

Audit Report – Realty Transfer Tax

To: David Gregor, Chief Financial Officer
Michael E. Kozikowski Sr., Recorder of Deeds
Richard E. Hall, General Manager, Land Use

Audit Conclusions and Reportable Items

Overall, we believe that adequate internal controls exist in all material respects over New Castle County's Realty Transfer Tax (RTT) collection and processing, except for the areas indicated below.

We have 2 Areas of Particular Concern which we believe warrant management's immediate attention. These are:

- The lack of internal controls over ascertaining entitlement to claimed exemptions from the RTT. Our review of 550 transfer tax returns for 14 business days in September 2018 revealed that 300 of the returns had a corresponding Affidavit of Exemption. Thus, applicants for over half of the returns claimed an RTT exemption. See Comment # 1 on page 6.
- The County's processes for ascertaining whether an applicant for a building permit owes RTT per Delaware Code Title 30, Chapter 54, Section 5401(9), i.e., RTT related to construction of all or part of a building within one year of the date of transfer of the property on which the building is constructed. See Comment # 2 on page 13.

Other opportunities for improvement are included in the "Opportunities for Improvement" section of this report, beginning on page 19.

Overview – Realty Transfer Tax Audit

In Fiscal Year (FY) 2018, RTT contributed about 15% (\$36.9 million) of New Castle County's total revenues from governmental activities. This was an increase of \$4.1 million, or 12.9 percent above FY 2017, and reflected an overall improvement in the real estate market combined with an increase in large commercial transactions. Approximately \$30.9 million in RTT has been budgeted in the FY 2020 approved budget. (Please note that the County budgets 95% of projected RTT revenues.)

Key State and County Code Sections:

- Delaware Code Title 30, Chapter 54, Section 5401, "Definitions", gives the definitions of "document" (including most of the exemptions to the word "document"), "transaction", and "value."
- Delaware Code Title 30, Chapter 54, Section 5402, "Rate of Tax", provides the rate of tax, currently 2 ½ % to the State and 1 ½ % either to the County or to an incorporated municipality within the County

(if the property is located in that municipality). Such tax is based upon the definitions of “document”, “transaction”, and “value” from Section 5401.

- Delaware Code Title 9, Chapter 81, Section 8102 gives an overview of New Castle County’s authority and scope for imposing RTT¹:
 - (a) Notwithstanding any statute to the contrary, the county government of each county shall have the power by ordinance to impose and collect a tax, to be paid by the transferor or transferee as determined by the county, upon the transfer of real property within the unincorporated areas of the county; provided however, that any realty transfer tax which is imposed by any county government shall not be greater than 1 ½ percent of the value of the real property as represented by the document transferring the property; ...
- Delaware Code Title 22, Chapter 16, Section 1601 provides language on how RTT revenues are to be accounted for and how they may be utilized.
- New Castle County Code Chapter 14, Article 10 incorporates some of the RTT language from State Code and, in Section 14.10.012, provides language on how RTT revenues are to be budgeted and utilized.

The Recorder of Deeds office (ROD) acts as the agent for collecting the County’s portion of the RTT, as well as the State’s and incorporated municipalities’ portions. The ROD submits these funds daily to the County’s Office of Finance. Each month, Finance then remits to the State and incorporated municipalities their RTT revenues. The other department that plays a role in the collection of RTT is the Department of Land Use; before issuing Single-Family Dwelling Building Permits in certain situations, Land Use requires the applicant to submit a form showing whether the applicant is subject to the RTT [under State Code Section 5401(9)] and, if so, proof of payment of the RTT.

Audit Objectives, Methodology and Scope

This audit was a “performance audit” of New Castle County’s processes for collecting and processing New Castle County’s portion of the RTT, as well as processing and distributing the State’s and incorporated municipalities’ portions. Performance audits, as defined by Generally Accepted Government Auditing Standards, are audits that provide findings and conclusions based on an evaluation of sufficient, appropriate evidence against criteria. The overall performance audit objectives for this audit were:

- Internal Control: An assessment of the County’s system of internal control over RTT that is designed to provide reasonable assurance of achieving efficient and effective operations, reliable financial and performance reporting, and compliance with applicable laws and regulations.
- Compliance: An assessment of the County’s compliance with criteria, related to RTT, established by provisions of laws, formal policies and procedures, and other requirements.

¹ Delaware Code Title 22, Chapter 16, Section 1601 contains similar language.

- Program effectiveness, economy, and efficiency: An assessment of the extent to which the County is achieving its goals and objectives related to RTT.

Our performance audit, and its scope and methodology, encompassed the following:

1. Evaluation of controls in the Recorder of Deeds and Office of Finance over the collection, processing, and distribution of RTT. This included an evaluation of the controls over ensuring RTT, where applicable, is paid to the correct municipality.
2. Evaluation of controls over the granting of exemptions from RTT:
 - a. Obtained a general understanding of the number of exemptions by exemption category by reviewing 550 "New Castle County Realty Transfer Tax Return and Affidavit of Value" forms (referred to as the NCC Affidavits going forward) collected over 14 business days in September 2018.
 - b. Selected a sample of the NCC Affidavits for the more common exemption types and evaluated them against the State Code requirements for an RTT exemption.
 - c. Spoke to a couple of former County employees to ascertain the NCC Affidavits review process that used to take place in the Office of Law.
3. Evaluation of compliance with County Code restrictions on (1) the percentage of estimated RTT proceeds that may be utilized in the annual operating budget, (2) how actual RTT tax revenues up to that percentage can be utilized, and (3) how funds received in excess of that percentage can be utilized.
4. Evaluation of compliance with State and County Code Sections on segregation of RTT revenues.
5. Evaluation of controls over the Department of Land Use's determination of whether RTT is due before issuing Building Permits and Certificates of Occupancy. Specifically,
 - a. For a sample of new Single-Family Dwelling Building Permits, we tested whether all eligible applicants had submitted the proper form and, if applicable, paid the proper RTT.
 - b. For residential additions, used declared valuation [different (usually much lower) from actual cost of construction] to see if any properties would have been subject to RTT based on the declared valuation.
 - c. Discussed with the Department of Land Use their policies and processes for issuing Building Permits and Certificates of Occupancy. Posed legal questions to the Office of Law on proper interpretations of State and County Codes.
 - d. Determined whether the appropriate amount of New Castle County RTT, related to Building Permits, was being collected at the Recorder of Deeds.
 - e. Evaluated situations where there were multiple Building Permits for the same property within a year of sale.
6. Discussion, with the State's Director and Assistant Director of Revenue, of issues related to the Delaware Code on RTT and a few of the State's processes related to RTT.

In general, our testing involves audit sampling. We evaluate the results of the tests and use professional judgment, based on the number of exceptions and/or the materiality of such exceptions, whether to include exceptions in the audit report. In some cases, we perform additional testing to help us obtain additional audit evidence in making such evaluation and determination.

If our audit work reveals an item which we believe is significant in the context of one or more audit objectives, we include this in an “Areas of Particular Concern” section of the audit report. An Area of Particular Concern is an item (such as a deficiency in internal control or noncompliance with a particular law) which we believe has or could have a significant adverse impact upon the County’s ability to accomplish a major objective and, therefore, warrants management’s immediate attention. All other reportable items are included in an “Opportunities for Improvement” section of the audit report.

Because the scope of an audit does not allow us to examine every single function and transaction performed by an area, an audit would not necessarily disclose all matters that might be reportable items.

Generally Accepted Government Auditing Standards

Except as discussed in the following paragraph, we conducted our audit in accordance with Generally Accepted Government Auditing Standards (GAGAS) promulgated by the United States General Accounting Office. 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.

We have not met the requirement of Section 3.96 of GAGAS that requires an audit organization performing audits in accordance with GAGAS to have an external review every three years. In Fiscal Year 2020, we plan to have the Association of Local Government Auditors perform a peer review of the County Auditor’s Office.

Views of Responsible Officials

Management’s responses are included after each of the report’s recommendations.

Appreciation of Cooperation

We sincerely appreciate the cooperation of the Office of Finance, Recorder of Deeds Office, the Department of Land Use and Office of Law in their willingness to work together with us in determining constructive improvements to the RTT processes.

Cc:

Matthew Meyer, County Executive
Vanessa Phillips, Chief Administrative Officer

Aundrea Almond, Chief of Staff
Brian Boyle, Policy Director
Brian Cunningham, Director of Strategic Communications
Wilson Davis, County Attorney
Karen Sullivan, County Solicitor
Sanjay Bhatnagar, Assistant County Attorney
Adam Singer, Assistant County Attorney
Edward Dale, Recorder of Deeds Office Administrator
Tom Ferrier, Chief Deputy Recorder of Deeds
Michael Smith, Director of Operations, Office of Finance
George Haggerty, Assistant Land Use Manager
David Holston, Department of Land Use Licensing Manager
Michele Davis, Land Use Administrator
Nellie Hill, Clerk of Council
New Castle County Council Members
New Castle County Audit Committee Members

AREAS OF PARTICULAR CONCERN

- 1. Consider implementing a policy (and procedures) which encompasses a review of the Realty Transfer Tax Returns for reasonableness of the consideration amount and a review of the Affidavits of Exemption for entitlement to the exemption.**

Comment

Relevant Code

Delaware Code Title 30, Chapter 54:

- Section 5401, “Definitions”, provides the definition of “document” as “any deed, instrument or writing whereby any real estate within this State, or any interest therein, shall be quitclaimed, granted, bargained, sold, or otherwise conveyed to the grantee, but shall not include the following ...” The Section then lists over 20 items which are not considered to be a “document.” These are considered to be exemptions from having to pay the Realty Transfer Tax (RTT).
- Section 5402, “Rate of tax”, states that the RTT is applied to “Every person who makes executes, delivers, accepts or presents for recording any document (underline added) ... or in whose behalf any document is made, executed, delivered, accepted, or presented for recording ...” and that the transfer tax is based upon the “value of the property represented by such document.”
- Section 5401(4) defines “value” as “... in the case of any document granting, bargaining, selling or otherwise conveying any real estate or interest or leasehold interest therein, the amount of the actual consideration thereof ... provided, that in the case of a transfer for an amount less than the highest appraised full value of said property for local real property tax purposes, ‘value’ shall mean the highest such appraised value unless the parties or one of them can demonstrate that fair market value is less than the highest appraised value, in which case ‘value’ shall mean fair market value, or actual consideration, whichever is greater ...”

New Castle County Code Chapter 14, Article 10 (“Real Property Transfer Tax”), Section 14.10.001A states “The definitions in 30 *Del. C.* § 5401 (Realty Transfer Tax Definitions) are hereby incorporated by reference.”

Realty Transfer Tax (RTT) Returns and Claims for Exemptions

When a deed is presented to the Recorder of Deeds Office to be recorded, the individual providing the deed must also provide the transfer tax return documents. These include:

- A completed “Realty Transfer Tax Return and Affidavit of Gain and Value” for the State of Delaware, Form 5402. The applicant is required to list on this form the amount of consideration exchanged in the transaction.
- A completed “New Castle County Realty Transfer Tax Return and Affidavit of Value”, or a second State of Delaware Affidavit in the case where the County is collecting the transfer tax on behalf of an incorporated municipality. The applicant is required to list on this form the amount of consideration exchanged in the transaction.

The State transfer tax form and the incorporated municipality’s transfer tax form (if applicable) are sent to the State and incorporated municipality, respectively. If there is a County transfer tax form and the buyer and seller (or just buyer in the case of the First Time Homebuyer exemption) are claiming an exemption from the County portion of the transfer tax, the buyer must complete an Affidavit of Exemption.² This Affidavit contains two sections pertaining to the entitlement of the exemption:

- “Upon request by New Castle County, I agree to submit all documents necessary to prove my entitlement to this exemption and any additional documentation the County believes necessary to determine my eligibility for exemption.”³
- “I swear/affirm, under penalty of law, that the information contained herein, the statements below, and in any documents appended hereto is true and correct to the best of my knowledge, information, and belief.”

If the exemption is the First Time Homebuyer exemption, there is an additional section on the form which reads:

- a. “I have never held any legal interest in residential real property anywhere. (If a husband and wife or other individuals are purchasing in any form of co-tenancy, none of them has ever held such an interest.)”
- b. “I intend to occupy the property as my principal residence within 90 days.”

The buyer must sign (under the stamp of a Notary) signifying agreement with these sections. In addition, there is a Lender’s Certification at the bottom of the Affidavit, which is to be completed if the First Time Homebuyer exemption is claimed and the buyer is using financing to purchase the property. This section reads:

“On behalf of (lending institution name) I, (representative of lending institution), hereby certify that I am familiar with the loan made by me/my institution in connection with this transaction

² There is a section on the State’s Form 5402 for claiming an exemption from the State transfer tax. Since we are not auditing the collection of the State transfer tax, we are not covering that section here.

³ It appears that some attorneys are using an earlier version of the “New Castle County Realty Transfer Tax Return and Affidavit of Value” as we saw some returns with the language “I have attached copies of all documents necessary to prove my entitlement to this exemption and agree to submit, upon request by New Castle County, any additional documentation the County believes is necessary to determine my eligibility for exemption.” It should be noted that, in none of the situations, was any documentation attached to the return.

and, to the best of my knowledge and belief, no information submitted by the buyers or reported to me or to this institution indicates that any of the persons taking title to the real property that is the subject of this transaction has ever held a legal interest in any residential real property.”

Please note that we are not aware whether the lending institution performs any research to determine whether the buyer has ever held any legal interest in any residential real property.

County’s Review Process for Realty Transfer Tax Returns and Affidavits of Exemption

The Recorder of Deeds Office (ROD), which collects the RTT on behalf of the County, reviews the RTT returns for completeness and checks whether the amount of consideration on the deed matches that on the returns. This check is not useful, however, unless the deed contains the actual price of the conveyance; in many cases, the deed reflects a nominal amount (e.g., \$1) – not the actual conveyance price.

ROD also reviews the Affidavits of Exemption to determine whether a box has been checked in the list of possible exemptions, whether the buyer(s) has signed the form and the signature has been notarized, and whether the Lender’s Certification has been completed. (If not, the assumption is made that the buyer did not use financing to purchase the property.) ***ROD does not do anything to ascertain the legitimacy of the exemption, as ROD does not believe this is their responsibility. See below.***

The “New Castle County Realty Transfer Tax Return and Affidavit of Value” forms, and the Affidavits of Exemptions, used to be sent to the Office of Law for a review⁴, but Law in May 2017 instructed ROD to no longer send them and stated, “The function has been turned over to the Office of Finance.” It is our understanding that Finance is not currently receiving these forms from ROD and, thus, is not performing any sort of a review.

We were unable to ascertain what Law’s review encompassed immediately prior to asking ROD to no longer send the forms, but we have the general impression that Law was not doing much except to store the forms. However, we were able to ascertain through a former Paralegal for the County that, at least prior to her leaving the County’s workforce in 2008⁵, she was checking the “New Castle County Realty Transfer Tax Return and Affidavit of Value” forms and the Affidavits of Exemption. She told us the following:

- She would send about 20 letters a week asking for more documentation or for more money. Most of these letters were sent to applicants for the First Time Homebuyer exemption.
- Certain attorneys were notorious for signing on behalf of the client; the client did not sign him/herself.

⁴ At one time they were sent to the Office of Finance when the position of “Finance Legal Officer” existed and this position resided in Finance.

⁵ Note: This individual told us that, after she left the County’s workforce, there was another employee performing a review of the Affidavits and that this employee left the County’s workforce in 2009 or 2010.

- Sometimes the attorney would sign the Lender’s Certification instead of the lender.
- She found situations where the applicant for a First Time Homebuyer exemption had actually held a home before. For example, sometimes two people living together (not married) would buy a home jointly and one of them had previously held a home.
- She found situations in which the consideration listed on the “New Castle County Realty Transfer Tax Return and Affidavit of Value” form was incorrect.

Thus, the County is not performing any review to determine the person(s)’s entitlement to the exemption. We are presuming, at some point in time, that the Office of Finance and/or Office of Law determined:

- The cost of doing so exceeded the benefit to be derived.
- The County could place some reliance on the sections in the Affidavit of Exemption which the buyer and lender must certify to.
- The County can place some reliance on the fact that an attorney is involved in most real estate transactions.

Audit Testing

We reviewed the “New Castle County Realty Transfer Tax Return and Affidavit of Value” forms (and associated Affidavits of Exemptions if applicable) for 14 business days in September 2018. During this period, there were 550 transfer tax returns submitted of which 300 had a corresponding Affidavit of Exemption. 134 of these exemptions were for the First Time Homebuyer exemption. The next three highest were the Husband & Wife exemption, the Trustee exemption, and the Parent & Child exemption, at 37, 27, and 23 respectively. In reviewing the Affidavits for these exemptions, we noticed the following:

First Time Homebuyer

County Code Section 14.10.001C1 provides that the definition of “document” shall not include:

“Any conveyance to a first-time homebuyer on or after October 1, 2018, for at least the value of the property or four hundred thousand dollars (\$400,000), whichever is less; provided, however, that only that portion of the tax, not to exceed one-half (1/2) of the total taxes due, that is attributable to and payable by first-time homebuyer under this Article shall be exempt.”

County Code Section 14.10.001C1a defines “First-time homebuyer” as:

- “A natural person who has at no time held any direct legal interest in residential real estate, wherever located, and who intends to occupy the property being conveyed as his or her principal residence within ninety (90) days following the transaction;
- Spouses purchasing as joint tenants or tenants by the entirety, when neither spouse has ever held any direct legal interest in residential real estate, wherever located, and both of whom intend to occupy the property being conveyed as their principal residence within ninety (90) days following the transaction.”

Although (as stated previously), the applicant is required to sign the Affidavit of Exemption attesting to the fact that he/she has never held any legal interest in residential real property and will be occupying the property as his/her principal residence within 90 days, the County does not perform any review to verify this information.

Please note that, during the audit, we met with the State Division of Revenue on whether they review the State RTT returns (i.e., the Forms 5402, which contain a section on exempt conveyances). The Division of Revenue informed us that historically they have not reviewed them on a routine basis; however, they recently reviewed about 1,300 applications for First Time Homebuyer refunds and found about 80 that did not qualify.⁶ Some of these exceptions were cases where a husband or wife held property previously.⁷ The Division of Revenue is considering instituting some sort of ongoing review (for First Time Homebuyer exemptions and possibly other exemption types) in the future. The Division of Revenue has a particular concern with company reorganizations where property may be transferred from one entity to another within the same umbrella company (where there is no requirement that a deed be filed).

Conveyance to Trustees

The language in Delaware Code, Section 5401(1)j is:

“Any conveyance:

1. To a trustee, nominee or straw party for the grantor as beneficial owner,
2. For the beneficial ownership of a person other than the grantor where, if such person were the grantee, no tax would be imposed upon the conveyance pursuant to this chapter, or
3. From a trustee, nominee or straw party to the beneficial owner.”

Most of the exemptions we reviewed were the first item above and we found ourselves asking, particularly when the conveyor’s name was different than the name of the trust, how does one know that the conveyor of the property interest (i.e., the grantor) is a beneficial owner of the trust? The Affidavit of Exemption does not require the trust document to be submitted so one can ascertain who the beneficial owner is.⁸ We also found one situation where the conveyor and conveyee were each an individual name. How does one know that there is a trustee, nominee, or straw party involved in this situation?

Husband & Wife

⁶ Note that the Office of Finance informed us that they will be requesting from the Division of Revenue detailed information on these 80 items.

⁷ The Division of Revenue used a LexisNexis product called Accurint to perform this review.

⁸ Note: The instructions for the State’s Form 5402 state, for this exemption, to “attach a copy of the conveyance which shows the transfer to the trustee, nominee, or straw party to this return.” However, the State’s Division of Revenue recently informed us that people claiming this exemption are not attaching the conveyance document. Thus, the Recorder of Deeds Office, which initially receives the Form 5402, is not requiring this document to be provided.

The language in Delaware Code, Section 5401(1) is:

“g. Any conveyance between husband and wife;

h. Any conveyance between persons who were previously husband and wife, but who have since been divorced; provided such conveyance is made after the granting of the final decree in divorce and the real estate or interest therein subject to such conveyance was acquired by the husband and wife, or husband or wife, prior to the granting of the final decree in divorce.”

In the Affidavits we reviewed, there were sometimes conveyances where the transferor and the transferee had different last names. Therefore, we found ourselves asking the question as to how, without a marriage license or divorce decree, one can ascertain that the conveyance is truly between a husband and wife. Also, in the case of a divorce, how can one ascertain that the conveyance is being made after the granting of the divorce decree and that the property was acquired before the divorce decree?

Parent & Child

The language in Delaware Code, Section 5401(1)i is:

“Any conveyance between parent and child or the spouse of such a child.”

Although we did not look at any of the Affidavits for these exemptions, we did speak to the former Finance Legal Officer who told us that, during his time with the County when his paralegal reviewed these forms, he saw instances of grandparents trying to convey property to grandchildren which is not an exemption from the RTT.

Corporation/Partnership

The language in Delaware Code, Section 5401(1)n is:

“Any conveyance to or from a corporation, or a partnership, where the grantor or grantee owns stock of the corporation or an interest in the partnership in the same proportion as the grantor’s or grantee’s interest in, or ownership of, the real estate being conveyed ...”

This raises the question of how does one ascertain that the grantor(s) and grantee of the conveyance are the same owners of the property and that the grantor’s and grantee’s interest after the conveyance is in the same proportion as before the conveyance.

Recommendations – Office of Finance

County Code Article 10 (“Real Property Transfer Tax”), Section 14.10.006 states “In addition to the other duties of the Office of Finance, the Office or its designee ... Is charged with the enforcement of this Article and is authorized and empowered to prescribe, adopt, promulgate, and enforce regulations relating thereto.”

Therefore, based upon this report comment, we recommend that the Office of Finance:

- Meet with the State Division of Revenue to obtain more details on RTT audit work the Division has been performing and any plans the Division has to review the State RTT returns going forward.
- Consider developing a policy, and associated procedures, to perform some sort of review of the County RTT returns – perhaps concentrating on those items with the most risk of abuse such as incorrect consideration listed and certain exemptions such as First Time Homebuyer.
- Consider requiring the applicant for an exemption to provide documentation (at the time of applying for the exemption) showing proof of entitlement.
- Work with the Real Estate Section of the Delaware Bar Association to ensure all real estate attorneys are using the latest “New Castle County Realty Transfer Tax Return and Affidavit of Value” forms.

Management’s Response – Office of Finance

While ultimately the realty transfer tax is a State tax governed by State Code, the Office of Finance recognizes that its effective administration depends on the effort and cooperation of State and local governments. Because both levels of government benefit from and share administrative responsibilities for the realty transfer tax, a coordinated response would likely be the most successful and cost-effective means of addressing the issues identified in this section. Accordingly, the Office of Finance will work with the State’s Division of Revenue to identify compliance opportunities and strategies.

2. Design and implement policies and procedures to ensure the County complies with Delaware Code Section 5401(9) concerning Realty Transfer Tax due in certain situations involving building construction.

Comment

Once a property has been transferred, it may still be subject to Realty Transfer Tax (RTT) if a construction contract is entered into within a certain timeframe. Specifically, Delaware Code Title 30, Chapter 54, Section 5401(9) states:

a. Notwithstanding paragraph (1) of this section, there shall be included in the definition of “document” for purposes of this chapter any contract or other agreement or undertaking for the construction of all or a part of any building all or a portion of which contract, agreement or undertaking (or any amendment to the foregoing) is entered into, or labor or materials are supplied, either prior to the date of the transfer of the land on which the building is to be constructed or within 1 year from the date of the transfer to the grantee.

b. No jurisdiction in this State shall issue a building permit for any such building unless and until the person or persons (including corporations or other associations) requesting such permit shall demonstrate in whatever form may be specified by the Director of Revenue, including at the Director’s discretion, a form of affidavit, that:

1. No transfer as described in this section has occurred within the preceding year;
2. No portion of the contract for construction for which the permit is being requested was entered into and no materials or labor with respect to the building have been provided within 1 year of the date on which the property was transferred; or
3. There has been paid a realty transfer tax on the document as defined in this paragraph.

c. In addition, no jurisdiction in this State shall issue a certificate of occupancy relative to any building on which a tax is provided by this subsection unless and until the owner recertifies the actual cost of the building and pays any additional tax due as a result of such recertification.

d. A “building” for purposes of this paragraph shall mean any structure having a roof supported by columns or walls which structure is intended for supporting or sheltering any use or occupancy but shall not include any alteration of or addition to an existing building where the cost of said alteration or addition is less than 50% of the value of the property transferred.

e. A “transfer” for purposes of this paragraph shall include any transfer made by a “document” as described in this section, other than this paragraph, and shall not include any transaction excluded from the definition of “document” under the provisions of paragraph (1)a.-u. of this section.

Current Process for Issuing Building Permits

In accordance with Delaware Code Section 5401(9)b, the State of Delaware has designed a form called the “State of Delaware Realty Transfer Tax Declaration for Building Permit” [Form 5401(8) BP].⁹ This form asks various questions to ascertain if the applicant is subject to the RTT. The County’s Department of Land Use requires proof that the form has been prepared (and the State and County transfer taxes paid if applicable) only in the case of Building Permit applications for new Single-Family Dwellings that are not part of an active subdivision plan. Land Use does not require the form for Building Permit applications for:

- Single-Family Dwellings built as a part of an active subdivision plan. Apparently, the theory behind this exclusion is that the builder or developer is constructing the building for resale and, thus, such building (and the lot on which it is built) will be subject to the RTT when completed and sold. On the other hand, non-builder/developer applicants for building permits are most likely constructing such buildings to reside in. Also, we met with the State’s Director of the Division of Revenue concerning the State form’s language “does not pertain to the application for a building permit by a builder or developer who acquires the realty with the intention of erecting improvements for resale.” The Director opined that the reason for the exclusion may relate to the language in Section 5401(9)a of “any contract or other agreement or undertaking for the construction of all or a part of any building.” She said that builders/developers may not be entering into a “contract” for the construction because the builder/developer has employees who are doing the work. Also, even if the builder/developer has formed a construction subsidiary to do the construction, there may still not be an actual “contract” between the parent and the subsidiary.
- Non-Residential Buildings.
- Residential and Non-Residential alterations/additions to an existing building: Please note that Delaware Code Section 5401(9)d does state that the definition of “building” does not include “any alteration of or addition to an existing building where the cost of said alteration or addition is less than 50% of the value of the property transferred.” However, the way the State form is designed, one has to complete the form to determine whether the value is less than, or equal to or greater than, 50%. Thus, it appears that the form should be required. (It is our understanding that it is rare to have an addition or alteration where the cost is 50% or more of the value of the property transferred; therefore, it would be rare to have any transfer tax liability in the case of alterations/additions.)

In a memorandum dated July 9, 2019, we asked the Office of Law for its opinion on whether the Form 5401(8) BP should be required in the above situations.¹⁰ In that memorandum, we refer to a recording (provided to Law) regarding the 1990 State Senate Hearing on the Act which created Code Section 5401(9) -- then 5401(8). In an August 1, 2019 meeting with the County Attorney and an Assistant County Attorney, the Office of Law verbally opined that Land Use should be requiring submission of the Form 5401(8) BP for non-residential buildings and for residential and non-residential alterations/additions to an existing

⁹ See Exhibit A for form. Please note that this form refers to a Code Section – 5401(8) – that is now 5401(9). The State needs to revise the form accordingly.

¹⁰ See Exhibit B.

building. Law has not opined on whether the Form should be required for single-family dwellings built as part of an active subdivision plan.

Also, in accordance with Delaware Code Section 5401(9)c, the State of Delaware has designed a form called the “State of Delaware Realty Transfer Tax Declaration for Certificate of Compliance or Occupancy” [Form 5401(8) CO].¹¹

When the recipient of a Building Permit applies for the Certificate of Occupancy, Land Use is not requiring [for situations where the Form 5401(8) BP indicated RTT was due] a recertification of the actual cost of the building and proof of payment of any additional RTT due after recertification. Land Use has not established a process for recertification of final construction costs prior to issuing a Certificate of Occupancy.

In our July 9, 2019 memorandum to the Office of Law, we asked for a legal opinion on whether Land Use should be requiring submission of the Form 5401(8) CO in such situations. In an August 1, 2019 meeting with the County Attorney and an Assistant County Attorney, the Office of Law verbally opined that Land Use should be requiring submission of the Form 5401(8) CO in such situations.

Audit Testing

In an attempt to identify Building Permit applicants who may have been subject to State and County RTT under Delaware Code Section 5401(9)a, Audit requested from the Department of Land Use a report of all Building Permits processed in the first quarter of CY2019 which related to parcels having a date of transfer within a year of application for a Building Permit. There were 226 such Building Permits. These included 91 new Single-Family Dwelling Building Permit applications, 130 Residential Addition Building Permit applications, 4 Commercial Fit Out Building Permit applications and 1 Commercial Building Permit application. Audit also requested “State of Delaware Realty Transfer Tax Declaration for Building Permit” forms for 7 of the Single-Family Dwelling Building Permits from the sample.

Audit also requested Land Use to provide the Declared Valuation field (“DECLVLTN” field) on this report; this field is either calculated by the Hansen System based upon the square footages of the project or, in the case of projects that are not able to be measured in area, provided by the applicant. Since Land Use does not currently require submission of the “State of Delaware Realty Transfer Tax Declaration for Building Permit” form for alterations/additions (the form requires the applicant to provide the estimated costs of construction), the intent was to use this field as an approximation of the costs of construction. However, please note that the Declared Valuation field is typically less than the actual costs of

¹¹ See Exhibit C for form. Please note that this form refers to a Code Section – 5401(8) – that is now 5401(9). The State needs to revise the form accordingly.

construction.¹² In fact, on the “Estimated Building Permit Fee Form Residential and Commercial Renovation”, there is language “This form is not intended to be used for construction cost estimating.”

Our testing revealed:

- As noted earlier, Land Use is not requiring applicants to submit Form 5401(8) BP for Non-Residential Building Permits and for Addition/Alteration Building Permits.
 - For one of the Residential Addition Building Permits where the parcel was transferred within one year of the date of the permit application, the Declared Valuation on the permit application was 49.58% of the value of the parcel transferred.¹³ Since we know that the Declared Valuation is typically less than the actual costs of construction, this may have been a situation where transfer taxes should have been paid on the costs of construction of the addition.
 - For the one Non-Residential (Commercial) application where the parcel was transferred within one year of the date of the permit application, the Declared Valuation was \$3,518,067. Had Land Use required the completion of the Form 5401(8) BP in this situation, there may have been transfer taxes due of at least \$123,132 (between the State and the County).
- As noted earlier, Land Use is not requiring applicants to submit Form 5401(8) CO for situations where the Form 5401(8) BP indicated RTT was due.
- One property in our sample applied for a Residential Addition Building Permit after obtaining a new Single-Family Dwelling Building Permit. The owners of this property paid RTT on the Single-Family Permit but not on the Addition Permit. It makes sense to us that the applicant should have had to pay RTT on the cost of the addition – since the permit for the addition occurred shortly after the permit for the dwelling and thus could be considered as part of the initial Building Permit.
- Six properties had multiple (2 or 3) Residential Addition Building Permit applications within a year of the date of transfer of the property. For purposes of evaluating the 50% threshold in State Code Section 5401(9) d, the Department of Land Use may want to consider a process (for RTT purposes) for consolidating multiple Residential Addition Building Permits issued within a year of the date of transfer.

August 16, 2019 and August 26, 2019 Meetings

Representatives of the Department of Land Use, Office of Finance, Office of Law, and the County Auditor’s Office met on August 16, 2019, and then again on August 26, 2019¹⁴, to discuss possible changes to Land Use’s processes to ensure compliance with State Code Section 5401(9). At these meetings, it was decided that:

- Land Use will continue to require the submission of the State Form 5401(8) BP (and evidence that the applicant has paid both the State and County RTT, if applicable) for applications for Single-Family

¹² For example, the “DECLVLTN” amount for a project involving finishing a basement with full bath, living room and bedroom with new egress (egress being installed under a separate permit) was \$4,098. This would appear to be less than what it would actually cost to do the work.

¹³ We calculated the value of the parcel transferred based upon the State and County transfer taxes paid.

¹⁴ An Office of Law representative was not at the August 26th meeting.

Residential Building Permits where the home is not part of an active subdivision plan. (Finance agrees with not requiring it for homes built as part of an active subdivision plan.)

- Finance and Land Use will work together on determining the most effective and efficient processes for ensuring the County complies with State Code Section 5401(9). This will include making use of automation wherever possible. It should be noted that the Hansen System has limitations; however, since Finance and Land Use are currently working on a system requirements document for a replacement to Hansen, it is possible that additional automation/control will be achieved with the new system. Items Finance and Land Use hope to implement in the near future using Hansen include:
 - For applications for Non-Residential Building Permits and Addition/Alteration Building Permits, checking to see if the date of application is within one year of the date the parcel (on which the construction is to occur) was last transferred. If so, Land Use will require the applicant in certain management-defined situations (to be determined and then documented in formal procedures) to submit the State Form 5401(8) BP and evidence of State and County RTT payment if applicable.
 - For all situations in which the State Form 5401(8) BP indicated that RTT was due, the establishment of a tickler to ensure Land Use knows to require the Form 5401(8) CO (and evidence of payment of State and County RTT if applicable) before issuance of a Certificate of Occupancy.

At the August 26, 2019 meeting, we discussed whether Land Use should:

- Follow up on the two items mentioned in our testing results (first item under testing results on page 15) where it appears that RTT may have been due, and determine whether the County should request the applicants to now submit the 5401(8) BP Forms.
- Consider generating a report for the last three calendar years showing all parcels having a date of transfer within a year of application for a Building Permit, and determine if there were any applicants that should have submitted a Form 5401(8) BP Form.
- Require proof of the cost of construction contracts on the Form 5401(8) CO.

Land Use and Finance decided to address the State Code Section 5401(9) issues on a prospective basis and not to research potential past exceptions. Land Use does not feel it has the authority to request copies of construction contracts and that, to do so, would be very burdensome. Also, the County has protection by virtue of the applicant signing the form under penalty of perjury.

Recommendations – Office of Finance and Department of Land Use

To ensure that the County fully complies with Delaware Code Section 5401(9) concerning RTT due in certain situations involving building construction, we recommend the following:

- Office of Finance and Department of Land Use: Work together on determining the most effective and efficient processes for ensuring the County complies with State Code Section 5401(9). These processes should help to ensure, when applicable, that the proper State forms [5401(8) BP and 5401(8) CO] are submitted and the applicable State and County RTT is collected when due.
- Land Use: For purposes of evaluating the 50% threshold in State Code Section 5401(9) d, consider a process in the new system (i.e., the replacement to Hansen) for consolidating multiple Residential

Addition Building Permits issued within a year of the date of transfer of the property. Land Use should first check with the Office of Law to determine if Section 5401(9) allows such consolidation.

Management’s Response – Office of Finance

Office of Finance is working with the Department of Land Use to develop procedures to ensure the Realty Transfer Tax (RTT) is reported and collected, if applicable, on improvements to parcels, both residential and commercial, that are subject to Del Code 30 § 5401(9) prior to issuing a county permit and then subsequent county certificate of occupancy.

Management’s Response – Department of Land Use

Land Use will continue to work with Finance to review our current practices and explore new opportunities with Hansen, or future software, to maintain compliance with State Code.

OPPORTUNITIES FOR IMPROVEMENT

3. Clarify the New Castle County Realty Transfer Tax rate to be collected on relevant building construction.

Comment

Per New Castle County Code, Chapter 14, Article 10, Section 14.10.002.C:

“The rate of tax on documents described in Section 14.10.001.A.1 shall be one and one-half (1 1/2) percent on amounts exceeding ten thousand dollars (\$10,000.00), which shall be borne by the owner of the building whose construction is made subject to tax under subsection d of the definition of document in Section 14.10.001.A.1.”

The references to Section 14.10.001.A.1 and “subsection d of the definition of document in Section 14.10.001.A.1” are erroneous because there is neither a subsection “1” nor a subsection “d” in 14.10.001. Since 14.10.001.B refers to building construction, it appears that the reference to Section 14.10.001.A.1 should be changed to Section 14.10.001.B.1 and “subsection d” should be struck from the language.

Perhaps because of these erroneous references in County Code, there has been a mis-communication to the Recorder of Deeds of RTT rates to be assessed on eligible building construction. The Recorder of Deeds currently assesses only 1% on eligible building construction, whereas we believe the intent of the Code is to assess a rate of 1.5%. The County collected approximately \$31,000 from RTT on building construction in the first quarter of CY 2019. Hence, it lost approximately \$15,500 in RTT in this period from using a 1% instead of 1.5% rate.

Recommendations – Office of Finance

We recommend the Office of Finance:

- Seek clarification from the Office of Law on the RTT rate to be collected on eligible building construction, and communicate the Office of Law’s recommended rate to the Recorder of Deeds office. Please note that we issued our own memorandum (see Exhibit B) to the Office of Law on the issues identified in this comment.
- Consider performing further analysis of the amount of RTT lost by only charging the 1%, and consider trying to recoup these funds if possible.
- Request the Office of Law to write legislation correcting the erroneous references on County Code.

Management's Response – Office of Finance

Should the Office of Law determine that the 1.5% rate should have applied, the Office of Finance will determine whether, given the information provided or otherwise available to taxpayers who were subject to this provision, it is reasonable and practical to recoup the difference between the 1.0% and 1.5% rates on past transactions. Regardless of the determination regarding past transactions, updates to County Code that eliminate ambiguity in this area should and will be pursued.

4. Correct the “New Castle County Realty Transfer Tax Return And Affidavit Of Value” Form to clarify the computation of “value.” Consider approaching State Legislature about possibility of re-defining State Code’s definition of “value” in Section 5401(4) given that re-assessments have not been done for many years.

Comment

Delaware Code Title 30, Chapter 54, Section 5401(4) gives the definition of “value” in RTT transactions:

“ ‘Value’ means, in the case of any document granting, bargaining, selling or otherwise conveying any real estate or interest or leasehold interest therein, the amount of the actual consideration¹⁵ thereof, including liens or other encumbrances thereon and ground rents which encumber the interest in real estate and any other interest in real estate conveyed; provided, that in the case of a transfer for an amount less than the highest appraised full value of said property for local real property tax purposes, “value” shall mean the highest such appraised value unless the parties or one of them can demonstrate that fair market value is less than the highest appraised value, in which case “value” shall mean fair market value, or actual consideration, whichever is greater. A demonstration that the transaction was at arm’s length between unrelated parties shall be sufficient to demonstrate that the transaction was at fair market value.”

Observation: Since the last time a Countywide reassessment was performed was 1983, most properties will have a 1983 value for “the highest appraised full value of said property for local real estate tax purposes.” Thus, it is not very likely that a property will be transferred “for an amount less than the highest appraised full value of said property for local real property tax purposes.” And, thus, it is unlikely that the “value” for RTT purposes would be anything other than the actual consideration.

¹⁵ In order for any agreement to be deemed legally binding, it must include “consideration” on the part of every person or company that enters the contract. Consideration is the benefit that each party gets or expects to get from the contractual deal. In the case of RTT, consideration is usually the amount of money provided by the buyer in exchange for the seller’s property.

New Castle County Code Chapter 14, Article 10, Section 14.10.001A incorporates the definition of “value” from the State Code by reference. Section 14.10.005 says that a statement of value should be required when recording a document:

“Under this Article, every document, when lodged with or presented for recording to the Recorder of Deeds in and for the County, shall set forth therein as part of such document the true, full, and complete value thereof or shall be accompanied by an affidavit executed by a responsible person connected with the transaction showing such connection and setting forth the true, full, and complete value thereof and the reason, if any, why such document is not subject to tax under this Article.”

Hence, one should refer to the State code for a definition of “value” in RTT transactions and all New Castle County Realty Transfer Tax Return forms must indicate the true, full, and complete value.

The “New Castle County Realty Transfer Tax Return And Affidavit Of Value” Form

Currently, Part D of the “New Castle County Realty Transfer Tax Return And Affidavit Of Value” form (henceforth referred to as the County Affidavit) is used to compute the RTT (as well as any partial exemptions from the RTT, such as the First Time Homebuyer exemption) for conveyances of real property in New Castle County. It determines “value” of the transaction as follows:

- In case of conveyances with full consideration, “value” is the total amount of consideration.
- For conveyances without full consideration, “value” is the higher amount between the actual full monetary worth of the property and New Castle County’s Tax Assessment of the property.”

We do not understand the need for different computations of value dependent on whether the conveyance is with full consideration or without full consideration. We also don’t understand how the person completing a County Affidavit would understand those terms, given that the consideration is what the buyer and seller have agreed to and thus appears to be “full” at least in most cases. (We assume that the County is defining “without full consideration” as a transaction for less than full market value but, as indicated in the next paragraph, conveying a property at less than full market value does not matter unless the property is conveyed at less than the appraised value for local tax purposes.)

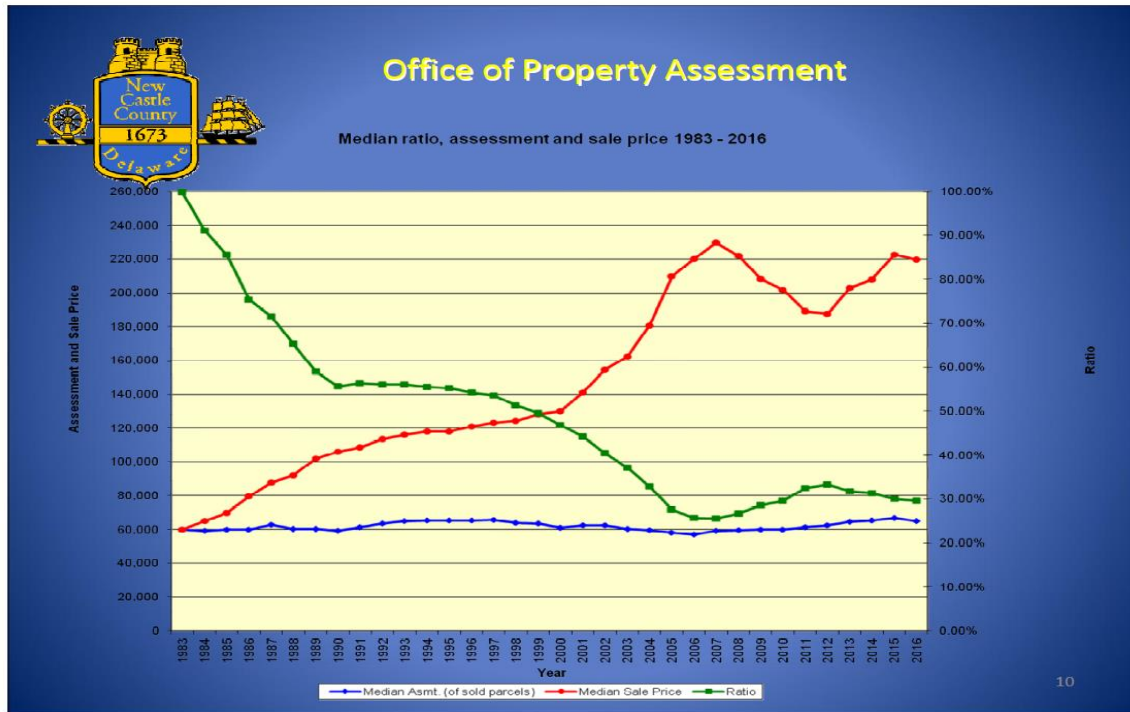
Given the definition of “value” in the State and County Codes, it appears to us that the 2 scenarios for computing value are (1) when the transfer is for consideration greater than the appraised value for local property tax purposes, and (2) when the transfer is for consideration less than the appraised value for local property tax purposes. The Codes do not say anything about transfers for less than full consideration. In fact, as treated in the State’s “Realty Transfer Tax Return And Affidavit Of Gain And Value Form 5402”,

the “value” of a transaction is correctly treated as the greater of the consideration amount and the highest assessed value for local tax purposes.¹⁶ The County Affidavit’s Part D should be corrected accordingly.

Assessed value vs. fair market value

As noted earlier, the property assessments in New Castle County are currently as of July 1, 1983, i.e., the appraised values of properties are what the fair market value would have been as of July 1, 1983. This is because the last time a County-wide reassessment was performed was in 1983, with changes effective July 1, 1985, so all properties are assessed as of that “base year”. Generally, this has led to a wide gap between the present fair market value (red line in the chart below) and assessed value (blue line in the chart below) of properties in Delaware.

Chart 1: Median Assessment, Sale Price and Ratio 1983 - 2016



Source: <https://www.nccde.org/DocumentCenter/View/17404/NCC-Reassessment-2-17-PDF?bidId=>

Due to this gap in assessed value and fair market value of properties, it would seem to be good practice to revisit and review the State Code’s definition of “value” for RTT purposes. This part of the Code was last amended in 1994.

¹⁶ Note: In 2018, a question arose in the State’s Division of Revenue regarding the correct value to be used for a zero-consideration transfer of real property that is not otherwise exempt, that is, whether the assessed value or present fair market value of a property should be used as “value” of the property. The State’s Deputy Attorney General determined that based on legislative history, the assessed value for property tax purposes should be used. The transfer was between an unmarried couple in that case.

Recommendations – Office of Finance

We recommend the Office of Finance:

- Work with the Office of Law to revise the County Affidavit’s Part D regarding the computation of RTT to ensure it complies with the State Code’s current definition of “value.”
- Work with the State’s Division of Revenue to approach the State Legislature about redefining the Section 5401(4) definition of “value” for situations where a property is conveyed at less than full market value, especially if a reassessment of properties is not imminent.¹⁷

Management’s Response – Office of Finance

The Office of Finance agrees with the recommendations.

5. Segregation of realty transfer tax revenues and the spending of such revenues for the allowable categories per State and County Codes.

Comment

Relevant State and County Codes

Delaware Code Title 22, Chapter 16, Section 1601c (“Realty Transfer Tax”) states:

“Any funds realized by a municipality pursuant to this section shall be segregated from the municipality’s general fund and the funds, and all interest thereon, shall be expended solely for the capital and operating costs of public safety services, economic development programs, public works services, capital projects and improvements, infrastructure projects and improvements and debt reduction.”

County Code Article 10, Section 14.10.012 (“Use of transfer tax revenues”) states:

- A. “Any funds realized pursuant to this Article shall be segregated from the County’s general fund and the funds, and all interest thereon, shall be expended solely for the capital and operating costs of public safety services, economic development programs, public works services, capital projects and improvements, infrastructure projects and improvements, and debt reduction.
- B. In setting the estimates for use of the transfer tax in support of the proposed budget, the County Executive shall not certify a revenue estimate that exceeds ninety-five (95) percent of the transfer tax estimate provided by the Office of Finance and certified by the New Castle County

¹⁷ There is currently a Chancery Court lawsuit against the State of Delaware and all three counties asking for all counties to assess properties at their “true value.” Such lawsuit could result in the counties having to perform reassessments. Thus, we don’t believe anything should be done with this recommendation until the Court has issued its opinions.

Finance Advisory Committee to be used as a funding source in the proposed operating budget; nor shall County Council adopt a budget based on revenue estimates that exceed ninety-five (95) percent of the transfer tax estimate provided by the Office of Finance and certified by the New Castle County Finance Advisory Committee.

- C. Proceeds from the real estate transfer tax received in any fiscal year in excess of those certified shall be designated as cash in lieu of capital bond authorizations that would ordinarily be used to support construction of capital facilities, or land acquisition, economic development programs, or to defease or otherwise reduce the County's indebtedness.”

Whether County is in Compliance with Delaware Code Section 1601 and County Code Sections 14.10.012 A and C.

In the setting of property tax rates for the incorporated and unincorporated areas of New Castle County, the County’s Office of Finance is required by State and County Codes to annually prepare a local service function budget¹⁸ and general operating budget.¹⁹ In preparing these budgets, the Office of Finance allocates non-property tax revenues to services which are directly related to those services. (e.g., projected fees from property maintenance violations are allocated to Code Enforcement’s expense budget to reduce the amount of Code Enforcement’s budget which needs to be covered by property taxes.)

Realty transfer taxes (RTT) are allocated to the categories per State and County Codes which such revenues are allowed to be expended on. (See Delaware Code Section 1601 and County Code Section 14.10.012 A and C above.) The amount allocated is based upon the percentage of each category’s budget to the total of all categories. For example, in the FY 2020 Excel workbook which allocates these revenues, Police Operations’ total expense budget is 66.24% of the total of the budgets for all categories; therefore, 66.24% of the projected transfer tax revenues (i.e., the 95% of the actual revenue estimate per County Code Section 14.10.012) is allocated to Police Operations’ expense budget.

To aid in complying with County Code Section 14.10.012 C, the Excel workbook also allocates to debt service a portion of the Transfer Tax Reserves -- which represent the accumulation over the years of the transfer tax revenues received in excess of the amounts budgeted minus the amounts used each year to help balance the County’s budget. (The Office of Finance tracks the balance and activity of this reserve

¹⁸ Delaware Code Title 9, Chapter 11, Section 1131(a): “The Chief Administrative Officer and the County Executive, in the preparation of the annual operating budget, shall divide and segregate in a separate budget, entitled Local Service Function Budget, all expenditures for the performance of local service functions which are not performed by the County within the limits of any municipality ...” The general purpose of this exercise is to ensure that taxpayers of incorporated municipalities do not pay property taxes on County services which the municipality itself already performs.

¹⁹ Delaware Code Title 9, Chapter 11, Section 1131(d): “The Chief Administrative Officer and the County Executive, in the preparation of the annual operating budget, shall divide and segregate in a separate budget entitled General Operating Budget all expenditures not properly allocable to the Local Service Function Budget or other operating budget fund.

outside of the accounting system.) Regarding these reserves, Footnote 18 in the County's June 30, 2018 CAFR (Comprehensive Annual Financial Report) states: "This balance was legislated to designate funds received beyond what was certified to cover capital bond authorizations, reduce the County's indebtedness, or for economic initiatives. County Council is authorized through an Ordinance to establish and appropriate these proceeds as may be necessary" (which we presume occurs when County Council approves the annual operating budget ordinance).

Thus, although the County does not use a separate governmental fund to account for transfer tax revenues and how such revenues are spent, the County believes it is meeting the spirit of State Code Section 1601 and County Code Sections 14.10.012 A and C by separately accounting for this information in the calculation of the local service function and general operating budgets. It should be noted, however, that:

- There is no mechanism in the County's accounting system which allows the County to prove that transfer tax revenues were used for the intended purposes.
- We are not aware of any separate tracking (independent of the accounting system) that is done to track how the transfer tax revenues are spent.
- It is our understanding that any interest on the County's investments is allocated between the General Fund and Sewer Fund based on a formula and, within the General Fund, there is no allocation of any interest directly to transfer tax revenues. Therefore, it would be difficult to say that interest on transfer tax revenues is allocated to the specific allowable purposes in State and County Codes.

Therefore, we do not express an opinion on whether the County is in compliance with State Code Section 1601 and County Code Sections 14.10.012 A and C.

Please note that we talked to the Finance/Budget offices of Sussex County, Kent County, and the City of Wilmington, and all of these municipalities account for their transfer tax revenues in the municipality's General Fund – none of them use a separate governmental fund.

Whether County is in Compliance with County Code Sections 14.10.012 B.

On March 21, 2019, the New Castle County Financial Advisory Council (NCCFAC), in accordance with its responsibilities per County Code Section 14.01.018, submitted its FY 2020 Revenue Forecast in a memorandum to the County Executive.²⁰ Included in this memorandum was the language "Included in the FY 2020 General Fund Revenue Forecast amount is \$30,875.0 for RTT. This is 95% of the FY 2020 estimated RTT of \$32,500.0."²¹

The County Executive used these amounts in his proposed FY 2020 operating budget and the County Council approved the FY 2020 budget.

²⁰ Section 14.10.018 D4 states "The NCCFAC revenue estimates required herein shall be duly considered by the Executive in developing the official revenue estimates in compliance with 9 Del. C. § 1158 (Budget of revenues)."

²¹ Please note that these figures are in thousands.

Thus, in our opinion, the County has complied with Section 14.10.012B for the FY 2020 budget.

Recommendations – Office of Finance, Executive Office

The State Legislature has created a Task Force to review and propose revisions to Delaware Code Title 9, Chapter 11 regarding County and municipal responsibility for local service functions and how the County budgets expenditures for the performance of local service functions and establishes tax rates for municipalities that perform such functions. Since the allocation of transfer tax revenues is part of the County’s preparation of the local service function and general operating budgets, we believe that this Task Force should also evaluate Delaware Code Title 22, Chapter 16 dealing with the use of transfer tax revenues by the County and the municipalities. This evaluation should include looking at whether it’s really necessary to account for such revenues in a separate fund and to limit expense categories where such funds can be spent.

We recommend that the Office of Finance ensure that the members of the Task Force appointed by the County Executive include an evaluation of Delaware Code Title 22, Chapter 16 in the Task Force’s objectives. (Please note that if the Task Force recommends changes to this Chapter of State Code, this could result in the necessity of making changes to County Code also.)

Management’s Response – Office of Finance

The Office of Finance agrees with the recommendation.

6. Consider revising the “New Castle County Realty Tax Return And Affidavit Of Value” Form by requiring Sellers to also sign the New Castle County “Affidavit of Exemption” and correcting erroneous Code references.

Comment

Regarding the allocation of the RTT due:

- Delaware Code Title 30, Chapter 54, Section 5402(a) states “... Said tax is to be apportioned equally between grantor and grantee.”
- County Code Chapter 14, Article 10, Section 14.10.002.A. states “... In the absence of any agreement to the contrary, the tax shall be apportioned equally between the grantor and grantee.”

Whereas Delaware Code Title 30, Chapter 54 Section 5412 states “As between the parties to any transaction which is subject to the realty transfer tax imposed by this subchapter, in the absence of an agreement to the contrary, the burden for paying the tax shall be on the grantor.”

Hence, in the absence of any agreement between the buyer and seller, the seller is responsible for paying all the RTT.

The New Castle County Realty Transfer Tax Return And Affidavit Of Value Form

Part F of the “New Castle County Realty Transfer Tax Return And Affidavit Of Value” (referred to as the County Affidavit going forward), requires the:

“Seller and Buyer hereby attest that their computation of the Tax, as set forth on this Return, is based on the highest value as defined by §14-11110.001(A) of the New Castle County Code, and that this affidavit (including any information presented in support of any claim of exemption) is true and correct to the best of their knowledge, information, and belief.”

Please note that the County Code Section 14-11110.001(A), referenced in 2 places in the County Affidavit, is erroneous and needs to be corrected.

Apart from the above attestation, the County Affidavit has an Affidavit of Exemption which is signed and notarized only by the Buyer. Since many full exemptions involve the Seller too (e.g., “Husband & Wife/Divorce”, “Parent/Child”, “Trustee/Straw Party”), we question why the Seller is not required to sign (and have his/her signature notarized on) the Affidavit Of Exemption.

We also reviewed the State’s “Realty Transfer Tax Return And Affidavit Of Gain And Value Form 5402.” This form, including Part D – Exempt Conveyances, only requires the Seller’s notarized signature. For the First Time Home Buyer partial exemption, a Buyer only exemption, the State also requires the Buyer to complete the “First Time Home Buyer’s Credit Form 5402 – Schedule 1.”

But for all other exemptions, the State seems satisfied with only the Seller’s notarized signature, which seems to satisfy the Section 5412 requirement. Although we still think it would be a good idea for the State to also require the buyer’s signature [particularly for certain buyer-centric exemptions like “Gift to §501(c)(3) organization”], that is a matter for the State to decide – not the County.

Recommendations - Office of Finance

We recommend that the Office of Finance:

- Correct the erroneous references to §14-11110.001(A) in the County Affidavit.
- Consult with the Office of Law as to whether Sellers (Grantors) should also be required to sign the New Castle County “Affidavit of Exemption.”

Management's Response – Office of Finance

The Office of Finance agrees with the recommendations.

7. Automate certain controls over the recording of Realty Transfer Taxes on the DTS system, including capping the system-calculated tax amount that can be overridden without supervisory approval.

Comment

Processes for collecting Realty Transfer Taxes at the Recorder of Deeds office

The Recorder of Deeds office (ROD) collects RTT for New Castle County, the State of Delaware and some of the incorporated municipalities within New Castle County.²²

Once the real estate attorneys (or their representatives) deliver a recording package to the Office, the recording clerks review the package to ensure that all the materials have been submitted and the forms in the package are filled in properly. Once the recording clerk is satisfied that the deeds package is complete, s/he enters the transfer tax data into the DTS TrakRecord software (the DTS system).

Allocation of the local RTT between the County and municipalities

While entering the data into the DTS system, the recording clerk has to manually select the municipality from a drop-down menu in the Terms of Transfer window. The DTS system does not automatically determine the municipality based on the beginning digits of the parcel number.

This could cause errors in allocating RTT to the correct municipality (as happened during our visit of the Office). Please note that the ROD does have a control in place to catch such incidents – the Recording Deputy daily reviews all RTT transactions.

Our testing of all RTT transactions recorded in the first quarter of 2019 shows that this control is currently working well. However, the manual nature of this control makes it more prone to errors (if there was a change in personnel for example) and may not be the most efficient.

²² New Castle County collects transfer tax for 6 municipalities: Newark, New Castle City, Delaware City, Middletown, Smyrna and Town of Clayton.

Manual overrides of Realty Transfer Tax amounts computed by the DTS System

Once the recording clerk enters the consideration amount into the DTS system, the system computes the RTT. However, with the recent changes in the First Time Home Buyers (FTHB) credit on RTT [State Code Section 5402(c)], the clerks override the DTS amount and calculate the State's share of FTHB transfer taxes as Regular Transfer Tax minus \$2,000 for properties with a value greater than or equal to \$400,000. Starting October 1, 2018, the recording clerks also have had to override the NCC portion of the RTT for FTHB transactions with a value greater than or equal to \$400,000.

During our audit testing of NCC RTT amounts collected in the first quarter of 2019, we found 3 cases where incorrect amounts had been calculated and collected for transactions with a value greater than \$400,000 and involving FTHB. (All three amounts were less than what should have been collected.) As a result, the Office Administrator reviewed all such transactions involving FTHB since October 1, 2018 (when the new cap of \$400,000 on FTHB exemptions was implemented) and ensured us that there were no other miscalculated NCC RTT collections from transactions involving FTHB with consideration greater than or equal to \$400,000.

Note that there are other situations, not necessarily involving the FTHB, where overrides are needed. Sometimes a check written by an attorney may be pennies off from the amount calculated by DTS; in these situations, there is a manual override so that the amount on DTS agrees with the check amount.

Apart from erroneous calculations caused by manual overrides of DTS RTT amounts, the recording clerks' unrestricted ability to override DTS RTT amounts can leave the collection process vulnerable to irregularities. Though there are no known incidents of irregularities, and our audit testing did not give us any reason to believe that the current process is failing, we believe that limiting the amounts by which recording clerks can override the DTS RTT amounts would allow for greater security and control over the process.

Recommendations – Recorder of Deeds Office

We recommend the Recorder of Deeds Office:

- Consider asking the DTS System vendor to make DTS System enhancements to:
 - Have the first 2 digits of the parcel number determine the selection of the municipality to receive the local RTT.
 - Allow the ROD to place a cap on the amount by which the DTS-computed tax can be overridden without requiring supervisory approval.
 - Have the system calculate the RTT in first time homebuyer situations, based upon the new parameters.
- Establish a policy for the conditions under which DTS-computed tax amounts can be overridden; for example, First Time Home Buyer RTT calculations for properties \$400,000 or more.

Management's Response – Recorder of Deeds Office

- The Recorder of Deeds Office has now added the Parcel Number to the State Transfer Tax Report which now shows municipality and corresponding Tax Parcel #. This is an easy reference to make sure correct municipality has been selected. Also, this information is entered by three different employees, thus making it more difficult for errors to occur.

The Recorder of Deeds Office will contact their vendor, DTS, to see what can be done about the other two recommendations.

- Currently there are only two reasons for an override of transfer tax, an over \$400,000 transaction and on occasion, a check (from customer) is a penny or two over so we change the tax due to equal the check. We will establish a policy where on any override a supervisor must be called for approval. We will also contact the vendor (DTS) to see what, if anything, they can do about this issue.

EXHIBIT A

FORM 5401(8)BP

<https://revenuefiles.delaware.gov/docs/54018BP.pdf>

EXHIBIT B

Robert B. Wasserbach
County Auditor



To: Karen Sullivan, County Solicitor

From: Bob Wasserbach, County Auditor

Cc: Dave Gregor and Michael Smith, Office of Finance

Subject: Delaware Code Title 30, Chapter 54, Section 5401(9)

Date: July 9, 2019

The County Auditor's Office is performing an audit of realty transfer taxes and, based upon existing County practices, we have a few legal questions the Auditor's Office and the Office of Finance are asking the Office of Law to clarify for us. Please let me know if Law is able to perform research to answer these questions. Thank you.

Relevant Code

Delaware Code Title 30, Chapter 54, Section 5401(9) states:

- a. Notwithstanding paragraph (1) of this section²³, there shall be included in the definition of "document" for purposes of this chapter any contract or other agreement or undertaking for the construction of all or a part of any building all or a portion of which contract, agreement or undertaking (or any amendment to the foregoing) is entered into, or labor or materials are supplied, either prior to the date of the transfer of the land on which the building is to be constructed or within 1 year from the date of the transfer to the grantee.
- b. No jurisdiction in this State shall issue a building permit for any such building unless and until the person or persons (including corporations or other associations) requesting such permit shall demonstrate in whatever form may be specified by the Director of Revenue, including at the Director's discretion, a form of affidavit, that:

²³ Paragraph (1) of Section 5401 provides the definition of "document" and includes a list of items which are not considered to be "documents."

1. No transfer as described in this section has occurred within the preceding year;
 2. No portion of the contract for construction for which the permit is being requested was entered into and no materials or labor with respect to the building have been provided within 1 year of the date on which the property was transferred; or
 3. There has been paid a realty transfer tax on the document as defined in this paragraph.
- c. In addition, no jurisdiction in this State shall issue a certificate of occupancy relative to any building on which a tax is provided by this subsection unless and until the owner recertifies the actual cost of the building and pays any additional tax due as a result of such recertification.
- d. A “building” for purposes of this paragraph shall mean any structure having a roof supported by columns or walls which structure is intended for supporting or sheltering any use or occupancy but shall not include any alteration of or addition to an existing building where the cost of said alteration or addition is less than 50% of the value of the property transferred.
- e. A “transfer” for purposes of this paragraph shall include any transfer made by a “document” as described in this section, other than this paragraph, and shall not include any transaction excluded from the definition of “document” under the provisions of paragraph (1)a.-u. of this section.²⁴

Similar language is in County Code Article 10, Section 14.10.001B. However, certain aspects of Section 5401(9) are not included in County Code, e.g., Section 5401(9)c.

Delaware Code Section 5402(f) states “... the rate of tax on documents described in Section 5401(9) of this title shall be 2% on amounts exceeding \$10,000, which shall be borne by the owner of the building whose construction is made subject to tax under Section 5401(9) of this title.”

County Code Section 14.10.002 states “The rate of tax on documents described in Section 14.10.001.A.1 shall be one and one-half (1 ½) percent on amounts exceeding ten thousand dollars (\$10,000), which shall be borne by the owner of the building whose construction is made subject to tax under subsection d of the definition of document in Section 14.10.001.A.1.”

Legal Questions Presented / Current Practices

Questions Presented

In determining whether realty transfer tax (RTT) is due under Delaware Code Section 5401(9)b,

- Is the State properly following State Code in excluding “a builder or developer for a building permit in order to construct, alter, or add to a building for resale on land owned by the builder developer”?
- Regarding single-family residential building permits, is the County properly following State Code in only requiring transfer tax forms for “Single-Family Dwellings not built as part of an active subdivision plan”?

Current Practice

In accordance with Section 5401(9)b, the State of Delaware has designed a form called the “State of Delaware Realty Transfer Tax Declaration for Building Permit” (Transfer Tax Declaration).²⁵ This form asks

²⁴ Ibid.

²⁵ See attached exhibit.

various questions to ascertain if the applicant is subject to the realty transfer tax. The form states, at the bottom of page 2, that the tax “does not pertain to the application for a building permit by a builder or developer who acquires the realty with the intention of erecting improvements for resale.” Also, question 6B on the form asks, “Is this an application by a builder or developer for a building permit in order to construct, alter, or add to a building for resale on land owned by the builder developer?” If the answer is “Yes”, the form instructs the preparer to stop and then sign the form – no transfer tax is due.

The County’s “Building Permit Requirements Single-Family Dwelling” document states “State and County transfer tax forms are required for Single-Family Dwellings not built as part of an active subdivision plan.”²⁶ When an applicant for a single-family dwelling, not part of an active subdivision plan, applies for a building permit, the County’s Land Use Department requires the submission of a copy of the State Transfer Tax Declaration and, if State transfer tax was due, evidence from the Recorder of Deeds Office that the applicant also paid the County transfer tax. If the single-family dwelling is part of an active subdivision plan, the Land Use Department does not require a copy of the Declaration (although the applicant may submit it anyway).

Please note that we do not see any language in Delaware Code Section 5401(9) which excludes a builder/developer who is constructing, altering, or adding to a building for resale (or excludes a building constructed as part of an active subdivision plan). There are also no State regulations governing Section 5401(9). Apparently, the theory behind this exclusion is that the builder or developer is constructing the building for resale and, thus, such building (and the lot on which it is built) will be subject to the RTT when completed and sold. On the other hand, non-builder/developer applicants for building permits are most likely constructing such buildings to reside in.

Section 5401(9) was enacted in 1990 by House Bill (HB) 729. In an attempt to understand the Legislature’s intent in proposing this bill, we obtained from the State’s Division of Research a recording of the Senate hearing of HB 729.²⁷ (We have emailed you this recording.) In listening to the tape, we noted the following:

There had been a prominent developer who bought land and subdivided the land into lots; then, to avoid the RTT, the developer sold the lots to owners and then later entered into contracts with the owners to build homes on the lots. Thus, although RTT would have been paid on the sale of the lots, RTT would not have been paid on the cost of building the homes. Instead, the cost of building the home was considered to be an improvement to the lot and RTT would not have been realized until the owner of the lot sold the home at some future date. If the developer had sold the lot and the home together, then RTT would have been due on both at settlement. This bill was designed to close that loophole.

Also, we met with the State’s Director of the Division of Revenue concerning the State form’s language “does not pertain to the application for a building permit by a builder or developer who acquires the realty with the intention of erecting improvements for resale.” She agreed that the intent of HB 729 was as discussed above from the Senate hearing. The Director also opined that the reason for the exclusion may relate to the language in Section 5401(9)a of “any contract or other agreement or undertaking for the construction of all or a part of any building.” She said that builders/developers may not be entering into

²⁶ See attached exhibit.

²⁷ We also obtained the recording of the House hearing; however, there was no discussion other than to say it was closing a loophole (did not say what the loophole was).

a “contract” for the construction because the builder/developer has employees who are doing the work. Also, even if the builder/developer has formed a construction subsidiary to do the construction, there may still not be an actual “contract” between the parent and the subsidiary.

Since the County only requires transfer tax forms for “Single-Family Dwellings not built as part of an active subdivision plan”, we question whether the County may be losing RTT in situations where someone purchases a lot from a developer and then engages his/her own builder to construct the home. It is our understanding that there may be subdivisions which allow for one to either (1) have the developer build the home on the lot, or (2) purchase the lot from the developer and have his/her own builder construct the home.

Question Presented

In determining whether realty transfer tax is due under Delaware Code Section 5401(9)b, should the County be requiring the submission of the “State of Delaware Realty Transfer Tax Declaration for Building Permit” form for non-residential building permits and for alteration/addition building permits?

Current Practice

The County’s Land Use Department is not requiring the submission of the State Transfer Tax Declaration for non-residential building permits and for addition/alteration building permits. Please note that Section 5401(9)d states that the definition of “building” does not include “any alteration of or addition to an existing building where the cost of said alteration or addition is less than 50% of the value of the property transferred.” (It is our understanding that it is rare to have an addition or alteration where the cost is 50% or more of the value of the property transferred; therefore, it would be rare to have any transfer tax liability in the case of alterations/additions.)

Please note that the State’s Transfer Tax Declaration contains a question asking, “Is the Building Permit applied for solely for alteration of or addition to an existing building?” If the answer is “yes”, the applicant is required to “enter the value at the time of conveyance for realty tax purposes of land and structure on which construction is intended” and to “Enter amount of money paid or to be paid under any and all contracts which (a) pertain to all phases of the construction or alteration of, or addition to, the building for which this Building Permit is sought ...” Therefore, since the Declaration requires the applicant to go through this exercise, this lends credence to the County needing to require the submission of this form.

In the Senate hearing on HB 729 [which enacted Section 5401(9)], there was a hypothetical situation discussed in which a company has a plant and owns a vacant piece of land next to the plant. The State’s then Secretary of Finance said that Section 5401(9) would be applicable if the company decided to construct a building on the vacant land and such land had been bought within one year of the application for the building permit. This lends credence to the County needing to require the submission of the State’s Transfer Tax Declaration for non-residential building permits. Also, the State’s Transfer Tax Declaration does not differentiate between residential and non-residential building permits. Nor does State Code.

Questions Presented

- In determining whether additional realty transfer tax is due under Section 5401(9)c, should the County be requiring the submission of the “State of Delaware Realty Transfer Tax Declaration for Certificate of Compliance or Occupancy” form prior to issuing a Certificate of Occupancy?

- Should the County be assessing additional tax if the actual cost of the building is more than the estimated cost provided on the “State of Delaware Realty Transfer Tax Declaration for Building Permit” form?
- Should the County be charging any transfer tax at all since the reference in County Code is incorrect?
- If the answer to the above question is “yes”, should the rate of tax the County charges for the “State of Delaware Realty Transfer Tax Declaration for Building Permit” and “State of Delaware Realty Transfer Tax Declaration for Certificate of Compliance or Occupancy” forms be 1 ½ %.

Current Practice

The County is assessing a tax rate of 1% if the “State of Delaware Realty Transfer Tax Declaration for Building Permit” form indicates the applicant owes tax. We believe this rate should be 1 ½ %.

In accordance with Section 5401(9)c, the State of Delaware has designed a form called the “State of Delaware Realty Transfer Tax Declaration for Certificate of Compliance or Occupancy.”²⁸ This form requires the applicant to recertify, prior to the issuance of the Certificate of Occupancy, the actual cost of the building and to pay any additional transfer tax due as a result of the recertification. For situations where the Transfer Tax Declaration shows that transfer tax was due, neither the State nor the County is following up with the applicant to ensure (prior to the issuance of the Certificate of Occupancy) that the applicant “recertifies the actual cost of the building and pays any additional tax due as a result of such recertification.”

Delaware Code Section 5402(f) states “... the rate of tax on documents described in Section 5401(9) of this title shall be 2% on amounts exceeding \$10,000, which shall be borne by the owner of the building whose construction is made subject to tax under Section 5401(9) of this title.” Thus, for purposes of the State’s realty transfer tax, a tax rate of 2% is to be applied if additional tax is due under Section 5401(9)c.

County Code Section 14.10.002 states “The rate of tax on documents described in Section 14.10.001.A.1 shall be one and one-half (1 ½) percent on amounts exceeding ten thousand dollars (\$10,000), which shall be borne by the owner of the building whose construction is made subject to tax under subsection d of the definition of document in Section 14.10.001.A.1.” Please note the following:

- The language from State 5401(9)c, regarding the possibility of charging additional tax at the time the applicant applies for the Certificate of Occupancy, is not included in County Code.
- It appears that the references above to Section 14.10.001.A.1 should actually be to 14.10.001.B. Section 14.10.001.A.1 does not exist and 14.10.001.B is the section which refers to construction contracts.

²⁸ See attached exhibit B.

EXHIBIT C

FORM 5401(8)CO

<https://revenuefiles.delaware.gov/docs/54018COre.pdf>