

REAL ESTATE ISSUES®

Published by THE COUNSELORS OF REAL ESTATE® Volume 40, Number 1, 2015



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Third class postage paid in Chicago. *Real Estate Issues*® publishes three times annually. Subscription rates are: \$60 for one year (3 issues); \$99 for two years; \$120 for three years; \$52 per year to students and faculty; \$85 for two years; \$97 for three years; \$67 for one year (3 issues) foreign rate, \$115 for two years; \$142 for three years - submit in U.S. currency; single copy \$25. Remittance may be made by credit card or personal check, payable to The Counselors of Real Estate. Remittance, change of address notices, undeliverable copies, orders for subscriptions and editorial material should be sent to *Real Estate Issues*. The Counselors of Real Estate, 430 N. Michigan Ave., Chicago, IL, 60611. Phone 312.329.8427; Fax: 312.329.8881; Email: info@cre.org; Website: www.cre.org. Library of Congress card number LC 76-55075.

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Although a Dealer in real estate normally will not realize capital gain, with sales normally generating ordinary income, this article examines a recent case where the "Dealer" was able to support the position that for this given piece of property, capital gain was allowed. (This case follows some older authority on this same issue that supports unique circumstances that can support capital gain for one who is normally reporting all ordinary income as a Dealer.)

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Valuing the Leased Fee Simple Estate: The Answer for Ad Valorem Taxation Issues

Thomas W. Hamilton, Ph.D., CRE, MAI

The real estate appraisal profession has for years discussed various types of ownership interests in real property that can be valued. Of these, the leased fee and the fee simple have drawn significant attention as to their proper use in various appraisal assignments. What this article presents is a fresh view on the topic of valuing leased property and how this fresh view addresses many of the issues raised by David Lennhoff, CRE, in a recent *Real Estate Issues* dealing with answering the "wrong question." This fresh look on valuing leased property helps the appraiser to define markets more clearly and concisely, and guides the appraiser to conclude the unsurpassed highest and best use of the property being appraised

RESOURCE REVIEWS

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Making a Living, Making a Life

Reviewed by Bowen H. 'Buzz' McCoy, CRE

Daniel Rose, CRE, has had an extraordinary business career including developing Pentagon City in Washington D.C., and One Financial Center in Boston. He developed Manhattan Plaza for the Performing Arts in New York City. He is not only an icon of the past 60 years of real estate development, but he is also an acclaimed, treasured and award winning essayist and public speaker.

This book is a wonderful antidote to "Trumpism," according to reviewer Buzz McCoy, and can make a fine gift from a parent or mentor to a younger person. It elevates the possibility of leading a successful business life (even as a developer!) together with a successful personal life, while keeping the faith and without having to become a billionaire.

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Placemaking: Innovations In New Communities

Reviewed by Peter C. Burley, CRE, FRICS

Mahlon 'Sandy' Apgar IV, CRE, joins a continuing discussion on the effort to create healthier, sustainable living environments that enhance the social and economic well-being of those who reside within them. The literature has been fairly extensive, particularly over the past couple of decades, and not without controversy and debate throughout the planning and real estate communities. Reviewer Peter Burley, CRE, agrees with Apgar that this relatively short work is "work in progress," as planners and policymakers will need to reach out proactively to deal with social, demographic and economic changes.

LEGAL REVIEW

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This new section will feature summaries of recent judicial decisions, legislative and regulatory updates, or other legal news that concerns the real estate industry. Summaries can refer to published case law, news items, blogs and other reference materials. To provide a summary, email REI@cre.org. In this issue, there is one summary:

New Jersey Supreme Court Decides No Statute Of Limitations Applicable to Spill Act Contribution Claims

Joseph J. Maraziti, Jr., Esq., CRE and Joanne Vos, Esq.

Editor's Note

BY MARY C. BUJOLD, CRE



“Events that seem improbable appear to be occurring with increasing frequency and the immediacy of global communication and connectivity magnify the outcomes.”

I must begin with an apology for the delay in getting our first issue out to you. Scheduling for our Roundtable Discussion has been challenging, but we are continuing to pursue important topics for these discussions among our members, here in the United States and abroad. Continue to look for these roundtables in upcoming issues of REI.

Our second issue for this year, which will be published in the late fall will focus on water and water-related real estate topics. This continues to be top of mind for many and especially for those in drought-ridden states and as global warming warns us of sea-level rise.

We will continue to focus on sourcing articles for the Top Ten as we have space in the publication.

We are already thinking about 2016 and articles for the upcoming year. Look for an additional roundtable discussion, and subject matter on housing and overseas markets.

We had postponed a review of a couple of books that we had in mind and we will be bringing those forward in coming issues.

It seems these days that I am frequently reminded of Nassim Taleb's book *The Black Swan*. Events that seem improbable appear to be occurring with increasing frequency and the immediacy of global communication and connectivity magnify the outcomes.

Is it that these events have a high level of improbability or is our world shifting exponentially so that what originally appeared to have been improbable is now appearing with greater regularity?

An interesting concept.

We are always looking for articles and I am always thankful to the REI Editorial Board and staff for their ideas, input and willingness to contribute.

A handwritten signature in black ink that reads "Mary C. Bujold". The signature is fluid and cursive.

MARY C. BUJOLD, CRE
EDITOR IN CHIEF

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The Counselors of Real Estate® is seeking original manuscripts for publication in *Real Estate Issues* (REI), a peer-reviewed journal published three times annually. The journal reaches a lucrative segment of the real estate industry as well as a representative cross-section of professionals in related industries.

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Building a 24-hour City: "Just Imagine Real Estate in 2030"

BY HUGH F. KELLY, Ph.D., CRE

*Presented at the 9th RED Business Forum,
Athens, Greece, October 13, 2014*

IT IS AN HONOR AND A PLEASURE TO BE HERE TODAY IN Athens, for this very special conference. I'm taken with the conference's overall title, "Inventing the Future — Invest in the Future."

The future is not just something that blows in! It is powerful like the wind, to be sure. Our predecessors here in Athens called "power" *dunamis*. We face the future as a dynamic force. But we don't wait for it passively. We act.

The word "invent" is derived from Latin "*in-venire*," to come into. That's its first meaning: **we are coming into** the future city, **we are entering** it. But since the 16th century "invent" has also meant to discover, to think up, to produce by creative thought. And surely **that's our challenge for the city of 2030 — to produce it in a creative way.**

Just as interesting is the word "invest." Its oldest meaning is to put on clothes. In some sense **we "put on" our future city.** Since the 17th century — and we have the Dutch East Indies Company to thank for this — "invest" has meant **"the conversion of money to property in hopes of profit."** We not only produce our future by the power of creative thinking, we do so by means of putting money to work, through property, in order to earn a return.¹

Isn't that what cities have always been about? In ancient Athens, the Greeks gathered in the *agora* for commerce and for the business of the *polis*, the work of the citizens. This is politics in Aristotle's sense of the word, the *Politeia* that Plato reflected upon in *The Republic*.²

So even though we want to concentrate on the future city, the one that we'll be creatively producing, especially by our investment, we need to think a little bit about cities in history. Invention is not a god-like process — creation *ex nihilo*. The city of the future emerges from the city of the past and the present. And we need to understand that, to reflect upon that history.

About the Author



Hugh F. Kelly, Ph.D., CRE, has been a member of The Counselors of Real Estate since 1989. Formerly Chief Economist at Landauer Associates, he presently serves clients as the Principal of Hugh Kelly Real Estate Economics. Hugh is a Clinical Professor of Real Estate at NYU's Schack Institute of Real Estate, and editor-in-chief of the school's real estate magazine, *Premises*. In 2014, he served as the Counselors' Chair of the Board of Directors.

As always, we owe a debt to Greece. Herodotus was not only the Father of History, but the first historian of cities. What do we learn about cities through history?

Well, first that they are the key to civilization. According to Sir Peter Hall's magisterial book, *Cities in Civilization*, Athens is the fountainhead, followed by Florence in the Renaissance. London in the Elizabethan era advanced drama, Vienna did the same for music. Paris gave us a new language of painting, first with Monet, Degas, Cezanne, Sisley, and Renoir, followed by Picasso, Braque, Utrillo, Modigliani, and Toulouse-Lautrec. Early 20th century Berlin probed our irrationality with the theatre of Brecht, Piscator, and Weill, clued us into its urban dimension with Fritz Lang's film "Metropolis," and exposed the disintegration of Western values with the rise of National Socialism.³ **Our question is, "Where will cities lead us next?" Or, more pertinently, where will we take our cities?**

A second point is that cities are never to be considered in isolation: cities are always situated in a broader regional context. Although we've known the specialized functions of cities since the time of Herodotus, we've gotten progressively more sophisticated in our understanding

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of the spatial characteristics of economies. Starting with pioneering work by Von Thunen, Cristaller, and Losch, we have come to think more and more about **systems of cities, their hierarchies and their networks.**⁴

Third, that **context is often global in scope**, especially as regards the network of cities seen in commercial trade. Konichi Ohmae, the former senior partner running McKinsey & Co.'s Asian practice, has argued in books like *The Borderless World* and *The End of the Nation-State*⁵ that cities and their regions are the most effective agents in the world economy. How New York relates to London, how San Francisco deals with Shanghai, how Houston interacts with Riyadh, how Miami is linked to Bogota — these define our economic world in a globalized network. My organization — The Counselors of Real Estate — will be convening a conference in early 2016 on the subject "Global Cities in an Era of Change," co-sponsored by RICS and by Stanford University in Silicon Valley — a follow-up to a similar conference we held at Harvard in 2002.

Fourth, **cities are centers of capital, in all its forms — physical, financial, and human capital.** More than half the world's population now lives in urban areas — a tipping point reached just a couple of years ago, the first time in human history that this has been the case. The concentration of people, buildings and money becomes one of the 21st century's defining features.

Just to use my own country, the United States, as an example, we can see the relative disproportion vividly. The ten largest cities⁶ have an aggregate population of about 25 million, or 7.8 percent of the country's total. But their downtown office markets represent 18.8 percent of the national TOTAL office space, and their metro areas account for an incredible 45 percent of all the nation's office area.⁷ And the TOP TEN doesn't include Atlanta, Boston, San Francisco, Miami, Washington, D.C., or other major cities you might think of. The largest ten metros in population produce 32.7 percent of all goods and services produced by the nation's 381 metropolitan areas. Our big cities punch above their weight whether measured by physical capital or economic contribution.

Remember, too, that the U.S. is atypical in that it does not have one "primate city," a city that dominates its national economy, as London and Paris do, as Athens does. Buenos Aires fills such a role, as do Cairo, Dublin, Mexico City, Seoul, and Vienna — among others. Countries with primate cities are even more driven than the United States by what's happening in their centers of physical, financial, and human capital.

And rounding out the list as a fifth observation, **cities are the driving force behind innovation.** They are not only the locus of human achievement, they are the places where human problems are most acute, most visible, and most in need of resolution.

This was true in the industrial revolution and it is no less true right now. Research by Deborah Strumsky of UNC-Charlotte, Jose Lobo of ASU and others has shown that 63 percent of U.S. patents are generated by just twenty metro areas.⁸ Bruce Katz and Julie Wagner at the Brookings Institution issued a report last summer discussing what they call "Innovation Districts," places where innovative firms and talented workers are "choosing to concentrate and co-locate in compact, amenity-rich enclaves in the core of central cities." **Cities turn out to be hotbeds of entrepreneurship.**⁹

These five attributes — historical, yet contemporary and shaping our future — are absolutely germane to our headline topic of inventing and investing. They are also critically important to understanding the phenomenon of 24-hour cities, their characteristics, their economic and real estate performance, and their future.

It's a curious term — "the 24-hour city." It feels like it has been around forever, but the publication *Emerging Trends in Real Estate* claims to have coined it in 1994, just 20 years ago. The assertion published back then was that 24-hour cities would produce superior real estate investment performance compared with those cities whose downtowns were truly just Central Business Districts — places where commuters came to work from 9 a.m. to 5 p.m., and they headed home to residential suburbs. *Emerging Trends* over the years has evolved the term to characterize Live-Work-Play urban environments. The salient features are a mix of uses (housing, retail, office), good public transportation access, a safe and secure environment, attractive neighborhoods proximate to downtown and a multidimensional range of recreational/cultural amenities.

Emerging Trends' approach presented a descriptive definition only. My own research¹⁰ has sought to measure the variables, so that an operational distinction can be made between 24-hour cities and the far more numerous cities that have more restricted activity. Using, as a working hypothesis, two sets of cities discussed over the years as "24-hour" or "9-to-5" by *Emerging Trends*, a criteria set measurably distinguishing the two types of city was discovered. Here it is.¹¹

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24-hour cities have at least four of the following six characteristics:

- More than 13 percent of daily automobile traffic between the hours of 9 p.m. and 5 a.m.
- More than 25 drug stores open 24-hours, within 10 miles of the city center.
- City Population density of 9,000 per square mile or greater.
- A Regional Distinctiveness Rank¹² above 20.
- A Crime Rate lower than 6,000 per 100,000 population.
- More than 38 percent of workers using non-auto transportation to commute.

None of the listed 9-to-5 cities satisfy more than two of the criteria. New York satisfies all six; Boston, Chicago, San Francisco, and Washington, D.C., meet five of the standards; Las Vegas and Miami satisfy four.

The identified criteria were found to be strongly correlated with other attributes including large downtown residential populations, strong Walkscores, significant college and university populations, and the number of "Edge Cities" within the metropolitan area.

So there do exist measurable criteria that we can use to target the "24-hour-ness" of specific cities. The question remains, what difference does it make for real estate investment?

Until recently, the real estate industry *believed* that 24-hour cities would produce superior investment results but had never rigorously tested the proposition. I believe that my doctoral research was the first such test, and I'm very happy that the academic literature is now beginning to build off that research foundation.¹³ Statistically significant differences in office space density, occupancy measures, rents, operating ratios, cumulative investment returns and transaction prices all emerge from the data.

Although they were roughly equal in population and employment in the 2000 US Census, the 24-hour cluster has 1.3 billion square feet at the Metropolitan Statistical Area (MSA) level, versus 760 million square feet for the 9-to-5 cluster. At the Central Business District (CBD) level, the 24-hour markets have 3.6 times the volume of office buildings when compared with 9-to-5 downtowns, 737 million square feet versus 207 million.

Since 1987, 24-hour downtowns have averaged occupancy rates 5.4 percentage points better than 9-to-5 downtowns,

fluctuating in a fairly narrow range. In terms of inflation-adjusted office rents, 24-hour cities have enjoyed a \$12.36 per square foot advantage. This is partly due to higher occupancy, but begs the question of why tenants would pay more for 24-hour city locations instead of moving to lower cost cities or lower cost suburbs. The reasons are related to productivity and profits.

From a landlord's perspective, rents only tell part of the story. Although operating expenses and real estate taxes are substantially higher in 24-hour downtowns, they are not higher relative to the rental levels. The "operating expense ratio" (that is, the costs of operation divided by rent received) averages 43.2 percent for 24-hour downtowns, compared with 48.7 percent for 9-to-5 CBDs, a 5.5 percentage point difference. Owners get to keep more of the rent as net operating income in 24-hour markets.

Cumulative investment returns for 24-hour downtown offices have been twice as high as returns in 9-to-5 downtowns since 1987. Given these verified conditions, investment capital flows have been sustained at high levels. Capital sources of all kinds, domestic and international, private and public market (REITs) firms, large institutions and consortia of small investors have all combined to deploy investment disproportionately into the 24-hour cities — led by New York above all.

Using the term "disproportionately" means by comparison with the population base, with the employment base and even with the inventory of commercial space available for investment. The only measure with rough proportionality of office investment flows is a critical one: gross city product. This is critical, since it helps explain the superior real estate performance: **24-hour cities are more economically productive than 9-to-5 cities. That is, there is a 36 percent higher Gross City Product in the 24-hour cluster of Metros, and even accounting for the more recent growth of jobs an 8 percent advantage in output per worker, so that with every new worker added in a 24-hour city, the output gap widens.**

Through the first decade of the 21st century, 24-hour downtowns attracted \$231 billion in office building investment, 4.7 times the amount of investment in the comparison 9-to-5 markets. Prices reflected the capital volume differential, with 24-hour CBDs averaging a 76 percent premium in price per square foot.

Has this pattern held after the Great Recession? Yes, it has. Over the first nine months of 2014, the 24-hour downtowns saw \$36 billion in office investment, versus

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\$16.7 Billion in the 9-to-5 CBDs. The weighted average price per square foot in the 24-hour downtowns this year has been \$505, while in the 9-to-5 downtowns prices average \$207, indicating a pricing premium favoring the 24-hour cities of 144 percent. Capital volumes and pricing clearly demonstrate how investors value the attributes of 24-hour markets as supporting superior economic performance.¹⁴

If the analysis stopped here, it might warrant a pat on the back for real estate owners, but it really wouldn't cause those who care about cities to stand up and cheer. If all we found was that 24-hour cities generated high prices, what would be the lesson for the future? We need to probe, I feel, for the reasons behind the prices. **What makes for the success of the 24-hour city economy? How does the high value of its commercial property support that success? The value of the real estate has to be more than just a way of keeping score. It is a dynamic variable in the complex urban economic structure.**

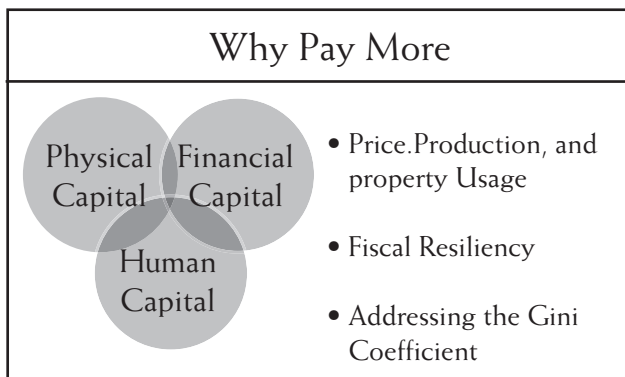
Let's look at a few of the many ways commercial real estate, in the context of 24-hour cities, impacts the urban economy. I'll pick three particulars to discuss. You can think of more, I'm sure.

PRICE, PRODUCTIVITY, AND PROPERTY USAGE

Why in the world would tenants pay high rents in the most expensive cities, and why would investors believe that competition would not bring the stratospheric prices of the "superstar cities" back to earth?

The answer lies at the intersection of physical, financial, and human capital. Obviously, the preference for 24-hour city investments — from both domestic and worldwide capital sources — is the financial circle in this Venn diagram. Figure 1 Below.

Figure 1



The physical capital issue is two-fold.

- At the level of the property, 24-hour cities support the usage of commercial space for longer periods each day. Firms realize that their rent pays for space that is in place 24-hours each day, every day of the year. However, they only get value from that space when their employees are at work. In 24-hour cities, offices do not "go dark" in the evening as they do in cities where the workforce jumps in their cars by 6 p.m. and heads home for the suburbs. With more intensive utilization of the space over time, company revenues expand. Space in use is a productive asset; idle space is unprofitable.
- At the level of the city, we recognize a similar dynamic. Cities have tremendous investment in infrastructure of all kinds: transportation, communications, utilities, and so forth. If *that* capacity is idle for more than half the time each day, there is money going to waste. Take highways, for example. Cities build road capacity for peak usage: the rush hours. For 9-to-5 cities, those highways are virtually empty after nine or ten in the evening. That's true even in traffic-clogged Los Angeles, Atlanta and Dallas. But traffic studies paint a very different picture for New York, Miami, Chicago and San Francisco. What's true of traffic is also true of electrical usage. We build for peak capacity everywhere, but cities have vastly different off-peak usage patterns. 24-hour markets are more efficient in their use of public physical capital, as well as commercial physical capital. That makes them more sustainable environmentally as well.

A RESILIENT FISCAL PLATFORM

The confluence of real estate market factors has resulted in a reliable, deep, and broadly distributed commercial property tax base in 24-hour markets. This is a key to fiscal resilience in the face of shocks, whether economic, political, or environmental. In a world where event risk increasingly dominates business strategic planning discussions, and where investors need to protect their downside risk, the resilience of a city cannot be stressed too strongly. Every place — New York, Washington, New Orleans, Madrid, London, Mumbai, Tel Aviv and Athens — is subject to shocks, to "black swan" events. Although we do everything we can to mitigate the risks, bad things will happen. The key question is whether and how the cities can bounce back.

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After 9/11, for example, New York was faced with vast challenges, beginning with the clean-up of Ground Zero at the World Trade Center site, but including the damage to transportation infrastructure, communications systems and the strain on the City's health and public safety networks. Federal aid helped, but New York needed to rely on its own resources as the primary foundation for economic recovery, provision of public services and plans for future growth. The same story can be told for the devastation visited on the City by Mother Nature in the form of Superstorm Sandy a couple of years ago and by our self-inflicted financial meltdown in 2008.

How could New York afford to absorb these shocks and not only regain balance, but grow at a faster rate than the nation over the past dozen or more years? A large component of New York's fiscal platform is the \$21 billion collected from the property tax, which of course is a function of the value of the real estate. As we've seen, that value is linked to the city's 24-hour character, which in turn enhances its overall economic vitality. Just as a healthy body is more disease resistant than a weakened body, so healthy cities can resist both generalized economic illness and recover from acute trauma. Long-term commercial leases undergird reliable cash flow for office buildings, and it is that reliable cash flow that permits New York to undertake long-range planning to fund its operations, provide services, and expand its physical capital, as it does in PlaNYC 2030.¹⁵

REAL ESTATE AND THE GINI COEFFICIENT

I don't want to minimize the social and economic stress that accompanies the success of the 24-hour cities. As capital flows in torrents to relatively few markets, the consequent increase in real estate prices produces real strains on affordability for businesses and households alike. Although the Occupy Wall Street movement petered out fairly swiftly, without the discipline of real organizing behind it, it did leave a legacy behind. The stark level of income inequality captured by labeling "the one percent and the 99 percent" brought this topic into public discussion to a degree not experienced before. And it turns out that some of the 24-hour cities — New York and Miami in particular — have income gaps that are among the most severe in America.¹⁶

Counterbalancing that, though, is the fact that 24-hour cities like New York, San Francisco, Boston, and Washington, D.C., rank among the top ten in income

mobility, according to the Equality of Opportunity Project — a joint effort of Harvard and University of California at Berkeley.¹⁷ 9-to-5 cities, including Atlanta, Dallas, Philadelphia and Phoenix, show much lower odds for children born into the lower one-fifth of incomes to achieve incomes in the 80th percentile or above as adults. The characteristics of the 24-hour markets — their diversity, social capital, capacity for innovation, and especially the dynamic mix of industries and occupations — appear to create a more efficient economic ladder for native-born poor and new immigrants as well.

Why might this be so? I think it is due, at least in part, to some of the unusual ways that industries combine. For example, the food and fashion industries are not only staples of New York's economy, they are industries that have many entry-level jobs, low-paying but not dead-end. But New York also is the center of the U.S. television production industry, especially the cable channels. Mix the industries together, and you have an explosion of TV "reality shows" or "competition shows" featuring restaurateurs, chefs, fashion designers and even wedding dress emporiums. What happens? First of all, the publicity increases the flow of money into New York's food and fashion sectors. But secondly, more and more enthusiastic young people who want to make their mark in food and in fashion flock to New York. Thirdly, the expansion of these industries encourage innovation and entrepreneurship — new ethnic restaurants, local artisanal bakers, brewers, food carts for gourmands; and clothing boutiques, fashion-forward small production garment makers, and all the wholesalers and retailers that connect to them. None of these need graduate university degrees, by the way. That may be one of the secrets of success. In a phrase, it is not just the 24-hour city ingredients, it is a recipe, a chemistry of how those ingredients interact. That chemistry is what we most urgently need to research next.

Pertinently, real estate also offers such an income mobility ladder. Even in the prospering 24-hour cities, ownership of income-producing property is not an oligopoly. Small apartment buildings, storefront retail, older office properties and most typical pre-World War II buildings combining such uses, are the province of entry-level purchasers with equity under a million dollars whose path to wealth lies in the addition of value to property by personal interventions — sometimes called "sweat equity." That's something not to be overlooked in cities.

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CONCLUSIONS

So what does it all mean as we try to imagine real estate in 2030? We do well to keep in mind the sage advice of Yogi Berra, the former player and manager of the New York Yankees, who said, "Forecasting is hard, especially when it is about the future." Here are a few observations, which may or may not rise to the level of prediction.

- **The world will have more cities, and many cities will be much bigger.** We are at about the 50 percent level of urbanization globally, at a population base of 7 billion. By 2050, the United Nations projects 70 percent urbanization and a population of 9 billion.¹⁸ That means the world's urban population grows from 3.5 billion to 6.3 billion in 35 years. 2030 is a milestone on that journey. That observation is neither new, nor is its forecast improbable. The amount of developed real estate on earth will certainly increase immensely in the next decade and a half.
- **Capital will be distributed unevenly. It will flow to cities disproportionately. And, amongst cities, it will flow to those places that use the capital most efficiently.** Remember, I am always speaking of all three forms of capital: physical, financial and human capital. Here's the rub: even with the globalization of capital, it is not arbitrated toward the mean, it gravitates toward the optimum. And, it is surprisingly still correlated to local sourcing. That's not likely to shift radically in so short a period of time as a decade and a half.
- The three forms of capital are not of equal weight, as far as cities are concerned. Evidence is accumulating that now, and into the future, **it will be human capital attributes that will drive the allocation of physical and financial capital.** That is a major shift in emphasis for development, requiring a re-think of incentives that heretofore have focused on subsidies for hard assets and for the owners of financial capital — large employers. Incentives need to be targeted to populations, encouraging the development of talent and of innovation, supporting human capital development while taking care not to compromise risk-taking and creativity, and the discipline of failure.
- **Fourth, the process will be messy.** Change comes in many forms, and is frequently surprising and often disruptive. In the 1970s, when Walt Disney established Disney World in Orlando, he set aside an area for EPCOT — the Experimental Prototype City of

Tomorrow. No real city has evolved that bears any resemblance to EPCOT. Why? Because Walt — and his company — had and have no tolerance for messiness. Let me commit heresy here: ***messiness is a good thing.*** Sanitized, ownership association controlled, gated communities and their new urbanism analogs eschew messiness. But **it is messy, emergent problems, that generate new solutions. The urban laboratory is not, and should not be, a sterile environment. The most successful cities will not be problem-free cities, but problem-solving cities.**

So that's our urban challenge for 2030: to invent — to produce by creative thought and action — and to invest — to convert money into assets in hope of profit. Not a simple task. But three thousand years of history, from Babylon and Athens to New York, London and Hong Kong suggest we'd be foolish to bet against our cities. Especially cities whose attributes of density and diversity, talent and tolerance, innovation and opportunity set them ahead of the game even today. ■

ENDNOTES

1. For the background on the words, "invent" and "invest," see www.etymonline.com
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4. Peter E. Lloyd and Peter Dicken, *Location in Space: A Theoretical Approach to Economic Geography* (2nd ed.), Harper & Row (New York, 1977)
5. Konichi Ohmae, *The Borderless World: Power and Strategy in the Interlinked Economy*, Harper Perennial (New York, 1999) and *The End of the Nation State: The Rise of Regional Economies*, Free Press (New York, 1995)
6. They are, in order of population, as of 2012: New York, Los Angeles, Chicago, Houston, Philadelphia, Phoenix, San Antonio, San Diego, Dallas, and San Jose.
7. Data from CBRE-EA on office inventory, U.S. Census Bureau for population, U.S. Bureau of Economic Analysis for Gross Metro Product.
8. Discussed in Emilia Istrate, Jonathan Rothwell, and Bruce Katz, "Export Nation: How U.S. Metros Lead National Export Growth and Boost Competitiveness," Brookings Institution Metropolitan Policy Program (Washington, D.C., July 2010).
9. Bruce Katz and Julie Wagner, "The Rise of Innovation Districts: A New Geography of Innovation in America," Brookings Institution Metropolitan Policy Program, (Washington D.C., May 2014)

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10. Hugh F. Kelly, *Twenty-four Hour Cities and Commercial Real Estate Performance*, Unpublished doctoral dissertation, University of Ulster (No. Ireland), 2011. See JREPM articles cited in footnote 13 for a briefer summary and for the data sources and analysis.
11. The 24-hour cities were New York, Boston, Chicago, Las Vegas, Miami, San Francisco, and Washington, DC. The 9-to-5 cities were Atlanta, Dallas, Los Angeles, Minneapolis, Philadelphia, Phoenix, and Seattle.
12. A measure developed by researchers Anne Markusen (Univ. of Minnesota) and Greg Schrock (Univ. of Illinois at Chicago), published in "The Distinctive City: Divergent Patterns of Growth, Hierarchy and Specialization," *Urban Studies* v.43, no 8, July 2006.
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15. See New York City's website at <http://www.nyc.gov/html/planyc/html/home/home.shtml>
16. Discussed by Richard Florida at <http://www.citylab.com/work/2012/10/high-inequality-us-metro-areas-compared-countries/3079/>
17. See the project's website at <http://www.equality-of-opportunity.org/>
18. United Nations population projections can be found at <http://esa.un.org/wpp/>

How Can a Developer Qualify for Capital Gain Treatment?

A Recent Case Means New Opportunity!

BY MARK LEE LEVINE, BS, JD, PAP, Ph.D., LLM

NO ONE WANTS TO PAY TAXES!

Certainly this statement reflects the feeling of most taxpayers, be they connected with real estate or otherwise.

Thus, as the title to this Note reflects, if there is a “legal” approach to avoid paying taxes at ordinary income rates, this topic should create excitement for most taxpayers.

But, it might help to backup for a moment and reflect on a few fundamental maxims that relate to the field of federal income taxes.

1. No one wants to pay any taxes.
2. If taxes are owing, the taxpayer wants to pay at the lowest rate.
3. The longer the taxpayer can delay paying taxes, *ceteris paribus*, the better it normally is for the taxpayer.

How do the three maxims present above relate then to the question at hand: How does a developer qualify to pay tax at capital gain rates?

This point relates to the first two items listed above, viz., “No one wants to pay taxes”; but, if you must pay taxes, “the taxpayer wants to pay at the lowest rate.”

Given that income is clearly subject to taxation¹ under the Internal Revenue Code,² generally by referring to Code Section 61,³ there is little likelihood that the developer in the above scenario could avoid paying tax on the income earned in connection with a real estate development.

Thus, #1, above, cannot be avoided.

Maxim #2, above, acknowledges that if taxes must be paid, the taxpayer will attempt to pay at the lowest rates

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available. This axiom begets the discussion of how taxpayers, in this case a developer, can pay at a low rate.

The general rule is that the federal income tax rate for ordinary income is that rate stated in the Code under Section 1.⁴ However, the rate is only part of what determines the amount of the tax calculation.⁵ That is, the table tells the taxpayer the rate to utilize or the multiple that is applied against the net taxable income. Yet, there is one other important adjustment, prior to applying the rate. The Code has various Sections that classify income into different types.⁶ This is important for one simple reason: The classification of the income can mean that different rates under Section 1 and other Sections of the Code apply. Not all income is taxed at the same rate given a certain set of circumstances. What circumstances? One of the most important classifications, which classification became very, very important in the *Long Case*,⁸ discussed below, as to the developer in question, is one which looks to types of income or loss generated by the taxpayer.

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The Code provides that some types of income, such as capital gain income, can be taxed at a rate lower than ordinary income.⁹ To suffice for now as to this differential, the approximate spread, on the larger side of this demarcation, is the difference of a rate of 39.6 percent, the highest ordinary income tax rate, generally speaking, and the highest capital gain rate of 20 percent.¹⁰

The essence of the discussion in this Note must, therefore, given the axioms stated above, determine how one can generate, as a developer, the lower, capital gain rate. The rules to qualify for this lower rate have normally made that goal fleeting and difficult for the developer to achieve, since, as noted below, the developer normally is unable to meet the requirements under the Code for the more favorable, lower tax rate treatment.

A recent case however, the *Long Case*,¹¹ from the 11th Circuit Court of Appeals, reversed the Tax Court, as discussed below, and supported the position of the Developer—in the limited setting of this case—to treat the millions of dollars in gain by the taxpayer as capital gain, taxed at a lower rate.

The necessary steps to follow the path of the *Long Case* for the capital gain treatment are discussed below.

WHAT DOES IT REQUIRE TO MEET THE CAPITAL GAIN TYPE TREATMENT? (HOW DID THE LONG CASE DO IT?)

Under the auspices of the Internal Revenue Code, one element that a taxpayer must meet to obtain the special lower rates for capital gain is the definition of a *capital asset*.¹² For purposes of this discussion, it should suffice that to obtain the capital transaction treatment, there needs to be a showing of two factors in the Code: a capital asset and a recognized disposition, such as a sale.¹³

There is little dispute in the *Long Case* and the other items in this Note as to what is a “disposition.” That is, normally this factor is not an area of focus as it typically is clear that there was a sale. This is true in this discussion for the most part. Thus, the focal point is on whether the asset sold by the taxpayer, to obtain the favorable tax rate, noted above, is in fact a “capital asset.” Code Section 1221, defining such asset, approaches this issue in the negative. That is, it defines a Capital Asset as everything other than eight (8) categories.¹⁴ All eight of the items referred to are not of much import for this examination, aside from two of the eight factors. Under Section 1221, the Code excludes from this special treatment of a capital asset, under its first of the eight exceptions, and hence, capital

gain treatment, those assets that are held primarily for sale to customers in the ordinary course of business. Stated succinctly, the Code does not allow an asset to be a capital asset if the asset is inventory.

Historically, one who sells inventory is normally a “dealer.” Therefore, we often see in the tax law and in other parts of business undertakings referred to as a “dealer,” that is, one who is selling inventory and not holding the property for longer term investments or use of the asset in business.¹⁵

Thus, again, the capital gain treatment will not apply if the asset is “inventory property,” that is, “dealer property.”

The other category, mentioned above, a second exception under the eight areas excluded as capital assets, involves property that is used in the trade or business of the taxpayer or is held for investment. To be clear on this setting, this means that a cash register in a shop is property “used in” (employed in) the business. It is not a capital asset. Also, property that is held for investment, such as a piece of land that was purchased many years ago with the hope for appreciation, is not a capital asset. These assets would be labeled as Code Section 1231 Assets, not as capital assets.¹⁶

Although, as mentioned, the dealer property will NOT receive the use of the lower capital gain rates, the property used in the trade or business or held for investment, i.e., the Code Section 1231 Property, has a special—and favorable—rule. Such property, although not a “capital asset,” receives in most instances the favorable capital gain treatment. That is, the gain from the sale of these assets can obtain the effective beneficial treatment of capital gain rates. This result exists because Congress endowed this Section with a special rule under Code Section 1231, allowing gain generated from the sale of such Section 1231 property to generally utilize the capital gain rates, thus helping businesses and investments.¹⁷

The taxpayer that is held to be a dealer on a given property is prevented, normally, from the capital gain/Section 1231 favorable use of the capital gain rates. However, IF—IF the taxpayer can avoid the classification of being a Dealer *on the given property in question* and can argue that the asset that was sold and generated the gain, was either a Section 1231 asset or a capital asset, the taxpayer will have “part of” the ingredients to employ the special capital gain rates on the net taxable income.¹⁸ The discussion that follows addresses some of the above issues, but the discussion is in the context of many cases that have been litigated on the issue of capital gain treatment and the elements necessary to produce such result.

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Thus, in summary, a Dealer is one that is selling property in the normal course of business. The property being sold is the inventory, otherwise known as property held for resale (not for use in the business or for investment purposes). The focal point of concern with this distinction, as stated earlier, is the tax rate that applies to gain by a dealer. The tax rate for gain by a dealer can increase to about 40 percent, whereas the maximum tax rate on gain produced from a long-term capital gain transaction is generally, on the high side, at 20 percent. This huge percent difference is what raises the interest level for taxpayers to pursue the long-term capital gain treatment in place of the ordinary income treatment.

The *Long Case* also mentioned another important ingredient to generate the favorable lower long-term capital gain treatment, viz., that the taxpayer has held the property “long-term.” That is, to gain the favorable, lower rate noted above for capital gain, the taxpayer must show that the disposition of the property was after the property was held for a “long term” period, defined in the Code as in excess of one year. This issue is examined in-depth, below.

The *Long Case* is examined in detail along with other cases that have shaped this area of Dealer taxation. However, as also discussed, this issue of being a Dealer selling inventory is NOT only important as to the rate of tax employed. The treatment of an asset as a capital asset (or Section 1231 asset) as opposed to an ordinary income asset can also be very important for other reasons, as mentioned below. For example, the issue of an asset classified as an ordinary income asset can be crucial in Tax Deferred Exchanges.¹⁹ (Once again, this point is discussed later in the article.)

EXISTING “DEALER” DECISIONS PRIOR TO THE LONG CASE:

As mentioned, there have been many decisions that have addressed the issue as to whether a given party was or was not a dealer on a given property. This determination rests on the intent of the party/taxpayer. That is, did the taxpayer have the intent to sell/dispose of the property when it was acquired? Was it a type of property that was purchased as inventory, such as cars on an auto dealer’s lot? Was the taxpayer a builder of homes, creating them with the intent of immediate sale?

These issues are not difficult to state. But, some cases are confusing and it is often trying to find the “intent” of the taxpayer. Thus, the courts, via many cases, have developed

a list of factors that *might* be important in a given case to resolve the issue of “intent.” In this setting, the courts have considered the following factors when dealing with a property in question:

1. What was the intent of the taxpayer when the property was purchased?
2. Did the intent change?
3. Did the taxpayer acquire the property and immediately place the property up for sale?
4. How did the sale come about? That is, for example, did the buyer solicit the seller for the sale?
5. How does the seller normally conduct his or her business? That is, if one normally sells cars for a living as a dealer, it is likely that all the cars held by the dealer will be inventory, unless the taxpayer can show some difference on a given car that the taxpayer alleges is not inventory? This same point applies to a builder of homes for sale, where the builder takes the position that a given home was **Not** for resale. That is, it was an investment property, not dealer property.
6. What is the history of the seller as to the type of property in question?
7. Did the circumstances change for the taxpayer, thus causing a change in the intent? As an example, did the taxpayer move from being a home builder to a landlord of leased houses?
8. What other factors impacted the activity of the seller and that might have affected the sale?

There are many cases, as noted, that have addressed this issue of intent. For example, there is the case of *Raymond v. CIR*.²⁰ The Tax Court concluded the taxpayer/seller was a dealer on the property in question. To test for intent, the Court looked to some of the following factors:

- a. The taxpayer’s purpose when acquiring the property;
- b. The taxpayer’s purpose when holding the property;
- c. The extent to which the taxpayer made improvements to the property (and the type of improvements that would suggest or not suggest a longer term hold of the property);
- d. The frequency, number and continuity of dispositions of property; and
- e. Other factors.

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Sometimes the courts have stressed the *primary* purpose of holding the property. See, for example, the case of *Malat v. Riddell*,²¹ an older but often cited case.

Other cases have considered many of the above factors to derive intent; and, many courts have added other factors to consider. In *Klarkowski v. CIR*,²² the Tax Court considered factors such as the purpose of acquisition, the subsequent use of the property, improvements made to the real estate, the business of the taxpayer, how much advertising and promotion was undertaken for the sale, whether the property was listed for sale, etc.

In the *Adam* Case, (*Adam v. Comm.*, 60 TC 996 (1973)) a CPA was arguing for capital gain on the sale of property.

The taxpayer sold different property over a number of years. Since there were many factors to consider, and the taxpayer was in the accounting business a good part of the time, the Court concluded the intent was to hold for the longer term, not for resale. Thus, capital gain treatment was allowed.

Can the intent change? Yes.

In *Maddux Construction Co.*,²³ the Court concluded that the taxpayer bought property to build homes on it. However, with part of the property, the taxpayer retired before building homes on it. As such, the Court concluded that the intent with some of the property changed from dealer property to holding it for investment, not for resale as a dealer. Hence, on part of the gain, capital gain treatment was allowed. *Maddux* is an important older case that continues to support the position — that if the taxpayer can show a change in circumstances — moving the taxpayer from a dealer building homes to owning property for investment, the sale of the property can produce capital gain treatment. *Maddux* changed the intent for the use of the land when the taxpayer concluded that it would no longer build homes on the land in question, but rather, the property would be held for long term investment use. Of course, the taxpayer has the burden to show this change and the intended use of the property when sold.

LONG CASE:

There are many other cases that have taken place over the years and that could be cited on this topic of intent. The recently decided *Long* Case,²⁴ cited earlier, is one such case. This case involved a developer.

It is well established, as mentioned above, that when one acquires property with the intent to sell the property

in the ordinary course of business, that property being “inventory,” the gain or loss generated from the activity is ordinary income.²⁵

In the Case of *Long*, the Tax Court followed the above reasoning and held the income generated was subject to ordinary income tax rates. The fact pattern was a bit unusual, but the result, per the Tax Court, was the same: Ordinary income was produced from the sale of property held primarily for re-sale.

Factually, the Taxpayer, Mr. Long, was a developer of land to build various types of properties. In the first instance with the property in question, Long was planning to develop the property for condos. He contracted to buy the property in Las Vegas. He, after being under contract, started the approval work necessary to build and sell condominiums. However, as things moved along, the seller refused to convey the property to the buyer, Long (and his entity). Long sued. Long won a multi-million dollar judgment.

Long, having the judgment, determined he wanted the cash; thus, he sold the claim which was in the form of the judgment; it was sold by use of an assignment to the buyer.

Long reported his gain as capital gain. The IRS, on audit, asserted the position that the gain was ordinary income. The Tax Court agreed with the IRS.

However, on appeal to the 11th Circuit, the Court of Appeals reversed the Tax Court and held the gain, via the sale of the right to collect the judgment, was capital gain, not ordinary income.

The Tax Court reviewed the normal factors that courts have considered to show the intent of the taxpayer to hold property for investment or business use, which could generate a capital transaction, vis-à-vis the actions that show an intent to hold property as inventory or for re-sale.²⁶ The Court of Appeals held that such matters were not controlling in the *Long* Case. The Appellate Court held that the intent by the Taxpayer was to develop the property. But, the Court said that this Case was different. The language of the Court on this point was clear:

“We have already held that selling a right to *earn* future undetermined income, as opposed to selling a right to *earned* income, is a critical feature of a capital asset. *United States v. Dresser Indus., Inc.*, 324 F.2d 56, 59 (5th Cir. 1963). The fact that the income earned from developing the project would otherwise be considered ordinary income is immaterial.”²⁷

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This characterization of the gain is very important under the tax rates, since the highest level of federal income tax for ordinary income is close to 40 percent, yet the rate for the capital gain would be at a maximum of 20 percent. This huge difference gave rise to the aggressive positions of both the Taxpayer and the IRS in the Long Case as well as in many of the other cases mentioned earlier.²⁸

ANOTHER IMPORTANT ELEMENT TO EMPLOY CAPITAL GAIN RATES: THE HOLDING PERIOD

Although only mentioned in passing, another element to obtain the favorable lower capital gain rates includes a requirement to show that the holding period of the asset by the taxpayer is “long term.” That is, as discussed, if the taxpayer can show that the asset is a capital asset and that it was sold or exchanged, this will produce a capital transaction. But, that does not mean the lower rates can be used. The taxpayer must also show that the *holding period* was long-term.²⁹

Why is this holding period necessary? Because Congress said that the favorable, lower rates, noted above, do not apply unless the taxpayer can show the holding period is long term, that is, in excess of one year.³⁰

That is, the taxpayer cannot simply have a capital asset or property held for investment or business use, sell it and gain the lower rates, if the taxpayer has not *held* the property in excess of one year.

This stumbling block comes up very often when a taxpayer is approached by a buyer, enthusiastically wanting to buy the property, yet the seller has not owned the real estate in question the prerequisite time frame of “in excess of one year.”

This holding period was an issue the IRS raised in the Long Case. And, as to this issue, the Taxpayer might have won the battle on the character of the asset being non-inventory, but lost the war to apply the lower rates, if the Court would have concluded that the holding period was one year or less. However, the Court sided with the position of the Taxpayer. The Court said that the Taxpayer established his holding period from the time it brought suit to enforce the contract. What the Taxpayer sold were the rights to a judgment, not land held for resale. He gained these rights when he signed the contract to buy the land. Thus, the gain was characterized as *long term* capital gain (*i.e.*, the asset was held over one year).

The Court of Appeals concluded that the income from selling the judgment gained via the contractual position was very different than selling the land that was to have been developed. The decision by the Court of Appeals was that the holding period of the asset began when the suit was filed. As such, it produced long term capital gain.

Thus, Mr. Long gained the benefit of long term capital gain treatment and thus the lower tax rate applied! Effectively, much like the *Maddux* Case mentioned earlier,³¹ the intent of the Taxpayer changed. Had he developed the condos and sold those in the normal course of business, this would have produced ordinary income to the Taxpayer. However, the Taxpayer, as the Court of Appeals stated, changed his position, and sold a claim, via the judgment. This was not dealer property.

CONCLUSION

A well informed taxpayer (with his or her advisors) might consider not so easily giving up on the position to report gain as capital gain. Even if one might normally be a dealer on most of the transactions undertaken by the taxpayer, there may be enough changes in the present transaction to support the capital gain treatment.

In the Long Case, the Taxpayer not only showed the intent to hold the property (contract and judgment) for investment, not for resale, but the Taxpayer also showed that the holding period was long term. Both factors were crucial to the Court’s conclusion that the lower long term capital gain rate was applicable.

The conclusion that the property in question was capital gain property is important to obtain the lower tax rates for capital gain as mentioned in this article. However, it is also crucial to have the determination of a *capital asset*, not inventory property, when considering the use of other Code sections, such as installment sales,³² tax deferred exchanges,³³ etc.³⁴ These are topics to explore for the future. ■

ENDNOTES

1. There are only a few exceptions to this point, since the Internal Revenue Code of 1986, herein often referred to as the “Code,” as amended, Provides under Code Section 61, effectively, that all income, with rare exception, is subject to tax.
2. *Id.*
3. *Id.*

How Can a Developer Qualify for Capital Gain Treatment? A Recent Case Means New Opportunity!

4. Code Section 1 details the rates for various classes of taxpayers, such as those that are single, those that are married and filing jointly, etc. This part of the Code gives the rates/tables for the number to be used to calculate the percentage of the net taxable income that must be paid for the income tax. This rate depends in part on the amount of taxable earnings the taxpayer develops during the year. See Section 1 of the Code as noted. See also, Real Estate Transactions, Tax Planning,) by Levine, Mark Lee and Segev, Libbi R., Appendix A, Thomson/West (2015).
5. This part of the Code gives the rates/tables for the number to be used to calculate the percentage of the net taxable income that must be paid for income tax. This rate depends in part on the amount of taxable earnings the taxpayer develops during the year. See Section 1 of the Code as noted. See also, Real Estate Transactions, Tax Planning, by Levine, Mark Lee and Segev, Libbi R., Appendix A, Thomson/West (2015).
6. See the Levine and Segev text, Note 5, supra, under Chapter 7 of this authority.
7. Id.
8. 114 AFTR 2nd Paragraph 2014-5446.
9. Capital gain income, as discussed below, requires a showing by the taxpayer that it is, under Code Section 1221, entitled to this special treatment. In such setting, the taxpayer may qualify, again, as discussed below, for a tax rate that is less than the ordinary rate. The current rates under the Code, Section 1, can move as high as 39.6% for an individual, without other adjustments. Generally, the highest tax rate for capital gain, where qualified, will be at 20%, as stated earlier. Thus, this becomes very important to qualify for this special, lower capital gain rate.
10. For more on this issue, see the Levine and Segev text, cited supra note 5, Chapter 8 of said text.
11. See supra, Note 8.
12. This definition is under Code Section 1221. Without being too obtuse, the capital gain treatment noted above can be obtained by selling a capital asset. Such favorable treatment can also be obtained when selling qualified investment property and/or other property used in the trade of business of the taxpayer. This latter rule is called Section 1231 Property; however, for the purpose of this discussion and the *Long* Case mentioned earlier, this Note discussed capital assets/capital gain and the trade or Business property, Code Section 1231, together. Distinctions will be made in this Note only in a few instances where the demarcation is important under the tax rules as they relate to this Note.
13. For more on this issue, see the Levine and Segev text, cited supra, Note 5.
14. Refer to Code Section 1221 and the Levine and Segev text, cited supra Note 5.
15. See this issue discussed in the Levine and Segev text, Chapters 8 and 16, this Work cited above in Note 5.
16. See Code Section 1231 and Chapter 7 of the Levine and Segev text, cited supra, Note 5.
17. Id.
18. The reference was to “part of the ingredients” in the prior sentence, since there are some other limitations that must also be addressed. For example, the taxpayer must show that there was a “long term holding” of the property in question if the taxpayer desires to be taxed at the lower capital gain rate. This issue, in connection with the *Long* Case, is discussed below.
19. This area of Tax Deferred Exchanges under Code Section 1031 is also raised in the material, below, as it relates to this question of “dealer” property.
20. TC Memo 2001-96.
21. 1966-1 CB, 184, 383 US 569 (1966).
22. TC Memo 1965-328.
23. 54 TC 1278 (1970).
24. See Note 11, cited supra.
25. See Code Section 1221 and the earlier discussion in this Note.
26. See supra, Notes 21-23.
27. See supra, Note 11.
28. See supra Note 11 and Notes 21-23.
29. See Code Section 1222.
30. Id.
31. See supra, Note 23.
32. See Code Section 453 and the Levine and Segev text, Chapter 25, cited supra, Note 5.
33. See Code Section 1031 and the Levine and Segev text, Chapter 29, cited supra, Note 5. See also Levine, Mark Lee, Exchanging Real Estate, 7 Volumes, (PP & E, Inc., 2014), available at Amazon.com and CreateSpace.com
34. See Note 5, cited supra, under Chapters 1, 7, and 8 of the Levine and Segev text.

Valuing the Leased Fee Simple Estate: The Answer for Ad Valorem Taxation Issues

BY THOMAS W. HAMILTON, Ph.D., CRE, MAI

THE REAL ESTATE APPRAISAL PROFESSION HAS FOR YEARS discussed various types of ownership interests in real property that can be valued. Of these, the leased fee and the fee simple have drawn significant attention as to their proper use in various appraisal assignments. What this article presents is a fresh view on the topic of valuing leased property and how this fresh view addresses many of the issues raised by David Lennhoff, CRE, in a recent *Real Estate Issues* dealing with answering the “wrong question.”¹ This fresh look on valuing leased property helps the appraiser to define markets more clearly and concisely, and guides the appraiser to conclude the unsurpassed highest and best use of the property being appraised.

A NEW VIEW OF THE WORLD

On June 22, 1633, the Holy See of the Roman Catholic Church in Rome handed down the following order: “We pronounce, judge, and declare, that you, the said Galileo ... have rendered yourself vehemently suspected by this Holy Office of heresy, that is, of having believed and held the doctrine (which is false and contrary to the Holy and Divine Scriptures) that the sun is the center of the world, and that it does not move from east to west, and that the earth does move, and is not the center of the world.”

Modifying one’s belief in a learned and universally accepted concept is difficult, regardless of how undeniably true the alternative may be. The same can be said how the leased fee interest is viewed in real property valuation. The leased fee interest, as currently applied in the appraisal profession, is equivalent to the fee simple interest of a property that is currently leased to others (i.e., a leased fee simple interest). The basis for this new view is based on the premise that a fee simple leased property contains two sets of property rights components, one being the real property interest (the fee simple interest) and the other a personal property interest (the lease contract).

When a leased property has lease terms and conditions

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that are equivalent to the overall market terms and conditions for comparable leased properties, the value of the leasehold interest (i.e., the chattel real) in the property is zero. Equivalently the net, contributory value of the lease contract (i.e., the quasi-personalty) to the fee owner of the property is also zero, and this directly results in the market value of the leased fee interest (the fee simple interest of a property leased to others) to exactly equal the market value of the fee simple interest. Simultaneously,

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the full bundle of property rights held by an estate in real property, regardless whether the property is leased or owner occupied, can be identical because the full bundle is transacted from grantor to grantee through the simultaneous execution of the real estate deed and the assignment of the personal property lease. It is only when an appraiser is using contract rents that are specific to the subject property in the valuation assignment (and not market-based rents) is the special condition of the traditionally accepted “leased fee interest” being valued.

THE FULL BUNDLE OF RIGHTS

Valuing real estate for ad valorem purposes is becoming even more complex as assessors and property owners fight over definitions and the valuation procedures associated with those definitions. To assist in this discussion, this article describes the terms, conditions and procedures that are necessary to achieve proper valuation for ad valorem purposes when the standard for valuation is the market value of the fee simple interest.

There are two primary issues at hand in this discussion: the transfer of property rights and highest and best use (HBU). Before HBU can be thoroughly discussed, the transfer of property rights must first be determined. When valuing property for ad valorem tax purposes, the market value of the fee simple interest is (usually) needed. The fee simple interest is a freehold estate in real property ownership. The term “fee” means that an ownership interest in land and all attached to the land is inheritable, and fee estates are “freeholds” which means that the fee interest is either uncertain or unlimited in duration. Historically, the terms fee and fee simple are interchangeable and therefore equivalent, and the first discussion of leased fee refers to the ownership of the fee interest when a property is leased was in 1926.² This evolved into the term “leased fee” that appraisers use today. The fee simple interest (or simply, the fee interest) is considered the greatest type of interest in property ownership available and is often termed the “fee simple absolute estate.” What this means is that the fee simple absolute estate (interest), the fee simple estate (interest), and the fee estate (interest) are synonymous terms and indicate the same thing—the greatest possible ownership of a land parcel including all the rights, interests, limitations, obligations and improvements to that land parcel.

When transferring ownership of the property, a warranty deed will not only include the names of the grantor and grantee, the physical description of the property, and

consideration of the grantee and words of conveyance by the grantor, it will also include any appurtenances and hereditaments of the property, including leases which are termed quasi-personalty.³ In addition to recording deeds for the sale of real property, many states also require leases to be recorded to give official public notice of such transactions, and the recordation order for these public documents is specific. Regarding recordation in the case of a sale-leaseback transaction, the real property deed is recorded first and the lease is recorded afterwards. This is necessary to ensure that the true parties to the subsequent lease are properly reflected in the titled ownership of the estate in real property even though both are executed together at a real estate closing. These issues are extremely important considerations in the valuation process for leased property since the real property bundle of rights associated with leased property transactions must be addressed and recognized properly. In the chart below, the bundle of rights and obligations—both real and personal—associated with an owner occupied property are compared to the bundle of rights and obligations of a leased property (owned, but occupied by a tenant).

Figure 1

*Ownership Rights for Owner Occupied and
Leased Property*

Owner Occupant					Owned but Occupied by Tenant					
Possess	Control	Enjoy	Dispose	Exclude	Possess	Control	Enjoy	Dispose	Exclude	Lease

The typical bundle of rights associated with the fee simple estate (owner occupied) include the right of possession (the property is owned by the title holder), the right of control (the owner controls the property’s use), the right of enjoyment (the holder can use the property in any legal manner), the right of disposition (the holder can sell the property), and the right of exclusion (the holder can deny people access to the property), among possibly other rights. It is when a property is leased to others that an additional personal property interest is created—this is the lease contract interest in the property. This lease

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intertwined with the real property right of exclusion in the fee simple bundle of rights through proper execution. This is why the lease is termed a quasi-personalty. In other words, the right to exclude remains with the bundle of rights transferred in a property transaction because the specific terms of exclusion giving the tenant temporary occupancy of the property (the quasi-personalty) are present in the lease contract that is assigned during the property's conveyance along with the remaining bundle of rights in the deed.

As depicted in Figure 1, the lease contract does not remove any rights from the bundle of rights of the fee simple estate, but rather it is an addition to the fee simple estate. This is evidenced by the fact that whenever a property that is currently leased is sold from one party to another, the new owner (the grantee listed in the deed) obtains not only the full bundle of realty rights associated with the property, but also the quasi-personalty interests and obligations of the lease. The right to exclude others is conveyed to the new owner through the lease that is part of the bundle of rights contained in a leased property's transfer, and, upon termination of the lease contract, the right of exclusion is no longer governed by the lease but is held exclusively by the owner of the estate in real property—the grantee of the conveyance. An example of this process is developed and explained later.

The bundle of rights depicted in Figure 1 is also consistent with generally accepted appraisal practice where leased properties, whose contractual lease terms are at market levels, are said to have a value that is at “market,” or is numerically equivalent to the fee simple value of the property. It is also maintained by the appraisal profession that even though the value of the “leased fee” property is equal to the “fee simple” value of the property, conceptually the two real property interests are different. This second statement is not true because the leased property has the same bundle of real property rights as a fee simple property. The leased property simply contains an additional set of personal property rights and obligations that exist in the lease contract, but the real property rights of possession, control, enjoyment, disposition and exclusion all exist and are conveyed and/or assigned from the grantor to the grantee. This means that the same set of real property rights can exist in all conveyed properties regardless if they are leased or owner occupied, and if the purpose of the appraisal assignment is to value only the real estate the appraiser must simply remove the incremental value of the personal property

component (i.e., remove the net value of the lease). When the lease contained in a property transaction is identical to market terms and conditions, the net value of the lease is zero; and the value of the leased property is equal to the fee simple value of the property.

BIG-BOX AND SPECIALTY RETAIL VALUATION

In the *Real Estate Issues* article,⁴ Mr. Lennhoff discusses some topics that are at issue in property tax litigation across the country that he states lead to the “right answer to the wrong question,” and this article will explain how Mr. Lennhoff's discussions can lead to the wrong answer to the wrong question. Mr. Lennhoff uses Appraisal Institute definitions throughout his discussion to emphasize his points, however, legal definitions of these terms will yield different conclusions. For example, Black's Law⁵ defines fee simple as:

“An interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs; esp., a fee simple absolute—often shortened to fee.”

According to the *Dictionary of Real Estate Appraisal*, the definition of fee simple is quite different:

“Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the government powers of taxation, eminent domain, police power, and escheat.”⁶

By focusing on the Appraisal Institute definition of fee simple, and in particular the phrase “unencumbered by any other interest or estate,” appraisers for property owners in ad valorem litigation follow the premise that Mr. Lennhoff explains on page 23 of his article: a property must be vacant and available to be leased in the valuation process (i.e., the property must be “dark”). Using the Black's Law definition, a property does not need to be “vacant and available to be leased” to obtain a fee simple appraised value as long as the full bundle of rights is included. The concept of a property being vacant and available to be leased (i.e., “dark”), which is based primarily on the premise of a property being “unencumbered,” is the basis for differentiating between “fee simple” property transactions and “leased fee” property transactions and how and when such transactions can or should be used to obtain the market value of the fee simple estate. Additionally, but rarely if ever addressed in the valuation assignment for property tax purposes using the “dark property” premise, if an existing property is “dark,” something adverse must have

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occurred previously to cause the property to be dark. In particular, Mr. Lennhoff uses examples of Circuit City and Hechinger properties that needed to be “re-dressed” to meet generic market standards, however he fails to explain why these stores were dark property transactions. When a market changes, whether it is a real estate market or the general economy, there will be fallout. Both the Circuit City (2009) and the Hechinger (1999) chains of stores went through liquidation bankruptcy. This added unplanned supply of space to real estate marketplaces that were not ready to absorb this new supply, causing distress in property prices. These types of dark properties are not typical market transactions, because they are by definition liquidations of distressed properties. The underlying economic reasons of why these properties are liquidated, distressed properties is often ignored by appraisers when valuing an owner’s interest in ad valorem litigation.

Regarding discussion of “leased fee,” the entire bundle of rights associated with the fee interest in property actually does convey from grantor to grantee when that property is leased because the lease contract that contains the right of exclusion (or to use, or to occupy) is simultaneously conveyed along with the deed to the real estate, and the appraiser therefore does not answer the wrong question. In fact, the right to exclude others transfers with the property from seller to buyer. For example, Builder Bob owns a property and leases it to Larry Lessee. The lease stipulates that Larry Lessee can occupy the property until the lease term expires upon which Larry Lessee must give his right of occupancy back to Builder Bob (because the parties to the lease are Larry Lessee as tenant and Builder Bob as owner). Before the lease expires, Builder Bob decides to sell the property to Ivan Investor subject to the lease between Larry Lessee and Builder Bob and Ivan Investor agrees to the purchase subject to the existing lease. Builder Bob transfers all of his rights in the property to Ivan Investor, including the lease which is “quasi-personalty” (i.e., personal property). Upon the termination of the personal property lease contract, Larry Lessee leaves the property. So, who has the right to occupy the property once Larry Lessee leaves? If the right of exclusion (or to use, or to occupy) did not transfer between Builder Bob and Ivan Investor, then when Larry Lessee’s lease expired Builder Bob would still have the right of exclusion (or to use or to occupy). But this is not the case, because when Builder Bob deeded his ownership rights to Ivan Investor, the right of exclusion transferred through the assignment of the lease between Builder Bob and Ivan Investor as part of the deed’s wording. In effect,

the transaction of this leased property included the full bundle of rights.

Another issue that appraisers for property owners use in ad valorem litigation surrounds the concept that a current occupant cannot be a potential buyer or occupant for the property. Nowhere in real estate economic or appraisal theory is this a requisite condition in determining the demand for real estate in the market analysis process. A current occupant of property is one of the potential demanders/users in the entire universe of potential demanders/users. In fact, the current occupant is one of the **more likely** buyers or occupants for the property. Excluding the current occupant is a proactive, selection bias error that results in limiting the actual market forces of supply and demand in the marketplace, and it will skew the market demand potential for the property. Even if the property is built-to-suit, there must have been sufficient market evidence initially to support the development of a first-generation user at market rates, and using Mr. Lennhoff’s own words, “there is no reason the occupant should be willing to pay more than a dollar more than the rest of the pool. Why should he?”⁷ The appraiser’s correct market of competitive, comparable properties for first-generation space is actually other first-generation user property transactions and rents, and the appraiser should not use second-generation, distressed or “dark” transactions as comparables. It simply does not make economic sense in a competitive marketplace that first-generation space users will pay more than what they would pay for other space **if that other space has the same market features and attributes** because they wouldn’t “pay more than a dollar more.” For first-generation users, the second-generation space does not have the same market features and attributes required by the first-generation space user and therefore are not actually comparable. If second-generation properties were truly comparable with first-generation properties, first-generation big-box retailers would purchase the distressed property at bargain prices and make greater returns on their real estate investments (either owned or leased) by acquiring the bargains.

In discussing marketing time, appraisers for property owners often claim that the leases for big-box retail do not compete in an open market, but rather the lease payments are simply a function of development costs. This is neither new nor surprising and nothing more than the “Front Door” approach that developers use regularly to determine the financial feasibility for their development

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projects. The developer's construction costs are known or computed, and, from those costs, a minimally acceptable rental rate is determined based on market costs of capital. If the rental market will support the developer's minimally acceptable rental rate from the "Front Door" analysis, then the project is deemed feasible. It is also using this analysis that an appraiser determines a property's highest and best use as improved. Given all the potential uses and configurations of improvements to land, the one configured use that achieves the greatest profitability is deemed highest and best. The other way that developers analyze projects is called a "Back Door" approach. This method starts with net rents and derives a maximum developer's construction cost. So, if a potential big-box retail user is concerned about maximizing its profitability, then they would focus on the "Back Door" approach to find the maximum cost they are willing to incur to obtain a property (or build it or have it built). Combined together, these two approaches yield an economic rent that is synonymous with market rent.⁸ Since retailers compete in their own relevant markets for real estate and retail consumers, the successful retail development for a particular user will incrementally out-bid the competition by a dollar to obtain the property and control that location. Paraphrasing Mr. Lennhoff's recent article, why would they overpay? Once the retailer successfully controls and develops the property, it knows the all-in cost of the project and applies a cost of capital to the project costs to determine a fair market rent that is consistent with the highest and best use of the site. What this process shows is that the marketing time needed to determine the market rent is built into the development process which is based on market costs of land, labor, capital, and entrepreneurial effort. To argue otherwise and, in effect say that they are overpaying for real estate, is to say that these multi-billion dollar big-box corporations do not understand basic corporate finance and do not conduct capital budgeting exercises—nor are they pursuing their fiduciary responsibility to maximize shareholder wealth. This is difficult to believe.

Regarding sale-leaseback transactions, if there always is a financial advantage to develop real estate using these types of transactions, then all real estate development would use a sale-leaseback. A space user would be financially imprudent to use anything but a sale-leaseback arrangement if there always was a financial advantage to the sale-leaseback. In an efficient financial marketplace, all financing sources are priced according to their individual risk characteristics, and the financial markets are for the

most part fairly efficient in properly assigning risk to the various sources of capital. There are potential income and capital gains tax advantages and detriments to using sale-leaseback financing, but as with any financing that is not part of valuing the fee simple interest in a property and any such benefit or detriment can be addressed in both the sales comparison and the income approaches to value. To refute or ignore a sale-leaseback transaction solely on the presence of the sale-leaseback agreement in a transaction is not sufficient. If the financial marketplace is efficient, then the weighted average cost of capital in the sale-leaseback will be equivalent to the weighted average cost of capital in a traditionally financed acquisition. This argument follows hand-in-hand with the front door/back door arguments addressed previously.

In the highest and best use analysis process, after the market analysis component is completed, the final step is to determine the one use of the property that achieves the highest and best use for the site. If the highest and best use and the current use are the same, then the current use is highest and best. If that is the case, then the market value of the value in use will be equal to the market value of the fee simple interest in the property, even if the property is currently under lease. Too often the highest and best use of a property is generically stated, when the true highest and best use of a property is, and can be, more distinctly defined. According to Module 5 of the Appraisal Institute's course, "Business Practices and Ethics," students are warned—in the section discussing Highest and Best Use—that HBU "is nearly always critical" and that in "many problematic appraisals, the highest and best use analysis is flawed and insufficiently reported" such as when HBU leads to "conclusions that are too broadly stated (e.g., 'commercial' or 'residential')." ⁹ It is not just identifying which property rights that matter, identifying the proper market of competitive properties is critical. Furthermore, the *Appraisal of Real Estate* describes the highest and best use analysis process:

"General categories such as 'an office building,' 'a commercial building,' or 'a one-unit residence' may be adequate in some situations, but in others the particular use demanded by market participants must be specified, such as 'a suburban office with 10 or more floors' or 'a three-bedroom residence with at least 2,500 square feet.' In any case the appraiser should provide market evidence that leads to an understanding of the use or uses, the timing for those uses and the *probable users and buyers*."¹⁰ (emphasis added)

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Again, in an occupied property, a probable user of that property includes the current tenant or owner and this situation does not immediately cause the current use to be a value in use—it could very well be the highest and best use (and user) which is essential for a market value appraisal assignment. This particular case, where the highest and best use is the current use, is a moot issue and could result in the value in use to equal the market value because the appraisal assignment is to give a market value opinion of the fee simple interest of the current (highest and best) use. To purposefully exclude a known and existing user from the highest and best analysis introduces appraiser bias. If the existing use and user are highest and best, this would introduce a hypothetical condition to the appraisal assignment — something that is known to be contrary to existing fact. That is not the market value standard for ad valorem property valuation. This is true for all market value appraisal assignments.

THE APPROACHES TO VALUE

As discussed to this point, there are many issues regarding how big-box property is developed and rented and how the appraiser conducts the highest and best use analysis. Oftentimes, appraisers for property owners in ad valorem litigation will stress that there are significant quantities of vacant big box properties in many markets, suggesting that they are equal substitutes for recently constructed and highly successful big box properties, and that the data for the vacant properties should be used in the various approaches to value. These issues flow through Mr. Lennhoff's discussion of the various approaches to value as well.¹¹ A major issue often missing in these appraisal reports for property owners is the underlying reason why big box stores are vacant and available. Changing market forces including things such as wholesale liquidations due to bankruptcy, or a shift in consumer trends to a different type of retail environment such as lifestyle centers have made the "dark and vacant" properties second-generation properties. As such, big-box retailers often move to different locations within an area/region because the local marketplace has shifted its focus to that new location. What was once the "prime" location for retail is now secondary, tertiary or even lower on the consumer preference hierarchy for desirable shopping locations. As such, retailers will chase the consumer market, leaving behind lesser quality locations for the next better location. This is analogous to fishing — fishermen go to where the fish are biting. Likewise, to say that vacant retail in secondary or tertiary submarkets is equally desirable to the "prime" submarket is illogical. It is equally illogical

to claim that the rents or prices paid for secondary or tertiary locations are equal substitutes for the rents paid in "prime" locations. In fact, for some retail uses (such as pharmacies), the difference between being on a fully signaled intersection with multiple access points and not having such features (such as mid-block or limited ingress/egress) can change the highest and best use of the property and will most likely drastically reduce the value of a property lacking the better attributes—even if they are adjacent to one another. The appraiser must be diligent to sufficiently refine the market analysis and the highest and best use analysis so as not to be overly broad. To do so will result in an aggregation bias that distorts the true market conditions affecting the subject property's price and rents.

Regarding special property transactions such as 1031 exchanges, appraisers often miss one key and necessary element of a 1031 exchange of real estate. The exchange must be real estate for real estate. If some of the value of the property given up for the exchange is not real estate, it cannot be included in the new property's taxable basis. According to the IRS, "Real property and personal property can both qualify as exchange properties under Section 1031; but real property can never be like-kind to personal property."¹² Therefore, if both parties to a 1031 exchange attest to the fact that the real property transferred in a 1031 exchange is real estate for capital gains tax deferral purposes, then it cannot be personal property.

When developing value opinions in the income approach, appraisers for property owners in ad valorem litigation will focus on second-generation sales and rents because they use the limiting definition of fee simple and subsequently misidentify the highest and best use of the property. What they are left to use in the income approach are properties that are second-generation properties that don't directly compete with first-generation properties and are often sold or leased at very low prices. In his section on income capitalization, Mr. Lennhoff states that these are not "fire-sale" opportunities. Even if they are not "fire-sale" opportunities,¹³ they do oftentimes represent properties from secondary and tertiary locations with substantially different economic considerations for prices and rents from what exist for properties in "prime" locations. Additionally, there is no need for an appraiser to require lease up costs for fully occupied leased properties because there is no economic rationale to require a property to be "dark" to obtain the fee simple value. If the appraisal assignment is to determine the market value of the property under the hypothetical condition that a

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property is vacant (when it is, in fact, fully occupied), then a “go dark” analysis would be applied, otherwise it is an unnecessary and illogical step that will lead to an incorrect value conclusion. Nowhere in the legal definition of fee simple is it required for a property to be “vacant and available to be leased.”¹⁴

Appraisers for property owners in ad valorem litigation will often assume that the value in use is not the highest and best use of the property. If the value in use is the highest and best use, then the procedure of explaining why a newly constructed property is “overbuilt” from the very beginning of its existence results in creating a straw-man argument. The straw-man argument goes like this: assume that the highest and best use of the site is not as a major warehouse outlet (e.g., Costco), but rather something else that has a lower required ceiling height. The extra 10 feet of clearance for the major warehouse outlet is properly termed functional obsolescence (in the form of a superadequacy), but only if the use is not as a major warehouse outlet. If however, the structure had a 20-foot clear height and the highest and best use of the site was determined to be a major warehouse outlet (such as Costco), then there would be a different functional obsolescence in the building (in the form of a deficiency). The answer to the question again depends on the highest and best use of the property, and the current use of a property is not an automatically discarded possibility in the highest and best use analysis process, but rather it must be considered as a potential use and other potential uses must be more financially feasible to eliminate the current use from consideration.

CONCLUSION

Like Mr. Lennhoff states in his conclusion,¹⁵ an appraiser “must correctly value the mandated basis of ad valorem tax, which is usually the market value of the fee interest.” The fee interest, as shown in this article, can exist for an owner occupied property or for a property leased to others when one recognizes that the right to exclude is inextricably intertwined with the lease contract and never really leaves the balance of the bundle of rights. As such two major issues must be addressed in such a task: the highest and best use of the property; and the real property rights and interests inherent of property ownership when a property transacts. This is particularly important in appraisals for ad valorem litigation. As was shown in the first part of this article, the complete bundle of rights transfer between grantor and grantee regardless if the property is leased to others, and this is consistent with the legal definition of fee simple. The concept that a property

leased to others contains fewer “sticks” in its bundle is simply not true. They are all there, and there are additional personal property rights that also transfer. Secondly, the highest and best use and the market analysis components of the appraisal assignment must dictate how the appraiser conducts the individual approaches to value. Oftentimes major errors exist in an appraisal because the appraiser fails to properly recognize and analyze specific real estate markets, and that results in the appraiser not concluding the true highest and best use of the property and therefore uses incorrect data and methods in the approaches to value in the appraisal assignment. ■

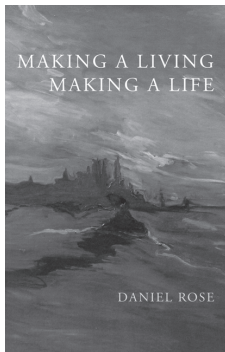
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Making a Living, Making a life

By Daniel Rose, CRE (©2014, Half Moon Press, 366 pages)

REVIEWED BY BOWEN H. MCCOY, CRE



DANIEL ROSE, CRE, HAS HAD an extraordinary business career including developing Pentagon City in Washington, D.C., and One Financial Center in Boston. He developed Manhattan Plaza for the Performing Arts in New York City. He is not only an icon of the past sixty years of real estate development, but he is also an acclaimed, treasured and award

winning essayist and public speaker. His range of topics is eclectic, including happiness, urban development, history, foreign policy, American race, and his deep interests in religion and philanthropy. There is no one else I know who could receive enthusiastic testimonials from as wide a range of fellow icons as Jacques Barzan, Henry Louis Gates, Jr., Fareed Zakaria, Anthony Downs and Paul Goldberger.

He has won four Cicero speech writing awards (for having written the best speeches on four different topics), and he is a member of the American Academy of Arts and Sciences. *Making A Living, Making A Life* is a collection of nearly 50 essays and speeches that are filled with humanity, intelligence and a full lifetime of “doing the right thing.” If one could convince our business and political leaders to read and think about Dan’s sage and practical wisdom, we could ameliorate many of our systemic problems. His broad range, keen wit and basic decency make him a true “Renaissance Man.”

I am proud to confess a 40 year friendship with Dan, through the Urban Land Institute and The Counselors of Real Estate. I also have an interest in writing and teaching, and I have published a hundred magazine articles and a couple of books. While perhaps equaling Dan in numbers of articles and speeches, my content is woefully non-comparable. Many years ago, Dan and I began the habit of sharing our written material with one another.

About the Reviewer



Bowen H. ‘Buzz’ McCoy, CRE, is past president of The Counselors of Real Estate. McCoy was employed at Morgan Stanley for 27 years. He is the author of the award-winning and broadly used case study on values-based leadership *The Parable of the Sadhu*. His book on values-based leadership entitled *Living Into Leadership* was published by Stanford University in 2006.

His comments were always generous, insightful, and, above all encouraging. In fact, he mentions my book on leadership in one of his essays, and he has patiently sat through a couple of my speeches. That is a sign of true friendship, indeed.

The essay titles alone assure the reader that something interesting lies ahead: *Talleyrand Entertains Metternich*, *Fighting Alligators vs. Draining the Swamp*, *Ulysses and Modern Business Enterprise*, *You Didn’t Build That Alone* and *Gertrude Stein and the Real Estate Markets*. Rose’s thesis is stated early on: “Morality and worldly success are not now and never have been, necessarily incompatible. Just as every society contains some people with larceny in their hearts, so every society known to man has had people who conducted themselves with honor and who led satisfying and fulfilling lives in the process.” At the same time, he raises the cautionary yellow flag: “In the business world as in life generally, there are temptations, pressures, morally ‘gray’ areas. In many fields, what is technically ‘legal’ may not be truly ethical.” “... morality is demonstrated not by what you believe or say, but by what you do ... morality ... is developed over a lifetime through the influence of parents, teachers and religious leaders.”

Rose champions a balanced life, which for him includes the following:

Making a Living, Making a life

My **personal** life: My family

My **professional** life: Rose Associates

My **public** life: Politics, civic organizations, professional groups

My **philanthropic** life: to which I give my time, my thought and my money

My **inner** life: My intellectual and spiritual concerns, those inner voices one hears when no one else is listening.

With respect to philanthropy, Rose challenges young people: “So my final word to is to wish you success in earning your fortune, success in enjoying it and success in disposing of it.”

I was deeply impressed by Rose’s obvious commitment to his Jewish faith and his willingness to share his religious views and his inner life throughout the collection. He is a man who is “comfortable in his own skin.” Dan writes: “What Jung called key racial memories must be kept fresh and alive: the sense of historical continuity; the values and ideals of the ‘extended family’ carried out to one’s neighbors and the community beyond; and the sense of being ‘chosen’—not in terms of privilege, but of obligation. Jews should feel not that they are better, but that they should be.”

He defines happiness as “a byproduct that comes, not from all activity you engage in, but from the life you lead. Happiness reflects values, attitudes, and the sense of being at peace with oneself.” “Happiness flows from producing more than you consume, from seeing the shine in the eyes of those you have helped, from expending your energies in a struggle, whether won or lost, that you know was worth the effort. The happiest people have family and friends; they belong to a community; they have more than a job, they have careers; they identify with causes larger than themselves; and, most important, their lives have meaning and purpose.”

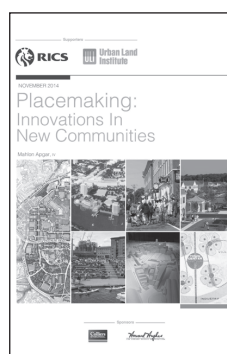
His wit sparkles throughout. “We should remember that Jack Kennedy noted not only that ‘the rising tide lifts all boats,’ but also, as he smirked privately to friends, ‘when the police raid a house, they take all the girls.’”

This book is a wonderful antidote to “Trumpism” and can make a fine gift from a parent or mentor to a younger person. It elevates the possibility of leading a successful business life (even as a developer!) together with a successful personal life, while keeping the faith and without having to become a billionaire. ■

Placemaking: Innovations in New Communities

by Mahlon 'Sandy' Apgar IV, (ULI, 2014), 35pp, with Appendix

REVIEW BY PETER C. BURLEY, CRE, FRICS



MAHLON 'SANDY' APGAR IV, CRE, joins a continuing discussion on the effort to create healthier, sustainable living environments that enhance the social and economic well-being of those who reside within them. The literature has been fairly extensive, particularly over the past couple of decades, and not without controversy and debate

throughout the planning and real estate communities. Tomes have been written on the subject of Master Planned Communities, Smart Growth, and New Urbanism, including a large number of ULI's publications, from *Bohl's Place Making: Developing Town Centers, Main Streets, and Urban to Mixed-Use Development Handbook*, 2003, by Dean Schwanke, to Massengale and Dover's *Street Design: The Secret to Great Cities and Towns* (2013), and a host of others.

The discussion (not always civil) continues as planners and developers argue about what homebuyers and community residents really want – McMansions in the automobile-dependent suburban expanse or more modest accommodation in a walkable community. As recently as this past February (2015), in an article published in the *Atlantic*, Alena Semuels notes that urban planners and “smart growth” advocates (argue) for a drastic change in homebuilding – calling for more compact homes in walkable communities ... located near public transit. Doing so, they argue will jump-start the housing market since that's what home buyers say they want.¹ At the same time, it is clear that the home “building industry has been incredibly resilient at resisting change,” according to Smart Growth guru Christopher Leinberger,² a senior fellow at the Brookings Institution.

About the Reviewer



Peter C. Burley, CRE, FRICS, is director of the Richard J. Rosenthal Center for Real Estate Studies, REALTOR® University, in Chicago. A real estate market and economics research professional with extensive executive experience building and managing strategic investment research platforms in the real estate industry, Burley is recognized for his analyses of national and regional economic, demographic, industry and property market trends and for his development of real estate portfolio investment strategies. Prior to becoming director of the Center, Peter was vice president of Research at Simpson Housing LLLP, a multi-family development and management firm, and director of Research at Amstar Group LLC, a private global investment firm. He has published widely, with numerous articles on current and expected trends in the economy and real estate markets. He has been quoted in various newspapers and has been a contributor to *UrbanLand*, *National Real Estate Investor*, and *TheStreet*. He holds graduate and undergraduate degrees from the University of California where he also taught urban economic geography, regional geography and quantitative methods. He is a Counselor of Real Estate (CRE), A Fellow of the Royal Institution of Chartered Surveyors (FRICS), A Fellow of the Hoyt Institute, and a member of the Advisory Board of the Real Estate Research Institute (RERI).

In an era of massive global urbanization brought by dramatic demographic changes, economic upheaval, and environmental challenges, the discussion is of critical importance to today's planners and real estate practitioners. With the rise of the Millennial Generation, which clearly prefers a walkable urban setting, and the imminent downsizing of the Baby Boomers, the push and pull between the suburbs and the urban core becomes ever more important. A recent Nielsen study reinforces that notion, noting that “Millennials are fueling an urban revolution looking for the vibrant, creative energy [of] cities offering a mix of housing, shopping and offices right

Placemaking: Innovations in New Communities

outside their doorstep. They're walkers and less interested in the car culture that defined Baby Boomers.”³

As suburban developers now look to create “urban ‘burbs” with more “urban” attributes, including walkable downtown areas, transit-friendly areas, and mixed housing types, the New Community concept is gaining new visibility and viability and is becoming much more common practice. It is here that Apgar's extensive experience is of immense importance, and notability, as he draws on his personal experience studying British New Towns; working with James Rouse in the development of Columbia, Maryland; serving on the ULI New Communities Council; and, co-founding the International New Towns Association. Few others can speak with the experience or the authority that Apgar brings to the discussion.

But, he does not stop with his own experience. Apgar surveyed more than 700 professionals in the Counselor, RICS, and ULI communities and among the National Town Builders Association, the Royal Town Planning Institute and the Town and Country Planning Association. He interviews some 20 high-level active professionals from a variety of stakeholder interests as well.

Apgar focuses on two types of New Communities: “Greenfield,” developed where land is plentiful and inexpensive, that can serve as “antidotes to the high land consumption and infrastructure costs of single-family tract housing”; and smaller and denser “Urban Renaissance,” developed within cities, often to “correct negative effects of earlier policies” and to “propel improvements” or “increase utilization of underdeveloped land and buildings.”

From his surveys and interviews, Apgar compiles findings that result in a set of Innovations that emerge from the New Community experience and a set of Initiatives. Innovations include: Comprehensive Plans, Portfolio Economics, Integrative Business Models, Public-Private Partnerships and Resident-Driven Services. Initiatives include: Prime Movers (using New Communities as generators of responsive urban growth; through partnerships with various key entities), Information and

Analytics, Unconventional Uses, Community Designs, and Investment Funds. He discusses each aspect in detail, offering examples and case studies. Case study examples and sidebars are scattered throughout, while two detailed examples (“Caselets”) of New Communities are included in the publication: Columbia, Maryland and the Residential Communities Initiative (RCI) at Fort Belvoir, Virginia.

Apgar considers the publication “a work-in-progress on a topic of profound importance for policymakers and practitioners.” I could not agree more. Planners and policymakers will need to reach out proactively to deal with social, demographic and economic changes. And, practitioners will need to grasp some of the changing needs of those who consume their products and services, being somewhat less resistant to change.

In his concluding note, Apgar draws three conclusions (no spoilers here): 1. New Community Developers are not only seers; they also seek to improve our built environment; 2. New Community Development is not formulaic, although management principles can be codified and decision-makers can apply them to the challenges of urbanization; and, 3. Innovation is not a choice for New Communities Developers – it is a must.

The report itself is short, just 35 pages, but it is thorough, professional and filled with Sandy Apgar's unique perspective guided by experience and wisdom. The Appendix, which runs a little over 100 pages is loaded with specific survey results and data and would draw an interested researcher's attention for a solid afternoon.

All in all, a great read on an important subject. ■

ENDNOTES

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New Jersey Supreme Court Decides No Statute of Limitations Applicable to Spill Act Contribution Claims

By: Joseph J. Maraziti, Jr., Esq., CRE, and Joanne Vos, Esq.

IN 2013, A NEW JERSEY APPELLATE COURT TEMPORARILY ended the long standing debate of whether a statute of limitations applies to contribution claims brought under the State of New Jersey law which governs liability for the cleanup of environmental contamination, the New Jersey Spill Compensation & Control Act (the “Spill Act”). In *Morristown Associates v. Grant Oil Company*, the Appellate Division determined that responsible parties which spent funds cleaning up contamination could not recoup any financial contribution from other parties which were also deemed responsible for the contamination if the claim for contribution was brought outside of the six (6) year property damage statute of limitations. In a lengthy, notable and unanimous January 26, 2015, opinion, which tips its hat at every turn to the remedial nature of the Spill Act, the Supreme Court of the State of New Jersey has reversed the decision of the appellate court in *Morristown Associates*, holding that no statute of limitations applies to such contribution claims.

The Spill Act establishes the liability of any party which has discharged a hazardous substance or “is in any way responsible” for the discharge of a hazardous substance within or upon the lands or waters of the State of New Jersey. *N.J.S.A. 58:10-23.11g*. This liability is joint and several amongst those parties that are in any way responsible and as such, any one responsible party can be required to shoulder the entire burden. Since the statute is grounded in strict liability, neither “fault” nor negligence are factors, thereby leaving the net it casts over parties which could potentially be deemed responsible very broad. *N.J.A.C. 7:1E-1.6*. However, any party which conducts a cleanup, whether the cleanup is voluntary or required, may pursue any responsible parties for their fair

About the Authors



Joseph J. Maraziti, Jr., Esq., CRE, is a Partner at Maraziti Falcon, LLP, Short Hills, N.J. He represents both public and private sector clients in regulatory, transactional and litigation matters having local and national significance involving environmental, redevelopment issues and land use issues. Mr. Maraziti is an active leader and driving force in the redevelopment arena.

Mr. Maraziti served as Chairman of the New Jersey State Planning Commission, which adopted the State Development and Redevelopment Plan in March 2001.

He has been annually identified by New Jersey Monthly as a “Super Lawyer” in environmental law and is rated AV Preeminent by Martindale Hubble Law Directory.

A graduate of Fordham College and Fordham Law School, Mr. Maraziti lectures on a variety of issues related to his practice and serves as a member of the Board of New Jersey Future, The Alan M. Voorhees Transportation Center and is a member of the New Jersey Committee of Regional Plan Association.



Joanne Vos, Esq., is a Partner at Maraziti Falcon, LLP, in Short Hills, N.J. She focuses her practice on environmental law in both private transactional and redevelopment settings.

New Jersey Supreme Court Decides No Statute of Limitations Applicable to Spill Act Contribution Claims

cleanup costs by asserting a contribution action. *N.J.S.A. 58:10-23.11fa(2)(a)*.

In arriving at its determination that such a contribution claim is not subject to any statute of limitations, the Court reasoned that the plain text of the law (or lack thereof) supported its conclusion, as there is no reference to any statute of limitations within the Spill Act. The Court rejected the argument that the six year statute of limitations barring claims for damage to real property applied. Additionally, the short list of defenses within the statute does not include a limitations period within which a contribution claim must be brought or else be deemed forfeited. More importantly, and citing to the nationally recognized *Ventron Corp.* opinion which famously stated that “those who poison the land must pay for its cure,” the Court explained that reading a statute of limitations into the law would only frustrate the remedial purpose of it by limiting the reach of remediating parties to recoup any portion of cleanup costs (*See State of New Jersey Department of Environmental Protection v. Ventron Corp.* 94 N.J. 473, 493 (1983)).

Prior to the first *Morristown Associates* decision, it was not an uncommon practice for a remediating party to bring a Spill Act contribution claim against the other responsible parties many years after the contamination first occurred and even years after the remediation was fully implemented. Practically speaking, a remediating party’s option to recoup cleanup costs is now kept open forever, unless and until a contribution claim is asserted against

any one responsible party. The re-establishment of this legal right could impact real estate transactions involving the purchase and sale of contaminated properties. For example, sellers must be alerted to the possibility of an expensive cost recovery action years after a closing and buyers will have the luxury of time to evaluate the extent of contamination and marshal their evidence before litigating. These are key factors for both parties to consider at the contract negotiation table.

In conclusion, the public policy concept underlying environmental law that “the polluter pays” has been vigorously reinforced by this recent decision. It clearly demonstrates that the contribution provision of the Spill Act will continue to be liberally implemented in the State of New Jersey, thus promoting the spirit of the statute and the cleanup of environmental contamination. (*See Morristown Associates v. Grant Oil Company*, 220 N.J. 360 (2015)). Although the *Morristown Associates* opinion is not binding on courts in other states, it is expected to be persuasive guidance where this issue remains open. New Jersey has historically been considered a national leader in environmental law making, given that the New Jersey Spill Act has served as a model for the Comprehensive Environmental Response Compensation & Liability Act (CERCLA), the federal counterpart to the Spill Act. In contrast to New Jersey, however, it is interesting to note that where an environmental contribution claim for remediation only arises under CERCLA, it has already been settled that a six-year limitations period applies. ■



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