SOMETIMES IT PAYS TO BE A "CONTROL" FREAK
Avoiding Maryland's Transfer Tax Trap

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Most property owners are aware that transfer and recordation taxes must be paid when real estate is bought or sold. Such taxes are generally imposed on the recordation of a deed and are based on the consideration paid for the property. One method previously employed to avoid the imposition of such taxes involved the contribution of real estate to an entity, such as a limited liability company, followed by a sale of the interest in the entity. Under this strategy, effective ownership of the underlying real estate could be transferred, as a result of a change in the actual ownership of the entity, without having to record a deed, thereby avoiding the payment of transfer and recordation taxes.

Unfortunately for property owners, however, many states, including Maryland, have enacted statutes (known as controlling interest statutes) designed to prevent the avoidance of transfer and recordation taxes through the use of the technique described above. Maryland's controlling interest statute, contained in Section 12-117 of the Tax-Property Article of the Annotated Code of Maryland (the "Statute"), imposes tax on the sale of an interest in an entity that owns real estate if two conditions exist. First, there must be a transfer of a "controlling interest" in an entity, and second, such entity must be a "real property entity."

Regarding the first condition, a "controlling interest" is defined as the ownership of more than 80% of the interests of the entity, e.g., more than 80% of the total value of the stock of a corporation, or more than 80% of the total interests of a limited liability company. Regarding the second condition, a "real property entity" is defined as an entity that owns real property, the value of which (i) constitutes at least 80% of the value of all of the entity's assets, and (ii) is at least $1,000,000.

If both conditions are satisfied, then the Statute imposes a tax on the transfer of the controlling interest in the real property entity in the same manner as if the real property owned by the entity was actually conveyed by an instrument recorded with the clerk of the circuit court for the county in which the property is located. Thus, the Statute can be a trap for the unwary because it imposes a transfer and recordation tax even though no document is recorded in connection with the sale and transfer of the controlling interest in the real property entity.

The Statute, however, provides for certain exceptions which, when coupled with careful planning, may allow a sale to be structured to avoid the imposition of tax. One such exception provides that no tax is due if the transfer of a controlling interest in a real property entity is effectuated in more than one transaction if the transfer is completed over a period of more than 12 months. Thus, application of the Statute may be avoided if the transfers that result in an ownership change of more than 80% can be spread out over more than 12 months. Caution must be exercised, however, in qualifying under this exception, as a judicial principle exists that may allow the State to impose tax under the Statute where the facts and circumstances indicate that the transfers, which resulted in an ownership change of more than 80% spread out over more than 12 months, were component parts of a pre-arranged plan with purpose of avoiding application of the Statute.

Another way to structure a transaction to avoid imposition of tax under the Statute is to transfer non-real estate assets, e.g., cash, marketable securities, etc., to the entity so that less than 80% of the entity's value is comprised of real property, thereby ensuring that the entity does not meet the definition of a "real property entity." As discussed above, the Statute applies only to an entity in which more than 80% of its value is attributable to real property. Again, careful planning and structuring is necessary to prevent the State from successfully asserting that the structure was part of a pre-arranged plan designed solely to avoid application of the Statute.

The Statute contains other exceptions that, depending upon the particular facts and circumstances, may allow property owners to avoid the imposition of tax under the Statute.

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