

REAL ESTATE

New Construction Not Always Subject to Realty Transfer Tax

BY ALAN NOCHUMSON

Special to the Legal

With residential new construction exploding throughout the Philadelphia region, many individuals may be unwittingly placing themselves on the hook for unwanted realty transfer taxes when they purchase an undeveloped parcel of land and construct the home of their dreams on that land.

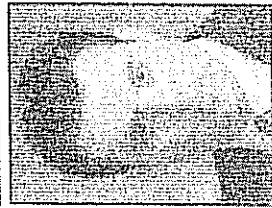
In a rather informative pamphlet titled *Commonly Asked Questions: Pa. Realty Transfer Tax & New Home Construction*, the state Department of Revenue states that "the value of a construction contract is subject to the Realty Transfer Tax when ... an executory construction contract for building a house is effective prior to or contemporaneously with the transfer of the title to a building lot and ... the seller and the builder are affiliated in some way."

According to the Department of Revenue, an "executory" construction contract is "when the purchase takes title to a lot" and "is legally bound to build a house with a specific builder." The Department of Revenue points out that an affiliation between the seller and contractor may be created by agreement or common ownership.

In the pamphlet, the Department of Revenue sets forth the following examples of an agreement between the seller and contrac-

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tor causing an affiliation implicating the realty transfer tax:

- An existing contract for the construction of the house between the seller and the builder that is assigned to the buyer;
- Options to purchase or buy a lot or lots given by the seller to the contractor;
- Rights of first refusal to buy a lot or lots given by the seller to the contractor;
- Agreements of sale for a lot or lots given by the seller to the contractor;
- Written agreement designating the contractor as the only builder that can build houses on the lots;
- Agency agreement whereby the seller acts as an agent for the contractor in selling a lot or lots to the buyer.

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AREA MORTGAGE RATES

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	30 yr.	15 yr.	1 yr.	50 yr. Jumbo	
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East Coast Financial 800-353-9440	6.38/0	6.13/0	N/A	6.63/0	No
Executive Home Mortgage 866-234-0504	6.38/0	6.13/0	N/A	6.63/0	No
etecapital	6.30/0	6.13/0	5.88/0	6.75/0	No
877-785-5626	6.30/0	6.13/0	N/A	6.75/0	No
Wilmington Mortgage 619-558-3099	6.30/0	6.25/0	5.75/0	6.63/0	No
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1st Metropolitan Mortgage 800-328-0557	6.50/0	6.25/0	N/A	6.75/0	No
Stepping Stone Lending 800-638-2659	6.50/0	6.25/0	N/A	6.88/0	No
CFHC Home Mortgage 610-430-7766	6.00/2	5.63/2	5.50/0	6.15/2	No
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* A "Jumbo" or nonconforming mortgage is a loan amount in excess of \$417,000.

** Indicates if a lender offers mortgage loans for commercial properties. Call to discuss rates and terms.

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- An agency agreement whereby the contractor acts as an agent for the seller in selling a lot or lots the buyer, or
- A partnership agreement or joint venture agreement between the seller and contractor to develop the lots.

The Department of Revenue then lists the following examples where common ownership may cause such an affiliation:

- Seller or close relative is a shareholder or partner in the contractor;
- Contractor or close relative is a shareholder of a partner in the seller; or
- Seller and contractor are owned in whole or in part by the same individuals or entities.

Not all of the affiliations listed by the Department of Revenue may be readily apparent by a buyer. To illustrate, an unsuspecting buyer who purchases an undeveloped lot may use a builder recommended by the seller. Assuming the buyer pays the builder in full consideration for the construction work, if the seller or close relative is a shareholder or partner in the contractor, or vice versa, the buyer would still incur an additional tax burden, even if that buyer was unaware of that relationship when he made the decision to purchase the builder.

In order to avoid paying for the value of the construction work, whenever a buyer purchases undeveloped land and constructs a new house onto the land, he should make sure he fully understands the "affiliation," if any, which may exist between the seller and contractor.

RECENT COURT DECISIONS

In *Harmon Homes, Inc. v. Commonwealth*, the Commonwealth Court recently rejected a seller's attempt to use the "turnkey project" exemption of Pennsylvania's Realty Transfer Tax Act in order to avoid paying realty transfer taxes for the value of the construction work.

On Feb. 4, 2002, Harmon Homes filed a deed dated Jan. 28, 2002, with the recorder's

executory contract from the value of the real estate conveyed by Harmon Homes to Robbins.

In upholding the administrative ruling, the Commonwealth Court heavily relied on its previous decision in *Pennsylvania Builders Association v. Department of Revenue*. In *Pennsylvania Builders*, the court flatly rejected taxpayers' argument that an agreement to make future improvements to land does not convey an interest in real estate and, thus, should not be subject to the transfer and instead concluded that the state's Realty Transfer Act "was intended to tax 'all new home sales uniformly on the full monetary worth of the interest in real estate conveyed.'"

Although the transfers from Robbins to One Stop and back to Robbins were obviously exempted from taxation as a turnkey project, the Commonwealth Court emphasized that it did "not follow that because one part of the transaction by which Robbins acquired his home and land fit the exemption for a turnkey project, that the entire transaction can be considered a turnkey project."

The Commonwealth Court rather determined that "the intervening transfer to One Stop Realty had no effect on the value of the transaction between Harmon Homes and Robbins that took place on Jan. 28, 2002. When the deed for the transfer from Harmon Homes to Robbins was recorded, the executory building contract was in effect and, thus, the value of the realty subject to the recording included both the combined value of the newly constructed home and the lots."

LESSON LEARNED

Purchasers of undeveloped land who construct the house of their dreams on that land must be wary of creating the ultimate nightmare of owing realty transfer taxes on the value of their newly constructed home. Only through due diligence and proper planning can these purchasers reap the benefits of the increase in the fair market value of their newly constructed house and adjoining land without giving the state government an unnecessary windfall. *

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