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TO: All Clerks of Circuit Court
All Land Records Departments

FROM: Stuart Cordish, Courts Unit

SUBJECT: New Legislation – Taxation of IDOTs – Revised Memo

Dear Folks:

As you know, Chap. 2 of the 2012 Special Session makes indemnity deeds of trust (IDOTs) taxable if they are for $1 million or over. The new law affects IDOTs that are recorded on or after July 1, 2012.

A mortgage or deed of trust generally is subject to the State recordation tax, and the tax normally is imposed when the instrument is presented for recording, based on the amount of the secured debt incurred. Tax-Prop. §§12-102 & 12-104.

With a guaranty (or indemnity) deed of trust, the debt has not been incurred by the grantor of the IDOT at the time the instrument is presented. The lender agrees to make a loan to the borrower if a third party, the grantor of the IDOT, guarantees its repayment. The guarantor/grantor then executes a mortgage creating the lien on its property. Because the debt has not been incurred at the time the IDOT is recorded, no tax is collected. However, if the borrower defaults on the repayment of the loan, the debt is incurred by the grantor, and the tax becomes due. Tax-Prop. §12-105(f); 74 *Op. Att'y Gen.* 281 (1989).

This bill changes the landscape for IDOTs of at least $1 million. The new law provides that for these instruments, the debt is considered to be incurred by both the borrower and the guarantor/ grantor at the same time. Because the debt is deemed incurred, these IDOTs are now taxable when presented.

The bill also provides that the tax doesn't get collected on the IDOT if the tax has already been paid on another instrument that secures the repayment of the same loan. This provision that the tax doesn't get collected on a counterpart mortgage is consistent with our interpretation of Tax-Prop. §12-108(e), which states that you don't tax a supplemental instrument.

There have been a number of questions raised as to the application of the new law, including some since the June 15th memo, and I hope to address some of them here.

Q: What is the operative date for collecting the tax?

> A: The statute applies to IDOTs recorded on or after July 1. In counties where recordings are presented at more than one office, the date of recording is the date that the instrument is stamped for taxes at the first office; the first "stamp" controls.

Q: What if the IDOT is presented prior to July1 but rejected? If it is presented again after July 1, when do we consider the IDOT to have been recorded?

> A: The word has gotten out to the title companies not to wait until the last minute. If they anticipate a question as to the acceptability of the instrument, they should allow time to make corrections. The instrument will be considered recorded when the first collector accepts it and stamps it for taxes.

Q: The tax only applies to IDOTs that guarantee the repayment of loans of at least $1 million. Even though an IDOT is for over $1 million, does that mean that the first $999,999 is exempt?

> A: No, the bill was enacted as a revenue-generating measure for the counties and will be applied with that in mind. Once the IDOT crosses the $1 million threshold, the entire amount is taxable.

Q: What about an IDOT that is amended by an instrument that changes the amount of debt secured to $1 million or more (e.g., a "Supplemental IDOT," or an "Amended and Restated and Consolidated IDOT")? Do we charge tax, and on what amount?

A: Previously recorded but untaxed IDOTs will be taxed if they are amended on or after July 1, to change the amount of debt secured, and the result is an IDOT for $1 million or more. The tax will be assessed on the entire newly stated amount of the secured debt.

If the new amount of debt secured is at least $1 million, it is subject to the new law. The supplemental instrument is the trigger, but the entire amount of the loan is now taxable. This applies regardless of whether the first IDOT was recorded on, before or after July 1.

Under Tax-Prop. §12-108(e), you would not tax a supplemental instrument except on the new amount of debt secured. But, in order to claim that exemption, the tax must have been paid on the debt secured by the original instrument.

If an IDOT on which the tax has been paid is amended or modified to increase the amount of debt secured, tax will be due only on the new amount of the secured debt.

Examples:

1. An existing IDOT was not previously taxed either because: 1) the IDOT was recorded prior to July 1, 2012; or 2) the IDOT, whenever it was recorded, secured a debt of less than $1 million. The amendment or modification increases the secured debt to the amount of $2 million. The entire secured debt of $2 million is taxed.

2. An existing IDOT securing a debt of $2 million was not taxed because it was recorded prior to July 1, 2012. The amendment or modification decreases the secured debt, but the secured debt will still be $1 million or more, i.e., $1.5 million. The entire secured debt of $1.5 million is taxed.

3. A $2 million IDOT on which the full tax was paid is modified, to increased the amount of secured debt to $2.5 million. This qualifies as a supplemental instrument, and will be taxed only on the new amount of secured debt, i.e., $.5 million.

4. A $2 million IDOT on which the full tax was paid is modified, to decrease the amount of secured debt to $1.5 million. The supplement is not increasing the amount of the debt secured. No additional tax is due.

5. A $2 million IDOT on which the full tax was paid is being modified to change its terms, but does not result in an increase of the amount of debt secured. Unless there is consideration being paid for the supplemental instrument, i.e., the lender is receiving money in consideration for agreeing to more favorable terms, no additional tax is due. If there is consideration for the supplement, tax is due only on that amount.

   If an amended or supplemental instrument is being offered for recording, which modifies the original instrument only as to non-debt terms of the loan, no additional tax is due. Examples would include:
   a) adding or substituting properties as collateral;
   b) modifying the loan rate;
   c) altering the maturity date of the loan;
   d) changing the trustees.

   An amendment or modification which merely reflects a change in the lender, because the Note has been sold/assigned, is not taxable.

Q: How will we know whether the IDOT is taxable?

A: Unlike traditional Deeds of Trust, IDOTs are not required to state the amount being secured when presented for recording. Because the grantor's liability under the IDOT was contingent, no debt had yet been incurred.

As of July 1, however, you will need to know the amount of debt being secured. Therefore, you should not accept an IDOT for recording unless you receive a completed IDOT affidavit (see attached), and you are satisfied as to amount of debt being secured by the IDOT. The parties offering the IDOT for recording should be prepared to present:

1. A copy of the promissory note;
2. The guaranty agreement; or
3. The HUD-1 or other closing statement.

The affidavit will not be recorded, but may be retained by your office, along with a copy of the IDOT, between audit cycles. If an existing IDOT is being amended, you will need to see a copy of the original IDOT and a copy of the original note.

There is an exception to this rule, although it is rare. Although they are called "indemnity" deeds of trust, what you normally see are "guaranty" deeds of trust, where the grantor's obligation to repay a third party's debt under the guaranty doesn't arise until the third party defaults.

A true "indemnity" deed of trust secures the grantor's own obligation, but the obligation is contingent or is otherwise indeterminate. There is no debt incurred at the time the IDOT is presented, because it has not yet become fixed. These may still be recorded without the payment of tax. They will still be taxable when the contingency occurs.

Q: What about an IDOT for more than $1 million that is secured by real property located in Maryland *and* by property located in another state. If the amount of the loan that is allocated to Maryland property is under $1 million, does the IDOT still get taxed?

A: Yes, once the IDOT crosses the $1 million threshold, it becomes taxable, like any other deed of trust. And like any other deed of trust where the security is real property located both within Maryland and without, it is subject to allocation. You would collect the tax attributable to the Maryland real property.

Q: Could you have two separate loans for $750,000, each involving an IDOT from the same grantor, secured by the same property and presented at or about the same time, and record each IDOT without the payment of the tax?

A: If the transactions are truly independent of each other, then technically each gets recorded without the payment of recordation tax. Odds are you won't see it very often.

Q: Tax Avoidance. What happens if the grantor tries to avoid the tax on a single loan of $1 million or more, by recording multiple IDOTs, all of which are under $1 million? How would we know this is occurring?

A: This statute was enacted specifically to provide additional revenue for the counties, and it will be applied as broadly as the law permits. If a single taxable transaction is disguised, by breaking it down into multiple steps to avoid payment of the tax, we will consider "collapsing" those steps back into one taxable transaction. The "step transaction" doctrine, approved by the Court of Appeals in *Read v. Supervisor of Assessments*, 354 Md. 383 (1999), permits the collector to look at the true substance of a transaction and disregard the form.

Therefore, the parties who submit the IDOT for recording must present the affidavit and documentation sufficient to reflect the actual amounts involved in the transaction (i.e., the guaranty, the promissory note, or the HUD-1 or closing statement).

If you are presented with an IDOT securing $500,000, and a Note reciting a loan amount of $2 million, you are entitled to question that IDOT and request documentation as to the full amount of the loan. If you still have doubts about the taxability of an instrument, please contact our office.

I've been advised by several members of the real estate bar, that it you may see a transaction where the amount secured by a Deed of Trust is considerably less than the loan amount. For example, a commercial lender agrees to lend $20 million, and most of the collateral will be inventory or other personal property. However, the lender still wants the borrower's real property as collateral, which is worth only $500,000. The Deed of Trust that is presented would recite that it secures indebtedness under the Note, but only in the amount of $500,000. Tax would be due only on that amount.

That was not an issue with traditional Deeds of Trust, because the lender has a lien only to the extent of the principal sum recited on the face of the Deed of Trust, and that Deed of Trust is the only instrument you would see. Because IDOTs still are not required to state the amount being secured in order to protect their lien, you will need to see the affidavit and loan documentation. Again, if a question arises as to the taxability of a particular transaction, please refer it to our office.

I expect additional questions to arise. We'll blow up those bridges as we come to them.

Stuart

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