pennsylvania
DEPARTMENT OF REVENUE

May 2, 2008
Pennsylvania Realty Transfer Tax
No. RTT-08-003
Substitution of IRA Custodian
Transfer from IRA Custodian to IRA Owner

ISSUES:

1. Is a deed that evidences the change in a person's individual retirement account custodian subject to Pennsylvania Realty Transfer Tax when the account holds title to Pennsylvania real estate?

2. Is a deed that conveys an interest in Pennsylvania real estate from an individual retirement account custodian to the individual retirement account owner as part of a mandatory IRA withdraw/distribution subject to Pennsylvania Realty Transfer Tax?

CONCLUSIONS:

1 and 2. Because an IRA can be set up as a trust or custodial account, the analysis of the proper realty transfer tax treatment of transfers of title to real estate to and from IRAs changes depending upon how the IRA is set up.

FACTS:

On February 18, 2005, Taxpayer entered into an agreement with Trust Company No. 1 to open a self-directed individual retirement account ("Account").[1] (Hereinafter, an individual retirement account will be referenced as an "IRA".) A self-directed IRA is an IRA in which the account owner has control and decision making authority over the IRA investments.

The Account was established according to the requirements of Section 408(a) of the Internal Revenue Code of 1986. The Account was set up as a custodial account. Taxpayer was the depositor and owner of the Account and Trust Company No. 1 was the Account custodian. Trust Company No. 1 is qualified to serve as a custodian of IRAs under the Internal Revenue Code.

Trust Company No. 1, as the Account custodian, was to purchase real estate and finance the construction of improvements on the real estate. The real estate and improvements were to serve as a writers retreat and family vacation lodge.

Trust Company No. 1 identified real estate and purchased the real estate. State and local Realty Transfer Tax was paid based upon the sale value of the real estate. The deed for the real estate was titled in the name of "Trust Company No. 1, Custodian FBO,[2] Taxpayer, IRA Account." The improvements have been made to the real estate. (The real estate and improvements are hereinafter collectively referred to as "Real Estate").

The Real Estate has been used as a rental property and is managed by the Account custodian. All rental income payments are made to the Account custodian.

Trust Company No. 1 acted as the Account custodian for several years. Trust Company No. 1 managed the Real Estate during that time.

Recently Taxpayer was advised to secure the services of a different IRA custodian, Trust Company No. 2, in order to save money. In January 2008, Taxpayer entered into an agreement with Trust Company No. 2 to serve as his Account custodian. Although not provided to this Office, it is assumed that Taxpayer executed some agreement with Trust Company No. 1 to terminate his Account or transfer it to Trust Company No. 2.

Because of the change in the Account custodian, Taxpayer was required to change the Account custodian from Trust Company No. 1 to Trust Company No. 2 on the deed for the Real Estate. A deed changing the Account custodian was executed on February 15, 2008. It is assumed that no consideration was paid for the deed. The deed indicated that the grantor was "Trust Company No. 1, Custodian FBO, Taxpayer IRA Account" and the grantee was "Trust Company No. 2, Custodian FBO, Taxpayer IRA Account". When the deed was filed, Taxpayer claimed that the deed was excluded from Realty Transfer Tax and did not pay any tax. Taxpayer has inquired as to whether the deed is subject to Pennsylvania Realty Transfer Tax.

In addition to the change in the Account custodian, Taxpayer has indicated that he is now required under IRS rules to begin receiving mandatory distributions from his Account. It is proposed that instead of receiving cash distributions from the IRA, Taxpayer will take his distributions "in-kind" in the form of tenant in common interests in the Real Estate. In other words, each Account distribution will be made in the form of a deed that conveys a percentage tenant in common interest in the Real Estate to Taxpayer equal to a percentage determined by a fraction the numerator of which is the cash value of the mandatory distribution and the denominator is the fair market value of the Real Estate. It is assumed that such deeds will be given for no or nominal consideration. Taxpayer has inquired as to whether these deeds are subject to Pennsylvania Realty Transfer Tax.

DISCUSSION:

An IRA is a federal income tax construct. Internal Revenue Code (IRC) Section 408 provides for the creation of and federal income tax treatment of IRAs.

It is important to note, that an individual can make only cash contributions to an IRA.[3] IRC § 408(a)(1). Real estate cannot be contributed to an IRA. However, an IRA can purchase real estate with IRA funds for investment purposes so long as the purchase is not a prohibited transaction under IRC § 408(e)(2)(A). "If the person for whom a regular individual retirement account is established engages in a 'prohibited transaction' with the account, the account will no longer qualify as an IRA (Code Sec. 408(e)(2)(A)). A prohibited transaction for this purpose is defined by means of a cross reference to Code Sec. 4975, which imposes a penalty tax on 'disqualified persons' engaged in specified transactions with qualified plans, individual retirement accounts, and individual retirement annuities. The transactions listed in Code Sec. 4975(c) must take place between the plan (or IRA) and a 'disqualified person' to be deemed prohibited transactions. Although the statutory definition of a 'disqualified person' (Code Sec. 4975(e)(2)) does not specifically include the owner of an IRA, the IRS has taken the position in a private letter ruling (see ¶ 18,922.60) that the IRA will be disqualified if its owner participates with the IRA in any of the transactions listed in Code Sec. 4975(c)." Stand. Fed. Tax Rep. (CCH) ¶ 18,922.0224.

Subsection 4975(c) of the Code defines a prohibited transaction as follows:

(c) Prohibited transaction. --

(1) General rule. --For purposes of this section, the term "prohibited transaction" means any direct or indirect --

(A) sale or exchange, or leasing, of any property between a plan and a disqualified person;

(B) lending of money or other extension of credit between a plan and a disqualified person;

(C) furnishing of goods, services, or facilities between a plan and a disqualified person;

(D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;

(E) act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account; or

(F) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

IRC § 4975(c). The use of IRA funds to make a down payment on real estate to be used as a personal residence during the IRA owner's retirement has been determined to be an IRA investment that is a prohibited transaction under § 4975(c)(1)(D). Harris v. Commissioner, 67 T.C.M. (CCH) 1983 (1994). This suggests that if an IRA invests in real estate, no beneficial ownership in the real estate may inure to the account owner while the real estate is in the IRA. Otherwise, the investment will be a prohibited transaction that will cause the account to lose its status as an IRA and its federal tax benefits.

An IRA is defined as "a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries" as long as the trust meets certain criteria. IRC § 408(a). A written instrument must exist to create and govern the trust. IRC § 408(a) and Treas. Reg. § 1.048-2(b).

Although the IRC defines an IRA as a "trust," an IRA may also be set up as a "custodial account" that will be treated as a trust for federal income tax purposes. IRC Section 408(h) provides that:

> a custodial account shall be treated as a trust if the assets of such account are held by a bank (as defined in subsection(n)) or another person who demonstrates, to the satisfaction of the Secretary [of the U. S. Treasury], that the manner in which he will administer the account will be consistent with the requirements of this section, and if the custodial account would, except for the fact this it is not a trust, constitute an individual retirement account described in subsection (a). For purposes of this title, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof.

IRC § 408(h). See also Treas. Reg. § 1.408-2 (a), which provides that an IRA must be a trust or custodial account.

An IRA trustee or custodian must be a bank or another person (nonbank trustee) who demonstrates that the person can and will administer the trust or account in a manner consistent with the requirements of IRC § 408. IRC § 408(a)(2) and Treas. Reg. § 1.408-2(b)(2) and (e).

Whether an IRA is set up as a trust or custodial account, there must be a written instrument that establishes and governs the trust or account.

The IRC and its corresponding regulations related to IRAs do not define what qualifies as a trust or custodial account, nor do they define the difference between the two. This Office found very little material from federal sources that explain the difference.

In the context of Health Saving Account (HSA) trustees and custodians, the United States Department of Treasury has provided the following guidance:

> **What is the difference between an HSA "custodian" and an HSA "trustee"?**
> The differences between a "custodian" and a "trustee" are minor. A trust is a legal entity under which assets are actually owned and held on behalf of a beneficiary. The trustee has some level of discretionary fiduciary authority over the assets of the fund. The trustee must exercise that authority in the best interests of the beneficiary. A custodial arrangement, on the other hand, is like a trust, but the custodian simply holds the assets on behalf of the owner of the assets. Other than holding the assets and doing as the owner orders, the custodian has no fiduciary obligations to the owner. The determination of what constitutes a trust or custodial arrangement is a determination made under state law.

U. S. Dept. of Treas., *HAS Frequently Asked Questions*, *at* http://www.ustreas.gov/offices/public-affairs/hsa/faq_setup.shtml.

The Federal Deposit Insurance Corporation Trust Examination Manual provides the following regarding IRA trustees and custodians:

> <u>F.3. Bank Trustee and Custodial Responsibilities</u>
> As trustee, the bank's responsibilities may range from ministerial functions to the exercise of broad discretionary duties. In most instances, IRAs found in trust departments are subject to the investment direction of the Individual or possibly an investment advisor. However, the trust department may be given full discretion in the investment selection process. As custodian, responsibilities are essentially ministerial in nature. The examiner should note that IRC Section 408(h) considers bank custodians of IRAs to be trustees, hence fiduciaries (refer to Appendix E).
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> Whether acting as trustee or custodian, the bank's responsibilities and duties will be controlled by provisions of the instrument under which the relationship is established. Examiners should perform a careful review of this instrument in order to ascertain the degree of responsibility assumed by the bank and conformity with the duties imposed upon the institution under the agreement.

F.3.a. Self-Directed Custodial IRAs - Own Bank Deposits
The majority of IRAs serviced by banks are handled in the commercial department in a custodial capacity. These accounts are restricted to investments in own bank deposits. Unless state law provides to the contrary, trust powers for such accounts are not required, even if the account document indicates the bank is a trustee.

Federal Deposit Insurance Corporation, Trust Examination Manual, § 5F.3, *available at* http://www.fdic.gov/regulations/examinations/trustmanual/index.html.

"There is no requirement that any particular form be used to establish an individual retirement account. It is only required that there be a written agreement between the trustee or custodian and the taxpayer that meets the requirements outlined at ¶18,922.0216.[[4]] However, the IRS has developed model agreements that meet these requirements. Form 5305 is the model agreement for a trust account and Form 5305-A is the model agreement for a custodial account." Stand. Fed. Tax Rep. (CCH) ¶ 18,922.045.

Even though an IRA can be set up as a custodial account, the term does not have the same meaning as a custodial account for a minor as provided for under Pennsylvania's Uniform Transfers to Minors Act. 20 Pa.C.S. §§ 5301, et seq. This is not to suggest that a minor cannot be an IRA account holder through a custodian. It just means that the IRC designation of an IRA as a custodial account does not mean that the account is necessarily held in the name of a minor or incapacitated person who requires a guardian or custodian to manage the person's financial affairs.

A custodial account for purposes of an IRA is merely a deposit account of an individual that is maintained and held by a bank, financial institution or other person designated by the Secretary of the U.S. Treasury to act as an IRA custodian. An IRA custodial account will be subject to Pennsylvania banking laws if the IRA is administered by a bank or other financial institution that qualifies as a bank under Pennsylvania banking laws. Generally, under banking laws the relationship between an IRA account owner and a bank is one of a creditor (account owner) and debtor (bank) relationship. P.L.E. Banks and Banking § 63.

In the case where the IRA is administered by a financial institution or other person who does not qualify as a bank, then the IRA is subject to general contract law, and the relationship between an IRA account owner and a financial institution or other person will largely be defined by the instrument that creates the IRA.

If an IRA is set up as a trust, then the relationship between an IRA account owner and the institution or person maintaining the account is one of a settlor/beneficiary (account owner) and trustee (bank).

Because an IRA can be set up as a trust or custodial account, the analysis of the proper Realty Transfer Tax treatment changes depending upon how the IRA is set up.

If an IRA is created as a trust, then the Realty Transfer Tax rules associated with transfers of real estate to and from trusts are applicable.

For Realty Transfer Tax purposes, there are two types of trusts—living and ordinary trusts. A living trust and ordinary trust are defined as follows:

> "Living trust." Any 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.
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> "Ordinary trust." Any trust, other than a business trust or a living trust, which takes effect during the lifetime of the settlor and for which the trustees of the trust take title to property primarily for the purpose of protecting, managing or conserving it until distribution to the named beneficiaries f the trust. An ordinary trust does not include a trust that has an objective to carry on business and divide gains, nor does it either expressly or impliedly have any of the following features: the treatment of beneficiaries as associates, the treatment of the interest in the trust as personal property, the free transferability of beneficial interest in the trust, centralized management by the trustee or the beneficiaries, or continuity of life.

72 P.S. § 8101-C. Department regulations further define living and ordinary trusts as follows:

> Living trust—An ordinary trust:
> (i) Which, throughout the settlor's lifetime, is wholly revocable by the settlor without the consent of an adverse party.
> (ii) Which vests no present interest in any of the trust corpus or income in any person other than the settlor or trustee until the settlor dies.
> (iii) All the corpus and income of which can be reached or materially affected by the settlor without revocation of the trust or the consent of an adverse party.
> (iv) From which no transfer of corpus or income may be made by the trustee at any time prior to the death of the settlor to any person in the capacity of a beneficiary other than the settlor.
> (v) Under which the trustee exercises no discretion as to the disposition of the trust corpus or income during the settlor's lifetime to any person other than the settlor without the express direction of the settlor to make the specific disposition.
> (vi) Which the trustee or, if the settlor was the trustee, the successor trustee is required under the governing instrument to distribute the corpus and retained income upon the death of the settlor.
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> Ordinary trust—
> (i) A private trust which takes effect during the lifetime of the settlor of the trust and for which the trustees of the trust take title to property primarily for the purpose of protecting, managing or conserving trust assets, under the ordinary rules applied in the orphan's court division of the court of common pleas or in other chancery or probate courts, until distribution to the beneficiaries of the trust.
> (ii) The term does not include:

(A) Business trusts organized under Pennsylvania law or the law of any state or foreign jurisdiction, or any form of trust that has either of the following features:

(I) The treatment of beneficiaries as associates.

(II) Beneficial interests in the trust estate or profits that are evidenced by transferable shares, similar to corporate shares, or are otherwise treated as personal property.

(B) Minors' estates.

(C) Incompetents' estates.

(D) A resulting or constructive trust created by operation of law.

(E) A testamentary trust.

61 Pa. Code § 91.101.

Documents that effectuate or evidence the conveyance of real estate to and from living and ordinary trusts are excluded from tax under certain circumstances. The applicable exclusions and rules that explain when transfers of real estate to and from trusts are excluded form tax can be found at 61 Pa. Code §§ 19.156 and 91.193(b)(8), (9), (32) and (33). Documents that merely evidence a substitution of one trustee for another or addition of a trustee are also excluded from tax. 61 Pa. Code § 91.193(10). This exclusion only applies if the trust itself continues to exist and there is a mere substitution or addition of a trustee. It is not applicable to a document that conveys title to real estate from the trustee of one trust to the trustee of another trust. Such documents are fully subject to tax.

Under the above definitions, in order for a trust to be considered an ordinary trust, the trust must be subject to the jurisdiction and rules of the orphan's court division of the court of common pleas of Pennsylvania or in other chancery or probate courts. A living trust is a specific type of ordinary trust, and is therefore, also subject to that rule.

Although the Pennsylvania orphans' court division of the court of common pleas has jurisdiction over many types of testamentary and inter vivos trusts, its jurisdiction does not extend to "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 . . . or similar trusts or fiduciary relationships." 20 Pa.C.S. § 711(3)(xi) and (xv). An IRA falls within this category of trust and is therefore beyond orphans' court jurisdiction. Therefore, it cannot qualify as either an ordinary or living trust for Realty Transfer Tax purposes. As a result, documents that effectuate or evidence the conveyance of title to real estate between an IRA settlor/beneficiary (i.e., the IRA account owner) and the IRA trustee (i.e., the IRA account holder) are not excluded from tax under the living and ordinary trust exclusions. Further, the exclusion for the substitution of trustees is not applicable to IRA trust accounts either.

If an IRA is set up as a custodial account, then the analysis of the Realty Transfer Tax treatment is different from the analysis of the tax treatment associated with an IRA trust.

As stated above, an IRA custodial account will either be considered a bank account or other contractual arrangement. The relationship between the account owner and custodian and the duties, obligations, ownership interests and other right between them will be defined by banking laws and the governing custodial account instrument. There is not a specific Realty Transfer Tax exclusion for documents that effectuate or evidence the conveyance of title to real estate to or from a bank and an account owner. Further, there is not a specific exclusion for a document that effectuates or evidences the transfer of title to real estate between an IRA custodian and account owner. Therefore, the general rule is that such documents are fully subject to Pennsylvania Realty Transfer Tax.

However, if it can be demonstrated that under the contractual terms of IRA custodial account the custodian does not have any ownership interest in the real estate, but rather, the ownership interest lies with the account owner, then any document for the real estate that lists the custodian as the grantor and the account owner as the grantee will be treated as an excluded confirmatory deed because the document does not convey title to the real estate to the account owner. Further, if ownership of the real estate under the IRA custodial account agreement lies with account owner, then any document for the real estate that lists the custodian as the grantor and a new custodian as the grantee will be treated as document that merely evidences the a change in the designation of the custodian and will be deemed an excluded corrective deed. Id. Ownership of the real estate remains with the account owner; therefore, no tax is due on the document that changes the name of the custodian.

In this case, Taxpayer entered into an IRA custodial account agreement with Trust Company No. 1. Therefore, the RTT tax consequences will follow the rules for IRA custodial accounts provided above.

The documentation that was provided provides very little evidence related to the ownership of the Real Estate. The deeds themselves provide some evidence. When Trust Company No. 1 acquired the Real Estate, the deed indicated that Trust Company No. 1 acquired and held the Real Estate for the benefit of Taxpayer. The subsequent deed that was executed to change the Account custodian from Trust Company No. 1 to Trust Company No. 2 also indicates that Trust Company No. 2 is to hold the Real Estate for the benefit of Taxpayer. Those deed designations suggest that nominal ownership was and is with Trust Company No. 1 and Trust Company No. 2, respectively, and that Taxpayer is the beneficial owner of the Real Estate.

However, it is inconsistent with federal income tax law related to IRAs for Taxpayer to be the beneficial owner of the Real Estate. In fact, as referenced above, if Taxpayer has actual or beneficial ownership of the Real Estate, such interest will cause the Account to lose its IRA and tax exempt status. It makes no logical sense to put the Real Estate in the Account only to have the transaction destroy the nature and tax benefits of the Account. Therefore, it must be assumed that the Account custodian owns the real estate and no beneficial ownership flows to Taxpayer. This is further supported by the fact that income from the rental of the Real Estate flowed to Trust Company No. 1 and now to Trust Company No. 2. Taxpayer did not receive the rental income.

Based upon the above, it appears that while Taxpayer is the owner of the Account and its value, the Account custodian is the owner of the investments and assets held in the Account, including the Real Estate. Consequently, for Realty Transfer Tax purposes, when Trust Company No. 1 purchased the Real Estate, and received the deed for the Real Estate, it became the owner of the Real Estate. Thereafter, when Taxpayer changed his Account custodian from Trust Company No. 1 to Trust Company No. 2, and executed the deed changing the Account custodian there was a conveyance of ownership from Trust Company

No. 1 to Trust Company No. 2. Because the deed effectuated a change in ownership of the Real Estate, the deed is subject to tax on the computed value of the Real Estate.

Because Trust Company No. 2 is the owner of the Real Estate and because there is no Realty Transfer Tax exclusion for a transfer of an interest in the Real Estate from Trust Company No. 2 to Taxpayer, any deed that conveys a percentage interest in the Real Estate from Trust Company No. 2 to Taxpayer as part of a mandatory IRA distribution is subject to Realty Transfer Tax. The taxable value is the computed value of the Real Estate multiplied by the percentage interest that each deed conveys to Taxpayer.

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[1] Trust Company No. 1 defines a self-directed IRA as follows:

The term 'self-directed' does not actually have any legal connotation. It does not imply a different type of IRA, or a separate set of IRSrules. 'Self-directed' is simply an accepted industry term indicating that the IRA custodian is allowing the IRA owner greater control over their investment decisions. When an IRA account is self-directed, the IRA owner makes all investment decisions and instructs the custodian to act. Even this control, however, can vary greatly in degree. For example, you might be offered - or have – a 'self-directed' IRA at a major broker dealer. This account, while offering more hands-on control, will still, in most cases, limit you to a range of publicly traded investment options such as stocks, bonds, and mutual funds.

The phenomenon of a self-directed IRA that still limits you to a brokerage account has spawned the use of yet another industry descriptive - the 'truly self-directed' IRA – to mean the type of account that allows for non-publicly traded assets like real estate or private placements (pre-IPO stock, Limited Liability Company membership, Limited Partnerships, etc.).

[2] "FBO" – for the benefit of.
[3] Except in the case of a rollover contribution.
[4] An individual retirement account must be either a trust or a custodial account established in the United States for the exclusive benefit of the owner and the owner's beneficiaries. It must be established by a written document and must meet all of the following requirements (Code Sec. 408(a)):

(1) Trustee or custodian. The trustee or custodian must be a bank, state or federally insured credit union, savings and loan association, or an entity that has satisfied the IRS that it is capable of administering the trust or custodial account in a manner that is consistent with the requirements of law. See Reg. §1.408-2(e), Announcement 2007-47, I.R.B. 2007-20, 1260. There is a $14,500 fee for securing an IRSdetermination that a nonbank is qualified to act as a trustee (Rev. Proc. 2008-8, 6.01(8), I.R.B. 2008-1, 233). The owner of the account may not serve as trustee or custodian.
(2) Contribution limits. The trustee or custodian cannot accept contributions of more than a specified dollar amount during the year and contributions must be in cash. See ¶18,922.0229 for the dollar limits on IRA contributions. In the case of contributions by an employer under a SEP arrangement (see ¶18,922.0245), the trustee or custodian may accept greater amounts. In the case of a rollover contribution (see ¶18,922.033 et seq.), the contribution need not be in cash, and there is no limit on the amount of the contribution.
(3) Vesting. The owner's interest in the account must be fully vested (nonforfeitable) at all times.
(4) Life insurance. No part of the amount in the account may be used to buy life insurance.
(5) Commingling. The assets of the account may not be commingled with other property, except in a common trust fund or common investment fund (see Reg. §1.408-2(b)(5)). See also ¶17,513.022.
(6) Payout at age $70^1/_2$. The owner must begin to receive distributions from the account not later than April 1 of the year following the end of the tax year in which he reaches age $70^1/_2$ (Code Sec. 401(a)(9) and Code Sec. 408(a)(6)). This requirement --together with the penalty tax for excess accumulations after the owner reaches age $70^1/_2$ --is discussed at ¶18,922.0327 et seq.
(7) Incidental death benefits. The IRS is required to issue regulations regarding the application to an IRA of the incidental death benefit rule that is applicable to pension plans. See ¶17,508.024 and ¶17,509.026. Such regulations were proposed in 1987. The preamble to the proposed 1987 regulations states that they may be relied on by taxpayers and that they will be applied by the IRS (see ¶49,109) in issuing determination letters, opinion letters and rulings and in auditing returns. See Proposed Reg. §1.408-8 (B-13) and 1987 Proposed Reg. §1.401(a)(9)-2. See also ¶18,922.0327.

Stand. Fed. Tax Rep. (CCH) ¶ 18,922.0216.