

August 16, 2012
Pennsylvania Realty Transfer Tax
No. RTT-12-001

Assignment and Sale of Special Declarant Rights in a Flexible Condominium

ISSUE:

Is an instrument that transfers special declarant rights to develop convertible real estate reserved in a flexible condominium under the Pennsylvania Uniform Condominium Act subject to Pennsylvania Realty Transfer Tax?

CONCLUSIONS:

Special declarant rights to convert convertible real estate in a flexible condominium are an interest in real estate and any instrument conveying the special declarant rights are subject to Pennsylvania Realty Transfer Tax.

FACTS:

Taxpayer created a flexible condominium in Pennsylvania ("the Condominium") under the Pennsylvania Uniform Condominium Act. Taxpayer, the developer and declarant, filed the declaration of condominium with the Recorder of Deeds.

Taxpayer planned to develop the Condominium in phases with six separate multi-story buildings consisting of up to 198 residential condominium units. To date, only two buildings consisting of 64 units and common recreational amenities have been developed. As a result of market conditions, the remaining four buildings and units have not been developed, and Taxpayer cannot obtain financing to develop the remaining buildings and units.

Consequently, Taxpayer intends to sell and transfer to a third party Taxpayer's special declarant rights to develop the remaining four buildings and units on the convertible real estate under the declaration for the Condominium.

DISCUSSION:

The Pennsylvania Uniform Condominium Act (the "UCA"), 68 Pa.C.S. § 3101, et seq., permits the creation of a "flexible condominium," defined as:

A condominium containing withdrawable or convertible real estate, a condominium to which additional real estate may be added, or a combination thereof.

68 Pa.C.S. § 3103.

Effectively, a flexible condominium allows the development of a condominium in phases. The creator of the condominium, or declarant,¹ upon filing a declaration of condominium can develop a declared number of condominium units with the ability to develop additional units from “convertible real estate” in the future if the declarant explicitly reserves the right to create such additional units and files an amendment to the condominium declaration. 68 Pa.C.S. § 3206(1) and 3211(a). Convertible real estate can be taken from a portion of a flexible condominium as long as it is not within a building containing a condominium unit. 68 Pa.C.S. § 3103 (see definition of “convertible real estate”). The time in which the declarant has to develop additional units from convertible real estate is limited to a maximum of seven years. 68 Pa.C.S. § 3206(2).

Each condominium unit created in a flexible condominium includes a proportionate share of the common elements, and “each unit together with its common element interest constitutes for all purposes a separate parcel of real estate.” 68 Pa.C.S. § 3105(a).

¹ A “declarant” is defined as:

"Declarant."

(1) If the condominium has been created, "declarant" means:

(i) any person who has executed a declaration, or an amendment to a declaration to add additional real estate, other than persons holding interests in the real estate solely as security for an obligation, persons whose interests in the real estate will not be conveyed to unit owners, or, in the case of a leasehold condominium, a lessor who possesses no special declarant rights and who is not an affiliate of a declarant who possesses special declarant rights; or

(ii) any person who succeeds under section 3304 (relating to transfer of special declarant rights) to any special declarant rights.

(2) If the condominium has not yet been created, "declarant" means any person who offers to dispose of or disposes of his interest in a unit to be created and not previously disposed of.

(3) If a declaration is executed by a trustee of a land trust, "declarant" means the beneficiary of the trust..

68 Pa.C.S. § 3103.

When a declarant creates a flexible condominium, the declarant becomes the owner of the condominium units until sold, at which time the buyer of each unit becomes the owner of the unit and its corresponding common element interest.

The declarant also becomes the owner of any reserved rights at the time the condominium is created, which rights are known as "special declarant rights."² Special declarant rights include the right to "convert convertible real estate in a flexible condominium" into more units. 68 Pa. C.S. § 3103. The question in this case is whether special declarant rights reserved by Taxpayer to convert convertible real estate are an interest in real estate that is subject to the Pennsylvania Realty Transfer Tax if conveyed.

For Pennsylvania Realty Transfer Tax purposes, instruments that transfer title to real estate are subject to tax. 72 P.S. § 8102-C. "Real estate" and "title to real estate" are defined as:

"REAL ESTATE."

² "Special declarant rights." --Rights reserved for the benefit of a declarant to:

- (1) Complete improvements indicated on plats and plans filed with the declaration (section 3210).
- (2) Convert convertible real estate in a flexible condominium (section 3211).
- (3) Add additional real estate to a flexible condominium (section 3211).
- (4) Withdraw withdrawable real estate from a flexible condominium (section 3212).
- (5) Convert a unit into two or more units, common elements, or into two or more units and common elements (section 3215).
- (6) Maintain offices, signs and models (section 3217).
- (7) Use easements through the common elements for the purpose of making improvements within the condominium or within any convertible or additional real estate (section 3218).
- (8) Cause the condominium to be merged or consolidated with another condominium (section 3223).
- (9) Make the condominium subject to a master association (section 3222).
- (10) Appoint or remove any officer of the association or any master association or any executive board member during any period of declarant control (section 3303(c)).

68 Pa.C.S. § 3103.

(1) Any lands, tenements or hereditaments within this Commonwealth, including, without limitation, buildings, structures, fixtures, mines, minerals, oil, gas, quarries, spaces with or without upper or lower boundaries, trees and other improvements, immovables or interests which by custom, usage or law pass with a conveyance of land, but excluding permanently attached machinery and equipment in an industrial plant.

(2) A condominium unit.

(3) A tenant-stockholder's interest in a cooperative housing corporation, trust or association under a proprietary lease or occupancy agreement.

"TITLE TO REAL ESTATE."

(1) Any interest in real estate which endures for a period of time, the termination of which is not fixed or ascertained by a specific number of years, including, without limitation, an estate in fee simple, life estate or perpetual leasehold; or

(2) any interest in real estate enduring for a fixed period of years but which, either by reason of the length of the term or the grant of a right to extend the term by renewal or otherwise, consists of a group of rights approximating those of an estate in fee simple, life estate or perpetual leasehold, including, without limitation, a leasehold interest or possessory interest under a lease or occupancy agreement for a term of thirty years or more or a leasehold interest or possessory interest in real estate in which the lessee has equity.

72 P.S. § 8101-C

The UCA is, by its very terms, somewhat equivocal as to whether special declarant rights to convert convertible real estate are an interest in real estate.

On the one hand, the UCA seems to provide that once a declarant sells all of the units in a flexible condominium, the unit owners are the owners of all of the real estate in the condominium (the units and their respective common elements). As stated above, each unit is a separate parcel for real estate, and each unit is separately taxed and assessed to the unit owner. 68 Pa.C.S. § 3105. Therefore, the special declarant rights would not be real estate because the unit owners own all of the real estate interest in the condominium.

However, special declarant rights give the declarant the right to create additional condominium units that can later be sold by the declarant as real estate. As stated above, a condominium unit is considered real estate for Pennsylvania Realty Transfer Tax purposes. This would suggest that the special declarant rights are a real estate interest.

The UCA describes the special declarant right to convert convertible units in terms of both a "reservation" and an "option." It states that a declarant must include in a flexible condominium declaration an "explicit **reservation** of any **options** to create units, limited common elements, or both, within convertible real estate or to add additional real estate to or withdraw withdrawable real estate from the condominium." 68 Pa.C.S. § 3206(1) (emphasis added). The use of both terms in this context creates a problem for

Pennsylvania Realty Transfer Tax purposes because a reservation of an interest in real estate is treated differently than an option that encumbers real estate.

A reservation in real estate is generally created when an owner of real estate conveys a portion of their real estate interest and retains a portion of his interest. For example, in the case of the conveyance of a life estate, the owner of the real estate conveys the life estate and retains or reserves a remainder interest. The remainder interest is a future interest in the real estate and is subject to tax if conveyed.

In contrast, an option is usually a contractual interest, which when related to real estate, encumbers the real estate, but it is not itself a real estate interest. For example, an option to purchase real estate is a contractual right to purchase the real estate within a fixed time for an agreed upon price. In many cases, an option agreement can be assigned and sold. Because the option is a mere contractual right, the assignment and sale of an option is not subject to tax.

If viewed as a “reservation,” a declarant in a flexible condominium retains a future interest in the convertible real estate of the condominium, which interest vests upon the filing of an amendment to the condominium declaration.

If viewed as an “option,” the declarant transfers his entire real estate interest to the buyers of the condominium units and retains the right to have part of the interest in the convertible real estate returned to him (a reversionary interest) upon the filing of an amendment to the condominium declaration (effectively, the filing of the amendment is the exercise of the option). This interest would be akin to a fee simple determinable or a fee simple subject to condition subsequent. (“A fee which is subject to revert to the grantor can be either a fee simple determinable or a fee simple subject to a condition subsequent. Although both of these types of fees are characterized by the possibility of reversion to the grantor, they are distinguished by the circumstances which will cause the fee to revert.” *Emrick v. Bethlehem Township*, 506 Pa. 372, 378 (Pa. 1984).)

In either case, upon the filing of the amendment, the declarant becomes the owner of any units created by the amendment. 68 Pa.C.S. § 3211(a). The only question is—whether the declarant’s ownership is something the declarant reserved from the inception of the condominium or whether it is something that is returned or reverts back to the declarant.

It is the Department’s position that the special declarant right to convert convertible real estate in a flexible condominium is more akin to a reservation than a reversionary interest pursuant to an option. This is supported by the fact that the declarant retains certain rights and liabilities in the convertible real estate that are similar to rights associated with real estate ownership.

First of all, the UCA envisions that special declarant rights can be transferred just as real estate interests are transferred. Section 3304 of the UCA provides that:

No special declarant rights (section 3103) created or reserved under this subpart may be transferred except by an instrument evidencing the transfer recorded in every county in which any portion of the condominium is located in the same records as are maintained for the recording of deeds of real property and shall be indexed in the name of the condominium in both the grantor and grantee index. The instrument is not effective unless executed by the transferee.

68 Pa.C.S. § 3304(a). These characteristics of a transfer of special declarant rights are similar to the characteristics of a transfer of title to real estate by deed.

Second, although the purchasers of condominium units are the legal titleholders of the convertible real estate until the declarant files an amendment to convert the real estate, the declarant retains the liability for the real estate taxes and expenses attributable to the convertible real estate. Further, any income or proceeds from the convertible real estate inures to the benefit of the declarant.³

³ See 68 Pa.C.S. §§ 3105(b) and 3211(c) that provide as follows (emphasis added):

§ 3105(b). *Taxation and assessment.* --If there is a unit owner other than a declarant, each unit together with its common element interest, **but excluding its common element interest in convertible or withdrawable real estate**, shall be separately taxed and assessed, and **each portion of any convertible or withdrawable real estate shall be separately taxed and assessed**; otherwise, the real estate comprising the condominium may be taxed and assessed in any manner provided by law.

§ 3211(c). *Liability for expenses and right to income.* --Until conversion occurs or the period during which conversion may occur expires, whichever occurs first, **the declarant alone is liable for real estate taxes assessed against convertible real estate and all other expenses in connection with that real estate**. No other unit owner and no other portion of the condominium is subject to a claim for payment of those taxes or expenses. Unless the declaration provides otherwise, any **income or proceeds from convertible real estate inures to the declarant**.

Third, when viewed in terms of the practical application of the tax law, treating the special declarant rights as a reversion interest under an option would create an undue burden upon the future development of convertible real estate in a flexible condominium in the Commonwealth. If viewed as an option and reversion, every time a declarant exercises his rights to convert convertible units, ownership of the convertible real estate would revert back to the declarant upon the filing of the amendment, and the amendment itself would become a taxable document for Pennsylvania Realty Transfer Tax purposes.⁴ The declarant would become liable for the tax. Further, all existing condominium unit owners would become jointly liable for the tax with the declarant according to their proportionate ownership in the converted real estate.

Compare the option and reversion treatment to treating the conversion as a reservation of an interest in real estate. If the declarant had reserved a future interest in the convertible real estate, then when the conversion occurs, the declarant's future interest vests and there is no transfer of ownership that would be subject to tax. The declarant has always owned the future interest. The only tax liability that could exist associated with the special declarant rights would be the assignment and transfer of such rights, and the only parties that would be liable for the tax would be the declarant and the transferee.

Consequently, when interpreting the UCA in conjunction with the Pennsylvania Realty Transfer Tax Law from a practical standpoint, it seems untenable and contrary to the likely intent of the General Assembly to treat the special declarant rights to convert convertible real estate as a mere option and reversionary interest rather than a reservation of a future interest in real estate. Because special declarant rights to convert real estate are a reservation of a future interest in real estate, they are subject to Pennsylvania Realty Transfer Tax when transferred.

In this case, when Taxpayer sells Taxpayer's special declarant rights to the third-party purchaser, the instrument of transfer is subject to Pennsylvania Realty Transfer tax. Assuming that the sale price is a bona fide sale for actual monetary worth, then the sale price is the taxable value. 72 P.S. §§ 8101-C (definition (1) of "value) and 8102-C.

⁴ A taxable "document" can be "[a]ny deed, instrument or writing which conveys, transfers, devises, vests, confirms or evidences any transfer or devise of title to real estate" 72 P.S. § 8101-C (definition of "document").