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PHILADELPHIA BAR ASSOCIATION

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INDEPENDENT REGULATORY REVIEW COMMISSION

Tax Law Section

October 29, 2007

Mr. Kim Kaufman, Executive Director
kkaufman@irrc.state.pa.us
Independent Regulatory Review Commission
14th Floor
333 Market Street
Harrisburg, PA 17101

Re: Comments and Suggestions Concerning Final Proposed Regulations, Department of Revenue, 61 Pa Code, Chapter 91, Realty Transfer Tax ("RTT") Regulation Amendments (the "Final Proposed Regulations")

Dear Mr. Kaufman:

The notice of Filing of Final Rulemakings for the Final Proposed Regulations by the Department of Revenue (the "Department") interpreting the RTT was published in the *Pennsylvania Bulletin* on October 13, 2007. As explained below, the Tax Section of the Philadelphia Bar Association strongly believes that a number of important provisions contained in the Final Proposed Regulations are plainly contrary to law and sound policy. They also will have a significant chilling affect on the overall Pennsylvania real estate market. Accordingly, the Tax Section urges IRRC to reject the Final Proposed Regulations and request that the Department remedy the defects described below. We also request the opportunity to testify before IRRC at its public meeting on November 1, 2007.

The Final Proposed Regulations are extremely important to the real estate community and will affect thousands of transactions, many of them negatively. The Tax Section previously submitted extensive, detailed comments to the Draft Proposed RTT Regulations issued in 2000, the Proposed RTT Regulations issued in 2005, and the Draft Final Proposed Regulations issued in March 2007. Each of the practitioners who prepared these comments has decades of experience with the RTT and devotes a substantial portion of his or her practice to this area. The Department's response to our prior comments has been disappointing and inadequate, and very significant issues are presented in the Final Proposed Regulations. For example:

- The Final Proposed Regulations are directly contradictory to decisions of the Pennsylvania Supreme Court and Commonwealth Court. We have explained, in detail, why the regulations proposed by the Department are

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directly inconsistent with the decisions of the Pennsylvania Supreme Court and Commonwealth Court in *Allebach v. Commonwealth*, 546 Pa. 146, 683 A.2d 625 (1996), *Baehr Bros. v. Commonwealth*, 487 Pa. 233, 409 A.2d 326 (1979), and *Exton Plaza Associates v. Commonwealth*, 763 A.2d 521 (Pa Commw. 2000). Simply put, the Department is trying to reverse, through regulations, Supreme Court and Commonwealth Court decisions. Overturning court decisions requires an action of the legislature, not a regulation. The Department has offered no explanation of why it believes the regulations are consistent with these decisions.

- Like kind exchanges of real property are critical to the health of the real estate industry. By imposing significant and unwarranted taxes on like kind exchanges the Final Proposed Regulations could deter investors from investing in Pennsylvania real estate. In a transfer that is effectively between two parties, which should give rise to one transfer tax, the Final Proposed Regulations would result in the imposition of multiple transfer taxes. In our prior comments, we asked the Department to clarify that intermediaries used for purposes of like-kind exchanges of real estate could qualify for the RTT exclusion for agents and straw parties. The Comment and Response Document said that "the Department agrees" but the Final Proposed Regulations now provide <u>exactly the opposite</u> of what we had urged. The Department's response is misleading. In any event, we believe that the Department's position is contrary to law and will be struck down if challenged.

- We note that the Comment and Response Document prepared by the Department and submitted to you with the Final Proposed Regulations address comments that we made in 2005, but it appears to ignore the 27 pages of detailed comments we submitted in April 2007. You should be aware, therefore, that other very significant issues that were raised have not been addressed in the Final Proposed Regulations.

Our primary objections to the Final Proposed Regulations are summarized below. A more detailed discussion of our objections can be found in our April 2007 comments, a copy of which is attached.

A. <u>Section 91.152 – Confirmatory Deed</u>

This Section proposes new rules regarding conversions that are contrary to established law.

The proposed definition of *conversion* in § 91.101 includes a change in an entity's name or identity. Section 91.152 sets forth detailed and restrictive requirements that must be satisfied for a conversion not to be taxable. A change in name is not, in fact, a conversion in any

sense of the word. Nonetheless, under the Final Proposed Regulations, it appears that a partnership changing its name from ABC Partnership to XYZ Partnership and filing a confirmatory deed would incur a tax unless it meets the restrictions of § 91.152. That result is contrary to common sense and to long-standing RTT law.

The Final Proposed Regulations state rules that are contrary to *Exton Plaza Associates v. Commonwealth,* 763 A.2d 521 (Pa. Commw. 2000). In *Exton Plaza*, one partnership deeded real estate to another partnership in order to facilitate certain financing. The court held that the transfer was a conversion not subject to tax. The court stated: "[r]egardless of the details of how this 'conversion' was accomplished, the shopping center was essentially 'contributed' to the Limited Partnership ..." and RTT was not imposed. However, Final Proposed Regulations § 91.152 in Example 4 states that a conversion is taxable if there is a direct transfer from one entity to another. That requirement is flatly contrary to *Exton Plaza,* in which there was indeed a direct transfer of real estate. Thus, on the exact facts at issue in *Exton Plaza*, the Final Proposed Regulations would reach a result exactly the opposite of the result determined by the Commonwealth Court.

The Final Proposed Regulations further err in introducing a requirement in Example 3 that there be no change in management rights in a conversion. A change in management rights is not a change in the economic interests and has never been a consideration in the RTT law in determining whether a transfer is taxable.*

Similarly, § 91.152 errs by stating that the distribution of property from a general partnership to an entity holding all the general partnership interests in what otherwise would qualify as a conversion is nonetheless taxable, on the grounds that there is a "break in the continuity of the general partnership." There is no such requirement in *Exton Plaza*; indeed, the court specifically stated that the details of how a conversion is accomplished are not relevant. In contrast, under the Final Proposed Regulations, the exact method used to convert an entity is of critical importance. A merger will work, but other methods commonly used to achieve the identical result will result in the imposition of tax.

In addition to being contrary to settled law, these errors are bad tax policy. These Final Proposed Regulations will make Pennsylvania a less attractive place to do business.

B. <u>Section 91.153 – Like-Kind Exchange Accommodation Parties</u>

We previously commented that the Department should address transactions involving like-kind exchange intermediaries and clarify that only one RTT is owed where a buyer acquires so-called "replacement property" through these types of accommodation parties,

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* We made this same comment repeatedly in the past and in its Comment and Response Document, the Department stated "[t]he Department has removed the language requested by the commentators ..." See Number 13. Notwithstanding that the Department agrees with our comment on this issue, the Final Proposed Regulations were not changed.

that clearly meet the state law tests for "agency" or a "straw party." The Department's regulations are premised on the unfounded misconception that the accommodation parties in exchange transactions cannot act as the taxpayer's agents. The Department's Comment and Response Document disingenuously states that the Department agreed with the comments made by the Tax Section, but new § 91.153 takes a position diametrically opposite not just to our recommendation but also to the conclusions *reached by every other state or locality that has addressed this issue*. The effect of this new regulation (if upheld) would be to impose a double tax (or possibly a quadruple tax) on like kind exchanges. Subjecting these common exchange transactions to two taxes or possibly four taxes (see comments to § 91.170) is contrary to the law and likely will reduce RTT and other tax collections because real estate owners and investors needing to complete like-kind exchanges will avoid Pennsylvania and look for replacement property in other jurisdictions.

C. Section 91.168 – Sale-Leaseback

This section would subject to tax both a sale and a leaseback to the same party if the lease term is 30 years or more and then impose another tax if the seller reacquires the property at a later date. The current regulations which have been in force for over 20 years subject only the sale to RTT because the seller retains the beneficial use of the property. Businesses frequently use sale-leasebacks to finance headquarters buildings and major manufacturing plants. Subjecting these transactions to two taxes or three taxes is not required by the law and is bad public policy; it will discourage businesses from locating in Pennsylvania.

D. Section 91.170 – The rule in *Baehr Bros. v. Commonwealth,* 487 Pa. 233, 409 A.2d 326 (1979)

In *Baehr Bros.*, the Pennsylvania Supreme Court ruled that a deed was not subject to RTT because, in substance, it represented two tax-free transactions. This case reached the common sense conclusion that if A could transfer real estate directly to B tax-free, and B immediately could have transferred the real estate to C tax-free, then a transfer directly from A to C likewise should be tax-free.

Section 91.170 of the Final Proposed Regulations purports to codify the rule in *Baehr Bros.*, but in doing so imposes confusing and unwarranted restrictions. For example, the regulations would require that the separate writings would be effective "notwithstanding the insolvency, bankruptcy or other legal disability of the signatories thereto" and that there be no "economic or personal detriment associated" with completing the separate steps of the transaction. These restrictions are confusing, ambiguous and serve no apparent purpose.

Even more troubling, the Final Proposed Regulations turn *Baehr Bros.* on its head by taking the heretofore unheard of position that a single deed can be subject to multiple impositions of RTT if, in substance, the deed represents two taxable transfers. For example, assume that B purchases a limited partnership interest in partnership A and, less than two years later, partnership A liquidates. For liability reasons, B does not want to hold his share of the real estate directly, so B forms a new, wholly owned LLC and directs partnership A to transfer B's

share of the real estate directly to B's LLC. Under the Final Proposed Regulations, this apparently would trigger a double transfer tax on the grounds that this ought to be viewed as a taxable transfer from A to B followed by a taxable transfer from B to his LLC. In this case, tax would be based not on what actually happened, but on the tax that would have been imposed if the parties had elected to structure the transaction in the manner that imposed the maximum possible amount of tax.

Example 1 in § 91.170(b) is directly contrary to the Pennsylvania Supreme Court's holding in *Allebach v. Commonwealth of Pennsylvania*, 546 Pa. 146, 683 A.2d 625 (1996). *Allebach* held that where an executory agreement for the sale of real estate was assigned by the purchaser for a valuable consideration, and where the real estate was transferred directly from the owner of the real estate to purchaser's assignee, there would be a single transfer tax based on the original price set forth in the agreement of sale. *Allebach* stated that "[e]xpanding this definition [of value] so that it would include executory agreements . . . would be a flagrant violation of the General Assembly's dictate that we strictly construe taxing statutes." *Id.* at A.2d at 628-629. That is exactly what the Department would be doing in this Section because the value of the executory agreement would be included in the tax base. Indeed, the logic of the rules set forth in this Section could be read to say that multiple taxes (and not just a single tax at a higher value) could be imposed in a case where an agreement of sale has been transferred. IRRC should not permit the Department flagrantly to violate the clear holding of the Supreme Court and the dictates of the General Assembly.

In addition, much of the language in § 91.170 is so obtuse that it is exceedingly difficult to understand. In particular, the language in § 91.170, which introduces the new concept of "splitting transactions," is virtually incomprehensible. We urge the members of IRRC to read this section and see if they understand what it means and when it applies. Regulations should make the law more, not less, understandable.

E. <u>Sections 91.101, 91.156, and 91.193(32) – Living Trusts and Ordinary Trusts</u>

We previously commented on this portion of the Final Proposed Regulations, suggesting that the Department define the term living trust ("LT") consistent with the statute as a will substitute. Instead of clarifying the definition, the Final Proposed Regulations further restrict the definition based on the Department's incorrect view that a will substitute must be revocable. Under the definitions in the Final Proposed Regulations, transfers to trusts that are common will substitutes used in normal estate and family wealth planning may become taxable. The common meaning of a "will substitute" is an instrument that transfers assets at the death of the settlor. There is no requirement that the trust or "will substitute" be revocable so long as the settlor retains the beneficial use of the property for life.

The definition of LT in the Final Proposed Regulations is not in keeping with the statutory intent. An individual should not be penalized for transferring real estate to a trust that distributes the real estate to a family member upon the transferor's death as opposed to the individual dying and leaving the property to the family member in his will. This is precisely the type of transfer that the statute intended to exempt.

For the reasons discussed above, and detailed in our comments dated April 18, 2007, we urge IRRC to reject the Final Proposed Regulations and require the Department to repropose regulations that are consistent with the law and good public policy.

Very truly yours,

Joan C. Arnold
Chair, Tax Section
Philadelphia Bar Association

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Attachment

Tax Law Section

April 18, 2007

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Harrisburg, PA 17128-1061

Re: Comments and Suggestions Concerning Draft Final Regulations, Department of Revenue, 61 Pa. Code, Chapter 91,, Realty Transfer Tax ("RTT") Regulation Amendments (the "Draft Final Regulations")

Dear Ms. Sprunk:

The Tax Section of the Philadelphia Bar Association respectfully submits the following comments and suggestions regarding the Draft Final Regulations. These comments were prepared by experienced private tax practitioners who regularly work with the RTT.

We previously submitted detailed comments to both the Draft Proposed RTT Regulations issued in 2000 and the Proposed RTT Regulations issued in 2005 that were intended to help explain the laws and make it clear and understandable to both tax practitioners and the public. We appreciate that the Department has responded to a number of our previous comments and suggestions. We do, however, continue to have serious concerns about a number of points in the Draft Final Regulations. As explained in more detail below, our concerns include the following:

- The provisions dealing with conversions of entities are inconsistent with *Exton Plaza Associates* and the RTT Law, create restrictions for which there is no legal or public policy basis, and create traps for unwary or poorly advised taxpayers.

- An example in the Draft Final Regulations directly contradicts the Pennsylvania Supreme Court's decision in *Allebach* and is inconsistent with another example in the Draft Final Regulations. The contradictory example was not included in the Proposed Regulations and thus has not been reviewed by the Independent Regulatory Review Commission.

- The provisions in Draft Final Regulations § 91.170 dealing with greater interests, lesser interests, combining transactions and splitting transactions require examples in order to make the principles clear. Based on the current wording, we are unable to determine what the provisions are intended to accomplish, or when or how they are intended to apply.

- The definition of "living trusts" imposes restrictions that are not justified by the RTT Law, and that cannot be satisfied by "garden variety" trusts regularly used for gift and estate planning purposes.

- The Draft Final Regulations fail to apply the statutory exclusions for certain transfers to transfers of interests in a real estate company. Instead, the Draft Final Regulations take the position that the exclusions apply only to direct transfers of real estate. This position treats the indirect transfer of an interest in real estate more harshly than a direct transfer of real estate, which is contrary to sound public policy, is not required by the letter of the RTT, and is contrary to the intent of the RTT.

- The like-kind exchange provisions are problematic. As written, qualified intermediaries and exchange accommodation titleholders that are commonly used to effect like-kind exchanges of real estate under federal tax law cannot qualify for the straw party exclusion. This result (i) is based on a misunderstanding of federal tax rules as it elevates a legal fiction that applies only for purposes of section 1031 of the federal Internal Revenue Code into a *per se* rule that these parties cannot be agents or straw parties under state law, (ii) will result in the double imposition of transfer tax with no legitimate policy justification, (iii) will frequently operate as a trap for unwary taxpayers, and (iv) is at odds with every other jurisdiction that has considered this issue; and

- The decision to defer addressing an exclusion permitting a transfer of real estate to a "special purpose entity" in connection with a financing transaction imposes an unjustified toll charge on owners of Pennsylvania real estate.

We can be of greatest assistance to the Department if we could have a face to face meeting to discuss our concerns. We thus request a meeting with the Secretary, the drafters of the Draft Final Regulations and the others in the Department who are involved in the process of drafting and finalizing the regulations.

In advance of that meeting, below is a more detailed explanation of our concerns:

A. <u>Section 91.152 - Conversions and Confirmatory Deeds</u>

The Department's response to our comments confirm that Draft Final Regulation §91.152 is intended to codify the "Department's implementation" of the Commonwealth Court's decision

in *Exton Plaza Associates v. Commonwealth*, 763 A.2d 521 (Pa Commw. 2000). However, the Draft Final Regulations include positions contrary to the *Exton Plaza* decision. In fact, the very transaction that was held to be exempt from RTT in *Exton Plaza* would be taxable under this Section of the Draft Final Regulations.

The Department responded to our comments by explaining that the *Exton Plaza* decision "only excluded documents that 'memorialized' the change in form" and "did not exclude documents that actually convey title to real estate as part of a change in form." As shown below, this is not true. The Department's position as set forth in Draft Final Regulation §91.152(b) limits the confirmatory deed exclusion to a deed made "for the sole purpose of confirming an Entity's existing real estate ownership following a conversion."

In *Exton Plaza*, the court described the transaction as follows:

> On December 28, 1995, at the closing on the mortgage refinancing, ***the general partnership executed a deed transferring the shopping center to the limited partnership***. The deed, recorded in Chester County on January 4, 2000, recited a consideration of $1.00. The statement of value indicated a county assessed value of $343,200, a common level ratio factor of 15.87, and a fair market value of $5,446,584. It claimed an exemption from realty transfer tax of 100% and bore the notation, "Principals of grantor and grantee are one and the same."

713 A.2d at 522 (emphasis added). The court held that the deed did not transfer a beneficial interest in the real estate and therefore was not taxable. In the Department's view, however, the transaction at issue in *Exton Plaza* would have been taxable, because it "actually conveyed" title to real estate as part of a change in form and did not merely "memorialize" existing ownership.

In *Exton Plaza*, the court used the term *conversion* to describe the transaction. A critical purpose of the Draft Final Regulations is to describe when a transaction will qualify as a tax-free conversion under *Exton Plaza*. The word conversion can be used in a technical or in a broad sense. Used in a technical sense, a conversion means a statutory procedure in which a single entity is changed from one form to another, for example from a limited partnership to a limited liability company.[1] That was not what happened in *Exton Plaza*. In a more general sense, the term is used to describe a merger, a deed transfer or other transaction the result of which is to replace one form of entity holding the real estate with another. It is obvious from the careful description of the actual

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[1] Delaware law permits one type of entity to "convert" to another type of entity without undergoing a formal merger. This is a relatively recent provision, however, and Pennsylvania does not yet have any analogous procedure. The Commonwealth Court was not using the term "conversion" in this highly technical manner.

transaction that the court used the term *conversion* in the second, more general sense. The court spelled it out as follows:

> In this context, the stipulated facts tell us that the general partnership "converted" to the limited partnership, transferring a 1% interest to a limited liability company as the general partner. ***Regardless of the details of how this "conversion" was accomplished, the shopping center was essentially "contributed" to the Limited Partnership***, and the principals' property rights in the shopping center remain essentially unchanged. The execution of the deed transferring the shopping center merely memorialized the conversion from a general partnership to a limited partnership.

763 A.2d at 524 (emphasis added). The court makes it clear that the method used to accomplish the "conversion" is immaterial; it is the result that counts.

Our specific objections to the Draft Final Regulations concept of what constitutes a tax-free conversion are as follows:

- The notion that to be an exempt transfer, a deed must merely "memorialize" a change in form and may not "actually convey title" is inconsistent with *Exton Plaza*. As noted above, in *Exton Plaza* there was, in fact, an actual conveyance of title from the old general partnership to the new limited partnership. The language in *Exton Plaza* to the effect that the deed "merely memorialized the conversion" has to be read in light of the actual facts of the case and the general statement that the actual details of the conversion are not relevant.

- *Exton Plaza* makes it clear that the details of how the conversion is accomplished are not relevant, yet the Draft Final Regulations contain form based requirements that are inconsistent with *Exton Plaza* and create traps for unwary taxpayers. The Department appears to sanction a conversion effected by a statutory merger or a conversion under Delaware law, but not other common types of converting an entity, such as transferring all of the interests in a partnership to a newly formed LLC, thereby terminating the partnership by operation of law. As noted above, the very form of conversion used in *Exton Plaza* (a direct transfer of real estate to a newly formed entity) would not qualify as a conversion under the Draft Final Regulations. The particular manner in which a conversion is accomplished should not matter.

- We strongly object to the conclusion that the conversion described in Example 4 of Final Draft Regulation §91.152(b) should be subject to tax. This Example concludes that the deed from the terminated partnership to the new LLC "effectuated a direct transfer of real estate from the general partnership to the LLC while they both existed." This is not correct because when the LLC becomes the owner of 100% of the interests in the partnership, by operation of

law, the partnership dissolves. The LLC did not becomes the owner of the property until the dissolution, by operation of law, of the partnership. Consequently, the partnership no longer existed at the time of the transfer. Even if this statement in the Example were true, it should not matter because under the clear holding of *Exton Plaza,* a conversion no matter how accomplished is not subject to tax.

- The Draft Final Regulation incorrectly states that a tax-free conversion will not occur if, as a result of a change in the form of the entity, there is a shift in management control. There is no support for this position in the statute or case law. To the contrary, a *real estate company* becomes an *acquired company* only if 90% or more of the ownership interests are shifted within a period of three years. All kinds of lesser shifts can occur in the interim, and shifts of management control are not relevant at all. None of them will result in a real estate company becoming an acquired company. The same pattern should be followed in codifying the rule in *Exton Plaza.*

- The Draft Final Regulations create unnecessary ambiguity about when and under what circumstances a change in either ownership percentage or management control will be deemed to "result" from the conversion. The Draft Final Regulations create a trap for unwary taxpayers, because well advised taxpayers could adjust ownership either before or after the conversion, rather than as an integral part of the conversion.

We reiterate our prior comment that it is important to include clear, unambiguous provisions that describe when a "conversion" of an entity can be accomplished without triggering RTT. These provisions must be consistent with *Exton Plaza* and should not create a trap for taxpayers by only approving of a conversion if it is effected in a particular manner. We submitted suggested language to effectuate *Exton Plaza* with our comments to the Proposed Regulations, and would be happy to work with the Department on revising this important Section of the regulations. Our prior proposal on this issue, slightly revised, is attached as "Exhibit A."

B. Subsections 91.152(b) and 91.154(b) – Transfers from owners to their entities

In response to our prior comments dealing with the issue of transfers of title to real estate from the owners of a partnership or other entity to the partnership or other entity, the Department made some helpful changes and clarifications to the Proposed Regulations. For example, Subsection 91.154(b) of the Draft Final Regulations now makes it clear that if a person dedicates and sets aside real estate for an entity's use through a writing (e.g., a partnership agreement) without conveying title to the real estate, the writing is not subject to RTT. This is a useful clarification. We believe, however, that further clarification is needed.

It is well established that, in the absence of an applicable exclusion, a transfer of title to real estate from the owners of a partnership or other entity to the partnership or entity is subject

to transfer tax, notwithstanding that both before and after the transfer the real estate was ultimately owned by the same persons in the same percentages. While the wisdom of such a rule is debatable, this result appears mandated by the RTT statute.[2]

The Draft Final Regulations imply that any transfer of title to real estate from the owners of an entity to their entity will inevitably be subject to RTT, with no exception for a situation in which the owner was merely acting as agent for the entity or in which the property had always been treated by the owner as belonging to the entity. We believe that any such position is incorrect as a matter of law, and the regulations should be amended to remove the implication.

We believe that an exclusion from RTT applies in the case in which (1) the owners of an entity (usually a partnership) initially acquired title to real estate in their own names, but always intended that the property would be held for the benefit of the entity, (2) the owners consistently treated the property as owned by the entity, not individually by the owners (for example, they always reported the income and deductions from the property on a partnership income tax return and never treated the property as held by them as tenants in common) and (3) the owners later transfer title to the real estate to the entity that was treated as owning the property (either the original entity or an entity resulting from a conversion of the original entity).

While there may be a transfer of legal title when the property is contributed to the entity in such case, there is no transfer or contribution of property for RTT purposes in such a case because the entity in question was always the principal that was the owner of the property. The record owners should be viewed as agents of the entity. In the past, the Department routinely issued favorable private rulings allowing the owners to transfer title to real estate to their entity without imposition of RTT where the foregoing requirements were satisfied. Several years ago, however, the Department stopped issuing rulings in such cases. This created considerable confusion and uncertainty among tax practitioners, and hardship to Pennsylvania residents who were effectively prohibited from putting title in the names of their entities. Unfortunately, the Draft Final Regulations perpetuate the uncertainty and ambiguity in this area.

The example that concerns us is Example 1 of Subsection 91.152(b). In that example, A and B were equal owners of a general partnership that was converted into a limited partnership. The example says that "[o]ne of the assets of the partnership is real estate that A and B contributed to the partnership but own in their individual names." After the conversion, A and B (and the general partnership) transferred legal title to the limited partnership. The example concludes that the deed to the converted partnership "is taxable because the real estate was in the

[2] As noted in Section I, below, the inability to transfer real estate to a wholly owned single purpose entity, as now required by most commercial lenders, is a serious impediment to the financing and refinancing of property. We see no policy justification for imposing RTT where there is no transfer of beneficial ownership and the transfer to a single purpose entity is a requirement of financing. We strongly support a narrowly drafted regulatory or statutory amendment that would permit such transfers.

name of A and B individually" and "[l]egal title was never transferred to the general partnership."

The mere fact that "the real estate was in the name of A and B individually" is legally insufficient to support the conclusion that the transfer is subject to RTT. An agent will hold title in its "individual" name, yet a transfer to its principal is excluded from tax. See RTT Regulations § 91.193(b)(11). As explained above, this agency exclusion should apply in the case where A and B had originally acquired the property for the benefit of the partnership and had always treated the property as owned by the partnership, rather than themselves individually (or as tenants in common).

We are not sure what the Department intends when it provides in Example 1 that A and B had previously "contributed" the property to the general partnership. If this a shorthand way of saying that A and B had originally acquired the property themselves, and held it for their own use, but later "contributed" the property to the general partnership without paying tax, the Example is much less troubling. However, if this Example intends to illustrate a fact pattern in which the title was vested in the partners, but the partners acquired the property as agents for or on behalf of the general partnership, we think the example is incorrect. If they acquired the property as agents for or on behalf of the general partnership, the partnership owned the property, the conversion to a limited partnership is not a "transfer," and the transfer of the title is a mere ministerial act - the partnership owned the title all along.

We urge that Example 1 in Subsection 91.152(b) be revised to make it clear that this is not a case where A and B had originally acquired the property intending to hold it as partnership property and where they always treated the property as held by the partnership. It would be helpful to include an example where a transfer to a partnership is tax-free because the partners had always treated the property as owned by the partnership.

C. Sections 91.101, 91.156, and 91.193(32) - Living Trusts and Ordinary Trusts

The RTT Law was amended by Act 7 to add or revise definitions relating to trusts. The intent of the amendments was to prevent taxpayers from using trusts to effect tax-free transfers of real estate to unrelated parties, not commonplace estate planning trusts. Unfortunately, under the definitions of "living trust" ("LT") and "ordinary trust" ("OT") contained in Act 7, it is at least arguable that transfers of real estate to "garden variety" trusts commonly used in normal estate and family wealth planning may be taxable. We have been assured by the drafter of the Act 7 amendments and by others that there was no intention to interfere with normal estate planning techniques. The Draft Final Regulations should clarify the drafter's intentions to not narrow the application of the exemption beyond the intention of the statute.

We reiterate our previous comments to this portion of the Draft Proposed Regulations and offer suggestions to accommodate nonabusive trusts that are used by many estate planners. In general, the statute and the regulations divide trusts intended for estate planning into two categories: LTs and OTs, each of which is discussed below. LTs are a subset of OTs. (The Draft

Final Regulations at § 91.101 "Living Trust" state in the definition of LT that it is an OT.) Consequently, one overarching comment is that Draft Final Regulations should clarify that the exemptions for an OT also should apply to an LT.

1. Section 91.101 - Definitions of "Living Trust," "Ordinary Trust," "Settlor" and "Testamentary Trust"

(1) Living Trust

Under the RTT Law, LT is defined as:

> [a]ny trust, other than a business trust, intended as a will substitute by the settlor which becomes effective during the lifetime of the settlor, but from which trust distributions cannot be made to any beneficiaries other than the settlor prior to the death of the settlor. RTT Law § 8101-C ("Living Trust").

The statutory restriction that distributions from an LT during the life of the settlor may only be made to the settlor is a significant constraint on the utility of an LT for estate planning purposes. The Draft Final Regulations contain an even more restrictive definition of an LT than that contained in the RTT Law. The Draft Final Regulations contain the following definition:

> Living Trust - an ordinary trust:
>
> (i) Which, throughout the settlor's lifetime, is wholly revocable by the settlor without the consent of an adverse party.
>
> (ii) Which vests no present interest in any of the trust corpus or income in any person other than the settlor or trustee until the settlor dies.
>
> (iii) All the corpus and income of which can be reached or materially affected by the settlor without revocation of the trust or the consent of an adverse party.
>
> (iv) From which no transfer of corpus or income may be made by the trustee, at any time prior to the death of the settlor, to any person in the capacity of a beneficiary other than the settlor.
>
> (v) Under which the trustee exercises no discretion as to the disposition of the trust corpus or income during the settlor's lifetime to any person other than the settlor without the express direction of the settlor to make the specific disposition.

(vi) Which the trustee or, if the settlor was the trustee, the successor trustee is required under the governing instrument to distribute the corpus and retained income upon the death of the settlor.

The RTT Law does not require an LT to be revocable at any time by the settlor during his lifetime; thus, subparagraph (i) of the definitions in the Draft Regulations should be deleted in its entirety. It is not uncommon for a revocable trust to become irrevocable because of the incapacity of the settlor. Since there is no statutory requirement for excluding such a trust from the definition of an LT, and since it is quite common in normal estate planning for living trusts to include such a provision, there is no reason to exclude such a trust from the definition of an LT.

The Department argues that under the RTT Law, the trust is to be a will substitute and therefore must be revocable since it is a "well-accepted principle of trust and estate law that a 'will' must be freely revocable during the testator's lifetime." However, a will can become irrevocable if the testator becomes incompetent. The interpretation by the Department is extremely limited and is beyond the scope or intent of the RTT Law. The common meaning of a "will substitute" is an instrument that transfers assets at the death of the settlor. There is no requirement that the trust or "will substitute" be revocable, since both a will and trust will become irrevocable if the testator becomes incompetent. Further restricting the definition of LT is clearly not in keeping with the statutory intent and beyond the scope of the Draft Final Regulations. Moreover, no policy purpose can be ascertained in the restrictive nature of the Draft Final Regulations. An individual should not be penalized for transferring real estate to a trust which distributes the real estate upon the transferor's death to a family member as opposed to the individual dying with the property and leaving it in his will to the same family member. This type of transfer is precisely what the statute intended to exempt regardless of whether the individual becomes incompetent. In this example, the trust clearly is a will substitute.

Similarly, subparagraphs (ii), (iii), (v) and (vi) of the definition contained in the Draft Final Regulations go beyond the scope and intention of the statute and should be deleted. The vesting of a present interest in the assets of the trust in a person other than the settlor is not a basis to make a transfer to a trust taxable under the RTT unless there is an actual transfer before death to someone other than the settlor. The LT definition contained in the RTT Law is designed to prevent the transfer of real estate for consideration from a trust to someone other than the settlor. There will be no abuse if the settlor does not retain the right to reach or materially affect the assets and income of the trust without revocation or vests any interest in the property in someone else without consideration or to an otherwise exempt transfer. In particular, new subparagraph (v) further limits the definition and seriously hinders the ability of a person to transfer real estate to an LT, even though the settlor could die with the property and the transfer from the estate would be exempt. Moreover, if the settlor becomes incapacitated, the trustee should be able to make payments for the benefit of the settlor, *e.g.*, to pay hospital expenses, and this should not disqualify the trust as a LT.

In summary, subparagraphs (i), (ii), (iii), (v) and (vi) should be deleted. None of the clauses clarify the definition of LT as found in the statute, but in reality are intended to further

restrict the definition based on the Department's narrow view of what constitutes a "will substitute."

Subparagraph (iv) of the definition of LT and the related examples are helpful. However, we suggest that Subparagraph (iv) be expanded to include distributions made to someone other than the settlor but on behalf of the settlor, whether or not directed by the settlor. For example, if a trustee makes a distribution to a hospital for the settlor's stay in the hospital, even though the distribution was not made directly to the settlor, it was on behalf of the settlor and it should qualify as an LT.

2. Testamentary Trust

The new definition of testamentary trust is incomplete and makes use of a term that is not defined. This definition should include an OT or LT that becomes effective upon the death of the either the settlor or the income beneficiary. Moreover, this definition should exclude the word private in reference to trust. We agree with the view of the Independent Regulatory Review Commission that the use of the word private detracts from the clarity of the regulation. We suggest that the definition be revised to read as follows:

> Testamentary Trust – a trust, other than business trusts formed under Pennsylvania law or law of any state or foreign jurisdiction that is established or created by will, and shall include for the purposes of this definition, an Ordinary Trust and a Living Trust in which a transfer or distribution of property occurs at the death of the settlor or the income beneficiary

3. Section 91.193(32) - Excluded Transactions

As noted above, we expect that the exemptions accorded an OT should also apply to an LT. As such, subparagraph (32) should be amended to read as follows:

> (32) Transfers for no or nominal consideration to the trustee of a living trust from the settlor of the living trust, or if the transfer is not from the settlor, the transfer would comply with Section 91.193(b)(8).

D. Section 91.170. The rule in *Baehr Bros. v. Commonwealth,* 487 Pa. 233, 409 A.2d 326 (1979)

Section 91.170 of the Draft Final Regulations appears to be intended to address a series of related taxable transactions that are done in steps designed to minimize or eliminate RTT and the reverse, transactions that are completed in otherwise taxable steps that are exempt. Unfortunately, we find § 91.170 to be very abstract in its wording. In the absence of meaningful and concrete examples, we cannot tell what these provisions are intended to accomplish, or when

or how they would apply to real life situations. If these provisions are not deleted, they need to be clarified and concrete examples illustrating their operation need to be added.

1. Section 91.170(a) – General Rules.

As we noted in our comments to the comparable provisions of the Proposed Regulations there are significant issues raised by Draft Final Regulations §§ 91.170(a) (2) and (3) which provide as follows:

> (2) Separate transfers of a greater estate and a lesser estate in real property will be taxed as a single transfer of both estates if the transactions are entered into in contemplation of a merger thereof.
>
> (3) Separate transfers of an interest in timber, coal, oil, gas, or other appurtenance to real estate and the real estate to which the interest is appurtenant will be taxed as a single transfer of both interests if the transactions are entered into in contemplation of their coinciding and meeting in the same person.

It is not clear what these provisions mean, the transactions to which they are meant to apply or the consequences of taxing separate transfers of interests in real estate as a single transfer. We understand that the Draft Final Regulations are trying to deal with the reverse of the *Baehr Bros.* situation, namely, to say that taxpayers may not reduce or avoid RTT by splitting a single transaction into multiple transactions where it is "contemplated" that all of the separate pieces will be merged.

The issues raised by Draft Final Regulations § 91.170(a)(2) can be illustrated with an example. Assume landowner A, who owns fee title to land, enters into a 29 year ground lease with B, an unrelated party, and that B then constructs a building on the land. Assume that after the building has been completed and when the ground lease has 27 more years to run, C, who is not related to either A or B, and who wants to acquire undivided ownership of the improved real estate, pays $500,000 to A for fee title to the land, subject to the ground lease. Assume A then enters into a separate transaction with B in which A pays a $4,500,000 termination fee to B to terminate the ground lease. Notwithstanding that only the purchase of the land by C from A is subject to RTT, this provision arguably would subject to RTT a non-taxable event - the termination of a lease with a term of less than 20 years.

In this case, the leasehold interest is not real estate for RTT purposes and the termination of the lease, standing alone, would not be subject to RTT. B, the holder of a non-taxable leasehold interest, should not be affected by the separate transaction between A and C. In addition, we do not understand what is meant by the phrase "will be taxed as a single transfer of both estates." Does B have liability for RTT in this case even though B never owned a taxable

interest in real estate? Does A, the fee title holder, have to pay tax on consideration received by B, an unrelated party?

Perhaps Draft Final Regulations § 91.170(a)(2) was not meant to be interpreted as broadly as its words suggest. A more narrow interpretation is that this provision is only intended to apply in situations where both the "greater estate" and the "lesser estate" in real property are interests that, by themselves, constitute a taxable interest in real estate for RTT purposes.

For example, if we modified the above example to extend the remaining term of the ground lease from 27 years to 31 years, then both the fee interest (which presumably is the "greater estate") and the leasehold interest (the presumptive "lesser interest") would be taxable interests in real estate, and each of these interests would be subject to RTT if transferred separately. (We note in this regard that the Draft Final Regulations will narrow the exclusion for termination of a lease, so a fee paid to terminate a lease with a remaining term of 30 or more years will trigger RTT). If this is the correct interpretation of Draft Final Regulation § 91.170(a)(2), since the transfers are already fully taxable, Draft Final Regulation § 91.170(a)(2) is unnecessary.

Another possible way to try to narrow the apparent scope of Draft Final Regulations § 91.171(b) is to focus on the requirement that the transfers be "entered into in contemplation of a merger." That phrase, however, remains undefined. Is there a sufficient "contemplation of a merger" if the purchaser (C in the above example) was intending to acquire an undivided interest in the land and the improvements, even if A and B were acting independently of each other and of C? Or must there have been some sort of "contemplation" on the part of A and B, when they set up the lease arrangement, that this might enable them to transfer the land and improvements in a way that minimized RTT? Perhaps the "contemplation of a merger" requirement should only be satisfied in a case where the holders of the "greater estate" and "lesser estate" are <u>related</u> to each other.

All of the questions we point out above demonstrate why § 91.170(a) must be clarified. Highly qualified and knowledgeable tax attorneys are confused; taxpayers will be lost. We think that concrete examples of where and how this Section would apply would be helpful and look forward to discussing this at the meeting.

2. <u>Section 91.170(b) – Combining Transactions</u>.

As we described in our comments to the Proposed Regulations, we have the same concerns regarding Draft Final Regulation § 91.170(c). It is not clear (i) what sort of separate interests are potentially to be combined as a single transfer, (ii) whether this provision is intended to apply (or legally can apply) where one or both of the separate transfers is not itself subject to RTT, (iii) whether a grantor can be subject to RTT on consideration that that grantor did not actually receive or (iv) how the "in contemplation" language is to be interpreted. As is true of the Draft Final Regulation § 91.170(a)(2), Draft Final Regulation § 91.170(b) should be narrowed so that only abusive transactions are covered. In addition, the language should be

clarified so that taxpayers can understand what transactions are intended to be covered. Finally, a more concrete example of the consequences of treating separate transfers as a single transfer (in particular, what is the tax liability of the separate grantors) should be provided. In the absence of these clarifications, we suggest that these provisions be deleted.

We suggest the following alternatives if these sections are not deleted:

> (a)(ii) Separate transfers of a greater estate and a lesser estate in real estate, if the transfer of the greater and the lesser estate both would be subject to tax, shall be presumed to be a single transfer of both estates if the transactions are entered into in contemplation of a merger thereof and the grantors or sellers are "affiliates". For purposes of this Section 91.171(b) "affiliate" has the same meaning as the term "grantor's affiliate" in Section 91.131.
>
> (a)(ii) Separate transfers of an interest in timber, coal, oil, gas, or other appurtenance to real estate and the real estate to which the interest is appurtenant, if each transfer of the real estate and the appurtenance both would be subject to tax, shall be presumed to be a single transfer if the transactions are entered into in contemplation of their meeting in the same person and the grantors or sellers are "affiliates". For purposes of this Section 91.171(c) "affiliate" has the same meaning as the term "grantor's affiliate" in Section 91.131.
>
> The presumption in Section 91.170(a)(ii) and (iii) may be rebutted by the taxpayers by demonstrating that the multiple transfers are not for realty transfer tax avoidance purposes.

3. Section 91.170 (b) Examples.

The inclusion of Example 1 in the Draft Final Regulations is directly contrary to the Pennsylvania Supreme Court's holding in *Allebach v. Commonwealth of Pennsylvania*, 546 Pa. 146, 683 A.2d 625 (1996). The Department had included similar provisions the Draft Proposed Regulations. The Department appropriately deleted those provisions from the Proposed Regulations it issued in 2005, which was consistent with a suggestion in the comments that we had submitted. Example 1 should be deleted because as the Supreme Court noted "[e]xpanding this definition so that it would include executory agreements . . . would be a flagrant violation of the General Assembly's dictate that we strictly construe taxing statutes." *Id* at A.2d pp. 628-629.

Example 1 is as follows:

> X enters into an agreement of sale with Y for the conveyance of real estate for $100,000. Y subsequently assigns the sales

> agreement to Z for $1 Million. X executes a deed for the conveyance of the real estate to Z and receives $100,000. Y receives $1,000,000 from Z for the assignment. The taxable value of the deed from X to Z is $1,100,000. X is liable for the tax on $100,000 (See § 91.132(c)). Y is liable for the tax on $1,100,000. Z is liable for the tax on $1,000,000.

Like the facts in this example, in *Allebach*, owners of realty entered into an agreement of sale with Party 1 to sell the realty for what ultimately was $657,828 ("Owners Agreement"). Party 1 assigned his rights under the Owner's Agreement to Party 2 for $1,643,000 (the "Assignment Agreement 1"). Party 2 ultimately, through a series of transactions, assigned its rights under Assignment Agreement 1 to Party 3 for $3,200,000, a portion of which was to be paid to Party 1.

Party 3 paid $3,200,000, of which $657,828 was paid to Owners for the real estate. In *Allebach*, and this example, the Department contended that the RTT base was the total consideration paid by the Party 3 ($3,200,000), not the amount Party 3 paid the Owners for the real estate ($657,828). In *Allebach*, the Pennsylvania Supreme Court held that the Department's position was in error. The Court held that the proper base for the RTT was the amount paid to the Owners ($657,828) because the statutory definition of value does not "include executory agreements which fail to provide for the construction of any structure."(emphasis added) *Id*, 683 A.2d at 628. The Court went on to state, "[e]xpanding this definition so that it would include executory agreements . . . would be a flagrant violation of the General Assembly's dictate that we strictly construe taxing statutes." *Id* at A.2d pp. 628-629.

As a second ground for its holding, the Court noted that, under the statute, only an executory agreement to which the grantor is a party may be taken into account in determining the value of real estate. Since Owners were not a party to the agreement between Party 1 and Party 2, or the later agreement between Party 2 and Party 3, these later executory agreements could not be taken into account in determining value for assessment of the RTT. The Court described the Department's argument that Owners were in some sort of "de facto joint venture" as "baffling."

The law is clear. The term "value" does not include consideration for an executory agreement unless both (i) the agreement involves construction and (ii) the grantor (or an agent, principal or related party) is a party to the agreement. This example is wrong under Pennsylvania laws as interpreted by the Supreme Court of Pennsylvania and should be deleted.

4. Section 91.170(c) – Splitting Transactions.

We do not understand what Draft Final Regulations §91.170(c) is intended to accomplish, and cannot identify the transactions or types of transactions to which it potentially could apply. We have interlineated our questions in the example in the regulation:

X agrees to sell and convey real estate to Z for $2 Million. The conveyance can be accomplished by one taxable document based upon a sale price of $2 Million. In order to avoid paying tax on the full sale price of the transfer, X and Z agree to divide the conveyance into four separate transactions: D, E, F and G. **[What are these transactions? What do the transactions actually or purportedly accomplish? Are other parties involved? This example is not understandable without identification of what they are. If they are assignments of the contract from X to another party, as discussed above, under *Allebach*, they are not taxable]** Z pays $100,000 for the deed. **[To X?]** Transactions E, F, and G are effectuated by separate writings that each, by appearance, is nontaxable. Z pays $400,000 for transaction E and its respective writing and a total of $1.5 Million for transactions F and G and their respective writings. **[Is Z buying documents? If so, *Allebach* holds that the transactions are not taxable. Who receives the funds paid by Z?]** The four transactions and writings effectuate the same outcome as would have been accomplished by the single transaction document. **[This may not be so. If X only receives $100,000 and others who may or may not be related to X receive other parts of the total $2 Million paid, a single transaction may not have been possible]** Therefore, all four transactions are considered accomplished by the same document, and each writing is taxable upon the portion of the value of the real estate it represents. **[While this conclusion may be true in certain circumstances, this example does not illustrate a circumstance where it is so because there are no facts]** The deed of conveyance for transaction D represents the conveyance of a portion of the real estate. Z paid $100,000 for the deed. Therefore its taxable value is $100,000. Transactions E, F and G and the associated writings effectuated the transfer of the remaining portion of the real estate. **[This example does not explain why this is true because we don't know what D, E, F and G are]** Because Z paid $400,000 for the writing under transaction E, the taxable value of the writing is $400,000. **[Assuming there in fact is a taxable transaction, who owes the tax?]** There was no allocation of the purchase price for transactions F and G and the associated writings. Therefore, the remaining portion of the real estate value that has not been allocated, that is $1.5 Million, is divided equally, $750,000 each, between the writings for transactions F and G. **[If there is a taxable transaction, what authority is there for allocating consideration equally? There are no facts indicating the relative fair market values of F and G]**

Examples should present factual circumstances that illustrate the legal point being made. The reader cannot discern those transactions to which the regulation being illustrated may apply. If the Department has sample transactions with which it is concerned, it should provide clear and understandable factual examples. As is true of the Draft Final Regulation § 91.170(c), we cannot discern the application of the sections to real life transactions, and are anxious to discuss this at a meeting.

E. Section 91.193(b)(26) - Rescission, Cancellation or Abandonment of a Lease

We believe that the Department appropriately adopted our comment to the Proposed Regulations on this topic. However, further clarification is needed as to the realty transfer tax base in the event of a taxable rescission, cancellation or abandonment of a Lease. We believe that actual monetary worth is the appropriate measure because it is an accurate measure of value where consideration is paid.

Additionally, if the "acquiror" of a taxable lease is the landlord, the termination or cancellation of the lease should not be subject to RTT, even if the termination or cancellation is for consideration because the landlord is only getting its own property back. Alternatively, at the very least, there should be a credit for the tax paid upon creation of the taxable lease when the landlord is the "acquiror." See *e.g.*, § 8103-C(c) of the RTT Laws and § 91.234 of the RTT Regulations.

F. Section 91.193(c) - Exclusions Applicable to Transfers of Interests in Real Estate Companies

We reiterate our comment to the Proposed Regulations that the statutory exemptions and exclusions from RTT that apply to direct transfers of real estate should also apply to transfers of interests in a real estate company. The policy for including the acquired real estate company rules in the RTT Law is to make transfers of interests in certain companies that own real estate equivalent to transfers of the real estate itself. There is no rational reason to tax transfers of interests in real estate companies where comparable transfers of real estate would be subject to an exclusion or exemption from RTT.

Pursuant to § 8102-C.5 of the RTT Law, for a real estate company to become an acquired real estate company, the change in ownership "of itself or together with prior changes has the effect of *transferring*, directly or indirectly, 90% or more of the total ownership interest in the company . . ." (emphasis added). The following excluded transactions each apply to transfers and generally are not specifically limited to transfers of real estate: RTT Law § § 8102-C.3(1), (2), (3), (4), (5), (6), (7), (8), (8.1), (9) (1st sentence), (9.1), (9.2), (10), (11), (12), (14), (16), and (18). The exclusion found at RTT Law § 8102-C.5(20) merely expands the family members to whom an exempt transfer may be made; it is not the exclusive route to exemption.

For these reasons, the RTT Law and the policy for including the acquired real estate company rules in the RTT Law dictate applying the statutory exclusions and exemptions

applicable to transfers of real estate to transfers of interests in real estate companies. Absent such application of exemptions and exclusions, anomalous results will occur. For example, the following is a non-exclusive list of examples that would be subject to RTT under Section 91.193(c):

i. Individual A dies owning 90% of a real estate company. If Individual A died owning real estate, a transfer by operation of law to A's estate and from A's estate to A's beneficiaries would be exempt from RTT. However, the same exemptions do not apply to transfers of interests in A's real estate company upon his death and RTT would be imposed unless the transfer was to family members.

ii. A merger by a parent corporation (that owns 90% or more of the interests in a real estate company subsidiary) with and into another corporation. If the parent corporation owned real estate, no RTT would apply on the merger. However, since instead of owning real estate directly, the parent owns 90% or more of the interests of a real estate company, the merger would be subject to RTT.

We urge that the second sentence of § 91.193(c) be deleted and replaced by the following:

> A transfer of ownership interests in a family farm corporation, family farm partnership or real estate company will not be treated as a transfer for purposes of the acquired real estate company rules found in 72 P.S. § 8102-C.5 and Regulations §§ 91.202, 91.212, and 91.222, if an exemption or exclusion under 72 P.S. § 8102-C.3 or §§ 91.192 or 91.193 would apply if, instead of transferring interests in the family farm corporation, family farm partnership, or real estate company and the transferor owned the real estate or interest therein directly and then transferred the real estate to the transferee.

G. Family Farm Corporations and Partnerships

1. Section 91.221 - Family Farm Partnership.

The definition of family farm partnership in the RTT Law mimics the definition of family farm corporation. See 72 P.S. § 8101-C "Family Farm Corporation" and "Family Farm Partnership." For an entity to qualify for the family farm entity benefits, in each case, "at least seventy-five percent of its assets [must be] devoted to the business of agriculture." *Id.* The statute does not explain how to measure whether 75% of either a family farm partnership's assets

or a family farm corporation's assets are devoted to agriculture. Notwithstanding that the RTT Law is identical with respect to both types of entities on this issue, the Draft Final Regulations at § 91.221(a)(2) add a requirement that at least 75% of the book value of a partnership's assets must be devoted to the business of agriculture. The Department comments that the Regulations are identical with regard to the 75% test for Family Farm Corporations and Family Farm Partnerships. This is not so because 61 Pa. Code § 91.211 does not include the "book value" measurement base. We see no reason to distinguish between these two types of entities for this purpose and suggest either deleting this requirement at § 91.221(a)(2) or adding it at current regulations § 91.211(a).

Second, there is nothing in the RTT Law that requires a family farm partnership to be a common law partnership or general partnership. We have never heard of the term "common law partnership," but presume this term is meant to refer to a general partnership.[3] A partnership in Pennsylvania can be a general or limited partnership and either may elect to be a limited liability partnership. Such entities are all partnerships and the definition of family farm partnership in the RTT Law is not limited to a general partnership. The Department suggests that the common understanding of the word partnership is a common law or general partnership. This is not so. See the definition of "partnership" at Dictionary.com (http:\\dictionary.reference.com). Therefore, Draft Final Regulations § 91.221(a)(3) should be deleted.

2. <u>Section 91.222 - Acquired Family Farm Partnership.</u>

We reiterate our comment that there is no reason to distinguish between a family farm partnership and a family farm corporation definitionally for purposes of determining whether such an entity is eligible for the family farm entity benefits or when such an entity becomes an acquired entity. Draft Final Regulations §§ 91.222(1) and (2) should mimic the current regulations § 91.212(1) and (2), or in the alternative, the current regulations § 91.212 should be amended to reflect the same changes as are reflected in Draft Final Regulations § 91.222(1) and (2).

Finally, as discussed above, since the RTT Law does not limit the type of partnership that may be a family farm partnership to a general partnership (or a common law partnership), Draft Final Regulations § 91.222(3) should provide only that "[t]he partnership is voluntarily or involuntarily dissolved." The remainder of Draft Final Regulations § 91.222(3) is contrary to the statute and should be deleted.

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[3] The definition of "partnership" in Black's Law Dictionary, 5th Ed, does not mention a "common law partnership," although it does define collapsible partnership, commercial partnership, family partnership, general partnership, implied partnership, limited partnership, mining partnership, particular partnership, partnership at will, partnership in commendam, secret partnership, special partnership, subpartnership, statutory partnership association, trading partnership and universal partnership.

H. Section 91.153 - Like-Kind Exchanges

Comment 25 in the Comment and Response section of the Draft Final Regulation Package notes our prior comment that the Proposed Regulations should address the RTT consequences of certain common like-kind exchange transactions under Section 1031 of the Internal Revenue Code of 1986 ("Code") involving so-called accommodation parties such as a "qualified intermediary" or "QI" (as defined in Treasury Regulation §1.1031(k)-1(g)(4)) or an "exchange accommodation titleholder" or "EAT" (within the meaning of IRS Revenue Procedure 2000-37).

While Comment 25 suggests that the Department agrees with our prior comment, the amendments to §91.53 in the Draft Final Regulations take an approach *exactly opposite* to the one we recommended. That is, we suggested language and examples to make clear that a transfer of real estate from a QI or EAT to its client (*i.e.*, the taxpayer engaging in the Code §1031 exchange) qualifies for the "agent or straw party" exclusion under the RTT Law. In contrast, §91.153(d) of the Draft Final Regulations provides that a QI or EAT cannot qualify for the "agent or straw party" exclusion under any circumstances.

We recognize that the position set forth in §91.153(d) is consistent with the position espoused by the Department in RTT Bulletin 2006-01 (October 20, 2006). The Department's position is incorrect, however, because it is premised upon a misunderstanding of the role served by a QI or EAT in Code §1031 exchanges. In particular, we note that RTT Bulletin 2006-01 states that "federal tax law precludes a QI or EAT from being an agent of taxpayer." To the contrary, Treasury Regulation §1.1031(k)-1(g)(8), Example 3(v) provides that a person may serve as a QI for Code §1031 purposes "regardless of whether [such person] was [the taxpayer's] agent under state law." Similarly, the IRS permits an EAT to act in an agency capacity for state law purposes albeit without being treated as the taxpayer's agent for purposes of Code §1031. See PLR 200148024. The whole point of the federal rules dealing with QIs and EATs is to create a legal fiction, solely for limited purposes under Code §1031 and not for other federal income tax purposes, that QIs and EATs are not acting as the agents of the taxpayers who hired them. This legal fiction is only necessary because of the fact that, under normal state law rules dealing with agents and principals, QIs and EATs clearly <u>are</u> acting as mere agents.

For RTT purposes, the governing rules should be the normal state law rules dealing with agency, not the federal tax law "fiction" of non-agency status solely for purposes of Code §1031.[4] Accordingly, we reiterate our comments to the Proposed Regulations explaining why

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[4] Footnote 3 in RTT Bulletin 2006-01 notes that "Treas. Reg. §1.1031(b)-2 and 1.1031(k)-1(g)(4)(i)...specifically state that a QI is not considered an agent of the taxpayer." The full text of the first cited Treasury Regulation provides that a QI is "not considered the agent of the taxpayer *for purposes of section 1031(a).*" [Emphasis supplied.] The full text of the second cited Treasury Regulation provides that for purposes of section §1031(a), receipt of money by a QI is treated "*as if* the [QI] is not the agent of the taxpayer." [Emphasis supplied.] Thus, the relevant Treasury Regulations clearly establish the non-agency status of a QI as a "fiction" solely for purposes of Code §1031. Indeed, RTT Bulletin 2006-01 elsewhere recognizes that "federal tax law indulges in a fiction" regarding multi-party exchanges through

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QIs and EATs should be viewed as agents for state law (and thus RTT) purposes and re-propose the suggested amendment to §91.160(b) and accompanying examples set forth in our prior comments and below.

We also point out that, to the best of our knowledge, all other jurisdictions which have a similar "straw party/agency" exclusion under their realty transfer tax laws, and which have considered whether QIs or EATs qualify for such exclusion, have reached the opposite conclusion of that expressed in the Draft Final Regulations. See, *e.g.*, State of Florida, Department of Revenue, Technical Assistance Advisement 07M-001 (January 11, 2007) (Deed from EAT to taxpayer to complete "reverse" exchange exempt from Florida documentary stamp tax as transfer from agent to principal); Memorandum of Advice from Bruce C. Benshoof, Maryland Assistant Attorney General, to All Clerks of the Circuit Courts (October 28, 2004) (EATs and QIs qualify as "straw men" for purposes of exclusion from Maryland recordation and transfer taxes); New York City Finance Letter Ruling No. 02-4795 (March 13, 2003) (EATs and QIs qualify as agents of their clients for City's Real Property Transfer Tax as they cannot earn profit or suffer losses from property ownership, earn only a fee for their services, and hold title to property for a limited period of time not to exceed 180 days).

In our prior comments, we noted that "the uncertainty surrounding the RTT treatment of various types of exchanges places Pennsylvania property owners at a distinct disadvantage in accessing [the Code §1031] market." Resolving this uncertainty in favor of unwarranted double RTT taxation of common Code §1031 exchanges, based on an interpretation of Federal Treasury Regulations which is both misguided and at odds with every other jurisdiction which has considered the issue, only will exacerbate this disadvantage. Accordingly, we urge the Department to reconsider its position regarding the status of QIs and EATs for RTT purposes and to adopt the amendments proposed in our prior comments and below.

(b) Like-Kind Exchanges.

(1) The transfer of property (i) from a "qualified intermediary" or "QI" (within the meaning of federal Treasury Regulation § 1.1031(k)-1(g)(4)) or from an "exchange accommodation titleholder" or "EAT" (within the meaning of Rev. Proc. 2000-37) to the person who has engaged the QI or EAT to facilitate a like-kind exchange of properties under Section 1031 of the Internal Revenue Code (the "Exchangor") or (ii) from the Exchangor to a QI or EAT, shall be treated in each case as a transfer between

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accommodation parties. It should also be noted that the federal tax regulations creating this fiction were enacted well after the adoption of the RTT Law so the drafters of the RTT Law could not possibly have had the federal tax rules in mind.

a principal and an agent, provided that under the arrangement between the parties the QI or EAT will derive no profit or loss from the acquisition, holding or disposition of real estate (other than a fee for providing qualified intermediary or exchange accommodation services).

(2) Where a QI or EAT acquires legal title to a property through a newly-formed, special purpose entity which is disregarded as a separate entity for federal income tax purposes under Treasury Regulation § 301.7701-3 (a "Disregarded Entity"), and the arrangement between the parties provides that the QI or EAT will derive no profit or loss from the acquisition, holding or disposition of such property (other than a fee for providing qualified intermediary or exchange accommodation services) a subsequent transfer of equity interests in the Disregarded Entity from the QI or EAT to the Exchangor shall be ignored for purposes of determining whether the Disregarded Entity is an "acquired real estate company" under § 91.202, and the Exchangor shall be treated as the beneficial owner of the Disregarded Entity's equity interests for purposes of § 91.202 during the period the EAT or QI holds nominal title to such interests.

Example A Exchangor engages an EAT to acquire and hold a property intended to be a replacement property (within the meaning of Treasury Regulation § 1.1031(k)-1(a)) in a like-kind exchange for Exchangor's benefit. The EAT acquires the property from a third-party seller ("Seller") for cash. The arrangements between the EAT and Exchangor (including the exchange documents, loan documents, leases and/or property management agreements) establish that the EAT will derive no profit or loss from the acquisition, holding or disposition of such property (other than a fee for providing services as an EAT). As part of the exchange, EAT transfers the property to the Exchangor within 180 days of the date EAT acquired such property. The transfer from the Seller to the EAT is subject to realty transfer tax based on the cash consideration paid by the EAT. The transfer from the EAT to the Exchangor is exempt as a transfer from an agent to a principal.

Example B Exchangor engages an EAT to acquire and hold a property intended to be a replacement property (within the meaning of Treasury Regulation § 1.1031(k)-1(a)) in a like-kind exchange for Exchangor's benefit. The EAT acquires the property

from a third-party seller ("Seller") for cash through a newly-formed, special purpose Disregarded Entity. The arrangements between the EAT and Exchangor (including the exchange documents, loan documents, leases and/or property management agreements) establish that the EAT will derive no profit or loss from the acquisition, holding or disposition of such property (other than a fee for providing services as an EAT). As part of the exchange, EAT transfers 100% of the equity interests in the Disregarded Entity to the Exchangor within 180 days of the date the Disregarded Entity acquired the replacement property. The transfer from the Seller to the Disregarded Entity is subject to realty transfer tax based on the cash consideration paid by the Disregarded Entity. The transfer from the EAT to the Exchangor of the equity interests in the Disregarded Entity is not taken into account in determining whether such entity is an "acquired real estate company" under § 91.202 because there has been no change in the beneficial ownership of such entity.

I. Special Purpose Entities

The Department has deferred addressing special or single purpose entities ("SPE's") in the Draft Final Regulations. However, we again urge the Department to do so because the rules as they currently exist interfere with legitimate business transactions and make Pennsylvania stand in a lonely group of business unfriendly states.

In the current real estate lending market, real estate lenders very often require that real estate that secures a loan be held by a SPE. An SPE is a bankruptcy remote entity that has no assets other than the real estate that secures the loan and conducts no business other than that in connection with the ownership of the real estate. Lenders do not want other activities of the borrower to cause financial difficulties and bankruptcy. It is therefore customary for borrowers to transfer title to a new, wholly owned entity with no other assets or activities. In fact, *Exton Plaza*, *supra* was a case involving an SPE limited partnership in which the court found that RTT should not be imposed. Pennsylvania is infamous in the lending and real estate circles for the roadblock that the RTT presents to facilitating these transactions in a cost effective manner.

We believe that if the following conditions are satisfied, an SPE transaction should be treated as a financing transaction that is not subject to RTT: (i) the SPE is wholly owned by the original owner of the real estate, (ii) the transfer of the real estate to the SPE is required as a condition of the lender making the loan, (iii) the SPE only holds the real estate (and incidental personalty) that secures the loan, and (iv) the SPE conducts no other business than that in connection with the ownership of the real estate described in (i), (ii) and (iii).

We suggest that the definition of financing transaction in § 91.101 "Financing transaction" in the Draft Final Regulations be revised as follows:

Financing transaction – An arrangement in which the following apply:

(A) In General.

(i) Realty is transferred by the debtor solely for the purposes of serving as security for the payment of a debt.

(ii) No sale or gift is intended.

(iii) The debtor retains possession and beneficial ownership of the real estate transferred before default.

(iv) The transferee obtains title or ownership to the real estate only so far as is necessary to render the instrument effective as security for the debt.

(v) The transferee or the transferee's successor is obligated to return the transferred real estate at no or only nominal consideration to the debtor upon payment of the debt before default.

(B) Special Purpose Entity Transactions.

A transfer of real estate to a special purpose entity in connection with a loan secured by the real estate if all of the following are satisfied:

(i) the special purpose entity is wholly owned by the original owner of the real estate,

(ii) the transfer of the real estate to the special purpose entity is required as a condition of the lender making the loan,

(iii) the special purpose entity only holds the real estate (and incidental personalty) that secures the loan, and

(iv) the special purpose entity conducts no other business than that in connection with the ownership of the real estate described in (i), (ii) and (iii).

The committee that drafted these comments was chaired by Wendi Kotzen (215-864-8305, kotzenw@ballardspahr.com) and included Joseph Bright (215-977-2022,

jbright@wolfblock.com), Rod Gagne (215-981-4695, gagner@pepperlaw.com), Stanley Kull (215-972-7105, skull@saul.com) and David Shechtman (215-988-1167, david.shechtman@dbr.com). Please feel free to contact Wendi or any of the other members of her committee if you have any questions or you require clarification of our comments.

As noted above, we respectfully request a meeting with the Department so that we can more fully explain our recommendations and better understand the Department's point of view. In addition, we reiterate our offer to help with the drafting of the regulations. Even if we do not agree with the Department's position on a matter, we are committed to assisting, to the extent you are willing to permit us, in the drafting of regulations that will facilitate the proper administration and implementation of the law.

Very truly yours,

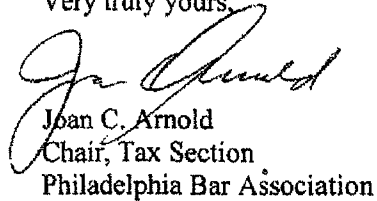

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EXHIBIT A

1. Suggested Definitions

In order properly to interpret the statute in the light of *Exton Plaza* and other authorities, we recommend adding to the Regulations the following definitions to address changes in form of a single entity:

a. Conversion or Convert. A conversion includes any of the following processes by which an Original Entity changes its form or place of organization to become a Reformed Entity or Resultant Entity:

(i) A general partnership files a certificate of limited partnership, which causes the general partnership to become a limited partnership in the filing state or foreign jurisdiction;

(ii) An Original Entity changes its name or the state or foreign jurisdiction in which it is organized;

(iii) Under the laws of any state or foreign jurisdiction, the Original Entity changes the form,in which it is organized to another form (the Reformed Entity) if the laws of the state or foreign jurisdiction of organization of the Reformed Entity provided that the Reformed Entity continues as the same entity as the Original Entity; or

(iv) Any of the following processes (I) by which all assets and liabilities of a single Original Entity become vested in a Resultant Entity which Resultant Entity prior to the transactions did not engage in business activities, (II) through which the separate existence of the Original Entity terminates, and (III) following which only the Resultant Entity survives:

(A) The Original Entity is merged or consolidated with and into the Resultant Entity under the merger or consolidation statute of any state or foreign jurisdiction; or

(B) The owners of the Original Entity contribute their ownership interests in the Original Entity to the Resultant Entity in exchange for Ownership Interests in the Resultant Entity, but only if the Original Entity is dissolved in connection with this transaction.

(C) The Original Entity transfers all of its assets subject to all of its liabilities to the Resultant Entity provided that the Original Entity promptly dissolves following the transfer.

c. Original Entity. A corporation or association that undertakes a Conversion.

d. Ownership Interest. The capital interests in a corporation, the capital and profits interests in a partnership or limited liability company, or the beneficial interests of a business trust.

e. Reformed Entity. A corporation or association into which an Original Entity Converts.

f. Resultant Entity. A corporation or association into which an Original Entity merges or consolidates, or to which the Original Entity transfers all of its assets subject to all of its liabilities.

2. Sections 91.152(b)(2) to (b)(5)

Substitute the defined terms Original Entity, Reformed Entity, and Resultant Entity where appropriate.

3. Section 91.152(b)(4) – Change in Proportionate Ownership Interests

The first sentence of § 91.152(b)(4) should provide:

(4) If the Original Entity is a real estate company, any ownership change that is part of a Conversion, together with all other transfers of Ownership Interests in the Original Entity in the three year period ending on the date of the Conversion, does not cause the Original Entity to become an acquired real estate company.

4. Section 91.152(b)(5) Example 1

The references in example1 to business continuity should be deleted and this example should make clear that its result occurs only if A and B did not hold title as agents for the AB partnership.

5. Section 91.152(b) (5) Example 3

Example 3 should be deleted for the reasons discussed in the comment letter and in its place, we suggest the addition of the following example:

A and B are equal partners in general partnership AB, which is a real estate company. In a Conversion, AB general partnership becomes AB limited partnership AB, which has the following partners: (1) A is the 1% general partner; (2) A is a 5% limited partner; (3) B is a 6% limited partner; and (4) C is an 88% limited partner. Provided there have been no other changes in ownership during the three years immediately preceding the conversion, the deed confirming the change in form from a general to a limited partnership is not taxable because less than 90% of the Ownership Interests in the partnership have been transferred over three years.

6. **Section 91.152I(b) (5) Example 4**

Example 4 should be deleted because as *Exton Plaza* stated, a conversion, regardless how accomplished is not a taxable transaction.