Changing Nature of Maryland Indemnity Deeds of Trust (IDOTS)

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For decades, commercial real estate lenders and their developer customers have used a particular financing technique to minimize payment of Maryland's steep recordation tax on mortgages. This tax, which is triggered by the recordation of a deed of trust or mortgage, is levied at different rates in each of Maryland's 24 jurisdictions and can be as high as 1.2%. Although the recordation tax is a state tax, each local jurisdiction sets its own rate. So, for example, a deed of trust securing a $5 million loan recorded in the City of Baltimore (where the rate is 1% of the secured debt) would incur a recordation tax of $50,000. However, by using an indemnity mortgage or indemnity deed of trust (commonly called an “IDOT”), this recordation tax could be avoided – that is, until July 1, 2012 when a new law took effect.

Senate Bill 1302 and House Bill 1802 were passed during the late spring special session of the 2012 Maryland General Assembly, which was called to address Maryland's budget shortfall. This new legislation amends Section 12–105(f) of the Tax Property Article of the Maryland Code to impose the recordation tax on any IDOT or indemnity mortgage recorded on or after July 1, 2012 which secures debt of $1 million or more.

By way of background, a mortgage or deed of trust in a real estate loan is typically provided by a borrower to secure its obligations under a promissory note. By contrast, indemnity mortgages and indemnity deeds of trust are given by a guarantor to secure its obligations under a guaranty of a promissory note. Because a guaranty obligation is contingent upon an event of default under the borrower’s loan documents and is therefore not a present obligation of the guarantor, the recordation tax did not apply under the previous statute, according to several formal opinions issued by the Maryland Attorney General dating back to 1944.

Over the years, the General Assembly has made frequent attempts to tax IDOTS. In fact, bills were introduced in the General Assembly to close the IDOT “loophole" every year from 2004 to 2011, with the lone exception of 2010. With an estimated $35.7 million in local revenues from the change expected to be generated in fiscal 2013, the allure to state legislators was too great this year, and as a result of the new legislation the recordation tax will now apply to all IDOTs and indemnity mortgages securing guaranties of loans of at least $1 million.

There are some noteworthy exceptions, however. First, the new legislation applies only to IDOTs and indemnity mortgages securing guaranties of loans $1 million or more. Thus, the IDOT technique remains available for smaller loans. Second, the new legislation does not affect the so-called purchase money exemption which, under certain circumstances, exempts a mortgage or deed of trust securing a purchase money loan up to the amount of the recordation tax paid on a deed.

Finally, the recordation tax can be avoided when refinancing an existing mortgage or deed of trust loan if the new lender purchases the existing loan documents from the outgoing lender. At the time of closing under this “loan purchase” structure, the new lender will typically amend and restate the purchased loan documents in order to reflect the new loan terms and conform the purchased loan documents to the new lender's desired loan document forms. While the loan purchase method of avoiding recordation tax is not new, the IDOT technique has generally been favored in the past because the loan purchase method avoids the recordation tax only to the extent of the recordation taxes paid on the existing mortgage or deed of trust. For example, if the original mortgage or deed of trust secured $4 million, and the new loan is $5 million, then recordation tax must be paid on the $1 million of "new money". Moreover, if the original loan was secured by an IDOT or indemnity mortgage, then the "loan purchase" method will not avoid any recordation tax because no such tax was paid on the original loan.

An additional drawback of the "loan purchase" method is that the new lender must actually purchase the outgoing lender's loan documents, as distinguished from simply paying off the existing loan with the new loan proceeds. This requires some level of cooperation and documentation between the incoming and outgoing lenders, which can sometimes be a burdensome task. Nevertheless, as the commercial real estate lending landscape adjusts to the impact of the new legislation, expect to see this "loan purchase" method used with increasing frequency.

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