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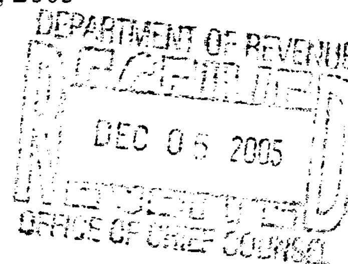
PHILADELPHIA BAR ASSOCIATION

Tax Law Section

December 2, 2005



Ms. Mary R. Sprunk
Office of Chief Counsel
Pennsylvania Department of Revenue
Office of Chief Counsel, Dept. 281061
1133 Strawberry Square
Harrisburg, PA 17128-1061

Re: Comments and Suggestions Concerning Proposed Amendments, Department of Revenue, 61 Pa. Code, Chapter 91, Realty Transfer Tax ("RTT") Regulation Amendments (the "Proposed Regulations") published in the Pennsylvania Bulletin dated November 5, 2005

Dear Ms. Sprunk:

The Tax Section of the Philadelphia Bar Association respectfully submits the following comments and suggestions regarding the Proposed Regulations.

A. Section 91.101 - Definition of Association - Restricted Professional Company

The Proposed Regulations add to the definition of association a: "restricted professional company *that is deemed to be a limited partnership under 15 Pa.C.S.A. § 8997*" (emphasis added).

It is unclear whether this language is intended to mean that the characterization of a restricted professional company ("RPC") depends on whether it has one member or multiple members, and there is no need or reason to make such a distinction in any event.

Pursuant to 15 Pa.C.S.A § 8925, unless otherwise provided, an RPC is treated as a corporation for all Commonwealth tax purposes. An exception is found in 15 Pa.C.S.A § 8997 (relating to taxation of restricted professional companies). Prior to Act 7 of 1997 ("Act 7"), 15 Pa.C.S.A. § 8997 provided that unless an RPC (i) was engaged in a business not permitted to be conducted by an RPC, (ii) had only one member, or (iii) has been a member of a limited liability

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company, for all Commonwealth tax purposes, it is deemed to be a limited partnership and its members are treated as limited partners. However, Act 7 repealed these restrictions insofar as they were inconsistent with Act 7. As a result, it is entirely unclear what, if anything, remains of the three requirements listed above. This is a difficult issue that should not be addressed in the RTT regulations.

We believe that all RPCs are properly treated as limited partnerships and see no reason to distinguish between single member RPCs and multi-member RPCs for RTT purposes. For these reasons we suggest that all RPCs, single or multimember, be treated as associations and that the following words be deleted "that is deemed to be a limited partnership". In the alternative, we believe the Regulations should set forth how a single member RPC is treated for RTT purposes.

B. <u>Sections 91.132(c) - Valuation - Appraisal - *Allebach*</u>

The Proposed Regulations provide that:

> (c) This value does not include the value of the consideration paid by buyer's assignee, or a subsequent assignee thereof, for the right to have the seller convey the real estate to the assignee or subsequent assignee unless the seller is a party to the assignment and receives part or all of the consideration paid for the assignment. If the seller is a party to the assignment and receives all or part of the consideration paid for the assignment, the value shall include the value of the consideration that the seller receives.

This subsection ratifies the ruling in *Allebach v. Commonwealth of Pennsylvania*, 546 Pa. 146, 683 A.2d 625 (1996) and the Department is correct to adopt this rule. We believe that to prevent abuse, the Department should revise the rule to include in value amounts received by a seller's affiliate for an assignment of a contract. For example, if a seller enters into a contract with its affiliate, such as a limited liability company wholly owned by the seller, and the affiliate assigns the contract to a buyer for a fee, all of the consideration received by the seller and its affiliate should be included in value. We suggest the following:

> (c) This value does not include the value of the consideration paid by buyer's assignee, or a subsequent assignee thereof, for the right to have the seller convey the real estate to the assignee or subsequent assignee unless the seller or the seller's affiliate is a party to the assignment and receives part or all of the

> consideration paid for the assignment. If the seller or the seller's affiliate is a party to the assignment and receives all or part of the consideration paid for the assignment, the value shall include the value of the consideration that the seller and its affiliate receives. For purposes of this section 91.132(c) the term "seller's affiliate" has the same meaning as the term "grantor's affiliate" in Section 91.131.

C. Section 91.152 - Conversions and Confirmatory Deeds

The Proposed Regulations codifies the exemption of confirmatory deeds in Section 91.152 to deal with mergers, consolidations and changes in the form or identity of a single entity. Specifically, the Proposed Regulations would add:

> (b) A deed made without consideration for the sole purpose of confirming real estate ownership following a merger, consolidation or change in the form or identity of a corporation or an association. This subsection only applies if all of the following occur:
>
> (1) Record title to the subject real estate is in the entity as opposed to its owner(s).
>
> (2) Without the making of any document:
>
> (i) The resultant entity is vested with all the property, real, personal and mixed, and franchises of, and the debts due, the original association or, in the case of a merger or consolidation, each party thereto.
>
> (ii) The resultant entity is subject to all the obligations of the original association or, in the case of a merger or consolidation, the parties thereto.
>
> (iii) Liens upon the property of the original association or, in the case of a merger or consolidation, any party thereto, are not impaired by the change in form.

(iv) Any claim existing or action or proceeding pending by or against the original association or, in the case of a merger or consolidation, any party thereto, may be prosecuted to judgment against the resultant entity.

(3) The original entity or, in the case of a merger or consolidation, any party thereto, is not required to wind up its affairs or pay its liabilities and distribute its assets either because there is no break in the continuity of its existence or because its separate existence ceases with the reformation.

(4) Considering all the ownership interests in the original entity or, in the case of a merger or consolidation, any party thereto, there is no change in proportionate ownership interests resulting from the change in form.

(5) Title to real estate would not revert or be in any way impaired by reason of the merger, consolidation or change.

[examples omitted]

(c) A deed made without consideration for the sole purpose of confirming a change in place of organization.

(d) Notwithstanding the provisions of § 91.154 (relating to documents involving corporations, partnerships, limited partnerships and other associations), when determining if there is a change in proportionate ownership interests, corporations and associations shall not be considered to be entities separate from their members, partners, stockholders or shareholders; and when determining if there is a change in proportionate ownership interests resulting from the change to limited partnership, the interests of the limited partners and general partners shall both be considered.

(e) A deed made without consideration for the sole purpose of confirming that a prior recorded document was void ab initio and revesting record title in the grantor is not taxable.

We believe the proposed addition makes a number of errors in interpreting the RTT and case law. We address them in the following sections.

1. **Exton Plaza Associates**

The changes in the Proposed Regulations relating to conversions incorporate the decision in *Exton Plaza Associates v. Commonwealth*, 763 A.2d 521 (Pa. Commw. 2000). In *Exton Plaza,* the partners in a general partnership formed a parallel limited partnership with essentially no change in beneficial ownership. Real estate was then transferred from the general partnership to the limited partnership. The transaction was undertaken to meet the requirement of a lender that the property be held in a new single purpose, bankruptcy-remote entity. Because the business continued unchanged (apart from the financing), and because there was no change in beneficial ownership, the court found that no tax was due. "Our conclusion - - that the deed in this case does not effect a transfer of a beneficial interest in the shopping center to someone other than the grantor - - is most analogous to the exclusion for a correctional or confirmatory deed that does not change the beneficial interest in the property." 763 A.2d at 524. In other words the Commonwealth Court determined in *Exton Plaza* that the transferor general partnership and the transferee limited partnership were to be treated as one and the same. See 763 A.2d at 523.

We believe that the following principles follow from a correct interpretation of *Exton Plaza*:

- A true conversion of a single entity does not involve any transfer of real estate and cannot be subject to RTT because the converted entity is the same entity both before and after the conversion.

- A change in proportionate ownership should be relevant in an *Exton Plaza* type of case only where the converted entity may become an acquired real estate company.

- The RTT treatment of an organizational change should not be affected by whether record title was held by an entity or by its owners provided that the owners prove that at all times they held the real estate on behalf of the entity.

- Since the court in *Exton Plaza* stated "[R]egardless of the details of how this 'conversion' was accomplished, . . . the execution of the deed transferring the [property] merely memorialized the conversion from a general partnership to a limited partnership," any process by which a conversion may be accomplished should be converted by the exemption. See 763 A.2d at 524.

2. **Suggested Definitions**

In order properly to interpret the statute in the light of *Exton Plaza* and other authorities, we recommend adding to the Proposed 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.

3. **Section 91.152(b) - Confirmatory Deeds**

The first sentence of Section 91.152(b) of the Proposed Regulations provides:

(b) A deed made without consideration for the sole purpose of confirming real estate ownership following a merger, consolidation or change in the form or identity of a corporation or an association.

The sentence should be changed to read as follows:

A deed made without consideration for the sole purpose of confirming ownership of real estate as the result of a Conversion of an Original Entity is not subject to tax.

4. **Section 91.152(b)(1) – Record Title Held by Owners**

The Proposed Regulations provide that a deed made in connection with a merger, consolidation, or change in form or identity qualifies for the confirmatory deed exclusion:

> (1) Record title to the subject property is held by the entity as opposed to its owner(s).

The effect of this sentence is to impose tax upon a confirmatory deed if record title to property is held by the owners of the Original Entity, rather than in the name of the Original Entity, prior to the Conversion. The sentence incorrectly ignores general principal-agency principles. If property is titled in the names of A, B and C, but it is clear from the date on which the property was first acquired that A, B and C held the property as partnership property for ABC partnership and not in their own capacities, the subsequent transfer from A, B and C to ABC partnership should be excluded from tax as a transfer between a principal and agent under RTT Regulation § 91.193(b)(11). Proof that property is held by owners of an entity on behalf of the entity might consist of documents contemporaneous with the acquisition of the property, or federal and state income tax returns that consistently treat the property as partnership property. The Department has so ruled in the past. Under similar circumstances, no tax should be imposed upon a deed confirming the conversion to the Reformed Entity or transfer to the Resultant Entity pursuant to a Conversion, regardless whether title to the real estate was held in the name of the Original Entity or in the name of the owners of the Original Entity prior to the Conversion. Accordingly, Proposed Regulations § 91.152(b)(1) and Example 1 should be changed to read as follows:

> (1) The owners of the Original Entity at all times treated the subject real estate as the property of the Original Entity, rather than as the property of the owners of the Original Entity.
>
> Example 1. A and B are equal partners in a general partnership known as AB, general partnership. One of the assets of the partnership is real estate. The real estate is titled in the names of A and B, individually, as co-tenants. Since the inception

> of AB, AB has filed partnership tax returns showing that it is the owner of the real estate. A and B want to convert their general partnership to a limited partnership known as AB, LP. A and B set up an LLC to be the 1% general partner in the limited partnership. A and B will have a 99% limited partnership interest in the limited partnership (that is, A and B each have a 49.5% limited partnership interest). In order to effectuate the conversion, A and B, merge the partnership into the limited partnership. The limited partnership is the surviving entity of the merger. The general partnership ceases to exist as a result of the conversion. After the conversion, A and B prepare a deed for the partnership real estate to confirm the partnership's change of form to the limited partnership. Because the general partnership owned the real estate and there has only been a change in the form of the business, the deed is not taxable.

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

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

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

The Proposed Regulations provide that a deed made in connection with a Conversion will be tax exempt only if:

> Considering all the ownership interests in the original entity or, in the case of a merger or consolidation, any party thereto, there is no change in proportionate ownership interests resulting from the change in form.

A change in proportionate ownership interests in connection with a Conversion should be largely irrelevant. The Court in *Exton Plaza explicitly* stated that there was no change in beneficial ownership, *i.e.*, the general partnership was the same entity as the limited partnership. In the case of a direct transfer of ownership interests in a real estate company, RTT is imposed only if the real estate company becomes an acquired real estate company because of a transfer of 90% or more of the capital and profits interests in the entity in the three year period ending on the date of transfer. If an entity is the same entity both before and after a Conversion, RTT is

imposed only if the entity is a real estate company that becomes an acquired real estate company. Furthermore, since if the Converted entity experienced an ownership change of less than 90% immediately before or after the Conversion, RTT would not be imposed either upon the change in ownership or the Conversion, the rule in *Baehr Bros v. Commonwealth*, 487 Pa. 233, 409 A.2d 326 (1979) would allow an ownership change as part of a Conversion.

Accordingly, § 91.152(b)(4) should be revised to read as follows:

> (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.

7. **Section 91.152(b) Example 2**

The Proposed Regulations provide:

> Assume the same facts as Example 1 except that general partnership AB purchased the real estate with partnership funds and titled the property in the name of the partnership. A and B have merely converted their form of organization from that of a general partnership to a limited partnership. It continues its same business and has all the same assets and liabilities as the general partnership. Further, ownership has not changed. A and B were equal partners in the general partnership and are equal general partners (through their equal ownership of the LLC) and limited partners. Because the general partnership held the real estate of record and there has been a change in form of the business, the deed is not taxable.

The following sentences should be deleted: "Further, ownership has not changed. A and B were equal partners in the general partnership and are equal general partners (through their ownership of the LLC) and limited partners."

The acquired company rules currently set forth in current RTT Regulations § 91.202 make clear that an ownership interest includes only an economic interest. The quality of the interest as a general or limited partner interest or economic or managerial interest is irrelevant. The Regulation defines an ownership interest as both the capital and profits ownership interest in the company. The Regulations should formally adopt this definition for Ownership Interest. See Section C.2. above. Under the current Regulations, an ownership interest may be changed only by transactions that affect the economic ownership of the entity; the quality of the interest is irrelevant. The Proposed Regulations should apply a consistent definition of Ownership Interest, as an economic interest only, in both the acquired company rules and the confirmatory deed rules.

The reference in Example 2 in the Proposed Regulations to the continuity of business test should be deleted because it is irrelevant.

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

The Proposed Regulations provide:

> Assume the same facts as Example 2, except that A becomes the general partner and B becomes the limited partner. Each holds a 50% interest in the partnership's income. Although A and B each have an equal income interest, A now has sole control over the partnership as the general partner and B has only an income interest as a limited partner. In the general partnership, A and B had equal management and income interests. Because there is a change in ownership interests, the deed is taxable.

Example 3 should be deleted for the reasons discussed above at Section C.7. 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.

9. **Section 91.152 (c) - Change in Place of Organization**

The Proposed Regulations provide:

(c) A deed made without consideration for the sole purpose of confirming a change in place of organization.

The sentence is incomplete. Add at the end: is not taxable.

10. **Section 91.152(d) - Change in Ownership Interest**

The Proposed Regulations provide:

(d) Notwithstanding the provisions of § 91.154 (relating to documents involving corporations, partnerships, limited partnership and other associations), when determining if there is a change in proportionate ownership interests in connection with a conversion, corporations and associations shall not be considered to be entities separate from their members, partners, stockholders or shareholders; and when determining if there is a change in proportionate ownership interests resulting from the change to a limited partnership, the interests of the limited partners and general partners shall both be considered.

The clause after the semicolon should be deleted for the reasons discussed above at Section C.6. In addition, this section should clearly state that it applies solely for purposes of determining when a conversion causes a real estate company to become an acquired real estate company. We suggest the following:

Notwithstanding the provisions of § 91.154 (relating to documents involving corporations, partnerships, limited partnership and other associations), solely for purposes of Section

91.152(b), when determining if there is a change in proportionate ownership interests in connection with a Conversion, corporations and associations shall not be considered to be entities separate from their members, partners, stockholders or shareholders.

D. Section 91.154 - Documents involving Corporations, Partnerships, Limited Partnerships and other Associations

Under the RTT, transfers between owners and their entities are subject to tax unless an explicit exemption applies such as a proportional distribution by an entity of real estate to owners that have held their interests in the entity for more than two years. See RTT §§ 8102-C.4 and 8102-C.3(13). The Proposed Regulations at § 91.154(a) adopt these statutory rules. However, Proposed Regulations §§ 91.154(b) and (c) create exclusions for circumstances that we believe cannot occur or that are not supported by the RTT Law.

Section 91.154(b) of the Proposed Regulations describes an exclusion for "the conversion of real estate" from an owner to its or his entity unless (i) the "conversion" is effectuated by deed or memorialized by a writing satisfying the Statute of Frauds or (ii) the "conversion" is confirmed in writing. There is no mechanism in the law for an owner of real estate to convert the ownership thereof to an entity without transferring title thereto. Title can be transferred without recording anything. The RTT is a transfer tax, not a recording tax. RTT is due at the earlier of the date that a document is presented for recording or the document is accepted. See RTT Law § 8102-C. Therefore, if title is transferred by a titleholder to an entity, the transfer is subject to RTT. We cannot think of any transaction to which this section would apply.

Section 91.154(c) of the Proposed Regulations describes an exclusion for "the conversion of real estate" from an entity to its owners unless (i) the "conversion" is effectuated by deed or memorialized by a writing satisfying the Statute of Frauds or (ii) the "conversion" is confirmed in writing. The only circumstance that we can think of where this section could apply is upon a statutory dissolution of an entity whereby all of the entity's properties are distributed to its owners. Section 8102-C.3(13) of the RTT Law provides an exclusion for such a distribution but the exclusion applies only if the owners have held their interests in the entity for more than two years. This section would provide an exclusion for a distribution to owners that have not held their interests for at least two years.

The RTT is imposed upon the making, executing, delivering, accepting, or presenting for recording of a document. RTT Law § 8102-C. A document, with certain exclusions, is any

deed, instrument or writing which conveys, transfers, devises, vests, confirms, or evidences any transfer or devise of title to real estate. RTT Law § 8101-C "Document." We believe that the document that must be filed with the Secretary of State to dissolve an entity is a document under the RTT law. If this is not the case, then RTT would not apply to transfers by operation of law and it is quite clear that RTT does apply to transfers by operation of law.

Based on the foregoing, the following should be deleted: the new language in Proposed Regulations § 91.154(a) and Proposed Regulations §§ 91.154(b), (c), and (d).

E. 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 these amendments was to prevent taxpayers from using trusts to effect tax-free transfers of real estate to unrelated parties. 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 Proposed Regulations should clarify the drafter's intentions. We 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 Proposed Regulations at § 91.101 "Living Trust" state in the definition of LT that it is an OT.) Consequently, one overarching comment is that Proposed 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"

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

> Living Trust - an ordinary trust:
>
> (1) Which, throughout the settlor's lifetime, is revocable by the settler [sic] without the consent of an adverse party.
>
> (2) Which vests no present interest in any of the trust assets in any person other than the settlor or trustee until the settlor dies.
>
> (3) 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.
>
> (4) From which no transfer of property or money 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.
>
> (5) 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 (1) of the definitions in the Proposed 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 same comment applies to subparagraphs (2) and (3) of the definition contained in the Proposed Regulations. In both instances, the Proposed Regulations narrow the statutory definition of an LT. 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. Consequently, both subparagraph (2) and (3) should be deleted.

Subparagraph (4) of the draft definition of LT provides that during the settlor's life, no transfer of property or money may be made "to any person in the capacity of a beneficiary other than the settlor." It appears this language was intended to amplify and explain the statutory rule that to qualify as an LT, "distributions cannot be made to any beneficiaries other than the settlor" prior to the settlor's death, but we believe that further guidance is required. This is a critically important issue for taxpayers and their advisers. In practice, all "garden variety" living trusts drafted by gift and estate planners as will substitutes provide the flexibility for payments to be made directly from the trust to persons other than the settlor. If these other persons who may receive distributions are considered "beneficiaries" then the trust will not qualify as an LT, whereas the trust should qualify as an LT if all of these distributions to third parties are treated as having been made <u>on behalf of the settlor</u>, and if the settlor is the sole "beneficiary" of the trust prior to the death of the settlor. The concept of who is a "beneficiary" is clarified by including the following:

For Example:

(A) If a trust agreement provides that the income of the trust is distributable one-half to settlor and one-half to settlor's spouse, at least annually, the trust is not a Living Trust, because money or property of the trust is being transferred to someone other than the settlor (the settlor's spouse) in her capacity as a beneficiary during the settlor's lifetime.

(B) If a trust agreement provides that during the settlor's life, the trustee, at the direction of the settlor, may direct the trustee to transfer money or property to the settlor's spouse or children, the trust is a living trust, since any money or property transferred by the trustee is either transferred to the settlor or for his benefit, since the settlor directs the trustee to make the transfer and the transfer is not to settlor's spouse or children as beneficiaries.

> (C) If a trust agreement provides that during settlor's life, the trustee may in trustee's sole and absolute discretion, make distributions to members of the settlor's family, the trust is a Living Trust, because the settlor effectively is directing the Trustee to make distributions to the members of the settlor's family, who are not vested beneficiaries of the trust.

Similarly, Subparagraph (5) is not a requirement of the RTT Law and should be deleted since it precludes any trust that could continue and accumulate income or principal for a beneficiary after the death of the settlor. It is common for a trust to provide that the trustee may accumulate income after the death of the settlor for a beneficiary who is a minor. In addition, it is common to provide that if the settlor becomes incapacitated, the trustee has the authority to continue to make gifts to the natural objects of the settlor's bounty. These terms are helpful to allow income or corpus of a trust to be distributed to a member of the settlor's family (see RTT Law § 8101-C "Members of the Same Family"); and, therefore, it is not an abusive transfer. Finally, the requirement to force a transfer to the settlor and then for the settlor to make a subsequent transfer to an exempt transferee is not consistent with Proposed Regulations § 91.171. Thus, Subparagraph (5) should be deleted.

b. <u>Section 91.101 "Ordinary Trust"</u>

Subparagraph (1) of Proposed Regulations § 91.101 "Ordinary Trust" contains the term "Associations Code," which is not a defined term and is limited in its scope. We suggest the following definition be revised as follows:

> (1) Business trusts organized under Pennsylvania law or the law of any state or foreign jurisdiction, or any association using the form of a trust which have either the following features: . . .

c. <u>Section 91.101 "Settlor"</u>

The definition of settlor in the Proposed Regulations is too limited in that it restricts the definition to the creator of the trust. In many common estate planning situations, a husband and wife own property jointly and make a gift of the property to an LT. The definition of settlor should include any contributor of property to a trust if such person is a member of the same family (see RTT Law § 8101-C "Members of the Same Family"). Section 91.171 of the Proposed Regulations should give sufficient support for the notion that a husband or wife need

not first transfer the property to the spouse creating the trust, and then have that spouse make the transfer to the trust. The definition should be changed to read as follows:

> Settlor – One who creates or furnishes the consideration for the creation of a trust or a child, brother, sister of the settlor or a spouse of any of the foregoing named persons who transfers property to the trust.

d. Testamentary Trust

The new definition of testamentary trust is incomplete. It should include an OT or LT that becomes effective upon the death of the either the settlor or the income beneficiary. We suggest that the definition be revised to read as follows:

> Testamentary Trust – a private trust 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.

2. **Section 91.156 - Trusts**

Section 91.156(b) of the Proposed Regulations should be identical to the statute and the words "by itself neither qualify nor" should be deleted and replaced with the word "not."

Section 91.156(c) should be expanded to encompass the intent and purpose of the statute to apply to estate planning trusts that satisfy either or both of the definitions of an OT or an LT. The provision should be amended to add at the end thereof "or, if not the settlor, it satisfies the provisions of 91.156(a)." In addition, if the definition of settlor is not changed, Section 91.156(e)(2) should provide at the end "or if the property was conveyed to the trust from someone other than the settlor, the transfer from that person to the settlor would not have been subject to tax."

3. **Section 91.193(32) - Excluded Transactions**

To conform the suggested changes above to expand the exemptions accorded an OT to an LT, 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).

4. **<u>Section 91.193(b)(33) - Excluded Transactions</u>**

Proposed Regulation § 91.193(b)(33) should permit the transfer of real estate from a trust to any person during the life of the settlor without imposition of RTT if the transfer from the settlor to the person would not be taxable. The requirement to force a transfer to the settlor and subsequently for the settlor to make a transfer to an exempt transferee is not consistent with Proposed Regulations § 91.171. Moreover, there is no substantive policy rational for taxing such a transfer. We suggest that Proposed Regulations § 91.193(b)(33) be revised to provide:

> "Transfers for no or nominal actual consideration from the trustee of a living trust during the settlor's lifetime of property conveyed to the trust by the settlor to the settlor or any person to whom the settlor could transfer real estate without imposition of tax. If the property was conveyed to the trust by a person other than the settlor, the rules of Section 91.193(b)(6) shall apply."

F. <u>Section 91.171. The rule in *Baehr Bros. v. Commonwealth*, 487 Pa. 233, 409 A.2d 326 (1979)</u>

Section 91.171(a) of the Proposed Regulations appears to be a restatement of the principle set forth in *Baehr Bros. v. Commonwealth*, 487 Pa. 233, 409 A.2d 326 (1979), that if real estate could be transferred in two separate documents, and each document would be tax-free, than the real estate can be transferred directly, in a single document, on a tax-free basis. In *Baehr Bros.* a corporation made a distribution of real estate directly to a liquidating trust established for the benefit of its shareholders. The Pennsylvania Supreme Court held that the direct deed of real estate from the corporation to the liquidating trust was exempt from RTT because there was no need for the corporation first to deed the property to its shareholders, and then for the shareholders to deed the property to the liquidating trust - that this two step process was not necessary where each step, individually, would have qualified for an exclusion from RTT.

We do not understand the requirement in Proposed Regulation § 91.171(a)(2) that each of the writings that were not actually prepared would be "effective notwithstanding the insolvency,

bankruptcy or other legal disability of the signatories thereto." Since a writing (which is merely hypothetical in the first place) cannot be effective if a party suffers from a legal disability, this requirement cannot be satisfied and we do not believe *Baehr Bros.* includes this requirement.

Also, there are significant issues raised by Proposed Regulations §§ 91.171(b) and (c), which provide as follows:

> (b) Separate transfers of a greater estate and a lesser estate in real property shall be taxed as a single transfer of both estates if the transactions are entered into in contemplation of a merger thereof.
>
> (c) 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 shall 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.

We do not understand what these new 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 Proposed 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. We do not believe that the RTT Law provides for this interpretation. Moreover, the scope of the provisions is unclear because they are drafted very broadly and could reach many non-abusive transactions. At a minimum, these provisions should be revised so that they only apply to abusive transactions and so that taxpayers can understand what transactions are covered.

The issues raised by Proposed Regulations § 91.171(b) 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, and then 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 a transaction such as this will be subject to tax "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, Proposed Regulations § 91.171(b) 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 Proposed 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 Proposed Regulations § 91.171(b), since the transfers are already fully taxable, Proposed Regulations § 91.171(b) would be unnecessary.

Another possible way to try to narrow the apparent scope of Proposed Regulations § 91.171(b) is to focus on the requirement that the transfers be "entered into in contemplation of a merger." There is no guidance as to what this language means, however. 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.

We have the same concerns regarding Proposed Regulations § 91.171(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. In the case of both Proposed Regulations § 91.171(b) and Proposed Regulations § 91.171(c), the proposed language should be narrowed so that only abusive transactions properly subject to tax are covered, and the language should be clarified so that taxpayers can understand what transactions are intended to be covered. In addition, clarifications 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:

> (b) 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.
>
> (c) 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 91.171(b) and (c) may be rebutted by the taxpayers by demonstrating that the multiple transfers are not for realty transfer tax avoidance purposes.

G. Section 91.193(b)(26) - Exclusion Applicable on Rescission or Cancellation of a Lease

This section of the Proposed Regulations is designed to address the following situation: Owner owns real estate and ground leases the real estate to A. A builds and pursuant to the

documents between Owner and B owns a building on the ground leased real estate. Buyer buys from Owner the ground leased real estate for $10x and then pays A $100x to cancel the ground lease, thereby acquiring both the land and the building. Pursuant to the existing RTT Regulations, realty transfer tax would be imposed on $10x only. The change in the Proposed Regulations is designed to impose RTT on the $100x as well.

The RTT Law does not impose tax on a lease unless its term (as defined in the RTT Law and RTT Regulations) is 30 years or more. RTT Law § 8101-C "Title to Real Estate." Consequently, payment for rescission, cancellation or abandonment of a lease of less than 30 years is not subject to tax because it is not a transfer of title to real estate. Therefore, we suggest that § 91.192(b)(26) be clarified to make clear that it applies only to leases or other contracts the remaining term of which is 30 years or more:

> The rescission, cancellation or abandonment of a lease or contract (i) for no or nominal consideration or (ii) the remaining term of which is less than 30 years. For purposes of this Section 91.192(b)(26), the remaining term of the lease or the contract shall be determined under Section 91.192(b)(24)(v).

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

We believe that the statutory exemptions and exclusions from RTT that apply to direct transfers of real estate 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 policy 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 percent 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, 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 suggest that the second sentence of § 91.193(c) be deleted and in its place the following should be added:

> 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, the transferor transferred real estate to the transferee.

In addition, even if all of the statutory exclusions do not apply to transfers of entity interests in real estate companies, certain of the excluded transactions do, in fact, apply to transfers of interests in real estate companies. For example, if A holds all of the interests in an LLC as agent for B, if A transfers the LLC interests to B, there should be no RTT imposed because there has been no transfer of the interests in LLC. Since A holds the interests as B's agent, upon a transfer by A, the agent, to its principal, B, there is no transfer.

I. Section 91.195 - State-related universities and public charities

Section 91.195(b) states:

> Other state-related universities, such as Lincoln University, the Pennsylvania State University and its affiliates, the Pennsylvania College of Technology, Temple University and its subsidiaries, Temple University Hospital, Inc., and Temple University Children's Medical Center, and the University of Pittsburgh do not constitute excluded parties.

We presume that the conclusion that these entities are not excluded parties is based on *Penn State University v. Derry Twp. School District,* 731 A.2d 1272, 557 Pa. 91 (1999) the holding of which was reversed by Act 55, The Institutions of Purely Public Charities Act, 10 P.S. § 371 *et seq.* ("Act 55"). In *Derry*, the Pennsylvania Supreme Court determined that The Pennsylvania State University was not an instrumentality of the Commonwealth for purposes of exemption from real estate taxes. In that case, since the statute creating The Pennsylvania State University was silent as to whether The Pennsylvania State University is an instrumentality of the Commonwealth, the Court analyzed various factors to determine if, for real estate tax purposes, The Pennsylvania State University is an instrumentality of the Commonwealth. The Court concluded that for real estate tax exemption purposes, the key factor is whether the Board of the institution is controlled by the Commonwealth. Since the Board of The Pennsylvania State University was not controlled by the Commonwealth, the Court concluded that for real estate tax purposes, the Pennsylvania State University was not an instrumentality of the Commonwealth.

Since 1997, when Act 55 was enacted applicable to years after those in issue in *Derry*, for real estate tax purposes, all real property of State-related universities is public property when actually and regularly used for public purposes, and therefore is exempt from State and local taxation. 10 P.S. § 374(a). For the purposes of Act 55, the term State-related universities is defined as "The Pennsylvania State University and its affiliate, the Pennsylvania College of Technology, the University of Pittsburgh, Temple University and its subsidiaries Temple University Hospital, Inc., and Temple University Children's Hospital, Inc., and Lincoln University." 10 P.S. § 374(d).

In contrast to The Pennsylvania State University, the acts creating Lincoln University, the Pennsylvania College of Technology, Temple University and the University of Pittsburgh, each

explicitly provide that each institution is an instrumentality of the Commonwealth. See 24 P.S. § 2510-402, 24 P.S. § 2510-503(7), 24 P.S. § 2510-2, and 24 P.S. § 2510-202 respectively. Moreover at 24 P.S. § 2510-503(6) the General Assembly declares "The Corporation for Penn State is a wholly controlled affiliate of the Board of Trustees of The Pennsylvania State University, a state-related university and an *instrumentality of the Commonwealth.*" (emphasis added). As a consequence, the General Assembly has made clear that the other institutions listed above as well as The Pennsylvania State University are instrumentalities of the Commonwealth. Moreover, the General Assembly overruled *Derry* and made clear that for real estate tax purposes all of the above institutions (including The Pennsylvania State University) are instrumentalities of the Commonwealth. As a consequence, the *Derry* decision does not apply to the other institutions listed above and each is an instrumentality of the Commonwealth. Therefore, transfers involving these institutions are excluded under RTT Law § 8102-C.3(1).

Therefore, § 91.195 should be revised to provide:

> (a) For the purposes of § § 91.192 and 91.193(a) (relating to excluded parties; and excluded transactions), institutions that are part of the State System of Higher Education as well as Lincoln University, The Pennsylvania State University and its affiliates , the Pennsylvania College of Technology, Temple University and its subsidiaries, Temple University Children's Medical Center and the University of Pittsburgh ("Exempt Institutions") constitute excluded parties. Transfers to such institutions by gift or dedication are excluded transactions.
>
> (b) Transfers of property to an Exempt Institution other than by gift or dedication and all transfers by such institutions are taxable upon the same basis as other transfers to or from excluded parties.

J. 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 Proposed 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. 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. A common law and general partnership are the same thing. 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. Therefore, Proposed 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. Proposed 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 Proposed 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), Proposed Regulations § 91.222(3) should provide only that "[t]he partnership is voluntarily or involuntarily dissolved." The remainder of Proposed Regulations § 91.222(3) is contrary to the statute and should be deleted.

K. <u>Other Realty Transfer Tax Regulation Comments</u>

The following comments deal with matters that are not covered in the Proposed Regulations, but that we urge be addressed.

1. **<u>Special Purpose Entity Transactions</u>**

In the current real estate lending market, real estate lenders very often require that real

estate that secures a loan be held by a special purpose entity ("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 where 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.

Although we understand that the Department believes that it has no authority to address this issue, 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 Proposed 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).

2. **Like-Kind Exchanges**

The Proposed Regulations do not address the RTT consequences of like-kind exchange transactions under Section 1031 of the Internal Revenue Code of 1986 (the "Code") involving accommodation parties. The market for like-kind exchange replacement properties constitutes a significant and growing part of the overall real estate market. The uncertainty surrounding the RTT treatment of various types of exchanges places Pennsylvania property owners at a distinct disadvantage in accessing this market.

Like kind exchanges typically involve an exchanging taxpayer ("Exchangor") and either a so-called "qualified intermediary" or "QI" (as defined in Treasury Regulation § 1.1031(k)-1(g)(4)) or a so-called "exchange accommodation titleholder" or "EAT" (within the

meaning of IRS Rev. Proc. 2000-37). The Department has issued two rulings on so-called "reverse" exchanges (the later ruling involving a transaction with an EAT) which create confusion concerning the circumstances under which an EAT (and perhaps by analogy a QI) may be treated as an agent of the Exchangor or as a straw party. See RTT-00-005 and RTT-02-013.

Under § 1031 of the Code and the applicable federal regulations, a QI facilitates the Exchangor's deferred like-kind exchange by (i) acquiring the Exchangor's "relinquished property," (ii) transferring the relinquished property to a third-party cash buyer (the "Buyer"), (iii) acquiring a "replacement property" identified by the Exchangor from a third-party seller (the "Seller") and (iv) transferring the replacement property to the Exchangor. The Exchangor and the QI must complete the deferred exchange within a period of 180 days. The applicable federal regulations do not require the QI to obtain legal title to any property but rather permit (i) the Exchangor to deed the relinquished property directly to the Buyer and (ii) the Seller to deed the replacement property directly to the Exchangor. See Treasury Regulation § 1.1031(k)-1(g)(4)(v). In some cases, however, such as an exchange involving constructed property, it may be necessary for a QI to acquire and transfer legal title to the Exchangor's replacement property. The applicable federal regulations permit the QI to act in an agency capacity albeit without being treated as the taxpayer's agent for federal income tax purposes. See Treasury Regulation § 1.1031(k)-1(g)(4)(i).

Similarly, Rev. Proc. 2000-37 permits an EAT to facilitate so-called "reverse" or "parking" exchanges for an Exchangor. Unlike a QI, however, an EAT generally must acquire legal title to either the Exchangor's intended relinquished property or, more commonly, the Exchangor's intended replacement property. In the more common structure, an EAT will (i) acquire from the Seller legal title to the Exchangor's intended replacement property and (ii) transfer legal title to the replacement property to the Exchangor after the Exchangor has transferred its relinquished property to the Buyer. Normally, the EAT borrows money from the Exchangor to acquire the intended replacement property from the Seller or obtains a third-party loan guaranteed by the Exchangor. The IRS permits the EAT to act in an agency capacity albeit without being treated as the taxpayer's agent for federal income tax purposes. See PLR 200148042. The EAT may hold title to the Exchangor's intended replacement property for a maximum period of 180 days.

Frequently, pending completion of an exchange, an EAT or a QI holds property in a newly-formed, special purpose legal entity (such as a limited liability company) which, for federal income tax purposes, is disregarded as a separate entity, and treated as one and the same entity as the EAT or QI, under Treasury Regulation § 301.7701-3 (a "Disregarded Entity"). In

those cases, the exchange may be completed by the QI's or EAT's transfer to the Exchangor of 100% of the equity interests in the Disregarded Entity.

Under the Code § 1031 "safe harbors" for QI's and EAT's, it is clear that such entities fulfill the traditional role of an agent or a straw party by acting solely at the direction of the Exchangor in order to facilitate a like-kind exchange of properties for the Exchangor's benefit. Such entities typically derive no profit or loss from the acquisition, holding or disposition of real estate; rather, they earn a fee for providing exchange accommodation services. Accordingly, we believe the RTT Regulations should clarify that any transfers of real estate interests either (i) from a QI or EAT to an Exchangor or (ii) from an Exchangor to an EAT or QI should be exempt from RTT under the exclusion for principal/agent transfers or straw party transfers. We also believe that a transfer of equity interests in a Disregarded Entity from an EAT or QI to an Exchangor should be ignored for purposes of determining whether the Disregarded Entity is treated as an "acquired real estate company." The RTT will be imposed on the disposition of the relinquished property and the acquisition of the replacement property. Additional taxes on these transactions are not warranted or required by statute. Accordingly, we suggest making § 91.160 of the current RTT Regulations § 91.160(a) and then adding the following as a new § 91.160(b):

> (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 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.

L. <u>Typographical Errors</u>

1. Section 91.101 "Living Trust" (1) the second time the word settlor is used it is misspelled as settler.

2. Section 91.101 "Ordinary Trust" - the word "of" that is the second to last word of line 3 of subparagraph (1) should be "or both of".

3. Section 91.171 "The rule in *Baehr Bros v Commonwealth*, 493 Pa 417, 426 A.2d 1086 (1981)" - the correct citation is 487 Pa 233, 409 A.2d 326 (1979).

Should you have any questions or comments, please contact any of the principal drafters of these comments: Joseph Bright (215-977-2022 jbright@wolfblock.com), Rod Gagne (215-981-4695 gagner@pepperlaw.com), Wendi Kotzen (215-864-8305 kotzenw@ballardspahr.com), or David Shechtman (215-772-7314 dshechtman@mmwr.com).

Very truly yours,

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