservation
Tax Credits Program**

by Stephen J. Day, Real Property Law Group PLLC, Seattle

I. Introduction

Since 1976, the Federal Historic Preservation Tax Incentives program has quietly played a major role in real estate development involving historic landmark properties. The Internal Revenue Code (“IRC”), at Sections 38 and 47, includes provisions for the “historic rehabilitation credit” which can be utilized in connection with “qualified rehabilitation expenses” for renovations of “certified historic structures.” This Historic Tax Credits program has spurred the redevelopment of more than 30,000 historic properties in the United States. Over \$30 billion in rehabilitation dollars have been associated with these projects, providing approximately \$6 billion in tax credits for investors.

In Seattle, recent historic rehabilitation projects have generated substantial Historic Tax Credits for the benefit of project developers, including the following:

- The Smith Tower renovations, with over \$28 million in qualified expenses, creating the potential for approximately \$5.6 million in tax credits;
- Pacific Medical Center (Amazon.com headquarters), with approximately \$21 million in qualified expenses and \$4.2 million in potential tax credits; and
- The Seaboard Building, a mixed use office/retail/residential building in downtown Seattle, including over \$20 million in rehabilitation expenses and the potential for more than \$4 million in tax credits generated for the benefit of investors.

In spite of these success stories, projects like these have not been widely replicated in Seattle. While the Historic Tax Credits program has been very prominent in other parts of

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this provision, if the stock of a controlled corporation is transferred and the transferor retains, either directly or indirectly, the right to vote the stock, it will be included in the taxable estate of the transferor. Note that for this purpose, only 20 percent ownership (determined under the attribution rules of Section 318) is necessary for the corporation to be a controlled corporation. I.R.C. § 2036(b)(2). As a result, use of closely held corporate stock to fund a family partnership or LLC is often problematic. *See, e.g.,* Tech. Adv. Mem. 199938005 (Sept. 24, 1999). This can also be a concern for founders of a company that goes public or issues stock to financial investors, depending on the amount of stock retained, who wish to take advantage of this strategy. Note, however, that nonvoting stock can be used to avoid the impact of this rule. Rev. Rul. 81-15, 1981-1 C.B. 457; Priv. Ltr. Rul. 9710021 (Mar. 7, 1997).

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the United States, Seattle-area developers have not played a major role in using the credits. Part of this is explained by the sheer volume of qualified historic properties in cities such as New York, Chicago and San Francisco. Also, the tax credits rules and process can be complicated, the documentation can be extensive and the program is not well-suited to every project or development scenario. But this does not explain the whole story behind Seattle developers' infrequent use of the tax credits, especially when you consider the fact that developers in Spokane (a city with a much smaller pool of historic properties) have surpassed Seattle developers in the use of the tax credit program in recent years.

This uneven use of the Historic Tax Credits in Seattle and other cities is due (at least in part) to a general lack of familiarity with the details of the program. And there are many intricacies and many traps for the unwary that must be avoided if Historic Tax Credits are to be fully realized for a project. Still, this particular tax credit (along with the affordable housing tax credit, discussed in the accompanying article by Joe McCarthy) presents one of the few significant tax credit advantages that remain available to real estate developers after the 1986 code changes eliminated most tax credits for real estate investors.

This article summarizes the basics of the Historic Tax Credits program and gives an overview of which redevelopment projects are eligible, how developers can take advantage of the program, and some recurring legal and tax challenges involved in using the credits.

II. Basic Parameters of the Historic Preservation Tax Credits Program

A. What Is the Historic Tax Credits Program?

This program, administered jointly by the U.S. Department of the Interior (through the National Park Service) and the Department of the Treasury (through the IRS), makes tax credits available to developers that rehabilitate qualified historic buildings. As set forth in IRC § 47(c)(3)(A), qualifying buildings must be "certified historic structures" defined as: (a) buildings listed on the National Register of Historic Places; or (b) buildings that contribute to a National Register Historic District or another qualifying local historic district. Treas. Reg. § 1.48-12(d). A tax credit equal to 20 percent of the "qualified expenditures" in the renovation of certified historic structures may be allocated to the developer entity. So if a developer entity spends \$5 million on qualified expenditures for a project, there could be \$1 million in tax credits available to directly offset income taxes owed by that entity or one or more of its members/partners.

B. Who Uses the Tax Credits?

The Historic Tax Credits are used by owners (or long term lessees) of certified historic structures. Historic Tax Credit utilization by individuals is very limited, due in large measure to the passive activity loss provisions introduced in the Tax Reform

Act of 1986. See IRC § 469 regarding passive activity provisions and phaseout of credits. However, taxable corporations regularly take advantage of the credits to reduce their income tax liabilities. A typical arrangement, then, is to bring a corporate tax-credit investor entity into the development entity as a member and allocate the tax credits to that investor, in exchange for cash. The tax-credit investors pay anywhere from 50 cents to 90 cents on the dollar for the tax credits, depending upon such variables as size of the deal, the local market, project parameters, etc. This arrangement can be extremely positive for the developer: the tax-credit investor comes into the project early and contributes cash at a crucial point in the project. In exchange, the credits (which are typically not useful for the developer) are allocated to this corporate entity. Entities that are affiliates of lenders are common users of the credits, (although the single biggest user/investor involved with Historic Tax Credits today is Exxon Mobil Corporation).

C. What Is a "Certified Rehabilitation" of a Historic Structure?

As a prerequisite to utilizing historic tax credits, the proposed rehabilitation work must be certified by the Secretary of the Interior as being in conformance with the Secretary of the Interior's standards for rehabilitation. See IRC § 47 (c)(2)(B) & (C); Treas. Reg. § 1.48-12(d). This certification and review process is administered through the National Park Service (NPS), in conjunction with the State Historic Preservation Officer (SHPO) in each state. Application for certification of a rehabilitation is made to the NPS through the SHPO. The SHPO reviews the applications for certification and forwards its comments and recommendations to the NPS for final approvals. In general, in order to be certified, the rehabilitation must be consistent with the historic character of the structure and/or the applicable historic district. The defining historic features and character of the structure must be maintained and not destroyed or compromised by the rehabilitation work.

D. Tax Basics

1. "Substantial Rehabilitation"

In order to get a project into the Historic Tax Credit arena, the project must be "substantial." "Substantial rehabilitation" is defined in Treas. Reg. § 1.48-12(b)(2)(i) and includes projects that involve qualified costs in excess of the larger of: (a) the adjusted basis of all owners of the building; or (b) \$5,000. The adjusted basis is generally described as the property purchase price, less the costs of the land, less any depreciation taken to date, plus the cost of any improvements made since the purchase. These costs must be expended within any 24-month period ending with or within the tax year that the Historic Tax Credits are claimed.

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2. “Qualified Expenditures”

Qualified Expenditures are defined in Treas. Reg. § 1.48-12 (c) and IRC § 47 (c) (2) (B) and can include a wide range of hard and soft costs associated with the building work. The total dollar value of the qualified expenditures is critical, because the total amount of tax credits is calculated as 20% of this value. Qualified expenditures can include costs of construction, along with certain developer fees, consultant fees (including legal, architectural and engineering fees), if added to the basis of the property. Costs that are not included in the qualified expenditures include property acquisition costs, new additions to the historic structure or other new buildings, parking and landscaping costs.

3. Building Uses

To qualify for the Historic Tax Credits, the building must be depreciable, so it must be income producing or used in a business. Rental housing, commercial and industrial uses all qualify. Owners of condominium housing units can utilize the tax credits provided that the unit is held for income or is used in a business or trade. An owner’s personal residence will not generate Historic Tax Credits. See IRC § 47 (c) (2) (A).

4. Building Users

There are also limitations on the types of users for the restored historic property. For example, tax exempt entities cannot lease more than 35% of the rentable area in a rehabilitated building unless the lease terms are limited in length and there are no purchase options at the end of the term. There are also restrictions on sale and leaseback arrangements with tax exempt entities. The tax exempt user rules are complex and must be analyzed carefully on a project by project basis. IRC § 47 (c) (2) (B) (v); Treas. Reg. § 1.48-12(c) (7); IRC § 168 (h).

5. Claiming the Credit

The Historic Tax Credits are generally claimed in the taxable year that the rehabilitated building is “placed in service,” which essentially means the date that the rehabilitation work has been completed such that a certificate of occupancy has been issued. For projects that have never been removed from service, this would be the date that the project work is completed. Any excess credit not claimed in the initial tax credit claim can be carried forward for up to 20 years and carried back 1 year. IRC § 47 (b); Treas. Reg. § 1.48-12(f)(2); Treas. Reg. § 1.48-12(c) (3) and (6).

6. Transferring or Allocating the Credits

Historic Tax Credits cannot be “sold” without selling the corresponding interest in the real estate. Only owners of the real property (or long term lessees; see below) can be allocated tax credits. But in practice the use of the Historic Tax Credits are often allocated differently to one or more members of the ownership entity (such as an LLC), so long as the percentage

allocation of the tax credits matches the members’ interests in profits for tax purposes.

7. How Long Must the Tax Credit User Own the Property?

An owner that claims the Historic Tax Credits must retain ownership of the property for at least five years after the date the project was placed in service, or the tax credits will be subject to recapture.

8. Recapture of the Credits

Historic Tax Credits can be recaptured if the project is sold before the end of the minimum five year holding period or if the property ceases to be income-producing. These recapture rules are laid out in IRC §50(a). Recapture can also take place if the project ceases to comply with other transfer or leasing restrictions imposed under the program or if the project is physically altered such that it no longer complies with the approved rehabilitation improvements. *See also* Treas. Reg. § 1.48-12(f)(3). The amount of the credit recapture is calculated on a sliding scale based on how much of the minimum five year holding period has elapsed at the time of noncompliance.

III. Challenges/Opportunities in Using the Credits

A. The Tax Credit Investor

A recurring challenge in using the tax credits is in identifying the partner entity that can utilize the credits and joining that entity with the developer in a partnership arrangement (usually an LLC). But this is a challenge that can also present real opportunities. For example, lenders have substantial tax liabilities that can be reduced by using the tax credits. An affiliated entity of a lender can act as a member in a development LLC and can be allocated the tax credits. An affiliate of that same lender can provide loans for the development project, perhaps on more favorable terms than another lender that does not have the tax credit incentive to lend on the project. This investor is typically interested primarily in taking advantage of the tax credits and in getting out of the project as soon as possible, with as little risk as possible.

B. Choice of Development Entity Type

The pass-through tax scheme of limited liability companies make the LLC the typical entity of choice for Historic Tax Credit developers, allowing the tax credit advantages to flow to individual members. The single entity structure is the most common structure for simpler projects, where the “developer” entity and the tax credit investor entity are members of a single LLC. In larger, more complex projects, a master tenant lease structure has also been used, where the owner/developer will pass through the tax benefits to a master tenant entity that leases the entire building from the owner/developer.

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C. Put/Call Provisions

As mentioned above, an owner that is allocated the tax credits must remain in title for at least five years after the project is placed in service. To accommodate this five year window, the development agreement will typically include put/call (buy/sell) provisions that set out a mechanism for the developer to buy out the tax credit investor. Caution is required in drafting these agreements to avoid an IRS characterization of these arrangements as a disguised sale, thus potentially invalidating the tax credit allocation.

D. Allocation of the Tax Credits

There are also potential pitfalls involving the allocation of the tax credits by the investor party. In general, the percentage allocation of the tax credits should match the profits interests of the parties. If one party is allocated all of the tax credits over the five year period that the tax credit investor remains an owner in the project, then that investor will be allocated all or nearly all of the profits interests. To accommodate this, and to compensate the developer partner for its participation in the project, the company will typically pay development fees or other distributions to the developer entity. Cash flows do not necessarily match the profit/loss allocation percentages. At the end of the five-year tax credit recapture period, profit/loss ratios are typically revised to allocate greater profits to the developer.

E. Leasing to Tax Exempt Entities

As mentioned above, leasing space in a certified historic structure to tax exempt entities is possible so long as the lease does not fall into the category of "disqualified leases" as defined in IRC § 168(h)(1). There are several factors in that code section that must be analyzed for each individual situation, including requirements that the lease term be less than 20 years, the lease cannot occur after a sale of the property from the lessee to lessor, the lease cannot include an option to purchase or a fixed or determinable purchase price for the property, along with limits on financing involving tax exempt financing. These limits are generally not applicable if in the aggregate no more than 35% of the rentable floor area in the historic building is leased to tax exempt entities.

F. Leasing to Taxable Entities

Taxable lessees may be eligible to claim Historic Tax Credits provided that the lease term is at least as long as the recovery period under IRC § 168(c), currently 39 years for non-residential property and 27.5 years for rental residential real property. See also IRC § 47 (c)(2)(B). If the lease term is less than this minimum recovery period, the full tax credit is not available but is instead reduced prorata based on a formula tied to the length

of the lease as compared with the recovery period and based on the fair market value of the rehabilitated lease property. See Treas. Reg. § 1.48-4(c)(3).

IV. Are the Historic Tax Credits Worth the Effort?

Not all historic property redevelopment projects are natural candidates for tax credit utilization. If for whatever reason the developer cannot or will not endure the designation and certification process, or the project does not fit the tax credit criteria, or if the developer cannot structure the deal to bring in the tax credits investor, then the project will not work as a tax credit venture. Also, if the project does not involve at least \$1 million in qualified rehabilitation expenditures, the transactions costs involved will likely make it infeasible as a tax credit project. But for those projects that involve certified or certifiable historic structures (and this category is broader than one might think, and getting broader every year), where the development strategy can be flexible, where the rehabilitation is substantial and where the tax credits investor can be identified that fits with the specific development strategy for the project, the historic tax credits can make the difference between a project that will pencil and one that won't.

V. A Note of Caution

The Historic Tax Credits rules are complicated and involve many interrelated parts. This brief summary is intended only as a general introduction to the subject. Project developers and investors should seek ongoing advice and counsel from experienced legal and tax advisors for any Historic Tax Credits project.

VI. Resources

The National Park Service web site at www.nps.gov includes numerous links to sites that include information on the various stages of the National Register process and Historic Tax Credits program. The IRS web site at www.irs.gov also has links to sites that focus specifically on tax aspects of the program. Stephen Mathison is also a great source of information as the administrator of the Federal Investment Tax Credit Program for the State of Washington, through the Office of Archeology and Historic Preservation.

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A Brief Description of Low-Income Housing Tax Credits

by Joseph P. McCarthy, Kantor Taylor McCarthy & Britzmann, P.C., Seattle

The Low-Income Housing Tax Credit is a federal income tax credit that is available each year for ten years and results in a dollar-for-dollar reduction of the taxpayer's regular tax liability. The credit is available to the owner of residential rental housing that meets the requirements of Section 42 of the Internal Revenue Code of 1986 (the "Code"). Unless, however, one purchases a building that already has an allocation of credit, the owner must obtain an allocation of credit for a proposed building before buying or constructing it. Thus the credit is generally only available to those who know about it and plan to develop a building that qualifies for it. In Washington, developers must compete to win an allocation of credit.

The credit that a building generates is based upon the number of low-income units in the building and the development cost of the building. An owner is only entitled, however, to receive credits up to the amount allocated to the building by the state. Thus a project can fail to generate its maximum potential credits if the owner is not familiar with the allocation plan of the state.

The amount of credit generated by a tax credit project and the general business credit rules and passive activity loss limitations of the Code make it difficult for most developers to directly use the credits generated by a building. Most developers of low income housing tax credit projects therefore sell the credits to a syndicator, who purchases a limited partner or investor member interest in the ownership entity. The low income housing tax credit generated by a building may, however, be useful to a corporate developer with significant tax liability who is willing to own a residential rental project in order to obtain tax credits.¹

I. LIHTC Project Eligibility

A. Minimum Set-Aside requirement

In order for a residential rental project to constitute a "qualified" low-income housing project, the owner of the project must irrevocably elect to meet one of the following minimum set-aside requirements:

- (1) at least 20% of the residential units must be made available to tenants with incomes at or below 50% of the area median income, *or*
- (2) at least 40% of the residential units must be made available to tenants with incomes at or below 60% of the area median income.²

The minimum set-aside requirement must be met within 12 months of the date the project is placed in service³ and must be complied with continuously for 15 years from the start of the first taxable year in which the credit is claimed.

B. Extended Use Requirements

A building⁴ must also be subject to a restrictive covenant (between the owner and the state allocating agency) that subjects the building to an additional 15-year period of continued low-income use commencing after the initial 15-year compliance period. In addition to the income and rent restrictions, the

restrictive covenant must allow qualified tenants to enforce the covenant and must prohibit evictions or rent increases for three years after the end of the 30-year extended use period. The restrictive covenant must be binding on all subsequent transferees, except through foreclosures or transfers in lieu of foreclosure.⁵

The extended use period may terminate prior to the 30th year either upon foreclosure or if, during the 14th year of the initial compliance period, the owner asks the state housing credit agency to find a buyer for the project. If the agency finds a buyer, the price is established pursuant to the Code. If the agency cannot find a bona fide purchaser within a year, the extended use period terminates. The owner may not, however, evict low-income tenants or increase rents of the low-income units for three-years.

C. Qualified Low-Income Housing Units

The credit is available only with respect to units that are "qualified low-income housing units." A qualified low-income housing unit must be:

- (1) leased to an income eligible tenant (as defined below);
- (2) rent-restricted (as defined below);
- (3) suitable for occupancy under state and local health or building rules and regulations;⁶
- (4) used on a nontransient basis, i.e. subject to a lease with a minimum term of 6 months;⁷
- (5) leased to a non-student household;⁸ and
- (6) available to the general public (the unit must be leased in a manner that does not discriminate in favor of or against special populations except as allowed under HUD guidelines).⁹

D. Tenant Income Eligibility

A tenant is income-eligible if his or her actual household income is at or below the set-aside requirement elected by the owner (e.g. 50% or 60% of area median income). The Department of Housing and Urban Development publishes the median income standards for various geographic areas annually. The area median income standards are adjusted for family (household) size. Tenants must meet the income limitation at the time of initial occupancy and each year thereafter during the compliance period. Each year the project owner must certify the level of low-income occupancy.

A household whose income rises above the applicable qualifying income standard is still considered to meet that income standard until its income exceeds 140% of the applicable qualifying income standard. When the tenant's income exceeds 140%, that unit ceases to be a qualified low-income unit unless the owner rents the next available unit of comparable or smaller size to a household with qualifying income.¹⁰

If a qualified tenant moves out, the vacant low-income unit is still considered to be qualified low-income housing unit if reasonable attempts are made to rent the unit and no comparable or smaller units are rented to non-eligible tenants. If the unit is rented to a non-eligible tenant, it is no longer qualified.

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A Brief Description of Low-Income Housing Tax Credits

E. Rent Restrictions

The gross rent paid by a tenant may not exceed 30% of the imputed income limitation (i.e., 50% or 60% of the current area median income, adjusted for family size) for the unit. Unlike income qualification, which is based on the tenant's actual family size, rent restriction is based on an imputed family size. For single-room occupancy units or studios (units with no separate bedroom), the number of occupants is assumed to be one. For all other units, the number of occupants is assumed to be one and one half times the number of separate bedrooms.

Number of Bedrooms	Deemed Household Size
0 BR	1
1 BR	1.5
2 BR	3
3 BR	4.5
4 BR	6

Thus an owner can charge rent based on the size of the unit rather than the size of the tenant household. The maximum gross rent allowable in the initial year serves as the minimum rental floor in subsequent years; therefore, a subsequent decrease in area median income will not result in a decrease in gross rent.

Gross rent is the total rental or occupancy charge for a unit including all utilities except telephone. If the tenant pays utilities directly, the owners must provide a utility allowance, reducing the maximum rent that can be charged to tenants.

Gross rent does not include any payments to third parties for the provision of meals, laundry, housekeeping and other services. If, however, receipt of those services is a condition of occupancy, payments to the owner for those services will be included in gross rent. If the owner provides continual nursing, medical, or psychiatric care, it will be presumed that such services are mandatory. For projects receiving credit allocations after 1991, meals provided in a common dining facility are presumed to be mandatory if tenants have no practical alternative for obtaining meals outside the common dining facility.

F. Eligibility of Existing Buildings

The credit is not available in connection with the acquisition of an existing building if the building was placed in service during the 10-year period preceding the acquisition. A building is placed in service under Section 42 of the Code upon its first use and upon a change in ownership interests. Thus, a developer planning to claim credits in connection with the acquisition and rehabilitation of an existing building must investigate the ownership history of the project and seller to determine when the seller acquired the project and what ownership interests were transferred within the last ten years. There are limited exceptions to the 10-year rule¹¹

The credit is not available in connection with the acquisition of an existing building (even if it meets the 10-year hold rule) unless the building is also substantially rehabilitated. The rehabilitation expenses in a given 24-month period must be the

greater of 10% of the adjusted basis of the building (at the start of the period) or \$3,000 per unit. The credit is not available if the building was previously placed in service by the owner or a related person. Thus, an owner can only obtain the credit for a building once.

II. Determination of Annual LIHTC

The credit is available each year for ten years beginning when the building is placed in service.¹² The annual credit amount is determined by multiplying the "qualified basis" of each low-income building in the project by the "applicable percentage." To account for lease-up, the credit for the first year is adjusted to reflect the actual low-income occupancy for the year (determined on a monthly basis). The balance of the first-year credit is available in the eleventh year.

Qualified basis is the portion of a project's "eligible basis" attributable to the acquisition and rehabilitation, or construction, of qualified low-income housing units. The applicable fraction is (i) the ratio of the number of qualified low-income housing units to the total number of residential units in the building or (ii) the ratio of the total floor area of the qualified low-income housing units to the total floor area of all residential units in the building.¹³ The owner must use the fraction that creates a lower qualified basis.

Eligible basis consists of (i) the properly capitalized and depreciable costs of developing a new building, (ii) the properly capitalized and depreciable costs of a substantial rehabilitation of an existing building, and (iii) the cost of acquisition of certain existing buildings if a substantial rehabilitation is performed.¹⁴ Eligible basis includes furnishings and other personal property, but excludes land and other separately capitalized costs (whether amortizable or non-amortizable) such as organization costs, syndication costs, marketing and other pre-opening costs, permanent financing costs, and excluding project reserves and deductible expenses.

Eligible basis must be reduced by the amount of any historic rehabilitation tax credit which is attributable to residential rental property.

The annual "applicable percentage" which is used to determine the credit amount depends on several factors, including the nature of the project (i.e., new construction, rehabilitation or acquisition), the nature of the financing (i.e., with or without a federal subsidy), and the date the project is placed in service or the date on which a reservation contract is entered into.

For new construction or substantial rehabilitation of qualified low-income housing units that is not financed with tax-exempt bonds, below-market rate federal loans or other federal subsidies, the applicable percentage is a percentage that will yield, over a 10-year period, credit with a present value equal to 70% of the qualified basis of the building.¹⁵

For new construction or substantial rehabilitation of qualified low-income housing units financed with tax-exempt bonds,

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below-market rate federal loans or other federal subsidies, or the acquisition and rehabilitation of existing qualified low-income housing units, the applicable percentage is a percentage that will yield, over a 10-year period, credit with a present value equal to 30% of the qualified basis of the building.¹⁶ The applicable percentages for November 2003 are 7.96% for rehabilitation/new construction and 3.41% for acquisition.

Using those percentages, a new building consisting of 110 units with an eligible basis of \$12,000,000 and an applicable fraction of 40% would have a qualified basis of \$4,800,000. The annual credit would be \$382,080 ($\$4,800,000 \times .0796 = \$382,080$). Over the ten-year credit period, the total credits would be \$3,820,800. If the applicable fraction is 100%, the annual credit would be \$955,200 and the ten-year credit stream would be \$9,552,000.

The acquisition and rehabilitation of a 65 unit building located in a difficult to develop area (thereby qualifying for the 30% boost in basis), with an applicable fraction of 100%, an eligible acquisition basis of \$1,600,000 and an eligible rehabilitation basis of \$6,500,000, would generate a total annual credit of \$727,180. The ten-year credit stream would be \$7,271,800. The annual acquisition credit would be \$54,560 ($\$1,600,000 \times .0341\% = \$54,560$). The annual rehabilitation credit would be \$672,620 ($\$6,500,000 \times 1.3 \times .0796 = \$672,620$).

III. Overview of Tax Benefits and Limitations

The credit is a general business credit. General business credits claimed by a taxpayer for any tax year may not exceed the taxpayer's net income tax less the greater of: (a) the taxpayer's tentative minimum tax for the tax year, or (b) 25% of the taxpayer's net regular tax liability that exceeds \$25,000. Net income tax is the sum of the taxpayer's regular tax liability and the alternative minimum tax less all nonrefundable credits. Net regular tax liability is the taxpayer's regular tax liability reduced by these nonrefundable credits.¹⁷ Any credit that is not allowed in a particular taxable year due to the general business credit limitation or to the alternative minimum tax can be carried back one year and forward 20 years (back 3 years and forward 15 years for credits that arise in tax years beginning before 1998). Low-income housing projects typically generate taxable losses in the first 7 to 10 years. These losses reduce the taxpayer's regular tax liability in proportion to the taxpayer's marginal tax rate.

The credit and any taxable losses are subject to the at-risk and passive activity limitations.¹⁸ Individuals and certain closely-held corporations *are* subject to the at-risk limitations and the limitations on passive activity losses and credits. However, corporations, other than personal service corporations and certain closely-held corporations, *are not* subject to the at-risk limitations and the limitations on passive activity losses and credits. An exception to the passive activity credit limitations for individuals allows individuals to utilize the credit up to an amount equal to the deduction equivalent of \$25,000 per year at the individual's marginal tax rate (e.g., a taxpayer in the 35% marginal bracket

may use \$8,750 in credit per year [$\$25,000 \times 35\% = \$8,750$]) regardless of whether or not the individual has any passive income and, for projects placed in service after 1989, regardless of the individual's income level. The amount of credit that the typical project generates, and the constraints on use of the low-income housing tax credit make it clear why the credit is typically syndicated to large corporate buyers.

IV. Partnership Allocations

Due to the size of the low-income housing tax credit and the limits on use of the credit, most developers are unable to use the credit for their own benefit. Therefore, developers of tax credit projects typically sell an ownership interest in the project to a partnership whose members include corporations seeking tax credits. Much work goes into structuring the partnership to allocate all the losses, depreciation and tax credits to the investor while allocating the profit and distributions more evenly among the partners. The rules concerning partnership allocations also force low-income housing tax credit projects to use non-recourse financing.

An owner may allocate the tax and economic benefits of a project disproportionately among its members (within reasonable limitations) by using a partnership to own the project. For federal income tax purposes, a partnership is treated as a pass-through entity whereby all partnership tax items are taxed to the partners and are allocable among them pursuant to a partnership agreement, subject to regulations which determine the validity of those allocations.

While any form of entity treated as a partnership for federal income tax purposes can be used, almost all developers choose a limited partnership or limited liability company because those entities allow the developer to control day-to-day matters and the investor to obtain pass through of tax benefits with limited liability for the obligations of the ownership entity.

A typical LIHTC partnership will allocate 99.9% of all tax credits and taxable losses to the investor and .01% to the developer, and will allocate cash flow from operations and proceeds from sale or refinancing of the project 50% to the investor and 50% to the developer.¹⁹ Generally, the validity of such allocations must be determined pursuant to the regulations under IRC Section 704(b). Those regulations do not specifically address the allocation of low-income housing tax credits among partners because they were drafted prior to the enactment of the low income housing tax credit program. They do, however, address the allocation of other credits.

The regulations distinguish between the allocation of the investment tax credit and the allocation of other credits. They recognize a safe harbor for allocating the investment tax credit among partners in accordance with the manner in which they share partnership profits as of the date the investment tax credit property is placed in service. For other credits, however, they indicate that credits attributable to partnership expenditures

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should be allocated in the same manner as the losses and deductions attributable to the expenditures which give rise to such credits.²⁰

While the low-income housing tax credit is similar in some ways to the investment tax credit, it is different in some significant ways. For example, the investment tax credit is a one-time credit earned when the property is placed in service while the low-income housing tax credit is earned each year for 10 years based on continued compliance under the credit program. Also, it seems inappropriate to allocate the low-income housing tax credit in accordance with the manner in which the partners share partnership profits when investors generally do not expect to generate profits from LIHTC investments and Section 183 of the Code does not require them to do so.²¹

Most commentators therefore believe that the applicable regulations are those that address the allocation of other credits. Thus, since the low income housing tax credit is attributable to expenditures for the acquisition and development of low-income housing, the credit should be allocated among the partners in the same manner as the ordinary losses, depreciation and other deductions from the ownership and operation of the housing are allocated.

When the credit is allocated in accordance with partnership losses and deductions, the focus in determining the validity of low income housing tax credit allocations in a partnership is on the validity of the loss allocations during the entire term of the partnership and, particularly, during the 10-year credit period. The technical requirement is that loss allocations must have substantial economic effect.

Under the applicable regulations, loss allocations (and hence LIHTC allocations) have substantial economic effect as long as the partnership agreement contains certain mandatory provisions regarding the proper maintenance of partner capital accounts and the distribution of proceeds on liquidation of the partnership in accordance with partner capital accounts, and the capital accounts of partners receiving loss allocations are not reduced below zero.

In the event that loss allocations would or likely could reduce partner capital accounts below zero, such allocations which actually would reduce partner capital accounts below zero will still be considered to be valid (i.e., have substantial economic effect) provided that (1) the partners receiving such allocations are obligated to restore the deficit (if any) that remains in their capital account upon liquidation of the partnership, or (2) the losses are attributable to nonrecourse deductions (i.e., deductions attributable to nonrecourse liabilities of the partnership) and the partnership contains certain mandatory provisions regarding the allocation of nonrecourse deductions and the allocation of partnership minimum gain among the partners.

Deficit restoration obligations are not acceptable to most investors because they tend to undermine their limited liability as limited partners or members of a limited liability company. In light of the unacceptability of deficit restoration obligations, it is essential that the debt financing for the project be nonrecourse.

The key provisions are referred to as qualified income offset and minimum gain chargeback provisions. In summary, once the capital accounts of the investor partners are reduced to zero, any further loss allocations to them will be invalid and will be subject to reallocation to other partners with positive capital accounts or to the general partner unless the partnership has *both* nonrecourse financing *and* proper qualified income offset and minimum gain chargeback provisions.

Developers of low-income housing tax credit projects are not necessarily bound to give up 99% of the economic benefits of the project. The applicable guidance allows portions of a development service fee to be included in eligible basis. The ownership entity may therefore pay a development services fee to a related entity²² and include a portion of that fee in its eligible basis. The developer thus receives compensation above the line. Above the line fees are commonly used to allocate cash flow and to fine tune the loss-making ability of the ownership entity.

V. LIHTC Allocations and Program Administration Allocation System

Each state is granted annual authority to allocated \$1.75 per capita per year in 2002 (adjusted for inflation) and is required to designate a state agency to allocate the credits and monitor tax credit compliance. The housing credit agency in the state of Washington is the Washington State Housing Finance Commission. The agency must adopt an allocation plan.

To obtain an allocation of credit, a project must be consistent with the plan. In many states the allocation plan favors projects with greater low-income set asides. The process can be competitive. For example in the State of Washington in 2003, fifty eight projects applied for an allocation, and twenty eight projects received an allocation. Due to the competition in Washington, most applicants commit to restricting 100% of the units to low-income use.²³

State housing credit agencies are required to evaluate the financial feasibility of projects, to give consideration to other available subsidies committed to the project, to consider the degree to which the credits will be used for project costs, to consider the reasonableness of the developmental and operational costs of a project and to adjust the amount of credit allocated to the project accordingly. The applicant must prepare a comprehensive market study of the housing needs of low income individuals in the area to be served by the project before an allocation may be made.

VI. Compliance Monitoring

Federal law mandates many features of a state's compliance programs. For instance, project owners must keep records for each building showing the total number of residential rental units, the percentage of low-income units, the rent charged on each

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residential unit, the low-income unit vacancies and the rentals of the next available units, the low-income certification of each low-income tenant and supporting documentation, and the character and use of the nonresidential portion of the building (if any) included in the building's eligible basis.

In addition, project owners must certify at least annually under penalty of perjury that the project meets the applicable minimum set-aside requirements, and that the owner has received an annual low-income certification from each low-income tenant, along with supporting documentation; that each low-income unit is rent-restricted; that all units are available for use by the general public on a nontransient basis; that each building in the project is suitable for occupancy under local health, safety and building codes; that there has been no change in any building's eligible basis (or that there has been a change, with an explanation of the nature of the change); that all tenant facilities included in eligible basis are provided on a comparable basis without separate charge to all tenants; that reasonable attempts are made to rent low-income units that become vacant during the year to tenants with qualifying income and while vacant no units of comparable or smaller size are rented to nonqualifying tenants; and that if the incomes of tenants of low-income units increase above the allowable limit, the next available units of comparable or smaller size are rented to tenants with qualifying income.

Finally, the state housing credit agency has the right to inspect each building in the project and the right to audit the owner's records during the 15-year compliance period.

Violation of the compliance requirements can result in recapture of the credit taken. The credit may be recaptured due to (1) a failure to maintain the project as a qualified low-income housing project, (2) a reduction in the low-income occupancy of the project, or (3) a transfer or disposition of the project or an interest in the project during the 15-year compliance period. Recapture is limited to the "accelerated portion" of the credit allowed in prior years plus interest from the year or years allowed. The "accelerated portion" is equal to one-third (1/3) of the credit allowed in prior years if the recapture event occurs during the first 11 years and declines ratably during the 12th through 15th years of the compliance period.

Recapture is a bad thing, but you don't need a lawyer to tell you that.

- 1 Section 42 of the Code is 38 pages long (at least in my CCH version). The reader who is bookish enough to master Section 42 will realize that this article describes only the general requirements of Section 42 and ignores many exceptions, special rules and technical definitions. Hopefully, however, this article will help developer's counsel to learn enough about the LIHTC to know if it may be of interest to his or her clients.
- 2 26 U.S.C. §42(g)(1). Due to the competition for an allocation of credits in Washington, an owner must frequently commit to greater set-asides such as 100% of the units at 60% of area median income.
- 3 "Placed in service" means placed in service by the owner claiming the credits. A new project is placed in service when it is first used. An existing project is placed in service when ownership interests change. As explained below, an existing project (an acquisition/rehab project) cannot qualify for credits if it has been placed in service within 10 years.

- 4 Except buildings receiving an allocation of credit before 1990.
- 5 The requirement that the covenant bind all successors in interest is understood by some attorneys for tax credit investors to require the covenant to be prior to all deeds of trust on the property. Thus a developer should make sure its lender is familiar with the tax credit program.
- 6 Violations may be cured within a specified period of time.
- 7 Single-room occupancy (SRO) units, however, may be leased on a month-to-month basis.
- 8 Dwelling units occupied by students receiving AFDC payments are exempt from this requirement.
- 9 HUD regulations and policies do allow preferences to certain classes of tenants such as the elderly, homeless, disabled and/or handicapped in the circumstances and under the conditions set forth by HUD. Including such preferences does not violate the general public use requirement.
- 10 26 U.S.C. §42(g)(2)(D)(ii).
- 11 The exceptions include placements in service in connection with: (1) carry-over basis transactions, in which the transferee determines his basis in whole or in part from the transferor's basis; (2) certain transfers from decedents, (3) certain nonprofit or governmental agencies, and (4) foreclosures, and (5) technical partnership terminations. 42 U.S.C. 42(d)(2)(D)(ii).
- 12 The credit period commences with the taxable year in which the building is placed in service or, at the election of the owner, the succeeding taxable year. The project owner is deemed to defer the start of the credit period unless he affirmatively elects to start it in the year each low-income building in the project is placed in service.
- 13 The adjusted basis of a unit occupied by a full-time resident manager is included in the building's eligible basis, but the unit is excluded from both the numerator and denominator of the applicable fraction for purposes of determining the building's qualified basis (Rev. Rul. 92-61). This rule may also extend to units occupied by full-time resident maintenance personnel or other on-site personnel. The significance of the ruling is that such resident managers or others are not subject to applicable median income limitations.
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- 16 Known as a 4% credit. To be eligible for the credit, the building must meet the placed-in-service rules discussed above.
- 17 26 U.S.C. § 38(c)(1).
- 18 26 U.S.C. § 465; 26 U.S.C. § 469.
- 19 For nonprofit 501(c)(3) developers, however, all allocations, including residual allocations, must be the same to avoid the impact of the tax-exempt use rules. Those rules impose a less favorable depreciation schedule to the extent of the nonprofit partner's greatest percentage allocation of items of profit (income, gain, or distribution) during the entire term of the partnership.
- 20 Treasury Reg. 1.704-1(b)(4)(ii).
- 21 Section 183 of the Code disallows losses, deductions or credits attributable to activities that are not engaged in for profit. The legislative history of the LIHTC program however indicates that Congress contemplated that tax benefits (including credits, losses and deductions) would be available to taxpayers investing in low-income housing even though the investment would not otherwise provide a potential for economic return. In 1992, the IRS adopted Treasury Reg. 1.42-1 that states Section 183 does not apply to the LIHTC.
- 22 Corporations, unlike partnerships, are not subject to self-employment tax. Thus a thoughtful developer can eliminate some tax on the developer fee by using a corporation as the developer.
- 23 Certain projects financed with tax-exempt bonds need not obtain an allocation of credits. Credit given to such projects does not reduce the state's annual credit authority. In order to qualify, 50% or more of the aggregate project costs must be financed with tax-exempt bonds which are subject to state volume limitations. However, the project must still be consistent with the qualified plan of allocation.

Real Property Taxation and Tax Savings Opportunities

by Kay S. Slonim and George Mastrodonato, Lane Powell Spears Lubersky LLP, Seattle

Washington *ad valorem* property taxes are based on the principle that the amount of property tax paid should depend on the fair market value of the property. A companion principle, established in the Washington State Constitution, is that all real property should be valued and assessed uniformly. Property tax assessments and collections are primarily the responsibility of elected county assessors. Residential and commercial properties are, for the most part, accurately and uniformly valued. However, most industrial properties are valued uniformly, but the assessments are too high. Washington is unique in that it provides taxpayers three opportunities for reducing property taxes.

Washington also imposes a leasehold excise tax *in lieu* of the property tax on any occupancy and use of public property that constitutes less than fee simple ownership. The leasehold excise tax is administered by the Department of Revenue. The tax rate is set at an amount that originally resulted in a tax fairly equivalent to the amount of property tax that would be due if the property was not publicly owned. However, the leasehold tax now often exceeds the amount of property tax that would otherwise be due. Therefore, the Legislature provided for a credit to offset the difference.

This article summarizes the basic principles of Washington's system of real property taxation and the manner in which the system operates. It then suggests ways in which practitioners can help clients evaluate the assessments of their properties and, where appropriate, seek reductions in assessments and refunds of taxes previously paid.

I. Application of the Property Tax to Real Property

A. Real versus Personal Property

Taxable real property includes land and all buildings, structures (*e.g.*, separate pollution control facilities), improvements (*e.g.*, clearing, grading), or other fixtures (*e.g.*, machinery and equipment that cannot be removed from the land or buildings without damage to itself or the real property). RCW 84.04.090; *Lipsett Steel Products, Inc. v. King County*, 67 Wn.2d 650, 409 P.2d 475 (1965).

Machinery and equipment treated as fixtures are generally assessed in a manner that is less favorable than if they are treated as personal property. The depreciation tables relied upon by the assessors assume a longer economic life for machinery and equipment when such property is considered to be part of the building. Also, personal property is revalued annually in every county. So in counties with longer revaluation cycles, the decrease in value due to depreciation is only recognized every two to four years, instead of annually.

B. Uniformity

The Washington State Constitution requires that all property taxes be uniform and that property tax assessments be administered in a systematic, nondiscriminatory manner. Op. Atty. Gen. 1995 No. 5.; Const. Art. 7, Sec. 1, 2. Since only uniformity is

constitutionally required, even if a property is assessed at market value, the assessment may be reduced if similar property is shown to be assessed at less than market value. *Burlington Northern, Inc. v. Johnston*, 89 Wn.2d 321, 572 P.2d 1085 (1977); *Inter Island Tel. Co. v. San Juan County*, 125 Wn.2d 332 (1994), Op. Atty. Gen. 1995 No. 5. Uniformity is required only for the total assessment, not the component parts. *University Village Ltd. Partners v. King County*, 106 Wn. App. 321 (2001).

The Washington Department of Revenue performs "ratio studies" each year in all the counties to determine if, and by how much, actual assessment levels fall short of 100% of market value. The studies usually find that assessments are less than 100% of market value and that the difference varies among the counties. The DOR uses the studies to equalize the state's portion of the property tax levy among the counties. RCW 84.48.080. But taxpayers could use the data to obtain reductions on uniformity grounds.

C. Special Programs and Exemptions

The Legislature has determined that various types of properties should have special valuation criteria applied in order to reduce the tax burden. These special programs cover historic property (Ch. 84.26 RCW), forest lands (RCW 84.33.130 *et seq.*), and open space, agricultural and timber lands (Ch. 84.34 RCW).

Exemptions from property tax are numerous. Ch. 84.36 RCW. It is important to keep in mind that qualification for exemption from federal income tax under IRC Sec. 501(c)(3) does not necessarily qualify such an organization's real property for an exemption from property taxes. The use made of the property controls and each exemption requires a showing of a specific type or character of ownership. *Corporation of Catholic Archbishops v. Johnston*, 89 Wn.2d 505, 573 P.2d 793 (1978).

All or part of the value of residences owned by seniors and the disabled may be exempt. RCW 84.36.381. In addition, the portion that does not qualify for an exemption may be deferred under Ch. 84.38 RCW.

D. Leasehold Excise Tax *in lieu* of the Property Tax

The leasehold excise tax is imposed on the privilege granted to a private entity to use or occupy publicly owned property. Ch. 82.29A RCW. The tax is levied on the contract rent paid to the public lessor, which does not include any payment for a concession or franchise. RCW 82.29A.020(2)(a); *MAC Amusement Co. v. State Dept. of Revenue*, 95 Wn.2d 963, 633 P.2d 68 (1981). If the Department of Revenue determines that the contract rent is less than market rent, the DOR will calculate the market rent for the property and impose the tax on that higher amount. RCW 82.29A.020(2); RCW 82.29A.060. In the case of aquatic lands leased by the Department of Natural Resources, specific statutes set the taxable rent. Ch. 79.90 RCW. Several exemptions from the leasehold tax are provided for in RCW 82.29A.130-136.

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Real Property Taxation and Tax Savings Opportunities

The leasehold excise tax is 12.84% of the contract rent. It is generally paid to the public lessor along with the rental payments, and the public lessor remits the tax to the Department of Revenue. Lessees of the federal government pay the tax directly to the DOR. RCW 82.29A.030 and 82.29A.050.

II. Property Tax Assessments and Tax Savings Opportunities

A. Valuation of Real Property by County Assessors

All property should be valued at 100% of its fair market value as of January 1 of the assessment year, unless a special program or exemption applies. RCW 84.04.010, 84.40.030. For property tax purposes, fair market value means the amount of money which a purchaser willing, but not obliged, to buy would pay an owner willing, but not obligated, to sell, taking into consideration all uses to which the property is adapted and might reasonably be applied. *Carkonen v. Williams*, 76 Wn.2d 617, 458 P.2d 280 (1969). Thus, all factors that can, within reason, affect the price in negotiations between a willing buyer and a willing seller, must be considered. *Cascade Court Limited Partnership v. Noble*, 105 Wn. App. 563, 20 P.3d 997 (2001). Property should be valued in accordance with its highest and best use, which is the most profitable, likely use to which it can be put. *Sahallee Country Club, Inc. v. State Board of Tax Appeals*, 108 Wn.2d 26, 33, 735 P.2d 1320 (1987). These holdings all reflect standard appraisal practice. Improvements to real property under construction are assessed as of its value on July 31 of the assessment year. RCW 36.21.080.

The statutory valuation guidelines for assessors also reflect the three standard approaches to valuation – market (sales of similar properties), capitalization of income and cost less depreciation. For complex industrial properties the income and cost approaches are most often relied upon. RCW 84.04.030 (1) and (2). Once the assessor has determined the value of the total property, the value is allocated between land and buildings. RCW 84.04.030(3).

Twenty counties have elected to revalue real property in four-year cycles rather than annually. One is on a two-year cycle and another is on a three-year cycle. RCW 84.41.030. RCW 84.41.030 was amended in 1996 to allow for mid-cycle value reductions arising from local government planning decisions, including threshold determinations under the State Environmental Policy Act. Ch. 43.21C RCW. In a related move, the Legislature enacted a provision allowing refunds to be obtained, for up to three years, upon application for a reduction in assessed value within three years of adoption of a restriction by a government entity. RCW 84.40.039.

B. Mass Appraisal

With up to hundreds of thousands of parcels of real properties to assess in a county, assessors use a “mass appraisal” system for determining individual valuations. Such a system works well for

the less complex residential and commercial properties because of the substantial amount of data available. Sales data from excise tax records are generally employed in the comparable sales approach for valuing single-family residences. The income approach analyzes a property’s capacity to generate benefits in the form of income and a reversion and is the most accurate method for valuing any income-producing property. For less complex commercial properties, a fair amount of data on income, vacancy rates, expenses and sales is available in the public domain.

There are generally few sales of complex commercial or industrial properties that are comparable to a specific property to be assessed. And there are few or no public records of the income and expenses for individual properties. Thus, for most counties, the cost approach is the most viable method for valuing industrial properties on a mass appraisal basis. This is a two-step process. First, the land value is determined using the sales approach. Then the building value is determined using a trended investment technique. This involves multiplying the original cost of buildings by factors provided by the Department of Revenue that combine inflation and an estimate of depreciation based upon a building’s remaining economic life.

C. Tax Savings Opportunities

Assessments of residential and less complex commercial property are generally accurate. In contrast, industrial properties are almost always assessed too high. And the grounds for challenging valuations also typically vary according to the type of property.

1. Residential and Commercial Properties

A key element in evaluating the validity of any residential or commercial property assessment is whether the sales and financial data relied upon is comparable to the taxpayer’s property. Differences in size, age, location or unique factors that affect income or expenses may indicate a lower value than determined by the assessor. And the dates of sale transactions and income and vacancy data are particularly important if dramatic changes in the economy occur.

Another error to look for is whether the sales and income transactions relied upon were not arms-length; i.e. whether the purchaser’s (or lessee’s) unique motivation results in the payment of a premium over the fair market value. For example, purchasers may pay a premium for the last parcel for an assemblage or if time is running out to complete a 1031 exchange. Also, there are many sale-leasebacks of fast-food properties that are actually sales of a business and a mechanism for sellers to extract profits from the business. Not only does the sale price include exempt intangible business value, but the lease payments may also include business value in the form of excess rent. (And since assessments may be based upon excise tax affidavits, the purchaser in such transactions

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Real Property Taxation and Tax Savings Opportunities

should also consider reducing the assessment to market value based on comparable arms-length transactions.)

Assessments may also be too high for properties such as hotels, assisted living centers, and shopping centers. Application of the income approach often results in assessment of the entire business enterprise, which may erroneously include exempt intangible assets such as franchises, goodwill, exceptional management, trade names, licenses or permits. RCW 84.36.070.

Taxpayers faced with restrictive land use changes and remediation orders for environmentally contaminated property may be able to demonstrate a reduction in the property's value. Extraordinary contamination and zoning or other changes in land use patterns may reduce the value of a commercial or industrial building on the site to nothing. In such cases, assessors often put a token value of \$1000 for the improvements on the assessment rolls.

2. Industrial Properties

For industrial properties, the application of the cost approach generally results in excessive assessments because the trended investment tables provided by the Department of Revenue do not measure additional depreciation in the form of functional and economic (external) obsolescence. Consequently, the Department of Revenue advises assessors to give consideration to taxpayers' evidence of additional depreciation.

Functional obsolescence can usually be quantified for the cost approach by calculating excess costs of various kinds. Occasionally an assessor will recognize additional economic obsolescence by simply applying the personal property tables used for the same type of equipment. However, the income approach is the best approach for estimating value when economic obsolescence is present because it is directly based upon a property's capacity to generate income.

Some assessors and the Department of Revenue perform individual appraisals for industrial properties, rather than simply applying the DOR's trending tables. They consider all three approaches to value, and usually determine a final estimate of value based upon indications of value from the income and cost approaches.

The importance of the income approach has grown since the early 1990s as many Pacific Northwest industries have suffered reduced profits due to external circumstances. A classic example is the forest products industry. First, values plummeted in the early 1990s when prices for the raw material increased due to the northern spotted owl regulations. More recently, profitability in some sectors further decreased as prices had to be lowered to match the lower prices of imports or synthetic products. In the last decade hundreds of facilities have closed because they were no longer profitable. Economic obsolescence has also reduced values significantly in all sectors of food processing and for aerospace related enterprises.

The ability of professional business appraisers to quantify economic obsolescence has improved in recent years in the

process of developing more accurate business valuations. Business appraisers apply a discounted cash flow analysis to determine a present value of the projected cash flow and reversion for the property, especially because risk and growth are key factors determining value. When used to determine the value of industrial properties for property tax purposes, the appraiser also eliminates intangibles, which is typically just working capital. Failing to use the discounted cash flow analysis for industrial property is grounds for invalidation of the assessment.

III. Procedures for Reducing Assessments and Obtaining Refunds

Since most complex commercial and manufacturing properties are assessed too high to begin with, owners of these properties should approach the assessor informally to obtain an appropriate valuation. The best time to engage the assessor is well before the May 31 deadline to finalize the assessment roll. If considerable personal property is also involved, a good time to act is well before the April 30 deadline for filing personal property tax affidavits. When an assessor has requested an advisory appraisal from the Department of Revenue, the DOR appraisers will always share their appraisal with the taxpayer and occasionally make corrections identified by the taxpayer.

A. Most Common Appeal Circumstances

1. Administrative appeal during assessment year

When an assessment is increased, the assessor must provide notice of the change in value and information on appealing the new value to the county board of equalization. RCW 84.40.045. But a taxpayer who believes the prior assessments were already too high should also file an appeal. The deadline is generally July 1 of the assessment year. However, because so many assessors are unable to meet the deadline for setting values, taxpayers receiving notices of a change in value may appeal within thirty days after the date of mailing a notice of assessment or change in value, or within sixty days if a county has adopted the longer appeal period. RCW 84.40.038(1). Appeals from the local boards are to the state Board of Tax Appeals and a taxpayer may elect to bypass the local board and appeal directly the BTA. RCW 84.40.038(3).

The assessors, or their representatives, are generally willing to meet informally to discuss the valuation issues. Once the assessor reviews information provided by the taxpayer, he or she often offers to stipulate to a reduction in value. A taxpayer may request that the clerk of the board of equalization, or of the BTA if a direct appeal is taken, not schedule a hearing while discussions with the assessor are ongoing.

BTA hearings are informal, unless one of the parties elects a formal hearing. In a formal hearing the assessor will be

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Real Property Taxation and Tax Savings Opportunities

represented by an attorney. If the assessor elects a formal hearing, the appeal is to superior court on the record. RCW 82.03.180. But a taxpayer is always entitled to pursue a trial *de novo* pursuant to the property tax refund suit procedure under Ch. 84.68 RCW. RCW 82.03.180; *Transamerica Title Ins. Co. v. Hoppe*, 26 Wn. App. 149, 611 P.2d 1361 (1980). To preserve the right to a trial *de novo*, the tax on the contested assessment must be paid under protest, even though an administrative appeal is pending when the contested tax is paid. The filing and pursuit of an administrative appeal of an assessment cannot substitute for the protest.

2. Property Tax Refund Actions in Superior Court

The property tax is payable in two equal installments on April 30 and October 31 of the year following the assessment year. RCW 84.56.020. Refunds of overpayments that have been properly protested may be obtained by filing refund suit in superior court by June 30 of the year following payment of the disputed tax. RCW 84.68.020; RCW 84.68.060.

The protest requirement can be a trap for the unwary. It is critical that the protest set forth all the grounds for the claim that the tax is excessive or unlawful. Furthermore, if a taxpayer protests only one installment, the refund will be only one-half the amount of that year's overpayment. *Longview Fibre Co. v. Cowlitz County*, 114 Wn.2d 691, 790 P.2d 149 (1990).

The refund suit procedure is completely independent of the administrative appeal process and administrative appeals need not be exhausted in order to pursue a refund suit. *Pettit v. Board of Tax Appeals*, 85 Wn.2d 646, 538 P.2d 501 (1975).

3. Presumption of Correctness Favors Assessors

Taxpayers appealing an assessment in either forum have a heavy burden. They must prove that the assessment is wrong by clear, cogent and convincing evidence; *i.e.*, the amount of evidence necessary to convince the trier of fact that the taxpayer's opinion of value is highly probable. RCW 84.40.0301; *In re Sego*, 82 Wn.2d 736, 513 P.2d 831 (1973). Overcoming the presumption requires two strategies: first, proving the errors in the assessor's valuation by clear, cogent and convincing evidence, and second, proving the correct valuation by a preponderance of the evidence. *Weyerhaeuser Co. v. Easter*, 126 Wn.2d 370, 894 P.2d 1290 (1995). In almost every case it is necessary to have an appraiser to both critique the assessor's valuation and prepare an opinion of value for the taxpayer's property. And it is critical that the appraiser testify at the hearing so that their credibility can be observed and any questions in the minds of the BTA members can be addressed.

In order to prove the assessor's errors, the taxpayer needs documentation of the basis for the assessment. This information can be obtained at any time under the public disclosure law and by requesting it on a petition appealing an assessment. RCW 84.48.150.

B. One-to-Three-year Windows to Reduce Assessments and Obtain Refunds under Certain Conditions

Incorrect assessments due to "manifest errors" (*i.e.*, errors that do not involve valuation judgment, such as double assessments and description errors) and changes in land use designations may be corrected for up to three years preceding the year in which the correction is made. RCW 84.48.065; RCW 84.69.020; WAC 458-14-127.

Taxpayers who can make a *prima facie* showing of constructive fraud with evidence that the assessed value of a property exceeds its market value by at least one hundred percent may also obtain assessment reductions for up to three years prior to a current assessment year. RCW 84.08.060; *Dexter Horton Bldg. Co. v. King County*, 10 Wn.2d 186, 116 P.2d 507 (1941). In the last few years some food processing and forest products manufacturing facilities have qualified for this retroactive refund opportunity.

Also, an assessor may agree to ask the board of equalization to permit a revised valuation for a prior year if the assessor's lack of knowledge of relevant, discoverable facts caused the valuation of a property to be materially affected. The application for a change must be made by April 30 of the year immediately following the assessment year. These cases are different than the manifest error in that appraisal judgment must be exercised in determining the effect of the discovered facts on the valuation. An example would be the assessor's lack of knowledge that the property was subject to an environmental contamination remediation order.

There is one other ground for obtaining a reduction that should see more use now than in recent years. If property is sold after July 1 and before December 31, for 90% or less of the assessment, the purchaser may apply for a reduction so that the tax paid the following year will be based upon the lower sale price instead of the higher, erroneous assessed value.

The procedures for obtaining assessment reductions on these grounds, and others, are found in WAC 458-14-127. Forms are available on the website for the Department of Revenue's property tax division (<http://dor.wa.gov>).

C. Leasehold Excise Tax Savings Opportunities

Taxpayers may be eligible for a credit against the leasehold excise tax in the amount of the difference between the leasehold tax and the property tax otherwise payable. RCW 82.29A.120. The credit may be claimed retroactively and a refund obtained for overpayment of the tax for the current and four prior years. RCW 82.32.060, 82.32.050(3). Application for a refund must be filed with the Department of Revenue in accordance with the procedures set forth in WAC 458-20-100. When the lessee and DOR have concluded the refund process, lessees should also be able to reach agreement with the DOR on a process for asserting the credit on an ongoing basis for future rent payments.

Recent Developments

Probate and Trust

by Colonel F. Betz, Perkins Coie LLP, Seattle

WASHINGTON STATE SUPREME COURT

Marriage of Chumbley, 150 Wn.2d 1 (2003)

Summary: The character of stock acquired during marriage using both separate funds and community stock options will be pro rated according to the separate and community assets used to acquire the stock at the time it was purchased.

Facts: Beckmann and Chumbley married in 1984. Part of Beckmann's compensation at Immunex took the form of options to purchase the corporation's stock at preferred prices. During the marriage, Beckmann exercised her stock options on three occasions. In December 1992, she purchased 1,600 shares financed by a loan from Immunex. In May 1993, she purchased 1,600 shares with approximately \$38,391 from her separate account (\$25,392 to purchase the stock and approximately \$12,999 in taxes.) In June 1993, she exercised options through a cashless transaction, where she purchased 1,000 shares and immediately resold 359 of the shares in order to pay for the purchase and taxes. The purchase resulted in a new acquisition of 641 shares.

Chumbley and Beckmann were divorced in May 2000. The trial court characterized the shares as Beckmann's separate property. However, the court recognized that the options used to purchase the stock were community property and compensated Chumbley with an offset in other assets for the value of the stock options at the time of exercise (\$51,000). On appeal by Chumbley, the Court of Appeals held that the shares resulting from the May 1993 options were community property, and that the exercise of the options with separate property did not extinguish the community's interest.

Beckmann appealed to the Supreme Court.

Discussion: Under RCW 26.16.030, assets acquired during marriage are presumed to be community property. To overcome the presumption, a party must present clear and convincing evidence that the acquisition fits within a separate property provision.

Property acquired during marriage has the same character as the funds used to purchase it. In the present case, Beckmann's separate funds were used to purchase the shares by exercising community property options, which allowed the purchases to be made at preferred prices.

In support of its ruling, the Court analogized the stock purchase to cases involving real property that was acquired with both separate and community funds. Under the "mortgage rule," where a buyer acquires legal title in exchange for a cash payment and an obligation to pay the remainder of the purchase price, the character of the asset is determined by the character of the cash and of the obligation at the time legal title (and ownership) was acquired.

The Court disagreed with Chumbley's argument that Beckmann was entitled to a lien on the stocks for her separate

contribution in their purchase, but that the stocks were community property. Chumbley's argument attributed the appreciation on the stocks to the community.

Since Beckmann clearly met her burden of proving that the funds used to exercise community stock options were separate and that no loan or gift to the community was intended, the Court held that the stock should be divided based upon the proportion of separate and community assets that were used to acquire the stock. In effect, the Court adopted a pro rata characterization to allocate the distribution of the stocks between separate and community property.

The Court rejected Chumbley's argument that allowing a pro rata distribution under these circumstances would permit the more sophisticated spouse to manipulate community property and frustrate the underlying principles of community property law. A spouse is under a statutory duty to manage and control community assets for the benefit of the community and any attempt to manipulate community property would be a breach of this duty.

The Court also reasoned that a pro rata characterization conforms to the most basic of investing principles – that reward is related directly to the amount of risk taken. A spouse who contributes separate funds for the purpose of exercising stock options takes an additional risk, and the reward should be proportionate to that additional risk. A pro rata characterization accomplishes this proportionate disposition, fairly separating the underlying ownership and any appreciation between separate and community property.

– WASHINGTON COURT OF APPEALS, DIVISION I –

Estate of Freitag v. Frontier Bank, 118 Wn.App. 222 (Div. I 2003)

Summary: A depositor bank did not breach its duty to an estate by honoring a personal representative's direction to transfer estate funds to the personal representative's individual accounts.

Facts: Patricia Olson was appointed as personal representative of the estate of her uncle, Eugene Freitag. Freitag's will granted Olson nonintervention powers, which were confirmed by the court. Olson presented Frontier Bank (the "Bank") with a certified copy of Freitag's death certificate, the letters testamentary issued by the court, and personal identification proving she was the personal representative named in the letters testamentary. She directed the Bank to close both a CD account and a checking account in Freitag's name, and to transfer a total of approximately \$120,000 in proceeds from these sources into two accounts that

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she established at the Bank as individual, not fiduciary, accounts. The Bank executed this payment order. Olson later directed the funds to be transferred from her individual accounts at the Bank to her bank in Montana. Ultimately, Olson stole the funds.

Following the discovery of the thefts, a successor personal representative was appointed. The successor commenced an action against the Bank for breach of its duty to the Estate of Eugene Freitag. The Estate appealed the summary judgment that the trial court granted to the Bank.

Discussion: To prove its claim, the Estate must establish (1) the existence of a duty owed to it; (2) a breach of that duty; (3) a resulting injury; and (4) that the claimed breach was the proximate cause of the injury. The Court quickly concluded that the Bank owed its customer a duty, but the relationship needed to be analyzed to determine if that duty was breached.

Olson’s directive to the Bank to close Freitag’s accounts and transfer the funds to her individual accounts was a payment order, or “funds transfer,” governed by Article 4A of the Uniform Commercial Code. The rules embodied in Article 4A are the “exclusive means of determining the rights, duties and liabilities of the affected parties in any situation covered by particular provisions of the Article.” RCW 62A.4A-102, Comments.

The payment order was an authorized payment by the Bank under RCW 62A.4A-202(1), which states, “[a] payment order received by the receiving bank is the authorized order of the person identified as sender if that person authorized the order or is otherwise bound by it under the law of agency.” The Court also concluded that Olson, as personal representative with nonintervention powers under Freitag’s will, had actual or apparent authority to cause the payment order to be issued in the name of the Estate. At the time of the payment order in question, the Bank knew that Olson was the personal representative under Freitag’s

will, but had no inkling that Olson would later divert the Estate’s funds to her own use.

Citing *In re Snyder’s Estate*, 122 Wash. 65 (2002), the Court agreed that although the placement of fiduciary funds in an individual account is not ideal, “there is no provision of law which requires estate funds to be separately kept, and if the executor ultimately accounts for all of such funds, it cannot be said that he is guilty of misconduct.” *Snyder*, 122 Wash. at 68.

While the practice of placing estate funds in a personal account is not a desirable one, it is not illegal. And there was no evidence that the Bank knew or should have known of Olson’s intent to divert funds to her own purposes. In short, the Bank’s decision to honor the payment order as one authorized by the personal representative was reasonable and its duty to the Estate was not breached.

In addition, the Court found that the Bank’s actions were reasonable in light of the statutes applicable to personal representatives with nonintervention powers. RCW 11.68.090(1) provides... “[a] party to such a transaction and the party’s successors in interest are entitled to have it conclusively presumed that the transaction is necessary for the administration of the decedent’s estate.” The successor personal representative did not address the statutory presumption that one dealing with a personal representative with nonintervention powers may “conclusively presume[] that the [payment order in this case] is necessary for the administration of the decedent’s estate.” Nothing in RCW 11.68.090(1) or the other statutes cited suggest that a personal representative with nonintervention powers is not permitted to deposit estate funds in an individual account. Accordingly, the Estate failed to establish that the Bank’s execution of the payment order was not reasonable.

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Recent Developments

Real Property

by Scott B. Osborne, Preston Gates & Ellis LLP, Seattle

There were three cases during the last year that further defined the obligations of title insurance companies acting in their role as title insurers and closing agents. All three cases arose from errors in legal descriptions in purchase agreements, preliminary commitments and title policies. Two of the cases, *Denaxas v. Sandstone Court of Bellevue*, 148 Wn.2d 654, 63 P.3d 125, 2003 Wash. LEXIS 75 (2003), and *Michak v. Transnation Title Insurance*, 148 Wn.2d 788, 64 P.3d 22, 2003 Wash. LEXIS 142 (2003), further defined the duties of title insurers acting as closing agents in real estate transactions. The third case, *Universal Holdings II LP v. Overlake Christian Church*, 115 Wn.App. 59, 60 P.3d 1254, 2003 Wash. LEXIS 27 (2003), dealt with a title insurer's attempt to reject a claim on the basis of failing to follow the claim procedure set forth in the policy.

The claim asserted in *Denaxas*, *supra*, arose from a series of mistakes. Sandstone Court, a development entity owned by Lee Singleton, entered into a purchase agreement to acquire property owned by Denaxas in Bellevue on which Singleton intended to construct an apartment complex. The purchase agreement identified the property as:

... commonly known as approximately 27,260 square feet of land and improvements at 10955 N.E. 4th Street, in the city of Bellevue, King County, Washington, legally described as Lots 3, 8, and 9 Summit Ridge Addition to Bellevue.

(Buyer and Seller authorize the Listing Agent, Selling Licensee, or Closing Agents to insert and/or correct, over their signatures, the legal description of the property.)
Denaxas, at p. 658-659.

This was the first mistake. The property owned by the seller consisted of only Lots 3 and 9, and a portion of Lot 8, namely, the west 26 feet. This resulted in a parcel that was approximately 6,800 square feet smaller than described in the purchase agreement. The preliminary commitment for title insurance prepared by Pacific Northwest Title Company correctly described the property, and both the buyer and seller received a copy of the preliminary commitment shortly after executing the purchase and sale agreement. Neither the buyer nor the seller noticed the discrepancy between the title commitment and the purchase agreement. This was the second mistake.

A survey was ordered for the property and an adjacent parcel that Singleton also was purchasing. The survey noted that the total combined area of the parcels was approximately 28,195 square feet, which was only 935 square feet more than the supposed area of the parcel being purchased. Had the area been correct in the agreement, the combined parcels would have had an area of 35,000 square feet. No one noticed this discrepancy. This was the third mistake.

The transaction closed pursuant to signed escrow instructions, which in part provided:

... [t]he undersigned PURCHASER and SELLER have received, reviewed and approved for use in this escrow the preliminary commitment for title insurance, including any supplementals thereto, and have reviewed and approved the legal description and general and special exceptions including the covenants, conditions and restrictions affecting said property as stated on the commitment. *Denaxas*, at p. 660.

In addition, the buyer granted to the seller a deed of trust on the property to secure a note given by the buyer for a portion of the purchase price. The deed of trust, which the purchaser also approved and executed, contained the correct legal description. The purchaser again failed to notice the discrepancy between the legal description in the closing documents and the purchase agreement. This was the fourth mistake by the buyer.

Finally, about eight months after closing, Singleton noticed the difference between the description in the purchase agreement and the correct legal description while he was obtaining construction financing. He demanded a reduction in the purchase price based on the smaller area, which the seller refused. Singleton stopped payments on the note and the seller sued to collect the balance. Singleton counterclaimed and sued PNWTC for breach of fiduciary duty and negligence. This turned out to be Singleton's final mistake.

The trial court dismissed the claims against PNWTC on summary judgment, but the Court of Appeals, Division I, reversed, holding that as a matter of law, the title company's failure to draw the buyer's attention to the discrepancy in the description was both a breach of fiduciary duty and a departure from the standard of care to be observed by an escrow agent.

The Supreme Court reversed the Court of Appeals and reinstated the trial court summary judgment. The Court noted that (i) PNWTC did not violate any written instructions in completing the transaction; and (ii) did not violate the standard of care of a practicing attorney in completing the closing documents, since inserting the legal description in the closing documents is not the practice of law.

The Title Company did not breach its fiduciary duty or duty of reasonable care. Purchaser cannot show that the Title Company breached a duty express or implied in the escrow instructions. Nor can it show that the title Company had a duty to notify Purchaser that the legal description in the Agreement was incorrect or different than in other documents. *Denaxas*, at p. 665.

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The Court also rejected the buyer's claim of mutual mistake asserted against the seller in an attempt to reform the contract and lower the purchase price.

... Purchaser had constructive knowledge of both the correct square footage and legal description. If a person exercising reasonable care could have known a fact, he or she is deemed to have had knowledge of that fact. [citations omitted] *Denaxas* at p. 667.

Similarly, in *Michak, supra*, the Court refused to impose liability upon a title company as a result of a discrepancy between the legal description of an easement in a preliminary commitment and the correct legal description for the easement contained in the closing documents.

Michak agreed to buy property for development from a trustee in bankruptcy. The preliminary commitment issued by Transnation Title for the property showed it was served by two easements, one of which was described as 60-foot wide. After receiving the preliminary commitment, the seller informed the title company that the easement had been reduced to a 30-foot width. Transnation issued a supplemental title report changing the description. At closing, Michak initialed the supplemental report and acknowledged receipt of the revised legal description.

When Michak began developing the property a year later, she realized that the easement was only 30-foot wide, and that the reduced easement would not support the access required for the development. She sued Transnation, claiming that Transnation had breached its insurance contract. The trial court dismissed the claim on a summary judgment motion, and the Court of Appeals, Division II, reversed the dismissal.

The Supreme Court reinstated the summary dismissal of the claim against the title company. Michak argued that the title company breached its contract to issue a title policy in accordance with the initial preliminary commitment that was issued showing a 60-foot easement. The Court rejected that argument:

Michak has identified no provision in the commitment that precludes Transnation from amending the legal description of the property in Schedule A prior to issuing the Policy.... we rest our resolution of Transnation's summary judgment motion on two facts: (1) that Transnation issued its

Supplemental prior to the transaction's closing and the issuance of its Policy and (2) that Michak initialed at closing the corrected legal description that Transnation had originally attached to its Supplemental. On these facts, Michak has no viable claim that Transnation breached its commitment to provide title insurance. *Michak* at pp. 799-800.

The title company did not fare as well in the *Universal Holdings, supra*, case. Like the claims in *Michak*, the claim in *Universal Holdings, supra*, arose from a mistake made by the title

insurance company in preparing the legal description in a preliminary commitment. In this case, however, the mistake was carried into the policy itself. The commitment recited a legal description used in a prior deed that included more property than was actually owned by the seller. A survey was prepared for an extended title policy, and the surveyor also failed to correct the legal description. Deeds were prepared based on the erroneous description and an extended title policy was issued in 1994 to Universal Holdings, the buyer, containing the incorrect description.

The purchaser discovered the error when the property was being fenced. A neighbor pointed out that Universal did not own 3,000 square feet of property that had been included in the deed to Universal. Informal discussions began between the buyer and the title company, although a claim was never filed. Likewise, the title company never issued the final policy. Discussions continued, and finally, in 2000, Universal sued the title company, making a claim on the policy. The trial court dismissed the claim on the basis that Universal had never provided the title company with a statement of loss as required under the policy.

The Court of Appeals reversed. The title insurer was not able to demonstrate any prejudice arising from the fact that Universal had not made a formal demand on the policy that included a statement as to the amount of monetary loss. In addition, the reliance on the claim procedures contained in the policy as a defense to the lawsuit was inappropriate since the policy had never been delivered to Universal. The policy was finally produced during the discovery phase of the litigation.

Transnation cannot be heard to argue that this lawsuit is premature based on language in a policy of title insurances that its insured never even saw until after it filed the lawsuit. Although it is true that Transnation wrote to Universal asking it to furnish a written statement of loss, and Universal responded by telephone instead of in writing, such a letter is simply not an adequate substitute for the policy itself. *Universal Holdings* at p. 70.

All three of these cases arose from mistakes made in preparing legal descriptions. In allocating the risk of loss associated with these mistakes: (i) escrow agents, in the absence of written instructions to the contrary, have no duty to advise the parties of discrepancies in legal descriptions between the purchase agreement and closing documents; (2) title companies are free to modify preliminary commitments to correct erroneous legal descriptions in transactions prior to closing so long as notice of the change is provided to the parties to the transaction; and (3) title companies are not able to use the claim procedures detailed in their policies as a defense to claims arising from erroneous descriptions in policies in the absence of showing prejudice from the failure to follow the procedure – particularly when the policy outlining those claim procedures is never delivered to the insured.

Technology for Lawyers: Great Web Sites for Estate Planning and Tax Lawyers

by Jody M. McCormick, Witherspoon, Kelley, Davenport & Toole, P.S., Spokane and
Brian J. Danzig, Lane Powell Spears Lubersky, LLP, Seattle

In the interest of parity and as a follow up on our Spring 2003 technology article entitled "Ten Great Web Sites for Real Property Lawyers," we have compiled a list of some of our colleagues favorite sites that offer information for the estate planning and tax lawyer.

1. <http://www.irs.gov>. This is the Internal Revenue Service's official site. The site provides IRS forms and publications. Many forms are "fill in the blank" forms that can be completed and saved in pdf format.
2. <http://dor.wa.gov>. This site provides Washington tax information, including state forms and tax related states, rules, advisories, Washington Tax Decisions and information on draft rules. This site also offers a search capacity called "Taxpedia" - a tax encyclopedia. Taxpedia allows the user to search essentially all of the above-described state tax related materials.
3. <http://www.wsbarppt.com>. The Real Property Probate and Trust Section website provides a great deal of information for the estate planner. For example, there is currently a transfer tax exemption table and information on recent state revenue rulings posted on the home page. It also provides links to other information of interest to the estate planning lawyer.
4. Various organizations serving estate planning professionals have their own web sites with differing degrees of information and links available to the public and to members. The following sites may be of interest to Washington estate planners:
<http://www.actec.org> - American College of Trust and Estate Counsel.
5. <http://www.epcseattle.org> - Estate Planning Council of Seattle.
<http://www.tacomaestateplanning.com> - Tacoma Estate Planning Council.
<http://www.abanet.org/tax/home.html> - American Bar Association Tax Section.
6. <http://vls.law.vill.edu/prof/maule/taxmaster/taxhome.htm>. This site calls itself "The Tax Master Homepage." It was created by law students under the supervision of Professor James Edward Maule of Villanova University School of Law. It has an amazing amount of tax information and links to much more, including tax calculators, tax articles, state and federal statutes, etc. Watch out - you can get lost in this site.
7. <http://www.finance.cch.com/sohoApplets/Tax1040.html>. There are several tax calculators available on the web. This is just one. Be sure to confirm that the tax calculator you are using is for the current tax year.
8. <http://personal.fidelity.com/planning/estate>. Click on "estate tax calculator" for the same.

There is a tremendous amount of tax information available on the Internet. There is so much information that it is easy to "click" your way into dated or unreliable sources. However, a discerning tax lawyer will find helpful tax information at his or her finger tips.

HOW TO REACH US

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