Internal Revenue Service

Number: **201234018**
Release Date: 8/24/2012

Index Number:
1031.00-00; 1382.00-00; 1388.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: N/A
Person To Contact:

ID No.
Telephone Number:

Refer Reply To:
CC:ITA:B04
PLR-148337-11
Date:
May 15, 2012

TY:

LEGEND:

Taxpayer	=
TQI	=
FinanceCo	=
Finance Trust	=
Manufacturer	=
Manufacturer Finance	=
Manufacturer Dealers	=
College	=
Shareholder A	=
TrustCo	=
State A	=
State B	=
State C	=
X	=
Y	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Date 1	=
Date 2	=
Date 3	=

Dear

This responds to your request for a private letter ruling, dated November 15, 2011, submitted on behalf of Taxpayer, that TQI is not a disqualified person as to exchange services it was organized to perform for Taxpayer's shareholders. Taxpayer also requests a ruling that earnings by TQI for services provided to Taxpayer's shareholders will be patronage source income eligible for distribution as deductible patronage dividends.

FACTS

Taxpayer is a non-exempt cooperative C corporation, subject to Subchapter T (§§ 1381 *et seq*.) of the Internal Revenue Code (Code), organized under the laws of State A. Its principal place of business is in State B. Taxpayer keeps its books and files its tax returns using an accrual method of accounting and an annual accounting period beginning April 1 and ending March 31. Taxpayer is owned by X independent Manufacturer Dealers, Y of which are foreign corporations (shareholders).

Taxpayer was organized to give its shareholders a lower cost alternative to bank financing for a portion of their working capital needs. Taxpayer began issuing commercial paper (CP) and making loans to its shareholder-patrons during Year 1. It charged interest rates to its borrowers based on its cost of funds plus "add-ons" to cover its operating costs, including premiums for credit enhancement. It organized as a cooperative to return any excess add-on charges and distribute net earnings to its borrowers as patronage dividends.

In Year 2, Taxpayer organized FinanceCo to address the short-term credit needs of Taxpayer's shareholders who did not meet certain underwriting standards. FinanceCo is a special purpose, bankruptcy remote, State B corporation, not related to Taxpayer within the meaning of §§ 267 and 707 of the Code. Finance Trust, a trust for the benefit of College and other educational institutions, owns all the stock of FinanceCo. TrustCo is the trustee of Finance Trust. FinanceCo's sole director is also a member of Taxpayer's board. The same four individuals serve as president, vice president, secretary and treasurer of Taxpayer and FinanceCo. FinanceCo has no separate office space or employees. Taxpayer has continually managed FinanceCo's CP issuance, loan operations, and day to day activities pursuant to a management agreement between Taxpayer and FinanceCo entered into in Year 2.

FinanceCo's loan programs were very similar to those of Taxpayer. However, FinanceCo's loans are credit enhanced by Manufacturer Finance, a subsidiary of Manufacturer, and are generally secured. Because FinanceCo is a corporation, Taxpayer did not treat management fees charged to FinanceCo as patronage sourced and FinanceCo borrowers did not receive patronage dividends from Taxpayer or FinanceCo.

On Date 1, because of adverse business conditions in the financial sector of the United States economy, Taxpayer ceased its direct issuance of CP and loan operations. The last outstanding Taxpayer CP matured and was repaid on Date 2. Taxpayer transitioned its borrowers to the FinanceCo program in the middle of Year 3.

Currently, Taxpayer's primary business activity is the management of FinanceCo's CP program and the processing of loans from FinanceCo to Taxpayer's shareholders and other eligible borrowers. FinanceCo enters into loan agreements only with borrowers that have applied to, and been approved by Manufacturer Finance, as eligible to borrow from FinanceCo. Taxpayer is not a party to the loan agreements between FinanceCo and Taxpayer's shareholders.

Some of Taxpayer's shareholders engage in like-kind exchanges to defer gain from the sale of property used in their rental businesses. In Year 4, Taxpayer's board directed Taxpayer's staff to start a pilot program to offer QI services to Taxpayer's shareholders.

In the middle of Year 5, Taxpayer formed TQI, its single–member, wholly-owned, State C, limited liability company, to provide intermediary services to Taxpayer's shareholders (or their affiliates) who maintain like-kind exchange programs using the safe harbors in the Income Tax Regulations under § 1031 of the Code and Rev. Proc. 2003-39, 2003-1 C.B. 971. TQI is a disregarded entity for federal income tax purposes and is treated as a branch or division of Taxpayer. It has not and will not file an election to be treated as a corporation for federal tax purposes under § 301.7701-3(c) of the Procedure and Administration Regulations.

TQI became the QI in Taxpayer's pilot program for Shareholder A on Date 3. TQI became the QI for a second shareholder before the end of Year 5. If successful, TQI will begin offering its QI services to all of Taxpayer's shareholders (and their affiliates). If requested (and if eligible under state and local law), TQI may instead act as the escrow holder of a qualified escrow account or the trustee of a qualified trust (both as defined in § 1.1031(k)-1(g)(3) of the Income Tax Regulations (Regulations)) for Taxpayer's shareholders (and their affiliates) who choose to use a QI other than TQI.

As Taxpayer implements its exchange program of providing exchange services through TQI, it will continue to operate on a cooperative basis. It will return any net income from QI operations to the customers of TQI based on the relative amount paid by each for QI services. Taxpayer will also distribute net income from trustee and escrow holder services in this manner.

In Year 6, Taxpayer will create another wholly-owned disregarded entity (Newco) for a new CP loan program. Newco will meet the requirements of the nationally recognized statistical rating organizations for special purpose entities and of a credit enhancement agency. Newco will begin CP issuance and loan operations in the middle of Year 6. As

a disregarded entity, Newco will be treated as a division of Taxpayer. For tax purposes, Taxpayer will be treated as issuing CP and making loans to its own shareholders.

LAW & ANALYSIS

PART 1: Taxpayer's Eligibility to Serve as a QI under § 1.1031(k)-1(k).

Section 1031(a)(1) of the Code provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

However, gain is recognized if a taxpayer actually or constructively receives money or other non-like-kind property, even though the taxpayer may ultimately receive like-kind replacement property. *See* § 1.1031(k)-1(a) of the Regulations. To assist taxpayers in structuring exchanges that avoids actual or constructive receipt of money or other non-like-kind property, the Regulations establish various safe harbors. These include the qualified escrow account, the qualified trust and the qualified intermediary (or QI). *See* § 1.1031(k)-1(g)(3) and (4) of the Regulations.

Section 1.1031(k)-1(g)(3)(ii)(A), (3)(iii)(A) and (4)(iii)(A) of the Regulations provide, in part, that a QI (and a trustee of a qualified trust or escrow holder of a qualified escrow account) is a person who is not the taxpayer or a disqualified person.

Section 1.1031(k)-1(k) of the Regulations generally provides that a disqualified person is –

(1) an agent of the taxpayer at the time of the transaction;
(2) a person related to the taxpayer under § 267(b) or § 707(b) of the Code (substituting 10% for 50% each place it appears); or
(3) a person related to an agent of the taxpayer under § 267(b) or § 707(b) (substituting 10% for 50% each place it appears).

Section 1.1031(k)-1(k)(2) of the Regulations provides, in part, that a person is treated as an agent of the taxpayer if that person at the time of the transaction has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2–year period ending on the date of the transfer of the first of the relinquished properties. However, solely for purposes of this paragraph (k)(2), the following services do not count –

(i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under § 1031 of the Code; and
(ii) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

In *Bollinger v. Commissioner*, 485 U.S. 340 (1988), the Supreme Court reaffirmed its agency analysis previously articulated in *National Carbide Corp. v Commissioner*, 336 U.S. 422 (1949). The Supreme Court's agency analysis has four factors and two requirements, "the sum of which has become known … as the 'six *National Carbide* factors.'"

The four factors include whether the party in question (1) operates in the name and for the account of the principal; (2) binds the principal by its actions; (3) transmits money received to the principal; and (4) whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal.

The two requirements provide that the agency-principal relationship cannot be founded solely on the fact that the principal owns the agent, and the business purpose of the party in question must be the carrying on of the normal duties of an agent. *Bollinger v. Commissioner*, 485 U.S. at 346.

Since TQI is a disregarded entity and its business consists entirely of rendering service intended to qualify transactions for nonrecognition of gain under § 1031 of the Code, TQI's status as a disqualified person depends entirely on attribution of activities and relationships of Taxpayer. If Taxpayer is not a disqualified person, then Taxpayer's status as the sole owner of TQI will not make TQI a disqualified person.

Taxpayer's activities in managing FinanceCo do not make it an agent for its shareholders or other borrowers. Further, when Taxpayer reinstates its CP and loan program in Year 6 (by issuing CP to investors and lending the proceeds to its shareholders directly or through Newco in the normal course of its business), it will not become an agent for its shareholders or other eligible borrowers.

Accordingly, Taxpayer is not a disqualified person, as defined by § 1.1031(k)-1(k) of the Regulations, with respect to its shareholders (and their affiliates) by reason of its activities as the manager of the operations of FinanceCo . Also, Taxpayer will not become a disqualified person, as defined by § 1.1031(k)-1(k), with respect to its shareholders (and their affiliates) if it reinstitutes its own CP issuance and shareholder loan program either directly or through Newco.

PART 2: Treatment of TQI Income as Patronage Source Income.

Section 1381(a)(2) of the Code provides that subchapter T shall apply to any corporation operating on a cooperative basis with certain exceptions. Section 1.1381-1(a) of the Regulations states that subchapter T of the Code applies to any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of business done with or for such patrons.

Section 1382(b)(1) of the Code provides, in part, that in determining the taxable income of a cooperative there shall not be taken into account amounts paid during the payment period for the taxable year as patronage dividends to the extent paid in money, qualified written notices of allocation, or other property with respect to patronage occurring during such taxable year.

Section 1.1382-2(b)(1) of the Regulations provides, in part, that there is allowed as deduction from the gross income of any cooperative to which part I of subchapter T applies, amounts paid to patrons during the payment period for the taxable year as patronage dividends with respect to patronage occurring during such taxable year, but only to the extent that such amounts are paid in money, qualified written notices of allocation, or other property (other than nonqualified written notices of allocation). Section 1388(d) of the Code defines the term “nonqualified written notices of allocation” as meaning a written notice of allocation other than a qualified written notice of allocation, or a qualified check that is not cashed on or before the 90th day after the close of the payment period for the taxable year.

Section 1382(d) of the Code provides, in part, that the payment period for any taxable year is the period beginning with the first day of such taxable year and ending with the fifteenth day of the ninth month following the close of such year.

Section 1388(a)(1) of the Code provides that the term “patronage dividend” means an amount paid to a patron by a cooperative on the basis of the quantity or value of business done with or done for such patron. Section 1388(a)(2) provides that a “patronage dividend” is an amount paid “under an obligation” that must have existed before the cooperative received the amount so paid. Section 1388(a)(3) of the Code provides that “patronage dividend” means an amount paid to a patron that is determined by reference to the net earnings of the cooperative from business done with or for its patrons. That section further provides that “patronage dividend” does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done with or for patrons.

Section 1.1382-3(c)(2) of the Regulations defines income from sources other than patronage (nonpatronage income) to mean incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association such as income derived from lease of premises, from investment in securities, or from the sale or exchange of capital assets.

In Rev. Rul. 69-576, 1969-2 C.B.166, a nonexempt farmers’ cooperative borrowed money from a bank for cooperatives (itself a cooperative) to finance the acquisition of agricultural supplies for resale to its members. The bank for cooperatives allocated and paid interest from its net earnings to the nonexempt farmers’ cooperative which it in turn allocated to its members.

In determining whether the allocation was from patronage sources the ruling states:

> The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources. Rev. Rul. 69-576 at 167.

The ruling concluded that inasmuch as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative's marketing, purchasing, or service activities, the income was patronage sourced.

In *St. Louis Bank for Cooperatives v. United States*, 224 Ct. Cl. 289, 624 F.2d 1041 (Cl. Ct. 1980), the Court held that interest on demand deposits in farm credit banks or on loans to brokerage funds received by St. Louis Bank for Cooperatives was patronage-sourced income. The Court stated that a particular item of income is patronage sourced when the transactions involved are directly related to the marketing, purchasing, or service activities of the cooperative association. 624 F.2d at 1045.

Taxpayer has represented that it has operated on a cooperative basis since its inception and intends to continue to do so. If Taxpayer performed the QI services directly for its patrons, the services would be a patronage activity. Because Taxpayer represents that TQI is a disregarded entity for federal income tax purposes, the result is the same.

Accordingly, the net earnings of Taxpayer attributable to the services provided to its shareholders (or their affiliates) by TQI (as a disregarded entity) will be treated as Taxpayer patronage source income (as if earned from business done directly by Taxpayer with its patrons) subject to compliance with §§ 1382 and 1388 of the Code, and will be eligible for distribution as deductible patronage dividends.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The ruling contained in this letter is based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Christina M. Glendening
Assistant to the Branch Chief, Branch 4
Office of associate Chief Counsel
(Income Tax & Accounting)

cc: