

# Shattering Right-To-Use Myths

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*As methods of timeshare ownership evolve, it is increasingly evident that some potential developers would like to offer a membership-based (right-to-use) product rather than deeded fee, but they are frightened by the ghosts of issues past. Yet some problems of the past may have been based on misconceptions, as the following presentation of key issues explores.*

## *Is It a Security?*

The U.S. Supreme Court held that a land sale was an investment contract, which is a security, in the leading case *SEC v. W.J. Howey Co.* [328 U.S. 293 (1946)]. Howey and his friends sold **parcels of real property** conveyed by a warranty deed in a Florida orange grove. But it was the promise of profits from the sale of oranges, based on the efforts of the promoters, that led the Supreme Court to find a violation of the securities laws. The Court referred to the deeded interests as “immaterial . . . nominal interests in the physical assets employed in the enterprise.”

Some states have adopted a “risk capital” securities theory, including California, Hawaii, Oregon, Washington, Nevada and Michigan. If money is taken from a purchaser for a product to be delivered in the future, the money may be “at risk” and the sale may be required to comply with the securities laws.

The leading risk capital case in California is *Silver Hills Country Club v. Sobieski* [55 Cal. 2d 811, 361 P.2d 906 (1961)]. Silver Hills sold country club memberships in a country club facility that was not yet built. The proceeds from the sale of the memberships were to be used to build and improve the country club facilities.

The California Supreme Court held that the sale of the memberships violated the securities laws because the facilities underlying the membership were not in existence when the memberships were purchased, and therefore the capital contributed by the purchasers was at risk.

The Court’s decision was based in part upon its finding that the membership constituted a “beneficial interest in title to property,” which was part of the definition of “security” in the California securities law. Therefore, even though the Silver Hills membership was a bare right-to-use — without any vote or interest in the assets, profits or proceeds of the country club — the Court construed the membership as a beneficial interest in title to property to support its finding of a violation of the securities law. Other factors discussed by the Court in Silver Hills were “a passive position on the part of the investor, and the conduct of the enterprise by the issuer with other people’s money.”

Whether or not a vacation product is deeded-based or a nonspecific right-to-use does not determine whether it is a security. Factors much more relevant to the securities issue are:

- promises of income or increase in value (profit potential);
- lack of control by purchasers;
- uncompleted units or amenities;
- monetary liens on the underlying real property; and,
- if the developer-seller still owns the underlying real property after the sale, the debt-to-equity ratio of the developer.

## *Are There “Windrifter” Tax Consequences?*

On September 30, 1977 the Internal Revenue Service issued a “National Office Technical Advice Memorandum” concerning the Windrifter project in New England. Although membership in the Windrifter project was a bare right-to-use, the IRS construed the transaction as a lease — **an interest in real property** — in order to arrive at the adverse tax consequences for which the Windrifter Memorandum is famous. Namely, it recognizes the “sales” proceeds as ordinary income (advance rent) in the year received, but capitalizing the cost of buildings and related amenities — and recovering it through allowable depreciation deductions over the projected life of the asset, which the developer still owned. In Windrifter the Certificate of Membership

- entitled each purchaser the use of a housing unit for a designated period of time each year (over a 40 year period);
- gave no right to extend or renew the term of use;

- gave no right to insurance proceeds upon destruction; and
- subordinated the membership to the lien of a lender obtained by the developer.

The developer received full payment in the year of “sale;” continued to own the property; managed the property; collected the management fee from the members; was responsible for all repairs; and was entitled to any proceeds of insurance upon destruction.

The IRS analysis was based on the principle that:

“the transaction must be properly characterized by relying on the **economic substance of the transaction rather than the form** in which it may be cast.”

Because the seller had not “transferred to the buyer all the benefits and burdens of ownership,” the seller was held to be in the position of a landlord under a lease. The catastrophic result was reached in Windrifter not because the membership was a right-to-use, but because the IRS rightly construed it as an interest in real property for a term of years — a lease.

Windrifter is sometimes discussed in the context of installment sale reporting for income tax purposes. “‘Installment sale’ means ‘a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs’ [IRC §453(b)(1)].”

The Windrifter Memorandum states that the developer “received full payment for the Certificates of Membership in the year of sale,” and “the transfers of the Certificate of Membership were, in substance, not sales but leases.” Therefore, because there were no installments and no sales, installment sale reporting is not a Windrifter issue.

However, under Subsections 453(b) and 453(l) of the Internal Revenue Code of 1986, installment sale reporting for income tax purposes is available for the **sale** of “a timeshare right-to-use or a timeshare ownership interest in residential real property,” under certain conditions. Again, it does not matter if the timeshare is a right-to-use or a deeded fee interest.

The most critical factor in the Windrifter TAM was the temporary nature of the timeshare and the on-going ownership and management by the developer, and not whether the timeshare interest was based on a right-to-

use membership as opposed to a deeded ownership. A "deeded" ownership for a specified term is merely a "lease" by another name and may be subject to the Windrifter consequences.

### *Is It an Executory Contract Which Could be Rejected in Bankruptcy?*

In 1982 the developer of the Sombrero Reef project went bankrupt and the U.S. Bankruptcy Court allowed rejection of the right-to-use timeshare interests in the project as executory contracts that did not have protection as unexpired leases or executory contracts for sale of real property.

The Bankruptcy Code was subsequently amended to allow owners of timeshare interests to retain their timeshare interests and receive the benefits of the timeshare program, regardless of attempted rejection by the bankruptcy trustee. A "timeshare interest" may be established by a membership, license, right-to-use agreement, lease or deed, or any other instrument [Bankruptcy Code §101].

There are still some open questions as to what kinds of timeshare interests are protected under the Code amendments. But those exceptions would probably apply as well to a timeshare interest based on a deeded fee if there were substantial on-going services to be performed by the developer, which could be held to be an executory contract.

Again, whether bankruptcy of the developer adversely affects the individual timeshare interests is no different whether the timeshare interest is a bare right-to-use or a deeded fee, unless the deeded fee has been completely paid for and is not tied to substantial on-going developer services.

But if the overall structure of the timeshare plan causes the value of the timeshare interest to be too dependent upon the on-going financial condition of the developer, there are probably securities issues and Windrifter issues which could thrust the developer into bankruptcy.

**D**eeded fee "ownership" sometimes creates a false sense of assurance that all crucial issues have been resolved and/or appropriate member safeguards have been provided when, in fact, they may not have been.

The securities, income tax and bankruptcy issues are no different whether the timeshare interest is based on a right-to-use membership or a deeded fee.

The **real** issues are the overall legal structure, the construction of the tangible amenities and the performance of marketing and sales. Therefore, a membership right-to-use product can be structured with all of the safeguards, powers and essential ownership of deeded fee. □