FEDERAL STANDARD ABSTRACT
TITLE NEWS

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Title News

Flushing Couple Convicted of Defrauding Landlords

Nancy Jace and Danny Nicholas were convicted for defrauding six landlords. In six different instances the couple moved into an apartment, paid rent for a cautionary time, and then claimed not to be able to pay. When asked to either pay or leave, they would do neither and wait for eviction proceedings to begin. When they felt the eviction decision was about to be entered, they would file for bankruptcy just before it, thereby extending their hold-over possession. In all six cases the eviction was eventually carried out, but the six landlords suffered an aggregated loss of $86,000. The Queens County Supreme Court found the couple guilty of Scheme to Defraud in the First Degree and four counts of Grand Larceny in the Third Degree for entering into six different leases with no intention to honor them. Nancy Jace and Danny Nicholas, who are known by many aliases, face up to seven years in prison.

Bankruptcy Amendments

The reach back period on fraudulent insider transfers has been extended from one to two years before the filing date of the petition (Bankruptcy Code Section 548 (a)(1)). Transfers in which there is no antecedent debt must now be recorded within 30 days or the transaction may be voidable by the trustee. In non-insider cases where there is a pre-existing debt, the reach back period is still 90 days. The Code now contains a provision that allows a look-back period of 10 years into trusts or similar devices created by the debtor to his benefit with "actual intent to hinder, delay, or defraud and entity to which the debtor was or became, on or after the date that such transfer was made, indebted" (Section 548(e)). These are only some of the amendments enacted on April 20, 2005 and October 31, 2005.

Matter of Grillo, 2006 NY Slip Op 01163 (2-14-06)

The revocation of the testamentary letters does not affect retroactively the validity of the real estate transactions, nor the decisions the executrix made in distributing the estate, provided the executrix and the parties involved in the purchases acted in good faith. Nevertheless, the question of whether there was good faith is a question left to the jury, and the discharged executrix may be asked to post a bond in the amount of the transactions closed -$500,000 in this case- to the benefit of the estate to cover any liability that may be entered against her. This bond does not only cover any possible damages for bad faith in conveyances of real estate, but also possible damages to heirs and legatees for bad faith in the distribution of the proceeds.

Perfecting the Closing

New Rules Regarding 1031 Exchanges
Revenue Procedure 2005-14

In 2005 the IRS issued new rules that may have the effect of substantially reducing the tax burden on capital gains due on the sale of real estate by combining the benefits of Internal Revenue Code Section 121 and Section 1031.

Section 121 allows a single person that has lived in the premises for at least two years within the last five years to exclude up to $250,000 of gain. For example, an apartment bought in 1995 for 100,000 and sold for 350,000 in 2005 would not be subject to any capital gains tax. In the case of married couples, the exemption excludes up to $500,000.

Although Section 121 was always considered generous, the reality shows that because of the huge rise in property prices in the last ten years, capital gains taxes may be due if the sellers held the property for a long term. For example, husband and wife buy a home in Long Island for $200,000 in 1985 and sell it in 2005 for $1,100,000. Section 121 would allow them to exclude $500,000 on the gains of $900,000 –the difference between the purchase price and the sale price-, but the couple would otherwise owe capital gains tax on the remaining $400,000.

Sellers of investment real estate are not entitled to the Section 121 exclusion, but avoid their gains tax through another device, Section 1031. Although real estate may appreciate on a constant basis, the IRS does not usually recognize a gain until the investment property is sold, at which time the gain materializes or is “realized.” Under Section 1031, the seller of real estate can delay the “realization” of the gain by using the proceeds of the sale to purchase other real estate. Tax-wise, the underlying idea is not that the owner is selling the property, but that it is being exchanged for another similar investment.

The new rules in 2005 allow the seller of real estate to combine the benefits of Section 121 and 1031. Following our last example, where husband and wife incurred capital gains tax on the remaining $400,000, the couple could attempt to do a 1031 exchange on that remaining balance. If the couple moves out and rents the house for two years before selling it, they would satisfy both sections: Section 121 would allow the $500,000 exclusion because it was used as a residence at least two of the five years preceding the sale (note that there is no requirement that the last two years immediately precede the sale); and Section 1031 would allow an exchange of the balance because the property was effectively an investment property at the time of sale. In our example, the remaining $400,000 would have to be used towards the purchase of other real estate, and the realization of the gain would effectively be deferred until the new real estate was sold. Note that this combination of sections 121 and 1031 only works on residential properties turned investment, not vice versa.

Lastly, while our example suggests renting the property for two years before the sale to qualify under Section 1031, a shorter period might be possible. Be sure to discuss your case thoroughly with your tax advisor before undertaking to combine both sections. This article is based on Recent Developments in 1031 Exchanges, Mary Kay Kennedy, TitleNews Jan./Feb. 2006, p.22.

So what if we don't have a Certificate of Occupancy? Should we stop a million-dollar closing because we may get building violations?

In the face of the increased purchase prices some people have felt that building regulations have lost their bite because the violations that would ensue from breaking them bear no relationship to the price of real estate. In that mind-set, closing without a certificate of occupancy seems to be merely an exposure to the risk of incurring violations, which the client may be readily tempted to accept if the purchase price is good. Besides, one may reason, what is the chance of being subject to a building inspection?

The risk of residing illegally is far greater than the violations the Department of Buildings ("DOB") may issue. First and foremost, no attorney is expected to have knowledge in construction as to advise whether the building is safe to inhabit. The purpose of the certificate is to ensure that the building is sturdy and inhabitable. If there is no certificate, one cannot rely on the seller's word for it. At the same time, residential hazard insurance may not be honored if the building is not qualified for residential use; especially in those cases where the DOB records disclose that the item pending sign-off was the one that caused the casualty (such as electricity or plumbing sign-offs). Equally troubling to the closing attorney is the fact that no rent may be collected on residential buildings illegally occupied. This applies to the recurrent illegal basement apartment as well as to the whole building if there is no certificate of occupancy. Lastly, if there is no certificate, the DOB may determine the building to be unsafe, evict the owners and pad-lock it.

It is important to note that lenders should also be concerned about the legality of residential properties. In Howard v. Berkman, Henock, Peterson & Peddy, P.C., 2004 NY Slip Op 51470 (11-05-04), the Civil Court of New York explained in an *obiter dictum* that licensed lenders of residential mortgages are precluded from collecting mortgage payments if the premises are not qualified for residential use, because lenders are barred from assisting in breaking local laws, and because giving a residential mortgage and having the borrower sign an occupancy agreement on property not qualified for residential use is an illegal unenforceable contract.

Holding money in escrow to ensure the seller's help in procuring a certificate of occupancy has given rise to an array of new problems and litigation. Unless the attorneys are familiar with construction and permits, the escrow amount becomes a wild guess. Even if the escrow amount is conservative, there is no telling whether the property can be made legal. The building may have to be substantially re-built for a certificate to be issued; which would mean increased costs of compliance and may cause the buyers to find alternative lodgings while the work is done. And there is always the issue of the seller's compliance. Very often the seller sets aside a sum such as $2,500 to ensure compliance, but later realizes that complying would cost more. The seller finds herself in a situation where it is better to forgo the escrow than comply. This is only made worse by the fact that escrow agreements drafted at closing often lack a provision explaining what is to be done with the proceeds if the seller fails to comply. The escrowee will not release it to the buyer if the agreement does not call for it no matter how long the seller has been in default. In some cases the buyers have decided to take the loss, obtained the certificate and then asked the escrowee to release the monies to them, only to be turned away because the agreement only considered release *to the seller* and the escrowee has no standing to extend it by interpretation. If escrow must be held, the amount should induce the seller into compliance, instead of simply covering the cost, and a procedure for the buyer's self-help in case of the seller's default should be stipulated.

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If you have any questions, comments or suggestions please feel free to e-mail us at fsa@federalstandardabstract.com.