

Department of Legislative Services
Maryland General Assembly
2014 Session

FISCAL AND POLICY NOTE

Senate Bill 106

(Chair, Budget and Taxation Committee)(By Request -
Departmental - Assessments and Taxation)

Budget and Taxation

Ways and Means

**Recordation and Transfer Taxes - Transfer of Property Between Business Entities
- Reorganizations - Exemption**

This departmental bill exempts from the recordation tax and the State transfer tax the transfer of real property between specified business entities as part of a reorganization under Section 368(a) of the Internal Revenue Code (IRC).

The bill takes effect July 1, 2014, and applies to all instruments of writing recorded on or after July 1, 2014.

Fiscal Summary

State Effect: State transfer tax revenues may decrease beginning in FY 2015 to the extent transfers pursuant to the bill occur. Based on the number of transfers of this type that occur each year, the revenue decrease is expected to be minimal. State expenditures are not affected.

Local Effect: Local recordation tax revenues may decrease beginning in FY 2015 to the extent transfers pursuant to the bill occur. Based on the number of transfers of this type that occur each year, the revenue decrease is expected to be minimal. Local expenditures are not affected.

Small Business Effect: The State Department of Assessments and Taxation (SDAT) has determined that this bill has minimal or no impact on small business (attached). The Department of Legislative Services concurs with this assessment.

Analysis

Current Law: Chapters 452 and 453 of 2013 exempted from the recordation tax and the State transfer tax the transfer of real property between a parent business entity and its wholly owned subsidiary or between subsidiaries wholly owned by the same parent business entity if the instrument of writing is for no consideration; nominal consideration; or consideration that comprises only the issuance, cancellation, or surrender of partnership interests, membership interests, or the ownership interest stock of a subsidiary business entity. Chapters 452 and 453 also exempted from the recordation tax and the State transfer tax the transfer of real property between a subsidiary business entity and its parent business entity under specified circumstances.

A business entity is defined as a limited liability company or corporation. Ownership interest is defined as a membership interest or stock.

Background: This bill includes the limited liability company (LLC) business entity type within the exemption in Tax-Property Article, § 12-108(p)(2). Chapters 452 and 453 amended subsections 12-108(p)(1) and (p)(3) and 13-207(a)(9) which created a definition of the term “business entity” to include both corporations and limited liability companies and used that new term in subsections (p)(1) and (p)(3). However, the legislation did not change the language of subsection (p)(2).

SDAT reports that subsection (p)(2) was created by legislation in 1975 of which the primary purpose was to enlarge the scope of transfer taxes to include corporate organizational transactions that effectively transferred ownership of real property. Subsection (p)(2) was an exception to, or an exemption from, the newly enacted larger scope of taxation that only impacted corporations. SDAT reports that it has, with an exception, applied this exemption only to corporations which was also consistent with the language and application of subsections 12-108(p)(1) and (3) prior to the 2013 legislation.

In 1997, the Internal Revenue Service (IRS) changed its regulations to allow an LLC to elect to be treated as if it were a corporation for federal income tax purposes. This meant that an LLC could utilize an IRC § 368(a) reorganization. Since the language of § 12-108(p)(2) has always referenced IRC § 368(a), LLCs began filing for an exemption under this subsection because the IRS was allowing them to reorganize under that IRC section. Initially, SDAT did not recognize the fact that this change in federal regulations did not actually change the language of IRC § 368(a), which only refers to corporations, and did not change a state law that referenced § 368(a). As a result, while some LLC reorganizations were allowed to use the § 12-108(p)(2) exemption for a period after the change in federal regulations, that was corrected in 2006 when SDAT adopted its current position that that subsection only addresses corporate reorganizations and the fact that an

LLC can be treated as if it were a corporation under the federal income tax law does not mean that an LLC is a corporation under Maryland real property transfer tax law.

However, because of the change in the IRS regulations, there have been business entities which have filed transactional documents with SDAT claiming an exemption under § 12-108(p)(2) only to learn that under the department's position, the transaction was taxable. Because of that confusion, there ultimately was a challenge of the department's position, but both the Tax Court and the Circuit Court for Baltimore City have upheld the SDAT's position. (*Super-Concrete Corporation v. State Department of Assessments and Taxation*; Circuit Court for Baltimore City; Case No. 24-C-12-05678 (May 24, 2013). SDAT reports that this decision has been appealed to the Court of Special Appeals.

SDAT reports that there is likely to be additional confusion resulting from the changes made by Chapters 452 and 453. Because the newly defined term encompasses both corporations and limited liability companies in § 12-108(p)(1) and (3) and because of the reference to IRC § 368(a), which does allow an LLC to be treated as a corporation, in § 12-108(p)(2), the current historic interpretation of subparagraph (p)(2), which has been upheld by the courts, is inconsistent with the new scope of (p)(1) and (p)(3). Accordingly, SDAT advises that this subsection requires clarification as proposed by the bill.

Local Recordation and Transfer Taxes

The counties and Baltimore City are authorized to impose locally established recordation tax rates on any business or person (1) conveying title to real property or (2) creating or giving notice of a security interest (*i.e.*, a lien or encumbrance) in real or personal property, by means of an instrument of writing.

The State and most counties impose a transfer tax. The State transfer tax rate is 0.5% of the consideration payable for an instrument of writing conveying title to, or a leasehold interest in, real property (0.25% for first-time Maryland homebuyers). In some jurisdictions, a local property transfer tax may be imposed on instruments transferring title to real property. A distinction is made in the local codes between instruments transferring title such as a deed and certain leaseholds and instruments securing real property such as a mortgage.

For purposes of local recordation taxes, which are applied to each \$500 or fraction of \$500 of consideration payable or of the principal amount of the debt secured for an instrument of writing, the consideration includes the amount of any mortgage or deed of trust assumed by the grantee. For purposes of the State transfer tax, the consideration includes the amount of any mortgage or deed of trust assumed by the grantee.

County governments collected \$553.0 million in local recordation and transfer taxes in fiscal 2012, and are expected to collect \$671.3 million in fiscal 2013 and \$656.8 million in fiscal 2014. These amounts are significantly lower than the amounts collected in fiscal 2006 when the soaring real estate market yielded recordation and transfer taxes totaling \$1.2 billion. **Exhibits 1 and 2** show current recordation and transfer tax rates and estimated local recordation and transfer tax collections for fiscal 2013 and 2014.

State Fiscal Effect: State special fund revenues may decrease beginning in fiscal 2015 to the extent that properties are transferred pursuant to the bill (transfers between specified business entities). However, the amount of any decrease depends on the number of transfers that occur pursuant to the bill and the amount of consideration associated with each transfer. SDAT reports that between 1999 and 2012, there have been 75 transactions of the type exempted by the bill. Due to the fact that there are less than 6 of these types of transfers each year, the overall effect on State transfer tax revenues is expected to be minimal.

As a point of reference, the State transfer tax on a transaction valued at \$250,000 is \$1,250. An exemption pursuant to the bill would result in a special fund revenue decrease of \$1,250 for each property transfer affected.

Local Fiscal Effect: Local recordation tax revenues may decrease beginning in fiscal 2015 to the extent that properties are transferred pursuant to the bill (transfers between specified business entities). However, the amount of any decrease depends on the number of transfers that occur pursuant to the bill and the amount of consideration associated with each transfer. As noted, due to the expected small number of this type of transfer each year, the overall effect on local recordation tax revenues is expected to be minimal.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): State Department of Assessments and Taxation, Department of Legislative Services

Fiscal Note History: First Reader - January 20, 2014
mc/hlb

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Exhibit 1
County Recordation Tax Collections
Fiscal 2013 and 2014

| County | Tax Rate | FY 2013 | FY 2014 |
|-----------------|-----------------|----------------------|----------------------|
| Allegany | \$3.50 | \$1,692,145 | \$1,050,000 |
| Anne Arundel | 3.50 | 39,000,000 | 36,500,000 |
| Baltimore City | 5.00 | 28,645,000 | 23,367,000 |
| Baltimore | 2.50 | 30,000,000 | 25,500,000 |
| Calvert | 5.00 | 5,909,376 | 6,000,000 |
| Caroline | 5.00 | 1,301,909 | 1,100,000 |
| Carroll | 5.00 | 10,021,395 | 9,750,000 |
| Cecil | 4.10 | 5,535,807 | 4,800,000 |
| Charles | 5.00 | 11,104,089 | 10,500,000 |
| Dorchester | 5.00 | 1,434,291 | 1,534,386 |
| Frederick | 6.00 | 24,339,679 | 22,453,062 |
| Garrett | 3.50 | 2,300,000 | 2,000,000 |
| Harford | 3.30 | 10,699,395 | 10,200,510 |
| Howard | 2.50 | 21,837,593 | 20,098,864 |
| Kent | 3.30 | 962,237 | 1,010,000 |
| Montgomery | 3.45 | 103,878,439 | 103,658,874 |
| Prince George's | 2.75 | 27,563,300 | 28,391,400 |
| Queen Anne's | 4.95 | 4,614,108 | 3,820,000 |
| St. Mary's | 4.00 | 5,688,996 | 5,100,000 |
| Somerset | 3.30 | 437,714 | 350,000 |
| Talbot | 6.00 | 4,900,000 | 5,050,000 |
| Washington | 3.80 | 5,213,999 | 5,000,000 |
| Wicomico | 3.50 | 2,249,756 | 2,516,123 |
| Worcester | 3.30 | 6,648,659 | 6,000,000 |
| Total | | \$355,977,887 | \$335,750,219 |

Source: Department of Legislative Services

Exhibit 2
County Transfer Tax Collections
Fiscal 2013 and 2014

| County | Tax Rate | FY 2013 | FY 2014 |
|-----------------|-----------------|----------------------|----------------------|
| Allegany | 0.50% | \$300,696 | \$350,000 |
| Anne Arundel | 1.00% | 38,000,000 | 36,500,000 |
| Baltimore City | 1.50% | 23,371,000 | 24,948,000 |
| Baltimore | 1.50% | 50,000,000 | 52,000,000 |
| Calvert | 0.00% | 0 | 0 |
| Caroline | 0.50% | 377,400 | 210,842 |
| Carroll | 0.00% | 0 | 0 |
| Cecil | \$10/deed | 23,946 | 20,000 |
| Charles | 0.00% | 0 | 0 |
| Dorchester | 0.75% | 619,002 | 650,000 |
| Frederick | 0.00% | 0 | 0 |
| Garrett | 1.00% | 1,375,000 | 1,150,000 |
| Harford | 1.00% | 10,854,826 | 9,600,000 |
| Howard | 1.00% | 25,253,440 | 27,000,000 |
| Kent | 0.50% | 451,355 | 580,000 |
| Montgomery | 1.00% | 85,409,701 | 86,684,000 |
| Prince George's | 1.40% | 66,661,700 | 68,664,800 |
| Queen Anne's | 0.50% | 1,351,064 | 1,650,000 |
| St. Mary's | 1.00% | 4,268,826 | 4,350,000 |
| Somerset | 0.00% | 0 | 0 |
| Talbot | 1.00% | 2,600,000 | 2,500,000 |
| Washington | 0.50% | 1,484,247 | 1,400,000 |
| Wicomico | 0.00% | 0 | 0 |
| Worcester | 0.50% | 2,912,622 | 2,750,000 |
| Total | | \$315,314,825 | \$321,007,642 |

Source: Department of Legislative Services

ANALYSIS OF ECONOMIC IMPACT ON SMALL BUSINESSES

TITLE OF BILL: Recordation and Transfer Taxes – Transfer of Property Between Business Entities – Reorganizations – Exemption

BILL NUMBER: SB 106

PREPARED BY: Department of Assessment and Taxation

PART A. ECONOMIC IMPACT RATING

This agency estimates that the proposed bill:

WILL HAVE MINIMAL OR NO ECONOMIC IMPACT ON MARYLAND SMALL BUSINESS

OR

WILL HAVE MEANINGFUL ECONOMIC IMPACT ON MARYLAND SMALL BUSINESSES

PART B. ECONOMIC IMPACT ANALYSIS

The economic impact on small business is minimal because there have been an average of only 5 of these transactions per year for the last 14 years, and it is indeterminate how many small businesses had a “reorganization” of an LLC that is affected by the proposed change in the law.