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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-113365-04 and REG-209619-93

RIN 1545-BD19 and RIN 1545-AR82

Escrow Accounts, Trusts, and Other Funds Used During Deferred Exchanges of Like-Kind Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking, notice of proposed rulemaking, and notice of public hearing.

SUMMARY: This document withdraws in part a notice of proposed rulemaking under section 468B of the Internal Revenue Code (Code) relating to the taxation and reporting of income earned on qualified settlement funds and certain other funds, trusts, and escrow accounts. This document also contains proposed regulations under section 468B regarding the taxation of the income earned on escrow accounts, trusts, and other funds used during deferred exchanges of like-kind property, and proposed regulations under section 7872 regarding below-market loans to facilitators of these exchanges. The proposed regulations affect taxpayers that engage in deferred like-kind exchanges and escrow holders, trustees, qualified intermediaries, and others that hold funds during deferred like-kind exchanges. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by May 8, 2006**.** Outlines of topics to be discussed at the public hearing scheduled for June 6, 2006, at 10 a.m. must be received by May 16, 2006.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-113365-04), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-113365-04), courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS-REG-113365-04). The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations under section 468B, A. Katharine Jacob Kiss, (202) 622-4930; concerning the proposed regulations under section 7872, David Silber, (202) 622-3930; concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garrett, (202) 622-3401 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document withdraws §1.468B-6 of a notice of proposed rulemaking (REG-209619-93) relating to the taxation of qualified settlement funds and certain other escrow accounts, trusts, and funds under section 468B(g) that was published in the **Federal Register** (64 FR 4801) on February 1, 1999 (the 1999 proposed regulations). This document contains new proposed regulations that provide rules under sections 468B(g) and 7872 regarding the taxation of qualified escrow accounts, qualified trusts, and other escrow accounts, trusts, or funds used during section 1031 deferred exchanges of like-kind property.

Section 468B was added by section 1807(a)(7)(A) of the Tax Reform Act of 1986 (Public Law 99-514, 100 Stat. 2814) and was amended by section 1018(f) of the Technical and Miscellaneous Revenue Act of 1988 (Public Law 100-647, 102 Stat. 3582). Section 468B(g) provides that nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax and that the Secretary shall prescribe regulations providing for the taxation of such accounts or funds whether as a grantor trust or otherwise.

Section 7872 was added to the Internal Revenue Code by the Tax Reform Act of 1984 (Public Law No. 98-369, 98 Stat. 494). Section 7872 provides rules for certain direct and indirect below-market loans enumerated in section 7872(c)(1). The legislative history of section 7872 states that the term loan is to be interpreted broadly for purposes of section 7872, potentially encompassing any transfer of money that provides the transferor with a right to repayment. See H.R. Rep. 98-861, 98th Cong., 2d Sess. 1018 (1984).

In general, section 7872 recharacterizes a below-market loan (a loan in which the interest rate charged is less than the applicable Federal rate (AFR)) as an arm's-length transaction in which the lender makes a loan to the borrower at the AFR, coupled with an imputed payment or payments to the borrower sufficient to fund all or part of the interest that the borrower is treated as paying on that loan. The amount, timing, and characterization of the imputed payments to the borrower under a below-market loan depend on the relationship between the borrower and the lender and whether the loan is characterized as a demand loan or a term loan.

Written comments responding to the 1999 proposed regulations under section 468B were received. A public hearing was held on May 12, 1999. After consideration of all the comments, portions of the 1999 proposed regulations are adopted in a Treasury decision published elsewhere in this issue of the **Federal Register**. The rules relating to the taxation of qualified escrow accounts, qualified trusts, and other escrow accounts, trusts, or funds used during deferred exchanges of like-kind property under section 1031 have been substantially revised and are reproposed in this notice of proposed rulemaking. All comments received in connection with the 1999 proposed regulations will continue to be considered in finalizing these proposed regulations.

Explanation of Provisions and Summary of Comments

1. Overview

Section 1.468B-6 of the 1999 proposed regulations provides rules for the current taxation of income of a qualified escrow account or qualified trust used in a section 1031 deferred exchange of like-kind property. The 1999 proposed regulations provide that, in general, the taxpayer (the transferor of the property) is the owner of the assets in a qualified escrow account or qualified trust and must take into account all items of income, deduction, and credit (including capital gains and losses) of the qualified escrow account or qualified trust. However, if, under the facts and circumstances, a qualified intermediary or transferee has the beneficial use and enjoyment of the assets, then the qualified intermediary or transferee is the owner of the assets in the qualified escrow account or qualified trust and must take into account all items of income, deduction, and credit (including capital gains and losses) of the qualified escrow account or qualified trust. The 1999 proposed regulations further provide that, if a qualified intermediary or transferee is the owner of the assets transferred, the transaction may be characterized as a below-market loan from the taxpayer to the owner to which section 7872 may apply.

The comments received reflect differing interpretations of the 1999 proposed regulations and disagreement on the proper rules for taxing these transactions. The comments address three major issues (1) whether §1.468B-6 should apply to all funds and accounts maintained by qualified intermediaries to facilitate deferred like-kind exchanges as well as to qualified escrow accounts and qualified trusts (the scope of the rules); (2) whether the regulations should adopt a per se rule in place of the facts and circumstances ownership test; and (3) whether these arrangements may be properly characterized as loans. Other comments requested clarification of the information reporting provisions.

2. Scope of the Rule

Section 1.1031(k)-1(g) of the Income Tax Regulations provides safe harbors that allow taxpayers to engage in deferred exchanges of like-kind property and to avoid being determined to be in actual or constructive receipt of the proceeds from the sale of the taxpayers' relinquished property during the exchange period. The proceeds may be held in a qualified escrow account or qualified trust or may be held by a qualified intermediary. The 1999 proposed regulations address the treatment of only qualified escrow accounts and qualified trusts whether or not used by a qualified intermediary, and do not address accounts or funds used by a qualified intermediary that are not qualified escrow accounts or qualified trusts.

Commentators on the 1999 proposed regulations stated that qualified intermediaries may maintain funds in accounts that are not qualified escrow accounts or qualified trusts, including accounts in which the proceeds of a disposition of relinquished property are commingled with other assets, such as the proceeds from deferred like-kind exchanges entered into by other taxpayers. Some commentators recommended applying the rules of §1.468B-6 to income earned on amounts held in any escrow account, trust, or other account or fund used by a qualified intermediary in connection with a deferred like-kind exchange. They suggested that the limited scope of the 1999 proposed regulations may result in uncertainty and inconsistent treatment of the different types of accounts that may be used for similar purposes in deferred like-kind exchanges.

Other commentators took the contrary position, that is, that applying the rules proposed in 1999 to accounts other than qualified escrow accounts or qualified trusts is inappropriate. One commentator stated that at least one party (either the taxpayer or the qualified intermediary) is taxed on the income earned on every account used by a qualified intermediary. Therefore, the commentator reasoned, because there are no instances of homeless income (income that is not currently being taxed because the identity of the taxpayer has yet to be determined), applying the proposed regulations to escrow accounts or funds that are not qualified escrow accounts or qualified trusts would not advance the purpose of the statute. Another commentator opined that section 468B was intended to apply only to segregated accounts.

Other commentators urged that the 1999 proposed regulations be finalized without change or that the appropriate rules for taxation of accounts used in deferred like-kind exchanges other than qualified escrow accounts and qualified trusts should be considered at a later time.

The IRS and the Treasury Department have concluded that the same rules should apply to all escrow accounts, trusts, and funds used during deferred exchanges to provide certainty and consistency of treatment. Additionally, the IRS and the Treasury Department have concluded that the rules should apply equally to escrow accounts, trusts, and funds used during exchanges that are intended to qualify as like-kind but fail to satisfy a requirement of section 1031. Therefore, these regulations propose to apply to exchange funds, defined as the relinquished property (if held in kind), cash, or cash equivalent that secures an obligation of a transferee to transfer replacement property, or the proceeds from a transfer of relinquished property, held in a qualified escrow account, qualified trust, or other escrow account, trust, or fund during a deferred exchange.

3. Facts and Circumstances Ownership Test

Under the 1999 proposed regulations, the taxpayer generally is treated as the owner of a qualified escrow account or qualified trust and is taxed on the income. If, under the facts and circumstances, however, a qualified intermediary or transferee has the beneficial use and enjoyment of the assets in the account, the qualified intermediary or transferee is the owner and is taxed on the income. The 1999 proposed regulations provide three factors that will be considered in addition to other relevant facts and circumstances in determining whether the transferee or qualified intermediary, rather than the taxpayer, has the beneficial use and enjoyment of the assets of the account or trust (1) who enjoys the use of the earnings of the account or trust; (2) who receives the benefit from appreciation in the value of the assets; and (3) who bears any risk of loss from a decline in the value of the assets. The 1999 proposed regulations include two examples that conclude that the taxpayer is the owner of the assets if the income from a qualified escrow account or qualified trust is paid to the qualified intermediary or transferee as compensation for services performed for the taxpayer. See Old Colony Trust v. Commissioner, 279 U.S. 716 (1929).

Some commentators recommended that the facts and circumstances test be eliminated and that the regulations provide a per se rule that the taxpayer must always take into account all items of income, deduction, and credit (including capital gains and losses) of the exchange funds in computing the taxpayer's income tax liability. They suggested that the taxpayer always owns the exchange funds and any income earned on the funds that is retained by the qualified intermediary constitutes compensation to the qualified intermediary for services rendered to the taxpayer in facilitating the deferred like-kind exchange. Therefore, consistent with the principles of Old Colony Trust, the taxpayer should be taxed on all the earnings in all cases.

Other commentators urged that the facts and circumstances test should be retained. They stated that like-kind exchanges are often structured so that a qualified intermediary has all the benefits and burdens of ownership of the exchange funds and that, in those circumstances, a qualified intermediary is the owner of the assets under general tax principles. These commentators explained that qualified intermediaries frequently charge separately stated fees that are the same if the earnings are paid to the taxpayer or retained by the qualified intermediary, indicating, they asserted, that the qualified intermediary's retention of the income is not properly characterized as compensation for services. These commentators further suggested, therefore, that in appropriate cases the qualified intermediary is the actual owner of the assets and the Old Colony Trust doctrine is inapplicable. These commentators also recommended that the rules should be sufficiently broad to permit parties to deferred like-kind exchanges flexibility in structuring the transactions, for example in the disposition of the income earned and in the use of commingled rather than segregated accounts.

A commentator recommended modifying the ownership rule to allow the allocation of the tax liability among the parties to the exchange and the qualified intermediary to the extent that those parties actually share the income earned on a qualified escrow account or qualified trust.

To enhance administrability, provide greater certainty, and ensure consistent treatment of taxpayers, these proposed regulations eliminate the facts and circumstances ownership test and propose specific rules that determine whether the income of an escrow account, trust, or fund used in a deferred like-kind exchange is taxed to the taxpayer or to an exchange facilitator, which is a qualified intermediary, transferee, or other party that holds the exchange funds. These rules are discussed further below.

Because the ownership test has been eliminated, these proposed regulations also eliminate the requirement in the 1999 proposed regulations that the parties provide a statement to the escrow holder or trustee when the taxpayer is not the owner of the assets.

4. Loan Treatment

One commentator argued that the treatment of a qualified intermediary as acquiring the relinquished property under the section 1031 regulations applies solely for purposes of section 1031. This commentator suggested that proceeds from the sale of the relinquished property in a deferred exchange are properly characterized in one of only two ways: (1) the taxpayer owns the funds and is taxed on the earnings; or (2) under section 7872, the taxpayer is treated as lending the funds to the qualified intermediary, in which case the qualified intermediary (or exchange facilitator) owns the funds and is treated as paying interest on the loan. The commentator also urged that, for reasons of administrative convenience, the parties should be permitted to elect either characterization and the rules should apply prospectively.

Other commentators stated that, if a qualified intermediary has the benefits and burdens of ownership, the funds are owned by the qualified intermediary and not the taxpayer, and therefore could not be loaned by the taxpayer. Because the taxpayer is deemed not to have actual or constructive receipt of the exchange funds under the rules of §1.1031(k)-1, these commentators reasoned that a taxpayer cannot lend assets it does not possess.

The IRS and the Treasury Department agree with the comment that exchange funds held by exchange facilitators in connection with deferred like-kind exchanges are properly characterized either as the taxpayer's funds or as loans from the taxpayer to the qualified intermediary or other exchange facilitator. Characterizing the exchange funds as having been loaned is consistent with the broad definition of the term loan in the legislative history of section 7872. The provisions of §1.1031(k)-1 stating that the taxpayer is deemed to not have actual or constructive receipt of the exchange funds if the safe harbors apply do not preclude loan treatment. These rules permit taxpayers to engage in like-kind exchanges on a deferred basis but are not statements of general tax principles. See §1.1031-1(n).

Therefore, these proposed regulations provide that exchange funds are treated, as a general rule, as loaned by a taxpayer to an exchange facilitator, and the exchange facilitator takes into account all items of income, deduction, and credit (including capital gains and losses). If, however, the escrow agreement, trust agreement, or exchange agreement specifies that all the earnings attributable to exchange funds are payable to the taxpayer, the exchange funds are not treated as loaned from the taxpayer to the exchange facilitator, and the taxpayer takes into account all items of income, deduction, and credit (including capital gains and losses). If an exchange facilitator commingles exchange funds with other funds (for example, for investment purposes), all the earnings attributable to the exchange funds are treated as paid to the taxpayer if the exchange facilitator pays the taxpayer all the earnings of the commingled account that are allocable on a pro-rata basis (using a reasonable method that takes into account the time that the exchange funds are in the commingled account, actual rate or rates of return, and the respective principal balances) to the taxpayer's exchange funds. Payments from the exchange funds, or from the earnings attributable to the exchange funds, for the taxpayer's transactional expenses are treated as first paid to the taxpayer and then paid by the taxpayer to the recipient. Transactional expenses include the costs of land surveys, appraisals, title examinations, termite inspections, transfer taxes, and recording fees. An exchange facilitator's fee is a transactional expense only if the escrow agreement, trust agreement, or exchange agreement, as applicable, provides that (1) the amount of the fee payable to the exchange facilitator is fixed on or before the date of the transfer of the relinquished property by the taxpayer (either by stating the fee as a fixed dollar amount in the agreement or determining the fee by a formula, the result of which is known on or before the transfer of the relinquished property by the taxpayer), and (2) the amount of the fee is payable by the taxpayer regardless of whether the earnings attributable to the exchange funds are sufficient to pay the fee.

5. Treatment under Section 7872 of Loans to Exchange Facilitators

The 1999 proposed regulations provide that if a qualified intermediary or transferee is the owner of the assets transferred, section 7872 may apply Aif the deferred exchange involves a below-market loan from the taxpayer to the owner.@

Several commentators did not agree that section 7872 could apply to exchange funds and suggested that the reference should be deleted. Commentators also suggested that, even if a transfer of the exchange funds from the taxpayer to an exchange facilitator is a loan, it would constitute a loan given in consideration for the sale or exchange of property (within the meaning of section 1274(c)(1)) or a deferred payment on account of a sale or exchange of property (within the meaning of section 483) and would be exempt from section 7872 under the rules contained in §1.7872-2(a)(2)(ii) of the proposed regulations that were published in the **Federal Register** (50 FR 33553) on August 20, 1985 (the 1985 proposed regulations). These commentators further argued that exchange facilitator loans should be exempted from section 7872 because those loans must be repaid within six months. These commentators argued that the section 1274 exclusion of debt instruments payable within six months evidences Congress' intent that burdensome reporting and recordkeeping requirements should not apply to short-term loans.

Having considered the comments received, the IRS and the Treasury Department conclude that section 7872, rather than sections 1274 or 483, applies to loans from taxpayers to exchange facilitators. Therefore, these proposed regulations provide special rules under section 7872 for the treatment of exchange facilitator loans. Under these proposed regulations, an exchange facilitator loan is a transaction that, under §1.468B-6(c)(1), is treated as a loan from the taxpayer to an exchange facilitator in connection with a section 1031 deferred exchange. Below-market exchange facilitator loans are treated as compensation-related loans under section 7872(c)(1)(B) and are treated as demand loans for purposes of section 7872.

A commentator suggested that, if section 7872 applies to these transactions, interest should be tested and imputed at an alternative rate (similar to the alternative rate in §1.1274-4(a)(iii)) rather than at the short-term AFR. These proposed regulations provide an alternative rate (the 182-day rate) for exchange facilitator loans for purposes of section 7872. This rate is equal to the investment rate on a 182-day Treasury bill determined on the auction date that most closely precedes the date that the exchange facilitator loan is made. This rate is based on semi-annual compounding and may be found at wwws.publicdebt.treas.gov/AI/OFBills. The IRS and the Treasury Department request comments regarding alternative rates for exchange facilitator loans under section 7872, including whether the 182-day Treasury bill rate is an appropriate rate. Notwithstanding

§1.7872-13 of the 1985 proposed regulations, the taxpayer and exchange facilitator may use the approximate method to determine the amount of forgone interest on an exchange facilitator loan.

One commentator urged that a de minimis exception for loans of exchange funds under $10,000,000 should be added under §1.7872-5T because these loans are without significant tax effect. Several other commentators opined that §1.7872-5T(b)(14) should exempt loans of exchange funds from section 7872 because they are loans without significant tax effect. However, the proposed regulations provide that exchange facilitator loans are not eligible for the exemptions listed in §1.7872-5T(b), including §1.7872-5T(b)(14). An exchange facilitator loan may be excepted from the application of section 7872 only if the loan qualifies for the $10,000 de minimis exception in section 7872(c)(3) for compensation-related loans.

6. Information Reporting

The 1999 proposed regulations state that an escrow holder or trustee must report the income of the escrow, trust, or fund on Form 1099 in accordance with subpart B, Part III, subchapter A, chapter 61, Subtitle F of the Code (currently, sections 6041 through 6050T), and provide rules for identifying the payee. Several commentators expressed concern that these provisions expand the existing information reporting obligations in sections 6041 through 6050T. The 1999 proposed regulations were not intended to create new information reporting requirements but merely to alert responsible persons of the potential obligation to report. To clarify this intent, these proposed regulations provide that a payor must report to the extent required by sections 6041 through 6050T and these regulations.

To enhance compliance, a commentator recommended that payors should be required to furnish Forms 1099 to corporate payees involved in deferred like-kind exchanges. This suggestion was not adopted because it would be inconsistent with provisions of sections 6041 through 6050T and the regulations thereunder that exempt payments to corporations from the information reporting requirements.

7. <u>Effective Dates</u>

Sections 1.468B-6 and 1.7872-16 apply, respectively, to transfers of property made by taxpayers and to exchange facilitator loans issued after the date these regulations are published as final regulations in the **Federal Register.** Section 1.468B-6 of these proposed regulations incorporates a transition rule similar to the transition rule in the 1999 proposed regulations. The transition rule provides that, with respect to transfers of property made by taxpayers after August 16, 1986, but on or before the date these regulations are published as final regulations in the **Federal Register**, the IRS will not challenge a reasonable, consistently applied method of taxation for income attributable to exchange funds.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. An initial regulatory flexibility analysis has been prepared for this notice of proposed rulemaking under 5 U.S.C. 603. The analysis is set forth below under the heading "Initial Regulatory Flexibility Analysis." Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for

Advocacy of the Small Business Administration for comment on its impact on small businesses.

Initial Regulatory Flexibility Analysis

The reasons for promulgation of these rules, and their legal basis, are set forth in this preamble under the heading "Background."

These rules impact exchange facilitators that hold exchange funds for taxpayers engaging in deferred exchanges of like-kind property. Exchange facilitators may be individuals, large entities such as banks, or small businesses. The IRS and the Treasury Department estimate that nationwide there are approximately 325 small businesses providing services as exchange facilitators, primarily as qualified intermediaries. For this purpose, a small business is defined as a business with annual receipts of up to $1.5 million, as provided in the Small Business Administration size standards set forth at 13 CFR 121.201 for NAICS code 531390 (other activities related to real estate).

Section 1.468B-6(c)(2) provides that exchange funds are not treated as loaned to an exchange facilitator if all the earnings attributable to the exchange funds are paid to a taxpayer. If the exchange facilitator commingles the exchange funds, the exchange facilitator will be required to account for the earnings attributable to the taxpayer's exchange funds.

As an alternative to these rules, retaining the facts and circumstances test of the 1999 proposed regulations was considered but rejected because the test lacks administrability and is subject to abuse. Other alternatives were considered and rejected as inconsistent with the statutory requirements of section 7872.

The number of transactions involving small entities that will be impacted by these regulations, and the full extent of the economic impact, cannot be precisely determined. Exchange facilitators may simplify the accounting for the earnings attributable to each taxpayer's exchange funds held in a commingled account by depositing each taxpayer's exchange funds in a segregated account and paying the taxpayer all the earnings of that account.

Comments are requested on the nature and extent of the economic burden imposed on small entities by these rules and on alternatives that would be less burdensome to small entities.

The IRS and the Treasury Department are not aware of any duplicative, overlapping, or conflicting federal rules.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for June 6, 2006, at 10 a.m., in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance more than

30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of topics to be discussed and the time devoted to each topic (signed original and eight (8) copies) by May 16, 2006. A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are A. Katharine Jacob Kiss of the Office of Associate Chief Counsel (Income Tax & Accounting) and Rebecca Asta of the Office of Associate Chief Counsel (Financial Institutions & Products). However, other personnel from the IRS and the Treasury Department participated in their development. **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of Proposed Amendments to the Regulations

Accordingly, under the authority of 26 U.S.C. 7805, §§1.468B-6 and 1.1031(k)-1(g)(3)(i) and h)(2) of a notice of proposed rulemaking (REG-209619-93) amending 26

CFR part 1 that was published in the **Federal Register** (64 FR 4801) on February 1, 1999, are withdrawn.

Proposed Amendments to the Regulations

Accordingly, under the authority of 26 U.S.C. 7805, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read, in part, as follows:

Authority: 26 U.S.C. 7805* * *

Section 1.468B-6 also issued under 26 U.S.C. 468B(g).* * *
Section 1.7872-16 also issued under 26 U.S.C. 7872.* * *

Par. 2. Section 1.468B-0 is amended by revising the entries for §1.468B-6 to read as follows:

§1.468B-0 Table of contents.

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§1.468B-6 Escrow accounts, trusts, and other funds used during deferred exchanges of like-kind property under section 1031(a)(3).

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(2) Exchange funds.
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(ii) Special rule for certain fees for exchange facilitator services.
(c) Taxation of exchange funds.
(1) Exchange funds generally treated as loaned to an exchange facilitator.
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(ii) Treatment of the taxpayer.
(d) Information reporting requirements.
(e) Examples.
(f) Effective dates.
(1) In general.
(2) Transition rule.

* * * * *

Par. 3. Section 1.468B-6 is added to read as follows:

§1.468B-6 Escrow accounts, trusts, and other funds used during deferred exchanges of like-kind property under section 1031(a)(3).

(a) Scope. This section provides rules under section 468B(g) relating to the current taxation of escrow accounts, trusts, and other funds used during deferred exchanges.

(b) Definitions. The definitions in this paragraph (b) apply for purposes of this section.

(1) In general. Deferred exchange, escrow agreement, escrow holder, exchange agreement, exchange period, qualified escrow account, qualified intermediary, qualified trust, relinquished property, replacement property, taxpayer, trust agreement, and trustee have the same meanings as in §1.1031(k)-1; deferred exchange also includes any exchange intended to qualify as a deferred exchange, and qualified intermediary also includes any person or entity intended by a taxpayer to be a qualified intermediary within the meaning of §1.1031(k)-1(g)(4).

(2) Exchange funds. Exchange funds means relinquished property, cash, or cash equivalent, that secures an obligation of a transferee to transfer replacement property, or proceeds from a transfer of relinquished property, held in a qualified escrow account, qualified trust, or other escrow account, trust, or fund during an exchange period.

(3) Exchange facilitator. Exchange facilitator means a qualified intermediary, transferee, escrow holder, trustee, or other party that holds exchange funds for a taxpayer during an exchange period.

(4) Transactional expenses--(i) In general. Transactional expenses means the usual and customary expenses paid or incurred in connection with a deferred exchange. For example, the costs of land surveys, appraisals, title examinations, termite inspections, transfer taxes, and recording fees are transactional expenses. Except as provided in paragraph (b)(4)(ii) of this section, the fee for the services of an exchange facilitator is not treated as a transactional expense.

(ii) Special rule for certain fees for exchange facilitator services. The fee for the services of an exchange facilitator will be treated as a transactional expense if the escrow agreement, trust agreement, or exchange agreement, as applicable, provides that--

(A) The amount of the fee payable to the exchange facilitator is fixed on or before the date of the transfer of the relinquished property by the taxpayer (either by stating the fee as a fixed dollar amount in the agreement or determining the fee by a formula, the result of which is known on or before the transfer of the relinquished property by the taxpayer); and

(B) The amount of the fee is payable by the taxpayer regardless of whether the earnings attributable to the exchange funds are sufficient to pay the fee.

(c) Taxation of exchange funds--(1) Exchange funds generally treated as loaned to an exchange facilitator. Except as provided in paragraph (c)(2) of this section, exchange funds are treated as loaned from a taxpayer to an exchange facilitator. The exchange facilitator must take into account all items of income, deduction, and credit (including capital gains and losses) attributable to the exchange funds. See §1.7872-16 to determine if a loan from a taxpayer to an exchange facilitator is a below-market loan for purposes of section 7872.

(2) Exchange funds not treated as loaned to an exchange facilitator--(i) Scope. This paragraph (c)(2) applies if, in accordance with an escrow agreement, trust agreement, or exchange agreement, as applicable, all the earnings attributable to a taxpayer's exchange funds are paid to the taxpayer. For purposes of this paragraph (c)(2)--

(A) Any payment from the taxpayer's exchange funds, or from the earnings attributable to the taxpayer's exchange funds, for a transactional expense of the taxpayer (as defined in paragraph (b)(4) of this section) is treated as first paid to the taxpayer and then paid by the taxpayer to the recipient; and

(B) If an exchange facilitator commingles (for investment or otherwise) the taxpayer's exchange funds with other funds or assets (whether or not the taxpayer's funds are in a segregated account), all the earnings attributable to the taxpayer's exchange funds are paid to the taxpayer if all of the earnings of the commingled funds or assets that are allocable on a pro-rata basis (using a reasonable method that takes into account the time that the exchange funds are in the commingled account, actual rate or rates of return, and the respective account balances) to the taxpayer's exchange funds either are paid to the taxpayer or are treated as paid to the taxpayer under paragraph (c)(2)(i)(A) of this section.

(ii) Treatment of the taxpayer. If this paragraph (c)(2) applies, exchange funds are not treated as loaned from a taxpayer to an exchange facilitator. The taxpayer must take into account all items of income, deduction, and credit (including capital gains and losses) attributable to the exchange funds.

(d) Information reporting requirements. A payor (as defined in §1.6041-1) must report the income attributable to exchange funds on Form 1099 to the extent required by the information reporting provisions of subpart B, Part III, subchapter A, chapter 61, Subtitle F of the Internal Revenue Code, and the regulations thereunder. See §1.6041-1(f) for rules relating to the amount to be reported when fees, expenses or commissions owed by a payee to a third party are deducted from a payment.

(e) Examples. The provisions of this section are illustrated by the following examples in which T is a taxpayer that uses a calendar taxable year and the cash receipts and disbursements method of accounting. The examples are as follows:

Example 1. All earnings attributable to exchange funds paid to taxpayer. (i) T enters into a deferred exchange with R. The sales agreement provides that T will transfer property (the relinquished property) to R and R will transfer replacement property to T. R's obligation to transfer replacement property to T is secured by cash equal to the fair market value of the relinquished property that R will deposit into a qualified escrow account that T establishes with B, a financial institution. T enters into an escrow agreement with B that provides that all the earnings attributable to the exchange funds will be paid to T.

(ii) On February 1, 2006, T transfers property with a fair market value of $100,000 to R and R deposits $100,000 in T's qualified escrow account with B. Between February 1 and June 1, 2006, T's exchange funds earn $750. On June 1, 2006, R transfers replacement property worth $100,000 to T and B pays $100,000 from the qualified escrow account to R. Additionally, on June 1, B credits the qualified escrow account with $750 of earnings and pays the earnings to T.

(iii) Under paragraph (b) of this section, the $100,000 deposited with B are exchange funds and B is an exchange facilitator. Because all the earnings attributable to the exchange funds are paid to T in accordance with the escrow agreement, paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to B, and T must take into account in computing T's income tax liability for 2006 the $750 of earnings credited to the qualified escrow account.

Example 2. Payment of transactional expenses from earnings. (i) The facts are the same as in Example 1, except that the escrow agreement provides that, prior to paying the earnings to T, B may deduct any amounts B has paid to third parties for T's transactional expenses. B pays a third party $350 on behalf of T for a survey of the replacement property. After deducting $350 from the earnings attributable to T's qualified escrow account, B pays T the remainder ($400) of the earnings.

(ii) Under paragraph (b)(4) of this section, the cost of the survey is a transactional expense. Under paragraph (c)(2)(i)(A) of this section, the $350 that B pays for the survey is treated as first paid to T and then from T to the third party. Therefore, all the earnings attributable to T's exchange funds are paid or treated as paid to T in accordance with the escrow agreement, and paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to B, and T must take into account in computing T's income tax liability for 2006 the $750 of earnings credited to the qualified escrow account.

Example 3. Earnings retained by exchange facilitator as compensation for services. (i) The facts are the same as in Example 1, except that the escrow agreement provides that B also may deduct any outstanding fees owed by T for B's services in facilitating the deferred exchange. In accordance with paragraph (b)(4)(ii) of this section, the escrow agreement provides for a fixed fee of $200 for B's services, which is payable by T regardless of the amount of earnings attributable to the exchange funds. Because the earnings on the exchange funds in this case exceed $200, B retains $200 as the unpaid portion of its fee and pays T the remainder ($550) of the earnings.

(ii) Under paragraph (b)(4) of this section, B's fee is treated as a transactional expense. Under paragraph (c)(2)(i)(A) of this section, the $200 that B retains for its fee is treated as first paid to T and then from T to B. Therefore, all the earnings attributable to T's exchange funds are paid or treated as paid to T in accordance with the escrow agreement, and paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to B, and T must take into account in computing T's income tax liability for 2006 the $750 of earnings credited to the qualified escrow account.

Example 4. Stated rate of interest on account less than earnings attributable to exchange funds. (i) The facts are the same as in Example 1, except that the escrow agreement provides that the qualified escrow account will earn a stated rate of interest. B invests the exchange funds and earns $750, but credits $500 to the qualified escrow account at the stated rate. B pays to T the $500 of interest earned at the stated rate on the qualified escrow account.

(ii) Paragraph (c)(1) of this section applies and the exchange funds are treated as loaned from T to B. B must take into account in computing B's income tax liability all items of income, deduction, and credit (including capital gains and losses) attributable to the exchange funds. Paragraph (c)(2) of this section does not apply because B does not pay all the earnings attributable to the exchange funds to T. See §1.7872-16 for rules relating to exchange facilitator loans.

Example 5. Exchange funds deposited by exchange facilitator with financial institution in account in taxpayer's name. (i) The facts are the same as in Example 1, except that, instead of entering into an escrow agreement, T enters into an exchange agreement with QI, a qualified intermediary. The exchange agreement provides that R will pay $100,000 to QI, QI will deposit $100,000 into an account with a financial institution under T's name and taxpayer identification number (TIN), and all the earnings attributable to the account will be paid to T.

(ii) On February 1, 2006, T transfers property with a fair market value of $100,000 to R, R delivers $100,000 to QI, and QI deposits $100,000 into a money market account with B, a financial institution unrelated to QI, under T's name and TIN. Between February 1 and June 1, 2006, the account earns $500 of interest at the stated rate established by B. On June 1, 2006, QI uses $100,000 of the funds in the account to purchase replacement property identified by T and transfers the replacement property to T. B pays to T the $500 of interest earned on the money market account.

(iii) Under paragraph (b) of this section, the $100,000 QI receives from R for the relinquished property are exchange funds and QI is an exchange facilitator. B is not an exchange facilitator. T has no direct relationship with B, and QI, not B, holds the exchange funds on behalf of T. Because all the earnings attributable to the exchange funds held by QI are paid to T in accordance with the exchange agreement, paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to QI, and T must take into account in computing T's income tax liability for 2006 the $500 of interest earned on the money market account.

Example 6. All earnings attributable to commingled exchange funds paid to taxpayer. (i) The facts are the same as in Example 5, except that the exchange agreement does not specify how the $100,000 QI receives from R must be invested.

(ii) On February 1, 2006, QI deposits the $100,000 with B, a financial institution, in a pre-existing interest-bearing account under QI's name and TIN. The account has a total balance of $275,000 immediately thereafter. On the last day of each month between February and June, 2006, the account earns interest as follows: $690 in February, $920 in March, $516 in April, and $986 in May. On April 11, 2006, QI deposits $50,000 in the account. On May 15, 2006, QI withdraws $175,000 from the account.

(iii) QI calculates T's pro-rata share of the earnings allocable to the $100,000 based on the actual return, the average daily principal balances, and a 30-day month convention, as follows:

	Account's	T's		Monthly

Month	Avg. Daily Bal.	Avg. Daily Bal.	T's Share*	Interest	T's End. Bal.**
February	$275,000	$100,000	36.4%	$690	$100,251
March	$275,690	$100,251	36.4%	$920	$100,586
April	$309,943	$100,586	32.5%	$516	$100,754
May	$236,626	$100,754	42.6%	$986	$101,174

* T's Average Daily Balance ÷ Account's Average Daily Balance
**T's beginning balance + [(T's share)(Monthly Interest)]

(iv) On June 1, 2006, QI uses $100,000 of the funds to purchase replacement property identified by T and transfers the property to T. QI pays $1,174, the earnings of the account allocated to T's exchange funds, to T.

(v) Under paragraph (b) of this section, the $100,000 from the sale of the relinquished property are exchange funds and QI is an exchange facilitator. Because QI uses a reasonable method to calculate the pro-rata share of account earnings allocable to T's exchange funds and pays all those earnings to T, paragraph (c)(2) of this section applies. The exchange funds are not treated as loaned from T to QI. T must take into account in computing T's income tax liability for 2006 the $1,174 of earnings attributable to T's exchange funds.

(f) Effective dates--(1) In general. This section applies to transfers of property made by taxpayers after the date these regulations are published as final regulations in the **Federal Register**.

(2) Transition rule. With respect to transfers of property made by taxpayers after August 16, 1986, but on or before the date these regulations are published as final regulations in the **Federal Register**, the Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation for income attributable to exchange funds.

Par. 4. Section 1.1031(k)-1 is amended by adding a sentence at the end of paragraph (h)(2) to read as follows:

§1.1031(k)-1 Treatment of deferred exchanges.

* * * * *

(h) * * *

(2) * * * For rules under section 468B(g) relating to the current taxation of qualified escrow accounts, qualified trusts, and other escrow accounts, trusts, and funds used during deferred exchanges of like-kind property, see §1.468B-6.

* * * * *

Par. 5. Section 1.7872-16 is added to read as follows:

§1.7872-16 Loans to an exchange facilitator under §1.468B-6.

(a) Special rules applicable to loans made to an exchange facilitator under §1.468B-6--(1) Scope. This section applies to a transaction that, under §1.468B-6(c)(1), is treated as a loan to an exchange facilitator in connection with a deferred exchange (exchange facilitator loan). For purposes of this section, the terms deferred exchange, exchange agreement, exchange facilitator, exchange funds, qualified intermediary, replacement property, and taxpayer have the same meanings as in §1.468B-6(b).

(2) Treatment as compensation-related loans. If an exchange facilitator loan is a below-market loan, the loan is treated as a compensation-related loan under section 7872(c)(1)(B).

(3) Treatment of exchange facilitator loan as a demand loan. For purposes of section 7872, exchange facilitator loans are treated as demand loans.

(4) 182-day rate for exchange facilitator loans. For purposes of section 7872(f)(2), in lieu of the applicable Federal rate (AFR) provided under section 1274(d)(1), the taxpayer and the exchange facilitator must use the 182-day rate for an exchange facilitator loan. For purposes of the preceding sentence, the 182-day rate is equal to the investment

rate on a 182-day Treasury bill determined on the auction date that most closely precedes the date that the exchange facilitator loan is made.

(5) Use of approximate method permitted. The taxpayer and exchange facilitator may use the approximate method under §1.7872-13(b)(2) to determine the amount of forgone interest on any exchange facilitator loan.

(b) No exemption for below-market exchange facilitator loans. If an exchange facilitator loan is a below-market loan, the loan is not eligible for the exemptions listed under §1.7872-5T(b), including §1.7872-5T(b)(14) (relating to loans without significant-tax effect).

(c) Example. The provisions of this section are illustrated by the following example.

Example. (i) T enters into a deferred exchange with QI, a qualified intermediary. The exchange is governed by an exchange agreement. The exchange funds held by QI pursuant to the exchange agreement are treated as loaned to QI under §1.468B-6(c)(1). Under paragraph (a)(1) of this section, the loan between T and QI is an exchange facilitator loan. The exchange agreement between T and QI provides that no earnings will be paid to T. On December 1, 2006, T transfers property with a fair market value of $1,000,000 to QI and QI deposits $1,000,000 in a money market account. On March 1, 2007, QI uses $1,000,000 of the funds in the account to purchase replacement property identified by T, and transfers the replacement property to T. The amount loaned for purposes of section 7872 is $1,000,000 and the loan is outstanding for three months. The 182-day rate under paragraph (a)(4) of this section is 1 percent, compounded semi-annually.

(ii) Under paragraph (a) of this section, the loan from T to QI is treated as a compensation-related demand loan. Because there is no interest payable on the loan from T to QI, the loan is a below-market loan under section 7872. Under section 7872(e)(2), the amount of forgone interest on the loan for 2006 is $833 ($1,000,000*.01/2*1/6). Under section 7872(e)(2), the forgone interest for 2007 is $1667 ($1,000,000*.01/2*2/6). The $833 for 2006 is deemed transferred as compensation by T to QI and retransferred as interest by QI to T on December 31, 2006. The $1667 for 2007 is deemed transferred as compensation by T to QI and retransferred as interest by QI to T on March 1, 2007.

(d) Effective date. This section applies to exchange facilitator loans issued after the date these regulations are published as final regulations in the **Federal Register.**

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