GOVERNMENT OF THE DISTRICT OF COLUMBIA
OFFICE OF THE INSPECTOR GENERAL

AUDIT OF COMMERCIAL MORTGAGE RECORDATION AT THE OFFICE OF TAX AND REVENUE

CHARLES J. WILLOUGHBY
INSPECTOR GENERAL

OIG No. 11-2-27AT **April 2, 2014**

GOVERNMENT OF THE DISTRICT OF COLUMBIA
Office of the Inspector General

Inspector General

April 2, 2014

Jeffrey DeWitt
Chief Financial Officer
Office of the Chief Financial Officer
The John A. Wilson Building
1350 Pennsylvania Avenue, N.W., Room 203
Washington, D.C. 20004

Dear Mr. DeWitt:

Enclosed is the final report summarizing the results of the Office of the Inspector General's (OIG) *Audit of Commercial Mortgage Recordation at the Office of Tax and Revenue (OTR)* (OIG No. 11-2-27AT). This audit covered commercial mortgage recordation tax transactions handled during the period of March 16, 2001, through October 31, 2011. The audit was conducted at the request of District of Columbia Councilmembers David A. Catania and Mary M. Cheh.

As a result of our audit, we directed 21 recommendations to the Office of the Chief Financial Officer (OCFO) for action we consider necessary to correct identified deficiencies. OCFO provided a written response to the draft of this report on November 8, 2013. The full text of OCFO's response is included at Exhibit F. Within this response, OCFO identified three major problems with the draft report and OTR disagreed with our conclusions relating to the basis and amount of the findings on said draft report. Our comments related to these issues with the draft report are included at Exhibit E.

OCFO actions taken or planned for Recommendations 1, 2, 3, 4, 6, 8,10, 11, 13, 14, 15, 17, 18, 20, and 21 are considered responsive and meet the intent of the recommendations. However, OCFO did not provide target dates for completing the planned actions for Recommendations 3, 8, 11, 13, 15, and 21. Thus, we request that OCFO provide estimated completion dates for these six recommendations within 60 days of the date of this final report.

OCFO responses to Recommendations 5, 7, 9, 12, 16, and 19 did not fully meet the intent of the recommendation and remain unresolved. Accordingly, we respectfully request that OCFO reconsider its position taken on these six recommendations and provide our Office with a revised response within 60 days of the date of this final report.

We appreciate the cooperation and courtesies extended to our staff by the OCFO personnel. If you have questions concerning this report, please contact me or Ronald W. King, Assistant Inspector General for Audits, at (202) 727-2540.

Sincerely,

Charles J. Willoughby
Inspector General

CJW/rjb

Enclosure

cc: See Distribution List

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ACRONYMS

AG	Attorney General
CA	Compliance Administration
CAFR	Comprehensive Annual Financial Report
CFO	Chief Financial Officer
CY	Calendar Year
DCMR	District of Columbia Municipal Regulations
DCRA	Department of Consumer and Regulatory Affairs
FY	Fiscal Year
GAGAS	Generally Accepted Government Auditing Standards
HUD-1	Housing and Urban Development Settlement Statement
I & E	Income and Expense
OAG	Office of the Attorney General, District of Columbia
OCFO	Office of the Chief Financial Officer, District of Columbia
OIG	Office of the Inspector General, District of Columbia
OTR	Office of Tax and Revenue, OCFO
ROD	Recorder of Deeds
RPTA	Real Property Tax Administration, OTR
TBD	To Be Determined
UCC1	Uniform Commercial Code Financing Statement

DEFINITIONS

Annual Percentage Rate. The actual cost of borrowing money, expressed in the form of an annualized interest rate. (BLACK'S LAW DICTIONARY 831 (8th ed. 2004).)

Assignment (for Value). The transfer of rights or property given in exchange for consideration. (BLACK'S LAW DICTIONARY 128 (8th ed. 2004).)

Blanket Deed of Trust. See "Blanket Mortgage."

Blanket Mortgage. A mortgage [or deed of trust] covering two or more properties that are pledged to support a debt. (BLACK'S LAW DICTIONARY 1032 (8th ed. 2004).)

Certificate of Satisfaction. A deed of trust may be released as a lien on the real property by recording a certificate of satisfaction executed by the beneficiary, mortgagee, assignee, or trustee. (D.C. Code § 42-818.02(c)(3).)

Closing Statement. A written breakdown of the costs involved in a particular real-estate transaction, usually prepared by a lender or an escrow agent. (BLACK'S LAW DICTIONARY 272 (8th ed. 2004).)

Consideration. The price or amount actually paid, or required to be paid, for real property including any mortgages, liens, encumbrances thereon, construction loan deeds of trust or mortgages or permanent loan deeds of trust or mortgages. (D.C. Code § 42-1101(5).)

Construction Loan Deed of Trust. A deed of trust upon real estate which is given to secure a loan for new real estate construction. (D.C. Code § 42-1101(9).)

Deed. Any document, instrument, or writing, including a security interest instrument, wherever made, executed, or delivered, pursuant to which: a title, interest, or security interest in real property is conveyed, vested, granted, bargained, sold, transferred, or assigned. (D.C. Code § 42-1101(3)(A)(i).) The word "deed" shall not include a will or a lease or ground rent for a term (with renewals) that is less than 30 years. (D.C. Code § 42-1101(3)(B).)

Deed of Trust. A deed conveying title to real property to a trustee [third party] as security until the grantor [borrower] repays a loan [to the beneficiary, lender, or grantee]. (BLACK'S LAW DICTIONARY 445 (8th ed. 2004).) Also see "Security Interest Instrument."

Face Amount (Par Value). The value of an instrument or security as shown on its face. (BLACK'S LAW DICTIONARY 627 (8th ed. 2004).)

DEFINITIONS

Foreign. Of or relating to another jurisdiction. (BLACK'S LAW DICTIONARY 675 (8th ed. 2004).)

HUD-1. Department of Housing and Urban Development form used as a statement of actual charges and adjustments paid by the borrower and the seller, to be given to the parties in connection with the settlement. (Http://www.gpo.gov/fdsys/pkg/CFR-2012-title24-vol5/pdf/CFR-2012-title24-vol5-part3500-appA.pdf)(last visited Feb. 12, 2013).) See "Closing Statement."

Modification. Generally occurs when the terms of a pre-existing security interest instrument are changed in some manner (e.g., borrowing additional money), but the obligation imposed by the preexisting instrument is preserved and the loan secured by that instrument is not paid off, extinguished, or retired. (OTR)

Permanent Loan Deed of Trust. A deed of trust upon real estate that secures an instrument made by the same obligors who made the instrument which the construction loan deed of trust secured, and which conveys substantially the same real estate. (D.C. Code § 42-1101(10).)

Prior Lien. A lien that is superior to one or more other liens on the same property, usually because it was perfected first. (BLACK'S LAW DICTIONARY 943 (8th ed. 2004).)

Priority of Liens. The ranking of liens in the order in which they are perfected [recorded]. (BLACK'S LAW DICTIONARY 1232 (8th ed. 2004).)

Purchase Money Mortgage or Purchase Money Deed of Trust. A mortgage or deed of trust provided as payment or part payment of the purchase price of real property. (D.C. Code § 42-1101(12).)

Real Estate. See "Real Property."

Real Property. Every estate or right, legal or equitable, present or future, vested or contingent in lands, tenements, or hereditaments located in whole or in part within the District [of Columbia]. (D.C. Code § 42-1101(4).)

Recordation. The act or process of recording an instrument, such as a deed or mortgage, in a public registry. (BLACK'S LAW DICTIONARY 1301 (8th ed. 2004).)

Recording. See "Recordation."

DEFINITIONS

Refinancing. An exchange of an old debt for a new debt, as by negotiating a different interest rate or term or by repaying the existing loan with money acquired from a new loan. (BLACK'S LAW DICTIONARY 1307 (8th ed. 2004).)

Secondary Market. A sale or assignment of a note, mortgage, deed of trust, or other instrument from one lender to another, where there are no changes in the terms or conditions provided in the instrument and the borrower has taken no action to refinance. (D.C. Code § 42-1102.01.)

Security Interest. Any interest in real property acquired for the purpose of securing payment of a debt. (D.C. Code § 42-1101(13).)

Security Interest Instrument. Any instrument which conveys, vests, grants, transfers, bargains, sells, or assigns a security interest in real property. A security interest instrument may include a mortgage, deed of trust, financing statement, refinancing statement, or another document, instrument, or writing which creates an encumbrance on real property. (D.C. Code § 42-1101(14).)

Supplemental Deed. A deed that confirms, corrects, modifies, or supplements a prior recorded deed without additional consideration. (D.C. Code § 42-1101(15).)

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OVERVIEW

The District of Columbia Office of the Inspector General (OIG) has completed an *Audit of Commercial Mortgage Recordation at the Office of Tax and Revenue* (OTR) (OIG No. 11-2-27AT). The audit was conducted in response to a request[1] from District of Columbia Councilmembers David A. Catania and Mary M. Cheh. Mr. Catania and Ms. Cheh had concerns that, over the course of the last decade, OTR failed to collect recordation taxes from refinanced purchase money deeds of trust (or refinanced mortgages) on commercial properties. Our audit covered the collection of recordation taxes for the period of March 16, 2001, through October 31, 2011.

The OTR, a division of the Office of the Chief Financial Officer (OCFO), has the responsibility for collecting commercial mortgage recordation taxes in the District of Columbia. The Tax Clarity Act of 2000 (D.C. Law 13-305) amended the law governing the taxability of refinanced commercial loans, which resulted in two different implementations administered by OTR.

The audit objectives were to: (1) determine whether OTR collected recordation tax on the whole debt at the time of refinance for commercial purchase money loans; (2) confirm the period of time for which this practice was in place; and (3) substantiate how much tax money has been collected on commercial refinances since the enactment of the Tax Clarity Act of 2000.

CONCLUSIONS

Our audit revealed that shortly after the Tax Clarity Act of 2000 took effect in March 2001 and continuing into Fiscal Year (FY) 2007, OTR collected a recordation tax on the whole debt for commercial mortgage purchase money loan refinance transactions on some occasions. At some time in FY 2007, OTR returned to the prior practice of permitting the purchase money exemption on subsequent refinances. Our audit determined that OTR collected approximately $439.8 million[2] of which $19.9 million was collected on the refinance of commercial purchase money loans during the audit period. In addition, our audit uncovered inadequacies in OCFO management controls that may have prevented considerable additional recordation revenue collection.

The OCFO lacked adequate management controls to ensure that commercial recordation of: (1) substantively similar purchase money refinancing transactions were consistently administered and taxed; (2) tax payments were properly collected and exemptions were properly supported; (3) security interest instruments clearly stated the amount of debt secured for recordation tax purposes; and (4) that governance incorporated timely implementation of

[1] The audit request was made on August 30, 2011, and is shown at Exhibit B.
[2] This amount does not include recordation tax collected on the recording of deeds transferring real property.

EXECUTIVE SUMMARY

legislative changes, effective monitoring of processes, and audit mechanisms. As a result, OTR may have failed to collect $24.8 million in commercial recordation tax revenues, of which $6.6 million may be currently collectable,[3] and lacked adequate controls to minimize the risk of undetected tax fraud and errors. These and other matters requiring management attention are detailed in the following sections of this report.

SUMMARY OF RECOMMENDATIONS

We directed 21 recommendations to OCFO that we believe are necessary to address deficiencies identified during the audit. The recommendations focus on: (1) strengthening internal controls, improving processes, and training responsible personnel to enhance the effectiveness of the District's collection of commercial mortgage recordation taxes; (2) expanding the audit function within OTR to include routine reviews of Real Property Recordation and Transfer Tax Form FP 7/C (Form FP 7/C) for accuracy, completeness, and compliance; (3) promoting compliance, accuracy, and consistency of tax transactions through adequate notice, guidance, forms, policies, and procedures; and (4) improving communication with other District agencies, including the Council of the District of Columbia and the Office of the Attorney General (OAG).

A summary of the potential benefits resulting from the audit is shown at Exhibit A.

MANAGEMENT RESPONSE AND OIG COMMENTS

On November 8, 2013, OCFO provided a written response to the draft of this report. OCFO actions taken or planned for Recommendations 1, 2, 3, 4, 6, 8,10, 11, 13, 14, 15, 17, 18, 20, and 21 are considered responsive and meet the intent of the recommendations. However, OCFO did not provide target dates for completing the planned actions for Recommendations 3, 8, 11, 13, 15, and 21. Thus, we request that OCFO provide estimated completion dates for these six recommendations within 60 days of the date of this final report.

OCFO responses to Recommendations 5, 7, 9, 12, 16, and 19 did not fully meet the intent of the recommendation and remain unresolved. Accordingly, we respectfully request that OCFO reconsider its position taken on these six recommendations and provide our Office with a revised response within 60 days of the date of this final report. Our comments to OCFO's response to the draft report are included at Exhibit E. The full text of the OCFO response is included at Exhibit F.

[3] This figure represents the amount currently collectable as of March 1, 2013, per the periods of limitation statute (D.C. Code § 47-4301).

EXECUTIVE SUMMARY

This final audit report was amended based on information provided by OCFO in response to the draft of this report (Exhibit F). Specifically, two errors reported in the draft were removed from Finding 3 (Amount of Debt Secured) and an additional error was reclassified from Finding 4 (Tax Administration) to Finding 3 as explained in our comments to OCFO's response (Exhibit E). These changes affected the amount of observed errors previously reported in Finding 3 and 4 and reduced the total value of commercial recordation tax revenue OTR may have failed to collect from $27 million to $24.8 million.

INTRODUCTION

BACKGROUND

Councilmembers David A. Catania and Mary M. Cheh requested an audit to examine the collection of commercial mortgage recordation taxes at OTR, which is a department under the CFO (see Page 2, Figure 1). This audit request was prompted by newspaper articles alleging that OTR failed to collect all recordation taxes on the total amount of refinanced purchase money deeds of trust (or mortgages) on commercial properties. The articles also alleged that OTR collected recordation taxes on the new debt acquired at refinancing instead of collecting recordation taxes on the whole amount refinanced in accordance with the Councilmembers' understanding of the legislative intent behind the Tax Clarity Act of 2000.[4]

The mission of OCFO is to enhance the fiscal and financial stability, accountability, and integrity of the government of the District of Columbia.[5] The OCFO is responsible for:

- oversight and direct supervision of the financial and budgetary functions of the District government;
- operating and maintaining a coordinated financial management system to budget, collect, control, and properly account for more than $7 billion in annual operating and capital funds;
- preparing the District's annual budget, representing the District in the federal appropriations process, and monitoring budget performance during the fiscal year;
- borrowing on behalf of the District, collecting receipts, payments, and transactions for the District, and investing the District's funds;
- administering and enforcing the District's tax laws, collecting revenue for the city, and recording deeds and other written instruments affecting a right, title, or interest in real or personal property in the District;
- developing, implementing, and monitoring the District's accounting policies and systems, and producing the audited Comprehensive Annual Financial Report (CAFR) for the city; and
- forecasting revenue for the District government, developing fiscal impact statements for proposed legislation, performing tax expenditure analysis, and providing advice on economic development matters.

The OTR's mission is to collect the proper amount of tax due to the District of Columbia and correctly account for all revenues, while minimizing the burden on taxpayers and the cost to the government. The OTR administers and enforces the District's tax laws, and records deeds and other written instruments affecting a right, title, or interest in real or personal property. The

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[4] Councilmember Catania requested a legal opinion from the OAG regarding the proper interpretation of the Tax Clarity Act's recordation tax collection provisions. The OAG provided its opinion to the Council on July 25, 2011.

[5] We obtained the information in this paragraph from OCFO's website at http://cfo.dc.gov. (Last visited Feb. 12, 2013).

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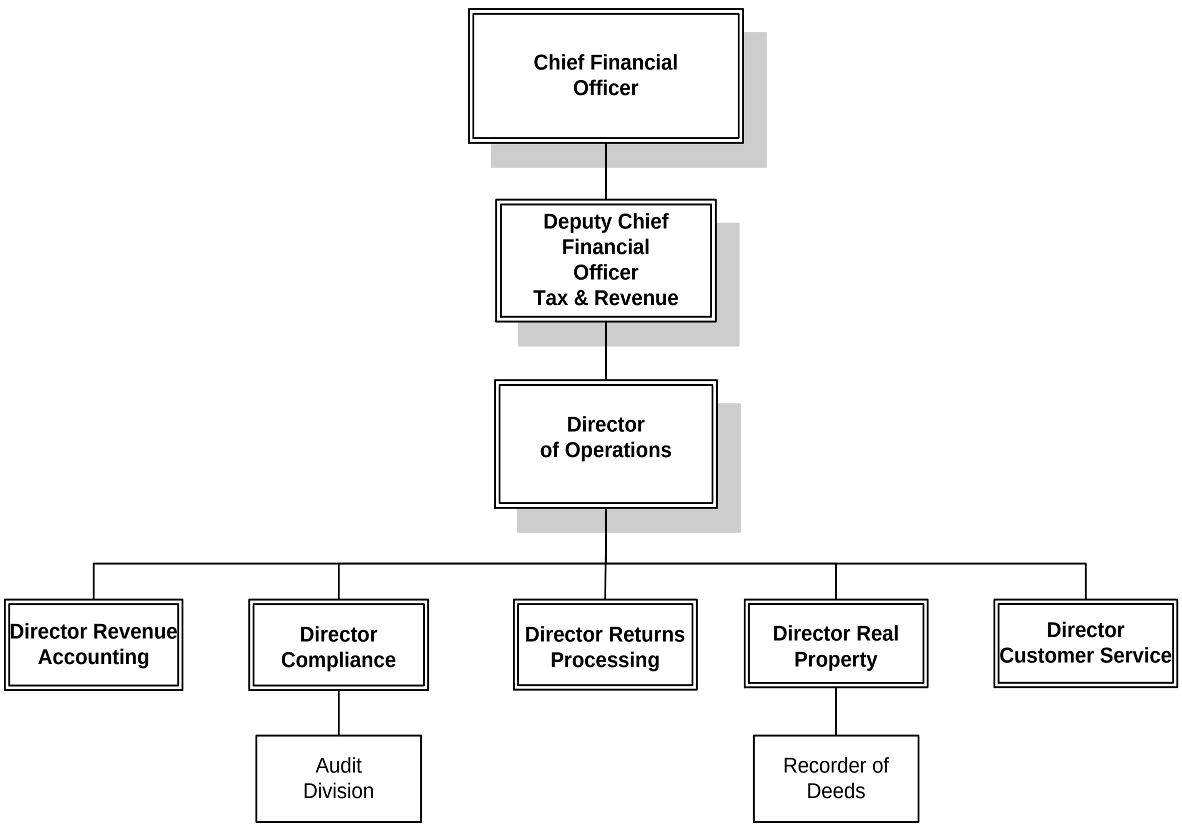
Recorder of Deeds (ROD), a department within OTR under the Real Property Tax Administration (RPTA), is the official repository of all land records and general public instruments for the District of Columbia (see Figure 1 below). The ROD is responsible for the collection of all recordation and transfer taxes as well as filing fees on instruments recorded, and maintains records of these transactions for public inspection.

Figure 1. Excerpt of the Office of the Chief Financial Officer Organizational Chart Relevant to the Collection of Recordation Taxes



Since the enactment of the Tax Clarity Act of 2000, there have been two contradictory interpretations of the law by OTR regarding the taxability of refinanced purchase money deeds of trust. Initially, ROD issued a public notice[6] in April of 2001 stating that 100 percent of a purchase money mortgage refinance would be taxed rather than new loan money over and

[6] The guidance to the public was the "Real Property Tax Clarity Emergency Act of 2001 – Extension Notice" issued by OTR (*see* Exhibit C), which stated, "[when] a purchase money deed of trust is refinanced, the entire amount of the new loan would be subject to the 1.1 percent recordation tax."

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above the initial exempt amount.[7] In FY 2007, however, OTR elected to tax only the new money borrowed over and above the principal balance due on the initial exempt amount due to an internal review of the law.

Recordation taxes are also due and payable on the recording of residential and commercial deeds conveying title to real property and leases of 30 years or more. However, these transactions were outside the scope of this audit, and were not reviewed except to the extent that a commercial deed conveying title would substantiate a purchase money exemption.

CRITERIA

The statutory provisions and regulations applicable to commercial mortgage recordation taxes for the period of our audit include the following:

Recordation of Deeds. D.C. Code § 47-1431(a) (West, Westlaw current through Dec. 11, 2012) stipulates that within 30 days after the execution of the deed or other document by which legal title to real property or security interest is conveyed, all transferees of, and all holders of the security interest in real property shall record a fully acknowledged copy of the deed or other document with ROD.

Imposition of Recordation Tax on Security Interest Instruments. According to D.C. Code § 42-1103(d), a deed is taxed at the current rate at the time a deed is submitted for recordation (see Page 4, Table 2). A deed that conveys a security interest in real property within the District is taxed on the principal amount of the debt that the deed secures (as stated on the document's face) unless other information indicates that the principal amount of the debt is a higher amount (D.C. Code § 42-1104(b)). In addition, D.C. Code § 42-1103(a)(3) stipulates that at the time a security interest instrument is submitted for recordation, it shall be taxed at a rate of 1.1 percent[8] of the total amount of debt incurred, which is secured by the interest in real property. However, if the existing debt is refinanced, the rate will be applied only to the principal amount of the new debt in excess of the principal balance due on the existing debt that was previously subjected to tax, provided that the tax on the existing debt was timely and properly paid. D.C. Code § 42-1107 further states that "all deeds are taxable and the burden shall be upon the taxpayer to show that a deed is exempt from tax."

Real Property. In accordance with D.C. Code § 47-813(a), for the purpose of levying taxes on real property in the District of Columbia, the Council may establish different classes of real property. Table 1 (see Page 4) describes the classification of real property in the District.

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[7] Purchase money mortgages or purchase money deeds of trust are exempt from recordation tax per D.C. Code § 42-1102(5) when recorded simultaneously with the deed conveying real property.
[8] D.C. Code § 42-1103 sets the recordation tax rate at 1.1 percent, which was subsequently increased to 1.45 percent (excluding residential properties transferred for consideration less than $400,000). *See* D.C. Code § 42-1103(a-4).

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Table 1. Current Classes of Real Property[9]

Classes of Real Property	Description of Real Property Classes
Class 1	Property comprised of improved residential real property and used for non-transient residential dwelling purposes.
Class 2	Property comprised of all real property which is not Class 1 Property, Class 3 Property, or Class 4 Property.
Class 3	All improved real property that appears on the list compiled under D.C. Code § 42-3131.16 (list of vacant buildings).
Class 4	All improved real property that appears on the list compiled under D.C. Code § 42-3131.17 (list of blighted vacant buildings).

Class 1 properties that contain no more than 5 dwelling units are exempt from recordation tax on deeds of trust per D.C. Code § 42-1102(21). The Department of Consumer and Regulatory Affairs (DCRA) is responsible for classifying properties as vacant or blighted (i.e., Class 3 and Class 4), and these alternate classifications of residential and commercial property do not affect recordation tax on security interest instruments. Therefore, this audit included a review of recorded security interest instruments relating to Class 1 properties with 6 or more units, and all other property classes (Classes 2, 3, and 4).

Recordation Tax Rates. Table 2 (below) summarizes the various tax rates and corresponding effective dates during the audit period. At the beginning of our audit period, the District of Columbia was operating in accordance with D.C. Law 08-017, which was enacted in 1989. The 1.1 percent tax rate remained in effect until December 31, 2002. Effective January 1, 2003, the Council of the District of Columbia (Council) enacted the Fiscal Year 2003 Budget Support Amendment Act of 2002, D.C. Law 14-307, which increased the tax rate to 1.5 percent through September 30, 2004. D.C. Law 15-205 was effective October 1, 2004, and reduced the tax rate back to 1.1 percent for the next 2 years. Effective October 1, 2006, a .35 percent increase was added to the 1.1 percent tax rate, thus raising the tax rate to 1.45 percent on all commercial property transactions, thereby becoming the current tax rate.

Table 2. Commercial Recordation Tax Rates 2001- Present

Law	Effective Date	Recordation Tax Rates
D.C. Law 08-017	07/01/1989 -12/31/2002	1.10%
D.C. Law 14-307	01/01/2003 - 9/30/2004	1.50%
D.C. Law 15-205	10/01/2004 - 9/30/2006	1.10%
D.C. Code § 42-1103(a-4)	10/01/2006 - Present	1.45%

[9] The class description of real property in Table 1 is set forth in D.C. Code § 47-813(c-8).

INTRODUCTION

Tax Exemption. Per D.C. Code § 42-1103(a)(4), security interest instruments that qualify for exemption under D.C. Code § 42-1102 shall be exempt from the recordation tax. Accordingly, a purchase money mortgage or purchase money deed of trust that is recorded simultaneously with the deed conveying the real property for which the purchase money mortgage or purchase money deed of trust was obtained is exempt from recordation tax. D.C. Code § 42-1102(5). Another exemption from recordation tax is a sale or assignment of a note, mortgage, deed of trust, supplemental deed of trust, or other instrument from one lender to another on the secondary market. D.C. Code § 42-1102.01. Additionally, D.C. Code § 42-1103(a)(3) provides for a partial exemption equal to the principal balance of a refinanced loan provided that the tax on the prior debt was timely and properly paid.

D.C. Code § 42-1102(11) provides that "[w]hen a permanent loan deed of trust or mortgage is submitted for recordation and the tax on the construction loan deed of trust or mortgage has been timely and properly paid, no additional tax liability arises under § 42-1103, except where the amount of the obligor's liability secured by the permanent loan deed of trust or mortgage exceeds the amount of his liability secured by the construction loan deed of trust or mortgage . . . ."

Enforcement and Periods of Limitation. Per D.C. Code § 42-1108.01, recordation tax on deeds shall be enforced according to Chapters 41, 42, 43, and 44 of Title 47 of the D.C. Code. As such, the period of limitation is generally 3 years after the return was filed and can be as much as 6 years if the taxpayer omits from the return more than 25 percent of the tax due.[10]

Office of Attorney General Interpretation. The OAG issued a legal opinion[11] regarding the question of whether OTR properly interpreted and implemented the Tax Clarity Act of 2000 (the Act), specifically, the refinance exemption codified at D.C. Code § 42-1103(a)(3). The OAG's opinion is limited to OTR's interpretation that "on a refinancing of commercial properties the recordation tax is due not on the full amount of the indebtedness but only on the difference between the new indebtedness and the amount of the original indebtedness, which at the time of the original recordation was exempt from taxation."[12]

The OAG's plain reading[13] interpretation of the Act is that on a commercial refinancing, the recordation tax is payable on the entire amount of the purchase money deed of trust if no tax was previously paid. Under this interpretation, a purchase money deed of trust should only be exempt from taxation if it is recorded simultaneously with the deed conveying title to the

[10] D.C. Code §§ 47-4301(a) and (d)(3).
[11] Recordation Tax Treatment of Refinances of Security Interest Instruments, D.C. Op. Att'y Gen. (July 25, 2011).
[12] *Id*.
[13] The plain-meaning rule refers to "[t]he rule that if a writing…appears to be unambiguous on its face, its meaning must be determined from the writing itself without resort to any extrinsic evidence." BLACK'S LAW DICTIONARY 1188 (8th ed. 2004).

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property. Any refinance of the purchase money occurring after the date that the deed is transferred would subject the entire amount of the refinanced loan to tax.

The OAG explains further that when courts interpret legislation, they do not end their analysis with the plain language meaning, particularly when the interpretation and implementation of the agency differ from the plain reading and when contrary legislative history is available. OAG's review of the legislative history indicates that the Council did not intend to change the prior practice under which the tax was imposed only on the additional amounts of indebtedness and continues the original exemption. Additionally, if the Act intended a change in amount of recordation tax to be charged on refinances of purchase money deeds of trust, then such a change would have resulted in an increase in revenue to the District and would have been so noted in the fiscal impact statement prepared by the Chief Financial Officer. However, the fiscal impact statement for the Act indicated that there would be "no revenue impact" and that the statutory language simply clarified "current practice." Moreover, if there is ambiguity in the law, considerable deference is placed on the agency responsible for administering the tax, which in this case was OTR.

Yet, as the OAG states, the fact remains that OTR collected the recordation tax on the full amount of the refinancing in accordance with the interpretation set forth by ROD in 2001 and then changed its interpretation of the statute in mid-2007 with neither a detailed legal analysis that led to this change nor a widespread written notification of the change to the public or the relevant industry. Ultimately, the inconsistency of tax administration, failure to formally notify the public, and various interpretations of the statute would make it very difficult for the District to litigate retroactively to seek full payments that would be due under the plain reading of the Act. Consequently, the OAG concluded there is insufficient clarity in the legislation to reach a conclusion that OTR's interpretation is erroneous or to suggest that there should be litigation to reassess prior payments to obtain additional amounts of tax on past recordation transactions.

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of the audit are to: (1) determine whether OTR collected recordation tax on the whole debt at the time of refinance for commercial purchase money loans; (2) confirm the period of time for which this practice was in place; and (3) substantiate how much tax money has been collected on commercial refinances since the enactment of the Tax Clarity Act of 2000.

Our review covered the collection of commercial mortgage recordation taxes during the period March 16, 2001, through October 31, 2011. We accomplished our audit objectives using the following methodology in gathering data and conducting tests: (1) reviewed Titles 42 and 47 of the D. C. Code, the Tax Clarity Act of 2000, and other applicable laws, regulations, and internal policies governing the collection of recordation taxes, and assessed compliance with those laws, regulations, and procedures; (2) interviewed appropriate OCFO, OTR, and ROD personnel and observed work processes; (3) tested completeness of the sample population;

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(4) selected a random sample of 321 transactions using statistical sampling software to represent the population; (5) examined deeds of trust, Form FP 7/C tax returns, deeds, payoff statements, and other relevant documents to assess the collection of recordation taxes; and (6) projected the testing results over the population[14] to estimate the effect of incorrect or inconsistent tax collection practices.

We conducted this performance audit in accordance with generally accepted government auditing standards (GAGAS). These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

RESULTS OF PRIOR AUDIT REVIEWS

We did not identify any prior reviews conducted within the last 5 years related to District commercial property recordation taxes. However, we reviewed a prior OIG audit report, *Audit of the Management of Commercial Property Income and Expense Reports by the OTR and Revenue's Real Property Tax Administration* (OIG No. 08-2-01AT), dated May 15, 2009, regarding the identification of District of Columbia commercial property owners who failed to file Income and Expense (I & E) reports with OTR and RPTA. During this prior review, the OIG determined that OTR failed to identify commercial property owners who did not file I & E reports and RPTA did not enforce reporting requirements for the preceding 10 years. In addition, we estimated lost revenue totaling over $13 million for tax years 2007 and 2008.

Our prior review addressed needed resources and strategies for OTR and RPTA to implement internal controls over I & E reports not filed by commercial property owners. We did not address the subject matter of the instant audit (e.g., commercial mortgage recordation taxes on the whole debt at the time of refinance for purchase money loans collected by OTR).

[14] The results of testing were projected over the population of refinanced purchase money mortgages for informational purposes only, due to the OAG's legal determination that there was insufficient clarity in the legislation to conclude that OTR's interpretation was erroneous. Additionally, due to the length of the audit period requested, period of limitations, and sample methodology used, we presented errors not directly related to the refinanced purchase money transactions as observed within the sample in this report (i.e., we did not project those errors to the population).

FINDINGS AND RECOMMENDATIONS

FINDING 1. REFINANCE OF PURCHASE MONEY LOANS

SYNOPSIS

The OTR did not consistently collect recordation tax on the whole amount of debt secured by commercial real estate at the time of refinancing substantively similar purchase money loans. This condition occurred because OTR: (1) revised its application of the law regarding the taxability of refinanced purchase money loans[15] in FY 2007; (2) inconsistently interpreted and administered the taxation of refinanced purchase money loans; and (3) failed to tax loan modifications subsequent to a purchase money loan as a refinance of purchase money, where new consideration was obtained. As a result, the District failed to: (1) collect all possible tax revenue; (2) adequately minimize the risk of tax evasion or errors; and (3) afford commercial borrowers equal and consistent application of the law.

DISCUSSION

Recordation tax is imposed on the face amount of each deed of trust when submitted for recording with ROD unless the instrument is specifically exempted under D.C. Code § 42-1102 (Deeds exempt from tax) or exempt (or partially exempt) as a refinance transaction that was previously subject to tax, and the tax was timely and properly paid. When recordation tax was properly paid on the previous recording, the exemption on the current recording is limited to the principal balance due on the existing debt (e.g., only the new consideration is taxable). From the enactment of the Tax Clarity Act of 2000[16] (Tax Clarity Act) through October 31, 2011, we determined that OTR collected approximately $439.8 million in taxes on the recording of commercial deeds of trust as shown in Table 3 (see Page 9).

[15] Due to the OAG's legal opinion that there is insufficient clarity in the legislation to conclude that OTR's revised interpretation of D.C. Code § 42-1103(a)(3) was erroneous, we likewise did not assign error to OTR's revised interpretation of the law.

[16] The Tax Clarity Act (D.C. Law 13-305) became effective on June 9, 2001. Prior to this date, an emergency version of the legislation (D.C. Act 14-0022) was enacted by Council, which became effective March 16, 2001, for a 90-day period. The ROD implemented the emergency version 30 business days later on April 26, 2001.

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Table 3. Recordation Tax Collection on Commercial Deeds of Trust by Fiscal Year ($000,000)

2001*	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012*	Total**
$8.5	$27.6	$40.7	$49.9	$42.9	$62.5	$71.7	$44.7	$32.8	$23.4	$30.0	$5.2	$439.8

* Partial years. For FY 2001, calculations beginning on March 16, 2001, and for FY 2012, those through October 31, 2011.
** Total does not sum due to rounding.

Common exemptions[17] provided by law and claimed by owners of commercial property are the purchase money and supplemental deed exemption. Purchase money loans are exempt from recordation taxes when recorded simultaneously[18] with the deed conveying the real property for which the purchase money deed of trust was obtained. A purchase money loan is a mortgage or deed of trust provided as payment or partial payment of the purchase price of real property. Additionally, a supplemental deed of trust which confirms, corrects, modifies, or supplements a prior recorded deed without additional consideration is exempt.

In general, recording a security interest instrument on a commercial property within the District is a taxable event[19] unless specifically exempt by law. In 2001, the ROD published guidance to the public stating that refinances of purchase money would be subject to tax on the entire amount of the new loan.[20] The ROD generally administered and collected recordation tax in this manner on refinanced purchase money transactions when the prior security interest instrument was retired,[21] from April 28, 2001, through FY 2007.[22] This interpretation, which taxed the refinancing of purchase money resulted in a projected $19.9 million in recordation tax revenue collected in the audit period.[23]

This estimate is based on selecting a random sample of transactions and projecting that sample over the population. We applied statistical sampling software to draw 321

[17] There are 30 exemptions enumerated in D.C. Code § 42-1102 available to property owners.
[18] When D.C. Code §§ 42-1102(5) and 42-1103(b-1)(1) are read together, "simultaneously" means "fully executed within 30 days of the date that the deed conveying title to the real property to the purchaser is fully executed and . . . recorded within 30 days after the date that the deed conveying title to the purchaser of the real property is duly recorded."
[19] All deeds are presumed to be taxable and the burden of proof is with the taxpayer to substantiate the deed is exempt from tax per D.C. Code § 42-1107.
[20] *See* Exhibit C.
[21] This practice did not apply to modified security interest instruments or instruments assigned to new lenders and subsequently modified.
[22] The OIG could not determine the exact date of the change in policy.
[23] Included in this projection was one instrument assigned to a new lender (initiated by the borrower) where OTR collected recordation tax on the refinanced purchase money debt.

FINDINGS AND RECOMMENDATIONS

samples from the electronic population of 11,107[24] transactions supplied by ROD to conduct the testing. We tested the electronic data to ensure a complete population was reviewed. The statistical parameters used for the sample selection, the sample size of the population, and the projection of the sample results give a 95 percent confidence level at a materiality level[25] of $5 million.

In FY 2007, prompted by a request for a private letter ruling,[26] OTR reevaluated the correctness of this application of the law and determined that the "Tax Clarity Act did not substantively change the [prior] law other than to clarify that payment of recordation taxes is required on refinanced debt, except for any portion of the debt that was previously exempted or on which the tax was paid."[27] This change in position by OTR was not pronounced in regulation or official notice, which may have contributed to an inconsistency in tax collection we noted below (see Page 12, Table 4).

Four years later, the OAG disagreed with OTR's FY 2007 interpretation based on the "plain reading[[28]] of the Act, particularly as compared with its former language, [which] suggests that the recordation tax should be assessed on the full amount of the indebtedness, to the extent that no recordation tax was paid on the original indebtedness."[29] However, the OAG further stated that the interpretation based on the plain reading of the Act is not supported by the legislative history, and that the Council of the District of Columbia did not intend to change the prior practice.[30] Therefore, OTR's interpretation in FY 2007 was not erroneous or inconsistent with the intent of the legislature per the OAG. Additionally, on June 5, 2012, and subsequent to the period under audit, the Council enacted new legislation[31] clarifying its intent, which legislation specifically exempts the refinance of purchase money mortgages from recordation tax assessment to the extent of the existing principal balance on the refinanced loan.

Based on the OAG's plain reading of the law and in conformance with the Council's request, we estimated the amount of tax that was not collected by OTR from the period of March 16, 2001, through October 31, 2011, (audit period) without regard to the

[24] The sample of 321 selected excluded a transaction type (classification), which was compensated for in the projection. The actual sample population was 12,316 transactions.
[25] This is the maximum amount of error we were willing to accept in the population without detection.
[26] A private letter ruling is a written decision by OTR in response to taxpayer requests for guidance based on specific taxpayer circumstances and relates only to the requesting taxpayer (i.e., not a guide for all taxpayers).
[27] Gandhi, Natwar M., Chief Financial Officer letter to the Council of the District of Columbia, Washington, DC. June 22, 2011.
[28] *See supra* note 13.
[29] Recordation Tax Treatment of Refinances of Security Interest Instruments, D.C. Op. Att'y Gen. (July 25, 2011).
[30] *Id*.
[31] *See* Fiscal Year 2013 Budget Support Act of 2012, D.C. Law 19-168, effective Sept. 20, 2012.

FINDINGS AND RECOMMENDATIONS

OAG opinion above. Further, we considered the successive recording of a purchase money deed of trust that was not a supplemental deed of trust to be a taxable recording in substance regardless of form. This includes: (1) refinances with a new lender and the prior deed of trust being satisfied and retired; (2) deeds of trust being assigned to new lenders[32] (excluding exempt sales or assignments in the secondary market) with or without modification; and (3) modifications with existing lenders where new money was obtained.

Based on the above suppositions and the sampling methodology described above, OTR did not collect a projected $47.3 million in recordation taxes on refinanced commercial purchase money loans during the audit period. OTR management officials indicated that they did not fail to collect the projected $47.3 million because their application of the law was not inconsistent with the legislature's intent as confirmed by the OAG opinion. The OIG does not dispute this assessment and presents this projected total for informational purposes as requested by the Council.[33]

However, our audit did reveal that OTR officials have not been consistent in their application of the law from FY 2007 through FY 2011.[34] Refinancing of prior purchase money was taxed 63 percent of the time in this period, while assignments were regularly not taxed. Modifications of purchase money loans whereby additional money was obtained were not taxed on the prior purchase money amount during the entire audit period (see Page 12, Table 4).

[32] This transaction type may have been a tax avoidance (planning) method whereby a borrower obtained a new loan from a new lender, which was secured by an existing (assigned and modified) deed of trust. However, we recognize that there may be additional non-tax business reasons (e.g., lower title or legal costs), which would necessitate this type of transaction (other than tax avoidance).
[33] The Council requested that the OIG determine whether OTR collected recordation tax on the whole debt at the time of refinance for purchase money loans. The $47.3 million figure is the projected amount uncollected on refinanced (including modifications and assignments) purchase money loans.
[34] The OTR failed to tax two sampled refinanced purchase money transactions from the FY 2001 through FY 2006 time period. These errors occurred in FY 2003 and were not considered by OIG to be an inconsistent application of the law as they represent less than 7 percent of the sampled refinanced purchase money transactions in that time period.

FINDINGS AND RECOMMENDATIONS

Table 4. Percentage of Tested Commercial Purchase Money Refinances Taxed by Fiscal Year and Transaction Type

Type	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total*
Refinance	100%	100%	71%	100%	100%	100%	100%		50%	50%	67%		38
Assignment[35]							33%	0%		0%	0%		10
Modification		0%		0%	0%	0%	0%				0%		13
Samples*	1	4	7	10	9	10	5	3	2	4	6	0	61

Key
- (red) Refinance of purchase money not taxed (no sample transactions taxed)
- (yellow) Refinance of purchase money inconsistently taxed (percentage of sample transactions taxed)
- (green) Refinance of purchase money taxed (all sample transactions taxed)
- (grey) No occurrence in sample data (unknown how transaction type was taxed in that particular fiscal year)

* Number of tested refinanced purchase money deeds of trust observed by fiscal year and type within the total sample of 321

OTR management indicated that the inconsistences in collection regarding refinances and assignments resulted from taxpayers not claiming an exemption that they may be entitled to rather than improper tax administration. For instance, when a taxpayer presents a document for recording and fails to claim an exemption, OTR assesses tax based on the face amount presented in the document. The OIG does not dispute OTR's explanation, except to note that OTR's failure to publish public notice on the agency's change of position in FY 2007 may have contributed to the inconsistent pattern of taxation collection observed.

Additionally, OTR management emphasized that modifications (and modified assignments) have been processed consistently in that they have never been treated or taxed as refinancing transactions, and are not specifically addressed in the law. Management further stated that modifications have been properly taxed on the incremental borrowing (or new money) only. However, refinancing includes the exchange of an old debt for a new debt and we noted from the modification agreements reviewed that the new debt is specified in its entirety therein, not just the additional incremental borrowing, and the modification agreement establishes the priority of the new combined loan amount. Additionally, there is no guidance in law or regulation stating that OTR's practice to tax only the new money on modifications was correct.

This inconsistency in the administration of recordation tax could have been detected and corrected in the course of periodic audits conducted by OTR, which is charged with examining taxpayer books and records to ascertain "the correctness of any return

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[35] This transaction type is an assignment to a new lender whereby the borrower has taken action to refinance (i.e., not a secondary market transaction initiated by the lender, which is exempt per D.C. Code § 42-1102.01).

FINDINGS AND RECOMMENDATIONS

required to be made… [and] determining the liability of any person or real property for any District of Columbia tax….”[36] The Audit Division of the Compliance Administration (CA) within OTR (see Page 2, Figure 1), which is responsible for auditing tax reporting, does not audit the accuracy of the Form FP 7/C tax return. The CA policy states, “[i]n support of the overall Office of Tax and Revenue (OTR) mission, the Audit Division is charged with obtaining, maintaining, and achieving tax compliance with all tax laws of the District of Columbia; except real property taxes.”[37] Currently and for more than 10 years, there has been no audit function within OTR to review Form FP 7/C tax returns, which may identify filing errors; help ensure equal and consistent application of the law; and verify information that is not available at the time of recording (i.e., a certificate of satisfaction that shows a lien on real property is released).[38]

CONCLUSION

OTR did not consistently tax the refinancing of purchase money mortgage transactions that fell within the OIG audit period. Changes by OTR in the application and administration of the District’s tax laws were not communicated to the public so that taxpayers could clearly understand their rights and duties under the law. Additionally, OTR did not conduct Form FP 7/C tax return audits, which could have detected inconsistent applications of the law governing recordation tax collection.

RECOMMENDATIONS, MANAGEMENT RESPONSES, AND OIG COMMENTS

We recommend that the Chief Financial Officer, OCFO:

1. Notify OAG of fundamental changes initiated by OTR in the application or administration of District tax law to ensure that the new interpretation and rules do not inhibit OAG’s ability to litigate pending or future cases, or enforce the District tax laws.

OCFO RESPONSE

OCFO agreed with the recommendation and stated that the OAG has been so informed.

OIG COMMENT

Action taken by OCFO is responsive and meets the intent of the recommendation.

[36] D.C. Code § 47-4313.
[37] OCFO Financial Policies and Procedure Manual, Volume VIII, Section 35603001.10 Administrative Procedures (Updated 04/29/2010).
[38] A HUD-1 is available at the time of recording and shows the funds allocated to pay the outstanding loan but does not substantiate that the loan was released.

FINDINGS AND RECOMMENDATIONS

2. Notify the public of proper and necessary changes in the administration of tax collection by issuing regulations or other public notices to consistently administer District tax law, and enable taxpayers to clearly understand their rights and duties.

OCFO RESPONSE

OCFO agreed with the recommendation and stated that changes in the administration of tax collection should be preceded by a statutory amendment, rulemaking, or notification as appropriate.

OIG COMMENT

Action taken by OCFO is responsive and meets the intent of the recommendation.

3. Expand the Audit Division's responsibilities within OTR to include requirements for routine and objective evaluations of taxpayer compliance with the District's real property tax laws, and ensure that errors identified from such reviews are regularly communicated to ROD for potential process improvements and training opportunities.

OCFO RESPONSE

OCFO disagreed with the recommendation stating that the requisite expertise to audit recordation tax resides with the ROD. The ROD is hiring a new Recordation Tax Specialist to audit instruments at the time of recording. Additionally, OTR will perform quality assurance audits on previously recorded instruments when the required FTEs are obtained.

OIG COMMENT

Action planned by OCFO is responsive and meets the intent of the recommendation. However, OCFO did not provide an estimated target date for the completion of planned actions for this recommendation. Thus, we respectfully request that OCFO provide a target date for planned corrective action within 60 days of the date of this final report.

FINDINGS AND RECOMMENDATIONS

FINDING 2. REFINANCE OF EXISTING DEBT

SYNOPSIS

The OTR failed to consistently collect all taxes due on the refinancing of commercial debt secured by real property. Specifically, OTR did not consistently: (1) ascertain the principal balance on refinanced debt in order to properly calculate the tax due; (2) require supporting documentation to substantiate the principal balance of the refinanced loan; and (3) substantiate prior taxes paid.

We attribute these internal control weaknesses to OTR: (1) providing inadequate management oversight, which resulted in ineffective procedures; (2) not providing taxpayers with a standardized method to itemize exemptions; and (3) failing to treat loan modifications where new consideration was obtained as a refinancing transaction. As a result, OTR failed to collect an observed[39] $5.7 million in recordation tax revenue, of which $500,000 is currently collectable,[40] on recorded security interest instruments, and adequately minimize the risk of tax fraud and errors.

DISCUSSION

D.C. Code § 42-1103(a)(3) states that when existing debt is refinanced, the tax rate shall be applied to the new debt in excess of the principal balance of the old debt provided that recordation tax was timely and properly paid on the prior security interest instrument. Therefore, the grantor (i.e., the borrower) may substantiate[41] and claim an exemption correlated to taxes previously paid on refinanced debt. As such, no additional tax is due when a commercial loan secured by real estate is refinanced and the amount borrowed does not exceed the principal balance outstanding (i.e., refinance principal balance only) given that the taxpayer has substantiated that taxes were timely and properly paid on the prior loan.

However, we observed in our sampling that the amount refinanced regularly included additional indebtedness above the principal balance outstanding. When additional money was obtained through the refinancing transaction, ROD routinely collected recordation tax on the new indebtedness in excess of the prior loan amount rather than the principal balance (of the

[39] *See supra* note 14.
[40] *See supra* note 3.
[41] D.C. Code § 42-1107.

FINDINGS AND RECOMMENDATIONS

refinanced loan) as required by law. This practice excluded a marginal portion of the loan amount[42] that was taxable.

To calculate the amount subject to tax on a commercial refinance and subsequently the tax due, ROD must: (1) determine whether the prior loan was properly taxed; (2) verify the principal balance due on the refinanced loan; and (3) identify the total amount of new debt incurred and outstanding.[43] The new debt incurred is reflected on the face of the current filing, but ROD has not consistently required or maintained documentation to validate the principal balance, debt outstanding, or in some cases, the prior tax paid on the refinanced loan.

Prior Tax Paid

To claim an exemption or a partial exemption on a refinanced commercial loan, the taxpayer is required to substantiate that taxes were timely and properly paid on prior loans.[44] Of the 130[45] tested refinance transactions, we observed 8 instances (6 percent) whereby the taxpayer claimed an exemption, but prior taxes paid could not be substantiated on the taxpayer's filed Form FP 7/C tax return or with other records maintained by OTR. The ROD policy[46] is to reject documents that are insufficient or deficient. These unverified exclusions resulted in an observed revenue loss of $4.6 million in recordation tax revenue prior to FY 2008.

Seven of the eight noted exemptions related to transactions where the grantor refinanced loans occurring prior to FY 1999 and the recorded deed of trust did not contain a clear and legible register receipt. Additionally, ROD could not substantiate the tax collected through the cash register application, and the taxpayers did not provide proof of prior payments with their Form FP 7/C tax returns.[47] The other unsubstantiated exemption related to a consolidation and modification of prior outstanding loans whereby a review of recordation tax paid on all prior deeds and deeds of trust did not support the exemption claimed.

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[42] The loan amount excluded from the amount subject to tax is the principal reduction paid (i.e., the portion of each mortgage payment applied to principal) over the period of the loan.
[43] An assessment of the total outstanding debt may be necessary to substantiate whether the loan being recorded is additional indebtedness (e.g., a newly acquired second mortgage), a refinancing, or a partial refinancing transaction which will affect the amount currently subject to tax.
[44] D.C. Code § 42-1107.
[45] The number of refinances is a subset of the total sample of 321 and excludes construction loans refinanced (converted) to permanent loans because the amount exempt from tax is the prior lien amount, per D.C. Code § 42-1102(11), and not the principal balance.
[46] OCFO Financial Policies and Procedure Manual, Volume VIII, Section 35508001.10, Examination of Legal Instruments (Updated 09/30/2010).
[47] The tax return should document and establish the taxpayer's claim for exemption.

FINDINGS AND RECOMMENDATIONS

We attribute these conditions to ROD not providing taxpayers with a standardized schedule to itemize exemptions, improper operation of cashier stamping equipment[48] used to record taxes paid on the deed of trust, and not requiring that all necessary documentation to substantiate the exemption be attached to the Form FP 7/C tax return[49] at the time of recording.

Principal Balance

The taxpayer is required to validate that taxes on the prior security interest instrument were timely and properly paid in order to claim this exemption. To determine the amount of exemption or partial exemption, the taxpayer should provide as an attachment to the Form FP 7/C tax return independent documentation such as a Housing and Urban Development Settlement Statement (HUD-1) to support the payoff of the prior loan (i.e., the current loan is not an additional loan), and a payoff statement validating the principal balance due on the refinanced loan. During the audit period, OTR did not consistently obtain these documents necessary to calculate the taxable amount.

In addition, by exempting from recordation tax the prior loan amount rather than the principal balance on the loan, ROD excluded a marginal portion of the amount subject to tax.[50] We observed that of the 130 tested refinances, ROD allowed exemptions that exceeded the principal balance owed at the time of refinance in 66 cases (51 percent). This practice resulted in an estimated loss of $1.2 million in recordation tax revenue. Per discussion with OTR management, ROD's practice was to not require the HUD-1 and payoff statements prior to FY 2008, but to accept them if they were provided. Additionally, as previously stated in this report's Finding 1, ROD does not consider modifications and assignments initiated by borrowers to be refinancing transactions and, therefore, did not require HUD-1s or payoff statements prior to the recent change in the law.[51]

The following table (see Page 18, Table 5) illustrates the inconsistency observed in testing by fiscal year and refinancing transaction type. The color green indicates that all tested transactions by type and fiscal year were correctly taxed based on the principal balance of the prior loan and the color yellow indicates an inconsistent practice with the percentage correctly taxed shown. Conversely, the color red indicates that all tested transactions were incorrectly taxed based on the prior loan amount.

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48 Improperly stamping the receipt on the deed of trust was not observed subsequent to calendar year 2004 and this issue is considered remediated by OIG.

49 D.C. Code § 42-1103(b)(1) provides, "Each such deed [submitted for recordation] shall be accompanied by a return in such form as the Mayor may prescribe, executed by all parties to the deed, setting forth the consideration for the deed or debt secured by the deed, and such other information as the Mayor may require."

50 *See supra* note 43.

51 *See* Fiscal Year 2013 Budget Support Act of 2012, D.C. Law 19-168, effective Sept. 20, 2012.

FINDINGS AND RECOMMENDATIONS

Table 5. Percentage of Tested Commercial Refinances Limiting Credits to the Principal Balance of the Prior Loan by Fiscal Year and Transaction Type

Type	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total*
Refinance	100%	100%	54%	78%	55%	60%	50%		100%	100%	100%	100%	69
Assignment[52]	100%			50%		50%	50%	0%		0%	33%	0%	20
Modification	100%	0%	25%	20%	50%	18%	0%	0%	100%	0%	0%		41
Samples*	3	9	17	18	17	23	14	5	3	7	12	2	130

Key
- ROD did not consider principal balance of prior taxed loan (all samples under taxed)
- ROD inconsistently considered principal balance (percentage of samples correctly taxed)
- ROD limited credits to the principal balance of prior loan (all samples correctly taxed)
- No occurrence in sample data (unknown how transaction type was taxed in that particular fiscal year)

* Number of tested refinanced deeds of trust observed by fiscal year and type within the total sample of 321

Because the principal balances of the refinanced loans were not available in file documents and Form FP 7/C tax returns (i.e., payoff statements), we estimated the principal balance at the time of refinance to evaluate the extent of this error. Our methodology involved: (1) identifying customary amortization periods common to commercial loans; (2) obtaining current commercial mortgage rates from three financial institutions[53] for commercial property types observed in the sample; (3) determining the average premium above the federal prime rate; (4) estimating a probable annual percentage rate of interest available to the borrower by adding the interest rate premium to the prime rate in effect when the prior loan was initiated; and (5) calculating the principal balance at the time of refinance by applying the above information to the prior loan amount and period between refinances. We believe this methodology provides a reasonable estimate of uncollected tax in individual samples observed whereby ROD did not obtain documentation to validate the principal balance of the refinanced loan.

CONCLUSION

During the audit period, ROD did not consistently require or maintain documentation necessary to substantiate exemptions and partial exemptions related to recordation tax on refinanced commercial properties, and prior tax payments could not be validated in all tested cases. Additionally, ROD did not provide taxpayers with a schedule to uniformly substantiate and itemize prior instruments, which form the basis of the current exemption.

[52] This transaction type is an assignment to a new lender whereby the borrower has taken action to refinance (i.e., not a secondary market transaction initiated by the lender, which is exempt per D.C. Code § 42-1102.01).
[53] We obtained commercial mortgage rates from RealtyRates.com, Capital Funding of America, and Steelhead Capital Commercial Mortgage & Loan Financing.

FINDINGS AND RECOMMENDATIONS

RECOMMENDATIONS, MANAGEMENT RESPONSES, AND OIG COMMENTS

We recommend that the Chief Financial Officer, OCFO:

4. Collect recordation tax on refinanced loans based on the difference between the current indebtedness and the principal balance of the prior loan as stipulated by D.C. Code § 42-1103(a)(3).

OCFO RESPONSE

OCFO agreed with the recommendation and stated the ROD is assessing and collecting recordation taxes as described.

OIG COMMENT

Action taken by OCFO is responsive and meets the intent of the recommendation.

5. Implement and monitor a procedure that requires every Form FP 7/C tax return claiming a refinancing exemption based on a prior transaction to provide a payoff statement and a HUD-1 closing statement (or similar independent authoritative documents) to support the exemption.

OCFO RESPONSE

OCFO agreed with the recommendation and stated that OTR Notice 2012-06 is being updated to include the requirement for both documents.

OIG COMMENT

OCFO's response is noted, but does not explicitly meet the intent of the recommendation. OCFO stated that OTR Notice 2012-06 is being updated to inform the public of the requirement but does not clearly state that proposed changes to current policies will be monitored for OTR staff. OCFO stated in response to Recommendation 3 that quality assurance audits will be performed when resources are obtained, which could partly remediate this recommendation. Accordingly, we respectfully request that OCFO reconsider its response to this recommendation and provide the OIG with a revised response within 60 days of the date of this final report.

6. Require proof of payment from the taxpayer in instances where prior recordation tax payments cannot be substantiated to documents on file with ROD, and ensure that the recorded security interest instrument is taxed on the face amount secured when the exemption is not properly documented and supported.

FINDINGS AND RECOMMENDATIONS

OCFO RESPONSE

OCFO agreed with the recommendation and stated that when a taxpayer cannot substantiate the basis of exemption, the instrument will be taxed on the face amount.

OIG COMMENT

Action taken by OCFO is responsive and meets the intent of the recommendation.

7. Collect $500,000 in recordation tax not previously collected on transactions identified within the current period of limitation. Develop procedures to identify similar recordation errors (within the current period of limitation) without proper support, which may have resulted in uncollected taxes. Audit these similar transactions and collect additional tax as appropriate.

OCFO RESPONSE

OCFO agreed with the recommendation and stated that the list of instruments identified by OIG will be reviewed by the ROD and audited as appropriate.

OIG COMMENT

OCFO's response is noted, but does not explicitly meet the intent of the recommendation. OCFO stated that the list of instruments identified by OIG will be reviewed by the ROD and audited as appropriate but does not state that similar instruments will be identified for audit. Accordingly, we respectfully request that OCFO reconsider its response to this recommendation and provide the OIG with a revised response within 60 days of the date of this final report.

8. Implement a standardized schedule to itemize a taxpayer's basis for exemption to be attached to the Form FP 7/C tax return when an exemption is claimed. The schedule should allow for the calculation of partial exemptions and document all relevant information to support an exemption with instructions for proper completion.

OCFO RESPONSE

OCFO agreed with the recommendation and is in the process of developing a standardized schedule.

FINDINGS AND RECOMMENDATIONS

OIG COMMENT

Action planned by OCFO is responsive and meets the intent of the recommendation. However, OCFO did not provide an estimated target date for the completion of planned actions for this recommendation. Thus, we respectfully request that OCFO provide a target date for planned corrective action within 60 days of the date of this final report.

FINDINGS AND RECOMMENDATIONS

FINDING 3. AMOUNT OF DEBT SECURED

SYNOPSIS

We noted that not all security interest instruments reviewed in our sampling clearly stated the amount of debt secured by commercial real estate on the face or within the body of the security interest instrument. Certain deeds of trust examined: (1) secured properties in foreign jurisdictions without limiting a portion of the debt within the District of Columbia; (2) failed to quantify all security; or (3) failed to include, in the amount subject to tax, all security itemized within the instrument recorded.

We attribute these conditions to: (1) inadequate management oversight, which includes imprecise policies and procedures; (2) complicated and lengthy deeds of trust and insufficient time for reviewers to examine documents filed; (3) a lack of regulation or other public guidance governing the taxability of multi-jurisdictional security interest instruments; and (4) no audit function for Form FP 7/C tax returns. Consequently, there was an observed[54] revenue loss of $18.5 million in the District's recordation tax revenue of which $6.1 million is currently collectable.[55]

DISCUSSION

Recordation tax is imposed on the principal amount of debt recited on the face of the deed of trust when submitted for recording with ROD unless other information available determines that the principal amount of debt is a higher amount.[56]

Blanket Deeds of Trust

A loan secured by multiple properties can be structured so that each property secures a distinct portion of the entire debt with multiple deeds of trust being filed, or each property may secure the entire debt ("blanket deed of trust"). A blanket deed of trust secures a single debt by mortgages on two or more properties without allocating a portion of the debt to any single property or taxing jurisdiction.[57] This type of transaction reduces the lender's risk as it does not limit the lender to a predetermined amount on any specific property upon foreclosure. However,

[54] *See supra* note 14.
[55] *See supra* note 3.
[56] D.C. Code § 42-1104(b).
[57] Some observed blanket deeds of trust may encumber properties in various jurisdictions. Per discussion with ROD, the security interest instrument recorded in each jurisdiction (including the District) may be the same (i.e., without distinction or customization to the jurisdiction in which the instrument is filed).

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blanket deeds of trust are subject to tax based on the face amount stated on the deed regardless of the property's physical location or value of the property within the District.

We found that the blanket deeds of trust within our sample often stated a maximum principal amount secured or other limiting language,[58] which effectively assigned a definite portion of the debt to the properties within the District. Therefore, when a deed of trust limited the amount secured, we considered this certain amount to be the taxable amount for recordation tax purposes, rather than the total debt incurred, because the language limits the grantee's (i.e., the lender's) recovery in the event of foreclosure.

However, within our sample, there were four blanket deeds of trust that were not taxed on the face amount even though the properties within the District individually secured the entire debt (i.e., no maximum amount stated for District properties). This resulted in an observed revenue loss in recordation tax revenue of $18.3 million. Additionally, we observed that in certain blanket deeds of trust, the language describing the amount secured was ambiguous.[59]

In addition, ROD taxed these blanket mortgage transactions based on unclear or undocumented allocation methodologies, or estimated property values similar to those allowed by Maryland (MD)[60] and Virginia (VA)[61] statutes. We found that District law does not include provisions for assessing recordation tax for the apportionment of debt, and for exemption of foreign properties under blanket deeds of trust. Therefore, the blanket deed of trust should be taxed on the face amount in the District. It is unclear to current OTR management as to why these procedures, which are permitted in other jurisdictions (MD and VA), were accepted by former ROD without legislative guidance or regulation.

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[58] Examples included: "the total amount of debt incurred that is secured by the interest in real property created by this deed of trust is $…;" "[n]ot withstanding anything herein to the contrary, the amount secured by the property shall not exceed $...;" and "the outstanding principal balance secured by this deed of trust will not at any time exceed $...."

[59] Examples included: "THE FOREGOING ALLOCATIONS ARE FOR RECORDATION TAX PURPOSES ONLY AND SHALL NOT BE INTERPRETED TO LIMIT THE GRANTEE'S RECOVERY IN THE EVENT OF FORECLOSURE…;" "Beneficiary has the right…to reapportion the Total Indebtedness Secured among the Mortgaged Properties...;" and "the approximate value of the Collateral…" allocated rather than the amount of debt secured.

[60] Per the Maryland Code: "For a deed, deed of trust, or mortgage transferring title to real property located partly in the State, the recordation tax applies to the consideration payable or the principal amount of the debt secured in the same ratio that the value of the real property that is located in the State bears to the value of the entire property." MD. CODE ANN., TAX-PROP. § 12-105(a)(1) (West 2012).

[61] Per the Virginia Code: "Upon deeds of trust or mortgages conveying other property lying partly within the Commonwealth and partly without the Commonwealth the tax herein imposed shall be only upon such proportion of the debt secured as the value of the property located within the Commonwealth, or which may be brought into the Commonwealth, bears to the entire amount of property conveyed by such deed of trust or mortgage." VA. CODE ANN. § 58.1-803(B) (West 2012).

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We attribute these conditions to OTR's lack of policies and procedures regarding blanket deeds of trust; complicated and lengthy security interest instrument filings, which may contain contradictory and ambiguous language or instruments that do not clearly state the amount secured; District law not providing for a similar allocation methodology as used in neighboring jurisdictions; and a lack of regulations or other public guidance governing the taxability of multi-jurisdictional security interest instruments.

Other Principal Secured by Real Property

Within our audit sample population, we observed security interest instruments that did not clearly state all principal secured on the face of the document or failed to quantify all amounts secured by real property. The consideration on the face of the security interest instrument may have excluded quantified and/or unquantified, present and future obligations secured by real property as detailed in the recorded instruments.

Consideration described or referred to in supplemental documentation but not valued within the deed of trust or the Form FP 7/C tax return included: the amount borrowed, unspecified future advances, and swap agreements. This debt is secured by real property, but was unvalued and may have been excluded from the amount subject to tax. When all consideration is not properly stated on the face of the deed, D.C. law stipulates that other information available to the Mayor can be used to determine the principal amount of the debt being a higher amount, resulting in a greater amount of tax due. [62]

Amounts quantified or quantifiable but excluded from the amount subject to tax or from the face amount of the deed of trust included: a loan facility, letters of credit, personal property,[63] and recordation taxes. Excluding a portion of the debt secured by real property resulted in an observed loss of $281,875 in recordation tax revenue.

We attribute these conditions to complicated and lengthy security interest instrument filings not clearly stating the amount of debt secured on the face of the deed; ROD's inability to perform a comprehensive review of the filed document due to staffing levels; and the lack of an OTR audit function to review Form FP 7/C tax returns, which may identify instances of recording errors as previously stated in this report's Finding 1. Additionally, ROD explained that there is no

[62] D.C. Code § 42-1104(b).
[63] Personal property is commonly encumbered by a Uniform Commercial Code Financing Statement (UCC1) and not subject to recordation tax in the District. However, the use or allocation of the money borrowed and secured by real property (i.e., to purchase tangible personal or intangible property) is not a determining factor for recordation taxes; only that the amount borrowed creates an encumbrance on real property as shown within a security interest instrument.

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guidance in regulation providing permissible methods to implement D.C. Code § 42-1104(c)[64] in determining a higher amount of debt secured from available information.

CONCLUSION

Our review indicated that not all transactions observed were taxed based on the total indebtedness secured by commercial real estate because the security interest instrument contained inconsistent and indefinite statements, or foreign properties, which may indicate that the value being secured was a higher amount. Certain instruments tested did not clearly state the value of the amount secured.

RECOMMENDATIONS, MANAGEMENT RESPONSES, AND OIG COMMENTS

We recommend that the Chief Financial Officer, OCFO:

9. Collect recordation tax in compliance with D.C. Code § 42-1104(b) by assessing the recordation tax on the face amount on a blanket deed of trust; and implement regulations or other guidance to inform the public regarding the taxability of multi-jurisdictional security interest instruments within the District. Alternatively, request that the Council of the District of Columbia enact legislation that establishes an allocation methodology for multi-jurisdictional blanket deeds of trust.

OCFO RESPONSE

OCFO disagreed with the recommendation that multi-jurisdictional deeds of trust should be taxed on their face amount and alternatively stated that the ROD requires these security instruments to specifically limit their applicability to the extent they secure real property within the District. OCFO agrees that additional guidance should be provided and will promulgate a regulation that requires that the security interest instrument state the amount it secures and specifically limit its encumbrance of District property to the amount by which it secures real property located within the District.

OIG COMMENT

OCFO's response is noted, but does not explicitly meet the intent of the recommendation, which is to establish and promulgate guidance that can be applied in all cases (i.e., at time of recording and audit) regarding multi-jurisdictional deeds of trust. The OCFO's plan to require security instruments to limit their applicability to the extent they secure real property within the District

[64] D.C. Code § 42-1104(c) states: "Whenever, in the opinion of the Mayor, a submission for recordation does not contain sufficient information to determine … the principal amount of debt secured by a deed, the Mayor may determine the amount from the information available."

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only applies to instruments when recorded and does not address instruments subsequently identified as not meeting this new requirement. Taxing blanket deeds of trust on the face amount[65] or with a pro rata allocation methodology should address all situations. An allocation methodology could work concurrently with the alternate implementation suggested by OCFO. Accordingly, we respectfully request that OCFO reconsider its response to this recommendation and provide the OIG with a revised response within 60 days of the date of this final report.

10. Collect recordation tax on the principal amount of debt secured by security interest instruments. When the amount secured is not specified, ambiguous, or exceeds the amount stated on the face of the deed of trust, determine the amount of debt secured from information available in conformance with D.C. Code § 42-1104(c), or reject deeds of trust that are insufficient according to current policies and procedures.

OCFO RESPONSE

OCFO agreed with the recommendation and stated that when the amount of debt cannot be identified, the instrument will be rejected.

OIG COMMENT

Action taken by OCFO is responsive and meets the intent of the recommendation.

11. Collect $6.1 million in recordation tax not previously collected on transactions identified within the current period of limitation. Develop procedures to identify similar recordation errors (within the current period of limitation) whereby the security interest secured by real property exceeded the principal amount of debt subject to tax, which may have resulted in uncollected taxes. Audit these similar transactions and collect additional tax as appropriate.

OCFO RESPONSE

OCFO agreed with the recommendation and stated that the list of instruments identified by OIG will be reviewed by the ROD and audited as appropriate. However, the OCFO has declined further review of the most significant error because "[a]n allocable portion of the deed of trust was taxed, and the *available information* [emphasis added] does not establish that any additional

[65] The OIG agrees with OCFO in that taxation should be limited to the taxpayer's activities within the District and that taxing the document on the face amount may not be ideal in all cases. However, without legislative or regulatory guidance detailing an allocation methodology, the OIG determined that the recorded multi-jurisdictional instruments, that did not specifically limit the amount secured, secure the aggregate amount of debt recorded within the District and are taxable on the face amount.

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portion should have been taxed." The ROD is developing procedures to identify instruments where the security interest exceeds the amount of debt taxed.

OIG COMMENT

Action planned by OCFO is responsive and meets the intent of the recommendation and the OIG no longer considers the most significant error an open issue as the period of limitation expired on or about October 1, 2013. However, when establishing selection criteria to perform audits, the mere lack of information supporting how the tax was paid should not be the basis for concluding that no audit is warranted. Significant weight should be given to the potential under collection of tax and the District laws in effect at the time of filing. Additionally, OCFO did not provide an estimated target date for the completion of planned actions for this recommendation. Thus, we respectfully request that OCFO provide a target date for planned corrective action within 60 days of the date of this final report.

12. Develop, formalize, and monitor compliance with additional policies and procedures governing the assessment of recordation tax on blanket deeds of trust that contain vague submissions, and which lack sufficient information or documentation to determine the principal amount of debt secured.

OCFO RESPONSE

OCFO agrees that additional guidance should be provided and will promulgate a regulation.

OIG COMMENT

OCFO's response is noted, but does not explicitly meet the intent of the recommendation. OCFO stated that guidance will be provided to the public but does not clearly state that policies and procedures will be developed, implemented, and monitored for OTR staff. OCFO stated in response to Recommendation 3 that quality assurance audits will be performed when resources are obtained, which could partly remediate this recommendation. Accordingly, we respectfully request that OCFO reconsider its response to this recommendation and provide the OIG with a revised response within 60 days of the date of this final report.

13. Request the Council of the District of Columbia to consider legislation to limit the benefit of a recorded instrument to the amount stated on the face, or other method identified through a public process. Alternatively, consider imprinting the recorded document with the consideration attested to be correct on the Form FP 7/C tax return, or make the tax return an integral part of the deed of trust as permitted by D.C. Code § 42-1103(b)(2) to provide alternative evidence to the amount secured when not clearly stated within the security interest instrument.

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OCFO RESPONSE

OCFO disagreed with the recommendation and will promulgate a regulation that requires that the security interest instrument state the amount it secures and specifically limit its encumbrance of District property to the amount by which it secures real property located within the District.

OIG COMMENT

Alternative action planned by OCFO is responsive and meets the intent of the recommendation. However, OCFO did not provide an estimated target date for the completion of planned actions for this recommendation. Thus, we respectfully request that OCFO provide a target date for planned corrective action within 60 days of the date of this final report.

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FINDING 4. TAX ADMINISTRATION

SYNOPSIS

The OTR did not establish effective internal controls over tax collection to allow it to: (1) identify commercial property owners who did not provide sufficient documentation to support their tax payment, or recording errors; (2) collect recordation tax based on the tax rate in effect at the time of recordation on certain sampled transactions; and (3) perform all supervisory reviews required by established policy and practice. Consequently, OTR did not collect an observed[66] $589,000 in recordation taxes (none of which is currently collectable[67]) that could have been assessed and collected from the recording of certain commercial properties from FY 2003 through FY 2008, and adequately minimize the risk of tax fraud and errors.

We attribute these internal control weaknesses to OTR's failure to: (1) provide adequate management oversight, which resulted in ineffective procedures; (2) timely implement a statutorily mandated tax increase in calendar year (CY) 2003; (3) perform supervisory reviews on certain Form FP 7/C tax returns claiming exemption; and (4) provide instructions with the Form FP 7/C tax return to assist the public in calculating the tax due.

DISCUSSION

When a security interest instrument is submitted for recordation, the total amount of debt secured by an interest in real property is subject to taxation.[68] Further, in order to ensure proper administration and prevent evasion of recordation taxes, all deeds are presumed to be taxable and the burden shall be upon the taxpayer to show that a deed is exempt from tax.[69] Therefore, when taxpayers present documentation to validate an exemption, ROD has a process to review and approve claimed exemptions. Additionally, whenever a submission for recordation does not contain sufficient information to determine the principal amount of debt secured, the Mayor may determine the amount secured from the information available.[70]

[66] See *supra* note 14.
[67] *See supra* note 3.
[68] D.C. Code § 42-1103(a)(3).
[69] *Id.* § 42-1107.
[70] *Id.* § 42-1104(c).

FINDINGS AND RECOMMENDATIONS

Filing Errors

Within our sample population, we observed that ROD did not obtain or retain all documentation necessary to substantiate an exemption; hence, we were unable to reconcile the difference between the amount secured by real property as stated on the face of the deed of trust and the recordation tax payment for five tested transactions (2 percent of the sample). As a result, prior to FY 2008, OTR may have failed to collect an observed $319,814 million in recordation tax on the filing of commercial security interest instruments, and adequately minimize the risk of undetected recordation tax filing errors.

Four of the deeds of trust examined were not taxed on the loan amount secured by real property as stated on the face of the deed of trust. The largest error was a deed of trust securing two loans of which only one was taxed. A review of all deeds of trust filed by that particular grantor (i.e., borrower) did not show a similar recording for the excluded indebtedness or that the tax was paid on another instrument.

Two other observations related to claims of purchase money exemptions that were in excess of the purchase price of the property as evidenced by the recordation and transfer taxes paid on the deed conveying the real property. In accordance with D.C. Code § 42-1102(5), the purchase money exemption may be claimed when the purchase money deed of trust is recorded simultaneously with the deed conveying the real property for which the purchase money deed of trust was obtained.[71] In these two instances, the face of the deeds of trust did not state the amount of the purchase money that was being secured as required by D.C. Code § 42-1103(b-1)(2)(D).

Per discussion with ROD, one or more of these transactions may have been errors in the document filed and none should have been accepted for recording without correction or collection of recordation tax based on the amount stated on the face of the instrument less substantiated deductions.

Incorrect Tax Rate Applied to the Transaction

District law requires that when a commercial security interest instrument is submitted for recordation, it shall be taxed at the current tax rate.[72] However, we noted that two tested transactions were taxed at a rate of 1.1 percent when the tax rate in effect at the time the

[71] We note that D.C. Code § 42-1101(12) defines "[t]he phrase purchase money mortgage or purchase money deed of trust" to mean "a mortgage or deed of trust provided as payment or part payment of the purchase price of real property." [Internal quotation omitted.]
[72] In accordance with the Fiscal Year 2003 Budget Support Amendment Act of 2012, D.C. Law 14-307, effective January 1, 2003, the rate of tax in effect at the time the errors were observed was 1.5 percent. The rate of tax applied to commercial recordation transactions has changed three times during the audit period. (*See* Page 4, Table 2).

instrument was filed was 1.5 percent, which resulted in an observed $269,482 in lost revenue to the District.

One of the noted errors was due to a policy implemented by prior ROD management, which issued a public notice[73] delaying implementation of the new tax rate if the underlying transaction was executed prior to the effective date of the tax. Current OTR management is not certain as to why the delayed implementation was permitted, but speculates that it was due to the short period of time between the legislation being signed into law on December 4, 2002,[74] and the effective date of the legislation – January 1, 2003.

The second observation was a commercial property construction loan taxed at the residential tax rate. The Form FP 7/C tax form version in effect at the time of recording showed both tax rates (i.e., residential and commercial) and the tax return was incorrectly completed using the line for residential transactions. We attribute this error to the tax return not being reviewed by a supervisor, as required by practice, and the lack of instructions provided to the public on how to complete the tax form.

Review and Approval

The examination of a legal instrument when recorded includes a review of the Form FP 7/C tax return and documentation supporting an exempt transaction. The examination includes verification of pertinent information that should be noted on the instrument and tax return including the names of the grantor and grantee, square and lot of the property, date of filing, appropriate signatures, and the calculation of tax due. OTR's policy and procedure for approving recordation Form FP 7/C tax returns involves an examination[75] for completeness and consistency by the supervisory legal instrument examiner before approving or denying the tax exemptions sought (excluding purchase money transactions, per practice)[76] on the tax return.

Our testing showed that a supervisor's review, where the taxpayer claimed some type of exemption (other than purchase money), was not performed when required by established policy and practice 22 percent of the time between FY 2001 and FY 2008. The ROD did not know why certain Form FP 7/C tax returns lacked evidence of review and approval. While we did not observe any approval errors after FY 2008 (i.e., reviews required by practice), we consider

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[73] *See* Exhibit D. OTR legal counsel believes that this notice was likely distributed to the District of Columbia Land Title Association and its members. Additionally, it may have been posted on the OTR website and removed when its usefulness expired.

[74] The new law was not published in the D.C. Register until December 27, 2002, or 4 days prior to the implementation date.

[75] This supervisory review is referred to as a "pre-audit" within the Examination Unit of ROD. We refrained from calling it an "audit" to prevent confusion with the audit function of CA of OTR.

[76] Per OTR management, purchase money exemptions are standard and filed concurrently with the deed conveying title, which reduces the risk of errors. Consequently, they do not get a supervisory review in practice.

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proper review and approval a necessary key control for any claimed recordation exemption, and management should track adherence to this approval requirement. Proper review and approval reduces the likelihood of erroneous and fraudulent tax transactions.

Purchase Money Recording Requirements

There are specific documentation requirements set forth in District law regarding the filing of security interest instruments claiming a purchase money exemption. Specifically, D.C. Code § 42-1103(b-1)(2) provides:

> A purchase money mortgage or purchase money deed of trust . . . shall:
> . . .
>
> (B) Reference the deed conveying title to the purchaser of the real property by date and instrument number;
> (C) Recite on the face of the document that it is a purchase money mortgage or purchase money deed of trust; and
> (D) Recite on the face of the document the amount of purchase money that it secures.

We determined that OTR did not fully comply with the above documentation requirements. Of the 56 purchase money deeds of trust examined (within our sample population of 321), 98 percent (55 samples) did not reference the deed conveying title and 61 percent (34 samples) did not recite "purchase money mortgage" or "purchase money deed of trust" as well as the amount of purchase money secured on the face of the document.

The OTR administers the "Examination of Documents Submitted in Person"[77] procedure, which requires that the instrument examiner reject the recordation if there is insufficient or deficient documentation. OTR management indicated that the majority of security interest instruments claiming a purchase money exemption are filed together with the deed conveying title to real property making this requirement unnecessary. We disagree with OTR's assessment that this requirement is unnecessary and believe documentation as stated in District law promotes transparency and auditability of transactions.

[77] OCFO Financial Policies and Procedure Manual, Volume VIII, Section 35508001, Examination of Legal Instruments (Updated 09/30/2010).

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Tax Return Retention

Out of our sample selection, 4 percent (12 of 321) of the Form FP 7/C tax returns were not available for review. The OTR's record retention policy requires that tax returns, which are used to file and pay recordation taxes,[78] be retained for 4 years.

While our audit did not identify any violation of the record retention policy, we were unable to review the Form FP 7/C tax return for all sampled transactions, which made it difficult to determine how the tax payment was calculated on certain multiple property and complex refinancing transactions that were financed and refinanced multiple times over many years.

Refinancing exemptions are dependent on validating prior taxes paid, which may not be clear within the previously filed security interest instruments. The Form FP 7/C tax return may, in some instances, validate that the prior tax on the existing debt was timely and properly paid. Therefore, we believe that OTR's record retention policy should require a longer retention period to promote transparency, auditability, and proper tax collection on subsequent refinancing transactions.

Regulations Not Current

OCFO issued regulations to implement District statutes and give direction to taxpayers on compliance with District law. In our review of the DCMR, we determined that regulations relevant to the assessment of recordation tax were not updated to reflect changes in the law. This condition increases the risk of misinterpretation and noncompliance. The OIG noted that D.C. Code § 42-1103(a)(1)(B)(i) requires the assessment of recordation tax on leases with a term of at least 30 years, while the current regulation, 9 DCMR § 501.2, states that "Deeds transferred under wills and leases shall be exempt from the [recordation] tax." OTR management indicated that it assesses recordation tax on leases according to the provisions of D.C. Code § 42-1103(a)(1)(B)(i) and not the relevant regulation. In addition, OTR did not update references to the D.C. Code within the regulations to be consistent with the current codification of the D.C. Code.

While we acknowledge that the D.C. Code supersedes the DCMR when a contradiction exists, we believe that clear and consistent guidance to the public is necessary to avoid confusion and ensure compliance with the District's tax laws.

[78] The Form FP 7/C is also used for transfer taxes; however, our audit only examined those portions of the return related to recordation taxes and exemptions on security interest instruments.

FINDINGS AND RECOMMENDATIONS

CONCLUSION

The OTR lacked adequate management oversight or failed to implement controls to ensure that: (1) filing errors were prevented or detected; (2) effective monitoring, documentation, and auditing mechanisms were used to minimize the risk of fraud and errors; (3) changes in tax rates were timely enforced in accordance with law; (4) Form FP 7/C tax forms contained sufficient instructions to assist taxpayers in proper completion and payment of taxes; (5) Form FP 7/C tax returns are maintained for a sufficient period to allow for transparency and auditability; and (6) regulations are properly updated. These control deficiencies increase the risk that compliance failures, errors, and fraud within the commercial recordation tax collection processes may not be timely detected and corrected.

RECOMMENDATIONS, MANAGEMENT RESPONSES, AND OIG COMMENTS

We recommend that the Chief Financial Officer, OCFO:

14. Collect recordation tax based on the principal amount of the debt recited on the face of the deed of trust or total amount secured (if debt is a higher amount) less substantiated exemptions, and reject security interest instruments that do not agree with Form FP 7/C tax return, or when exemptions are not properly supported.

OCFO RESPONSE

OCFO agreed with the recommendation.

OIG COMMENT

Action taken by OCFO is responsive and meets the intent of the recommendation.

15. Develop procedures to identify similar recordation errors, within the current period of limitation, that did not subject all amounts secured by real property to tax, which may have resulted in uncollected taxes. Audit these similar transactions and collect additional tax as appropriate.

OCFO RESPONSE

OCFO agreed with the recommendation and stated that the list of instruments identified by OIG will be reviewed by the ROD and audited as appropriate. The ROD is developing procedures to identify instruments where the security interest exceeds the amount of debt taxed.

FINDINGS AND RECOMMENDATIONS

OIG COMMENT

Action planned by OCFO is responsive and meets the intent of the recommendation. However, OCFO did not provide an estimated target date for the completion of planned actions for this recommendation. Thus, we respectfully request that OCFO provide a target date for planned corrective action within 60 days of the date of this final report.

16. Develop metrics to monitor compliance with policies and procedures, and conduct frequent oversight reviews of the processes to ensure adherence.

OCFO RESPONSE

OCFO agreed with the recommendation and is developing a formal policies and procedures manual.

OIG COMMENT

OCFO's response is noted, but does not explicitly meet the intent of the recommendation which is to monitor compliance of policies and procedures by OTR staff. OCFO stated in response to Recommendation 3 that quality assurance audits will be performed when resources are obtained, which could remediate or partly remediate this recommendation. Accordingly, we respectfully request that OCFO reconsider its response to this recommendation and provide the OIG with a revised response within 60 days of the date of this final report.

17. Develop instructions to assist taxpayers in proper completion of the Form FP 7/C tax return.

OCFO RESPONSE

OCFO agreed with the recommendation and stated that the ROD has developed instructions to assist taxpayers and published OTR Notice 2012-06.

OIG COMMENT

Action taken by OCFO is responsive and meets the intent of the recommendation.

18. Work with the Council to ensure tax recordation legislation is enacted at the time prescribed by law and with sufficient public notice.

OCFO RESPONSE

OCFO agreed with the recommendation.

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OIG COMMENT

Action taken by OCFO is responsive and meets the intent of the recommendation.

19. Reject purchase money security interest instruments that do not conform to the legal recording requirements specified in D.C. Code § 42-1103(b-1)(2) or incorrectly specify the instrument number, date, or purchase money amount until the deficiencies are corrected and the document is recordable. Alternatively, petition the Council of the District of Columbia to remove unnecessary purchase money recording requirements.

OCFO RESPONSE

OCFO partly agreed with the recommendation and stated that Form FP 7/C will be amended to isolate the purchase money from the construction money.

OIG COMMENT

OCFO's response is noted, but does not explicitly meet the intent of the recommendation, which is to conform with all recording requirements specified in D.C. Code § 42-1103(b-1)(2) and not just the amount of purchase money secured. Accordingly, we respectfully request that OCFO reconsider its response to this recommendation and provide the OIG with a revised response within 60 days of the date of this final report.

20. Increase the record retention period for Form FP 7/C tax return or implement a regulation[79] making the tax return an integral part of the deed of trust requiring indefinite retention. A policy requiring retention for 30 years or more would provide ROD with a method of verifying what tax was previously and properly paid, how the tax was calculated, and whether an exemption has been previously substantiated.

OCFO RESPONSE

OCFO agreed with the recommendation stating that scanned images of Form FP 7/C began in 2000 and those images will be retained indefinitely for review and access.

OIG COMMENT

Action taken by OCFO is responsive and meets the intent of the recommendation.

[79] D.C. Code § 42-1103(b)(2) provides, "[t]he return shall be an integral part of the deed when prescribed and as required by regulation" which would require the same retention period that applies to a deed.

FINDINGS AND RECOMMENDATIONS

21. Update Title 9 DCMR Chapter 5 to be consistent with the D.C. Code as currently codified.

OCFO RESPONSE

OCFO agreed with the recommendation.

OIG COMMENT

Action taken by OCFO is responsive and meets the intent of the recommendation. However, OCFO did not provide an estimated target date for the completion of planned actions for this recommendation. Thus, we respectfully request that OCFO provide a target date for planned corrective action within 60 days of the date of this final report.

OTHER MATTERS OF INTEREST

Our audit identified the following issue during the recordation tax audit related to the tax return format of the Form FP 7/C. Even though this internal control weakness did not directly result in the insufficient collection of recordation taxes, we believe the potential risk of inefficiency and error warrants OTR management's attention.

We evaluated the Form FP 7/C tax form used to file and pay recordation taxes. Based on our review, we determined that the current format does not effectively require adequate documentation to support the exemptions, nor does it clearly document how the recordation tax was calculated. For example, it was difficult to determine the breakdown of the consideration and prior taxes paid when multiple properties were secured (i.e., blanket deeds of trust), multiple refinancing transactions were involved, or multiple loans were consolidated. During the course of the audit, we noted the following areas for potential improvements to the tax form:

- Instructions, itemizations, and more comprehensive calculation tables are necessary to ensure accuracy and transparency and to clearly document how the recordation tax was calculated;
- For the exemptions section, additional information such as prior transaction details in the case of a refinance, needs to be noted on the tax form to allow independent verification with OTR's records;
- Should fully document partial exemptions, which are permitted in the case of a refinance;
- Should detail what documentation a taxpayer is required to provide to justify an exemption and the basis upon which the ROD refuses to accept a filing; and
- For transparency and auditability, ROD recalculations of tax liability should be attached to the Form FP 7/C tax return to document the methodology used to calculate the new amount of tax due. Alternatively, ROD should obtain a corrected tax return from the taxpayer.

While these conditions do not merit a formal recommendation, we believe that the ROD should revise the Form FP 7/C tax form to make the process of assessing, documenting, and collecting the recordation tax more transparent for the taxpayer, and improve OTR's ability to determine whether the recordation tax amount calculated by the taxpayer is correct.

EXHIBIT A: SUMMARY OF POTENTIAL BENEFITS RESULTING FROM AUDIT

Recommendations				
No.	**Description of Benefit**	**Amount and Type of Benefit**	**Estimated Completion Date**	**Status**[80]
1	**Compliance.** Ensures agency coordination, legal consistency, and effective litigation of tax issues.	Non-Monetary	11/8/2013	Closed
2	**Compliance.** Promotes clarity for taxpayers and facilitates accurate filings.	Non-Monetary	11/8/2013	Closed
3	**Compliance, Economy and Efficiency, and Internal Control.** Ensures compliance with recordation tax laws and provides ROD with information to improve processes.	Non-Monetary	TBD	Open
4	**Compliance and Internal Control.** Ensures refinancing transactions are properly taxed.	Potential Monetary Benefit	11/8/2013	Closed
5	**Internal Control.** Ensures refinancing transactions are properly taxed.	Potential Monetary Benefit	TBD	Unresolved
6	**Compliance and Internal Control.** Ensures that only substantiated exemptions based on prior tax payments are granted and tax collection is correct.	Potential Monetary Benefit	11/8/2013	Closed
7	**Compliance.** Ensures that uncollected recordation taxes are collected.	Monetary $500,000	TBD	Unresolved

[80] This column provides the status of a recommendation as of the report date. For final reports, **"Open"** means management and OIG are in agreement on the action to be taken, but action is not complete. **"Closed"** means management has advised that the action necessary to correct the condition is complete. If a completion date was not provided, the date of management's response is used. **"Unresolved"** means that management has neither agreed to take the recommended action nor proposed satisfactory alternative actions to correct the condition.

EXHIBIT A: SUMMARY OF POTENTIAL BENEFITS RESULTING FROM AUDIT

Recommendations (continued)				
No.	**Description of Benefit**	**Amount and Type of Benefit**	**Estimated Completion Date**	**Status**
8	**Compliance and Internal Control.** Increases transparency and auditability, and ensures only substantiated exemptions are granted.	Non-Monetary	TBD	Open
9	**Compliance and Internal Control.** Achieves compliance with existing laws for tax assessment on blanket deeds of trust.	Potential Monetary Benefit	TBD	Unresolved
10	**Compliance and Internal Control.** Achieves compliance with existing laws for tax assessment on deeds of trust whereby the amount secured is unspecified or ambiguous.	Potential Monetary Benefit	11/8/2013	Closed
11	**Compliance.** Ensures that uncollected recordation taxes are collected.	Monetary $6.1 Million	TBD	Open
12	**Compliance and Internal Control.** Standardizes procedures and practices for the proper handling of blanket deeds of trust when ambiguous interests are secured.	Non-Monetary	TBD	Unresolved
13	**Compliance and Internal Control.** Minimizes the risk of under-collecting recordation tax on security interest instruments.	Non-Monetary	TBD	Open
14	**Compliance and Internal Control.** Achieves compliance with existing laws for tax assessment on deeds of trust.	Potential Monetary Benefit	11/8/2013	Closed

EXHIBIT A: SUMMARY OF POTENTIAL BENEFITS RESULTING FROM AUDIT

Recommendations (continued)				
No.	**Description of Benefit**	**Amount and Type of Benefit**	**Estimated Completion Date**	**Status**
15	**Compliance.** Ensures that uncollected recordation taxes are collected.	Potential Monetary Benefit	TBD	Open
16	**Compliance and Internal Control.** Standardizes procedures and practices for the oversight of recordation tax collection.	Non-Monetary	TBD	Unresolved
17	**Compliance, Economy and Efficiency, and Internal Control.** Facilitates accurate and complete tax return filings.	Non-Monetary	11/8/2013	Closed
18	**Compliance, Internal Control, Economy and Efficiency.** Ensures accountability and coordination for the implementation of legislation.	Potential Monetary Benefit	11/8/2013	Closed
19	**Compliance.** Ensures compliance with purchase money recordation requirements.	Non-Monetary	TBD	Unresolved
20	**Compliance and Internal Control.** Ensures transparency and auditability of recordation transactions.	Non-Monetary	11/8/2013	Closed
21	**Compliance.** Promotes clarity for taxpayers and facilitates accurate filings.	Non-Monetary	TBD	Open

EXHIBIT B: AUDIT REQUEST

Note: Excerpt due to size (attachments to audit request excluded).

COUNCIL OF THE DISTRICT OF COLUMBIA
THE JOHN A. WILSON BUILDING
1350 PENNSYLVANIA AVENUE, NW
WASHINGTON, D.C. 20004

ENTERED
13737

2011 SEP 30 AM 11:35

DAVID A. CATANIA
Councilmember, At - Large
Chair, Committee on Health

Committee Member
Finance and Revenue
Libraries, Parks and Recreation
Government Operations and the Environment

August 30, 2011

Charles J. Willoughby
Inspector General
Office of the Inspector General
Government of District of Columbia
717 14th Street, N.W., 5th Floor
Washington, DC 20005

Dear Inspector General Willoughby:

On June 10, 2011, I wrote to the District's Chief Financial Officer, Dr. Natwar Gandhi for clarification of a May 24, 2011 *Washington Post* article that alleged the Office of Tax and Revenue ("OTR") failed to implement a key provision of the Tax Clarity Act of 2000 (the "Act"). The article claimed that, over the last decade, OTR failed to collect recordation taxes from the total amount of refinanced purchase money deeds of trust or mortgages on commercial properties (i.e., purchase money loans). Instead, the OTR collected the recordation tax from only new debt acquired at refinance.

I wrote to Dr. Gandhi again on June 30, 2011 after his reply to my initial letter admitted that OTR had not collected recordation taxes on the whole amount refinanced as required by the Act. In my second letter, I asked for further clarification of several issues. First, his reply contradicted two 2001 tax guidance memos issued by his office that referred explicitly to the newly enacted law and explained the change that recordation taxes would henceforth apply to the entire amount of a purchase money loan at refinance. (Attachment A) Second, I provided testimony from the March 6, 2000 hearing for the Act that clearly reflects the understanding of those in industries most affected by the language of the Act. All industry testimony clearly demonstrates that the Act would subject the existing as well as new debt of purchase money loans to recordation tax during refinance. (Attachment B)

In my June 30th letter, I addressed his office's misapplication of *1137 19th Street Associates, LP v. District of Columbia*, 769 A.2d 155 (D.C. 2001). The court in *1137 19th Street Assoc.* held that those refinancing were responsible for paying recordation tax on both the existing debt and the new debt. From the court's reasoning in this case it logically follows that OTR was responsible for collecting recordation taxes on both the *existing debt* and the *new debt* of commercial property purchase money loans when they were refinanced after the enactment of the Act.[1]

[1] Though the refinance in *1137 19th Street Associates* occurred prior the Act, the court's reasoning is directly relevant to the issue at hand. The pre-Act language contained two exemptions for the *existing debt* at the time of a refinancing: (1) purchase money deeds of trust or mortgages; (2) amounts previously "subject to tax under this paragraph." The first exemption for purchase money loans was subsequently repealed by the Act. The loan in *1137*

EXHIBIT B: AUDIT REQUEST

Dr. Gandhi replied to my June 30, 2011 letter on July 8th, 2011 wherein he supplied what he referred to as a "legal summary" written on July 26, 2007 by OTR's then-Chief of Counsel, Michael Cooper. (Attachment C). Dr. Gandhi claims Mr. Cooper's legal interpretation from 2007 was "the basis for implementing a revised policy and procedure of the Recorder of Deeds with respect to the taxation of refinances.[2]" Dr. Gandhi's explanation in his June 24th letter, however, suggests that OTR collected the full amount of the recordation tax between June 2001 and July 26, 2007 but changed its implementation of the Act thereafter. Dr. Gandhi states that "during 2001, staff of the Recorder of Deeds issued certain guidance concerning the implementation of the Act, the legal interpretation which precipitated this guidance has since changed. This guidance is no longer effective."

To date neither Dr. Gandhi nor any of his staff have provided satisfactory answers to my questions. Indeed, all attempts he has undertaken to explain OTR's implementation of the Act between 2001 to 2011 raise more questions than answers. It is my opinion, and I am joined in it by Councilmember Cheh, that the Council and the public deserve a full explanation of this matter. Thus, we are requesting that you conduct an investigation to determine whether OTR ever collected a recordation tax on the whole debt at the time of refinance for purchase money loans and if so, during what period of time this practice was in place, and how much of this tax money OTR collected.

If you have further questions about this request, please contact Councilmember Catania's office at (202) 724-7772.

Sincerely,

David A. Catania
Councilmember, At – Large
Chair, Committee on Health

Mary Cheh
Councilmember, Ward 3
Chair, Committee on the Environment, Public Works and Transportation

cc: Mayor Vincent Gray
All Councilmembers

19th Street Associates was not a purchase money loan so the court's analysis focused on the meaning of "subject to taxation under this paragraph," (language still in § 45-923(a)(3) [now §42-1103(a)(3)]). The court held that the recordation tax exemptions for a refinance of a commercial property loan were contained in a distinct paragraph (§ 45-923(a)(3)), and therefore the loan in question had not been previously "subject to taxation under this paragraph."

Though the *existing debt* of the loan is exempt from recordation tax when it is first recorded under § 42-1102(5) [formerly 45-922(5)], it is not exempt from recordation tax during a refinance because, as the court held in *1137 19th Street Assoc.*, it has not been previously subject to recordation tax under "this paragraph."

[2] Letter from Natwar M. Gandhi to Councilmember David A. Catania; July 8, 2011.

EXHIBIT C: REAL PROPERTY TAX CLARITY EMERGENCY ACT OF 2001 – EXTENSION NOTICE

Office of the Chief Financial Office of the Chief Financial Officer
Office of Tax and Revenue

Reply To:
Recorder of Deeds
515 D St. N.W. #202
Washington, DC 20001

FAX: (20) 727-9629
PHONE:(202) 727-5374

ATTENTION

Real Property Tax Clarity Emergency Act of 2001 - Extension Notice

This notice extends the effective date of sections Five (5) and Six (6) of the Real Property Tax Clarity and Litter Control Administration Emergency Act of 2001. Sections Five (5) and Six (6) modify Sections 47-901, 47-902, 47-903, 47-1401, 47-1433, 45-921, 45-922, and 45-923 of the District of Columbia Code.

Section Five (5) of the Act, which modifies Sections 47-901(3), 47-902 and 47-903 of the Code pertaining to an interest in real property transferred by a lease or ground rent for a term (including renewals) that is at least 30 years. There shall be assessed a rate of 1.1% transfer of the total consideration paid for the transfer. The Recorder of Deeds shall not tax renewals, modifications and/or amendments providing the tax was paid on the underlying lease or ground rent agreements.

Section Six (6) of the Act, which modifies Section 45-923(a)(3) of the Code, pertaining to the tax on deeds of trust warrants clarification. Under the current statute, the 1.1% tax on deeds of trust that refinance existing debts is <u>not</u> taxable in two (2) instances:

1. The loan that is being refinanced was secured by a purchase money deed of trust; or
2. If the recording tax were previously paid on the loan that is being refinanced (and in both of these instances, under current law, if the amount of the new loan exceeds the principal amount outstanding under the existing loan, the tax is assessed only on the excess amount).

The second instance would include permanent loans that refinance a construction loan, where the tax was paid on the recordation of the construction loan deed of trust.

Under the new law the first exemption, i.e., a purchase money deed of trust is refinanced, the entire amount of the new loan would be subject to the 1.1% recordation tax.

To avoid delays in the recording process and to permit trustees, lenders, attorneys, settlement and title agents sufficient time to adopt operational procedures to comply with the changes to the Tax Clarity Act, the Recorder of Deeds shall extend the effective date to **<u>April 26, 2001</u>**.

If you have any questions, please contact William Henry Riley, Director, Recorder of Deeds, at (202) 727-0418.

941 North Capitol Street, N.E., Washington, D.C. 20002

EXHIBIT D: NOTICE, FISCAL YEAR 2003 BUDGET SUPPORT AMENDMENT ACT OF 2002, RECORDATION & TRANSFER TAXES/ROD SURCHARGE FEES

Note: Original notice was unavailable. Document reproduced from archived e-mail.

NOTICE

FISCAL YEAR 2003 BUDGET SUPPORT AMENDMENT ACT OF 2002

RECORDATION & TRANSFER TAXES/ ROD SURCHARGE FEES

The Office of Tax and Revenue, Recorder of Deeds Division hereby gives notice of an increase in **RECORDATION and TRANSFER TAXES** pursuant to the Budget Support Act of 2002 (Bill 14-0892). The increase will take effect January 01, 2003 increasing the District of Columbia Transfer and Recordation Tax from 1.1% to 1.5%. The Recorder of Deeds Office will collect the 1.1% Recordation and Transfer tax rate for a transition period of **30 business days following December 31, 2002** provided all of the document transactions were completed prior to January 1,2003. The Recorder shall require as evidence of completion of the closing, executed and notarized documents, and an executed settlement statement (HUD-1) certified by the Title Company or attorney. All of the aforementioned documents must be executed and dated prior to January 1, 2003. The controlling date will be the bearing date or acknowledgement date on the documents submitted for record and the execution date on the HUD-1. **NO EXCEPTIONS WILL BE MADE WITH RESPECT TO THE AFOREMENTIONED REQUIREMENTS.**

Under Bill 14-0892 the 1.1% recordation and transfer tax **may** apply if the following requirements are met:

- Consideration is $250,000.00 or less
- The deed filed with the Recorder's office within 30 days from the date of execution, and
- The shall be an owner occupied residential homestead property (domicile of the owner) as evidenced by the filing of a completed Homestead application with the deed

Economic interest transfers shall be taxed at 3.0% of the consideration and will be given the same grace period and subject to the same requirements as stated above.

Additionally, construction loans on owner occupied residential property shall continue to be taxed at 1.1% irrespective of the loan amount.

Finally, the surcharge fee of $5.00, which is required with every document submitted for record, shall increase to $6.50. The new $6.50 document Surcharge fee is applicable on all documents filed after January 1, 2003 regardless of document execution dates. **There will be no transition period given with respect to the increase of the surcharge fee.**

If there are any questions or concerns please contact Mr. Larry Todd Recorder of Deeds @ 202-727-0419 or e-mail larry.todd @ dc.gov. or Mr. John Mowery Deputy Recorder of Deeds @ 202- 727-0420 or e-mail john.mowery @ dc.gov.

EXHIBIT E: OIG'S COMMENTS TO OCFO'S RESPONSE TO DRAFT REPORT

OFFICE OF THE INSPECTOR GENERAL COMMENTS TO THE DISTRICT OF COLUMBIA, OFFICE OF THE CHIEF FINANCIAL OFFICER'S RESPONSE TO THE DRAFT REPORT ON OUR AUDIT OF COMMERCIAL MORTGAGE RECORDATION AT THE OFFICE OF TAX AND REVENUE (OIG No. 11-2-27AT)

OIG Overall Comments

In analyzing OCFO's response, OIG staff considered the information that OCFO provided, and adjusted the report where warranted. Specific OIG comments appear below following excerpts of OCFO's detailed response to the draft report. For OCFO's full response, see Exhibit F.

The OIG based its findings and related recommendations in this audit report on facts gathered during the course of the audit. Our audit results and conclusions are fully supported by sufficient and appropriate audit evidence.

Finding 1. Refinance of Purchase Money Loans (page 8 of this report). Our audit found that OTR did not consistently collect recordation tax on the whole amount of debt secured by commercial real estate at the time of refinancing substantively similar purchase money loans. This condition occurred because OTR: (1) revised its application of the law regarding the taxability of refinanced purchase money loans[81] in FY 2007; (2) inconsistently interpreted and administered the taxation of refinanced purchase money loans; and (3) failed to tax loan modifications subsequent to a purchase money loan as a refinance of purchase money, where new consideration was obtained.

OCFO Response, page 1 (page 55 of this report): The audit, which faults OTR for not taxing modifications and other instruments as refinancings, relies repeatedly and heavily on OIG's incorrect reading of District law. The purpose of any audit should be to review facts and circumstances under the law as it existed during the audit period, and not as if the law had been written differently. Instead, OIG substituted its own view for the legal conclusions of the Attorney General and widely-accepted case law. Under District recordation tax law, modifications were not treated in the same manner as refinancings until 2012, well after the audit period, and this legislative change to District law provided this treatment on a prospective basis only.

OIG Comment: OCFO contends that modifications were not treated in the same manner as refinances until 2012, well after the audit period. However, a review of recorded documents has shown that OTR did treat refinances and modifications in the same manner but used a different and sometimes inconsistent methodology at arriving at the taxable amount. Generally, when a refinance was presented for recording, the taxable amount was reduced by the principal balance of the prior loan.[82] This is the same manner in which modifications were handled except the taxable amount was reduced by the prior loan amount (rather than the principal balance of that loan). Also

[81] *See supra* note 15.
[82] This generalization presupposes that prior taxes were timely and properly paid on the prior recorded instrument.

EXHIBIT E: OIG'S COMMENTS TO OCFO'S RESPONSE TO DRAFT REPORT

noted in testing, the modification method (i.e., giving credit for the prior loan amount) was also inconsistently applied to certain refinances. Generally, the OIG has determined that treating a modification (that is not a supplemental deed of trust) as a refinance is a reasonable interpretation of the law.

OCFO Response, page 1 (page 55 of this report): The Office of the Attorney General (OAG) opined (Exhibit D of the Draft Report) that relevant statutory language, legislative history and the intent of the Council did not show that OTR's method of taxing refinances of commercial security interest instruments was erroneous. Contrary to the audit's implied assertion, OAG did not opine on whether a modification is a refinancing or how modifications should be taxed for recordation tax purposes.

OIG Comment: As stated above, OIG has determined that treating a modification (that is not a supplemental deed of trust) as a refinance is a reasonable interpretation of the law.

OTR Response, page 1 (page 57 of this report) and associated support on pages 2 to 7 (pages 58 to 63 of this report): As to [F]inding 1, OIG prepared an "informational" estimate of additional recordation tax that could have been collected on purchase money refinancings had the entire amount of the refinancing been taxed. As OIG acknowledges, this amount does not represent an amount that OTR should have collected. Nonetheless, OTR disagrees with the basis and amount of this "informational" figure.

OIG Comment: OTR puts forth the case that modifications and assignments are not refinancing transactions and should not have been considered as such in our testing of refinanced purchase money transactions. This supposition lacks direct support by District statute, regulation, or case law. As stated above, the OIG has determined that treating a modification (that is not a supplemental deed of trust) as a refinance is a reasonable interpretation of the law.

The District case cited (*1137 19th Street Associates v. District of Columbia*, 769 A.2d 155 (2001 D.C. App.) in OTR's argument states that a refinancing is the retirement or extinguishment of prior debt. There is no discussion in that decision that the court intended this to be an exclusive or required component of a "refinance" or that a modification (with additional consideration) is not a refinance. Additionally, Black's Law Dictionary, 8th Edition (2004) on page 1301, defines a refinance as "[a]n exchange of an old debt for a new debt, as by negotiating a different interest rate or term or by repaying the existing loan with money acquired from a new loan." This definition does not specifically require retirement or payoff of the prior loan but certainly includes that type of transaction as a refinance.

To further support their position, OTR cites Maryland case law in the context of Maryland's recordation tax statute. Per OTR, "[t]he[se] cases have generally ruled that, where the original mortgage is preserved, and its lien is not extinguished, and if the new instrument cannot operate

EXHIBIT E: OIG'S COMMENTS TO OCFO'S RESPONSE TO DRAFT REPORT

without the retention of the old, the new instrument is a supplemental and exempt from tax." However, we noted from the modification agreements reviewed during testing that the new debt is specified in its entirety therein, not just the additional incremental borrowing, and the modification agreement establishes the priority of the new combined loan amount from the date recorded forward. The new security interest instrument appears to operate on its own (i.e., similar language and covenants as the prior instrument) with reference to the old. Additionally, OTR contends that modifications are "in the nature of supplemental deeds, which are not taxable except to the extent of additional consideration furnished," which became the practice but was not supported in law and directly contradicts the D.C. Code's definition of a supplemental deed.

Lastly, OTR states that modifications cannot be taxed as refinances because the form of the transaction supersedes the substance of the transaction. However, even if this is correct, there is no guidance in law or regulation stating that OTR's practice to tax only the new money on modifications was correct.

Incidentally, if modifications should not have been treated as a refinances during the audit period and they are not exempt supplemental deeds (as defined by statute), there was no available credit/exemption for prior taxes paid[83] and all transactions of this type should have been taxed on the face amount as a taxable security interest instrument. There was no guidance in law or regulation, during the audit period, addressing modifications.

OTR Response, pages 1 and 2 (pages 57 to 58 of this report). OTR disagrees with OIG's estimate that an additional $47.3 million in recordation taxes could have been collected on refinanced purchase money loans. This figure does not reflect an actual under-collection of purchase money refinances based on OTR's application of the law.

OIG Comment: We estimated the amount of tax that was not collected by OTR without regard to the OAG's opinion or OTR's application of the law, but in conformance with the Council's request (see Exhibit B). This figure is based on the sampling methodology described within Finding 1 (pages 9 to 10 of this report) and is not an actual under-collection of tax but an estimate based on the sampling parameters applied.

This estimate was based on the supposition that a subsequent recording of a purchase money deed of trust, that is not a tax-exempt supplemental deed of trust (as defined by statute), is a taxable recording in substance regardless of form. This includes: (1) refinances with a new lender where the prior deed of trust is satisfied and retired; (2) deeds of trust assigned to new lenders[84] (excluding exempt sales or assignments in the secondary market) with or without modification; and (3) modifications with existing lenders where new money is obtained.

[83] D.C. Code § 42-1103(a)(3) provides for an exemption to the amount of "the principal amount of the new debt in excess of the principal balance due on the existing debt" when "existing debt is refinanced."
[84] *See supra* note 32.

EXHIBIT E: OIG'S COMMENTS TO OCFO'S RESPONSE TO DRAFT REPORT

Finding 2. Refinance of Existing Debt (page 15 of this report). Our audit found that OTR failed to consistently collect all taxes due on the refinancing of commercial debt secured by real property. Specifically, OTR did not consistently: (1) ascertain the principal balance on refinanced debt in order to properly calculate the tax due; (2) require supporting documentation to substantiate the principal balance of the refinanced loan; and (3) substantiate prior taxes paid.

OTR Response, page 1 (page 57 of this report): OTR disagrees with the estimate in the Draft Report's executive summary (Draft Report p. ii) that OTR may have under-collected $27 million in taxes during the audit period. This figure is based on the conclusions of [F]ingings 2, 3, and 4 of the Draft Report. As discussed below, OTR has reviewed the available information concerning the transactions on which these findings are based and has concluded that, as a general matter, substantial under-collections of tax were not established.

OIG Comment: As this management response is a summary of multiple OTR responses to follow, we will comment on each under their respective finding which, in aggregate, total the disputed amount above. Based on information provided by OTR, this figure of $27 million was revised to $24.8 million in the final report.

OTR Response, page 7 (page 63 of this report): With respect to Finding 2, OTR disagrees that an under-collection of $5.7 million of recordation tax occurred. This figure actually represents the sum of two sets of different transactions.

The first of these involves an alleged under-collection of approximately $4.6 million attributable to pre-2008 transactions for which OIG stated (Draft Report, p. 16) full records could not be reconstructed. However, the mere absence of records relating to such old transactions, where records would have been disposed of consistent with established document retention schedules, does not constitute evidence that the tax was under-collected. Moreover, a Recorder of Deeds review of these instruments disclosed that they generally would not be fully taxable, as they involved (1) modifications, which would be taxable only on the increase in the face amount of the modified instrument, (2) permanent deeds of trust replacing construction loan deeds of trust on which tax had been paid, and (3) refinances, which would be taxable only on the excess of the face amount of the new instrument over the principal balance of the old instrument.

OIG Comment: OIG observed that seven of the eight recorded deeds did not have a clear and legible stamp indicating the amount of tax collected[85] and the ROD could not provide alternate evidence (e.g., scanned copies of FP 7/C tax returns) for OIG review. Therefore, because the OIG could not establish that the taxes were previously paid on the prior transactions and the sampled transactions were not taxed on the face amount, we calculated the additional amount of tax due based on the information available.

[85] The recorded document is stamped with the tax type and amount of tax paid whether it is $0.00 or any other amount.

EXHIBIT E: OIG'S COMMENTS TO OCFO'S RESPONSE TO DRAFT REPORT

The other unsubstantiated exemption related to a consolidation and modification of prior outstanding loans whereby a review of recordation tax paid on all prior deeds and deeds of trust did not support the exemption claimed.

Additionally, OTR's response implies that a systematic purging of records occurred according to established document retention schedules, which prevented the auditors from viewing alternate tax collection evidence. However, the OIG has not observed this occurrence as it relates to scanned records (i.e., copies of FP 7/C tax returns). For example, in OCFO's response to Recommendation 20 of the draft report (page 67 of this report), OTR confirms that the ROD has scanned and retained FP 7/C tax returns since 2000 and those records will be retained indefinitely.

OTR Response, page 7 (page 63 of this report): The second set of transactions identified by OIG involved an alleged under-collection of $1.2 million on transactions that OIG stated should have been taxed as refinances, with the tax being figured on the excess of the face amount of the new instrument over the principal balance of the old instrument. However, a review of these instruments by the Recorder of Deeds showed that they generally constituted modifications, rather than refinances, and so were not properly taxable as refinances, as suggested by OIG.

OIG Comment: Approximately 61% of the transactions described in this finding were modifications. The OIG has determined that treating a modification (that is not a supplemental deed of trust) as a refinance is a reasonable interpretation of the law.

Finding 3. Amount of Debt Secured (page 22 of this report). Our audit found that not all security interest instruments reviewed in our sampling clearly stated the amount of debt secured by commercial real estate on the face or within the body of the security interest instrument. Certain deeds of trust examined: (1) secured properties in foreign jurisdictions without limiting a portion of the debt within the District of Columbia; (2) failed to quantify all security; or (3) failed to include, in the amount subject to tax, all security itemized within the instrument recorded.

OCFO Response, page 1 (page 55 of this report): OIG incorrectly asserts that OTR should have taxed mortgages securing an aggregate sum from properties located within the District and in other states on the full amount of the mortgage without any consideration to apportionment. This view defies constitutional law, as stated in several court opinions and widely accepted practice throughout the country with respect to multijurisdictional deeds.

OIG Comment: See the next OIG Comment on the following page, which addresses this response.

OTR Response, page 8 (page 64 of this report) and associated support on pages 9 and 10 (pages 65 and 66 of this report): With respect to Finding 3, the Recorder of Deeds disagrees that there was a revenue loss of $14.3 million resulting from under-collection of tax on multijurisdictional and certain other blanket deeds of trust (Draft Report, p. 21). It is incorrect to

EXHIBIT E: OIG'S COMMENTS TO OCFO'S RESPONSE TO DRAFT REPORT

assert that a multijurisdictional deed of trust encumbering property located in other states as well as the District should be taxed on its face amount regardless of the location of the property securing the debt or the value of the property in the District.

OIG Comment: The OIG agrees with OCFO and OTR in that taxation should be limited to the taxpayer's activities within the District. OTR contends that the ROD taxed blanket deeds of trust based on an allocation between the taxable and nontaxable portions of the instrument. However, OTR did not and OIG could not identify any laws, regulations, documented policies or procedures, or consistently applied observable practices to show this taxing methodology and that all affected taxpayers were treated in the same manner during the audit period.

Additionally, OCFO rejected the OIG suggestion of working with Council to enact an apportionment methodology in the law (Recommendation 9), as used in neighboring jurisdictions, in favor of taxpayers stating how much is being secured by District properties. Based on current laws and regulations, this would require the grantor to limit the amount secured in proportion to District activity or pay tax based on the face amount of the document.

Therefore, in the absence of legislative guidance, agency regulation, or any limiting language to definitively assign a definite portion of the debt to District properties, OIG determined that the recorded instruments secured the aggregate amount of debt being recorded within the District.

OTR Response, page 9 (page 65 of this report): Below we re-examine the four largest transactions in the sampling reviewed by OIG, on which the $14.3 million figure was based. We believe that OIG is incorrect in its application of the law to the taxability of these instruments and that the Recorder of Deed did, in fact, collect the proper amount of tax owed:

With Instrument No. 2007001821, OIG states that the deed of trust should have been taxed on $253,028,543, gleaned from the generally non-enforceable recitals within the instrument. However, Section 18.4 of this instrument, which is enforceable, states that the properties are encumbered only up to $169,173,226.20 which is the consideration upon which the instrument was properly taxed. It is erroneous to contend that the instrument should have been taxed on the amounts in the recitals.

OIG Comment: A re-review of the transaction disputed by OTR indicates that the instrument stated a maximum principal amount secured notwithstanding statements made elsewhere in the document, which effectively assigned a definite portion of the debt to the properties within the District. Therefore, this error was removed from the final report.

OTR Response, page 9 (page 65 of this report): With Instrument No. 2007001808, OIG states that the deed of trust should have been taxed on $447,021,956, gleaned from the generally non-enforceable recitals within the instrument. However, Section 18.4 of the instrument, which is

EXHIBIT E: OIG'S COMMENTS TO OCFO'S RESPONSE TO DRAFT REPORT

enforceable, stated that the properties are encumbered only up to $385,000,000 which is the consideration upon which the instrument was properly taxed after deduction was given to allowable purchase money exemptions. Thus, the instrument was only taxable to the extent of $163,734,613, which was the amount secured above the exempt purchase money (and part of the $385,000,000). It is erroneous to contend that the instrument should have been taxed on the amount in the recitals.

OIG Comment: A re-review of the transaction disputed by OTR indicates that the instrument stated a maximum principal amount secured notwithstanding statements made elsewhere in the document, which effectively assigned a definite portion of the debt to the properties within the District. Therefore, this error was removed from the final report.

OTR Response, page 10 (page 66 of this report): With Instrument No. 2002152343, OIG's worksheet indicates apparently that OIG concluded that this multijurisdictional deed of trust should have been taxed on $350,000,000 of consideration, of which only $24,000,000 was actually taxed. The non-taxed $326,000,000 was secured by property located in other states and thus, as discussed above, this portion of the instrument could not be taxed because of the constitutional principles governing taxation of interstate transactions. As an aside, the $326,000,000 consideration figure does not translate to the error figure show on the OIG worksheet.

OIG Comment: During the audit, the ROD obtained verbal information and advised OIG that this transaction related to properties in multiple jurisdictions. The OIG has not received any additional documentary evidence to support this assertion, any supporting allocation methodology, or list of foreign jurisdictions. OTR did not and OIG could not identify any limiting language to definitively assign a definite portion of the debt to District properties. Therefore, without evidence to the contrary, the OIG concluded that the District properties secure the aggregate amount of the debt recorded.

Additionally, the error figure calculated for this transaction was allocated as three separate (and mutually exclusive) errors to prevent overstatement. This transaction was, in part, the refinancing of a purchase money transaction and a new money transaction.

OTR Response, page 10 (page 66 of this report): With Instrument No. 2006152528, OIG states that this multijurisdictional deed of trust should have been taxed on $600,000,000 of consideration, of which only $4,757,378 was actually taxed. The non-taxed $595,242,622 was secured by property located in other states and thus, as discussed above, this portion of the instrument could not be taxed because of the constitutional principles governing taxation of interstate transactions.

OIG Comment: The recorded document failed to limit the amount secured by District property. An attachment to the Deed of Trust stated an allocation to the District based on the taxpayer's "approximate value" of collateral being $4,757,378 (rather than the amount secured by District properties). The actual value of collateral, per OTR, at the time of recording was $32,064,260 but

EXHIBIT E: OIG'S COMMENTS TO OCFO'S RESPONSE TO DRAFT REPORT

this may not be indicative of the amount secured because it was often observed that borrowers obtained financing far exceeding the property value to develop properties. The OIG has not received any additional documentary evidence to support OTR's allocation methodology, or list of foreign jurisdictions. OTR did not and OIG could not identify any limiting language to definitively assign a definite portion of the debt to District properties. Therefore, without evidence to the contrary, the OIG concluded that the District properties secure the aggregate amount of the debt recorded.

Finding 4. Tax Administration (page 29 of this report). Our audit found that OTR did not establish effective internal controls over tax collection to allow it to: (1) identify commercial property owners who did not provide sufficient documentation to support their tax payment, or recording errors; (2) collect recordation tax based on the tax rate in effect at the time of recordation on certain sampled transactions; and (3) perform all supervisory reviews required by established policy and practice.

OTR Response, pages 10 and 11 (page 66 and 67 of this report): With respect to Finding 4, the Recorder of Deeds disagrees with the conclusion (Draft Report, p. 25) that there was an under-collection of $6.7 million in recordation tax, and that $6.1 million is currently collectable. The $6.1 million figure appears to relate to a single, multijurisdictional (blanket) deed of trust that was secured by real property located in other states, as well as the District of Columbia. The value of the property in the other states appears to be quite substantial and, as discussed above, the Recorder of Deeds is precluded from taxing the portion of the deed of trust allocable to property in other states. Accordingly, it is incorrect to suggest that tax could have been collected on the full amount of the deed of trust. All allocable portion of the deed of trust was taxed, and a substantial amount of tax (almost $1.7 million) was collected on the instrument. The available information does not establish that any additional portion of the deed of trust should have been taxed. Any suggestion that an additional amount of tax should have been collected is pure speculation.

OIG Comment: A re-review of the transaction disputed by OTR indicates that the instrument would be properly classified as a multi-jurisdictional (blanket) deed of trust with foreign property in Virginia and Louisiana as well as property in the District. As such, this error and OTR's response was moved to Finding 3 of this final report.

OTR notes that a "substantial amount of tax (almost $1.[8] million) was collected" but this amount represents less than twenty-one percent (21%) of the total amount secured without providing documentary evidence (e.g., Form FP 7/C tax return) to OIG demonstrating how the ROD calculated/reviewed the allocation method between taxable and non-taxable portions or why this method would be appropriate when not provided for in law or regulation. While the OIG agrees that taxation should be limited to the taxpayer's activities within the District, OTR did not and OIG could not identify any limiting language to definitively assign a definite portion of the debt to

EXHIBIT E: OIG'S COMMENTS TO OCFO'S RESPONSE TO DRAFT REPORT

specific properties or jurisdictions. As such, without evidence to the contrary, the OIG concluded that the District properties secure the aggregate amount of debt recorded with the ROD.

This transaction could have been audited by OTR, prior to the expiration of the period of limitation, to definitively ascertain the facts and circumstances surrounding this transaction. As such, the OIG no longer considers this specific transaction an open issue as the period of limitation expired on or about October 1, 2013.

EXHIBIT F: OCFO'S RESPONSE TO THE DRAFT REPORT

Government of the District of Columbia
Office of the Chief Financial Officer

Natwar M. Gandhi
Chief Financial Officer

NOV - 8 2013

Mr. Charles J. Willoughby
Inspector General
717 14th Street, NW, 5th Floor
Washington, DC 20005

Re: Audit of Commercial Mortgage Recordation at the Office of Tax and Revenue, OIG No. 11-2-27AT

Dear Inspector General Willoughby:

The Office of Tax and Revenue (OTR) has reviewed the above-referenced draft audit report prepared by the Office of the Inspector General (OIG) concerning the taxation of commercial security interest instruments recorded at OTR's Recorder of Deeds. Enclosed please find our response to the draft report. In summary, our response details the following major problems with the draft report:

1. The audit, which faults OTR for not taxing modifications and other instruments as refinancings, relies repeatedly and heavily on OIG's incorrect reading of District law. The purpose of any audit should be to review facts and circumstances under the law as it existed during the audit period, and not as if the law had been written differently. Instead, OIG substituted its own view for the legal conclusions of the Attorney General and widely-accepted case law. Under District recordation tax law, modifications were not treated in the same manner as refinancings until 2012, well after the audit period, and this legislative change to District law provided this treatment on a prospective basis only.

2. The Office of the Attorney General (OAG) opined (Exhibit D of the Draft Report) that relevant statutory language, legislative history and the intent of the D.C. Council did not show that OTR's method of taxing refinances of commercial security interest instruments was erroneous. Contrary to the audit's implied assertion, OAG did not opine on whether a modification is a refinancing or how modifications should be taxed for recordation tax purposes.

3. OIG incorrectly asserts that OTR should have taxed mortgages securing an aggregate sum from properties located within the District and in other states on the full amount of the mortgage without any consideration to apportionment. This view defies constitutional law, as stated in several court opinions, and widely accepted practice throughout the country with respect to multijurisdictional deeds.

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EXHIBIT F: OCFO'S RESPONSE TO THE DRAFT REPORT

Mr. Charles J. Willoughby
Audit of Commercial Mortgage Recordation at the Office of Tax and Revenue,
OIG No. 11-2-27AT
November 8, 2013
Page 2

If you have any questions regarding the enclosed response, please contact Deputy Chief Financial Officer Stephen M. Cordi at (202) 442-6383.

Sincerely yours,

Dr. Natwar M. Gandhi
Chief Financial Officer

Enclosure

EXHIBIT F: OCFO'S RESPONSE TO THE DRAFT REPORT

GOVERNMENT OF THE DISTRICT OF COLUMBIA
OFFICE OF THE CHIEF FINANCIAL OFFICER
OFFICE OF TAX AND REVENUE

Stephen M. Cordi
Deputy Chief Financial Officer

MEMORANDUM

TO: Natwar M. Gandhi
Chief Financial Officer

FROM: Stephen M. Cordi
Deputy Chief Financial Officer

DATE: November 8, 2013

SUBJECT: Draft Report: Audit of Commercial Mortgage Recordation at the Office of Tax and Revenue (Report Number: OIG No. 11-2-27AT)

The Office of Tax and Revenue (OTR) responds to the findings and recommendations of the Office of the Inspector General (OIG) in the above-referenced draft report as follows:

<u>EXECUTIVE SUMMARY</u>

OTR disagrees with the estimate in the Draft Report's executive summary (Draft Report p. ii) that OTR may have under-collected $27 million in taxes during the audit period. This figure is based on the conclusions of findings 2, 3, and 4 of the Draft Report. As discussed below, OTR has reviewed the available information concerning the transactions on which these findings are based and has concluded that, as a general matter, substantial under-collections of tax were not established.

As to finding 1, OIG prepared an "informational" estimate of additional recordation tax that could have been collected on purchase money refinancings had the entire amount of the refinancing been taxed. As OIG acknowledges, this amount does not represent an amount that OTR should have collected. Nonetheless, OTR disagrees with the basis and amount of this "informational" figure.

OTR has also reviewed and specifically responded to the recommendations set forth in the draft report. Where appropriate, OTR has agreed to adopt these recommendations.

<u>FINDING 1</u>

OTR disagrees with OIG's estimate that an additional $47.3 million in recordation taxes could have been collected on refinanced purchase money loans. This figure does not reflect an actual under-collection of tax on purchase money refinances based on OTR's

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application of the law. First of all, OTR notes that the Draft Report, at page 11, states that this figure is provided for "informational" purposes only. Furthermore, OIG does not dispute the Office of the Attorney General's (OAG) conclusion that OTR's application of the law governing refinances was not incorrect. As the OAG stated in its July 25, 2011 letter, the legislative history of the statute governing taxation of refinancings during the audit period indicates that the Council did not intend to change the practice of exempting the previously exempted portion of the refinancing and taxing only the additional amounts of indebtedness. As a result, OAG concluded that "there is not sufficient clarity in the legislation to reach a conclusion that OTR's interpretation is erroneous."

Moreover, this "informational" figure is artificially inflated because, rather than simply examining purchase money refinances, as the Council requested, the draft report incorrectly includes loan modifications, which are a different type of transaction from refinances. As discussed below, OIG's rationale that these transactions are similar in substance, regardless of their form (Draft Report, p. 11), is erroneous. OTR rejects OIG's assertion that modifications of security interest instruments are refinancings.

Furthermore, the OAG does not support OIG's view; OAG's July 25, 2011 opinion letter on refinancings did not address the tax treatment of modifications but was strictly limited to an analysis of District law covering refinances. Finally, it is grossly inaccurate to assert that OTR could have collected an additional $47.3 million in recordation taxes, based on equating modifications to refinancings, when to do so would have been contrary to District of Columbia (District) law.

OTR's tax treatment of modifications of debt instruments has been consistent with governing law. OIG points to a change in OTR's position regarding the taxation of refinancings from 2001 to 2007. This change in position, however, was related strictly to refinancings, and did not pertain to modifications.

There was no basis in the law as it stood during the audit period for treating modifications and refinancings, two distinct types of transactions, in the same manner. A brief review of the applicable law will demonstrate the error in OIG's position.

Refinancings

Because the words of a statute are to be construed according to their generally understood meaning, the term "refinance" in the recordation tax statute, D.C. Official Code § 42-1103(a)(3) means a refinancing in the ordinary sense of the term. In general, a refinance of a debt involves the retirement or extinguishment of the prior debt, the making of a new debt and the recordation of a new security interest instrument, according to the governing case law in the District and other jurisdictions. For instance, the District of Columbia Court of Appeals has used this interpretation for purposes of the recordation tax. <u>1137 19th Street Associates v. District of Columbia</u>, 769 A.2d 155 (D.C. 2001). In that case, an existing permanent loan was replaced by a new permanent loan, with a new deed of trust to secure this loan, and the court treated this transaction as a refinancing.

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Other courts have also recognized transactions of this type as refinancings. In Springhill Lake Investors Limited Partnership v. Prince George's County, 690 A.2d 535 (Md. Spec. App. 1997), the court reviewed the various definitions of the term "refinancing" and concluded that a refinancing involved the lending of a new sum of money to pay off a prior obligation. Other cases involving Maryland's recordation tax statute also support this meaning. Hammond v. Philadelphia Electric Power Co., 63 A.2d 759 (Md. 1949) (stating that "in general it may be said that where there is a new creditor, a new loan and a new contract relationship, and where the old note holders and their debts are paid and these debts extinguished, where one mortgage is paid by a new agreement, even though the latter is made with the same mortgagee, the new agreement is taxable. 'There is a new transaction with a new tax.'"); Hampton Plaza Joint Venture v. Baltimore County, 460 A.2d 633 (Md. Spec. App. 1983).

Even the definition of refinancing noted in the definitions section of OIG's draft report, taken from Black's Law Dictionary (8^{th} ed. 2004), which states that a refinancing is "[a]n exchange of an old debt for a new debt" recognizes that a refinancing involves the retirement of old debt and its replacement with a new debt.
Accordingly, refinancings for purposes of recordation tax are properly limited to situations where the old debt is extinguished or retired and a security interest instrument securing a new debt is recorded. Other types of transactions which do not have these characteristics are not refinancings, and are not taxable as refinancings.

Modifications

In contrast, a modification is a different and distinct transaction from a refinance. While there does not appear to be significant District case law defining a "modification," it is well established that, in such cases, District authorities may look to Maryland law for guidance in determining what constitutes a "modification" of a debt instrument. In re C.A.P., 633 A.2d 787, 790 (D.C. 1993). Case law in Maryland addresses what constitutes a "modification" in the context of applying Maryland's recordation tax statute, which generally exempts "supplemental" instruments. Md. Code Tax-Prop. § 12-108(e). The cases have generally ruled that, where the original mortgage is preserved, and its lien is not extinguished, and if the new instrument cannot operate without the retention of the old, the new instrument is supplemental and is exempt from tax. Hammond v. Philadelphia Electric Power Co., 63 A.2d at 764; Howard County v. Howard Research and Development Corp., 367 A.2d 18 (Md. Spec. App. 1977). New York law seems to be similar. Bay View Towers Apartments v. State Tax Commission, 367 N.Y.S.2d 856 (N.Y. App. Div. 1975) (stating that "[s]ubsequent filings that consolidate, perfect, or modify the original mortgage without creating new indebtedness do not incur any tax liability. As long as the parties are careful not to extinguish the original debt so as not to create a new indebtedness, no tax should be incurred").

Accordingly, while documents evidencing modification of an existing debt and security interest would come within the scope of the term "security interest instrument" as used in the tax statute, they would not be a refinancing, since the prior debt and security

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instrument would remain in force. Instead, these documents would be in the nature of supplemental deeds, which are not taxable except to the extent of additional consideration furnished. D.C. Official Code § 42-1102(6). The term "deed," as used in the statute, includes security interest instruments. D.C. Official Code § 42-1101(3)(A)(iii). A supplemental deed is one which, among other things, "modifies" a previously recorded deed or security interest instrument without additional consideration. D.C. Official Code § 42-1101(15). The administrative practice (supported by the plain language in the first sentence of former § 42-1103(a)(3)) with respect to a modification has been to tax it only on its face amount, which constitutes additional consideration over the face amount of the original instrument that it modifies.

Modifications Cannot be Taxed as Refinances

OTR correctly taxes instruments (including modifications) as required by District law on the nature of their form and legal effect. OIG is incorrect that modifications should be taxed as refinances in "substance regardless of form." (Draft Report, p. 11). Transactions are to be taxed on the basis of their actual nature, not on the basis of speculation concerning a taxpayer's motives or a transaction that did not actually occur, or another structure that could have been used, but was not.

The District's highest court adopted the same approach as OTR in a recordation tax case involving a transfer of property between two entities controlled by the same investors. Columbia Realty Venture v. District of Columbia, 433 A.2d 1075 (D.C. 1981). In that case, the Court rejected the argument that the transfer should not be taxed because, in substance, control of the property did not change. The court refused to look behind the form of the transaction to evaluate the purported similarity of ownership of the transferor and transferee, stating that:

> The deeds which were taxed in this case represent a conveyance of property from one business entity to another. Those entities are legally distinct and separate from the individuals who hold interests in and receive benefits from the business conducted. The elements of similarity between the two business enterprises, to which appellant points, are simply not relevant to determining the nature of the property transaction between them; and applying the deed recordation tax on that basis would be both confusing and misleading. Specifically, appellant's approach creates inevitably in our view an endless dispute over how similar or dissimilar the characteristics of two enterprises must be before a transaction between them is viewed as one between two parties rather than a change in business organization.

433 A.2d at 1077-78. The court concluded that the actual form of the transaction controlled for purposes of determining its tax treatment, and that a transaction should not be recast into something other than what actually occurred. **In summary, with respect to recordation taxes, courts will only look to the form of the transaction and will not impute a substance.** The D.C. Council has recently recognized the importance of the

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form of the transaction in recent legislation (DC Law 19-210), where the Council, by enacting D.C. Official Code § 29-204.06(h), specifically granted recordation and transfer tax exemptions to conversions of business entities that otherwise would be taxable, notwithstanding that equity holders are the same in both the converted and converting entities.

Recordation tax treatment is customarily determined based on the character of the instrument submitted for record rather than on matters not reflected in the documents. The Attorney General of Maryland, after reviewing a transaction that was apparently structured to avoid the Maryland recordation tax, opined that the "nature of the instrument necessarily determines whether it gives rise to a tax, without regard to the substance of the transaction from which it originates," and that he was not free to disregard the form of the transaction. 64 Md. Op. Att'y Gen. 286, 288-89 (1979). The perceived loophole involved in that opinion was subsequently corrected by legislation, which was the appropriate approach.

Applying these principles here, it is readily apparent that modifications could not be taxed as refinances due to the actual differences between the two transactions. A change in the terms of an existing debt instrument while keeping the original lien, which occurs in a modification, cannot be treated as a retirement of an old debt instrument and its replacement with a new one, which occurs in a refinancing. The two transactions are intrinsically different and clearly distinguishable. A modification cannot be re-characterized as a refinance without inventing steps and events that did not actually occur, which is not permitted for purposes of determining tax treatment.

Moreover, even if taxpayers were using modifications to avoid the tax on a refinancing, the remedy for this would be an amendment of the statute, rather than trying to impose taxes on a transaction in which a taxpayer did not actually engage. Furthermore, the District's courts have shown reluctance to re-characterize transactions structured to avoid statutory provisions, leaving correction of perceived loopholes to the legislature. See, e.g., Waterside Towers Residential Association v. Trilon Plaza Co., 2 A.3d 1084, 1090-91 (D.C. 2010). In that case, the D.C. Court of Appeals refused to re-characterize a transaction that did not involve the transfer of a complete interest in a property as a sale, even though it was apparently structured in a way to avoid the provisions of the Rental Housing Conversion and Sale Act, which would have been triggered by a sale of the property. In that case, the court firmly rejected the argument that the transaction, which the court found was not a sale, should be treated as a sale because it was designed to skirt the conversion act, reasoning as follows:

> Appellants also urge us to adopt a "sham transaction doctrine," by which these transactions would still be considered "sales" under subsection (c) because they were designed to evade the plain language of the statute and because their purpose was to effectuate a 100% transfer of the Townhouses and the Towers. Appellants are correct in noting that the transactions involving the Holding Companies appear to be designed specifically to avoid subsection (c). This does not mean, however, that we

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> accept their contention that these transactions were a sham. The fatal flaw in appellants' argument is their failure to realize that the Sale Act was written to encompass only certain transactions as "sales." We have held that a transaction that specifically skirts subsection (c) is not necessarily a sham. Thus, the Towers transactions do not qualify as a "sale" under subsection (c).

2 A.3d at 1091-92.

Under guiding principles applicable specifically to tax law, the government does not have complete freedom to re-characterize transactions for tax purposes even if it thinks that taxpayers are attempting to minimize their taxes by using a certain type of transaction structure. As a general matter, it is well established that taxpayers are entitled to structure transactions in a manner that minimizes their taxes, as long as the structure has economic substance and a non-tax business purpose. See Gregory v. Helvering, 293 U.S. 465, 469 (1935) (stating that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted;" the question is "whether what was done . . . was the thing which the statute intended"); Boca Investerings Partnership v. U.S., 314 F.3d 625, 630 (D.C. Cir. 2003) (stating that "while taxpayers are allowed to structure their business transactions in such a way as to minimize their tax, these transactions must have a legitimate non-tax avoidance business purpose to be recognized as legitimate for tax purposes"); District of Columbia v. Neyman, 417 F.2d 1140, 1143 (D.C. Cir. 1969) ("A taxpayer is at complete liberty to decrease his taxes or avoid them altogether by means which the law tolerates. His motive to thereby reduce or eliminate taxation does not generate liability if without it the transaction does not do so."). A transaction, or part thereof, generally can be disregarded for tax purposes if only it does "not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax." Knetsch v. United States, 364 U.S. 361, 366 (1960).

Structuring a transaction, whether as a modification or a refinance, has economic and legal consequences to the parties aside from recordation tax considerations. For instance, in a modification, it is easier to retain the priority held by the original instrument, while a refinanced loan secured by a new deed of trust would generally have a later priority, unless application of a doctrine such as equitable subrogation gave it the priority of the loan that it replaced. See Eastern Savings Bank v. Pappas, 829 A.2d 953 (D.C. 2003). Since application of equitable doctrines depends on various factors, a lender might prefer to rely on the priority established by the original instrument. Title insurance costs may be lower in a modification transaction. Accordingly, there are significant non-tax consequences to structuring a transaction as a modification or a refinance. Because each type of transaction has substantial non-tax economic substance which must be taken into account in applying the proper tax treatment, the form of these transactions reflect their substance and determines the appropriate tax treatment. As a result, OTR could not have treated a modification transaction as a refinance for purposes of the recordation tax and therefore did not under-collect tax on modifications.

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OTR responds to the recommendations under Finding 1 (Draft Report, p. 13) as follows:

1. OTR agrees with this recommendation, and so informed OAG.

2. OTR agrees with this recommendation that changes in the administration of tax collection should be preceded by a statutory amendment, rulemaking or notification, as appropriate according to the nature of the issue.

3. OTR does not agree with the recommendation that recordation tax audits should be handled in the manner suggested by OIG. OTR believes that recordation tax audits should be handled by the Recorder of Deeds, which has the necessary expertise. Audits occur at the time of recordation of the instrument. The Recorder of Deeds is hiring a new Recordation Tax Specialist who will audit instruments at the time of recordation to ensure compliance with the District's recordation and transfer tax laws. OTR is committed to performing quality assurance audits on already recorded instruments, and OTR will work with the D.C. Council to obtain the requisite FTEs to perform such function.

FINDING 2

With respect to Finding 2, OTR disagrees that an under-collection of $5.7 million of recordation tax occurred. This figure actually represents the sum of two sets of different transactions.

The first of these involves an alleged under-collection of approximately $4.6 million attributable to pre-2008 transactions for which OIG stated (Draft Report, p. 16) full records could not be reconstructed. However, the mere absence of records relating to such old transactions, where records would have been disposed of consistent with established document retention schedules, does not constitute evidence that the tax was under-collected. Moreover, a Recorder of Deeds review of these instruments disclosed that they generally would not be fully taxable, as they involved (1) modifications, which would be taxable only on the increase in the face amount of the modified instrument, (2) permanent deeds of trust replacing construction loan deeds of trust on which tax had been paid, and (3) refinances, which would be taxable only on the excess of the face amount of the new instrument over the principal balance of the old instrument.

The second set of transactions identified by OIG involved an alleged under-collection of $1.2 million on transactions that OIG stated should have been taxed as refinances, with the tax being figured on the excess of the face amount of the new instrument over the principal balance of the old instrument. However, a review of these instruments by the Recorder of Deeds showed that they generally constituted modifications, rather than refinances, and so were not properly taxable as refinances, as suggested by OIG.

OTR responds to the recommendations under Finding 2 (Draft Report, p. 19) as follows:

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4. OTR agrees with this recommendation. The Recorder of Deeds assesses and collects recordation taxes on refinanced loans based on the difference between the current indebtedness and the principal balance of the prior loan as required in DC Code § 42-1103(a)(3). At the time of recordation, the Recorder of Deeds also collects and reviews all supporting documentation to support the exemption as provided in OTR Notice 2012-06, Notice Regarding the Taxation of Instruments Relating to Refinances and Modifications.

5. OTR agrees with this recommendation. The Recorder of Deeds requires that any claim of a refinancing exemption based on a prior transaction be substantiated by providing a payoff statement and HUD-1 or other closing statement. OTR Notice 2012-06 is in the process of being updated to conform therewith.

6. OTR agrees with this recommendation. The taxpayer currently must submit a copy of the deed of trust being refinanced where the stamp proves prior payment of the taxes or exempt treatment. If prior payment of the tax or exempt treatment (and basis thereof) including supporting documentation cannot be substantiated, the instrument is taxed on its face amount.

7. The Recorder of Deeds is reviewing the list of instruments identified by OIG and will audit as appropriate.

8. OTR agrees with this recommendation, and the Recorder of Deeds is in the process of developing such a standardized schedule.

FINDING 3

With respect to Finding 3, the Recorder of Deeds disagrees that there was a revenue loss of $14.3 million resulting from under-collections of tax on multijurisdictional and certain other blanket deeds of trust (Draft Report, p. 21). It is incorrect to assert that a multijurisdictional deed of trust encumbering property located in other states as well as the District should be taxed on its face amount regardless of the location of the property securing the debt or the value of the property in the District. Under well-recognized principles of constitutional law, the District cannot tax in its entirety an instrument that covers property located in other jurisdictions. Oklahoma Tax Commission v. Jefferson Lines, Inc., 514 U.S. 175 (1995); Goldberg v. Sweet, 488 U.S. 252 (1989); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983). Taxes that affect multistate transactions must pass court-mandated tests of internal and external consistency, and are invalid if they do not.

Under the "internal consistency" test, a tax cannot subject a taxpayer to multiple taxation on the same transaction, assuming it was adopted by every jurisdiction. Imposing recordation tax on the face amount of a multijurisdictional deed of trust covering property in other jurisdictions would clearly fail this test, because, if each jurisdiction in which the

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instrument was recordable taxed its full face amount, the taxpayer would have to pay multiple taxes on the face amount, in violation of the taxpayer's constitutional rights. Under the "external consistency test" examined in the cases cited above, the tax must not be out of proportion to the taxpayer's activities in the taxing jurisdiction. Taxing the full face amount of a blanket deed of trust covering substantial property in other jurisdictions would violate this test, as the tax would be out of proportion to the value of property securing the indebtedness located in the District. Accordingly, although District law does not provide expressly for apportionment of multijurisdictional deeds of trust, this treatment is required under the applicable constitutional law principles governing taxation of interstate transactions.

Available information and prior historical records indicates that the Recorder of Deeds taxed these instruments based on an allocation between the taxable and nontaxable portions of the instrument. The Recorder was required to do this, given that the full amount of a multijurisdictional deed of trust could not be taxed because it covered property located outside the District. In such situations, taxation based on a reasonable allocation of the face amount of the deed of trust between the taxable and nontaxable portions is appropriate. It appears that the allocation was generally made on the basis of information furnished by the parties recording the instrument. To the extent that this information was provided as part of the recordation tax return, it was submitted under penalties of perjury, and the persons signing the return affirmed that the information submitted was correct. Returns may be audited after filing and additional tax may be assessed within the applicable period of limitations in the event that the Recorder of Deeds determines that the tax was underpaid.

Below we re-examine the four largest transactions in the sampling reviewed by OIG, on which the $14.3 million figure was based. We believe that OIG is incorrect in its application of the law to the taxability of these instruments and that the Recorder of Deeds did, in fact, collect the proper amount of tax owed:

With Instrument No. 2007001821, OIG states that the deed of trust should have been taxed on $253,028,543, gleaned from the generally non-enforceable recitals within the instrument. However, Section 18.4 of this instrument, which is enforceable, states that the properties are encumbered only up to $169,173,226.20, which is the consideration upon which the instrument was properly taxed. It is erroneous to contend that the instrument should have been taxed on the amount in the recitals.

With Instrument No. 2007001808, OIG states that the deed of trust should have been taxed on $447,021,956, gleaned from the generally non-enforceable recitals within the instrument. However, Section 18.4 of the instrument, which is enforceable, states that the properties are encumbered only up to $385,000,000, which is the consideration upon which the instrument was properly taxed after deduction was given to allowable purchase money exemptions. Thus, the instrument was only taxable to the extent of $163,734,613, which was the amount secured above the exempt purchase money (and part of the $385,000,000). It is erroneous to contend that the instrument should have been taxed on the amount in the recitals.

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With Instrument No. 2002152343, OIG's worksheet indicates apparently that OIG concluded that this multijurisdictional deed of trust should have been taxed on $350,000,000 of consideration, of which only $24,000,000 was actually taxed. The non-taxed $326,000,000 was secured by property located in other states and thus, as discussed above, this portion of the instrument could not be taxed because of the constitutional principles governing taxation of interstate transactions. As an aside, the $326,000,000 consideration figure does not translate to the error figure shown on the OIG worksheet.

With Instrument No. 2006152528, OIG states that this multijurisdictional deed of trust should have been taxed on $600,000,000 of consideration, of which only $4,757,378 was actually taxed. The non-taxed $595,242,622 was secured by property located in other states and thus, as discussed above, this portion of the instrument could not be taxed because of the constitutional principles governing taxation of interstate transactions.

OTR responds to the recommendations under Finding 3 (Draft Report, p. 23) as follows:

9. OTR disagrees with the recommendation to tax multijurisdictional deeds of trust on their full face amount. OTR agrees that additional guidance should be provided on the tax treatment of multijurisdictional deeds of trust. The Recorder of Deeds requires that the security interest instrument state the amount it secures and specifically limit its applicability to the extent it secures real property located within the District. OTR will promulgate a regulation that requires that the security interest instrument state the amount it secures and specifically limit its encumbrance of District property to the amount by which it secures real property located within the District.

10. OTR agrees with this recommendation. The Recorder of Deeds collects recordation tax on the principal amount of debt secured by security interest instruments, and if the principal amount cannot be identified the instrument is rejected.

11. The Recorder of Deeds is reviewing the list of instruments identified by OIG and will audit them as appropriate. The Recorder of Deeds is developing procedures to identify instruments where the security interest exceeds the amount of debt taxed.

12. See response to # 9, above.

13. See response to # 9, above.

FINDING 4

With respect to Finding 4, the Recorder of Deeds disagrees with the conclusion (Draft Report, p. 25) that there was an under-collection of $6.7 million in recordation tax, and

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that $6.1 million of this amount is currently collectible. The $6.1 million figure appears to relate to a single, multijurisdictional (blanket) deed of trust that was secured by real property located in other states, as well as the District of Columbia. The value of the property in the other states appears to be quite substantial and, as discussed above, the Recorder of Deeds is precluded from taxing the portion of the deed of trust allocable to property in other states. Accordingly, it is incorrect to suggest that tax could have been collected on the full amount of the deed of trust. An allocable portion of the deed of trust was taxed, and a substantial amount of tax (almost $1.7 million) was collected on the instrument. The available information does not establish that any additional portion of the deed of trust should have been taxed. Any suggestion that an additional amount of tax should have been collected is pure speculation.

OTR responds to the recommendations under Finding 4 (Draft Report, p. 30) as follows:

14. OTR agrees with this recommendation. The Recorder of Deeds performs the recommendations stated herein.

15. The Recorder of Deeds is reviewing the list of instruments identified by OIG and will audit them as appropriate. We note that the alleged under-collection identified by OIG is principally attributable to a single, multijurisdictional deed of trust, which ROD cannot tax in its entirety. An allocable portion of that deed of trust was taxed, and the available information does not establish that any additional portion should have been taxed. The Recorder of Deeds is developing procedures to identify and audit instruments as appropriate.

16. OTR agrees with this recommendation and is developing a formal policies and procedures manual to more fully memorialize its standard operating procedures.

17. OTR agrees with this recommendation. The Recorder of Deeds has developed instructions at assist taxpayers in the proper completion of the Form FP 7/C. The Recorder of Deeds has also published OTR Notice 2012-06.

18. OTR agrees with this recommendation.

19. OTR agrees with this recommendation. The Recorder of Deeds will amend its Form FP 7/C to isolate the purchase money from the construction money.

20. The Recorder of Deeds has been scanning all Form FP 7/C tax returns since 2000, and these images will remain indefinitely in the offices of the Recorder of Deeds for review and access. Additionally, the burden to prove eligibility for a tax exemption is a burden typically born by the taxpayer, and thus it is the taxpayer who should maintain substantiating records.

21. OTR agrees with this recommendation.