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TRANSFER AND RECORDATION TAX SAVINGS:
BUSINESS TRUSTS AND OTHER STRATEGIES FOR STRUCTURING
NON-TAXABLE TRANSACTIONS.

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WHEN COMMERCIAL TENANTS FILE FOR BANKRUPTCY –
THEN WHAT? : SURVIVAL STRATEGIES FOR LANDLORDS
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**TRANSFER AND RECORDATION TAX SAVINGS:
BUSINESS TRUSTS AND OTHER STRATEGIES
FOR STRUCTURING TRANSACTIONS**

- I. Maryland Business Trusts – Why Just About Everyone in Commercial Real Estate Should Be Using Them (Instead of LLCs)
 - A. Why not a limited liability company (LLC)?
 1. Advantages to an LLC
 - a. Flexible
 - b. Accepted in the market (particularly by investors and lenders)
 - c. Only true conversion provided for Maryland entities under Maryland law is from a partnership into an LLC
 - d. Recordation and transfer tax exemptions for transfers from a predecessor partnership or a predecessor “real estate enterprise” to a clone LLC
 2. Disadvantages to an LLC
 - a. Once real property is in an LLC, there is only one exemption for a transfer out (transfer to original member(s) upon liquidation and termination of the LLC) – no exemptions for transfers to wholly-owned subsidiaries or affiliates owned by the same members
 - b. And there’s a form of entity that provides almost the same flexibility as an LLC, but has additional benefits and possibilities: a Maryland business trust
 - B. Why use a Maryland business trust?
 1. Recordation and transfer tax exemptions available
 - a. For purposes of recordation and transfer taxes, a business trust is treated as a corporation (while an LLC is not – LLCs are their own category)
 - b. This means that the exemptions for articles of merger of two or more corporations, for articles of consolidation of two or more corporations, and for parent/sub, sub/sub, and sub/parent transfers (with certain limitations) are available to business trusts
 2. Income tax treatment
 - a. Can be treated as a disregarded entity, partnership, or corporation, just like an LLC

- b. Can also qualify to be treated as a grantor trust, if structured properly – which means that a business trust can be used as a vehicle for 1031 exchanges of partial interests in property, instead of arranging a tenancy-in-common structure (and instead of paying recordation and transfer taxes on each transfer of a TIC interest – just try to avoid the tax on transfers of a “controlling interest”)

3. Maryland business trust can be a series business trust

- a. If a business trust is properly divided into series, “then the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to a particular series shall be enforceable against the assets of that series only, and not against the assets of the business trust generally or any other series, and, unless otherwise provided in the governing instrument, none of the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to the business trust generally or any other series shall be enforceable against the assets of that series”
- b. Delaware has provided for series LLCs, but Maryland has instead provided for series business trusts (which probably makes more sense)
- c. Useful for holders of numerous interests – it’s like having multiple entities for the price of one (at least for SDAT filing fees)

C. What’s the catch?

1. Although business trusts have been around for more than a century, statutory versions are rather new (Maryland’s only dates to 1999), which means that many are unfamiliar with them (which can be a problem if your lender, investor, or other source of funds doesn’t understand them and doesn’t want to make the effort to get comfortable with them)
2. There isn’t an exemption for a transfer from a predecessor partnership or predecessor “real estate enterprise”
3. Series business trusts (or series LLCs) – many unknowns
 - a. Will there be ways around the limitations on liability between each series and between each series and the whole business trust? Will it be in the same vein as “piercing the veil” and “alter ego,” or will it be easier to break the barrier?
 - b. How will bankruptcy courts deal with a bankrupt series or a bankrupt business trust (if other series are solvent)? Will bankruptcy courts be more likely or less likely to apply substantive consolidation rules to a series business trust?

4. Why not a foreign business trust (such as a Delaware statutory trust)?
 - a. Disagreement as to whether foreign business trusts need to (or even can) register to do business in Maryland (and if they need to, how do they do so) – unlike the LLC Act, the Business Trust Act does not address foreign business trusts
 - b. My position – this was settled in a 1930 Opinion of the Attorney General which says a foreign business trust is, and should register as, a “foreign corporation” under Maryland law (and the definition of “foreign corporation” remains essentially as it was in 1930 and is essentially the same as the definition in the Tax-Property Article that makes a business trust a “corporation” for recordation and transfer tax purposes)
 - c. SDAT position as expressed to me – foreign business trusts do not need to, and cannot, register to do business in Maryland (no applicable requirement for registration or authorization to register)
 - d. Alternative often seen – foreign business trust files a modified certificate of trust with SDAT (usually gets filed without problem, but seems to me to be a second chartering of the business trust as a Maryland business trust – which leads to the dual chartering problems that are the reason one rarely sees double chartering anymore)

II. Transfers of Controlling Interests – Things to Keep in Mind

- A. Investments of additional capital for the issuance of new interests are outside the scope of the tax if the day-to-day management remains the same and the new investors are not expected to participate in the day-to-day management
- B. Entities whose Maryland real property assets are worth less than \$1,000,000 are not “real property entities” and thus transfers of interests in such entities are outside the scope of the tax
- C. Entities whose Maryland real property assets are less than 80% of its assets are not “real property entities” and thus transfers of interests in such entities are outside the scope of the tax
- D. But keep in mind that a cumulative transfer of 80% or more within one year falls within the statute and at least triggers the reporting requirement (even if exempt – e.g., not an intentional “plan of transfer”)

Office of the Attorney General

200 St. Paul Place
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DATE: June 11, 1998

TO: All Clerks of the Circuit Courts

FROM: Julia Freit, Assistant Attorney General *JMF*

SUBJECT: Tax-Property Article, §12-108(p) - Application to Business Trusts

A question has arisen regarding application of the exemption under Tax-Property Article (hereinafter "TP"), §12-108(p)(1) to a conveyance from a corporation to a business trust that is wholly owned by the corporate grantor. This raises a question regarding the meaning of "corporation" as used in the exemption. For the following reasons, I have concluded that the exemption applies.

Under TP §12-108(p)(1), a conveyance of property from a parent corporation to a subsidiary corporation, or between two subsidiary corporations wholly owned by the same parent corporation, for no consideration, nominal consideration, or consideration comprised of only the issuance, cancellation, or surrender of stock of the subsidiary corporation, is not subject to recordation tax. This exemption is made applicable to State transfer tax and county transfer tax by TP §§13-207(a)(9) and 13-405(c).

While "corporation" is not defined in the Titles 12 and 13 definition sections, §§12-101 and 13-101, it is defined in TP §1-101(f). As defined, the term includes "an association or joint-stock company," and expressly excludes "a common trust fund as defined in §3-501(b) of the Financial Institutions Article." This definition of "corporation" was added to Article 81 by Acts of 1929, Chapter 226 as part of a major revision of the tax laws. The revision was based on the December 1, 1928 Report of the Tax Revision Commission Appointed under the Act of 1927, Chapter 687. The report was accompanied by a draft bill. The revisor's note following the proposed definition of "corporation" states as follows: "This provision is new. It is intended to take care of so-called 'Massachusetts trusts' and similar unincorporated associations which have a quasi-corporate organization and most of the attributes of corporations."

A business trust - some types of which are a common law trust, Massachusetts trust, and real estate investment trust (REIT)- historically has been considered to be an unincorporated association that has quasi-corporate organization and most of the attributes of a corporation. In 15 *Opinions of the Attorney General* 81 (1930), the Attorney General, relying on the definition of "corporation" in Article 81, determined that a Massachusetts Trust must comply with the laws of this state relating to registration and taxation of foreign corporations. The opinion stated that "all doubt with respect to the power of the state to treat Massachusetts Trusts as corporations within the meaning of the laws relating to registration and taxation, has been foreclosed by the Supreme Court of the United States

in the recent case of *Hemphill vs. Orloff*, 277 U.S. 537, 72 L. Ed. 978.”

As explained in *Laws of Corporations and Other Business Entities* by Harry G. Henn and John R. Alexander (1983), pp. 117-124, Massachusetts trusts were developed and used to achieve limited liability and to avoid the restrictions then existing on corporations acquiring and developing real property; this type of trust has been perpetuated in more modern times by the investment trust and REITs. Corporations and Associations Article, §3-101(d) defines “business trust” as “an unincorporated trust or association, including a common-law trust, Massachusetts trust, or Maryland real estate investment trust as defined in §8-101(b) of this article, which is engaged in business and in which property is acquired, held, managed, administered, controlled, invested, or disposed of by trustees for the benefit and profit of any person who may become a holder of a transferable unit of beneficial interest in the trust.”

The exemption currently set forth in TP §12-108(p) was enacted in 1975. Chapter 268 of the Acts of 1975 indicated that its purpose was for “imposing a recordation tax and property transfer tax when an instrument of writing is filed with the State Department of Assessments and Taxation pursuant to a sale, lease, exchange, or other transfer of all or substantially all the property and assets of a corporation, subject to certain exceptions.” New subsection (t) of §277 of Article 81 provided, in pertinent part, as follows:

Notwithstanding the other provisions of this section, on the filing with the State Department of Assessments and Taxation of articles of sale, lease, exchange or other transfer of all or substantially all the property and assets of a corporation under §3-112 of the Corporations and Associations Article, the Department shall collect the tax at the rate of \$1.65 for each \$500 of the actual consideration paid or to be paid for any real property or improvement thereto so transferred.

The tax shall not apply to (1) the transfer of title to real property between a subsidiary corporation and its parent corporation for no consideration, for nominal consideration, or in sole consideration of the issue or the cancellation or surrender of a subsidiary’s stock, or (2) the transfer of title to real property between two or more subsidiary corporations wholly-owned by the same parent corporation for no consideration, for nominal consideration, or in sole consideration of the issue or cancellation or surrender of a subsidiary’s stock, or (3) deeds made pursuant to reorganizations within the meaning of section 368(a) or in accordance with sections 371 to 374 inclusive of the Internal Revenue Code.

At the time of this enactment, Article 81 included the definition of “corporation” referenced above.

Finally, it is noteworthy that the various exemptions from recording taxes set forth in TP 12-108 that pertain to business entities never separately reference a business trust. For example, TP §12-108(q) relates to liquidation, dissolution, or termination of an entity and conveyance of real property from the entity to an original owner of the entity, an original owner’s direct descendant or relative

within 2 degrees, or a person who acquired an ownership interest in the entity by gift or bequest from the original owner. This exemption expressly references a corporation, limited liability company, and partnership. It contains no reference to a business trust. This omission of any express reference to a business trust supports the view that the word "corporation" includes a business trust. Because the term "corporation," as defined in TP §1-101(f), includes a business trust, there is no need to separately reference a business trust.

Therefore, I have concluded that the exemption in TP §12-108(p) includes transfers involving business trusts which own or are owned by corporations. Since the word "corporation" as used in that exemption includes a business trust, the term "stock" as used in the exemption must be construed as including units of transferrable interest in a business trust, also sometimes referred to as a "shares." See CA §8-101(c).

If you have any questions regarding this matter, please do not hesitate to contact me.

cc: David M. Lyon, Assistant Attorney General

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June 3, 1998

MEMORANDUM

TO: Jack Schwartz
Julia Freit

FROM: David M. Lyon *DML*

RE: Tax-Property Article, § 12-108(p)

Reference is made to the memorandum from Julia Freit to Jack Schwartz dated April 22, 1998. That memorandum raised the question whether a Real Estate Investment Trust (REIT) should be considered a corporation for purposes of Tax-Property Article, § 12-108(p). Julia came to the conclusion that it should. I would agree with that conclusion, but for slightly different reasons.

Tax-Property Article, Title 12 imposes a transfer tax on the filing of an instrument of writing that conveys real property. TP § 12-108(p)(1) creates an exemption from transfer tax (and recordation tax under TP § 13-207(a)(9)) when an instrument of writing is filed transferring property between a parent corporation and a subsidiary corporation. That section does not specifically address REIT's. However, it has always been the policy of SDAT when interpreting the subsections of § 12-108 that the references to corporations should be read literally and not encompass the other legislatively recognized entities, e.g., limited liability companies, limited partnerships and limited liability partnerships. Although the public has occasionally complained that this interpretation lacks logic, the General Assembly has specifically listed those entities when it intended to include them in the exemption (e.g., subparagraph (q)). Additionally, SDAT is aware of the legislative history of these subsections, many of which have been responses to creative loopholes avoiding the tax on transfers by corporations. The General Assembly has responded by selecting

those types of transactions which will be exempt. Consequently, SDAT has refused to extend those exemptions to similar transactions involving other entities. Accordingly, the initial response to the question of including a REIT as a corporation for purposes of § 12-108 was negative. However, a further review has reversed that determination.

Title 1 includes the definition section for the entire Tax-Property Article and defines "corporation" in § 1-101(f) as including an association or joint stock company. The genesis of that language was the Report of the Maryland Tax Revision Commission appointed under the Act of 1927, Chapter 687 (December 1, 1928). That report addressed the recodification of the tax laws existing at that time and included proposed language for a new Article 81. The Report also included an editor's note to explain the new definition of corporation: "This provision is new. It is intended to take care of so-called 'Massachusetts trusts' and similar unincorporated associations which have a quasi-corporate organization and most of the attributes of corporations." That new Article was subsequently enacted in Chapter 226 Laws of Maryland 1929 which adopted the Report's definition of a corporation verbatim. That same definition remains materially unchanged today, 70 years later.

In *Appeal of Western Maryland Railway Company Volunteer Relief Department* (State Tax Commission of Maryland) (The Daily Record, May 31, 1937), the State Tax Commission applied this definition of corporation. The Commission described the Western Maryland Railway Company Volunteer Relief Department as an unincorporated body whose members consisted entirely of employees of the company and its subsidiaries. Its purpose was to manage investments for those members and it was controlled by a general committee which was elected by either the members or the railroad company. The Commission held that this entity was included in the definition of corporation in Article 81.

Shortly thereafter, the Office of the Attorney General determined that a Massachusetts trust must comply with the corporate law of the State of Maryland for purposes of registration by a foreign corporation (15 Opinion of the Attorney General 81 (10/4/30)). That Opinion, citing *Hemp Hill v. Orloff*, 277 U.S. 537 as support, indicated that regardless of what you call an organization (a corporation, a partnership or a trust), you must look at how it functions. If it has the ordinary functions and attributes of a corporation, then it is subject to corporate law.

Laws Of Corporations And Other Business Entities (1983) by Harry G. Henn and John R. Alexander, a hornbook series published by the West Publishing Company, discusses a business trust, also known as a Massachusetts Trust (*Laws Of Corporation*, pp. 117-124.) It is described as an unincorporated business association established by a declaration or deed of trust and governed to a great extent by the laws of trusts. It was developed and used in Massachusetts from 1910 to 1925 to achieve limited liability and to avoid restrictions then existing on corporations acquiring and developing real property. The authors commented that this type of trust has really been perpetuated in more modern days by the modern investment trust and REIT's.

In Maryland, REIT's must comply with Corporations and Associations Article, Title 8. That Title defines REIT's as an unincorporated trust or association (C&A, § 8-101), but grants REIT's authority to function very similarly to a corporation. There are shareholders who own shares of the REIT; the shares can have different classes; and there is an election by the shareholders of trustees to manage the affairs of the REIT (See C&A, § 8-202-203). The REIT itself has powers similar to a corporation with limits on the type of investments (C&A, § 8-301 & 302) and can amend its charter and merge in a manner similar to a corporation. (C&A, § 8-501 *et seq.*). Finally, the liability of a REIT is limited to its assets (C&A, § 8-601) while shareholders and trustees are not personally liable except in situations of personal misconduct (Courts and Judicial Proceedings Article, § 5-419). Consequently, under Maryland law, a REIT is an unincorporated association with a quasi-corporate organization and most of the attributes of a corporation.

In summary, the definition of a corporation in the Tax-Property Article specifically includes an unincorporated association. The history of this section indicates that it was meant to include those associations that function similar to a corporation. Additionally, the legislative history affirms that the intent was to include a Massachusetts Trust, the predecessor of a modern day REIT. Finally, a real estate investment trust is defined in C&A, § 8-101 as an unincorporated trust or association with a quasi-corporate organization and most of the attributes of a corporation. More specifically, its purpose, under C&A, § 8-101, is to acquire, hold, manage, administer, control, invest and dispose of property by trustees for the benefit and profit of any person who may become a shareholder, a purpose or function similar to the Western Maryland Railway Company Volunteer Relief Department. Consequently, a REIT does fall within the definition of a corporation for the purposes of the Tax-Property Article.

My last hesitation stemmed from a concern about defining a REIT as a corporation for the Tax-Property Article while defining it as an unincorporated entity for the Corporations and Associations Article even though each Article has its own definitions. That hesitancy was resolved with a review of the Tax-General Article which has an identical definition of corporation in the income tax provisions in TG § 10-101(b). TG § 10-304 subsequently defines Maryland modified income for "a corporation, including a real estate investment trust or regulated investment company". The special Revisor's Note to that section states as follows:

The first clause of the first sentence of former Article 81, § 313A(a), which treated a real estate investment trust as a corporation for tax purposes, was deleted by Chapter 2, Acts of 1988, as unnecessary since these trusts fall within the broadly defined terms "corporation" and "person" in this article and the Tax-Property Article.

Based on the above, it is my conclusion that the term "corporation" as defined in the Tax-Property Article does include REIT's. Consequently, a transfer involving a REIT would be entitled to the exemption under § 12-108(p) if it otherwise complied.

WHEN COMMERCIAL TENANTS FILE FOR BANKRUPTCY -- THEN WHAT?

- I. INTRODUCTION --Just a Bit You Need to Know About Commercial Bankruptcy
 - A. Voluntary or Involuntary
 - B. Chapters 7 and 11
 1. Chapter 7
 - a. Trustee appointed
 - b. Estate created -- all of Tenant's assets, including leases
 - c. Trustee closes down business, liquidates assets
 2. Chapter 11
 - a. Trustee generally not appointed
 - b. Tenant's management remains in control of business as the Debtor-in-Possession (DIP)
 - c. DIP may use or sell assets while formulating plan
 - d. Plan may provide for sale or continued use of assets
 - C. Automatic Stay
 1. Effective the moment the bankruptcy petition is filed
 2. Stays all actions against the Tenant
 3. Does not stay action against guarantors or letters of credit
 - D. In a Chapter 11 case, DIP has the powers of a Chapter 7 Trustee
- II. When Bankruptcy Strikes
 - A. All creditors, including Landlords, should be notified by the Court
 - B. Automatic Stay becomes effective immediately
 - C. Chapter 7
 1. Trustee appointed to close up shop -- almost always
 2. Landlord should deal directly with Trustee
 3. Trustee may try to assume and assign the lease

D. Chapter 11

1. Landlord should continue to deal with the Tenant as DIP
2. Tenant may continue to operate the business in leased premises
3. Tenant may close down and keep the leased premises dark

III. Post-Petition Obligations of the Trustee or DIP

A. Trustee/DIP is obligated to comply with most provision of the lease, including payment of rent, until the lease is assumed or rejected

1. Trustee/DIP rarely complies with all provision of the lease, especially payment of rent, until the lease is assumed or rejected
2. Landlord may move to compel payment of rent
3. Court may defer rent payment for 60 days upon showing of cause

B. Unpaid post-petition rent is an administrative expense

1. Landlord entitled to allowed administrative claim
2. Timing of payment of claim
3. Partial month rent
4. Non-rent obligations (taxes, CAM, utilities, attorneys' fees)

C. Excluded Obligations

1. 'Ipso facto' obligations
2. Penalty rent rates

IV. Rejection/Assumption/Assignment of Lease

A. Timing

1. If lease not assumed within 120 days, it is "deemed" rejected
2. One 90 day extension for cause = 210 days without consent
3. No further extensions without Landlord's consent
4. Motion to compel earlier decision to assume/reject

B. Decision to Assume/Reject

1. Business judgment of Trustee/DIP
2. Effect on Landlord rarely considered

C. Rejection of Lease

1. May result from inaction or affirmative action by Trustee/DIP
2. Lease is treated as 'breached' by Tenant -- not terminated
3. Premises must be returned to Landlord promptly
4. Motion to compel DIP to vacate and return premises

D. Assumption of Lease

1. Cure of most monetary and non-monetary defaults
2. Ipso facto defaults need no cure
3. Compensation for all pecuniary loss resulting from defaults
4. 'Adequate assurance' of prompt cure and compensation
5. 'Adequate assurance' of future performance under lease
6. Special requirements for adequate assurance of future performance under 'shopping center' lease
7. Lease is assumed with all terms (except ipso facto provisions)
8. Landlord may consent to amendments before assumption

E. Assignment

1. Lease is assumed, with all requirements outlined above
2. Assignee must comply with all such requirements
3. Anti-assignment provisions in lease generally unenforceable
4. Landlord may require additional security from assignee
5. Assignee (and guarantors) of lease must be at least as solvent as Tenant was when the lease was signed
6. Upon assignment, Trustee/DIP absolved of all claims arising under the lease or subsequent breach by assignee

V. Landlord Claims for Rejection of Lease Not Previously Assumed in Case

A. Rejection Treated as Pre-Petition Breach of Lease

1. Pre-petition, general, unsecured claim with no priority
2. Landlord may treat lease as terminated

- B. Claim Includes All Damages Allowed Under Lease and State Law
 - C. Claim for Unpaid Rent is "Capped" by Bankruptcy Code
 - 1. All pre-petition unpaid rent is allowed
 - 2. Prospective rent claim capped at "rent reserved by such lease . . . for the greater of one year or 15 percent, not to exceed three years, of the remaining term of such lease"
 - D. Claims Not Arising Solely from Rejection of Lease Are Not Capped
 - E. Claims Against Non-Bankrupt Guarantors Are Not Capped
 - F. Cap Does Not Apply to Letter of Credit Securing Lease
 - G. Mitigation of Damages Considered
 - H. Reduction of Rent Claim to Present Value
 - I. Security Deposit Applied to Capped Amount of Claim
- VI. Claim for Rejection of Lease Previously Assumed, But Not Assigned, in Case
- A. Post-Petition Claim
 - 1. Administrative claim for all monetary obligations due under lease for two years from the date of rejection of lease or turnover of premises
 - 2. General unsecured claim for any further damages arising from post-assumption breach -- subject to the same cap applicable to rejection of lease not previously assumed in case
 - B. Odds of Recovering on Claim
 - 1. Slim
 - 2. None
- VII. Survival Strategies
- A. Drafting the Lease
 - 1. Guarantors
 - 2. Security
 - 3. Letter of Credit
 - 4. 'Bankruptcy Provision'

B. What Not To Do When Bankruptcy Strikes

1. Do not ignore the bankruptcy
2. Do not violate the automatic stay
3. Do not sit on rights

C. What To Do When Bankruptcy Strikes

1. Require the Trustee/DIP to comply with Bankruptcy Code
2. File proof of claim
3. Look at potential opportunities
 - a. New, better Tenant
 - b. New lease provisions