PHILADELPHIA BAR ASSOCIATION

Tax Law Section

December 14, 2011

2924

2011 DEC 16 P 2:41

RECEIVED IRRC

Via Email

Ms. Mary R. Sprunk
Office of Chief Counsel
PA Department of Revenue
P.O. Box 281061
Harrisburg, PA 17128-1061

RE: Comments on Proposed Realty Transfer Tax Regulations
Published in the Pennsylvania Bulletin on November 19, 2011

Dear Ms. Sprunk:

The Tax Section of the Philadelphia Bar Association hereby submits the following comments on the proposed realty transfer tax regulations (the "Proposed Regulations") issued by the Department of Revenue (the "Department") on November 19, 2011. For the reasons set forth below, the Proposed Regulations should not be adopted in their present form.

The existing realty transfer tax regulations are referred to herein as the "RTT Regulations," the realty transfer tax law (72 P.S. § 8101-C *et. seq.*) is referred to as the "RTT Law," and the realty transfer tax is referred to as "RTT." Our comments are in the order of relative importance.

§ 91.101. Definitions

Trusts in general

Transfers of real estate to a "business trust" are subject to RTT. Transfers of real estate to a "living trust" or "ordinary trust" are not subject to RTT.

The General Assembly created a detailed statutory scheme to enable transfers of real estate free of RTT for transfers to "living trusts," and to "ordinary trusts." The RTT Law includes detailed definitions of the terms "living trust" and "ordinary trust" and provides exclusions from RTT for certain transfers of real estate to such trusts. It therefore is clear that transfers of real estate to some common, ordinary estate and family planning trusts are intended to qualify for the statutory exclusions and this necessarily means that some trusts must satisfy the definition of "living trust' or "ordinary trust." The Department appears to agree with this proposition.

There is no definition of the term "business trust" in the RTT law. However, since the General Assembly's intention to exclude certain transfer of real estate to "living trusts" and to "ordinary trusts" is clear, the term "business trust" cannot encompass all trusts to the exclusion of some common estate planning and family trusts.

Nevertheless, under the definition of "business trust" in the Proposed Regulations, no trust can satisfy the definition of "living trust" or "ordinary trust" because the definition of "business trust" makes it impossible for any trust to qualify as other than a "business trust." Therefore, notwithstanding the General Assembly's intention to create a workable scheme to exclude transfers of real estate to "living trusts" and to "ordinary trusts" in the estate planning and family trust context, under the Proposed Regulations, every transfer of real estate to a trust will be subject to RTT. The definition of "business trust" in the Proposed Regulations clearly violates the legislative intent to permit certain trusts to qualify as "living trusts" and as "ordinary trusts." As a result, the Proposed Regulations should not be adopted in the current form and we suggest the following changes that will result in a more workable definition of the term "business trust."

The Proposed Regulations define a "business trust" as:

> A trust organized under Pennsylvania law, including a trust under 15 Pa. C.S.A. §§ 9501-9507 (relating to business trusts), or the law of any state or foreign jurisdiction that expressly or impliedly has any of the following features:
>
> (i) An objective to carry on business.
>
> (ii) An objective to divide or distribute gains or earnings and profits to a trust beneficiary.
>
> (iii) Treatment of a beneficiary's interest in the trust as personal property.
>
> (iv) Treatment of a beneficiary as an associate or owner of the trust.
>
> (v) The free transferability of the beneficiary's interest in the trust.
>
> (vi) Centralized management of the trust and its assets by the trustee or the beneficiaries.
>
> (vii) A continuity of life.

We believe that the purpose of this definition of "business trust" (a term that is not defined in the RTT Law) is to (1) distinguish between a "business trust" and a "living trust" or an "ordinary trust" so that the "living trust" and "ordinary trust" exclusions cannot be exploited by business entities and (2) to provide a definition for the term "business trust" as used in the definition of the term corporation. However, this definition does not distinguish between a business entity and a common family trust. Instead, this definition treats every trust of every kind as a "business trust."

The definition in the Proposed Regulations relies on the abandoned Treasury Regulations test for distinguishing between corporations and partnerships for federal income tax purposes – the four factor test. The four factor test was not designed to nor was it applied to distinguish between a business entity and an entity that is not a business entity. The IRS acknowledged that the four factor test was not useful in the context of trusts:

> . . . *since centralization of management, continuity of life, free transferability of interest, and limited liability are generally common to trusts* and corporations, the determination of whether a trust that has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom. On the other hand, since associates and an objective to carry on a business and divide the gains therefrom are generally common to both partnerships and corporations, the determination of whether an organization that has such characteristics is to be treated for tax purposes as a partnership or corporation depends on whether there exists centralization of management, continuity of life, free transferability of interests and limited liability. (emphasis added) PLR 9108025.

Under the abandoned four factor test, a non-corporate business entity was treated as a corporation for federal income tax purposes if it possessed at least *three* of the following four corporate characteristics: centralized management, unlimited life, limited liability, and free transferability. In contrast, the test in the Proposed Regulations causes a trust to be a "business trust" if it possesses any *one* of the factors. Trusts have centralized management because they are managed by a trustee or trustees, and may have continuity of life. Therefore, under the Proposed Regulations every trust would be a "business trust" and transfer of real estate to a trust would be subject to RTT.

For federal income tax purposes, the term "ordinary trust" is defined as follows:

> an arrangement created either by will or by an *inter vivos* declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Treas. Reg. §301.7701-4(a).

In contrast, a "business trust" is defined as follows:

> There are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of the beneficiaries, but which are not classified as trusts for purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have

> been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code. Treas. Reg. § 301.7701-4(b).

These Treasury Regulations recognize that the distinction between a "business trust" and an ordinary trust cannot be based on the four factor test because the factors are present in both business trusts and ordinary trusts. Instead, the proper distinction to be made is between a trust engaged in a trade or business and one that is not so engaged.

The Department either should (1) abandon the use of the four factor test to define the term "business trust" and use the definition in the Treasury Regulations described above or (2) the Department should define the factors in the definition of the term "business trust" so as to make the definition of "business trust" accomplish the General Assembly's intention.

For example, if the Department defined the following terms in the following manner, the definition of "business trust" would allow some trusts to qualify as "ordinary trusts or "living trusts," without ensnaring all trusts in the definition of "business trust:"

"Objective to divide or distribute gains or earnings and profits to a trust beneficiary" – the power of the trustee or trustees of a trust to buy, sell or hold trust assets and distribute the proceeds from the sale or the income therefrom to or for the benefit of one or more beneficiaries of the trust who are the object of the settlor's bounty in accordance with the terms of the trust shall not be treated as an objective to divide or distribute gains or earnings and profits to a trust beneficiary.

"Treatment of a beneficiary's interest in the trust as personal property" – unless the beneficiary's interest in a trust is freely transferrable by the beneficiary as an ownership interest in the trust, it will not be treated as personal property.

"Centralized management of the trust and its assets by the trustee or the beneficiaries" - centralized management will not exist merely because a trust is managed by trustees appointed by the settlor or their successor.

"Continuity of life" shall not exist merely because (i) a trust does not have a termination date or (ii) one or more beneficiaries of the trust are purely public charities that have perpetual existence.

<u>Ordinary Trusts</u>

We believe that the Department's goals of treating ordinary family trusts as "ordinary trusts" can be accomplished by simply creating a presumption that a trust, subject to the rules of the orphan's court division of the court of common pleas or other chancery or probate court, formed by an individual during his or her lifetime with a donative intent to benefit the objects of his or her bounty, is an ordinary trust. This presumption could be rebutted if the trust is not an arrangement to conserve the trust property for beneficiaries who are the objects of the settlor's bounty. Conversely, a trust created by a corporation or association would be presumed not to be an "ordinary trust." Such presumptions would facilitate estate planning and at the same time prevent business entities such as corporations, partnerships, etc. from using an "ordinary trust" to circumvent the RTT. We suggest the following language in lieu of the language in the Proposed Regulations:

> (i) An ordinary trust is a private trust, the assets of which are held by the trustee or trustees primarily for the purposes of protecting, managing or conserving the assets until distribution to the beneficiaries, other than a business trust or living trust. A trust established by an individual during his or her lifetime with a donative intent to benefit the objects of his or her bounty shall be presumed to be an ordinary trust, unless the trust is organized under the statutory law of any state as a business trust, which presumption may be rebutted. Any trust established by a corporation or association shall be presumed to be a business trust, which presumption may be rebutted.
>
> An ordinary trust also must meet all of the following requirements:
>
> (A) The trust is subject to the jurisdiction and ordinary rules applied in the orphans court division of the court of common pleas or other chancery or probate court; and
>
> (B) The trust takes effect during the lifetime of the settlor of the trust.
>
> (ii) this term does not include:
>
> (A) A minor's estate.
>
> (B) An incompetent's estate.
>
> (C) A resulting or constructive trust created by operation of laws.
>
> (D) A testamentary trust.
>
> (E) A trust for creditors.
>
> (F) An escrow relationship.
>
> (G) A temporary trust to hold disputed property.
>
> (H) A principal and agency relationship.
>
> (I) A relationship between a straw party and real party in interest.
>
> (J) A trust primarily for the benefit of business employees, their families or appointees, under a stock bonus, pension, disability or death benefit, profit-sharing or other employee benefit plan.
>
> (K) A trust for bondholders.
>
> (L) A mortgagee in possession relationship.

(M) A trust or fiduciary relationship similar to those listed above.

§ 91.193 Excluded Transactions.

Exclusion/Exemption

Section § 8102-C.3 of the RTT Law lists a series of "Excluded transactions." The Proposed Regulations change the term "excluded" as it applies to the "Excluded transactions" to "exempted." A change from the statutory "excluded" transactions to the proposed "exempted" transactions is not merely semantic or generic (as stated in the Preamble to the Proposed Regulations).

Exclusions are construed strictly against the Commonwealth and in favor of the taxpayer when there is reasonable doubt as to the legislative intent. See, *e.g.*, *Amp Inc. v. Commonwealth*, 852 A.2d 1161, 1167, 578 Pa. 366, 376 (Pa. 2004). In contrast, *exemptions* are evaluated according to a principle of strict construction in favor of taxation. 1 Pa. C.S.A. § 1928. See also, *Lehigh Valley Co-op. Farmers v. Commonwealth, Bureau of Employment Security, Department of Labor & Industry*, 447 A.2d 948, 950, 498 Pa. 521, 525 (Pa. 1982); and *Lehigh-Northampton Airport Authority v. Lehigh County Board of Assessment Appeals*, 889 A.2d 1168, 1175, 585 Pa. 657, 669 (Pa. 2005). As a consequence, the Proposed Regulations change from *excluded* transactions to *exempted* transactions is a drastic change in favor of the Commonwealth that is contrary to the RTT Law.

The Department currently is litigating the issue of whether the nontaxable transactions in the RTT Law are exclusions or exemptions and the Commonwealth Court has *twice* rejected the Department's position. *See Miller v Commonwealth*, 922 A.2d 950 (Pa. Commw. 2010) *affd en banc*, 18 A.3d 395 (Pa. Commw. 2011):

> We first address the Commonwealth's exception that the panel erred by stating that Section 1102-C.3(8.1) of the Realty Transfer Tax Act creates an "exclusion" from tax rather than an exemption. We disagree. It is a well settled principle of statutory interpretation that '[t]he headings prefixed to titles, parts, articles, chapters, sections and other divisions of a statute shall not be considered to control but may be used to aid in the construction thereof.' 1 Pa. C.S. § 1924 . Here, the legislature designated the transactions listed in Section 1102-C.3 as 'Excluded transactions,' and we presume that it understood the distinction between an exclusion and an exemption from tax. Section 1102-C.3(8.1) identifies a category of transactions that should not be taxed in the first place, *i.e.*, transfers to a living trust intended as a will substitute. We overrule the Commonwealth's exception and hold that Section 1102-C.3(8.1) provides an exclusion from realty transfer tax. (footnotes omitted).

18 A. 3d at 399. The *Miller* case currently is before the Pennsylvania Supreme Court.[1]

The Department is trying to reverse its losses in the Commonwealth Court on this very issue. However, like taxpayers, the Department is bound by the decisions of the Pennsylvania Courts. The Proposed Regulations include positions that are contrary to the RTT Law as determined by the Commonwealth Court. Because the RTT law is clear and the Commonwealth Court has determined that the transactions in the "Excluded transaction" list are exclusions, the Proposed Regulations should not be adopted.

§ 91.153 Agent or Straw Party Transactions

The RTT Law provides an exclusion at § 8102-C.3(11) of the RTT Law for a transfer "for no or nominal consideration between principal and agent or straw party." The concept of "agent or straw party" was badly misinterpreted by RTT Regulations § 91.153(d) and could be further and unnecessarily limited by the ambiguous new restrictions set forth in § 91.153(e) of the Proposed Regulations.

As we have previously commented, taxpayers who engage in like-kind exchanges under §1031 of the IRC will almost always retain the services of a qualified intermediary ("QI") to effect the exchange and, in the context of a so-called "reverse" exchange, will commonly retain an exchange accommodation titleholder ("EAT"). Under long-established state law principles a QI and an EAT are viewed as the taxpayer's agent because they have no economic investment in the real estate in question, act exclusively on behalf of the taxpayer, have no benefits or burdens of ownership with respect to the real estate, are indemnified by the taxpayer against any loss and merely earn a fee for services rendered. In order to facilitate the ability to engage in like-kind exchanges of real estate for federal income tax purposes, the Treasury Regulations under IRC § 1031 create a legal fiction that, despite the normal legal rules for determining when a party is acting as an agent, a QI and an EAT will not be viewed as the taxpayer's agent for certain limited federal income tax purposes. The Treasury Regulations and other guidance from the US Treasury Department make it clear that QIs and EATs can be agents "for all purposes other than federal income tax purposes." Indeed, the whole reason for this legal fiction for purposes of IRC § 1031 is precisely because a QI or an EAT normally would be viewed as a mere agent under normal state law legal principles.

As a matter of statutory interpretation, the adoption of US Treasury Regulations creating a legal fiction for QIs and EATs for certain federal income tax purposes has no bearing whatever on the proper interpretation and scope of the agency exclusion provided in the RTT Statute. Nonetheless, RTT Regulations § 91.153(d) take the position that a QI or an EAT can never qualify as an agent or straw party for RTT purposes, without regard to the long-established Pennsylvania law on the issue of when a person is acting as an agent. RTT Regulations § 91.153(d) place Pennsylvania at odds with every other state and local taxing jurisdiction which has considered the status of QIs and EATs under a transfer tax law that provides for an agency/straw party exclusion. The unique position taken in RTT Regulations § 91.153(d)

[1] The Philadelphia Bar Association filed an *amicus* brief with the Pennsylvania Supreme Court in support of the Commonwealth Court's decision on the exclusion/exemption issue in the *Miller* case.

discourages investments into Pennsylvania by businesses and individual real estate investors who take advantage of IRC § 1031 to redeploy their capital in a tax efficient manner through like-kind exchanges, which almost always require the services of a QI or EAT.

Proposed Regulations § 91.153(e) set forth a list of four factors that, if present, will preclude the existence of an agent or straw party relationship. The fourth of these factors, contained in Proposed Regulations § 91.153(e)(4), contains a typographical error and, beyond that, is ambiguous and should either be withdrawn or clarified. Under this fourth factor, an agent/straw party relationship will not exist if:

> The purported principal or real party in interest is not liable for the acts of the purported agent or straw party or for the debts, damages and other obligations associated with the purported agent or straw party's owners [sic] and use of the real estate. This condition is only applicable to liabilities the purported agent or straw party incurs as a result of actual or implied authority under the scope of the agency or straw party arrangement. The fact that the purported principal or real party in interest has contractually agreed to indemnify the purported agent or that the purported agent or straw party has subrogation rights for such liabilities against the purported principal or real party in interest outside of the agent or straw party arrangement does not circumvent this condition.

The word "owners" in the first sentence of this provision appears to be an error. We assume that the word "owners" should be "ownership." Aside from this error, the meaning, intent and scope of Proposed Regulations § 91.153(e)(4) is unclear and potentially overly broad. For example, what if an agent incurs a nonrecourse liability, secured by the real estate, at the direction of the principal (and for the principal's benefit)? Is the existence of a principal/agent relationship foreclosed in this case because the principal is not personally "liable" for an obligation "associated" with the agent's ownership and use of the real estate?

Most importantly, the last sentence of Proposed Regulations § 91.153(e)(4) is extremely ambiguous. In virtually every bona fide arrangement between a principal and an agent or straw party, the principal, explicitly or implicitly, will agree to indemnify the agent or straw party from and against any loss, cost or expense incurred by the agent for actions taken with the agent's scope of authority. This contractual indemnification is entirely consistent with a bona fide principal/agent relationship. The last sentence of this section of the Proposed Regulations says that such an indemnification arrangement "does not circumvent this condition." What does that mean? It appears to mean that the indemnification arrangement is somehow to be <u>ignored</u> for purposes of determining if a principal/agent relationship exists – that the principal somehow has to be found liable for the acts and obligations of the agent without regard to any contractual indemnification arrangement or legal right to subrogation. In our view, this is unduly restrictive. As long as a principal, in fact, is liable for the acts and obligations of an agent that are incurred within the scope of the agent's authority, this condition should be satisfied, and it should make no difference whether the liability of the principal arose by contract, or as a right of subrogation, or as a matter of law. It is extremely unclear when this condition would be deemed to be satisfied if contractual indemnification arrangements are to be ignored.

§ 91.157(b) – Joint Estates

Under RTT Regulations §§ 91.159(b) and 91.193(b)(5), where a joint interest in real estate was created by will or under intestate law, a subsequent transfer or division in kind between the heirs or devisees is not taxable unless the transfer is for consideration or an heir or devisee takes a share greater in value than his undivided interest. As a matter of policy, we believe that the same rules should apply to the division in kind of all joint estates in real estate, regardless how the joint estate was originally created (*i.e.*, by death or otherwise).

Proposed Regulations § 91.157(b) provide that if the joint estate in question was not created by reason of death, the division in kind of the joint estate always will be taxable in part and tax-exempt in part, based on the grantee's prior fractional ownership interest in the joint estate. As a policy matter, we disagree with the decision to distinguish between joint estates based on whether or not the joint estate was created at death.

Aside from policy issues, the examples in Proposed Regulations § 91.157(b) are confusing:

- Examples 1 and 3 incorrectly use the term "partition" to refer to a mere "subdivision" of jointly held real estate. The jointly held real estate is not "partitioned" if it remains jointly held, as in these examples.
- Examples 2, 3 and 4 all imply that the "actual monetary worth" of a partitioned parcel might differ from its "computed value," but in these examples actual monetary worth always equals computed value. Is there a circumstance where actual monetary worth and computed value could be different? If so, how would actual monetary worth be determined?
- In Examples 3 and 4, the holder of a 75% interest in jointly held property agrees to accept a parcel that appears to be worth only half of the total value of the jointly held property. Why would the holder of the 75% interest agree to this?

§91.193(b)(6). Transfers Between Certain Family Members

Examples (1) and (2) under subparagraph (F) refer to a divorce decree from the Orphans' Court. Divorce decrees in Pennsylvania are from the Court of Common Pleas. Therefore, the reference to Orphans' Court should be changed to Court of Common Pleas.

For all of the reasons discussed in this letter and particularly because (1) under the Proposed Regulations the General Assembly's (and likely the Department's) intention to permit transfers of real estate to ordinary estate planning and family trusts free of RTT is thwarted and (2) the Proposed Regulations attempt to change exclusions to exemptions contrary to the

Commonwealth Court's holding in the *Miller* case, the Proposed Regulations should not be adopted. As before, we would be happy to work with the Department to assist in resolving the problems with the proposed Regulations.

Very truly yours,

George F. Nagle

George F. Nagle
Chair, Tax Section
Philadelphia Bar Association

cc: Daniel P. Meuser, Secretary
David R. Kraus, Chief Counsel
John D. Brenner, Jr., Deputy Chief Counsel

DMEAST #14302760 v4