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THE ATTORNEY GENERAL OF MARYLAND
OFFICE OF COUNSEL TO THE GENERAL ASSEMBLY

January 27, 2010

The Honorable Sheila E. Hixson
131 House Office Building
Annapolis, Maryland 21401-1991

Dear Delegate Hixson:

You have requested advice on whether a county has the authority to assess recordation taxes on debt of a "short sale" seller of real property that is forgiven by the lender. This question was prompted by Anne Arundel County's decision to assess its recordation tax against both the amount paid by the buyer to the seller for the property and also on any amount of the seller's mortgage debt that is forgiven by the seller's lender. While not expressly prohibited, it is my view that the counties do not have the authority to include debt forgiven by the seller's lender in calculating the consideration on which the recordation tax will be calculated.¹

Background

Anne Arundel County decided to charge recordation taxes not only on the amount paid by a buyer, but also on the amount of debt forgiven by the seller's lender. The County appears to base its tax assessment on its conclusion that any of the seller's debt forgiven by his lender under a short sale is "consideration" that should be added to the price paid for the property by the buyer to determine the amount of recordation tax. The County further draws support on its view that a short sale is analogous to a deed in lieu of foreclosure. It is my view, however, that neither their definition of consideration nor the analogy to a deed in lieu of foreclosure is supported by the language of the statute or case law.

Short Sale and Deed in lieu of Foreclosure

As a starting point, it is important to explain what is meant by the term "short sale." A short sale is an alternative to foreclosure. It usually occurs when a homeowner

¹ Washington State reached a similar conclusion on the application of its real estate excise tax. See attached January 13, 2009 letter from the Washington Department of Revenue.

falls behind on his mortgage and is determined by his lender to be eligible for a short sale due to economic hardship. In a short sale, the homeowner/seller enters into a contract with a buyer for a negotiated price that is less than the mortgage balance owed on the property. The seller turns the proceeds of the sale over to the lender, and in exchange and to facilitate the sale, the lender agrees to remove the lien on the title. This is usually based on the lender's own appraisal and analysis of what the property could reasonably be expected to bring at an unforced sale. The lender may agree to forgive part or all of the balance owed on the mortgage over the proceeds of the sale. As a result of a short sale, the seller does not have to go through foreclosure, thereby mitigating the damage to his credit rating. The buyer purchases the property at a discount. And the lender incurs a smaller loss than it might otherwise incur by going through foreclosure and taking the property into its inventory.

A deed in lieu of foreclosure is also an alternative to foreclosure. A homeowner who can no longer pay his mortgage transfers the property to the lender. The mortgage is considered paid, and the homeowner is thus released from the liability of the mortgage payments. The lender then sells the property to retrieve part or all of the loan balance.

Maryland Recordation Tax

Generally, after a real estate closing or settlement, the closing agent will submit to the clerk of the circuit court for the county in which the real property is located documents such as deeds and mortgages relating to the sale or transfer of the property for recordation among the land records for that county. Before recordation may take place, State law requires the payment of recordation tax, Tax – Property Article (TP), § 12-101 *et seq.*, which is an excise tax imposed on the privilege of recording written instruments, and also the transfer tax, TP § 13-101, *et seq.*

Under TP § 12-102, the recordation tax is imposed on an instrument of writing: 1) recorded with the clerk of the circuit court for a county; or 2) in the case of articles of transfer, merger, or consolidation, filed with the Department of Assessments and Taxation. An "instrument of writing" is defined as a written instrument that conveys title to or creates or gives notice of a security interest in real property or creates or gives notice of a security interest in personal property. It includes, among other documents, a deed or contract, a mortgage, deed of trust, or other contract that creates an encumbrance on real property, a lease of real property, and an assignment of a lessee's interest in real property.

The governing body of a county and the Mayor and City Council of Baltimore City may set, by law, the recordation tax rate in the county. TP § 12-103(b); *Blumenthal v. Clerk of Circuit Court of Anne Arundel County*, 278 Md. 398 (1976)(affirming local governments' authority to set recordation tax rates). The tax rates are applied to each \$500 or fraction of \$500 of consideration payable or the principal amount of the debt secured for an instrument of writing. The consideration includes the amount of any mortgage or deed of trust assumed by the grantee. TP § 12-103(a). Under TP § 12-104(a), the consideration payable, including the amount of any mortgage or deed of trust assumed by the grantee, must be described in the deed, either in the body of the instrument or in an affidavit under oath.

Analysis

Under TP § 12-103(a), “[t]he tax rates under this section are applied to each \$500 or fraction of \$500 of consideration payable *or* the principal amount of the debt secured for an instrument of writing.”² The consideration includes the amount of any mortgage or deed of trust *assumed by the grantee*(emphasis added). But the term “consideration” is not defined in the statute.

Maryland common law also provides no support for the idea that debt forgiveness by a third-party should be considered consideration. The Court of Appeals considered the issue of what constituted “actual consideration” in *Dean v. Pinder*, 312 Md. 154 (1988). That case involved the conveyance of property from two individuals to a corporation of which they were the only shareholders. Even though no consideration was recited in the deed and no money changed hands, the Court found taxable consideration in the increase in value of the grantors’ stock that could be measured by the value of the property that had become an asset of the corporation. The Court stated that the “assessment of [the recordation and transfer] taxes is based on the ‘actual consideration

² The first sentence of this subsection should be read as requiring the recordation tax to be assessed based on either the consideration payable or the principal amount of debt secured for the instrument of writing. This reading is consistent with the way § 277 of Article 81 read in 1984 and earlier (before the 1985 non substantive code revision):

(b)(1) In the case of instruments conveying title to property, that tax shall be at the rate of 55 cents for each \$500 or fractional part thereof of the actual consideration paid or to be paid; in the case of instruments securing debt, the tax shall be at the rate of 55 cents for each \$500 of principal amount of debt secured.

paid or to be paid' to the transferor upon transfer of the property." *Id.* at 156. The Court, however, adopted the interpretation of the Court of Special Appeals in *Pritchett v. Kidwell*, 55 Md. App. 206, 213-14 (1983), that "actual consideration' flowing *from the grantee to the grantor* is what the parties themselves considered the bargain to be, regardless of the amount of money or other tangible property that the grantor may have received or that may have been stated on the deed." *Id.* at 162. (emphasis added). These cases together suggest that consideration might not be limited to what is stated on the deed, and both cases are still good law, but neither case addresses the issue of consideration in a short sale. Indeed, the courts in both cases plainly regarded consideration as that flowing from grantee to grantor, not that which is part of a separate agreement between the grantor and a third party (the lender). Thus, it is my view that the case law provides no direct support for including debt forgiven by the seller's lender as consideration in the transaction between the grantor (seller) and grantee (buyer).

By contrast, there is some statutory support for the view that debt assumed by the seller's lender in a short sale is not taxable consideration. That evidence is found in the second sentence of TP § 12-103(a) and TP § 12-104(a). While not structured as definitions, these provisions expressly include as consideration debt assumed by the grantee, but do not include debt forgiven or assumed by a party other than the grantee. In the case of a deed in lieu of foreclosure, the homeowner/seller is the grantor and his lender is the grantee. A deed in lieu of foreclosure is normally taxed on the principal balance due on the debt at the time of conveyance. If, however, the property is worth less than the principal balance due and the grantor is insolvent, the tax may be computed and paid on the value of the property. 24 *Opinions of the Attorney General* 974 (1939); Letter of Advice to the Honorable Elmer H. Kahline, Jr. from Assistant Attorney General Bonnie A. Travieso, dated December 9, 1981; Letter of advice to Judson R. Wood from Assistant Attorney General Julia M. Freit, dated September 17, 1993; and Letter of Advice to Lynne G. Howell from Assistant Attorney General Julia M. Freit, dated August 17, 1990.

Similarly, if a buyer in the ordinary course either assumes the seller's debt in exchange for the property or pays part of the purchase price in cash and part by assuming the seller's outstanding debt, the consideration would include the amount of the debt assumed. 22 *Opinions of the Attorney General* 799 (1937).

The Attorney General, as legal advisor to the clerks of court, has consistently taken the position that when property is conveyed subject to a mortgage or deed of trust, whether or not the buyer "assumes" the obligation, the "consideration paid or to be paid" includes the amount of the

outstanding debt. [citations omitted]. The rationale for that approach, as expressed first in the 1937 opinion, is that, in imposing the tax on "consideration paid or to be paid," the Legislature "had in mind the total amounts paid to obtain an unencumbered title to the property" and that, in the case of an existing mortgage, "future payments on the mortgage are a part of the consideration to be paid, for which the purchaser is obligated."

Pritchett at 212. Thus, it is clear that if the lender assumes (or forgives) part or all of the outstanding debt, or another grantee takes title to a property that is subject to an outstanding debt, that amount is included as consideration. In all of the above examples, however, whether the grantee is a private person assuming the grantor's debt or the grantor's lender in a deed in lieu of foreclosure, there are only two parties to the transaction – the grantor and grantee.

In a short sale, by contrast, the grantee is a buyer, not the seller's lender. While the seller's lender has an interest in the sale and plays a role in facilitating the sale, it is not an actual party to the transaction of conveying the property. Thus, it is my view that this provision of TP § 12-103(a) lends no support for an analogy between a deed in lieu of foreclosure and a short sale. Had the General Assembly wanted to include debt forgiven by a seller's lender in a short sale, it certainly could have so provided. Even if an analogy between a deed in lieu of foreclosure and a short sale were supported, as stated above, the tax would be on the principal balance due on the debt at the time of conveyance or the value of the property, not both.

Practical Issues

There are also several practical concerns raised by the imposition of recordation taxes on the debt forgiven in a short sale real estate transaction that raise potential legal issues. The first of these is whether and to what extent the buyer and the buyer's lender know that the sale is a short sale or whether there will be any forgiveness of debt. At the time the contract of sale is entered into, and even at the time of settlement, the seller and his lender may not have completed their negotiations on debt forgiveness. That notwithstanding, the buyer's lender is required to give the buyer a Good Faith Estimate ("GFE") of settlement charges that the buyer will be responsible for at settlement. Absent changed circumstances or a borrower-requested change, some settlement charges, such as points, loan origination charges and transfer taxes, including recordation taxes, may not be increased at settlement. 24 C.F.R. §3500.7 (e) and (f). Thus, if an amount of debt forgiveness is not known before the buyer receives the final GFE, it will not be possible to assess the additional tax against the buyer.

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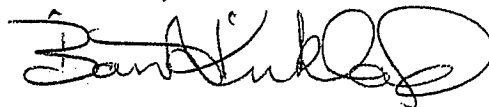
As mentioned above, the seller's lender will often agree to a short sale to facilitate a sale and avoid foreclosure. Additionally, as the purchase price may not be enough to pay off all liens that may be on the property, the seller may enter into negotiations with several parties. If the forgiveness of debt by the lender is consideration for assessment of recordation tax, one could argue that a real estate agent's reduction of a contractually required commission to facilitate the sale or a judgment creditor's agreement to take less than due also be consideration for that purpose.

When the deed is presented for recording, it recites the consideration of the purchase price as negotiated between the buyer and the seller. While the seller needs the approval of the lender to proceed with a short sale, the paperwork normally presented to the clerk or the county, i.e., the contract, the HUD-1, and the deed, will all be consistent in their recitation of the consideration. Normally, this is the extent of the county or clerk's inquiry. *Motels of Maryland, Inc. v. Baltimore County*, 244 Md. 306, 317 (1966) ("Nor can the clerk be required to act as a chancellor by going outside the proffered paper to resolve its effectiveness to accomplish what it is offered to and seems to accomplish"). If short sales are taxed differently the clerk will be required to request additional documentation. Because this is not set out by State law, it is likely that each clerk's office would require different documents to reflect the fact of a short sale and what, if any, debt has been or is to be forgiven. This would unreasonably complicate both the settlement and recording processes.

Summary

In sum, while the courts have not specifically addressed what is or is not consideration in the context of a short sale real estate transaction, and while it is not expressly prohibited by statute, it is my view that the counties do not have the authority to include debt forgiven by the sellers' lender in calculating the consideration on which the recordation tax will be calculated. In rendering this advice, I make no evaluation on what the impact the assessment of recordation taxes to the debt forgiven in a short sale will have on an already depressed housing market or whether such assessment should or should not be permitted. These are policy considerations for the General Assembly. I hope this is responsive to your request.

Sincerely,



Bonnie A. Kirkland
Assistant Attorney General



STATE OF WASHINGTON
DEPARTMENT OF REVENUE

January 13, 2009

Dear Interested Parties:

RE: Application of the Real Estate Excise Tax on "Short Sales"

Concern has been expressed about the proper application of Real Estate Excise Tax (REET) to transactions involving "short sales." In these situations, a property owner in jeopardy of foreclosure sells his/her property to a willing buyer for less than the amount owed on the outstanding mortgage, and negotiates with the financial institution to accept the net proceeds of the sale in forgiveness of the lien against the property and, sometimes, in forgiveness of the debt owed by the seller. The Department has previously ruled that the amount of the debt forgiven by the lender must be included in the measure of the REET. After receiving extensive input from interested stakeholders and industry representatives about the nature of these transactions, we have carefully reconsidered how the REET statutes apply to these unique transactions.

Our previous interpretation focused on the fact that the forgiveness of debt can be valuable consideration in the sale of property. After considerable input from stakeholders, however, we now see that these short sales are distinguishable from other transactions involving the forgiveness of debt because the seller negotiates separately with the lender for any debt reduction/forgiveness, apart from the actual purchase and sale of the property. As a result, the loan forgiveness is not "paid or delivered in return for the sale" of the property, as required by RCW 82.45.030.

Background

Chapter 82.45 RCW imposes an excise tax on every sale of real estate in the State of Washington. All sales of real property are subject to the real estate excise tax unless specifically exempted by statute. The measure of the tax is based on the total selling price of the property conveyed. The incidence of the tax is usually on the seller. However, if the tax is not paid in full, RCW 82.45.070 provides that the tax (together with any interest and penalties) becomes a lien on the real property.

RCW 82.45.030 defines "selling price" as the "true and fair value of the property conveyed." If property has been conveyed in an arm's length transaction between unrelated persons for a valuable consideration, a rebuttable presumption exists that the selling price is equal to the total consideration paid or contracted to be paid to the transferor, or to another for the transferor's

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benefit. The same statute goes on to define the term "total consideration paid or contracted" to be paid as including "money or anything of value, paid or delivered or contracted to be paid or delivered in return for the sale, and shall include the amount of any lien, mortgage, contract indebtedness, or other encumbrance, either given to secure the purchase price, or any part thereof, or remaining unpaid on such property at the time of sale." (Emphasis added.)

Stakeholder Input

On January 9, 2009, the Department held a stakeholder meeting involving more than 40 representatives of escrow agencies, title companies, realtors, attorneys, and short sale exchange facilitators. They walked us through how these transactions actually work. The seller/listing agent finds a buyer, but the lender must approve the "short sale." Then it becomes a very complicated process. The lender will not accept a sales price below Fair Market Value, so the lender has a valuation/appraisal completed. The lender (often an out-of-state, national company) approves/disapproves of every cost and step along the way. The seller separately negotiates with the lender for any reduction/forgiveness of debt. According to the people in the industry, only about 12% of the sellers in our state actually have their debt forgiven (the rest sign a note to the bank, which is not secured by the property). Even if there is forgiveness of debt, that may not be agreed to by the lender until quite some time after the sale has closed. The terms of the agreement between the seller and the lender require that the seller receive no further consideration for the sale beyond the purchase price (which, of course, is paid over to the lender).

Therefore, these are really two separate transactions: one a purchase and sale of the real property (between buyer and seller), and one a negotiation of debt obligation between the lender and the seller. In other words, the seller did not receive debt relief in return for the sale of the property, so it is outside the definition of consideration.

Application to Short Sale Transactions

Ordinarily, if a homeowner owed \$350,000 on his/her mortgage, but sold the house for \$300,000, he/she would still be liable for the remaining amount due on the debt. However, in the "short sale" situation, the financial institution may agree to forgive the remaining amount it is owed. The seller has been spared upwards of \$50,000 in personal liability. Alternatively, the financial institution may simply release its lien on the property, but require a personal note from the seller for repayment of the balance.

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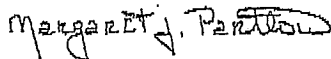
In either scenario, if the purchase price in a short sale transaction is the fair market value for the property, the amount of the debt owed by the seller exceeding the purchase price is not deemed consideration, because it is not paid or delivered in return for the sale of the property. The forgiveness of debt in this case is a negotiated transaction between the seller and the financial institution independent of the sale of the property. This important element distinguishes these transactions from other transfers of property involving the forgiveness of debt.

This analysis is based on the facts as presented to us and if transactions involve different facts, there may be a different result.

Refund Process

Persons who have previously paid REET on the amount of the forgiven debt in a short sale transaction may be entitled to a refund of the excess tax paid. Forms and instructions for requesting a refund can be found on the Department's web site at:
<http://dor.wa.gov/Docs/forms/RealEstExcsTx/RealEstExTxRefundReq.pdf>

Sincerely,



Margaret J. Partlow
Senior Policy Counsel