TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 19-03

Revenue rulings are not binding on the Department. This ruling is based on the particular facts and circumstances presented, and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes, and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.

SUBJECT

The application of the Tennessee recordation tax to financing and closings under the Small Business Administration's 504 Development Company Loan Program.

SCOPE

Revenue Rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue Rulings are advisory in nature and are not binding on the Department.

FACTS

Pursuant to its authority under Title V of the Small Business Investment Act of 1958,[1] the U.S. Small Business Administration (the "SBA") has established a loan program (the "504 Program") to provide long-term, fixed asset financing for small businesses.[2] The purpose of the 504 Program is to "foster economic development, create or preserve job opportunities, and stimulate growth, expansion, and modernization of small businesses."[3] This purpose is accomplished in part by providing long-term financing to small businesses to purchase or improve land, buildings, and major equipment.

The financing package for a project through the 504 program (the "504 Project"[4]) is delivered through a 3-way partnership that includes the borrower[5] (the "504 Borrower"), a Certified Development Company (the "CDC"),[6] and a private sector, third party lender.[7] The 504 Borrower must

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[1] 15 U.S.C. §§ 695, *et seq.* (2018).

[2] 13 C.F.R. §§ 120.800, *et seq.* (2018).

[3] 13 C.F.R. § 120.800.

[4] "*Project* is the purchase or lease, and/or improvement or renovation of long-term fixed assets by a small business, with 504 financing, for use in its business operations." 13 C.F.R. § 120.802.

[5] "*Borrower* is the obligor of an SBA business loan." 13 C.F.R. § 120.10.

[6] A CDC is typically a private nonprofit corporation set up to contribute to the economic development of its community. CDCs are certified and regulated by the SBA. 13 C.F.R. § 120.10.

[7] Chapter 13 of the Code of Federal Regulations provides the following explanation regarding how a 504 Project is financed:

(a) One or more small businesses may apply for 504 financing through a CDC serving the area where the 504 Project is located. SBA issues an Authorization if it agrees to guarantee part of the funding for a Project.

(b) Usually, a Project requires interim financing from an interim lender (often the same lender that later provides a portion of the permanent financing).

contribute at least 10 percent of the 504 Project costs.[8] The private sector, third party lender generally provides at least 50 percent of the 504 Project costs collateralized by a first lien on the 504 Project property.[9] The CDC generally provides the remaining 40 percent of the 504 Project costs, which are backed by a 100 percent SBA-guaranteed debenture.[10] The CDC's financing (the "504 Loan") is collateralized by a second lien on the 504 Project property.[11]

The 504 Loan cannot be closed until the 504 Project has been completed. Thus, by SBA policy, every 504 Project includes interim financing to fund the CDC/SBA share (up to 40%) of eligible 504 Project costs during the period between SBA approval of the 504 Project and the debenture sale. This short-term financing, which may be provided by the third party lender described above or by another third party lender, is necessary to facilitate completion of the 504 Project (e.g., purchase of land and building; construction; renovations; installation of machinery and equipment) prior to the sale of the debenture. The 504 Borrower makes interest only payments on the interim, short-term financing. Upon completion of the 504 Project, the 504 Loan is closed, the debenture is sold, and the net proceeds are paid to the interim lender for the amount of the 504 Project costs that it advanced on an interim basis. Since the debenture is guaranteed by the SBA, all 504 Loan documents are assigned by the CDC to the SBA when the 504 Loan is closed.

Regarding loan closing, upon SBA approval of the 504 Project, the typical scenario in Tennessee has included the recordation of both a Deed of Trust securing the third party loan (permanent financing) and a Deed of Trust securing the interim loan, with the 504 Borrower paying the mortgage recordation tax on the indebtedness evidenced by each of those instruments at that time they are recorded. Thereafter, when the 504 Loan is closed upon completion of the project, the SBA has required the CDC to obtain and record a new Deed of Trust, with the 504 Borrower paying the mortgage recordation tax again at that time. The indebtedness evidenced by the CDC Deed of Trust is the portion of the project costs previously advanced on an interim basis, plus administrative costs. The 504 Loan documents are ultimately assigned by the CDC to the SBA who steps into the position of second lienholder.

(c) Generally, permanent financing of the Project consists of:

(1) A contribution by the small business in an amount of at least 10 percent of the Project costs;

(2) A loan made with the proceeds of a CDC Debenture for up to 40 percent of the Project costs and certain administrative costs, collateralized by a second lien on the Project Property (the "504 Loan"); and

(3) A *Third Party Loan* comprising the balance of the financing, collateralized by a first lien on the Project property (see §120.920).

(d) The Debenture is guaranteed 100 percent by SBA (with the full faith and credit of the United States), and sold to Underwriters who form Debenture Pools. Investors purchase interests in Debenture Pools and receive Certificates[7] representing ownership of all or part of a Debenture Pool. SBA and CDCs use various agents to facilitate the sale and service of the Certificates and the orderly flow of funds among the parties.

13 C.F.R. § 120.801(a)-(d).

[8] 13 C.F.R. § 120.801(c)(1).

[9] 13 C.F.R. § 120.801(c)(3).

[10] A debenture is an obligation issued by a CDC (similar to a bond), the proceeds of which are used to fund a 504 Loan.

[11] 13 C.F.R. § 120.801(c)(2).

In order to avoid duplication of costs and assist small business borrowers, the SBA proposes to implement a revised closing procedure for 504 Loans in Tennessee,[12] under which the CDC will be permitted to take an assignment of the interim lender's note and associated liens, rather than record a new Deed of Trust. This will involve an Assignment of Note and Deed of Trust and Modification Agreement ("Assignment and Modification Agreement") and a 504 Renewal Note. By and through these documents, the interim loan amount will be increased to reflect the administrative costs associated with issuance of the debenture; the term of the loan will be extended; and the interest rate will be modified and fixed at the time of the debenture sale. The final step remains the same with the 504 Loan documents being assigned by the CDC to the SBA.

RULING

What is the application of the Tennessee recordation tax to 504 financing and closings where a CDC uses the proposed Assignment and Modification Agreement and 504 Renewal Note to take an assignment of the interim lender's note and associated liens, rather than record a new Deed of Trust?

> Ruling: If a CDC uses the proposed Assignment and Modification Agreement and 504 Renewal Note to take an assignment of the interim lender's note and associated liens, as long as the interim loan documentation reflects that the tax has previously been paid on the indebtedness evidenced by the interim lender's Deed of Trust and any modification, upon recordation of the Assignment and Modification Agreement at the time the 504 Loan is closed, the 504 Borrower is obligated to pay additional tax only on the amount of the increased indebtedness.

ANALYSIS

TENN. CODE ANN. § 67-4-409(b) (Supp. 2018) imposes the recordation tax on "any instrument evidencing an indebtedness, including, but not limited to, mortgages, deeds of trust, conditional sales contracts, financing statements contemplated by the Uniform Commercial Code . . . and liens on personalty, other than on motor vehicles. The tax is applied at the rate of $0.115 cents per $100 "of the indebtedness so evidenced."[13]

TENN. CODE ANN. § 67-4-409(b)(4) provides that the incidence of the tax "is declared to be upon the mortgagor, grantor or debtor, evidenced by the instrument offered for recordation." The tax does not, however, apply to the first $2,000 of the indebtedness.[14]

"Indebtedness" is defined as "the principal debt or obligation which is reasonably contemplated by the parties to be included within the terms of the agreement."[15] "'Indebtedness' does not include any amount of interest, collection expense including, but not limited to, attorney's fees and expenses incurred in preserving, protecting improving, or insuring property which serves as collateral for the

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[12] The SBA uses a similar closing procedure for 504 Loans in Florida.

[13] *Id.*

[14] *Id.*

[15] TENN. CODE ANN. § 67-4-409(b)(5).

indebtedness, or any other amount, other than the principal debt or obligation, for which a debtor becomes liable unless such amount is added to the principal debt or obligation, and is used to calculate additional interest pursuant to refinancing, reamortization, amendment or similar transaction or occurrence."[16]

If the amount of the indebtedness increases subsequent to the filing or recordation of an instrument, the holder of the indebtedness is responsible for paying tax on the amount of the increase.[17] It is the duty of every holder of an indebtedness to collect the tax imposed by TENN. CODE ANN. § 67-4-409(b) from the debtor and to timely remit the required tax.[18]

The recording of more than one instrument evidencing the same indebtedness does not result in the imposition of the recordation tax on each instrument.[19] The use of the proposed Assignment and Modification Agreement and 504 Renewal Note to take an assignment of the interim lender's note and associated liens represents the recording of more than one instrument evidencing the same indebtedness. Thus, provided the interim loan documentation reflects that the tax has previously been paid on the indebtedness evidenced by the interim lender's Deed of Trust and any modifications, upon recordation of the Assignment and Modification Agreement at the time the 504 Loan is closed, the 504 Borrower would be obligated to pay additional tax only on the amount of the increased indebtedness. If the loan amount does not change between SBA approval of the 504 Project and the debenture sale, no additional tax would be due. Likewise, if the loan amount decreases between SBA approval of the 504 Project and the debenture sale, no additional tax would be due.

APPROVED: David Gerregano
Commissioner of Revenue

DATE: 7/22/19

[16] *Id.*

[17] TENN. CODE ANN. § 67-4-409(b)(8).

[18] TENN. CODE ANN. § 67-4-409(b)(12).

[19] *Health and Educational Facilities Bd. of Shelby County v. King*, 678 S.W.2d 14, 16 (Tenn. 1984).