



MATTIONI, LTD.

COUNSELORS AT LAW

Newsletter

April 1, 2008
Volume 1 Issue 2

Mattioni, Ltd., 399 Market Street, Suite 200, Philadelphia, PA 19106
www.mattioni.com firmmail@Mattioni.com (215)-629-1600

The Realty Transfer Tax: Why Inconsistencies in Law and Practice May Effect You

By Lauren M. Reap, Esquire

Real estate investors often enter into agreements of sale to purchase a property with the goal of assigning the purchase rights to third party developers. The investor may acquire permits or the right to develop the property prior to assigning the right to purchase. The ultimate developer will pay a premium because the delay and expense of seeking development approvals has been borne by the real estate investor. The developer escapes the uncertainty of the approval process, while the original investor does not face the cost of actually developing the property. Until now, such an assignment was not considered a transfer subject to the transfer tax.

Please see *The Realty Transfer Tax: Why Inconsistencies...* on page 2

INSIDE THIS ISSUE

- 1 The Realty Transfer Tax:
Why Inconsistencies in Law
and Practice May Effect
You
- 1 Care Should Be Taken
When Using a Letter Of
Intent
- 6 Saying Goodbye to
"Stepped-Up" Basis (at
least temporarily)
- 8 Firm News and Updates

Care Should Be Taken When Using a Letter Of Intent

By Patricia M. O'Neill, Esquire

A letter of intent is often used prior to entering into a formal agreement for purposes of outlining the terms and conditions of an agreement between parties. Letters of intent are often used in complex transactions that require extensive negotiations. They allow parties to negotiate additional terms and conditions of the ultimate agreement. In addition to allowing parties to identify and agree upon basic terms and conditions, a letter of intent can also notify others that the parties are in the process of negotiation and provide safeguards in the event negotiations fail.

Please see *Care Should Be Taken When Using a Letter Of Intent* on page 3

The Realty Transfer Tax: Why Inconsistencies... from page 1

According to Pennsylvania Statute, the Realty Transfer Tax (“Tax”) will be imposed on: “Every person who makes, executes, delivers, accepts or presents for recording any document or in whose behalf any document is made . . . shall be subject to pay for and in respect to the transaction or any part thereof . . . a State tax at the rate of one per cent of the value of the real estate represented by such document” *72 P.S. c 8102-C*. Thus, the Tax is applied to deeds used in the transfer of title of property, but, until recently, not to agreements of sale or to assignments of such agreements.

The Pennsylvania Supreme Court affirmed the application of the Tax under the formula followed by Pennsylvania Statute in its decision in *Allebach v. Commonwealth Department of Finance and Revenue*, 683 A.2d 625 (Pa. 1996). In that case, the Allebachs were entered into an Agreement of Sale in April to sell 61 acres of property for \$610,000.00, contingent upon the Buyer obtaining subdivision and other approvals. After subsequent assignments of the right to purchase the property, the ultimate buyer paid \$3,200,000.00, to with all but the initial agreed purchase price being paid to third parties for the assignment of the right to purchase the property. The Allebachs paid the Tax on the consideration received of \$657,828.00.

The Department of Revenue sought Tax from the original seller on a \$3,200,000.00 transfer, claiming that was the amount the buyer paid for the right to purchase the property. The Allebachs appealed the decisions of the Board of Appeals and Board of Finance and Revenue, who sustained the Department of Revenue’s decision, to the Commonwealth Court. The Commonwealth Court reversed the administrative decisions because none of the formulas for valuing property under the Realty Transfer Act resulted in imposition of the tax on the \$3,200,000.00 assignment fee.

The Supreme Court affirmed the Commonwealth Court’s decision, explaining that the fourth definition of property “value,” did not include executory contracts not involving construction. Further, the Court held that the Allebachs did not owe tax on the \$3,200,000.00 because they were not a party to the agreements involving exchange of that money. It stated that the definition of “value” only included imposition of the Tax on executory agreements to which the grantor is a party. The Court rejected the Department of Revenue’s claim that there was a “joint venture” through which the Allebachs could be considered parties to the subsequent executory agreements. Thus, the Court made it clear that subsequent agreements assigning purchase rights are not subject to the Tax.



The Realty Transfer Tax: Why Inconsistencies... cont. on page 3

The Realty Transfer Tax: Why Inconsistencies... cont. from page 2

In 2007, the Department of Revenue promulgated new regulations, which directly contradict the Supreme Court's *Allebach* decision. Effective December 2007, the regulations provide that the Tax will apply to the ultimate purchase price underlying a conveyance of property, which includes the sums paid by subsequent assignees of purchase rights. The Seller will remain responsible for paying the Tax only on the sum it receives as documented on the Deed. However, any and all additional sums paid by subsequent assignees through however many executory agreements are involved, will be the responsibility of the Grantee listed on the deed. Therefore, both deed transfers and executory assignments will be subject to the Tax under the new regulations.

It remains to be seen how the courts will resolve the conflict between the new regulations and the *Allebach* decision. What is clear is that anyone receiving an assignment of a right to purchase real estate is likely to face a claim for Tax on the price paid for the assignment. This should be taken into consideration when structuring the purchase of real estate.

This article provides general information about legal issues. It is not a comprehensive article regarding all of the issues involved in the transfer of real estate. The facts and circumstances of every transfer will vary and lead to different results. Anyone with questions or contemplating the use of an assignment in the transfer of real estate should contact the appropriate professional for advice on the implications of such a transaction.

“Effective December 2007, the regulations provide that the Tax will apply to the ultimate purchase price underlying a conveyance of property, which includes the sums paid by subsequent assignees of purchase rights.”

Care Should Be Taken When Using a Letter of Intent from page 1

A letter of intent may resemble a contract, however, most are non-binding. However, letters of intent may contain binding provisions, such as a duty to negotiate in good faith and non-disclosure statements. Also, if a letter of intent closely resembles a formal contract, the letter may be partially or fully binding on the parties. In a recent case, *WP 851 Associates, L.P. v. Wachovia Bank, N.A.*, 2008 U.S. Dist. LEXIS 2211 (E.D. Pa. 2008), the United States District Court for the Eastern District of Pennsylvania determined whether a provision in a letter of intent to that effect. Court's will not find an implicit duty to negotiate in good faith.

The dispute in *WP 851* arose when WP 851 Associates, L.P. (“WP 851”) as landlord entered to lease property where Wachovia Bank (“Wachovia”) planned to build and operate a bank. Wachovia sent WP 851 a draft letter of intent which contained proposed lease terms and conditions. In response to the draft, WP 851's agent sent Wachovia an e-mail “confirming” that the parties had reached an

Care Should Be Taken When Using a Letter of Intent cont. on page 4

Care Should Be Taken When Using a Letter of Intent cont. from page 3

agreement and requesting information regarding the preparation of the lease. An initial draft "Agreement of Ground Lease" was then forwarded to WP 851 by Wachovia. Subsequently, numerous revisions and comments were made by each party to the draft Lease. Wachovia failed to respond or comment on the changes of the draft and ultimately advised WP 851 that it would not be leasing the premises, but was pursuing "another opportunity" with another owner for different property.



Wachovia and WP 851 never executed the letter of intent, however, WP 851 alleged that the parties agreed that each would abide by the "material terms" in the letter of intent, including the precise location of the premises, the term of the lease, and the amount of rent. When negotiations collapsed, WP 851 sued Wachovia for breach of contract, fraud, promissory estoppel, and breach of the duty to negotiate in good faith. Wachovia, claimed that it never reached an agreement that would constitute an enforceable contract and moved to dismiss of WP 851's claims. The District Court granted the motion as to claims of fraud and breach of duty to negotiate in good faith. Regarding the claim for breach of duty to negotiate in good faith, the District Court noted that although the Pennsylvania Supreme Court "has not found that a cause of action for breach of a duty to negotiate in good faith exists under Pennsylvania law, the Court of Appeals for the Third Circuit has predicted that the Pennsylvania Supreme Court would find that an agreement to negotiate in good faith would be enforceable if it meets the requisite elements of a contract." Factors to be considered in determining whether there is an agreement include: whether both parties manifest an intention to be bound by the agreement; whether the terms of the agreement were sufficiently definite to be enforced; and whether there was consideration for the agreement to negotiate in good faith. In reaching its decision in *WP 851*, the District Court also turned to two decisions by the Third Circuit Court of Appeals. *Channel Home Ctrs. v. Grossman*, 795 F.2d 291, 299 (3d Cir. 1986), was a dispute involving a letter of intent for a commercial real estate lease. The Third Circuit found that where the defendant "unequivocally promised" in a letter of intent to withdraw a piece of property from the market, and agreed to only negotiate with the plaintiff "to completion" an enforceable duty to negotiate in good faith arose. The Court reviewed the detail of the letter and the subsequent actions of the parties in determining the parties' intent to be bound by the terms of the letter of intent. Similarly, in another decision in *U.S.A. Machinery Corp. v. CSC Ltd.*, 184 F.3d 257 (3d Cir. 1999), the Third Circuit reasoned that there can be no duty to negotiate in good faith unless the parties establish a definite term or assent to be unequivocally bound. Where there is

Care Should Be Taken When Using a Letter of Intent cont. on page 5

Care Should Be Taken When Using a Letter of Intent cont. from page 4

“no detailed expression of the parties’ intent” the court will not find an intent to be bound.

In considering the requisite elements of a contract and the Third Circuit’s decisions, the District Court in *WP 851* held that the letter of intent’s provision for a duty to negotiate in good faith was unenforceable. The written terms of the letter of intent between Wachovia and WP 851 did not support such a duty, it expressly stated that it was not enforceable. Furthermore, the letter of intent did not require Wachovia to negotiate in good faith, but only placed this obligation on the landlord.

Finally, the District Court noted that “the duty to negotiate in good faith is not an implicit component of every contract. Pennsylvania, the courts require “not only an intent to be bound to *an* agreement, but an agreement to negotiate in good faith.” Absent an express provision or “unequivocal promise” expressing the mutual assent of the parties to negotiate a deal in good faith, such a duty will not be imposed on the parties.” Since the alleged letter of intent between Wachovia and WP 851 did not contain an adequate expression, the District Court refused to hold that such a duty could be implied and dismissed WP 851’s claim.

Although there is no common law duty to negotiate in good faith pursuant to a letter of intent, such an obligation can be created by the letters express terms. In Pennsylvania, the parties to a letter of intent must expressly state a specific intent to negotiate in good faith in order for that agreement to be enforceable. Specific facts or situations will lead to different outcomes depending on the language of the letter of intent itself. A party using a letter of intent should do so carefully and with a specific goal or reason for doing so. Any letter of intent should be carefully drafted with precise language to avoid ambiguities as to why it is being utilized and its intended legal effect. Therefore, anyone with questions regarding a letter of intent or specific provisions should consult with an attorney. This article is intended only to provide general information regarding the use of letters of intent, and is not a comprehensive review.



Saying Goodbye to “Stepped-Up” Basis (at least temporarily)

As is often the case in tax-law changes, when some taxpayers win, others lose. That will be the case in 2010 when, under current law, the federal estate tax disappears (at least for that year; to reappear in a modified form in 2011). Ironically, some heirs will find they owe more in taxes during the exemption year than they would if the tax had remained in place. For some taxpayers, the 2010 change is not tax relief, but actually a tax increase in disguise.

When the federal estate tax “temporarily” expires in 2010, the practice of receiving a stepped-up basis on property received through someone’s estate will no longer exist. Instead, beneficiaries of assets will take the decedent’s basis, commonly referred to as the “carryover” basis. This change can be significant because if the beneficiary decides to sell the asset he or she received from an estate, all the gain or appreciation that accrued during the decedent’s lifetime will be realized and taxable to the beneficiary.

Currently, the Internal Revenue Code Section 1014 provides that an individual who “acquires” property from a decedent may use as its income tax basis the fair market value of the property at the date of the decedent’s death. This stepped-up basis applies to property “acquired by bequest, devise, or inheritance, or by the decedent’s estate from the decedent. . .” This means that whether the decedent has a will or dies intestate (without a will), the beneficiary is eligible for the higher basis. This generates a significant tax savings for the beneficiary because the only taxable appreciation is the increase in value to the property between the date of death and the time the asset is sold. This provides a strong incentive to hold low basis property until death to achieve the stepped up valuation for heirs. For this reason, elderly people with appreciated assets often keep them.

But in 2010, heirs must assume the decedent’s basis in the property which may generate a significant capital gains tax. Since some property will have greatly appreciated over the years, lawmakers decided to give heirs some basis consideration by allowing \$1.3 million of inherited property to receive a step-up in basis, with surviving spouses getting an additional \$3 million, bringing the basis total for a widow or widower to \$4.3 million. While that basis consideration seems substantial, some individuals, particularly “non-spousal” heirs, will find that the step-up change will create capital gains issues they did not have to deal with when the estate tax was in force.

Obviously, the greater the appreciation of an inherited asset, the more valuable the step-up option becomes. In many cases, an estate’s largest asset is the family home. Beneficiaries of this type of



Saying Goodbye to "Stepped-Up" Basis (at least temporarily) cont. from page 6

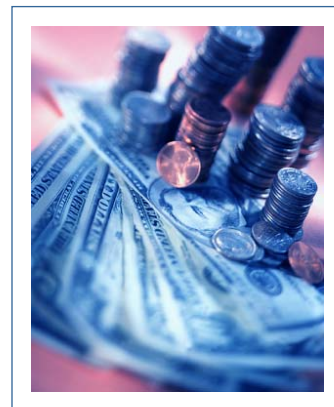
asset often decide to sell it so they can have cash to use for other needs. However, if the home experienced a huge increase in value over the many years the decedent owned it, the basis cap of \$1.3 million in 2010 could create a huge capital gains tax problem for beneficiaries.

By way of illustration, assume your widowed father passes away this year. You are your father's only heir, and his \$2 million home is the only asset in his estate. Under the current rules, his estate (the house) is not subject to federal estate tax since up to \$2 million is exempt (the amount increases to \$3.5 million in 2009). Under the current stepped-up basis rule, if you decided to turn around and sell the house, you would only have to pay tax on the difference between the market value of the house on the date your father died and the actual sales price.

So, if the fair market value on the date of death was \$2 million and you sold the house for that price, no capital gains tax would be owed. Keep in mind that we are only discussing income tax and not inheritance tax, or any applicable state transfer taxes.

However, if we took the same scenario and applied it to the tax changes of 2010, it would produce a much different result. If your father died in 2010 and left the same \$2 million home to you, you the heir, would not get away tax free. The basis issue looms large in your decision to sell the house. Rather than being able to use the \$2 million market value as basis, you can now only claim a basis of \$1.3 million. That means a sale price of \$2 million resulting in a \$700,000 profit, on which capital gains taxes of approximately \$105,000 would have to be paid by **YOU**. No longer will your father's estate be able to eliminate the realized gain on the property. The loss of the advantageous step-up in basis can be quite costly.

This article provides general information regarding federal estate and income tax issues. Every situation is different and anyone with questions regarding estate planning should contact the appropriate professional, such as an attorney or financial planner.



Firm News and Updates

Herbert Ocks joined the firm in March, 2008 in an of counsel position. Herb will practice in the estate planning and estate administration areas. Herb brings more than 50 years of legal experience to the firm. . . . Antoinette Falciani will be joining the firm in April, 2008 as an associate and resident attorney in the Firm's Swedesboro, New Jersey office. Antoinette will handle general litigation and business law matters. . . . John Mattioni was named by Mayor Nutter to the Historical Commission in Philadelphia. The Historical Commission enforces and grants variances from the requirements of the historic preservation ordinance in Philadelphia. . . . Michael Mattioni was re-elected as Vice Chair of the Board of Old City District. Old City District is a business improvement district that works to keep the Old City neighborhood clean and safe.

MATTIONI, LTD.

COUNSELORS AT LAW

Philadelphia Office

399 Market Street
Suite 200
Philadelphia, PA 19106

Phone:
(215)-629-1600

Fax:
(215)-923-2227

E-mail:
firmmail@Mattioni.com

New Jersey Office

1316 Kings Highway
Swedesboro, NJ 08085

Phone:
(856)-241-9779

Fax:
(856)-241-9989

Montgomery County Office

509 Swede Street
Norristown, PA 19401

Phone:
(484)-322-0886

Fax:
(484)-322-0887