

Real Estate Title Insurance & Construction Law

The Fair Share Crisis

Meeting the obligation to create affordable housing

By Donovan Bezer

At this very moment, New Jersey municipalities are worrying about how to meet their “Fair Share” obligation of creating affordable housing. Creative use of Internal Revenue Code Section 1031 may provide municipalities an opportunity to swap property they possess for property that can be converted into affordable housing units. In so doing, the municipality will achieve “Fair Share” credits and reduce its affordable housing obligation.

The Fair Share Crisis

Arguably, no issue in New Jersey history has created greater acrimony between the state and local governments than the current affordable housing obligations imposed upon municipalities. The New Jersey League of Municipalities (an association consisting of all 566 municipalities) recently sued the state for the first time in its history to contest the affordable housing goals set by the Corzine Administration (“Fair Share” obligation).

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The municipalities contend their Fair Share obligations are unrealistic: it is simply not possible given current regulations for municipalities to develop actual housing themselves or persuade developers to build affordable units. The state, which has a vested interest in casting affordable housing creation as feasible and simple, has estimated that a subsidy of \$160,000 per unit is required to create affordable housing. Many local governments feel this figure grossly underestimates the cost of building an affordable home.

If any municipality fails to create as many units as the state demands, under the *Mount Laurel* decisions and the Fair Housing Act, the municipality is vulnerable to a “builder’s remedy” lawsuit, whereby a builder can circumvent the municipality’s zoning requirements. This prospect frightens municipalities because zoning is their chief means of preserving the unique character of a municipality.

Like-Kind Exchanges Under IRC Section 1031

Normally, a taxpayer must pay taxes on gains he has achieved on an investment when the gain is “realized.” In most cases, gain is realized when the investment is sold. See, e.g., 17-SPG JAHCDL 179, 180 (2008).

Favorable income tax treatment of like-kind exchanges is nearly as old as the modern federal income tax. The Internal Revenue Code (“Code”) allows a taxpayer to avoid tax that would otherwise be assessed on capital gains due to appreciation of property, when the property is exchanged for other “like-kind” property. The theory behind §1031 is that the replacement property is deemed a continuation of the old property, where both properties are like kind, such as cattle for cattle, and realty for realty. Additionally, when property is swapped for property, the taxpayer does not receive liquidity with which to pay taxes, as he would if he sold the property.

IRC §1031 can enable a municipality to acquire housing units that can thereafter be treated as affordable units. Suppose taxpayer “ABC Inc.” purchases an apartment building for \$100,000, and the building’s value rises to \$1 million. ABC Inc. has thus gained \$900,000 (forgetting depreciation, etc.), and will be taxed on that appreciation when it is realized. Clearly, ABC Inc. wishes to avoid taxation on the appreciation gain, and in this sense, capital is trapped: ABC Inc. owns a valuable asset, but effectively cannot sell it.

IRC §1031 provides an incentive to ABC Inc. to swap its \$1 million building for another property worth \$1 million. There are two components to this incentive: (a) the taxpayer is able to defer a present obligation to pay tax; and (b) the taxpayer effectively not only defers the payment due date,

but avoids it altogether, insofar as he will increase his basis. (Essentially, "basis" is the cost of the asset as reported to IRS; no gains tax is due if a taxpayer lawfully reports that it bought property for \$1 million and sold for \$1 million). Where ABC Inc. is an entity that not only possesses property but seeks new properties with the potential for a high rate of return, it will be highly motivated to avoid capital gains tax by swapping appreciated property for other property through which it can achieve further capital gains.

The requirements for a like-kind exchange are: (1) there is an exchange of property, (2) held for productive use in a trade or business or for investment, (3) if the property is exchanged solely (4) for other property of like kind and (5) which is to be held either for productive use in a trade or business or for investment.

While local governments technically do not hold property "for use in a trade or business," the productive use requirements may be met where the municipality has no intent to liquidate the property it receives, and none of the property exchanged is for personal use (e.g., vacation property). *Bolker v. C.I.R.*, 760 F.2d 1039 (9th Cir. 1985) and *Starker v. U. S.*, 602 F.2d 1341 (9th Cir. 1979). The like-kind requirement is met so long as both properties are realty — even if vacant land is traded for an apartment complex. 26 C.F.R. §1.1031(a)-1(c).

Parties that can assist the municipality in identifying property owners willing to engage in §1031 exchanges include municipal attorneys, the municipal business administrator, realtors and brokers. Additionally, "Qualified Intermediaries" (QIs) cannot only assist municipalities in finding sellers, but are qualified under the Code to broker complex exchanges involving multiple parties. Such exchanges can be preferable when the owner of the property to be used for affordable housing does not desire property possessed by the municipality, but does want certain property possessed by a third party (potentially, for example, a company that both purchases tax sale certificates and possesses realty).

Counsel for property owners should advise the owners to fill out and submit IRS Form 8824 so as to receive the tax deferral.

Public Property and Powers of Municipalities

New Jersey municipalities are empowered to possess and purchase property for public use. The Local Lands and Buildings Law ("LLBL," N.J.S.A. §40A:12-1 to -38) controls acquisition and disposition of all public property. A municipality is normally required to engage in public bidding before it can dispose of property it owns.

However, §40A:12-16 enables a municipality to exchange property for other property in the absence of public bidding. To do so: (a) the municipality must pass an Ordinance approving the exchange; (b) property used for public highways cannot be exchanged; (c) the municipality may (but need not, unless the property received is of lesser value) exact a cash consideration in addition to the exchange; (d) if the property received is of lesser value, the governing body must determine that the cash plus property received is at least equal to the property being conveyed and the "acquisition is more advantageous . . . than the lands . . . to be conveyed"; (e) the property conveyed cannot be valued at less than what it was acquired for; (f) if the property being given was acquired by gift, then its fair market value must be determined by the Tax Assessor pursuant to N.J.S.A. §54:4-23; and (g) the property received by the municipality shall be valued by the Tax Assessor in a similar manner.

In every case, notwithstanding redundancy, the municipality should pass another ordinance approving the acquisition of real property by exchange. N.J.S.A. §40A:12-5(a) (1). If the property traded by the municipality was initially received subject to conditions (e.g., to be used as a public park), then it must determine by ordinance, pursuant to N.J.S.A. §40A:12-5(d), that the property can no longer be used advantageously for the purposes for which the property was acquired. Such transfer must be in accord with N.J.S.A. §40A:12-13.

The New Jersey Statutes will permit an exchange of vacant land for improved real property if the property received is of greater public use than the property given. See *Bruno v. City of aLong Branch*, 35 N.J.Super. 304 (App. Div. 1955). If the municipality has a population of 265,000 or greater according

to the latest federal census, and has adopted a "Mayor-Council Plan" of government, then the mayor or his designee must play the central role in the exchange. N.J.S.A. §40A:12-13.9.

Challenges to municipal transfers of property usually focus on deviation from procedural requirements, as opposed to the utility or expediency of the actual transaction. 35 N.J. Practice §14:18. It is therefore advisable that the municipality obtain all necessary zoning and planning approvals before conveying the property.

Municipalities may possess property due to a variety of reasons: property can be acquired through eminent domain, through tax foreclosure, by purchase, by being abandoned, by gift or devise, or by other means. If the property has value to investors, it can be traded.

Creation of Affordable Units

Ideally, a municipality will swap property that is attractive to the owner of an older apartment complex. The symbiosis of §1031 is noteworthy because generally, the municipalities that have the highest Fair Share obligations are the ones that have grown the quickest, and have concomitant boosts in real estate prices. This will increase the likelihood that even older apartment complexes have highly appreciated values trapped by the threat of gains taxation.

Once the municipality receives the sub-luxury housing units, it can keep the property in its inventory of property, convey to its Housing Authority, convey to a nonprofit that manages affordable housing, or one of several other options. However, after the exchange, the municipality should consummate the creation of affordable housing units by restricting the deeds of each unit within the property it receives so as to limit occupancy to those qualified as moderate-, low-, or very-low-income. The municipality should also adhere to the requirements of the specific means by which COAH recognizes the creation of affordable units (e.g., market-to-affordable program, \$25,000 per unit subsidy required). Thus, deed-restricted affordable units can be claimed as credits against the municipality's Fair Share obligation. ■