Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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October 13, 2015

LEGEND:

Taxpayer

Initial Lenders

Administrative Agent

Lenders

Voting Participants

Date 1

Date 2

A

B

C

D

Dear :

This is in reply to a letter dated April 30, 2015, requesting a ruling that the patronage dividends described below do not constitute gross income to Taxpayer for purposes of § 856(c)(2) or § 856(c)(3).

FACTS

Taxpayer is a domestic corporation whose common stock is publicly traded. Taxpayer elected to be treated as a real estate investment trust ("REIT") beginning with its taxable year ending Date 1. Taxpayer is a calendar year taxpayer that uses an overall accrual method of accounting. Taxpayer's primary business is to own and manage timberland properties.

The Lenders are subchapter T (§§ 1381-1388) cooperatives owned by the patrons who borrow from them. The Lenders make distributions to their patrons in the form of "patronage dividends." The amounts of patronage dividends are based on the quantity or value of business done with the patron.

Taxpayer entered into a seven year credit agreement dated Date 2, (the "Credit Agreement") with the Initial Lenders to borrow $A from the Initial Lenders. Prior to closing the Credit Agreement, one of the Initial Lenders assigned $B of its commitment under the Credit Agreement to the Administrative Agent and Administrative Agent together with the Initial Lenders became the Lenders under the Credit Agreement. Administrative Agent sold participating shares in its share of the loan under the Credit Agreement to the Voting Participants in the cumulative amount of $C.

Taxpayer receives annual patronage dividends from the Lenders (and not from any Voting Participants), the terms of which are set by each Lender in its respective bylaws and other relevant documents (the patronage dividends received specifically by Taxpayer with respect to amounts borrowed under the Credit Agreement are "Patronage Dividends"). The amount of any Patronage Dividend depends on the amount borrowed and the time such amount is outstanding. Administrative Agent pays part of its Patronage Dividends in the form of equity. Per its bylaws, Administrative Agent targets D% of its total patronage dividends to be paid in equity until the target equity percentage has been met by the patron (in this case the Taxpayer).

REPRESENTATIONS

The following representations are made by Taxpayer:

(a) Taxpayer has used the proceeds of the Credit Agreement to pay off a mortgage of an affiliate secured by real estate assets described in § 856(c)(4)(A).

(b) The Patronage Dividends will be patronage dividends within the meaning of § 1388(a) and will be included on the tax return of Taxpayer as gross income.

(c) For financial accounting purposes, Taxpayer will treat the Patronage Dividends as a reduction in the interest expense related to Borrowings under the Credit Agreement.

LAW AND ANALYSIS

Section 856(c)(2) provides that in order for a corporation to qualify as a REIT, at least 95 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from sources that include dividends, interest, rents from real property, and gain from the sale or other disposition of stock, securities, and real property (other than property in which the corporation is a dealer).

Section 856(c)(3) provides that in order for a corporation to qualify as a REIT, at least 75 percent of the corporation's gross income (excluding gross income from prohibited transactions) must be derived from rents from real property, interest on obligations secured by real property, gain from the sale or other disposition of real property (other than property in which the corporation is a dealer), dividends from REIT stock and gain from the sale of REIT stock, abatements and refunds of taxes on real property, income and gain derived from foreclosure property, commitment fees to make loans secured by mortgages on real property or to purchase or lease real property, gain from certain sales or other dispositions of real estate assets, and qualified temporary investment income.

Section 856(c)(5)(J) provides that to the extent necessary to carry out the purposes of part II of subchapter M of the Code, the Secretary is authorized to determine, solely for purposes of such part, (i) whether any item of income or gain which does not otherwise qualify under §§ 856(c)(2) or (c)(3) may be considered as not constituting gross income for purposes of §§ 856(c)(2) or (c)(3), or (ii) whether any item of income or gain which otherwise constitutes gross income not qualifying under §§ 856(c)(2) or (c)(3) may be considered as gross income which qualifies under §§ 856(c)(2) or (c)(3).

Section 301(a) provides that except as otherwise provided in chapter 1 of subtitle A of the Code (which chapter includes §§ 301, 316, 317, 856, and 1388), a distribution of property (as defined in § 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in § 301(c).

Section 301(c) provides, in part, that in the case of a distribution to which § 301(a) applies, that portion of the distribution which is a dividend (as defined in § 316) shall be included in gross income.

Section 316(a) provides that for purposes of subtitle A (which subtitle includes §§ 856 and 1388), the term "dividend" means any distribution of property made by a corporation to its shareholders (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Section 316(a) provides in the flush language that, except as otherwise provided in subtitle A, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. It provides further that to the extent that any distribution is, under any provision of subchapter C of chapter 1 of subtitle A, treated as a distribution of property to which § 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

Section 1388(a) provides that, for purposes of subchapter T, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of subchapter T applies (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons. For this purpose, net earnings shall not be reduced by amounts paid during the year as dividends on capital stock or other proprietary capital interests of the organization to the extent that the articles of incorporation or bylaws of such organization or other contract with patrons provide that such dividends are in addition to amounts otherwise payable to patrons which are derived from business done with or for patrons during the taxable year.

Section 1388(a) further provides that the term patronage dividend does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

Section 1385(a)(1) provides, that, except as otherwise provided, each person shall include in gross income the amount of any patronage dividend which is paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation), and which is received by him during the taxable year from an organization described in § 1381(a).

The legislative history underlying the tax treatment of REITs indicates that a central concern behind the gross income restrictions is that a REIT's gross income should largely be composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-23 states, “[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business.”

Patronage dividends paid by a subchapter T cooperative are a return of earnings to its cooperative patrons based on the amount of business that the patron transacts with the cooperative. The patronage dividends paid by a subchapter T financing cooperative effectively reduce the costs that its patrons incur to borrow funds from the cooperative. The amounts paid by Lenders as Patronage Dividends represent earnings that the cooperatives are able to refund to Taxpayer based on the average amounts that Taxpayer borrowed from Lenders during the prior year. Thus, while Taxpayer must include Patronage Dividend income in its gross income under § 1385(a)(1), the Patronage Dividends effectively reduce Taxpayer's interest expense paid during the prior year. Under the facts of the instant case, exclusion of the Patronage Dividends from gross income for purposes of §§ 856(c)(2) and (c)(3) does not interfere with Congressional policy objectives in enacting the income tests under those provisions.

CONCLUSION

Accordingly, pursuant to § 856(c)(5)(J)(i), we conclude that the Patronage Dividends included in Taxpayer's gross income under § 1385 are excluded from its gross income for purposes of §§ 856(c)(2) and (c)(3).

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences related to the facts herein under any other provisions of the Code. Specifically, we do not rule whether Taxpayer qualifies as a REIT under Part II of Subchapter M of Chapter 1 of the Code. Additionally, we are not ruling on the tax treatment of the Credit Agreement and whether the agreement is a loan for federal income tax purposes.

This ruling is directed only to the taxpayer requesting it. Taxpayer should attach a copy of this ruling to each tax return to which it applies. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the Taxpayer under a penalties 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.

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

Sincerely,

_____

Steven Harrison
Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)

cc: