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Real Estate Tax

April 15, 2009

Plan Transfer and Recordation Taxes Correctly When Property Values Fall

by R.J. Davis and Emily K. Winton

Many Authorities are Basing Taxes on the Assessed Value When Property is Purchased at Distressed Prices.

Commercial real estate insiders are well aware that transfer and recordation taxes ("Taxes") accompany most transactions. Historically, in the Washington, DC metropolitan area, including Virginia and Maryland, Taxes are derived from the purchase price of the applicable property. However, with foreclosures and distressed sales accounting for many of the current transactions, many jurisdictions are basing Taxes on the higher of the purchase price or the assessed value of the property.

Planning for the costs and expenses of a commercial real estate transaction typically includes one or more line items for Taxes, the derivation of which used to be simply the purchase price multiplied by the rate charged by the applicable jurisdiction. Now, as purchase prices often reflect distressed market conditions, proper cost planning should include confirmation of the property's assessed value.

Interestingly, most applicable laws and regulations do not expressly permit authorities to base Taxes on the assessed value, instead generally requiring Taxes be assessed on the "consideration" in a transaction. However, with almost all of the state and local jurisdictions experiencing substantial budget shortfalls, it is not surprising that many taxing authorities (including those in Maryland and Virginia, and, in cases of extremely distressed purchase prices, Washington, DC) are interpreting the applicable laws and regulations in a manner that sustains higher Taxes when the assessed value exceeds the purchase price.

For example, Title 58.1 of the Code of Virginia requires the imposition of Taxes on the greater of the consideration or the actual value of the property. While some may interpret the "actual value" to be the fair market value of the property, many counties in Virginia, which actually collect the Taxes under state law, are interpreting the "actual value" to be the assessed value.

To illustrate the foregoing, imagine an asset that had a fair market value of $50,000,000 in 2006. In the current market, perhaps due to a lack of financing, this same asset may only sell for $40,000,000, but have an assessed value of $45,000,000. Under Virginia's interpretation of the applicable laws, the Taxes on such asset would be determined based on the assessed value of $45,000,000, rather than on the arms-length purchase price of $40,000,000. Based on the tax rate in the applicable jurisdiction, this can be a costly distinction. In an attempt to clarify the law, the Virginia House of Delegates introduced a bill on

January 14, 2009, which, if adopted, would revise the language of the Virginia Code to provide that the Taxes shall be levied on "the stated consideration of the deed, or, when the consideration is nominal or when the sale is through foreclosure or other similar sale, the appraised value of the property." If the real estate market remains distressed, it is likely that many jurisdictions will follow suit and adopt legislation expressly permitting Taxes to be determined on the appraised or assessed value under certain circumstances.

As Taxes are often one of the largest expenses in a real estate transaction, various strategies are employed to minimize the Taxes. One strategy to deal with the taxing practices discussed above is to seek preapproval from the applicable jurisdiction of the purchase price in a transaction as the appropriate tax basis. In a deeply underpriced transaction (e.g., ten cents on the dollar), jurisdictions are unlikely to accept the purchase price as a reasonable tax basis, but in situations similar to the example described above, some jurisdictions have agreed to base Taxes on the purchase price. In such situations, where the consideration does not reflect a complete meltdown situation, we encourage you to work with your counsel and commercial title company to determine how the Taxes will be calculated.

For further information, please contact:

R.J. Davis (bio)
Northern Virginia
+1.703.770.7977
rj.davis@pillsburylaw.com

Emily K. Winton (bio)
Northern Virginia
+1.703.770.7771
emily.winton@pillsburylaw.com