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# TRANSFER OF RESIDENCE TO TRUST IS TAXABLE

Joseph C. Bright • 215.665.2053 • *jbright@cozen.com*

A divided panel of the Commonwealth Court held that the transfer of a vacation residential property by husband and wife to themselves as trustees to benefit themselves and their children was taxable because the trust was a business trust, not an ordinary trust for realty transfer tax purposes. *Kosco v. Commonwealth,* No. 766 F.R. 2007 (Pa. Cmwlth. Dec. 16, 2009). The practical effect of the decision probably will be that virtually no transfer of real estate to a trust can ever qualify as a non-taxable transfer to an ordinary trust. The decision appears incorrect, in part for the reasons articulated by the dissent.

Part of the difficulty stems from the statutory language. The statute exempts a transfer to an ordinary trust if a transfer directly to the beneficiaries would be exempt. An ordinary trust is not defined, except that it does not include a business trust. The term *business trust* is defined by copying language developed under the Internal Revenue Code to distinguish between a partnership or other flow-through entity on the one hand, and an entity treated for federal income tax purposes as a corporation on the other hand. The federal language listed several criteria to be taken into account in deciding whether an entity is to be treated as a corporation or not. In copying this language, the transfer tax statute apparently requires that an entity have none of the characteristics listed in federal law. The requirement that a trust meet all of the federal factors is regrettable tax policy, but the statute seems to require it. However, the way that the Commonwealth Court applied the factors compounds the problem.

The majority of the Commonwealth Court first held that the trust had a business objective, citing paragraphs that authorize the trustees to rent, mortgage, sell or dispose of real property and earn investment income for the trust beneficiaries. The conclusion misapprehends commonplace trust provisions. Any prudent draftsman of a trust instrument will provide the trustee with flexibility to deal with investments. In the case of real estate, the instrument typically will include the power to buy, sell, mortgage or lease, because those are the commonplace ways that real estate is put to productive use. Generally speaking, the goal of preserving capital requires flexibility to deal with future events. It will be a very rare case in which a trust instrument will require that a particular parcel of real estate be held for the term of the trust and never sold. The court's conclusion takes a view that is unrealistic in practice.

The court concluded that the beneficiaries were treated as associates because the trust provided that they had the right to the earnings and proceeds from rentals and sales, and because upon termination of the trust, the beneficiaries had the right to the proceeds of any public sale of the real estate. Again, the court appears to reach a conclusion that is out of line with commonplace trust practice. Almost every trust, whether inter vivos or testamentary, will provide that the trustee will distribute income and perhaps other portions of the trusts to the beneficiaries. That is essentially what the trust provided with respect to the earnings from the real estate. Similarly, the court concluded that the beneficiaries' interests were considered personal property because the trust provided that their interest was limited to the right to receive the proceeds from rentals, sales and the like. Again, trusts generally, one way or another, provide a beneficiary with income rights. If such provisions mean that the beneficiary is an associate and his interest is personalty, the criterion is useless in distinguishing a business from an ordinary trust.

The court concluded that the beneficiaries could freely transfer their interests, notwithstanding that their interests were restricted under certain dispositive provisions and under a section dealing with the right of first refusal of certain beneficiaries. The court does not quote the trust language, but if the interests of the beneficiaries were indeed restricted in certain degrees, then by definition they were not freely transferable.

The court concluded that the trust was centrally managed because the trustees had the powers to rent, sell and take other actions with respect to the property. It is inherent in any trust relationship that the trustee has powers that the beneficiaries do not have. Indeed, that is the basic purpose of a trust. Thus, the court's conclusion that that language is evidence that the trust is a business trust seems unsupportable.

Finally, the court concluded that the trust had continuity of life because the trust provided for successor trustees. The conclusion is at odds with almost universal trust practice. Virtually every trust instrument will provide for substitute trustees, either naming them specifically, or establishing a mechanism for providing a substitute. Furthermore, if the instrument is silent, the Orphans Court Division will step in and appoint a successor trustee. It is hard to believe that any such provisions, or any such power of a court, means that an entity has continuity of life. Generally speaking, a trust is not an entity; it is a relationship. If the instrument or statutory law provides for successor relationships, that cannot be evidence of continuity of life if the term is to have any useful meaning.

In none of the court's conclusion did the court cite even a single item of federal precedent, even though the statutory language is copied directly from federal law.

A dissent by Judge Rochelle Friedman stated that she would reverse the decision below because the trustees in essence had no more powers than ordinary people would have with respect to their own property. That appears to be a shorthand way of making the points stated above.



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