MONDAY, DECEMBER 3, 2007

THE DAILY RECORD

MARYLAND'S BUSINESS & LEGAL NEWS SINCE 1888

On Real Property

Changing the rules on transfer taxes

New recordation and transfer tax on 'controlling interests' will have significant impact on real estate owners

After 17 years of debate, the General Assembly has passed a new transfer and recordation tax on the transfer of "controlling interests" in a business entity that owns real estate in Maryland. This new tax is one of the "corporate loopholes" sought to be closed by Gov. Martin O'Malley in the recent Special Session of the General Assembly. It is based on similar taxes in Delaware, Pennsylvania, New York and the District of Columbia and will become effective in Maryland on July 1, 2008.

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That was then —

The current transfer and recordation tax regime in Maryland imposes such taxes upon the privilege of recording an "instrument of writing" (e.g., a deed) in the land records. The combined transfer and recordation taxes in Central Maryland (up to 3 percent) are some of the highest rates in the United States.

Because of the high incidence of transfer and recordation taxes in Maryland, commercial real estate owners for years have sought to avoid such taxes by selling up to 100 percent of the intangible ownership interests in a business entity that owns the real estate. Because such transfers do not involve an "instrument of writing" that is recorded in the land records, no transfer or recordation tax applies. Meanwhile, when a pass-through entity such as a partnership or LLC is purchased, the underlying entity can "step up" its income tax basis in the property to reflect the purchase price paid. The Maryland State Department of Assessments and Taxation (SDAT) has complained that it is not able to readily obtain the purchase price or value of the property involved for real property tax assessment purposes, since the consideration is not disclosed in any public filing.

Because of this perceived abuse, Maryland legislators have proposed extending the transfer and recordation tax to the transfer of "controlling interests" in a "real property entity." This proposal dates back to 1991, but has never been approved by the Maryland Senate until this year. While New York, Pennsylvania, Delaware, and the District of Columbia have such statutes, this is a not a uniform statute, so the words and phrases in Maryland's new law will need to be interpreted.

This is now

The new law (contained in Tax Property Article §12-117(c) and §13-103(b)) provides for a transfer and recordation tax on the transfer of a *controlling interest* in a *real property entity*, thereby taxing the transfer to the same extent as if the real property, *directly or beneficially owned* by the real property entity, was conveyed by an instrument of writing that is recorded with the clerk of the circuit court for a county or filed with the SDAT.

A "controlling interest" is defined to mean more than 80 percent of: (a) the total value of all classes of stock of a corporation, (b) the total interest in capital and profits of an unincorporated entity or (c) the beneficial interest in a trust.

A "real property entity" (RPE) means a corporation, partnership, association, limited liability company, limited liability partnership, other unincorporated form of doing business, or trust that directly or beneficially owns real property that: (a) constitutes at least 80 percent of the value of its assets; and (b) has an aggregate value of at least $1 million. However, a RPE does not include an entity with land holdings that are subject to an agricultural use assessment (i.e., a farm). "Real property" means real property located in Maryland; however, it does not include unrecorded leases or mortgages, deeds of trust or other liens on real property that secures a debt on real property.

The tax is imposed on the consideration payable for the transfer of the controlling interest. The consideration includes any mortgage or other lien on the real property owned by the RPE and any other debt or encumbrance of the RPE. However, such consideration is reduced by the amount allocable to other assets of the RPE. If the RPE fails to establish the consideration, the tax is imposed on the assessed value of the real estate.

The RPE must file a report with the SDAT of any transfer of a controlling interest in the RPE that is completed within a period of 12 months or less, within 30 days following the date of the final transfer. The report shall include the consideration paid, the amount of excluded assets *and any exemption claimed* (see sidebar). Any tax due is *an obligation of the RPE*, not the transferor or transferee.

Unresolved issues

• *Constitutional limitations.* There will be some valid questions about the ability of Maryland to reach and tax out-of-state transfers of controlling interests. For example, in *Northern Central Railway vs. Fidelity Trust Company*, 152 Md. 94 (1927), the Maryland Court of Appeals recognized that a state may not impose an inheritance tax on the transfer of stock in a foreign corporation owned by a non-resident merely because the corporation was doing business, and had a large proportion of its property located, in the taxing state. Accordingly, Maryland may have a difficult time taxing transfers by out-of-state owners of controlling interests.

• SDAT *regulations.* The SDAT is to promulgate regulations, including additional standards and exemptions. It remains to be seen how the SDAT will extend or interpret the §12 108 exemptions (which apply to instruments of writing) to transfers of controlling interests. Also, it is unclear whether the SDAT has authority to adopt other exemptions. For example, many transfers may meet the statutory exemptions in the new statute. But will they still need to be reported? If so, the SDAT may be inundated with reports claiming exemption from the new tax.

Conclusion

The new tax will change the way buyers and sellers transfer real property in Maryland. However, it remains to be seen whether the new law will have the intended effect sought by the governor and the General Assembly.

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Exemptions to the new rule

Several exemptions will apply as follows:

(a) the same exemptions are to apply as the statutory exemptions for instruments of writing in TPA Section 12-108 (including between spouses, corporate transfers, complete dissolutions, LLC conversions, etc.);

(b) transfers completed over a period of more than 12 months or not made in accordance with a Plan of Transfer are also exempt. (A Plan of Transfer does not include a series of sales of shares of a publicly traded entity);

(c) exemptions also apply to transfers of a controlling interest to another business if the transferee business entity is held by the same persons and in the same proportions, as well as transfers by or to subsidiary corporations; and

(d) transfers to a non-stock corporation that is registered with the Department of Aging as a continuing care retirement community are also exempt.

Other exemptions include:

• the pledge of stock or other interest in a RPE as security for a loan; and

• the admission of additional equity owners to the RPE incident to the raising of capital, if (a) effective management is not changed and (b) the new members are not expected to participate in the day-to-day management of the RPE.

— Robert M. Ercole