

**Internal Revenue Service**

Number: **200630005**

Release Date: 7/28/2006

Index Number: 1031.06-00

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

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Refer Reply To:

CC:ITA:B05

PLR-121985-04

Date:

May 24, 2005

In Re:

Legend

A =

B =

Dear :

This is in response to your request, dated April 16, 2004, for a private letter ruling under section 1031 of the Internal Revenue Code of 1986 (Code) concerning whether A qualifies as a financial institution providing routine financial services when it loans money to its customers to acquire replacement properties in like-kind exchanges, including like-kind exchanges in which B, a related party to A, serves as a qualified intermediary (QI), and whether A's sale, or offering for sale, of properties it owns as replacement properties to customers of B in like-kind exchanges results in A or B being treated as a disqualified person with respect to such customers.

## STATEMENT OF FACTS:

A is a                    limited partnership. B is a                    limited liability company. A is the sole owner and member of B. The headquarters of both A and B are located at                    . B, a disregarded entity for federal income tax purposes, and A file a single federal income tax return. A and B use an accrual method of accounting for maintaining their books and records and for filing their federal income tax returns, and both use an annual accounting period that ends on December 31.

A is a privately held, specialty finance company. A's core businesses are the acquisition of seasoned loans (loans that have been in existence for a substantial period of time), residential and commercial real estate loans, and the wholesale origination of small balanced commercial real estate loans. Through various wholly owned limited liability companies, A also originates commercial real estate loans and acquires real estate investment properties throughout the United States. A holds the necessary licenses to make loans and is qualified to do business in all 50 states.

As a means of providing funding and liquidity for its core business, A, through an affiliate, issues fixed, and floating rate, asset-backed securities that are collateralized by mortgage loans acquired or originated by A. A retains ownership of the equity classes of such securitizations.

A sometimes acquires and holds real property for investment, and as a consequence of its lending activities, also holds real estate owned assets that are properties acquired through foreclosure. A does not hold any customer deposits and is therefore not subject to the federal and state laws that regulate traditional banks, savings and loan associations, or other similar organizations.

A wishes to expand its business and begin offering services as a QI (as defined in Treas. Reg. §1.1031(k)-1(g)(4)) in like-kind exchange transactions intended to qualify under section 1031. To accomplish this objective, A has established B as the entity that will perform the QI services for A's customers.

B intends to market its QI services through A's existing network of mortgage and real estate brokers and A's existing loan customers. In addition, A has developed a loan program that is specifically targeted to providing financing for replacement properties in deferred and reverse like-kind exchanges. This loan program will be marketed through A's network of independent brokers and existing loan customers and through relationships that B develops with exchange accommodation titleholders who will hold relinquished or replacement property. B does not expect to act as an exchange accommodation titleholder. These loans will be offered to customers of B and to others who are not customers of B.

A may also offer properties that it holds in its portfolio of real estate investments and real estate owned properties as a source of possible replacement properties in deferred or reverse like-kind exchanges. Such properties will be made available to customers of B and to others who are not customers of B.

#### STATEMENT OF LAW AND ANALYSIS:

Section 1031 of the Code provides for the nonrecognition of gain or loss in an exchange of properties that are held for productive use in a trade or business or for investment if such properties are exchanged solely for like-kind properties that are held for productive use in a trade or business or for investment. A deferred exchange is an exchange wherein the property to be exchanged by the taxpayer is relinquished before the replacement property is acquired. A reverse exchange is an exchange wherein the replacement property is acquired before the property to be exchanged by the taxpayer is relinquished. Generally, a deferred or reverse like-kind exchange utilizes an intermediary to hold the relinquished or acquired property before such property is transferred to the exchanging taxpayer.

If a taxpayer in a deferred like-kind exchange actually or constructively receives money or non-like-kind property before the taxpayer actually receives the replacement property, gain may be recognized on the exchange. Further, if a taxpayer in a deferred exchange actually or constructively receives money or non-like-kind property in the full amount of the consideration for the relinquished property, then the transaction will constitute a taxable sale and not an exchange, even though the taxpayer may ultimately receive like-kind replacement property. Treas. Reg. §1.1031(k)-1(a).

To assist taxpayers in structuring like-kind exchanges, the section 1031 regulations provide four safe harbors whereby taxpayers will not be in actual or constructive receipt of exchange proceeds in a deferred like-kind exchange: security or guarantee arrangements, qualified escrow accounts and qualified trusts, qualified intermediaries, and interest and growth factors. Of these four, only the safe harbor for qualified intermediaries also provides a safe harbor against characterization of the accommodator facilitating the deferred exchange as an agent of the taxpayer. Treas. Reg. §1.1031(k)-1(g)(4). The use of the qualified intermediary safe harbor further requires that the qualified intermediary not be considered a disqualified person with respect to the taxpayer involved in the exchange within the meaning of Treas. Reg. §1.1031(k)-1(k).

Treas. Reg. §1.1031(k)-1(k) defines a disqualified person, in part, as an agent of the taxpayer at the time of the transaction. Treas. Reg. §1.1031(k)-1(k)(2) provides some examples of a disqualified person including a person who 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 in a like-kind exchange will be considered an agent of the

taxpayer. See Treas. Reg. §1.1031(k)-1(k)(4). Solely for this purpose however, services to the taxpayer with respect to exchanges intended to qualify for nonrecognition of gain or loss under section 1031, and routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company, are not taken into account.

In this case, A intends to offer loans to customers to facilitate like-kind exchanges. Thus, in order to qualify for the exception to the disqualified person definition, A must meet two requirements. A must be a financial institution, and its loan services must be considered routine financial services. Although the exception comprises two separate requirements, the requirements are interrelated.

The deferred like-kind exchange regulations do not define the terms financial institution or routine financial services. Such terms, however, are defined for purposes of other provisions in the Code. The section 165 regulations provide a broad definition of the term “financial institution.” For purposes of section 165, the term includes banks, investment advisers, and finance corporations, a substantial part of the business of which consists of the making of loans or servicing debt obligations. Treas. Reg. §1.165-12(c)(1)(iv)(G). The regulations under section 1441, that deal with the obligation to withhold tax on the U.S. source income of nonresident aliens, define the terms financial institution and foreign financial institution by reference to the definition under section 165. Treas. Reg. §1.1441-1(c)(5).

One of the principal activities of financial institutions is the lending of money. As the Supreme Court has stated the principal product of banks is various types of credit. *United States v. Philadelphia Nat’l Bank*, 374 U.S. 321, 326 n. 5 (1963). The Tax Court has also observed that “the principal businesses of [banks] consist[s] of accepting demand and time deposits and using the amounts deposited, together with other funds, to make loans.” *PNC Bancorp, Inc. v. Commissioner*, 110 T.C. 349, 351 (1998).

One of the principal activities of A is to loan money to its customers to facilitate like-kind exchange transactions. This activity qualifies A as a financial institution as that term is defined in the Code. In addition, in exchange transactions A acts as a financial institution providing routine financial services because making loans is a routine financial service. Thus, A’s loaning of money to customers to facilitate like-kind exchange transactions will not, by itself, cause A to be a disqualified person.

However, in order to qualify for the exception to the disqualified person definition in the section 1031 regulations, A’s other activities must not cause it to be considered an agent of its customers.

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.

In transactions in which A sells, or offers to sell, properties to a customer utilizing B as a QI, none of these six factors would be present. Thus, the sale, or offering for sale, of properties by A to a customer as replacement property, by itself, does not cause A, the seller of the property, or B, acting as a QI, to be considered an agent of the customer for purposes of Treas. Reg. §1.1031(k)-1(k)(2), so long as A does not act as a real estate broker or agent.

## **CONCLUSIONS:**

For purposes of the deferred exchange regulations, A is a financial institution and the making of loans to customers, including loans to finance the acquisition of replacement property in a like-kind exchange where B is the qualified intermediary, constitutes routine financial services. A's sale, or offering for sale, of properties that it owns as replacement property in a like-kind exchange utilizing B's QI services makes neither A nor B the agent of a customer utilizing their services in a like-kind exchange.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

The rulings contained in this letter are based upon information and representations submitted by the 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,

William A. Jackson  
Branch Chief, Branch 5  
(Income Tax & Accounting)