Mortgage and Transfer Taxes Inch Up After Recession

by Catherine Collins, Patricia Atkins, and Lisa Lowry

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In this article, the authors discuss the significant negative effects the Great Recession had on state mortgage and transfer taxes, actions states and cities took to reduce the related revenue collapse, and the extent to which the taxes have rebounded with the economic recovery.

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I. Introduction

The Great Recession battered the residential and commercial real estate markets. In its wake, real estate sales and their financing plummeted. As a result, revenue from the taxes imposed on real estate transactions, namely the real estate transfer tax and the mortgage recording tax, declined significantly, and only now is that revenue showing signs of recovery. While those taxes are not as significant a revenue source for states as income or sales taxes are,[1] the sharp decline of that tax revenue nonetheless contributed to the recession-induced fiscal stress states experienced.

Transfer taxes have been widely adopted, in part because they provide mechanisms for reporting changes in ownership and market value that are critical for the adequate administration of property taxes.[2] Thirty-five states and the District of Columbia impose transfer taxes; nine of them also have mortgage taxes, while one state only has the mortgage tax.[3] Although the taxes have different characteristics in the states where they have been adopted, the basis of the taxes is similar: Real estate transfer taxes are imposed when real estate ownership is transferred and recorded, usually evidenced by a deed, and mortgage recording taxes are imposed when long-term debts secured by real estate are registered or recorded.[4] Because of the dominance of the transfer tax, this discussion will examine the transfer tax revenue disruption caused by the Great Recession.

II. Impact of Great Recession

A. Collapse of the Housing Market

The Great Recession, its resultant lower real estate prices, reduction in mortgage activity, decline in home sales despite federal incentives to stimulate home buying, and credit crunch all combined to adversely affect transfer tax revenue. Although the recession lasted from December 2007 until June 2009, the aftereffects of the downturn lasted longer for the transfer and mortgage taxes. By 2010, state transfer tax revenue had declined by nearly two-thirds to just over $4 billion from a 2006 peak of $12 billion (Figure 1). As the economic recovery took hold and the housing market stabilized, revenue began to recover. However, by 2014, revenue still remained low at close to $7 billion, below the level before the big run-up and still 40 percent below the peak.

Real estate prices — the basis of the transfer tax — dropped dramatically for both residential and commercial properties. Nationally, housing prices fell 27 percent from their peak in July 2006 to their low in February 2012, according to the S&P/Case-Shiller Home Price Index. Although prices are improving, they remain just under 10 percent below the peak, at a level equivalent to prices in April 2005.[5] Lower housing prices, however, did not translate into housing market resurgence. Home purchases and lending dropped dramatically, with new mortgages

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[1]According to the U.S. Census Bureau "Annual Survey of State Government Tax Collections for 2007," before the recession, documentary and stock transfer tax revenue accounted for 1.3 percent of total revenue collections, while income taxes were 42.1 percent and sales taxes were 31.5 percent.

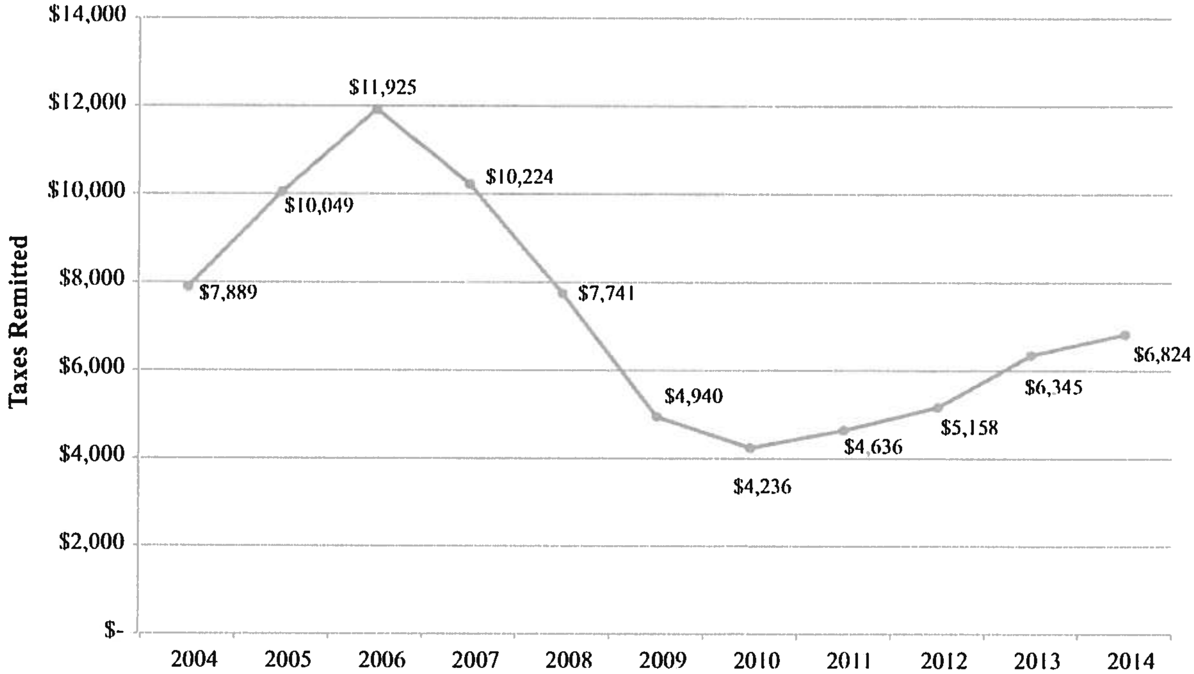
[2]Before 1968 this information was available from the value of federal documentary stamps affixed to deeds when they were registered. At the time of the federal repeal, states were encouraged to enact their own tax to replace the federal tax.

[3]Kansas, which adopted the mortgage recording tax in 1925, began phasing out the tax in 2015 over a period of five years.

[4]Consideration is given to those taxes based on the value or consideration of the property or mortgage recorded. Flat rate fees or per-page charges are not included.

[5]S&P/Case-Shiller, U.S. National Home Price Indices (latest update Dec. 2014).

Figure 1.
Annual State Documentary Tax Collections, 2004-2014
(millions of dollars)



Source: U.S. Census Bureau, Annual Survey of State Government Tax Collections, Documentary and Stock Transfer Taxes. Includes revisions through April 16, 2015.

dropping by two-thirds, from 7.4 million at their peak in 2005 to 2.4 million in 2011. Although loans are increasing, in 2013 they were only at the 2008 level.[6] The commercial real estate market was less affected by the recession, with the rise in the Moody's-Real Capital Analytics commercial price index for all commercial properties peaking in late 2007, with full recovery by the third quarter of 2014.[7] Overall, transfer tax revenue is recovering slowly.

Connecticut's experience illustrates the impact the collapse of the housing market had on transfer taxes. The culprit of the Connecticut decline was the substantial reduction in real estate activity in the state from its peak in 2006 to its low point in 2011. Taxable transactions declined sharply, by more than half. The sharpest decline was in middle-priced properties, those priced between $200,000 and $500,000. Accounting for 50 percent of the transactions in 2006, that segment of the market fell by nearly two-thirds by 2011 and has remained relatively stagnant. Other segments show only marginal increases in their activity from their 2011 low (Figure 2A).

Although the recession lasted only 18 months, its effect on Connecticut's real estate market and revenue has lasted considerably longer. Transfer tax revenue declined by 55 percent between 2006 and 2011, and even three years later, it remained at only 80 percent of peak level. Some of the strength in the revenue is the result of a rate increase, but that is insufficient to offset the overall decline in the real estate market prices and activity.[8] Some recovery is present in the high end of the real estate market, with the properties over $800,000 accounting for a slightly greater share of the revenue, but even for that market segment the revenue is still 10 percent below peak (Figure 2B).

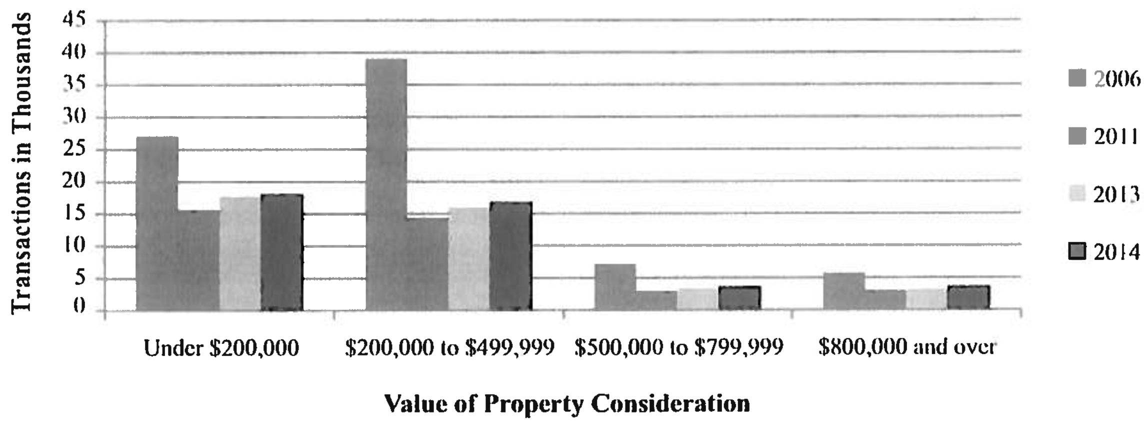
San Francisco provides another example. Facing a steep decline in revenue, the city took steps to offset its anticipated revenue loss by increasing its local rates. The housing prices collapsed dramatically in just two years, with the

[6]Neil Bhutta and Daniel R. Ringo, "The 2013 Home Mortgage Disclosure Act Data," Table 1 Application and Originations, 2004-2013, vol. 100, no. 6, *Federal Reserve Bulletin* (Nov. 2014).

[7]Moody's/RCA Commercial Property Price Indices.

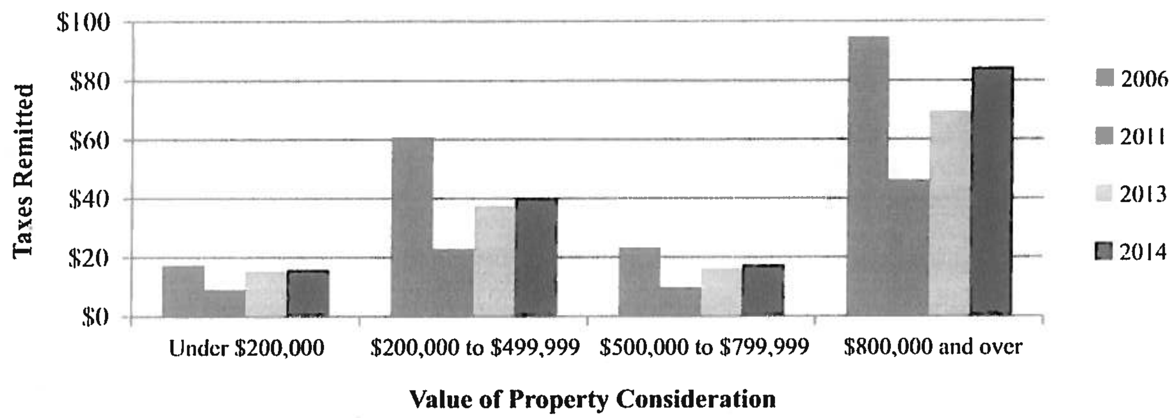
[8]As of July 1, 2011, Connecticut raised transfer tax rates from 0.5 percent to 0.75 percent on residential dwellings $800,000 or less and from 1 percent to 1.25 percent for the portion above $800,000 and for all nonresidential properties other than unimproved land.

Figure 2A.
Connecticut's Documentary Tax Transactions
Selected Years



Source: State of Connecticut, Department of Revenue Services, Annual Reports, fiscal years 2006, 2011, 2013, 2014.

Figure 2B.
Connecticut's Transfer Tax Makes Slow Recovery
Selected Years
(millions of dollars)



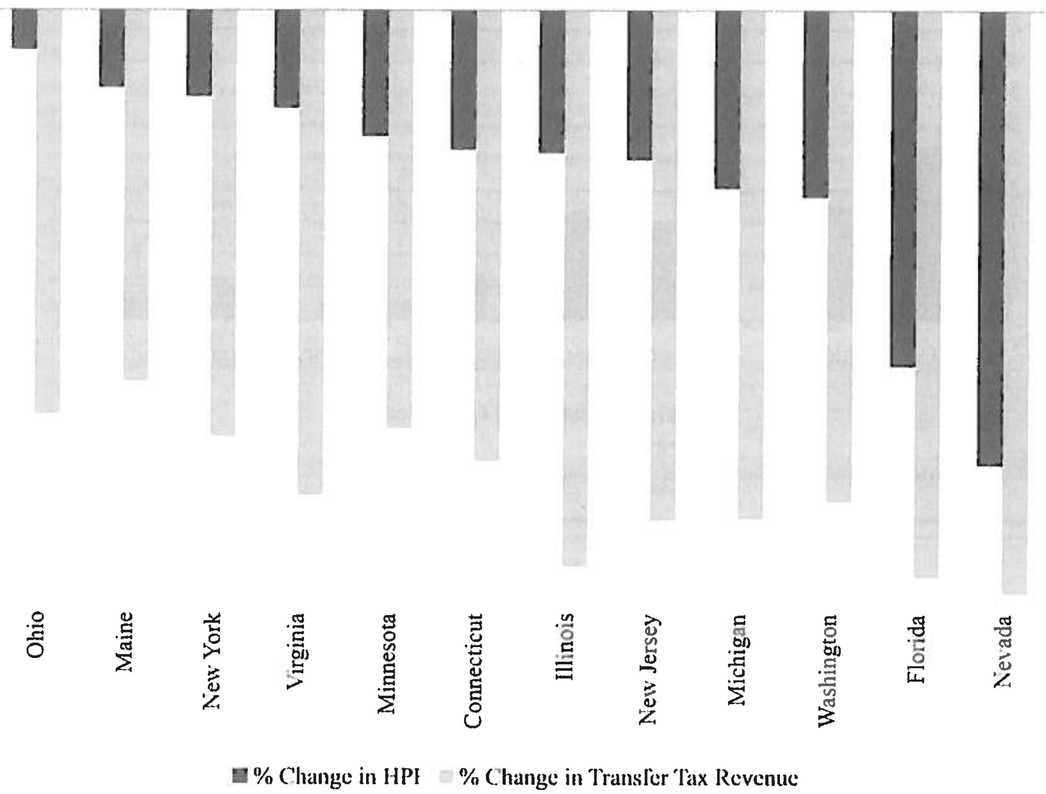
Source: State of Connecticut, Department of Revenue Services, Annual Reports, fiscal years 2006, 2011, 2013, 2014.

housing price index declining 45 percent from its peak in May 2006.[9] The revenue drop was more extreme, falling by two-thirds.

The city responded in two ways. First, it raised rates by creating additional brackets. The first rate change, in 2008, doubled the rate for properties over $5 million. In 2010 the city raised the rate for properties costing over $5 million to 2 percent, and for properties over $10 million to 2.5 percent. Both rate changes were strongly supported by voters, which is not surprising since the burden fell mostly on

[9]S&P/Case-Shiller San Francisco Home Price Index.

Figure 3.
Decline in Transfer Tax Revenues Greater Than Price Decline
Change in Housing Price Index Compared to Change in Revenues, Peak to Trough*



*The peak fiscal year was 2006, except Michigan (2004) and New York and Washington (2007). The trough fiscal year was 2009 in Ohio; 2010 in Florida, Michigan, Minnesota, New York, and Virginia; 2011 in Connecticut, Illinois, New Jersey, and Washington; and 2012 in Maine and Nevada.

Source: Compiled by the authors from the Federal Housing Finance Agency's Housing Price Index and from state revenue reports.

commercial properties — particularly office buildings.[10] By the time housing prices began to recover in 2012, those two brackets accounted for 75 percent of the transfer tax revenue.[11]

Second, the city in 2010 created the budget stabilization reserve specifically to address the volatility of the transfer tax and to complement the city's rainy day reserve. Transfer tax revenue is the backbone of the reserve as deposits include 75 percent of the transfer tax excess of the prior five-year average, adjusted for rate changes.[12]

While both Connecticut and San Francisco raised transfer tax rates, their revenue pictures do not differ substantially from that of other states or cities.[13] As shown in Figure 3, states experienced sharp revenue declines in transfer tax

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[10]Office of the Controller, "Increasing the Real Property Transfer Tax (amended): Economic Impact Report, Item #100750" (July 14, 2010).

[11]Office of the Controller, "City and County of San Francisco, FY 2014-15 and FY 2015-16 Revenue Letter: Controller's Discussion of the Mayor's FY 2014-15 and FY 2015-16 Proposed Budget," at 12 (June 10, 2014).

[12]Office of the Controller, *id.* at Appendix 2. General Fund Reserve Uses and Deposits, at 18 (June 10, 2014); and *supra* note 10. Other revenue deposited into the stabilization reserve included unassigned fund balances and certain asset sales.

[13] Between 2006 and 2014, four states — Connecticut, Hawaii, New Jersey, and Rhode Island — raised state transfer tax rates, and two states enacted legislation for new transfer taxes to fund transportation authorities, as taken from the Significant Features of the Property Tax website, *available at* http://www.lincolninst.edu/subcenters/signifi

(Footnote continued on next page.)

collections in excess of the drop in housing prices, reflecting the decreased number of transactions. That is most dramatic in Ohio, where, although the decline in housing prices was modest, the revenue declined significantly as a result of a decrease in the number of transactions. An Ohio Department of Taxation study looking at sales of residential property found that sales dropped 52 percent statewide from their peak in 2009.[14]

Florida and Nevada experienced the biggest boom-bust swings. As a result, revenue dropped only slightly more than housing prices. That may be attributed in part to the vast number of homeowners' mortgages underwater as home prices declined.[15] With homeowners unable to sell their homes without substantial loss of equity, the housing market stagnated, resulting in a precipitous decline in revenue.

With the decline in housing prices and homeowners' loss of equity, foreclosures rose dramatically. The Congressional Research Service reported that at the peak of foreclosures in 2011, nearly one-fourth of home mortgages were underwater; while the picture is improving, over 12 percent, or about 6.3 million homeowners, remained in a negative position in 2014.[16] That lack of equity also contributed to the decline of revenue as many states have provided relief for sales of distressed properties. States have adjusted the sale price to exclude forgiven debt or have even exempted the entire transfer from the tax when the sale involves a foreclosure or short sale.

These types of sales have raised issues that state officials had not needed to consider previously. In 2009 Washington state clarified that the taxable value "consideration at time of sale" was the price paid by the buyer. Any mortgage or debt forgiveness by a lender is not subject to the transfer tax.[17] Similarly, Florida, in addressing the issue of debt forgiveness, amended the statute to exempt forgiven debt from the tax.[18] While these states now exclude the amount of forgiven mortgage from taxable value, Connecticut went further. Beginning in 2010, the state began exempting the entire transaction of any sale of principal residence that involves deeds in lieu of foreclosure, foreclosure, and short sales. Between 2010, when that exemption was adopted, and 2014, exempt transactions increased 50 percent, accounting for one out of five sales.[19]

The increased involvement of Freddie Mac and Fannie Mae in foreclosures has also affected transfer tax revenue. When either agency sells properties after acquiring them through mortgage foreclosures, they contend that federal statute exempts them from paying state or local level transfer taxes. States — more particularly, counties as the collection agents — have challenged that position and have sued the federal agencies to collect the taxes. By 2015 nine of the 13 federal circuit courts had unanimously held that transfer taxes are not taxes on real property but excise taxes; therefore, federal charters preempted Freddie Mac and Fannie Mae from having to pay any real estate transfer taxes.[20] Some states have been able to impose the tax then on the buyer, but in other states the tax cannot be shifted.

III. Conclusion

Although transfer taxes lack transparency and the revenue is decidedly more volatile than income and sales taxes, the taxes provide critical information for adequate administration of the property tax. Also, in many states the revenue is dedicated to programs that mitigate some of the pressures of real estate development, such as open space preservation and low-income housing programs. Dedication of revenue also offsets some of the negative impact of the volatility of that revenue. However, while the Great Recession was over by mid-2009, its effect on the housing market lingers, and revenue from transfer taxes continues to be depressed.

A modest recovery in the real estate market is underway; however, current conditions are not going to lead to a quick return to previous revenue levels, which are largely functions of market activity. Because the housing market and real estate prices are only slowly recovering and buyers are slowly reentering the market, states and local governments will see only modest revenue gains from those taxes.

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cant-features-property-tax. Six states attempted to, but were unsuccessful in, increasing existing transfer tax rates or imposing additional fees on real estate transfers between August 2009 and January 2011, according to the National Association of REALTORS and Legal Research Center Inc., "Transfer Tax Advocacy Study 2011 Update," at 1.

[14]Ohio Department of Taxation, "The Impact of the Great Recession on the Ohio Residential Housing Market," Tax Research Series Number 5 (Sept. 2010).

[15]Staff, Federal Reserve Board, "The U.S. Housing Market: Current Conditions and Policy Considerations," at 4-5 (Jan. 2012), including cover letter of January 4, 2012, from then-Chairman Ben Bernanke to the U.S. Senate Committee on Banking, Housing and Urban Affairs and to the U.S. House of Representatives Committee on Financial Services.

[16]Katie Jones et al., "Housing Issues in the 113th Congress," Congressional Research Service, R43367, p. 4, based on CoreLogic Equity Report, First Quarter 2014.

[17]State of Washington, Department of Revenue, "Re: Application of Real Estate Transfer Tax on Short Sales" (Jan. 23, 2009).

[18]Fla. Stat. section 201.02(11), 2010 Florida Act 138.

[19]State of Connecticut, Department of Revenue Services, *Annual Report*, selected years, and "2010 Legislative Changes Affecting the Connecticut Real Estate Conveyance Tax," issued Dec. 10, 2010.

[20]The most recent decision has been handed down in the Eleventh Circuit, in *Montgomery County Com'n v. Federal Housing Finance Agency*, 776 F.3d 1247 (11th Cir. 2015). Similar decisions have been handed down in the First, Third, Fourth, Sixth, Seventh, Eighth, Ninth, and the D.C. circuit courts. For a further discussion, see David Sawyer, "David Loses to Goliath: Localities vs. Fannie and Freddie," *State Tax Notes*, Mar. 24, 2014, p. 723.