

TRANSFER TAXES AND NEW CONSTRUCTION: A LEGAL UPDATE

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Can builders and developers (legally) avoid paying Michigan's state real estate transfer tax on new construction? The answer: Maybe.

The Michigan Court of Appeals recently considered this issue in Eastbrook Homes v Department of Treasury, decided April 24, 2012. In this case, the developer and affiliated builder were found liable for transfer taxes, penalty and interest in excess of \$1,000,000.

The facts are not in dispute. Developer and Builder used the following business model: Developer conveys a vacant platted lot or site condominium unit to Buyer by warranty deed, and pays the transfer tax on the value of the undeveloped property at the time of the conveyance. When Buyer purchases the unit or lot from the Developer, Buyer also enters into a building contract with Developer's affiliated building company to construct a residence on the property. The purchase agreement between Buyer and Developer includes the value of the vacant land without the value of the later constructed home. Similarly, the contract between Buyer and Builder includes only the cost of construction, not the value of the underlying land. So far, so good.

Unfortunately for the Developer and Builder, there are additional facts. As security for payment of the contract price under the building contract, Builder requires Buyer to quit claim the property to Builder. Once construction is complete and Buyer pays for the home, Builder quit claims the property back to Buyer.

The case involves interpretation of an exemption from Michigan's State Real Estate Transfer Tax Act. MCL 207.526 states that, "The following written instruments and transfers of property are exempt from the tax imposed by this Act... (d) A written instrument given as security or an assignment or discharge of the security interest". The quit claim deed from Buyer to Builder states that the parties' intend to use the deed as security, and therefore, the instrument is exempt from Michigan state real estate transfer tax under MCL 207.526(d). The quit claim deed from Builder back to Buyer states that it was given to discharge a security interest, and is therefore likewise exempt from transfer tax pursuant to MCL 207.526(d).

So, does the state real estate transfer tax apply to (a) the quit claim deed from Buyer to Builder, transferring title to the vacant land ostensibly for purposes of granting Builder a security interest and/or (b) the quit claim deed from Builder back to Buyer, intended to discharge the security interest?

The Michigan Tax Tribunal ruled in favor of the Developer and Builder. The Tax Tribunal acknowledged several facts favorable to the Developer and Builder. The Court acknowledged that the Developer is in the business of taking raw, unimproved land and developing it into divisible parcels of property; the Builder is in the business of residential construction; the Developer and Builder are separate and distinct legal entities; both companies have a legitimate business purpose, other than avoiding transfer tax, to maintain and operate the building company and development company as separate entities, including, without limitation, complying with the condominium act and land division act and tort liability avoidance; the Builder has a legitimate business interest to maintain physical possession of the property throughout construction and the parties acted consistent with their intentions set forth in the transaction documents.

The Tax Tribunal concluded that the quit claim deeds should be treated as creating and discharging a security interest, and were exempt from payment of the state transfer tax. The Tax Tribunal reasoned

that the statute does not require a security interest be created by way of a mortgage. The quit claim deed from Buyer to Builder was really an equitable mortgage and therefore, satisfied the transfer tax exemption. Similarly, the deed from Builder to Buyer was exempt because it merely discharged that equitable mortgage.

The Michigan Court of Appeals disagreed, noting that exemption statutes are to be strictly construed in favor of the taxing authority. The Court of Appeals refused to interpret the quit claim deed from Buyer to Builder as “an equitable mortgage.” Therefore, the exemption from transfer tax for instruments used to create or discharge a security interest was not applicable. The quit claim deeds transferred all title to the property from Buyer to Builder, and from Builder back to Buyer. Unlike a mortgage, the quit claim deed from Buyer to Builder did not reserve to the Buyer any property rights. The deeds were taxable because they conveyed an interest in the property, for consideration, beyond creating or discharging a security interest.

What lessons can Developers and Builders draw from this Court of Appeals decision? Based upon the language of the decision, it appears that this Court of Appeals panel may have reached a different result had Buyer granted the Builder a traditional mortgage instead of using a quit claim deed. Second, even without a mortgage, the Builder would have lien rights under Michigan’s Construction Lien Act. Third, the Builder could have recorded a claim of interest or other instrument against title, to further limit the Buyer’s ability to sell (or further encumber) the property, free and clear of the Builder’s interest. This case leaves open the door to the proposition that, if structured properly, a Builder may be able to legally protect itself and still avoid paying transfer taxes on the value of a newly constructed home or building.

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