



Treasury Inspector General for Tax Administration Office of Audit

GUIDANCE COULD BE ENHANCED FOR DECIDING TO USE A QUALIFIED INTERMEDIARY IN LIKE-KIND EXCHANGES

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Highlights

Highlights of Report Number: 2008-30-154 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed Division and Wage and Investment Division.

IMPACT ON TAXPAYERS

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 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.

WHY TIGTA DID THE AUDIT

This audit was initiated in response to a request by the Chairman of the United States House of Representatives Committee on Financial Services. 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. In February 2008, the IRS cautioned taxpayers about recent incidents of qualified intermediaries declaring bankruptcy or otherwise being unable to meet their contractual obligations to the taxpayer. The objectives of this review were to examine transactions subject to Internal Revenue Code Section 1031, assess the qualification requirements for qualified intermediaries, and determine the legal protections available to taxpayers.

WHAT TIGTA FOUND

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.

While the IRS has broad authority to monitor and sanction problem tax preparers, its authority does not extend to qualified intermediaries. The absence of firm data on the extent of problem qualified intermediaries and the number of taxpayers affected precludes TIGTA from making a recommendation to involve the IRS in the oversight of qualified intermediaries. Such data would be needed to properly evaluate whether the benefit that might be derived from IRS oversight would outweigh the costs. While making no recommendation to involve the IRS in the oversight of qualified intermediaries, TIGTA did identify changes that could be made to enhance the written guidance provided to taxpayers in *Sales and Other Dispositions of Assets* (Publication 544).

WHAT TIGTA RECOMMENDED

TIGTA 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 instead of a qualified intermediary.

In their response to the report, IRS officials agreed with the recommendations. The Director, Examination, Small Business/Self-Employed Division, and the Director, Media and Publications, Wage and Investment Division, plan to revise Publication 544 to include a discussion regarding the risks associated with using a qualified intermediary and to enhance the discussion of other safe harbors.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

<http://www.treas.gov/tigta/auditreports/2008reports/200830154fr.pdf>.

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