



Advocacy: the voice of small business in government

Testimony of

***The Honorable Thomas M. Sullivan
Chief Counsel for Advocacy
U.S. Small Business Administration***

***U.S. House of Representatives
Committee on Small Business***

Date: July 25, 2006
Time: 2:00 P.M.
Location: Room 2360
Rayburn House Office Building
Washington, D.C.
Topic: **Deferred Exchanges of Like Kind Property**

Created by Congress in 1976, the Office of Advocacy of the U.S. Small Business Administration (SBA) is an independent voice for small business within the federal government. The Chief Counsel for Advocacy, who is appointed by the President and confirmed by the U.S. Senate, directs the office. The Chief Counsel advances the views, concerns, and interests of small business before Congress, the White House, federal agencies, federal courts, and state policy makers. Issues are identified through economic research, policy analyses, and small business outreach. The Chief Counsel's efforts are supported by offices in Washington, D.C., and by Regional Advocates. For more information about the Office of Advocacy, visit <http://www.sba.gov/advo>, or call (202) 205-6533.



Testimony Summary

Advocacy: the voice of small business in government

Chief Counsel for Advocacy Testifies Before House Small Business Committee on Proposed IRS Regulations Governing Exchanges of Like-Kind Property

On July 25, 2006, Chief Counsel for Advocacy Thomas M. Sullivan testified before the U.S. House of Representatives Committee on Small Business regarding proposed IRS regulations that would substantially change the rules governing taxation of escrow accounts, trusts, and other funds used during deferred exchanges of like-kind property. Key points from the testimony include:

- The IRS and Treasury should more frequently perform the analysis required by the Regulatory Flexibility Act (RFA) on rules that have a significant impact on a substantial number of small entities.
- In the proposed rule leading up to this hearing, IRS and the Treasury have attempted to comply with the RFA by including an initial regulatory flexibility analysis (IRFA) in the “Special Analysis” section of the regulation. However, IRS and Treasury could have provided a more thorough analysis.
- Early meetings with Advocacy and Treasury and IRS during their regulation development process would help assure that the spirit of the RFA is met and regulatory results achieved.

On May 8, 2006, the Office of Advocacy sent a comment letter to the Department of Treasury and IRS in response to their notice of proposed rulemaking entitled, *Escrow Accounts, Trusts and Other Funds Used During Exchanges of Like-Kind Property* (71 Fed. Res. 6231 February 7, 2006). Advocacy advised IRS and Treasury to publish in the *Federal Register* an amended IRFA. A copy of Advocacy’s letter can be accessed at <http://www.sba.gov/advo/laws/comments>.

For more information, visit Advocacy’s Webpage at <http://sba.gov/advo> or contact assistant chief counsel Candace Ewell by phone at (202) 401-9787 or by email at candace.ewell@sba.gov.

Good morning, Chairman Manzullo and Members of the Committee, I thank you for this opportunity to appear before you today. My name is Thomas M. Sullivan, and I am the Chief Counsel for Advocacy at the U.S. Small Business Administration (SBA). Congress established the Office of Advocacy (Advocacy) to represent the views of small business before Congress and Federal agencies. Advocacy is an independent office within the SBA. Therefore the comments expressed in this statement do not necessarily reflect the position of the Administration or the SBA. This statement was not circulated to the Office of Management and Budget (OMB) for comment.

I am here today to discuss the recently proposed rule by the Department of the Treasury (Treasury) and Internal Revenue Service (IRS) entitled *Escrow Accounts, Trusts, and Other Funds Used During Deferred Exchanges of Like-Kind Property*.¹ The proposed rule, if finalized in its current form, may impede the ability of hundreds of small business qualified intermediaries (QIs) from effectively competing with a small number of bank-owned QIs. In particular, the subject of this hearing is Treasury's and IRS' compliance with the Regulatory Flexibility Act (RFA) with respect to the proposed rule.

Advocacy takes its direction from small businesses and in order to understand the proposal, we hosted a roundtable on the proposed rule. The roundtable was attended by Treasury and IRS staff. The roundtable provided an opportunity for small business QIs to directly express their comments and concerns about the proposed rule to Advocacy, Treasury and IRS. As a result of the roundtable Advocacy submitted a written comment to Treasury and IRS on May 8, 2006, highlighting incomplete areas of their Initial Regulatory Flexibility Analysis (IRFA).

RFA Background

Congress created Advocacy in 1976 to ensure that Federal agencies measure the costs and impacts of regulations on small businesses. Congress realized, however, that the creation of Advocacy, in itself, was not sufficient to sensitize Federal agencies to the fact that there are differences in the scale and resources of regulated entities, and that the disproportionate impact of regulation adversely affected competition, discouraged innovation, and created market entry barriers. Congress enacted the RFA to help alleviate this problem in 1980 and designated Advocacy to monitor agency compliance and make sure agencies considered less burdensome regulatory alternatives.

In 1996, after reviews by this Committee and others revealed gaps in agency compliance with the requirements of the RFA, Congress strengthened the RFA by passing the Small Business Regulatory Enforcement Fairness Act (SBREFA). The RFA amendments in SBREFA permitted judicial review of an agency's failure to comply with the RFA, established special small business advocacy review panels for Environmental Protection Agency and Occupational Safety and Health Administration regulations impacting small entities, and required the Treasury and IRS to comply with the RFA on "interpretative" regulations that contain a collection of information requirement.

¹ 71 FR 6231 (February 7, 2006).

The premise of the RFA is that an agency must undertake a transparent and careful analysis of its proposed regulations—with specific attention to the small business community—to identify their impact on small businesses and develop alternatives to reduce or eliminate the small business burdens without compromising the public policy objective. Advocacy believes that it would be good for small business if the Treasury and IRS more frequently performed the analysis required by the RFA on all information collection rules that have the potential to have a significant impact on a substantial number of small entities.

An initial regulatory flexibility analysis (IRFA) provides the agency with a better understanding of the rule’s impact and results in better policy because the analysis is shared with those in the regulated community. The IRS could play an especially important role in the analysis process because the agency possesses unique data and detailed statistics that are very valuable to the rulemaking process. Lack of information makes it difficult for small entities to know how the proposal will affect their business practices. With respect to the rule at issue today we believe the Treasury and IRS have attempted to comply with the requirements of the RFA by including an IRFA in the “Special Analysis” section of the regulation. However, IRS and Treasury could have provided a more thorough analysis.

Industry and Proposed Rule Overview

Regulations under section 1031 of the Internal Revenue Code (Code) permit taxpayers to engage in deferred exchanges of like-kind property. In 1991, final regulations under section 1031 of the Code provided specific guidance for deferred exchanges of like-kind property using a QI. Like-kind property can be a variety of business property, not just real estate; it can be any property held for productive use in a trade or business or for investment.²

Advocacy understands that the QI industry is comprised of three categories of service providers: 1) bank and depository institution affiliates; 2) affiliates of title insurance and escrow companies and 3) independent QIs that may be lawyers, accountants, realtors or other professionals.

In general, when an exchanging taxpayer (exchanger) determines that a like-kind exchange is consistent with their business goals, then the exchanger may seek out the services of a QI. Under customary industry practice, the revenue of the QI is derived from two sources. First, QIs charge a fee for setting up the exchange. Second, QIs receive all or a portion of the interest on the exchange funds under their management as compensation for their services.

Generally, the proposal provides that where a QI is treated as owning the section 1031 exchange funds then the exchanger should be treated as loaning the exchange funds to the QI. Consequently, if all of the earnings attributable to the exchange funds are not

² See section 1031(a) of the Code.

paid by the QI to the exchanger, then under section 7872 of the Code, the exchanger is deemed to have earned imputed interest. The rate of interest is set by section 7872 to be equal to the 182-day Treasury bill.

Advocacy's May 8, 2006 Comment

The Special Analysis section of the proposed rule included an IRFA as required by section 603 of the RFA. In the IRFA, Treasury and IRS identify the potential number of small entities that may be affected by the proposal as approximately 325.³ The IRFA requests comments on the economic burden on small entities and possible less burdensome alternatives imposed by the rule. The IRFA does not describe the economic impact that the small entities would absorb. Treasury and IRS identified one alternative to the proposed rule, but rejected it as being too administratively burdensome and inconsistent with the approach taken by the proposed rule.⁴ In lieu of completing an economic analysis and considering additional alternatives, the IRFA seeks public comment to describe the economic impacts and identify any alternatives.

A central theme of the RFA is that the regulatory process should not take a one-size-fits-all approach to rule making. To this end, the RFA requires agencies to consider less burdensome alternatives to achieving their regulatory objective. This allows agencies to consider having different standards apply based on entity size or exempting certain or all small entities from coverage of the rule, among other approaches. The RFA's goal is to provide agencies with broad latitude to adopt rules that address the specific needs of the regulated industry while at the same time achieving their public policy goal.

As a result of Advocacy's communication with individual small QIs and trade associations representing QIs, Advocacy believes that the proposal has the potential to have a significant economic impact on a substantial number of small entities in the QI industry. In our May comment, we recommended that Treasury and IRS complete an amended IRFA that restates the purpose of the regulation, outlining the specific problem with current practice in the QI industry compelling the outcome reached by the proposed rule. In addition, the amended IRFA should contain an economic analysis describing the economic impact that the proposed rule will impose on small entities. Finally, the amended IRFA should contain a full analysis of less burdensome alternatives considered.

In closing I would hope the Treasury and IRS will come to Advocacy early in their regulation development process when they are promulgating rules that will have a significant impact on a substantial number of small entities. Useful exchange of information through confidential interagency communication can only help assure that the spirit of RFA is met and regulatory results will be best achieved. Also, Advocacy is charged with training agencies on proper RFA compliance. I would like to encourage Treasury and IRS to schedule training for their staff in the near future. Training can be done in person or on our new online training module.

³ 71 Fed. Reg. 6231, 6234 (February 7, 2006).

⁴ 71 Fed. Reg. 6231, 6234 (February 7, 2006).

Thank you for this opportunity to express our views. I would be pleased to answer any questions the Committee may have.