Passage of Pa. House Bill 761 Affects Taxability of 89-11 Transactions

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Unless there is an exception, sales of real estate in Pennsylvania are subject to a realty transfer tax. The tax is payable to three jurisdictions – the Commonwealth of Pennsylvania, the municipality, and the school district. The total tax due is usually 2 percent, of which 1 percent is collected by the state, while the municipality and school district each collect 0.5 percent. However, the rate of the tax due to Philadelphia and certain municipalities and school districts in Allegheny County can be higher than 0.5 percent, with the combined rate applicable to sales in Philadelphia and the City of Pittsburgh being 4 percent.

Many of the more valuable parcels of real estate in Pennsylvania are in either Philadelphia or Pittsburgh, so the 4 percent transfer tax rate applicable in those cities has provided real estate professionals with an incentive to structure transactions that are exempt from the tax. Until 1986, sales of valuable real estate owned by single-asset entities were often structured as transfers of interests in the owning entity instead of the real estate itself. Realty transfer taxes were not due because it was not a sale of real estate, but rather the intangible sale of stock. This opportunity ended when the law was changed to extend the realty transfer tax to any transfer of 90 percent or more of the interests in a “real estate company” within a three-year period. A “real estate company” is defined as any entity primarily engaged in the business of holding, selling or leasing real estate, 90 percent of which is held by 35 or fewer persons, which either received “60 percent or more of its annual gross receipts from the ownership or disposition of real estate” or owned real estate, the value of which comprises “90 percent or more of the value of its tangible assets exclusive of tangible assets which are freely transferable and actively traded on an established market.” In Philadelphia, the definition is modified and you only need the entity to have 50 percent of its value in real estate, and it includes an entity that owns 90 percent or more of the interests in a real estate company.

It was not long after the tax was extended to real estate companies that the so-called 89-11 transaction was devised. In such a transaction, a seller immediately conveys 89 percent of its interests in a real estate company, with the remaining 11 percent...
subject to an option that can be exercised by the buyer one day after the three-year period ends. The option price is set so that it is very unlikely that it will not be exercised. After the Pennsylvania Department of Revenue determined that such a transaction was not subject to realty transfer tax under the existing statute and regulations, the department proposed new regulations that would have clearly made 89-11 transactions to transfer tax. The proposed regulations were never adopted.

House Bill 761 of 2012, which was adopted on June 30, 2012 as part of the budget package, made numerous changes to Pennsylvania taxes, including a change affecting the taxability of 89-11 transactions. Section 12 of the bill provides that to determine if more than 90 percent has been transferred within the statutory three-year period, any transfers of interests in a real estate company will be deemed to have occurred within that period, even if the transfer is made after the period, provided all of the following conditions are met:

(i) the transferring party provides a legally binding commitment, enforceable at a future date, to execute the transfer
(ii) the terms of the transfer are fixed and not subject to negotiation, and
(iii) the transferring party receives full consideration, in any form, in exchange for the transfer.

This change will apply to transactions that occur after January 1, 2013.

It is unlikely that a buyer and seller would agree to structure a sale where condition (ii) was not met. Conditions (i) and (iii) however, both raise issues. With respect to condition (i), reasonable minds may disagree as to whether the seller has provided a legally binding commitment if the seller has provided an option. With respect to condition (iii), if the tax that otherwise needed to be paid were high enough, a seller might decide it was worthwhile to wait to receive “full consideration” until after the end of the three-year period. Indeed, currently many transactions are structured so that the consideration paid for the 11 percent interest is not received until after the end of the three-year period. The 89-11 transaction may not be dead.

House Bill No. 761 also passed a new Historic Preservation Incentive Tax Credit (the “Historic Tax Credit”). Beginning on July 1, 2013, a taxpayer may apply to the Department of Community and Economic Development (DCED) for a Historic Tax Credit Certificate, which shall be equal to 25 percent of the “qualified expenditures” determined by the Pennsylvania Historical and Museum Commission (Commission) to have been incurred by a taxpayer that owns a “qualified historic structure.” The DCED, the Department of Revenue (DOR) and the Commission are charged with developing written guidelines for the implementation of the Historic Tax Credit. In defining the terms “qualified expenditures” and “qualified historic structures,” and the other provisions, the DCED, DOR and Commission may liberally rely on definitions contained in the Internal Revenue Code of 1986, as amended, Code Section 47, in particular 47(c)(2) and (c)(3). The DCED shall not grant more than $3 million in Historic Tax Credits in any fiscal year and shall not grant more than $500,000 in Historic Tax Credits to a single qualified taxpayer in any fiscal year. The Historic Tax Credit may be carried forward for seven years but may not be carried back or create a refund. The taxpayer may sell the Historic Tax Credit with the approval of the DCED, but such assignee must use the credit in the year of the sale. It appears that the Historic Tax Credit will expire within seven years following the fiscal year of the effective date of the Act.
Renewal Options Are Worth Considering in Lease Negotiations

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When negotiating a new lease, both landlords and tenants should consider whether the tenant will have the right to extend or renew the lease beyond its initial term. Although this right is typically conditioned on the tenant not being in default under the lease at the time it exercises the renewal option and at the commencement of the renewal term, it remains a significant right for the tenant because the tenant has the right to force the landlord to extend the lease terms in accordance with the renewal option. The following is a summary of the main components of renewal option provisions to keep in mind when negotiating your lease.

• **Number of renewal options and length of renewal terms.** The number of renewal terms and length of each term vary greatly from lease to lease. As a tenant, it is important to consider your future business needs and how one or more renewal options may serve your goals. From a landlord’s perspective, the renewal terms should be more than one or two years – three- and five-year renewal terms are common – so the landlord is secure in the rental stream from the lease for a longer period of time if the tenant exercises the renewal option since it is foregoing the opportunity to enter into a long-term lease with a third party. Of note, a Pennsylvania lease with a term of 30 years or more is subject to real estate transfer tax; in determining the length of the term, renewal terms where the lease terms are set in the lease and not subject to later determination count toward calculating the length of the term, even if the tenant ultimately does not exercise its renewal option(s). Determining base rent during a renewal term based on the fair market rent just prior to the renewal term (as discussed below) would be an example of a lease term that is subject to later determination.

• **Notice required for exercise of renewal option(s).** Your lease should clearly state how much notice the tenant must give the landlord that it is exercising its renewal option under the lease. This time period typically ranges from three to 12 months (longer is customary for very large leases) prior to the expiration of the then-current term. Once the tenant has failed to timely renew, the landlord knows that it can freely market the space for relet following the expiration of the term. Larger spaces typically take longer to lease, so landlords want more notice. Similarly, tenants who are relocating large spaces will generally know that they are relocating well in advance of their lease expiration.

• **Rent during renewal term(s).** Typically all of the existing terms of a lease apply during a renewal term with the exception of base rent and tenant improvements (discussed below). Base rent is usually increased in some manner during a renewal term. The most straightforward way to accomplish this is for the parties to agree on an exact dollar amount increase to be stated in the lease. If, however, the initial term of the lease is fairly lengthy or there is uncertainty in the market or the overall economy, the parties may prefer to use a somewhat objective standard to determine the increase in base rent closer to the beginning of the renewal term. One way to accomplish this is to increase base rent by the corresponding increase in the Consumer Price Index. While this is a fair method, it can be cumbersome to calculate and the parties must be sure to specifically designate which Consumer Price Index will be used. Another alternative is for the base rent during the renewal term to
be the fair market rent at the time of the commencement of the renewal term (or sometimes 90 percent or 95 percent of such fair market value), which will be determined through an appraisal or arbitration process. In this method, some number of independent appraisers or real estate brokers are designated to determine the fair market rent and both landlord and tenant are bound by this determination. It is helpful for the lease to provide a short period of time (15-30 days) after the tenant delivers its notice exercising the renewal option, during which the landlord and tenant can negotiate to determine the fair market rent on their own. If they are not able to agree, then usually each party would designate an appraiser or real estate broker to render an opinion as to the fair market rent – note that the lease can provide certain qualifications for the appraisers or brokers, such as someone who maintains certain appraisal credentials or has at least ten years’ experience leasing space in similar buildings in the same geographic area. Once both appraisers deliver their fair market rent determinations, the lease may provide that the fair market rent is the average of the two or, if the difference between the two exceeds a certain amount, a third appraiser may be chosen. In this case, the third appraiser may choose one of the fair market rent determinations of the first two appraisers or the third appraiser may make his or her own determination and the fair market rent may then be the average of the two determinations that are closest to one another. There are many valid ways to arrive at a determination, but it is most important that the lease clearly states the method the parties have agreed upon.

- **Tenant Improvements.** During a renewal term, landlords generally do not provide new tenant improvements or tenant improvement allowances comparable to those provided for the original term. Occasionally landlords will agree on a renewal provision to provide a “refurbishment allowance” designed to provide some minor improvements for the renewal term such as painting or new carpeting.

Also, remember that a landlord and tenant always have the option to negotiate an extension of the term of a lease, regardless of the renewal option set forth in the lease. Indeed, this is often what happens but even in these situations, the renewal option terms in the lease provide a starting point for negotiations and thus, should be carefully considered.

### Pennsylvania Superior Court Holds that Unions May File Mechanics’ Liens

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Earlier this year, an *en banc* panel of the Superior Court of Pennsylvania ruled that a trustee of an employee union benefit fund is encompassed within the definition of “subcontractor” under Pennsylvania’s Mechanics’ Lien Law (MLL); and, as such, it may file a mechanics’ lien for the payment of contributions due to it by a contractor under the terms of a collective bargaining agreement entered into many years prior to the performance of work on the subject property. *Bricklayers of Western Pennsylvania Combined Funds, Inc. v. Scott’s Development Company*, 41 A.3d 16 (Pa. Super. 2012). The holding in *Bricklayers* is significant and has numerous implications upon commercial lenders, title insurance companies, real estate developers and investors.

In *Bricklayers*, the defendant/property owner, Scott’s Development Company (Scott’s), retained a general contractor, J. William Pustelak, Inc. (Pustelak), to perform construction work on its property. Several years prior to executing the construction agreement with Scott’s, Pustelak had entered into two collective bargaining agreements (the CBAs) with unions whereby Pustelak agreed to employ union members for certain specific construction work. Neither of the CBAs specifically contemplated work to be performed on any particular real estate project. Under the CBAs, Pustelak was required to pay to trustees named in the CBAs (“Trustees”) contributions towards the members’ health, welfare, retirement and/or fringe benefits. Following the construction work on Scott’s property, during which the unions’ members performed labor for Pustelak, the Trustees claimed to not be paid the appropriate benefits contributions.

To collect the amounts owed to them by Pustelak, the Trustees asserted a mechanics’ lien against Scott’s property, to which Scott’s filed preliminary objections in the nature of a demurrer. The Court of Common Pleas of Erie County granted Scott’s preliminary objections finding that the Trustees lacked standing to pursue a mechanics’ lien. The Trustees appealed to the Superior Court of Pennsylvania.
Before the Superior Court, the Trustees argued that they possess the requisite standing to assert a mechanics’ lien as a subcontractor under the MLL. The court, after noting that only contractors and subcontractors may file mechanics’ liens, examined the statutory definition of subcontractor:

[O]ne who, by contract with the contractor, or pursuant to a contract with a subcontractor in direct privity of a contract with a contractor, express or implied, erects, constructs, alters or repairs and improvement or any part thereof; or furnishes labor, skill or superintendence thereto; or supplies or hauls materials, fixtures, machinery or equipment reasonably necessary for and actually used therein; or any or all of the foregoing, whether as superintendent, builder or materialman.

The court then determined, by applying the provisions of the Statutory Construction Act, that the definition of subcontractor should be liberally construed to effectuate the MLL’s objectives and promote justice. Employing this liberal construction, the court concluded that the CBAs amounted to subcontracts with the contractor to furnish labor, skill or superintendence. The court justified its holding by citing appellate court opinions from other states where unions and their benefits trustees were granted the requisite standing to file mechanics’ liens, and persuasive guidance from the United States Supreme Court’s decision in *U.S. for Benefit and on Behalf of Sherman v. Carter*, 353 U.S. 210 (1957). Accordingly, the order of the Common Pleas Court was reversed.

Judges Judith Ference Olson and Susan Peikes Gantman filed dissenting opinions. Judge Olson dissented on two grounds: 1) although the majority correctly concluded that there was no express contract to furnish labor or improvements, it improperly considered an implied contract when that claim was never advanced by appellants; and 2) unions are not “subcontractors” under the MLL because they do not “furnish” any labor, and therefore even if the Trustees could stand in the shoes of the union members they could not be subcontractors under the MLL. Although she agreed that a liberal construction of the term “subcontractor” was appropriate, she maintained that the intent of the MLL (“to protect the prepayment of labor and materials that a contractor [or subcontractor] invests in another’s property, by allowing the contractor [or subcontractor] to obtain a lien interest in the property involved”) was not advanced by the majority because the Trustees did not expend any labor or money on the project that risked non-payment, and therefore they are not parties the MLL was created to protect. Further, Judge Olson found dubious the majority’s reliance upon other states’ jurisprudence and the *Carter* opinion because the statutes being interpreted therein allow for individual workers to file mechanics’ liens for the payment of wages. Instead, she distinguished the MLL from the laws of the jurisdictions cited by the majority based on several Pennsylvania appellate cases and a legislative comment to the MLL which unambiguously state that laborers employed by a contractor are not subcontractors under the MLL. Judge Gantman similarly found the majority’s opinion contrary to the intent of the MLL, especially where the claims asserted are derived from tangential contracts, collateral to the construction agreement between the general contractor and owner.

Scott’s has filed a petition for allowance of appeal with the Supreme Court of Pennsylvania, which is currently pending.

The court’s interpretation of the MLL, specifically including unions and their benefits trustees within the definition of subcontractor, will cause a myriad of new issues that must be considered by commercial lenders, title insurance companies, real estate developers and investors. Lenders, developers and investors may want to be certain that any contractors that have performed work on a property within six months of closing a mortgage loan (except for those secured by construction mortgages or purchase money mortgages) have paid or guaranteed payment of all financial obligations under any collective bargaining agreements that such contractors and subcontractors may have executed. Owners, developers and landlords should now pay closer attention to the type of subcontractors their general contractors are hiring and must scrutinize such contractors’ financial wherewithal to comply with their labor-related agreements. In addition, title insurers may become even more reluctant to provide coverage against mechanics’ liens, unless they are insuring the priority of a construction mortgage or a purchase money mortgage. Finally, with the Superior Court now liberally construing the substantive provisions of the MLL, lawyers, title companies and private parties should be warily monitoring future expansions of the MLL’s protections.
New Philadelphia Ordinance Requires Reporting Commercial Energy and Water Use

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On June 21, 2012, Philadelphia City Council unanimously passed Bill No. 120428-A, amending Chapter 9-3400 of the Philadelphia Code to require commercial and certain mixed-use buildings to report their energy usage to the City for ultimate public disclosure.

The City’s Office of Sustainability has been charged with implementation of the ordinance as well as promulgating regulations, if deemed necessary in connection with the ordinance. The ordinance applies to “Covered Buildings,” which includes any commercial building containing 50,000 or more square feet of indoor floor space, and the commercial portion(s) of mixed-use buildings with 50,000 or more square feet devoted to commercial use.

Under the ordinance, Covered Building owners must annually report their building’s energy usage (electric, gas, steam and oil), water usage, and building characteristics to the City through a “Benchmarking Application” (initially the U.S. Environmental Protection Agency’s Internet-based system, “Portfolio Manager”). Where available, Covered Building owners may arrange for their utility/energy supplier to submit the water and energy data directly to the Benchmarking Application, but not building characteristics. Building characteristics include a Covered Building’s age, use(s), and operating hours, and may also include the number of computers and/or refrigerator/freezer units in use in the building and the portion of the building that is heated and air conditioned, among other information. Tenants in Covered Buildings do not have separate reporting requirements per se. However, where a leased unit is separately metered for utilities, the ordinance requires time-sensitive tenant disclosures to the owner, if requested, so that the owner may comply with its own reporting deadline.

Failure to comply with the reporting requirements within 30 days of a compliance deadline subjects the violator to a $300 fine, plus $100 each day thereafter that the violation remains uncured.

Most controversial is the ordinance’s disclosure provision. Not only is a Covered Building’s energy performance information to be made available upon request by Covered Building owners to potential buyers or lessees, but the ordinance also contemplates making the reported information available online to the general public in the future. Although some property owners feel the disclosure requirements will unfairly blacklist some buildings with particular uses or tenants with unique energy needs, proponents of the disclosure believe it will force Covered Building owners to make their buildings more energy efficient as consumers become more readily informed.