



May 8, 2006

VIA ELECTRONIC MAIL AND FACSIMILE

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Re: Escrow Accounts, Trusts, and Other Funds Used During Deferred Exchanges of Like-Kind Property; 71 Fed. Reg. 6231 (February 7, 2006).

The Office of Advocacy offers the following comment in response to the above referenced notice of proposed rulemaking entitled Escrow Accounts, Trusts, and Other Funds Used During Deferred Exchanges of Like-Kind Property (NPRM), published by the Department of Treasury (Treasury) and Internal Revenue Service (IRS). The NPRM will affect taxpayers that engage in deferred like-kind exchanges and those that hold funds during deferred like-kind exchanges such as qualified intermediaries (QI).

Office of Advocacy

Congress established the Office of Advocacy (Advocacy) under Pub. L. 94-305 to represent the views of small business before Federal agencies and Congress. The RFA as amended by the Small Business Regulatory Enforcement Fairness Act (SBREFA)¹ enhances small businesses participation in the Federal rulemaking process. Advocacy is an independent entity within the SBA, so the views expressed herein by Advocacy do not necessarily reflect the views of the SBA or the Administration. Section 612 of the RFA requires Advocacy to monitor agency

¹ Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. § 601 et seq).

compliance with the RFA. On August 13, 2002, President Bush underscored the importance of agency compliance with the RFA and Advocacy's role in giving a voice to small businesses in the rulemaking process when he signed Executive Order 13272, titled "Proper Consideration of Small Entities in Agency Rulemaking."

Advocacy regularly disseminates information to, and solicits comments from, small businesses regarding proposed Federal rules affecting them. Advocacy holds roundtables as one means of gathering information from small entities. On March 23, 2006, Advocacy hosted a roundtable that was attended by Treasury and IRS staff, to listen to small business comments and concerns about the NPRM. The comments obtained during the roundtable and from subsequent meetings are the basis of this comment.

Background

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 NPRM 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 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.

Industry Overview

At the March roundtable held by Advocacy staff from Treasury and IRS asked the industry to provide additional information about the QI business practice. One inquiry was the average amount of time the exchange funds are held by the QI. The provisions under section 1031 require that the like-kind exchange transaction be completed within 180 days. According to the industry, most exchanges are completed within 90 days, with a significant number of transactions completed within 30 days. Additionally, Treasury and IRS inquired about the

² See section 1031(a) of the Code.

average size of an exchange transaction. According to data compiled by Deloitte Tax LLP, the average fair market value of replacement property exchanged by individuals in 2003 was just under \$302,000.³

Treasury and IRS subsequently inquired about how many QIs function as sole proprietors. The primary trade association representing QIs is the Federation of Exchange Accommodators (FEA).⁴ FEA completed an informal survey of its members, which revealed that of the 70 respondents only three percent of responding QIs function as sole proprietors.⁵ The remaining responders reported three percent are partnerships, 30 percent are limited liability companies, and almost 64 percent are corporations.

Significant Impact on a Substantial Number of Small Businesses

Section 603 of the RFA requires that during the preparation of a proposed rule, an agency must prepare an initial regulatory flexibility analysis (IRFA) if it determines that a proposal may impose a significant economic impact on a substantial number of small entities. Regulated communities are best served by an IRFA that includes a detailed discussion of the objectives and goals of the rule, as well as any additional reasons for the rulemaking. Additionally, the agency should discuss the reason for the rulemaking by listing any issues of concern prompting the rule. This type of discussion permits affected industries to address specific agency concerns when commenting on a proposed rule.

Agencies that successfully complete an IRFA include an analysis of the costs and other economic implications for the regulated industry. Completion of an IRFA requires the agency to consider alternatives to the proposed rule that will accomplish the agency's goal without disproportionately burdening small businesses. Each alternative considered should be analyzed. In short, an IRFA should allow affected parties to compare the impacts of regulatory alternatives based on the differing sizes and types of regulated entities.

FEA conducted another informal survey of its members following the publication of the NPRM that shows that the proposed regulation will have a significant economic impact on a substantial number of small entities. The survey had 219 respondents. Specifically the survey determined that 76.7 percent of the respondents were small businesses (\$1,500,000 or less in revenues), and 96.4 percent retain at least "some" interest.⁶ The survey determined that nearly 50 percent of the small entities responding to the survey rely on interest for 50 percent of their revenue and consequently, could lose up to 50 percent of their revenue if the proposed rule is finalized.⁷

The NPRM imposes administrative compliance burdens. These burdens were outlined in a comment submitted to Treasury and IRS by Ernst & Young dated December 21, 2005. Specifically, they state:

³ *Exchange Market Overview*, Lou Weller, Deloitte Tax LLP (2005).

⁴ FEA represents 278 QI member companies. FEA estimates that they represent 80 percent of the QI industry.

⁵ Federation of Exchange Accommodators Survey (May 1, 2006).

⁶ Federation of Exchange Accommodators Survey (March 29, 2006).

⁷ Federation of Exchange Accommodators Survey (March 29, 2006).

If section 7872 [of the Code] were to apply, each affected QI would, for each section 1031-deferred exchange transaction, need to: (i) determine whether there is adequate stated interest on a “loan”; (ii) calculate the amount of interest, if any, that should be imputed; (iii) report the imputed interest to each taxpayer; and (iv) record such amount as compensation that the taxpayer is deemed to pay back to the QI. Each taxpayer participating in one of these transactions would need to report and include the “phantom” interest income, and would need to add that to the basis to be recovered over the depreciable life of the replacement property.

The Special Analysis section of the NPRM contained 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 NPRM as approximately 325.⁸ The IRFA requests comments on the NPRM’s economic burden on small entities and possible less burdensome alternatives. 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 NPRM.⁹ 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 to the NPRM.

As a result of Advocacy’s communication with individual small QIs and trade associations representing QIs, Advocacy believes that the NPRM has the potential to have a significant economic impact on a substantial number of small entities in the QI industry. Treasury and IRS will gain valuable insight into the effects of the NPRM by completing and publishing an amended IRFA in the *Federal Register*. The amended IRFA should restate the purpose of the regulation outlining the specific problem with current practice in the QI industry compelling the outcome reached in the NPRM. In addition, the IRFA should contain an economic analysis describing the economic impact that the NPRM will impose on small entities. Finally, the IRFA should contain a full analysis of less burdensome alternatives considered.

Advocacy’s comment is meant to be responsive to Treasury and IRS’ request for additional information in the Special Analysis section of the NPRM. Our comments and the additional comments from the affected industry received by Treasury and IRS responsive to the requested additional information should be used to form the basis of an amended IRFA. The amended IRFA should be published in the *Federal Register* for public comment.

Less Burdensome 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.

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

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

Affected taxpayers that have communicated with Advocacy believe there are several alternatives that Treasury and IRS should consider that would minimize the impact of the NPRM on small QIs and still achieve the regulatory objective. Treasury and IRS could consider a de minimis rule that would permit small sums of interest to be excluded from the deemed below market loan provision. Alternatively, Treasury could consider a de minimis interest rate on transactions that are small. Additionally, Treasury and IRS should consider excluding certain size transactions from the ambit of the NPRM. Providing for de minimis rules would help lessen the burden these proposed rules will have on small QIs, while still accomplishing the regulatory goal of the Treasury and IRS.

Advocacy encourages the Treasury and IRS to review the comments of affected QIs carefully, and recommends that Treasury and IRS publish an amended IRFA prior to moving forward with the rule. The Office of Advocacy would be happy to supply any assistance it can. If you have any questions or require additional information please contact Assistant Chief Counsel for Tax Candace Ewell at (202) 401-9787 or by email at Candace.Ewell@sba.gov. Thank you for this opportunity to contribute to the record.

Sincerely,

/s/

Thomas M. Sullivan
Chief Counsel for Advocacy

/s/

Candace B. Ewell
Assistant Chief Counsel for Tax

cc: Donald Arbuckle, Acting Administrator, Office of Information and Regulatory Affairs, OMB