Guidance Could Be Enhanced for Deciding to Use a Qualified Intermediary in Like-Kind Exchanges

August 27, 2008

Reference Number: 2008-30-154

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

August 27, 2008

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Guidance Could Be Enhanced for Deciding to Use a Qualified Intermediary in Like-Kind Exchanges (Audit # 200830IE041)

This report presents the results of our review of qualified intermediary regulations and qualification requirements. The objectives of this review were to examine transactions subject to Internal Revenue Code Section 1031,[1] assess the qualification requirements for qualified intermediaries, and determine the legal protections available to taxpayers. We conducted this review in response to a request by the Chairman of the United States House of Representatives Committee on Financial Services.

Impact on the Taxpayer

The Internal Revenue Service (IRS) must ensure the clarity and effectiveness of written guidance provided in its tax publications for taxpayers to be able to understand and meet their Federal tax obligations. Under normal circumstances, when a taxpayer sells business or investment property, tax must be paid on the gain at the time of the sale. A like-kind exchange[2] allows for a deferral in the payment of capital gains tax. While a qualified intermediary can assist in properly structuring and facilitating the transaction, guidance could be enhanced to better inform taxpayers of the range of options available for structuring like-kind exchanges, including the use of qualified intermediaries.

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[1] Internal Revenue Code Section 1031 allows taxpayers to postpone paying tax on the gain from a sale of property if the proceeds are reinvested in similar property as part of a qualifying like-kind exchange.
[2] Also referred to as an Internal Revenue Code Section 1031 Deferred Exchange.

Synopsis

Driven in large part by the rise in real estate prices, the number of like-kind exchanges more than doubled between Tax Years 2001 and 2005, according to IRS statistics. In Tax Year 2005 alone, the IRS recorded deferred gains of approximately $101.3 billion from 429,000 like-kind exchanges. Qualified intermediaries can assist taxpayers in completing a like-kind exchange by receiving and holding the proceeds for the relinquished property and then disbursing the funds to acquire the replacement property.

Although qualified intermediaries have important fiduciary responsibilities, they are not licensed or regulated and have minimal Federal Government oversight. In addition, they are not subject to minimum standards for training, competency, or conduct, and they operate in a variety of business entities and enterprises ranging from large professional financial service entities to individuals with little or no formal training.

Despite the fact that qualified intermediaries operate in an environment with minimal oversight and regulation, few problems have been reported. However, when a qualified intermediary does not meet its fiduciary responsibilities, the consequences for the taxpayer can be significant. The industry trade association for qualified intermediaries, the Federation of Exchange Accommodators (FEA), reported to the Federal Trade Commission in 2007 that it was aware of 23 instances, involving $250 million in estimated losses, in which qualified intermediaries might not have met their fiduciary responsibilities. We were unable to obtain a more precise estimate on the extent of the problems with qualified intermediaries due to the absence of other available evidence.

The FEA would like the IRS to provide qualified intermediary oversight much like it does for the tax preparation industry. However, our discussions with attorneys from the IRS Office of Chief Counsel indicated that while the IRS has broad authority to monitor and sanction problem tax preparers, its authority does not extend to qualified intermediaries. Moreover, the absence of firm data on the extent of problem qualified intermediaries and the number of taxpayers affected precludes us from making a recommendation to involve the IRS in the oversight of qualified intermediaries. We believe that such data would be needed to properly evaluate whether the benefit that might be derived from IRS oversight would outweigh the costs.

While we are making no recommendation to involve the IRS in the oversight of qualified intermediaries, we did identify changes that could be made to enhance the written guidance provided to taxpayers in *Sales and Other Dispositions of Assets* (Publication 544). Generally, the changes we suggest are directed toward better ensuring that taxpayers understand the risks involved with using qualified intermediaries and the other options available for complying with the rules governing like-kind exchanges.

Recommendations

We recommended that the Commissioner, Small Business/Self-Employed Division, and the Commissioner, Wage and Investment Division, revise Publication 544 to include 1) a discussion about the risks associated with using a qualified intermediary, and 2) additional information about the other options taxpayers can use in lieu of a qualified intermediary.

Response

In responding to the report, IRS officials indicated they appreciated our thorough analysis and description of this complex subject matter. They also agreed with all of our recommendations and outlined the corrective actions to address them. The Director, Examination, Small Business/Self-Employed Division, and the Director, Media and Publications, Wage and Investment Division, will ensure that Publication 544 is revised to include a discussion regarding the risks associated with using a qualified intermediary and to enhance the discussion of other safe harbors. Management's complete response to the draft report is included as Appendix IV. In addition to its response, the IRS Office of Chief Counsel provided technical comments on a draft of this report which we incorporated as appropriate.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8510.

Table of Contents

Abbreviations

FEA	Federation of Exchange Accommodators
FTC	Federal Trade Commission
IRS	Internal Revenue Service

Background

Under normal circumstances, when a taxpayer sells business or investment property and realizes a gain, tax must be paid on the gain at the time of the sale. A like-kind exchange[1] allows for an exception to the payment of the tax on the gain. When taxpayers exchange business or investment properties for like-kind business or investment properties, they can defer payment of the tax on the gain. As long as a property used for business or investment is replaced with a similar property, no gain or loss is recognized at that time. Instead, it is deferred until the eventual sale of the replacement property.

Taxpayers who take advantage of like-kind exchanges increase their purchasing power, as well as their financing and leverage capabilities, because payment of Federal tax on the gains is deferred. Taxpayers can use exchanges to acquire replacement properties with greater income potential (e.g., raw land can be exchanged for income-producing property and qualify as a like-kind exchange). With additional equity to reinvest, taxpayers can execute exchange after exchange and continue to defer payment of tax on the gain realized. The tax liability might be forgiven upon the death of the investor because the heir(s) might qualify for a stepped-up basis on the inherited property.

While the concept of trading one property for another similar property might seem straight forward, the tax rules governing such transactions are firm and need to be closely followed. For example, strict timing rules require a taxpayer who trades property to identify, in writing, the replacement property within 45 calendar days and to complete the entire transaction within the earlier of 180 calendar days after the sale of the exchanged property or the due date, including extensions, of the income tax return for the year in which the relinquished property is sold. Strict rules also prohibit taxpayers from taking control of cash or other proceeds before the exchange is complete.

This review was performed at the Internal Revenue Service (IRS) National Headquarters in Washington, D.C., in the Office of the Commissioner, Small Business/Self-Employed Division, and the Office of Chief Counsel during the period September 2007 through April 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Detailed information on our audit

[1] Also referred to as an Internal Revenue Code Section 1031 Deferred Exchange. Internal Revenue Code Section 1031 allows taxpayers to postpone paying tax on the gain from a sale of property if the proceeds are reinvested in similar property as part of a qualifying like-kind exchange.

objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

Qualified Intermediaries Provide a Valuable Service With Few Reported Problems

Driven in large part by the rise in real estate prices, the number of like-kind exchanges more than doubled between Tax Years 2001 and 2005, according to the latest available IRS statistics. In Tax Year 2005 alone, the IRS recorded deferred gains of approximately $101.3 billion from 429,000 like-kind exchanges. Qualified intermediaries can assist taxpayers in completing a like-kind exchange by receiving and holding the proceeds for the relinquished property and then disbursing the funds to acquire the replacement property.

Our review of the tax rules, analysis of statistical information, and discussions with attorneys from the IRS Office of Chief Counsel and representatives from the Federation of Exchange Accommodators (FEA)[2] highlights the critical role qualified intermediaries play in a like-kind exchange. By law, taxpayers risk having transactions treated as a sale if they receive money or other proceeds before taking possession of the like-kind exchange property, which would cause all gain to be immediately taxable.

For those seeking to minimize the risk of having to pay a significant amount of tax associated with a sale, qualified intermediaries are one of several "safe harbors" that taxpayers can use to hold the exchange proceeds until the exchange is complete. Besides restricting access to assets during the exchange period, qualified intermediaries are popular because, as our research indicated, they can assist in properly structuring and facilitating the transaction to comply with the related tax rules governing like-kind exchanges.

Many taxpayers benefit from using a qualified intermediary, but some experience problems

When qualified intermediaries do not meet their fiduciary responsibilities, the consequences for the taxpayers can be significant. In 2007, the FEA reported to the Federal Trade Commission (FTC) that it was aware of 23 instances, involving $250 million in estimated losses, in which qualified intermediaries might not have met their fiduciary responsibilities. Two of the more publicized cases accounted for $228 million of the estimated loss. We were unable to obtain a more precise estimate of the extent of the problems with qualified intermediaries due to the

[2] The FEA is a national trade association organized to represent professionals who conduct like-kind exchanges under Internal Revenue Code Section 1031. Members include qualified intermediaries, their primary tax and legal counsel, and affiliated industries (banks, real estate brokers, title companies, escrow agents, etc.).

absence of other available evidence. However, the number of like-kind exchanges taking place and the limited number of reported losses suggest that the number of taxpayers experiencing such problems is relatively small.

Some Believe That Professional Standards and More Oversight Are Needed for Qualified Intermediaries

Qualified intermediaries are not licensed or regulated and have minimal Federal Government oversight. In addition, they are not subject to minimum standards for training, competency, or conduct, and they operate in a variety of business entities and enterprises ranging from large professional financial service entities to individuals with little or no formal training. In short, almost anyone can offer qualified intermediary services.

While most taxpayers might be satisfied with the service they receive from their qualified intermediaries, the poor experiences of some raise the question of whether steps need to be taken to better protect taxpayers from "problem" qualified intermediaries. Currently, the FTC, the Department of Justice, some State Governments, and the FEA engage in efforts to protect taxpayers. The FEA would like the IRS to provide qualified intermediary oversight much like it does for the tax preparation industry. However, our discussions with attorneys from the IRS Office of Chief Counsel indicated that while the IRS has broad authority to monitor and sanction problem tax preparers, its authority does not extend to qualified intermediaries.

Federal Government agencies, some State Governments, and the FEA engage in efforts to protect taxpayers as well as detect and take actions against problem qualified intermediaries

Although the IRS does not monitor the conduct of qualified intermediaries, we did find that at the Federal level, the FTC and the Department of Justice can protect taxpayers from problem qualified intermediaries. Under the Federal Trade Commission Act,[3] the FTC is responsible for protecting consumers from unfair or deceptive acts or practices in or affecting commerce. The Department of Justice is responsible for enforcement of Federal laws. At the local level, qualified intermediaries can be subject to criminal and civil penalties for violating State laws.

We identified three States that have or are proposing laws to provide qualified intermediary oversight or taxpayer protection from problem qualified intermediaries. For example, Nevada laws require qualified intermediaries to obtain a license from the State, maintain bonding, have insurance, and keep taxpayer funds in separate accounts during the exchange period. Nevada also conducts background checks and audits of qualified intermediaries' accounts and operations. Under Nevada laws, the Department of Business and Industry regulates the activities of qualified intermediaries operating in the State and has the authority to impose fines of $200 for each day

[3] Pub. L. No. 63-203, ch. 311, 38 Stat. 717 (1914) (codified at 15 U.S.C. Section 41 - 58).

that a qualified intermediary is not in compliance with State statutes. The Department can also sanction a qualified intermediary by suspending, revoking, or denying the renewal of its license to operate in the State.

In addition, the FEA imposes standards of conduct on the actions of its 300 member companies located throughout the country. The FEA also conducts background checks on principals and officers of its member companies that are not publicly traded or otherwise regulated under State or Federal Government banking laws, arranges for insurance companies to offer insurance and bonding, and administers a certification and continuing education program to exchange practitioners.

Although the FEA does not have the authority to act against problem qualified intermediaries who are not members, it can reprimand, suspend, or expel member-qualified intermediaries from the Association. Finally, the FEA has suggested actions to the FTC and the IRS that could be taken to increase taxpayer protections from problem qualified intermediaries. In 2007, the FEA suggested that the FTC adopt proposed nationwide rules to Federally regulate the industry. These nationwide rules would require persons who want to act as qualified intermediaries to register with the FTC, impose standards to safeguard consumer funds entrusted to qualified intermediaries, and establish standards to demonstrate that a person has the appropriate level of competence to act as a qualified intermediary. More recently, the FEA suggested, among other things, that the IRS modify the tax rules to specify how exchange funds might be used by qualified intermediaries during the exchange period.

The IRS would face challenges in providing qualified intermediary oversight

According to attorneys from the IRS Office of Chief Counsel, other IRS representatives, and our evaluation of the problem, any decision about having the IRS assume such responsibilities would need to consider at least two factors. First, the benefit that might be derived from IRS oversight would need to be weighed against the costs of providing it. As we indicated earlier in the report, there is an absence of data on the number of problem qualified intermediaries and taxpayers who have been affected. Further, we could not find any evidence that the effectiveness of the oversight already in place has been fully evaluated. Consequently, it would be difficult, if not impossible, to determine the level of resources the IRS would need and the mechanisms it should establish to provide effective oversight.

Second, without a budget increase, the IRS would likely have to divert resources from its important work of processing tax returns and collecting taxes. Moreover, IRS officials questioned whether the IRS would have the organizational capacity to take on this additional responsibility effectively, given its other tax administration priorities. We consider these factors significant enough to preclude our making a recommendation to involve the IRS in the oversight of qualified intermediaries.

While we are making no recommendation to involve the IRS in the oversight of qualified intermediaries, we did identify changes that could be made to enhance the written guidance provided to taxpayers in *Sales and Other Dispositions of Assets* (Publication 544). Generally, the changes we suggest are directed toward better ensuring that taxpayers understand the risks involved with using qualified intermediaries and the other options available for complying with the rules governing like-kind exchanges.

The IRS should ensure that taxpayers are aware of the risks involved with using a qualified intermediary and the other options available to complete like-kind exchanges

In responding to our earlier report,[4] the IRS recognized that the use of like-kind exchanges to defer gains is increasing. As a result, it is taking a number of actions to ensure compliance with the rules pertaining to like-kind exchanges. Among other things, it plans to complete a research study of reporting and compliance issues associated with like-kind exchanges and to update its guidance to better inform and educate taxpayers about like-kind exchange tax rules.

To its credit, the IRS also recognized the problem some taxpayers are experiencing with qualified intermediaries. As reprinted below, the IRS included a specific caution about the risks involved with using a qualified intermediary in a broad February 2008 public announcement about like-kind exchanges.

> *Be careful in your selection of a qualified intermediary since there have been recent incidents of intermediaries declaring bankruptcy or otherwise being unable to meet their contractual obligations to the taxpayers. These situations have resulted in taxpayers not meeting the strict timeliness set for a deferred or reverse exchange, thereby disqualifying the transaction from Section 1031 deferral of gain. The gain may be taxable in the current year while any losses the taxpayer suffered would be considered under separate* [C]*code sections.*

Public announcements, while helpful to taxpayers, are generally intended to have short-term value, according to the IRS. We believe that a more long-lasting taxpayer benefit might be realized by incorporating the above or a similar caution into Publication 544, because this is a key document used as a guide by taxpayers to comply with like-kind exchange tax rules.

In addition, our analysis identified another Publication 544 change that could help taxpayers when they are considering a like-kind exchange. Specifically, taxpayers might benefit from inclusion of additional information about the other options they can use to avoid taking control of cash or other proceeds before the exchange is complete. Publication 544 currently contains several paragraphs discussing qualified intermediaries but provides only a sentence describing the other safe harbor options. According to Treasury Regulations,[5] these other options include:

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[4] *Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance* (Reference Number 2007-30-172, dated September 17, 2007).
[5] Treas. Reg. Section 1.1031(k)-1(g) (1991).

- Security or guarantee arrangements such as a mortgage or deed of trust, a standby letter of credit, or a guaranty from a third party as security devices or guarantees.
- Qualified escrow accounts and qualified trusts in which the escrow holder or trustee is not the taxpayer or related party, and the taxpayer's rights to receive, pledge, or borrow the cash or cash equivalent are restricted.

The IRS Office of Chief Counsel commented that security or guarantee arrangements and qualified escrow accounts and trusts are generally used in addition to a qualified intermediary. Another method to complete a like-kind exchange is through an accommodating buyer who acquires the replacement property, which is then delivered to the exchanging taxpayer. This method completely eliminates the need for a qualified intermediary, but not the need for one or more of the other safe harbors. It is less commonly used because most buyers are not willing to accommodate the exchanging taxpayer by acquiring the replacement property.

Recommendations

The Commissioner, Small Business/Self-Employed Division, and the Commissioner, Wage and Investment Division, should revise Publication 544 to include:

Recommendation 1: A discussion about the risks associated with using a qualified intermediary.

> ***Management's Response:*** IRS management agreed with the recommendation. The Director, Examination, Small Business/Self-Employed Division, and the Director, Media and Publications, Wage and Investment Division, will ensure that Publication 544 is revised to include a discussion regarding the risks associated with using a qualified intermediary based upon the language in the February 2008 public announcement.

Recommendation 2: Additional information about the other safe harbor options taxpayers can use, in lieu of a qualified intermediary, to avoid taking control of cash or other proceeds before the exchange is complete.

> ***Management's Response:*** IRS management agreed with the recommendation. The Director, Examination, Small Business/Self-Employed Division, and the Director, Media and Publications, Wage and Investment Division, will ensure that Publication 544 is revised to enhance the discussion of other safe harbors.

Appendix I

Detailed Objectives, Scope, and Methodology

The objectives of this review were to examine transactions subject to Internal Revenue Code Section 1031,[1] assess the qualification requirements for qualified intermediaries, and determine the legal protections available to taxpayers. To accomplish the objectives, we:

I. Reviewed Internal Revenue Code Section 1031 and any proposed changes to Department of the Treasury regulations to determine:

   A. Safe harbors provided to taxpayers executing tax-deferred like-kind exchanges.

   B. The role of qualified intermediaries and qualification requirements.

   C. Additional protections being considered for taxpayers using qualified intermediaries.

II. Reviewed IRS publications and met with IRS personnel to identify:

   A. Instructions provided to taxpayers regarding the use of qualified intermediaries for like-kind exchanges.

   B. Protections provided to taxpayers using qualified intermediaries to execute like-kind exchanges and/or relief offered by the IRS to those affected by unscrupulous qualified intermediaries.

III. Met with the industry group representing qualified intermediaries to determine:

   A. The qualified intermediary industry as well as the qualification requirements and ethical standards of conduct.

   B. The number of instances of and financial impact from unscrupulous qualified intermediaries.

   C. Proposals submitted by the industry group to Federal Government agencies and/or Congressional committees to enhance regulation and oversight of qualified intermediaries.

[1] Internal Revenue Code Section 1031 allows taxpayers to postpone paying tax on the gain from a sale of property if the proceeds are reinvested in similar property as part of a qualifying like-kind exchange.

IV. Identified regulations and/or reforms adopted by States to increase regulation of the industry and enforce ethical standards for qualified intermediaries.

V. Reviewed IRS reports to assess the volume of like-kind exchange transactions subject to Internal Revenue Code Section 1031 reported by taxpayers on Like-Kind Exchanges (Form 8824) for Tax Years 2001 through 2005 and to identify the amount of the exchanged property and taxes deferred.

Appendix II

Major Contributors to This Report

Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)
Frank Dunleavy, Director
Robert Jenness, Audit Manager
Richard Viscusi, Lead Auditor
Carole Connolly, Senior Auditor
Van Warmke, Senior Auditor
Matthew Schimmel, Program Analyst

Appendix III

Report Distribution List

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Appendix IV

Management's Response to the Draft Report

RECEIVED
JUL 30 2008

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

July 30, 2008

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kathy K. Petronchak
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Guidance Could Be Enhanced for Deciding to Use a Qualified Intermediary in Like-Kind Exchanges (Audit # 200830IE041)

Thank you for the opportunity to review and comment on your draft report titled, "Guidance Could Be Enhanced for Deciding to Use a Qualified Intermediary in Like-Kind Exchanges". I appreciate your thorough analysis and description of this complex subject matter.

We concur with the report's recommendations. We will work with the Commissioner, Wage and Investment Division, to revise Publication 544 to include 1) a discussion about the risks associated with using a qualified intermediary, and 2) additional information about alternative methods for structuring like-kind exchanges. In addition to implementing your recommendations, we plan to further study this issue to ensure we have a comprehensive plan to provide additional guidance.

Attached is a detailed response outlining our corrective actions. If you have any questions or concerns, please contact me at (202) 622-0600 or Monica Baker, Director, Examination at (202) 283-2659.

Attachment

Attachment

RECOMMENDATION 1
The Commissioner, Small Business/Self-Employed Division, and the Commissioner, Wage and Investment Division, should revise Publication 544 to include a discussion about the risks associated with using a qualified intermediary.

CORRECTIVE ACTIONS
We concur with this recommendation. We will ensure Publication 544 is revised to include a discussion regarding the risks associated with using a qualified intermediary based upon the language in Fact Sheet 2008-18 located at http://www.irs.gov/newsroom/article/0,,id=179801,00.html.

IMPLEMENTATION DATE
February 15, 2009

RESPONSIBLE OFFICIAL
Director, Examination, Small Business/Self-Employed Division, and Director, Media and Publications, Wage &Investment Division

CORRECTIVE ACTIONS MONITORING PLAN
We will monitor this corrective action as part of our management internal control processes.

RECOMMENDATION 2
The Commissioner, Small Business/Self-Employed Division, and the Commissioner, Wage and Investment Division, should revise Publication 544 to include additional information about the other safe harbor options taxpayers can use, instead of a qualified intermediary, to avoid taking control of cash or other proceeds before the exchange is complete.

CORRECTIVE ACTION
We concur with this recommendation. We will ensure Publication 544 is revised to enhance the discussion of other safe harbor options.

IMPLEMENTATION DATE
February 15, 2009

RESPONSIBLE OFFICIAL
Director, Examination, Small Business/Self-Employed Division, and Director, Media and Publications, Wage &Investment Division

CORRECTIVE ACTIONS MONITORING PLAN
We will monitor this corrective action as part of our management internal control processes.