OLYMPIA J. SNOWE, MAINE, CHAIR
JOHN F. KERRY, MASSACHUSETTS, RANKING MEMBER

CHRISTOPHER S. BOND, MISSOURI
CONRAD BURNS, MONTANA
GEORGE ALLEN, VIRGINIA
NORM COLEMAN, MINNESOTA
JOHN THUNE, SOUTH DAKOTA
JOHNNY ISAKSON, GEORGIA
DAVID VITTER, LOUISIANA
MICHAEL ENZI, WYOMING
JOHN CORNYN, TEXAS
CARL LEVIN, MICHIGAN
TOM HARKIN, IOWA
JOSEPH I. LIEBERMAN, CONNECTICUT
MARY LANDRIEU, LOUISIANA
MARIA CANTWELL, WASHINGTON
EVAN BAYH, INDIANA
MARK PRYOR, ARKANSAS

WESTON J. COULAM, REPUBLICAN STAFF DIRECTOR
NAOMI BAUM, DEMOCRATIC STAFF DIRECTOR

United States Senate
COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
WASHINGTON, DC 20510–6350

May 18, 2006

BY FACSIMILE
ORIGINAL BY U.S. MAIL

Mr. Eric Solomon
Acting Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue N.W.
Washington, DC 20220

The Honorable Donald Korb
Chief Counsel
Internal Revenue Service
1111 Constitution Ave.
Washington, DC 20024

Dear Sirs:

The Department of the Treasury (Treasury) and the Internal Revenue Service (IRS or Service) has issued a notice of proposed rules for deferred like-kind exchanges with respect to funds held by qualified intermediaries (QI). 71 Fed. Reg. 6231 (Feb. 7, 2006). We have serious concerns regarding the potentially devastating and negative impact that these proposed regulations would have on small businesses. We fear that one result of the regulation would be a consolidation of the industry, and that numerous small businesses would be forced to close their doors.

Under section 1031 of the Internal Revenue Code, taxpayers are allowed to engage in like-kind exchanges of business property. QIs hold the proceeds of a sale of business property while the taxpayer locates replacement property. Generally, QIs generate revenue by charging a fee and retaining a portion of the interest earned on the exchange proceeds that they manage. The proposed regulations would treat the funds held by the QI as a loan from the exchanging taxpayer to the QI. This change has substantial tax implications for small business QIs.

**A Full and Complete Regulatory Flexibility Analysis Should Be Conducted Before any Final Rules are Issued**

As you know, the Regulatory Flexibility Act (RFA) requires that Federal agencies prepare a regulatory flexibility ("Reg Flex") analysis for proposed rules that would have a significant economic impact on a substantial number of small businesses. The purpose of the RFA is to ensure that Federal agencies properly and fully consider the impact of their rules on small businesses. The RFA requires that Treasury and the IRS provide an "initial regulatory flexibility

analysis"(IRFA) and an agency describe the reasons why action is being taken and the legal basis for action.

While we agree that a legal basis for the action has been provided in the IRFA, we believe that Treasury and the Service fail to adequately describe the reasons for taking action. The Service had issued proposed regulations in 1999 upon which the industry has relied for guidance. The new proposed regulations significantly revise these previous proposed regulations without adequately articulating a problem that the Service is attempting to address with this new action. Treasury and the IRS need to expressly state the rationale supporting the proposed rule and specifically discuss alternative regulatory proposals that could achieve the same policy goals without adversely impacting small businesses.

The RFA also requires that agencies describe and estimate the number of small businesses affected by the proposed rule. The Treasury and IRS state in the IRFA that small business is defined by North American Industry Classification System (NAICS) code 531390 (a business with annual receipts of up to $1.5 million). This classification code is designated for businesses that primarily perform real estate services. This designation runs contrary to the reality that section 1031 transactions are not restricted to real estate. In reality, many like-kind transactions involve property other than real estate. As a result, Treasury and the Service should have applied NAICS code 523991 (trust, fiduciary, and other custody activities). This classification provides a size standard of receipts of up to $6.5 million. Clearly, the appropriate designation under NAICS code 523991 may significantly affect the estimated number of businesses affected. Alternatively, if NAICS code 531390 as Treasury and the IRS opted for were the correct size standard, Treasury and the Service should have defined a small business as a business with annual receipts of $2 million, not $1.5 million, or less. 13 C.F.R. § 121.201 (2005). This designation would capture more small businesses.

Additionally, the notice makes a determination that the "proposed rulemaking is not a significant regulatory action." We could not disagree more given that the proposed rule will affect an entire industry of small business QIs. We have been told by small businesses from across the country that the proposed rule may force many of these small business QIs to close their doors. In fact, Executive Order (E.O.) 12,866 cited by Treasury and the Service states that "a significant regulatory action" includes one that affects an identifiable sector of the economy. It is clear that qualified intermediaries represent an identifiable sector of the economy. As a result, we strongly urge Treasury and the Service to reconsider this determination and perform a cost-benefit analysis of the proposed rule, including alternatives that would be less burdensome to small businesses as required by E.O. 12,866.

**Treasury and the Service should Reconsider its Legal Analysis**

In the ordinary course of business, a QI receives proceeds from the sale of property by a taxpayer. The QI then holds the proceeds for a period not to exceed 180 days. Under section 1031 regulations title is generally deeded directly from the taxpayer to the buyer. *See* 26 C.F.R. § 1.1031(k)-1(g)(4). The regulations also provide that the QI is treated as the transferee of the relinquished property and receives payment of the proceeds so that the taxpayer never actually or

constructively receives the proceeds. Once the taxpayer enters into a purchase contract with an unrelated party to purchase replacement property, the QI would deposit funds, up to the amount of the proceeds, into the settlement account for the purchase of the replacement property. If the exchange is successful, the taxpayer never receives anything other than replacement property. QIs often arrange their compensation by charging a nominal fee while retaining any interest received on aggregated deposits over a predetermined flat rate or a certain percentage of a variable rate.

The February 7 notice revises the proposed regulations under section 468B to provide that the proceeds received by the QI as a facilitator of the like-kind exchange transaction are owned, and therefore, taxable to the taxpayer. This interpretation is in conflict with the regulations under section 1.1031(k)-1(g)(4) that do not allow the taxpayer to be in actual or constructive receipt of the proceeds on the sale of the property.

The revised proposed regulations go on to deem that the QI has received a below-market loan from the taxpayer unless the QI returns all earnings attributable to the proceeds to the taxpayer. As a result, the proposed rules would impose imputed interest on the taxpayer under section 7872 of the Internal Revenue Code. Congress enacted section 7872 to address transactions that allowed taxpayers to disguise the economic substance of a transaction by the structure and thereby avoid or reduce tax liability. Clearly, Congress was concerned with dealings between related parties that allowed for tax avoidance, but by the nature and rules under a section 1031 like-kind exchange, the QI and taxpayer must be independent from one another or the transaction fails to qualify for section 1031 treatment. QIs have not engaged in tax sheltering transactions. In fact, they have thus far structured deferred like-kind exchanges with the blessings of the IRS through its now withdrawn proposed regulations.

While we believe that Treasury's and the Service's interpretation of section 468B is in conflict with section 1031 and thus should not apply, we further believe that Treasury and the Service have not properly considered its authority under section 7872(h)(1)(C) even should section 468B apply. Section 7872(h)(1)(C) directs the Secretary to prescribe regulations exempting transactions that have no significant effect on tax liability by the lender or borrower. We understand that neither party in a transaction described above would realize a change in tax liability over the life of the replacement property. Indeed, at no time will the QI's tax liability be altered by the imposition of these rules given that income is imputed on the taxpayer, not the QI. Though the taxpayer would have imputed interest income under the proposed regulations, this income would be treated as paid back to the QI as compensation for service, and therefore, would be added to the basis of the replacement property that would be recovered through depreciation. As a result, the taxpayer would not have a net change in the amount of tax liability over the life of the replacement property, but would only realize a timing consequence.

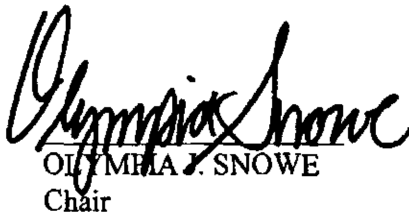
The regulations under section 7872 provide further guidance on what transactions do not have a significant tax effect. Regulation section 1.7872-5T(c)(3) provides four factors to consider when determining whether a transaction has a significant effect on tax liability. One factor listed is whether items of income and deduction generated by the loan offset each other. As just explained, any income imputed by the regulations would be offset over the life of

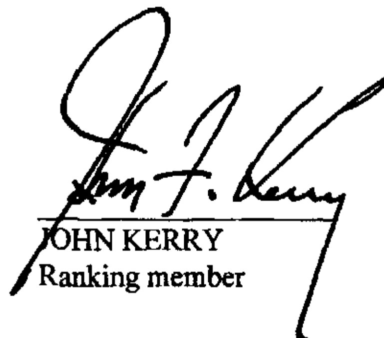
replacement property through depreciation deductions. Secondly, the amount of income generated by the transaction is a factor. In the typical deferred like-kind exchange, any income generated would be relatively small given the short time periods of these transactions. Third, the cost to the taxpayer of complying with the section if applied is a factor. Section 7872 would require calculating imputed interest and record-keeping over the life of the replacement property as it is depreciated. Finally, any non-tax reasons for deciding to structure the transaction is a listed factor. The structure as outlined previously simply allows QIs to provide a low-cost means for taxpayers to engage in a non-taxable event through a deferred like-kind exchange as appropriately provided under § 1031.

We have heard from small businesses providing QI services from across the country. They have explained to us the devastating impact that the proposed regulations would have on their industry. We have also heard the impact the proposed regulations would have on consumers that are served by small business QIs. We encourage you to review the comments that have been submitted by these small business QIs. These comments make a compelling argument about how the proposed rule negatively impacts them and how the regulation would change the balance that currently exists between small business QIs and large bank QIs.

In recent years, Treasury and the Service have made strides in attempting to reduce the regulatory burden on small businesses. We believe that the proposed regulations issued on February 7, however, would be a step backwards. As a result, we respectfully request that the proposed regulations be withdrawn, and at the very least, a full and complete regulatory analysis be conducted before a new proposed rule is issued.

Sincerely,


OLYMPIA J. SNOWE
Chair


JOHN KERRY
Ranking member

JOHNNY ISAKSON

MARK PRYOR