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Uncertain Times; Uncertain Taxes

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In the current economic climate, deeds recorded in connection with foreclosures, short sales or deeds in lieu of foreclosure transactions are common and recorder's offices are closely scrutinizing those transactions. In certain cases, recordation and transfer taxes are being imposed on a property value other than the stated deed consideration, thus making the process of predicting transaction costs difficult and uncertain.

The acquisition of distressed debt secured by real estate has long been an attractive investment for savvy investors. By acquiring the debt of an unrelated borrower, the investor steps into the former lender's shoes with the possibility of obtaining an above-market rate of return if the borrower even partially performs by paying default interest or late penalties. In other cases, an investor may itself be the defaulting borrower and can make an offer to its lender to purchase its own distressed debt at or below par. Given the current economic climate, it is often the case that a third party borrower is unable to perform and the investor who has assumed the role of lender is forced to exercise its default remedies. And, when an investor is both borrower and lender, the investor/lender may wish to exercise a particular remedy necessary to acquire clear title to the secured property for strategic reasons. In either case, the exercise of remedies invites a host of options for the investor/lender including: (i) accepting a deed in lieu of foreclosure ("DIL"); (ii) consenting to a short sale; or (iii) completing a foreclosure.

When considering which remedy to exercise, an investor typically considers, among other things, the transaction costs associated with each option. A major component of analyzing potential transaction costs is understanding the amount of transfer and recordation taxes due in connection with a given remedy. Regardless of the remedy selected, an investor recording a deed transferring title in the land records where the property is located will in many instances incur one or more taxes due at the time of recordation.[1] Generally, those transfer and recordation taxes are based on the stated deed consideration in accordance with applicable law. Nonetheless, although state and local taxing authorities are relying upon statutory law to impose the tax due, many recorder's offices are now interpreting the law to require payment of tax on property values greater than the stated deed consideration when deeds are recorded in connection with foreclosures, short sales or a DIL. That is

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particularly true when the grantor and grantee are affiliated parties. The recording process is further complicated since one cannot know exactly what tax base will apply as each individual at the recording office makes his or her own independent determination of the tax base when the deed is being recorded. Thus, in certain cases, it can be impossible or at a minimum extremely difficult, to ascertain with precision in advance how much tax will be due. That, in turn, makes for a harrowing decision about which remedy to pursue based on anticipated transaction costs.

Take, for example, a sample analysis comparing the amount of transfer and recordation tax due on a deed recorded in Maryland in connection with a DIL, short sale or foreclosure with a straightforward sale. Such analysis should begin with an examination of what the applicable transfer and recordation tax rates are in Maryland. That requires review of both the applicable Maryland state law and the laws of the county where the property is located. In addition to state-level taxes, Section 12-103(b)(1) of the Maryland Code Annotated (the "Maryland Code") provides that each county may set, by law, its own applicable recordation tax rate which is then applied to each $500 or fraction of $500 of consideration payable *or* of the principal amount of the debt secured for an instrument of writing.[2] Thus, for example, recording a deed to property located in Prince George's County, Maryland would result in the impositions of three taxes. First, § 10-192 of The County Code, Prince George's County, Maryland (the "PG Code") sets the recordation tax charged on written instruments at $2.50 for each $500 of consideration paid. Second, Prince George's County also imposes a transfer tax under § 10-187(a)(1) of the PG Code at a rate of 1.4 percent of the actual consideration paid or to be paid under every instrument of writing conveying title to real property (or any interest in property) offered for record. Third, § 13-203(a)(1) of the Maryland Code imposes a state transfer tax of 0.5 percent of the consideration[3] payable for the instrument of writing.

After establishing what taxes a given jurisdiction will impose on the recordation of a deed, the next step in the analysis is determining the tax base on which those taxes are imposed. In a traditional purchase and sale scenario, the consideration for transfer and recordation purposes is easily established as the purchase price agreed to in the underlying sale contract. However, when the deed derives from a DIL, short sale or foreclosure transaction, particularly if the grantor and grantee under the deed are affiliated, the determination of tax base becomes much less clear.

In a DIL transaction, the transferring borrower generally executes a document entitled "Deed In Lieu of Foreclosure" transferring title in the property to the lender/investor in full satisfaction of the distressed loan (and the lender will release all of its lien rights in the property simultaneously with the transfer). Since there is no sale contract reciting specific consideration, the general rule in Maryland is that the applicable recordation and transfer tax will be imposed on the amount of the outstanding principal balance of the loan at the time the deed is recorded. Commonly, the recording office will request a copy of the payoff letter issued by the lender to prove this amount. However, recently some title companies have warned that if the recorder's office understands the lender is affiliated with the borrower, which is certainly the case when an investor purchases its own distressed debt and then subsequently ac-

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cepts a DIL to obtain clear title to the property, the recorder's office may take a different tack. Rather than applying the general rule, the recorder's office may instead deem the stated consideration (i.e. outstanding principal balance) as nominal consideration given the relationship of the parties and treat the transaction as a "no consideration" transfer. In that event, the recorder's office may impose recordation and transfer tax based on the assessed value of the property if the assessed value is greater than the outstanding principal amount of the underlying loan. Notably absent from both the Maryland Code and the PG Code are any provisions that stipulate the recorder's office may impose taxes in this manner on a DIL.[4]

In a short sale transaction, the borrower transfers secured property to a purchaser with the lender's consent for a price less than the loan balance and the lender agrees to release its interest in the property. Surprisingly, even though the transaction is a sale with a specifically stated purchase price, the title companies are also warning that the recorder's offices may take a position similar to that in the case of a DIL transaction with resulting taxes based on the real property assessment rather than the stated consideration. In the short sale context, that position is even more puzzling not only because the relevant statutes lack any express authority to impose tax on the assessed value in such a scenario, but also because §§ 13-412 and 13-203 of the Maryland Code, with respect to transfer tax, specifically provide that the consideration does not include the amount of any debt forgiven or no longer secured by a mortgage or deed of trust on the property.[5]

In a foreclosure transaction, the foreclosure purchaser receives a deed transferring the secured property. Like a straightforward sale, the deed is subject to recordation and transfer taxes based on the consideration paid for the foreclosed property. It is common, in an arm's-length foreclosure sale, that the purchaser is responsible for all transfer and recordation taxes as a condition of the sale. Given the title company warnings that affiliated party transactions are closely scrutinized and potentially subject to tax on assessed value (if greater than the stated consideration), one should anticipate the possibility that a recorder's office might take that position in the event of a foreclosure sale between affiliated parties.

Even in a bankruptcy context, concerns about application of the tax on deeds by a recorder's office apply. That is true notwithstanding that frequently the bankruptcy plan will provide that the transfer of property from the debtor or plan trustee to an approved purchaser is exempt from transfer and recordation tax. Nonetheless, recorder's offices may still battle over this type of exemption and require that the party recording a deed to property acquired pursuant to a bankruptcy plan prove its exemption claim by delivering copies of many of the bankruptcy case documents, a detailed explanation of the plan and, possibly even legal arguments supporting the exemption.

The general rule in the District of Columbia ("D.C.") is that recordation tax of 1.45 percent[6] and transfer tax of 1.45 percent are imposed on the amount of consideration stated in a deed. Nevertheless, like the situation in Maryland, the D.C. recorder's office may scrutinize deeds between affiliated parties in the context of a DIL, short sale or foreclosure transactions and assert a different tax base. But, two major differences between Maryland and D.C. could affect the outcome

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of any challenge to the recorder's position: (i) the District of Columbia Code (the "D.C. Code"), unlike the Maryland Code, provides a stronger statutory basis for the recorder's office to impose tax on an amount other than the stated consideration[7] and (ii) under the D.C. Code, the tax may be imposed not only on assessed value but also on the fair market value of the property[8] as determined Recorder of Deeds. The D.C. Code explicitly provides that when there is no consideration for the deed or when the stated consideration is nominal, the consideration is deemed to be the fair market value of the property.[9] In D.C., the burden is on the taxpayer to show that a deed is exempt from tax[10] (arguably, the burden of proof also applies to a taxpayer seeking a reduction in tax).

While D.C. law provides a stronger basis for the imposition of tax on an amount other than stated consideration, application of that approach to deeds arising from distressed property situations remains troubling. Using the fact of affiliation as the basis for asserting that the applicable deed has nominal or no consideration on account of that relationship and nothing more, and thus requiring tax to be imposed on the fair market value, is unsupported. Furthermore, the D.C. recording office has historically applied the standard set forth in § 9-502 of the DC Municipal Regulations to confirm the tax base by comparing the consideration to fair market value — if the consideration is less than 30 percent of the fair market value of the property, the tax is based on the fair market value and not the consideration. Although in one regard this regulation permits greater leeway in the methods for determining the tax base than those applied in surrounding jurisdictions (like Maryland), the Recorder of Deeds may still use discretion to determine whether the consideration presented is nominal and what the fair market value of the property is by examining, among other things, the current assessed value of the property, an appraisal not more than six months old or "any other document upon which the fair market value of the property may be determined."[11] Codification of an explicit standard (not simply reliant on the discretion of the Recorder of Deeds) specifically applicable to foreclosure, short sale and DIL transactions would eliminate the possibility of a changing interpretive policy at the recording office unsupported by the law.

The approach to taxation in Virginia is of less concern than in Maryland and D.C. which impose higher transfer and recordation taxes; however, it remains a possibility that different approaches could apply to deeds in the context of DIL, short sale and foreclosure transactions. Section 58.1-801 of the Virginia Code provides that the rate of state recordation tax, which is 25 cents on every $100 or fraction thereof, is imposed on the consideration stated in the deed or the *actual* (versus fair market) value of the property conveyed, whichever is greater. In addition to the state recordation tax, deeds in Virginia are also subject to: (i) a grantor tax at the rate of 50 cents for each $500 or fraction thereof[12] and (ii) a local grantee tax in the amount of 1/3 of the state recordation tax.[13] Thus, recording offices in Virginia, like D.C. (and unlike Maryland) have some statutory authority to impose tax on an amount other than the stated consideration. It remains to be seen if recording offices in Virginia will choose to interpret the laws to apply the actual value standard when property is transferred in distressed situations. One might hope that since Virginia currently does not police and impose tax on the transfer of economic interests,[14] unlike Maryland[15] and D.C.[16] which do, the Virginia recording offices may adopt a far

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less aggressive stance with respect to the imposition of taxes in distressed transfers as well.

Recent experiences provide some practical considerations. As indicated, when trying to record a deed in a distressed property transaction, the recorder's office may ask for additional information (e.g., an underlying contract, payoff letter, underlying security instrument, affidavits verifying the consideration or other matters, bankruptcy court orders) to substantiate the stated consideration for the imposition of taxes. In addition, the recorder's office may review the assessed value of the property subject to the deed. If, as suggested, recorder's offices are taking an aggressive stance in collecting tax from DIL, short sale and foreclosure transactions between affiliated parties, the parties should prepare in advance to present documentation and, if possible, legal positions to substantiate their approach to the taxes due. Moreover if affiliated parties attempt to record a deed with a consideration less than the fair market value or assessed value of the property (and if greater than the outstanding principal amount of the loan), the recorder's office may reject the deed for the reasons described above. If that happens, it is possible that a red flag of sorts could also affect any future attempt to re-record the deed or to record a new deed on the same property resulting from a different transaction structure. Finally, a party preparing to submit a deed to a recording office together with supporting affidavits should consider carefully whether taking a position contrary to law (or the law as it is being interpreted by the recorder's offices) in effect will result in making a misrepresentation to the taxing authority with all its attendant bad consequences.

It is no mystery that recorder's offices have incentive to scrutinize closely all recordation transactions to maximize tax amounts collected. Recordation and transfer taxes provide valuable revenue to state and local authorities. In Maryland, revenue from transfer taxes is used to pay, among other things, principal and interest on bonds secured by a full faith and credit pledge of the state[17] and in Prince George's County, Maryland, recordation taxes collected are paid into the bus service fund.[18] Substantial portions of the taxes collected in D.C. are deposited into the U.S. Treasury to the credit of the General Fund of the District of Columbia with 15 percent of the funds deposited into the D.C. Housing Production Trust fund.[19] Virginia recordation taxes are deposited into a Transportation Trust Fund and a mass transit fund.[20] Despite the need for those taxes, one might wonder whether it is fair or appropriate for recorder's offices to apply an aggressive interpretation of the law in these troubling financial times to DIL, short sale and foreclosure transactions when many fewer deeds and mortgages arising from traditional acquisition and financing transactions are presented. And, for counsel, charged with the task of advising clients about projected transaction costs associated with a particular course of action in distressed property transactions, it is wise to chart out the various tax scenarios to ensure that their clients are not ill prepared for the possibility that the recording office will insist on payment of a higher tax than that explicitly prescribed by statute.

In these uncertain financial times, it is apparent that we face uncertain taxes, too.

NOTES:

[1]An investor/lender planning to take title to the property will be responsible for paying the required

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transfer or recordation tax to the appropriate authority.

[2]Md. Code Ann., § 12-103(a). An "instrument of writing" is defined in § 12-101(f) to include, among other things, a written instrument that conveys title including a deed. The Maryland Code does not differentiate between a deed recorded in connection with a deed in lieu of foreclosure, a foreclosure or a short sale and, therefore, the recordation tax will apply to each deed regardless of its genesis.

[3]Consideration is defined under Maryland Code Ann.§ 13-203 to include the amount of any mortgage or deed of trust assumed by the grantee and only includes the amount paid or delivered in return for the sale of the property. It does not include the amount of any debt forgiven or no longer secured by a mortgage or deed of trust on the property.

[4]Note, there are other provisions of the Maryland Code which explicitly provide that tax may be imposed on the *assessed* value of a property. See, e.g., § 12-105(d) with respect to certain leased property.

[5]The Attorney General of Maryland issued an opinion on January 27, 2010 in response to Anne Arundel County's attempt, in a short sale transaction, to collect recordation tax not only on the actual sales price for a residence but also on the debt that was forgiven. The Attorney General determined that the tax base should not include the forgiven debt. It will be interesting to see the extent to which this opinion impacts the issues presented in this article and whether the opinion will also apply to commercial transactions since the Attorney General relied on policies associated directly with residential short sales.

[6]D.C. Code §§ 42-1103 and 47-903.

[7]Under § 9-502 of the DC Municipal Regulations, the Recorder of Deeds has broad discretion to determine whether the consideration paid is nominal and what the market value of a property is.

[8]D.C. Code §§ 42-1103 and 1104.

[9]D.C. Code §§ 47-903 and 47-904.

[10]D.C. Code §§ 42-1107 and 47-903.

[11]D.C. Municipal Regulations § 9-502.10.

[12]Va Code Ann. § 58.1-802.

[13]Va Code Ann. § 58.1-814.

[14]Md. Code Ann. § 13-103 and D.C. Code § 42-1103.

[15]In fact, certain Maryland counties have sparked controversy lately by collecting tax on indemnity deeds of trust from *lenders* after an event of default, in certain cases. Title commitments for property located in, for example, Prince George's County and Howard County have raised an exception to title that the recording office may require tax previously avoided as a result of the use of the indemnity deed of trust structure to be paid before a deed may be recorded.

[16]D.C. Code § 42-1102.2 and related D.C. Municipal Regulations.

[17]Md. Code Ann. § 13-209.

[18]Prince George's County, Md. Code § 10-192.

[19]D.C. Code § 42-1122.

[20]Va Code Ann. §§ 58.1 to 815,4.

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