Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth, P.A.
800 North Magnolia Avenue, Suite 1500
P.O. Box 2346 (ZIP 32802-2346)
Orlando, FL 32803

407-841-1200
407-423-1831 Fax
www.deanmead.com

Orlando
Fort Pierce
Viera

CHARLES H. EGERTON
407-428-5112
cegerton@deanmead.com

March 20, 2009

Developing Strategies For Developers With Infrastructure Development Bond Responsibilities In A Down Market

By
Charles H. Egerton, Esq.
Christine L. Weingart, Esq.

The need for the financing and construction of infrastructure for large residential developments has led to the creation of special districts which are generally governmental or quasi-governmental entities authorized by special legislation in a number of states. These districts were created to provide a less costly source of funding to build or expand roads, lay the ground-work for utilities, and in some cases build schools and recreation centers. Generally, these districts are formed when a developer or group of developers approach a city, county or other governmental unit to approve the formation of the district. In Florida, these districts are called community development districts.[i] Georgia, which has legislation comparable to that in Florida, calls the districts infrastructure development districts.[ii] Although versions of these districts have appeared throughout the country, for the purpose of this article, we will focus on the Florida community development districts and enabling legislation.

The community development district ("Development District") is an independent unit of local government which has the power to issue bonds ("Bonds") for the purpose of funding the infrastructure improvements.[iii] Usually, the Bonds are special assessment revenue bonds, the primary source of payment for which is revenues derived by the Development District from special assessments levied on each parcel of land within the Development District which benefits from the infrastructure funded by proceeds from the Bonds ("Special Assessments").[iv] The Bonds are secured solely by pledges of revenues which the District will receive from the Special Assessments.

Under Florida law, the Special Assessments are a lien on the land against which they are assessed from January 1 of the year of assessment until paid or barred by operation of law.[v] The lien for the Special Assessment, as with a lien for ad valorem taxes, is a first lien, superior to all other liens, including mortgages.[vi] If the assessed landowner does not pay the Special Assessments on or before one year from the date the assessment becomes due, the District may enforce the collection through the same collection provisions applicable to ad valorem taxes, including selling tax certificates and tax deeds regarding the unpaid assessments. The law in Florida is clear that this proceeding is in rem, brought against the property and not the property owner.

Market conditions for residential developments in most parts of the country have degraded to the point that there is little, if any, demand for unsold inventories of residential lots and newly constructed homes. Many, if not most, developers have leveraged their investments and are struggling to meet the carry obligations on their acquisition and development loans, not to mention insurance premiums, ad valorem tax assessments and other similar annual costs, in the hopes that they can hold on until the market for new housing returns. For those hapless developers whose properties are located within a Development District that has issued Bonds to fund infrastructure improvements, the funding requirements to carry property are further increased by the annual Special Assessments levied on the property by the Development District. The expectation of these developers was that the Special Assessments would be passed on to individuals who purchased developed lots. However, if the property remains titled in the name of the developer because the lots are unsold, the burden for payment of each of these annual Special Assessments falls upon the developer. This has led to some unfortunate situations in the operation of Development Districts. For instance, in 2008 a Jacksonville, Florida community development district began foreclosure proceedings against the developer who was instrumental in creating the District. The developer had been unable to build a single home on the property in the District and was financially unable to keep up with the payments of the Special Assessments.[vii]

In light of the economic times, an understanding of the tax consequences applicable to the various options open to developers whose property is included within a Development District is particularly timely.

The first option, like that of the developer in Jacksonville, is to walk away from the property and let the property go into foreclosure. Although foreclosure proceedings by a Development District for unpaid Special Assessments typically proceed very slowly due to the multi-step process that must be followed, a failure to timely pay a Special Assessment will, in almost all cases, constitute a default under any acquisition and development mortgages encumbering the developer's property, thereby resulting in foreclosure by the mortgage holder. Because the lien for Special Assessments levied by the Development District is superior to the lien of the mortgage, the holder of the mortgage (or purchaser of the property in the foreclosure sale, if different from the mortgage holder) must either pay off the unpaid Special Assessments or acquire title to the property subject to the lien of these Special Assessments. In this situation, the foreclosure will have the same tax consequences as in any foreclosure of property, with those Special Assessments which have been assessed as of the time of foreclosure being treated as a tax lien against the property. Because the Development District's rights are solely against the property, the tax lien is a nonrecourse debt and, therefore, relief from the burden of the lien will result in sale or exchange treatment and the amount of the assessed but unpaid Special Assessments will be included in the amount realized from the deemed sale.[viii] To the extent that a portion or all of the acquisition and development mortgage is discharged in the foreclosure, the tax consequences of the discharge will be analyzed depending on the nature of the debt as either recourse or nonrecourse. In the case of recourse debts, if the amount of debt which is discharged exceeds the fair market value of the property, the developer may have cancellation of indebtedness income in the amount of such excess which should be analyzed for the availability of Code Sec. 108 relief.

As we discuss below, any future Special Assessments that have not yet been assessed are not yet liens against the property, and therefore there are no tax consequences associated with the relief from these future liabilities upon the foreclosure.

If a developer is fortunate enough to be well capitalized and have ample cash reserves on hand, a unique opportunity created by current economic conditions may be available. In many instances, an entire issue of Bonds issued by a Development District is acquired either by a single investor or by a small number of investors. Many of these bondholders are understandably concerned about the collectability of the Special Assessments that serve as collateral for the Bonds. The authors are aware of several situations which have occurred in recent months in which well capitalized developers have been able to negotiate directly with the bondholders for a lump-sum payment to the bondholders in consideration for a full release of the property from all future Special Assessments at discounts ranging from 40% to 60%. The removal of this obligation will presumably make lots in the development more marketable because future purchasers will not be faced with the burden of paying future Special Assessments on the lots that they purchase, and will also relieve the developer from the additional burden of paying the annual Special Assessment for the entire property each year while he waits for the market to return to some degree of normalcy.

If the developer is fortunate enough to negotiate a deep discount pay off of the obligation for all future Special Assessments, what are the tax consequences to the developer? Stated more succinctly, will the developer have cancellation of indebtedness income from the transaction? The beginning point in any such analysis must be whether the developer had a “debt” with respect to future Special Assessments that was discharged at less than face value.

Code Sec. 61 does not define debt. However, Code Sec. 108, which deals with exceptions to inclusion of discharge of indebtedness income, defines the term “indebtedness of the taxpayer” to mean any indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property.[ix]

As discussed above, Special Assessments give rise to a lien on the property as of the date the annual assessment is made, which in Florida is January 1 of each year. This clearly meets the definition of a debt under Section 108(d)(1) because the lien is a liability to which the property is subject. However, there is no clear guidance under state law as to whether <u>future</u> the Special Assessments represent a debt prior to their assessment.

The fact that the Special Assessments do not become a lien on the property until January 1 in the year in which they are assessed suggests that the liability of the Special Assessments does not accrue until the assessment is made on January 1 of each year. Therefore, because the debt will not arise until the assessment is made, one would logically conclude that no current debt exists for <u>future</u> Special Assessments which have not yet been assessed.

An additional argument against treating the future Special Assessments as a current debt is the treatment of the Special Assessments upon sale of the property. As noted in the discussion above, Special Assessments levied by a Development District are assessed and collected (at least in Florida) in the same manner as ad valorem real property taxes. Special Assessments, just as ad valorem real property taxes, are assessed on January 1 of a year but are not due and payable until the early part of the following calendar year. If property which is encumbered by a lien for ad valorem real property taxes is sold at any point in time during the year of assessment but before the taxes are due and payable, Code Sec. 164(d) provides that the obligation for payment of these taxes must be pro rated and ". . . so much of the real property tax as is properly allocable to that part of such year which ends on the day before the date of the sale shall be treated as a tax imposed on the seller . . ." Thus, if a sale of property which is subject to the lien of ad valorem taxes occurs in mid-year, only that portion of the ad valorem taxes as is properly allocable to the portion of the year during which the seller owned the property will be treated as an "obligation" of the seller. When a purchaser of property assumes debt of the seller, or acquires property from the seller subject to existing debt of the seller, the amount of such liabilities is considered part of the amount realized in calculating the seller's gain or loss on the sale.[x] Applying this concept to the sale of property which is subject to a lien for unpaid ad valorem taxes, a portion of the obligation for payment of these taxes that is allocable to the seller will be included within the debt which is either assumed or taken subject to and will be treated as an additional amount realized by the seller in connection with the sale. The remaining portion of the assessed ad valorem real property taxes (*i.e.*, the portion that is allocable to the purchaser under Code Sec. 164(d)) will not be treated as "debt of the seller" and, thus, will not increase the amount realized by the seller from the sale transaction. Although not addressed in Code Sec. 164, obligations for payment of ad valorem taxes which may be assessed against the property in future years will also not be treated as "debt of the seller" and will, therefore, not affect the amount realized by the seller in the sale transaction. Although Special Assessments levied by Development Districts will not meet the definition of "real property taxes" under Reg. §1.164-3(b), it is submitted that the same procedures for determining which portion of assessed ad valorem taxes should be treated as "debt of the seller" should, by analogy, also apply to assessed and unpaid Special Assessments levied by the Development District. The same should hold true for Special Assessments that will be (but have not yet been) assessed in future years.

If future Special Assessments which have not been assessed are not debts, then there can be no cancellation of indebtedness income on prepayment of the Special Assessments at a discount. Instead, the cost of prepayment will be capitalized into the basis of the property. Generally, costs which produce a benefit that will last substantially beyond the end of the taxable year must be capitalized.[xi] Because prepaying the expenses relieves the property of future Special Assessment liability, it is a cost that must be capitalized.

In conclusion, although the option of a deep discount buy-out from future Special Assessments will only be available to a relative few well capitalized developers, if the numbers make sense there should be no adverse tax consequences to the developer that would pose an obstacle to completing the transaction.

About the Authors:
Charles H. Egerton and Christine L. Weingart are members of Dean Mead's Tax Department. Mr. Egerton is certified as an expert in Tax Law by The Florida Bar Board of Legal Specialization and has been named an Outstanding Tax Attorney by *The Best Lawyers in America*, *Chambers USA - America's Leading Business Lawyers* and *Florida Trend Magazine*. He is a recipient of the Gerald T. Hart Award, which honors the Outstanding Tax Attorney in the State of Florida by The Florida Bar Tax Section.

About Dean Mead:
Dean Mead provides full-service legal representation to businesses and individuals throughout Florida. The firm has 48 lawyers practicing in Orlando, Fort Pierce and Viera. For more information, visit www.deanmead.com.

---

[i] Uniform Community Development District Act of 1980, Chapter 190, Florida Statutes, as Amended
[ii] Georgia Smart Infrastructure Growth Act of 2007, Chapter 93, 2007 Georgia Laws 564
[iii] Florida Statutes Section 190.016
[iv] Florida Statutes Section 190.021
[v] Florida Statutes Section 190.024
[vi] Id.
[vii] Foreclosures with a Twist in Jacksonville, Barnett, Cynthia. October 1, 2008, available at http://www.floridatrend.com/article.asp?aID=49802 (March 4, 2009)
[viii] Reg. §1.1001-2
[ix] Code Sec. 108(d)(1)
[x] Reg. § 1.1001-2(a); Commissioner v. Tufts, 461 U.S. 300 (1983)
[xi] Prop. Reg. § 1.263(a)-2(d)(4)(i)