

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **200724007**

Release Date: 6/15/2007

Index Number: 1031.02-00

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B04
PLR-139907-06

Date:
December 14, 2006

TY:

LEGEND:

Taxpayer =
State =
\$x =
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Dear

This responds to your request for a private letter ruling, dated August 18, 2006. Specifically, you have asked us to rule that the manner in which Taxpayer will be owned and the payment of commissions by Taxpayer to its owners will not cause Taxpayer to be a disqualified person under § 1.1031(k)-1(k) of the Income Tax Regulations.

FACTS:

Taxpayer is a State limited liability company that will serve as an intermediary for like-kind exchanges under § 1031 of the Internal Revenue Code. Although Taxpayer currently is a single-member entity, it proposes to sell ownership interests to multiple owners (also known as members or holders) and will then be classified as a partnership for federal income tax purposes under §§ 301.7701-2 and -3. Taxpayer will not be classified as a “publicly traded partnership” within the meaning of § 7704.

Taxpayer will offer shares in its capital and profits to persons who may be “disqualified persons” as to Taxpayer’s customers, within the meaning of § 1.1031(k)-1(k). Shares will also be offered to non-disqualified persons. Taxpayer will not hold any ownership interest in any disqualified person.

Taxpayer will be governed by a limited liability company operating agreement and will have a manager. The manager will not be a “disqualified person” as to customers, within the meaning of § 1.1031(k)-1(k). Pursuant to that agreement, each holder other than the manager will have an interest in the capital and profits of Taxpayer that is

proportional to their respective capital contributions. The manager will contribute capital to Taxpayer in a minimum amount equal to 1% of the aggregate capital contributions of the holders (or, if less, a minimum of \$x) in exchange for an interest having the distribution and allocation entitlements described below. Each holder will earn a 6% preferred return on its capital contribution, until such capital contribution has been returned by distributions to the holder. In addition to participating as a holder in Taxpayer, the manager will be entitled to receive an annual management fee equal to 2% of the aggregate capital contributions of the holders. The management fee will be treated as a guaranteed payment to the manager for federal income tax purposes. Memberships in Taxpayer will be represented by share certificates.

The operating agreement also restricts transfers of direct and indirect ownership of shares in Taxpayer. First, the operating agreement provides the manager with power to refuse to recognize any transfer of any shares, or to honor any request that Taxpayer redeem shares, if, in the sole discretion of the manager, the transfer or redemption could result in adverse tax consequences to Taxpayer. For example, the manager has the power to not recognize transfers or redemption requests as necessary to avoid a material risk of Taxpayer being classified as a publicly traded partnership for federal income tax purposes.

Second, the operating agreement contains extensive provisions designed to keep Taxpayer in compliance with the disqualified person rules of § 1.1031(k)-1(k). In particular, a holder is generally not permitted to own more than a 5% capital or profits interest in Taxpayer. The agreement provides that, unless specifically waived by the manager as described below, if any transfer of direct, indirect or constructive ownership of shares would cause any holder to beneficially own shares representing an amount in excess of 5% of the capital or profits of Taxpayer, the minimum number of shares that will bring the holder into compliance with the 5% ownership limit will automatically be transferred to a trust for the benefit of a charitable beneficiary, effective as of the date the ownership limit would otherwise be exceeded. Neither the trust nor the charitable beneficiary will be a disqualified person within the meaning of § 1.1031(k)-1(k). From that date forward, the holder will have no interest in the shares transferred to the trust, except that if the trustee eventually disposes of the shares, the holder may be entitled to a portion of the sales proceeds that corresponds to the amount, if any, that the holder paid to acquire the transferred shares. All voting rights, distribution rights and other rights will automatically reside in the trustee on behalf of the trust and the charitable beneficiary. In the event an automatic transfer to a trust is not effective to prevent a violation of the 5% ownership limit established by the operating agreement, the transfer of the minimum number of shares necessary to prevent the violation will automatically be voided from the outset, without the requirement of further action on the part of Taxpayer or the manager.

Third, the operating agreement requires that the share certificates bear a legend describing the transfer and ownership limitations. The operating agreement also

requires holders and prospective holders to provide Taxpayer with any information Taxpayer may demand in order to ensure compliance with the 5% ownership limit.

The manager has discretion to waive the 5% ownership limitation as to any holder if the manager determines that the waiver will not cause the holder to beneficially own shares representing a greater than 10% interest in the capital or profits of Taxpayer. The operating agreement expressly provides that the 5% ownership limit will not apply to the shares owned by the manager as long as the manager is not a disqualified person.

Finally, Taxpayer will pay a commission to any real estate broker, agent or other person in the real estate industry, including any disqualified person, holder or nonholder of shares in Taxpayer, who directs a customer to Taxpayer in connection with such customer's like-kind exchange. To fully qualify for payment of a commission, however, the professional must enter into a separate contract (or "Finders Fee Agreement") with Taxpayer. The commission paid by Taxpayer to holders will be the same as the commission paid to nonholders. The payment of the commission will comply with applicable state and local licensing and other legal requirements. No referral commission is expected to exceed \$y per exchange. Thus, a holder (including those that are disqualified persons with respect to a customer of Taxpayer) will be entitled to the share of Taxpayer's profits attributable to its interest, and also to the commission for all customers referred to Taxpayer by such holder. Taxpayer reserves the right to pay a larger or smaller commission in certain cases, depending on the facts and circumstances with respect to any customer.

Taxpayer requests the following ruling: (1) ownership of shares in Taxpayer (subject to the restrictions addressed above) by a disqualified person of a customer of Taxpayer will not cause Taxpayer to be a disqualified person with respect to that customer, and (2) payment of a commission to a holder that is a disqualified person of a customer of Taxpayer will not cause Taxpayer to be considered a disqualified person with respect to that customer.

APPLICABLE LAW AND ANALYSIS:

Section 1031(a)(1) 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 for productive use in a trade or business or for investment.

Section 1.1031(k)-1 provides rules for deferred exchanges of like-kind property. These deferred exchange rules enable a taxpayer to complete a like-kind exchange without actually or constructively receiving money or other unlike-kind property before receiving like-kind replacement property.

Section 1.1031(k)-1(g) establishes various safe harbors for avoiding actual or constructive receipt of money or other property for § 1031 purposes. Under § 1.1031(k)-1(g)(4), a taxpayer may use a qualified intermediary to facilitate a like-kind exchange. If the requirements set forth in § 1.1031(k)-1 are met, the determination of whether a taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer. Among other requirements, a qualified intermediary cannot be either the exchanging taxpayer or a “disqualified person.”

Under § 1.1031(k)-1(k), the term “disqualified person” includes three categories of persons. The first category includes any person who is an agent of the taxpayer at the time of the transaction. For this purpose, § 1.1031(k)-1(k)(2) provides that an agent includes 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 relinquished property.

Section 1.1031(k)-1(k)(3) describes the second category of disqualified persons as including persons to whom the taxpayer bears a relationship described in either § 267(b) or § 707(b) (determined by substituting in each section "10 percent" for "50 percent" each place it appears).

Finally, § 1.1031(k)-1(k)(4)(i) describes the third category of disqualified persons as any person who bears a relationship described in either § 267(b) or § 707(b) (determined by substituting 10% for 50% each place it appears) with a disqualified person described in § 1.1031(k)-1(k)(2). For purposes of both the second and third categories of disqualified persons, disqualifying relationships consist of the familial, fiduciary and ownership relationships described in either § 267(b) or § 707(b). In this connection, disqualifying relationships include, among others, a partnership and a person owning, directly or indirectly, more than 10% of the partnership’s capital or profits interest. In addition, certain indirect and constructive ownership rules apply for purposes of §§ 267(b) and 707(b).

A. Effect of Ownership by Disqualified Persons

In the present case, Taxpayer intends to issue its shares to persons who are disqualified persons as to customers for which Taxpayer will function as a qualified intermediary. Taxpayer will be classified as a partnership, and not as a publicly traded partnership, for federal income tax purposes. As a partnership, the ownership of shares by a disqualified person of a customer would only cause Taxpayer to be a disqualified person with respect to that customer if the disqualified person owns shares representing more than a 10% of the capital or profits interest in Taxpayer.

As stated above, no holder will own shares representing more than a 5% of the capital or profits interest in Taxpayer. Further, the operating agreement will include restrictive provisions to prevent the aggregate shares beneficially owned by any person from representing more than a 5% of the capital or profits interest as a result of any subsequent increase in the direct, indirect or constructive ownership of shares by such person, absent a waiver. Share certificates in Taxpayer will bear a legend describing the transfer restrictions. Taxpayer will take into account, for this purpose, the indirect and constructive ownership rules of §§ 267 and 707.

B. Effect of Payment of Commissions to Holders that are also Disqualified Persons

Section 707 (c) provides, in part, that to the extent determined without regard to the income of the partnership, payments to a partner for services (termed "guaranteed payments"), shall be considered as made to one who is not a member of the partnership, but only for purposes of § 61(a) and, subject to § 263, for purposes of § 162 (a).

Section 1.707-1(c) provides that guaranteed payments do not constitute an interest in partnership profits for purposes of §§ 706(b)(3), 707(b), and 708(b).

Under these definitions, the commissions to be paid pursuant to the Finders Fee Agreement are guaranteed payments that will not be characterized as an interest in Taxpayer's capital or profits. Therefore, the payment of these commissions to any of Taxpayer's holders will not affect the percentage of its ownership of Taxpayer's capital or profits. This result is the same regardless of whether the holder in question is, or is not, a disqualified person.

CONCLUSION:

Based on the forgoing facts and law, (1) ownership of shares in Taxpayer (subject to the restrictions addressed above) by a disqualified person of a customer of Taxpayer will not cause Taxpayer to be a disqualified person with respect to that customer, and (2) payment of a commission to a holder that is a disqualified person of a customer of Taxpayer will not cause Taxpayer to be considered a disqualified person with respect to that customer.

CAVEAT(S):

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. Specifically, we express no opinion about the eligibility of Taxpayer to serve as a qualified intermediary for its clients in like-kind exchanges under § 1031 beyond what is expressly stated in the above rulings.

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under § 6110.

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

Sincerely,

Michael J. Montemurro
Chief, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)