

**FAILURE TO COMPLY WITH THE REGULATORY  
FLEXIBILITY ACT: IRS ENDANGERING SMALL  
BUSINESSES YET AGAIN**

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**HEARING**

BEFORE THE

**COMMITTEE ON SMALL BUSINESS  
HOUSE OF REPRESENTATIVES**

ONE HUNDRED NINTH CONGRESS

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**FAILURE TO COMPLY WITH THE REGULATORY FLEXIBILITY ACT: IRS ENDANGERING SMALL BUSINESSES YET AGAIN**

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**TUESDAY, JULY 25, 2006**

HOUSE OF REPRESENTATIVES  
COMMITTEE ON SMALL BUSINESS  
*Washington, DC*

The Committee met, pursuant to call, at 2:20 p.m., in Room 2360, Rayburn House Office Building, Hon. Donald A. Manzullo [Chairman of the Committee] Presiding.

Present: Representatives Manzullo, Kelly, King, Gohmert, Velazquez and Bordallo.

Chairman MANZULLO. Good afternoon, and welcome to this important hearing. I was just working on the reauthorization of Ex-Im Bank, and that is why I am late.

On February 2006, IRS and Treasury released proposed regulations that substantially changed the rules governing the taxation of funds used during deferred exchanges of like-kind property, both real and personal, under section 1031 of the Internal Revenue Code. If finalized, I believe these proposed regulations would have a devastating impact on the hundreds of small qualified intermediary businesses in this industry and increase costs for investors.

Only Chicago Deferred Exchanges, a wholly-owned subsidiary of LaSalle Bank, which is owned by ABN AMRO, desires the completion of the proposed regulations. The rest of the businesses in this industry, most of which are small, are simply trying to stay in business. Worse, the situation has been created by Treasury and the IRS in the case where no regulations are needed. There simply is no homeless income here. Thus, one must ask why these proposed regulations are being pursued when they are so devastating to small businesses.

In addition to these problems, Mr. Don Korb, the chief counsel of IRS, has admitted in a letter to me—and that letter is back there on the table—that the Internal Revenue Service and Treasury did a sloppy job of complying with the Regulatory Flexibility Act by failing to complete a full Initial Regulatory Flexibility Analysis. Because of the impact on small businesses and the failure to comply with the RFA, I have requested that the proposed regulations be withdrawn. I have been joined in this effort by no less than six Senators. Still, the IRS and Treasury have not responded.

This hearing is about the survival of small businesses and the refusal of an agency to follow the law, and the refusal of Eric Sol-

omon, Acting Assistant Secretary for Tax Policy and Deputy Assistant Secretary for Regulatory Affairs, to come to this hearing at my request.

I am astonished that the IRS and Treasury will move forward in this matter, especially in the face of the 2005 U.S. Court of Appeals for the D.C. Circuit opinion in *U.S. Telecom Association v. FCC*, which empowers the courts to set regulations aside for failure to comply with the Regulatory Flexibility Act. We have asked on several occasions that Mr. Solomon appear. He refuses to do so. So here is the letter I am sending to 100 Senators.

Dear Senator, I am writing to inform you of an issue of vital concern to my Committee and the small business community. Proposed regulations were issued by the Internal Revenue Service that, if promulgated, will substantially harm all small businesses in this industry.

Because of the impact on small businesses and their customers, I have, with six of your colleagues, already requested that these proposed regulations be withdrawn. I invited Mr. Eric Solomon, Acting Assistant Secretary for Tax Policy, Deputy Secretary for Regulatory Affairs at the U.S. Department of Treasury, to appear before my Committee to explain the purpose of these proposed regulations and what impact he believes the regulations will have on the small business community. Unfortunately, Mr. Solomon willfully refused to appear before my Committee.

I cannot tell you how disturbed I am over the failure of Mr. Solomon to appear, especially in light of the fact that I specifically requested his presence; in addition, he has not even contacted me about the matter personally.

Although Mr. Solomon is still awaiting confirmation to become the Assistant Secretary for Tax Policy, his actions today have demonstrated to me that he should not even be Acting Assistant Secretary for Tax Policy. For this reason, I strongly recommend that he not be confirmed, I am also requesting that Treasury Secretary Paulsen seek Mr. Solomon's resignation.

If you have any questions, I am happy to provide you with additional clarification.

So this is a war between the IRS and the little people, and the chief general who is in charge of regulations thinks he is too good to show up at this hearing. Perhaps he thinks that things might be discovered about what goes on at IRS that the press doesn't want to know about. Well, I can assure you this: His hiding behind the fact that he has a confirmation pending before the United States Senate is not sufficient reason for a person in this position to blow off a hearing and to ignore the desires of a Committee chairman. I could have subpoenaed him if I wanted to. I wish I had; then I would have moved to have him held in contempt of Congress. Instead of being confirmed by the Senate, he could have gone to jail for the rest of the time this body is in session.

I guess on that thought I would turn to my Ranking Minority Member for her opening remarks.

[Chairman Manzullo's opening statement may be found in the appendix.]

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Small businesses are the driving force in this economy, yet even with their significant impact in this country, oftentimes they are an afterthought when it comes to improving economic conditions. No place is this more evident than in the regulatory arena.

This hearing will offer an opportunity to examine the way a specific regulation that has come out of Treasury will impact small businesses and the users of the so-called 1031 exchanges. Unfortunately, it seems with this regulation, as with many others over the past few years, Congress has been forced to consider whether it unfairly harms small firms rather than the agency. This is despite the fact that Congress intended for agencies to consider this impact under the Regulatory Flexibility Act.

Today we will examine specifically whether the IRS properly complied with the Regulatory Flexibility Act with this regulation, but it will also offer an opportunity to hear about the purpose and impact of the exchanges.

The proposed regulations will create significant changes in the way that 1031 exchanges are completed. This regulation will have an impact on both the hundreds of qualified intermediaries that assist with these transactions, as well as the thousands of small companies that are engaged in these exchanges.

I look forward hearing from the IRS on why the change is necessary now, and what is actually driving the need for this regulation. It will change the way hundreds of small businesses report their income to their clients and to the IRS, and will create new administrative hurdles.

I am anxious to hear testimony from both sides of this issue on why they believe this change is needed or is not needed to reflect the proper nature of the transaction.

Income certainly must be reported accurately to the IRS, but we need to know that this is the actual purpose. The question has been raised if this regulation is about reporting income or some other reason.

Another concern that needs to be addressed is the issue of competitive advantages this rule might create for those who do not do these exchanges. The qualified intermediaries are concerned it will put them out of business. It raises the question if the IRS considered all of its options when it pushed this regulation forward.

Most importantly, the officials from the Treasury here today need to tell us why was the effect on small businesses not fully considered when proposing this legislation. It is clear that the IRS has failed to identify all of the businesses that will be impacted by this rule and have failed to fully explain all the costs of complying.

It seems there are a lot of issues gone unanswered regarding this regulation. Small businesses already face a tremendous regulatory burden that has increased by 700 million hours in the last 3 years. The Office of Advocacy has consistently reported that the burden remains intolerable for small businesses. Before we finalize another regulation, we need to know its effect on the Nation's entrepreneurs. This seems to be another example of the administration acting first and considering consequences later. It will be only natural that when proposing a rule, the IRS should fully explain why, while there are a lot of priority projects, they feel it is necessary

to move forward with these regulations. In short, they have failed to provide an answer to this question.

If the goal of this rule is to make sure that income is reported properly to the IRS, there are ways to do that without impacting small businesses. Maybe the IRS is just trying to close down the tax gap on the part of small businesses. If it turns out that change is needed, I would strongly encourage them to adequately seek out and review alternative ways of addressing this problem.

Small businesses are the engine of the economy and are the largest provider of jobs; we need to do everything we can to make sure they have the tools they need to be successful, and not to increase the unnecessary regulatory burdens they face.

And I look forward to hearing the witnesses' testimony. Thank you, Mr. Chairman.

Chairman MANZULLO. Our first witness is Eric Solomon, Deputy Assistant Secretary for Regulatory Affairs. Mr. Solomon was a tax lawyer at Drinker & Biddle. Then he went to the IRS as Assistant Chief Counsel for Corporate. Then he returned to the private sector at Ernst & Young, Mergers and Acquisitions.

In 1999, he joined IRS again as Deputy Assistant Secretary for Regulatory Affairs in the Office of Tax Policy, and also Acting Assistant Secretary for Tax Policy. But he is not here. I am going to answer for him and give his testimony.

Mr. Solomon has been at the IRS since 1999. It was under his watch that these present regulations that we are debating today have been drafted. Mr. Solomon is in a position where he is personally responsible for these regulations coming out, and they came out under his signature.

Mr. Solomon, if you are there, we can't see you. Perhaps you are an apparition. Perhaps you can compose yourself so that we can see you, so that the people here that represent small businesses throughout the country can look at the person who is personally responsible for the actions that may result in over 350 small businesses going under. But since you are not here, I can't give any more testimony on your behalf, and I wish you the best.

The next witness is Don Korb. We have had some very interesting discussions at our office, and Don has always been there. He shows up, we get into interesting discussions, we disagree, as you will see, but, at least he has always been there. He has the decency to show up in my office and the decency to appear in this Committee hearing, unlike others in the Treasury that don't have the decency to show up here. I can't make myself any more emphatic. And I look forward to the debate in the Senate over Mr. Solomon's confirmation.

Mr. Korb is the IRS Chief Counsel; he was appointed to that position in 2004. He has been responsive on several occasions to the small business community for which we have sent him letters of gratitude, which he attached to his testimony, and I appreciate that. I also appreciate the fact that you are here to testify.

The testimony of the witnesses is normally 5 minutes, Mr. Korb, I am going to give you 10 minutes on the clock. You have got a difficult path to wind. The rest of the witnesses are limited to 5 minutes. I am giving you additional time because you are the only witness representing the Administration.



I look forward to your testimony. Your complete statement will be made part of the record, without objection, as well as that of the rest of the witnesses. Thank you very much.

**STATEMENT OF THE HONORABLE DONALD L. KORB,  
INTERNAL REVENUE SERVICE**

Mr. KORB. Chairman Manzullo, Ranking Member Velazquez, and members of the Committee, I am here this afternoon to talk about our Initial Regulatory Flexibility Analysis to the proposed regulations that are the subject of this hearing. However, before I do, I would like to take this opportunity to publicly thank the Chairman as well as Chief Counsel for Advocacy Sullivan, sitting to my left, for your recent letters to me expressing appreciation for my leadership in finalizing the regulations under section 199, and for including in those regulations an expanded simplified deduction method that will allow 99.5 percent of our country's manufacturing firms, most of them small business, to use this less burdensome method.

I want to note for the record that this commendation should, in fact, go to all of the dedicated and hard-working lawyers and staff at the IRS and Treasury who worked on this particular project. Too often in this town people are quick to criticize the efforts of these dedicated and hard-working public servants. It is rare indeed for me to be able to pass on to them the well-deserved compliments that you gave them in your letters. Thank you.

I would also like to point out that I am not in a position to discuss my view of or position on the proposed regulations that are the subject of this hearing. You have asked me to testify here today after expressing concerns both in writing and at the public hearing on the regulations which was held in the IRS building on June 6, 2006, before the flood, about the substance of the proposed regulations and the procedures under which they were issued. However, the integrity of the regulatory process requires me to suspend judgment on finalizing proposed regulations until all internal and public comments have carefully been considered and addressed through a rigorous process involving both the IRS and Treasury.

We have not yet reached the stage at which the information received from public comments has been sufficiently analyzed so that I can make a judgment about the proper course of action. Accordingly, I am sure you understand that it would be inappropriate for me to make any comments on the substance of the 2006 proposed regulations and how they might change at the hearing here today.

Although my written comments focus on four topics, I would plan to limit my oral statement to only the final topic, which is the Initial Regulatory Flexibility Analysis performed by IRS and Treasury as part of the regulatory process.

Mr. Chairman, as I have assured you privately, I take the IRS obligations under the Regulatory Flexibility Act very seriously. As my description of the regulatory process at the IRS and Treasury, which is in my written statement—as it demonstrates, the requirements of the IRFA are considered both during the process of drafting and viewing of proposed regulations, and during the review and revision of those regulations before they are made final.

The contents of the IRFA, to be included in a notice of proposal we are making, are delineated in RFA in section 603.

In my limited time available, I want to focus on one of these requirements, and that is the number of small entities to which the proposed rule applies. Preparing the IRFA, the drafting team identified questions that would help us determine the population of qualified intermediaries, which, as you know, are entities that facilitate deferred exchanges of like-kind properties, and to estimate the burden on those entities. These questions included the number of QIs and independent QIs, the number of small QIs, the annual number of deferred like-kind exchanges, the amount of principal QIs hold in exchange funds on average, and the average interest rate earned on the funds.

When government and publicly available sources of information, including the SBA and the Department of Commerce Web sites, do not provide answers to these questions, the drafting team turned to industry resources, and specifically the Federation of Exchange Accommodators, all this contemplated by the RFA.

FDA provided information on a number of its members, a number of those that constitute QIs, and its estimate of the percentage of the industry that belongs to the FEA. This information was reiterated by FEA numerous times and formed the basis of the IRFA estimate of 325 small businesses providing services as QIs. The FEA did not provide any other information that would help us estimate the impact of the regulations on small entities, nor did it suggest alternative sources for the information.

The drafting team was able to learn the financial details necessary to estimate the impact of the regulations on small entities, the decision was made to specifically request comments on the extent of the economic burden and on alternatives to it in the IRFA itself. The drafting team is in the process of evaluating those comments to collect all of the information it can about the potential impact of the proposed regulations on small entities as contemplated by the law.

In my written response to a letter from you, Chairman Manzullo, I maintain that the IRS and Treasury had met their legal obligations under the RFA, but I acknowledge, as you indicated, that we could have done a better job. I still hold that view, and I believe it is supported by the details I provided in my written statement. As you know, I have committed to you that we will do a better job in the future on a Regulatory Flexibility Act Analysis.

Thank you for inviting me to testify this afternoon, and I would be happy to respond to your questions at the appropriate time.

Chairman MANZULLO. Thank you very much.

[The Honorable Donald L. Korb's testimony may be found in the appendix.]

Chairman MANZULLO. Our next witness is Tom Sullivan, the Chief Counsel for Advocacy at the SBA. Mr. Sullivan, I look forward to your testimony.

**STATEMENT OF THE HONORABLE THOMAS M. SULLIVAN, OFFICE OF ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION**

Mr. SULLIVAN. Good afternoon, Chairman Manzullo, members of the Committee. I thank you for the opportunity to testify this afternoon.

Congress established the Office of Advocacy to represent the views of small businesses before Congress and Federal agencies. My office is an independent one within the SBA; therefore, the comments expressed in my written statement and in this oral statement don't necessarily reflect the position of the administration or the SBA. My oral and written statement were not circulated to OMB for comment.

I am here today to discuss how departments like Treasury and IRS can better comply with the letter and spirit of the Regulatory Flexibility Act. Much of my written statement applies that concept to a specific proposal published by Treasury and IRS in February of this year having to do with QIs and Like-Kind Exchanges.

My office takes its direction from small businesses, and in order to understand IRS's 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, my office submitted a written comment to Treasury and IRS on May 8, 2006. That letter highlighted what we believe to be incomplete areas of their Initial Regulatory Flexibility Analysis, IRFA. With the Chairman's permission, I would like to enter our written comment in the record.

Chairman MANZULLO. Without objection.

Mr. SULLIVAN. In our May letter, we recommended that Treasury and IRS republish their Regulatory Flexibility Analysis. The good news is that their original proposal did contain an IRFA, and I don't want to understate the importance of that fact; in the special analysis section there was an IRFA. And many times our interactions with agencies are to simply get to that step, but obviously the Regulatory Flexibility Act requires more. And the bad news is that IRFA may have significantly undercounted the impact on small entities. And the proposal asked the commenting public what type of impact the proposal may have.

My office hopes that agencies use data that they possess, work with my office and others to conduct analysis on potential impacts, and subject that analysis to comment. That way, an IRFA better informs small entities and other commenters on impacts to analyze, comment on and suggest alternatives. Quite frankly, Mr. Chairman, the economist in my office used the expression "garbage in, garbage out." and IRFAs, we believe, deserve to have a fully vetted analysis of impacts, whether that is done at a preproposal, proposal, or sometimes even correcting insufficiencies through a subsequent publication of simply that IRFA so it can better inform the rule writers.

I encourage that Treasury and IRS come to my office early in their regulatory development process. The useful exchange of information, sometimes through confidential interagency communication, and then subsequently through the formal notice and comment process, can only help assure that the spirit of the Regulatory Flexibility Act is met and regulatory results that will lessen the eventual impact of small business be achieved.

Thank you for this opportunity to express my views, and I would be happy to answer any questions the Committee might have.

Chairman MANZULLO. Thank you.

[The Honorable Thomas M. Sullivan's testimony may be found in the appendix.]

Chairman MANZULLO. Our next witness is Louis Weller. He is a principal at Deloitte Tax. He heads the firm's National Like-Kind Exchange Practice Group. We look forward to your testimony.

Mr. Weller, we understand you are testifying privately and on your own behalf, and not on behalf of the company with which you work is that correct?

Mr. WELLER. That is correct, nor on behalf of any clients.

**STATEMENT OF LOUIS S. WELLER, LIKE-KIND EXCHANGE  
PLANNING, DELOITTE TAX LLP**

Mr. WELLER. As you say, my name is Louis Weller, and I am pleased to appear before you in connection with your inquiry into proposed regulation section 1.468B.

I am a principal at Deloitte Tax. My professional practice focuses on advising clients on tax consequences of transactions involving acquisitions and dispositions and structuring of real estate and other business transactions.

I appear before you at your request. And as you say, I express my own views and not those of my firm.

I have been involved in the like-kind exchange area for more than 30 years. My clients have included over the years both taxpayers engaged in transactions under section 1031, and a number of qualified intermediary entities which help facilitate those transactions, both those affiliated with national institutions, banks, title companies, attorneys, escrow—really the entire gamut of the industry that has arisen to help facilitate like-kind exchanges.

My professional background is more described in the CV that is included with my testimony. I have written a number of outlines, articles and speeches on the topic, including a treatise on section 1031. The reason I think that I am here today is that my most recent article deals with this very subject of section 1.468B. It was published in the June 2006 issue of the Journal of Taxation. The article fairly comprehensively—at least we hope, myself and my co-author Kelly Alton—expresses our views of these proposals, the technical background, and what we view as limitations and errors we think of approach that are represented by the proposals as they have been issued. Again, they express my personal view.

I want to summarize fundamentally the points that were mentioned in the article as a basis for my testimony. First of all, we believe that it is an appropriate exercise of regulatory authority by Treasury and the IRS to attempt to create rules under section 468B, perfectly legitimate. And there were a number of rules that were issued in 1999 which are not the subject of this hearing, which have not been repropounded and which were probably just fine. 468B-6, the section that is the subject of this hearing, however, addresses a set of issues which, in our view, are not really the subject of this section of the Internal Revenue Code, nor was it intended to address them, particularly the thing that I think is at the core of your inquiry, which is qualified intermediary holding funds in what are called unsegregated accounts.

By characterizing the core observation we make as a technical matter, by characterizing deferred exchange arrangements as loans, the proposal we believe inappropriately draws a distinction between the status of qualified intermediaries under section 1031, in which they are treated as parties to an exchange transaction, and under 468B, in which they are treated as borrowers of money loaned to them by the taxpayer.

Following on that, we believe that the application of the rules of section 7872 to qualified intermediary arrangement, at least those which there is no segregated account, is inappropriate as a technical matter. And then even if one would concede that the arrangements are loans subject to section 7872, we believe that the short-term nature of deferred exchange arrangements, which by their terms can only last 6 months because of that time limit of the client under section 108183, the short-term nature makes them really inappropriate for regulation under the section 7872 regime.

Next, the testing rate that was adopted in the regs is too high. It is inconsistent with the economic practice of the industry and applies a set of rules which cannot be met by and large in the way that we understand that the intention was.

And finally, the projected effect of the proposal we believe favors bank and financial institution-owned qualified intermediaries at the expense of nonbank or nonfinancial-owned qualified intermediaries in a way that we don't believe was as carefully thought through as it might be, and we have urged in our article and continue to urge consideration of that distinction in the course of the consideration of these regulatory proposals.

I think the way that comments have come in on the proposals illustrates the differential effect that we believe would occur if the regulations went final in their present form.

As I say, these points are elaborated on in my article, so I won't go any further, and I am happy to answer questions at the appropriate time.

Chairman MANZULLO. Thank you very much.

[Mr. Weller's testimony may be found in the appendix.]

Chairman MANZULLO. Our next witness is Mike Halloran, President and CEO of Nationwide Exchange Services.

Mr. Halloran, we look forward to your testimony.

#### **STATEMENT OF MICHAEL HALLORAN, NATIONWIDE EXCHANGE SERVICES**

Mr. HALLORAN. Thank you.

Chairman Manzullo and members of the Committee, thank you for the opportunity to speak today. My name is Michael Halloran. I am the president and CEO of Nationwide Exchange Services. We are an independent qualified intermediary performing 1031 tax-deferred exchanges, independent by the fact that we are not owned by a banking institution. We provide investors and corporations with 1031 tax-deferred exchange services on a national basis, and we have operations in California, Illinois, and here in D.C.

My comments today are not only on behalf of Nationwide Exchange Services, but are generally reflective of a number of independent qualified intermediaries in the marketplace, quite a number of which are here in the audience today.

We at NES believe that the proposed changes, while the intention of the IRS may be noble, fail to identify and substantiate the specific deficiency that they are trying to remedy. They are unnecessary to address ambiguously stated concerns. They would effectively eliminate current free-market competitive environments and would hand the market into one particular segment of bank-owned qualified intermediaries. They run counter to the interests of individual consumers, commercial investors and corporations. And as a result, they would create the closing of hundreds of independent qualified intermediaries and a loss of literally thousands of job. Ultimately, we believe this would result in a lower tax revenue to the Federal Government. Our position is they are not an equitable solution.

I would like to start by stating that NES is in the business because of the IRS and the Tax Code. The Service is not our adversary by any means. To the contrary, qualified intermediaries act on a daily basis as the first line of defense to the Internal Revenue Service regarding 1031 exchanges. If it were not for the intermediary industry, the Service would be plagued with frequent and substantially incorrect executions of 1031 exchanges, inadvertent or fraudulent.

The Internal Revenue Service and the qualified intermediary industry have a long track record of a mutually beneficial codependency. Our industry would like nothing better than to have a meaningful opportunity to address any valid and substantiated deficiencies that are identified by the IRS in a way that would be balanced and equitable. We believe the current proposed regulation changes do not accomplish this objective and would result in a decisive competitive advantage for a handful of bank-owned qualified intermediaries.

To understand why we have come to that conclusion, it is probably important for you to have a basic understanding of what a 1031 exchange is and how a 1031 intermediary operates. Basically, as a 1031 intermediary, we process the paper where we do the education for the consumers. We provide them with levels of customer service to help them execute their 1031 exchanges. And according to the 1031 code, we actually have to act as the custodian and the fiduciary for the funds. Consumers cannot be in constructive receipt of their own funds.

What seems to be at issue in these proposed changes is the ability for the qualified intermediary to make any spread on the funds while we are holding those deposits. It is commonly accepted within banking and within financial services that they actually make money on the spread; it is a commonly disclosed practice to consumers and exchangers throughout the United States that we make a combination of fee and spread. Consumers are not stupid. They realize that we have to make money. So a free market environment allows qualified intermediaries to price their services in a combination of fee—it could be a high fee and a very low portion of the spread; it could be a low fee and a very high portion of the spread. But competitive forces are the best ones for determining who are the winners and what are the appropriate business models to be utilized in the marketplace.

And I am running out of time, so the proposed changes basically provide that all interest earned on exchange or assets has—

Chairman MANZULLO. We are okay on time. The next series of votes is in 2 hours.

Mr. HALLORAN. Okay. I will try and talk slower then.

The IRS proposed revisions provide that all interests earned on exchange or assets be taxed as income directly to the exchanger, whether received or not, regardless of the fact that the exchanger is not and cannot be in constructive receipt of their own exchange proceeds to earn interest. The question here would be, do you earn money on your checking account? Of course not, because that is how banks subsidize, how they provide all of the services around your checking account. They hold your money, they invest your money, and every consumer understands that. It is part of the way that they rationalize on paying for this checking account.

The IRS further proposes that the only legitimate form of income for the QI is in the form of exchange fees, and that all such fees must be set up front, regardless of any variable cost burden of executing the exchange transaction, and fully ignoring any competitive drivers that exist in the marketplace. Basically they said you can do a fee and nothing else.

The inequity in this is that a bank-owned qualified intermediary has more opportunities to monetize the deposits they are holding, whether they are in traditional savings accounts or in trust accounts, where they routinely distribute 12b-1 fees to their subsidiaries to help them with their operating expenses associated with garnering those deposits. That opportunity would no longer exist for qualified intermediaries that are independent; they would only have the opportunity to do this in fee and nothing else. So the independent qualified intermediaries would have to dramatically raise their fees while the bank-owned intermediaries could keep their fees low and still earn a certain amount of interest on the spread.

For a point of reference, Bank of America's return on deposits is 8.9 percent, far greater than any independent qualified intermediary could ever have done. So their ability to monetize those funds already puts them at a competitive advantage in the marketplace, and yet we are still able to compete and deliver high-value products as independent intermediaries.

The IRS states that in the event that the QI utilizes any of the interest earned on the assets to cover transactional expenses or operating costs, exchange proceeds will be treated as below-market loans, and the taxpayer will recognize computed income at a rate equivalent to a 6-month Treasury rate, regardless of the fact that deposits must be held as demand deposits, and on average are seldom held longer than 90 days, with many calling for shorter time frames. In my company, our average hold on funds is 67 days. We have many transactions, I would say easily 20 percent or more, where the demand on those deposits is within 10 days. So we will hold funds, and we have the consumer turning around and needing those funds for the closing on their replacement property within a very short period of time, yet if, according to the new IRS proposal, if we were to do that and cover any of our operational costs, the consumer would be taxed as if they were paid at a 6-month Treasury rate for the full 6 months.

The IRS goes on to define the only acceptable form of transaction costs that can be deducted from interest proceeds or exchanger assets are hard costs directly attributable to the specific exchange and paid to a third party—

Chairman MANZULLO. Now you are over.

Mr. HALLORAN. I will be done.

Chairman MANZULLO. I know you will be done, but when?

Mr. HALLORAN. I thought I could talk slower.

The bottom line is that the proposed changes, though the intention may be honorable, and specifically to determine better clarity around 1031 transactions, are extremely punitive upon the independent qualified intermediary, and they prejudice against one particular business model over another. And our argument would be that competition in the market, in a free market, is the best arbiter of who delivers the ultimate value to the consumer and will still drive interest revenue to the IRS.

Thank you.

Chairman MANZULLO. Thank you very much.

[Mr. Halloran's testimony may be found in the appendix.]

Chairman MANZULLO. Our next witness is Howard Levine, who has been involved in 1031 activities for more than 25 years. He is an instructor and adjunct professor for tax at Georgetown Law School and George Washington University. We look forward to your testimony.

**STATEMENT OF HOWARD J. LEVINE, ROBERTS & HOLLAND  
LLP**

Mr. LEVINE. Thank you. Chairman Manzullo and other members of the Committee, good afternoon, and thank you for inviting me to present testimony.

My name is Howard Levine. I am a partner in Roberts & Holland, which is a Washington and New York law firm which limits its practice to tax law.

My interest in the like-kind exchange area spans more than 30 years. I was chairman of the ABA Tax Section Sales, Exchanges & Basis Committee, which has primary jurisdiction in the ABA over 1031. I am the author of the BNA Tax Management Portfolio on 1031, which for more than 25 years has been the most widely used treatise around the country on like-kind exchanges. And I have been an adjunct professor at both George Washington University Law School and Georgetown Law School.

In the limited time that I have, I want to make five points. Number one, the repropoed regulations are correct, both as a matter of substantive tax law and as a matter of tax policy. The general rule in the repropoed regulations that the funds will be treated as loans to the QI unless all of the interest is paid over to the taxpayer is absolutely consistent with and, in fact, required by long-established case law that a taxpayer must have the benefits and burdens of ownership of property in order to be taxed on the income derived from that property.

Contrary to what some have claimed, it is also consistent with the intent of the original set of regulations that were proposed in 1999, which also set forth a burdens and benefits test and clearly indicated back then that section 7872 could apply in any situation



where for some reason the taxpayer was treated as the owner. Had the IRS immediately finalized those 1999 regulations, it is doubtful that there would be any real issue today as to who must report all the income from the exchange account and whether section 7872 could apply; however, the IRS took no action to finalize the regulations for 7 years, and that had the practical effect of allowing QIs to take inconsistent positions and aggressive positions.

From a substantive tax law viewpoint and a tax policy viewpoint, the bottom line is this: The funds are simply the proceeds from the sale of a taxpayer's property. If the funds are somehow treated as owned by the QI, one must answer this question: How did the QI get ownership of the funds? The answer can only be by way of a loan.

The question has been raised several times, is there any income that is not being reported? The answer unequivocally is yes. If I earn \$1,000 of investment income from my assets, and I use that same \$1,000 to pay my doctor bills, I am taxed on that \$1,000 of investment income, and my doctor is taxed on that \$1,000 of income from services he actually rendered, even though I am using the same \$1,000 to pay for my doctor for the services he rendered.

The exact same thing is happening here. There is substantial interest income being earned from the taxpayer's assets. That interest income is not business reported or paid by the taxpayer, it is instead being simply taxed to the QI instead of being taxed to the taxpayer and then being taxed to the QI. That is not double taxation, that is the way our tax law works. I get interest income from my investments. I use that interest income to pay for services rendered by third parties. We are both taxed.

Number two, this debate is not about big versus little QIs, nor is it about bank and title insurance QIs versus all others. Contrary to the way this is being portrayed by some, this debate is not about the big QIs and their affiliates versus the little QIs. At the forefront of those opposing and lobbying against the regulations are the very large title insurance companies and their financial parent companies, which in terms of revenue and assets far eclipse all other QIs and their affiliates. Nor is the debate about banks or banks and title insurance companies versus all others.

In my 30 years of experience in the like-kind exchange area, I have represented all kinds of QIs, and I continue to represent all kinds of QIs. I represent QIs who are strongly opposed to these regs, I represent QIs who are strongly in favor of the regs.

When the original set of regulations were proposed in 1999, I testified before the IRS in favor of those regulations. I did not at that time represent any QI affiliated with banks or title insurance companies, but I strongly supported those regs, and I continue to support these regs for the same reason; namely, that they are consistent with and required by established case law.

Moreover, as evidenced by the submissions that have been made to the IRS and Treasury, and certainly as admitted by those opposing the regulations, there are clearly QIs who are not affiliated with any bank or title insurance company who support the regulations. Therefore, what the debate is about is a difference in business models.

Number three, the reposed regulations will benefit most small businesses. The purpose of this hearing is to determine whether the reposed regulations will be harmful to small business. It is true that many, but not all, of the few hundred or so QIs around the country may end up deciding to change their business model as a result of these regulations. However, it is important for this Committee to understand that there are many, many more small business interests who will benefit from the finalization of these regulations; namely, the many thousands and thousands of taxpayers who do exchanges each year and are customers of the QIs. These small business investors are not represented here. The small business owners, the restaurants, the operators—

Chairman MANZULLO. How are you doing on time? You are about 1-1/2 minutes over.

Mr. LEVINE. Can I have 1 more minute?

Chairman MANZULLO. I can give you 20 seconds.

Mr. LEVINE. Okay. The reposed regulations will force the greater consumer protection, it will encourage a segregation of accounts—there have been many bankruptcies in this area. It should minimize that. The reposed regulations will lead to greater transparency. There is a tremendous amount of interest being earned which the individual taxpayer has no idea about.

Thank you for your attention. I would be happy to answer any questions.

[Mr. Levine's testimony may be found in the appendix.]

Chairman MANZULLO. I have got a series of questions. Mr. Gohmert, did you have any questions you wanted to ask?

Mr. GOHMERT. Not at this time.

Chairman MANZULLO. Okay. Mrs. Kelly, why don't we go to you.

Mrs. KELLY. Thank you very much, Mr. Chairman.

We have been struggling with an issue on Financial Services for some time, and that is the issue of the banks and commerce. So I would like to ask this panel a couple of questions about that.

If only banks are allowed to be QIs, doesn't that inexplicitly mix banks and commerce to an extent that is unwelcome?

Mr. LEVINE. Are you asking all of us—

Mrs. KELLY. I am asking the entire panel. Mr. Levine, would you like to respond to that?

Mr. LEVINE. That is not correct. The proposed regulations in no way state or imply that only banks can be QIs.

Mrs. KELLY. Well, anybody else want to talk about that?

Mr. HALLORAN. Practically that would be the impact. The reality is the monetization of funds is inherently different between a bank and an independent QI. And the QIs would be forced to raise fees to the tune of thousands of dollars, where banks would not have that same structure in place. So basically bank-owned QIs would have an advantage in the monetization of funds.

There is also another issue, and it would be a disadvantage actually back to the bank, and that is, with the bank acting as a qualified intermediary or having a qualified intermediary subsidiary, there is an issue where banks would go on and say you need to use our qualified intermediary services, and we will give you the best loan rate associated with it. If the QI ended up making a significant error in that exchanger's exchange, there is really an issue of

potential negligent referral on the part of the bank. And so the bank would have an associated liability that could be created out of that.

Mrs. KELLY. Mr. Halloran, you just jumped on to the second question I was going to ask. That is exactly what I see, and that is why I asked the question to begin with. I am concerned about that.

So is there anybody else who wants to jump in on this? Or I will ask my third question.

My third question is what is to prevent a bank from acquiring a geographic monopoly on the QI business if new nonbank competitors don't get into the QI business? Is there anything out there that would prevent them?

Mr. HALLORAN. No.

Mr. LEVINE. There is just a fundamental misunderstanding, I think, of the premise, because the assumption you are making is that these regulations will even effectively result in only banks being QIs. That is just not correct. What they may result in is they may result in the interest being paid over to the taxpayer. But I think what we all need to understand is that the range of fees that QIs charge right now is very minimal. It is between \$500 maybe and \$1,500, that is all. All QIs basically are within that range.

I think what effectively might happen by these regs is not that nonbank QIs will be prohibited somehow, but that I think QIs who are keeping most of the taxpayer's interest will wind up giving over that interest, and the overall fees, all of the fees that are being received, probably will reduce. It has to be beneficial to the ultimate consumer. It has to be.

Mrs. KELLY. That would depend on whether there is a geographic monopoly on the QI.

Mr. Halloran, I saw you shake your head. Do you want to respond to that?

Mr. HALLORAN. First of all, qualified intermediaries pay competitive rates of interest to consumers today, so this is not an issue of the interest not being paid to the consumer. There is no homeless income here. The consumer receives interest that is paid by the qualified intermediary, they are 1099 on it, they have to pay their taxes accordingly. The qualified intermediary reports all of their income, takes away their traditional operating deductions that any company is allowed to do, so there is no homeless income there. The banks would have a significant competitive advantage, particularly in the scenario that you are painting.

Mrs. KELLY. Thank you.

I want to ask the IRS a question. How many comments did you get on this proposed rule?

Mr. KORB. One hundred thirty-eight comments.

Mrs. KELLY. How many were in opposition to the proposed rule?

Mr. KORB. One hundred thirty-five.

Mrs. KELLY. One hundred thirty-five were opposed out of one hundred thirty-eight; is that correct?

Mr. KORB. That is exactly right.

Mrs. KELLY. What is your view regarding the security with regard to the consumer on the services that are provided by bank-owned QIs compared to the security and customer service—sorry,

let me do this again. What is your view regarding the security and consumer service provided by bank-owned QIs compared to the security and customer service provided by business-owned QIs?

Mr. KORB. Congresswoman Kelly, I am not sure I am the right person to answer that.

Mrs. KELLY. Let's throw it out to the whole panel here.

Mr. LEVINE. I think the level of service by both bank QIs and nonbank QIs is very good. I think there may be some point about banks being regulated, and because the bank is regulated by the OCC—the bank subsidiary, including the QI, has to be regulated by the OCC. So from the consumer's viewpoint, there may be more protection, but in terms of level of service, both, I think, offer very good service.

Mrs. KELLY. Thank you. My time is up.

Thank you, Mr. Chairman.

Chairman MANZULLO. Congresswoman Bordallo.

Ms. BORDALLO. Thank you, Mr. Chairman. I have a question for Mr. Korb.

Based on the testimony here today, there is a concern about the effect that this change would have on the qualified intermediary industry. Does the IRS and Treasury acknowledge that this regulation will create some burden or cause hardship for some of the small businesses represented here today?

Mr. KORB. Congresswoman, that is exactly what the Regulatory Flexibility Act is designed to get at. That is why it is so important that we take this step that has been recommended by Chief Counsel Sullivan to do a better job in that analysis, and it will come out in the analysis.

Ms. BORDALLO. So you do feel that small businesses could go out of business?

Mr. KORB. I didn't say that. I said that is what this process is designed to get at.

Ms. BORDALLO. I have another one for Mr. Halloran here. Based on what you heard so far at this hearing, do you believe that the IRS fully understands how your business operates and the impact that it will have on your business? And what bothers you the most about their testimony?

Mr. HALLORAN. Actually, I think you kind of got to the core of it. I am serious when I say I trust that their intentions were fine, they were good. I think the reality is because they are not necessarily business people, they don't understand the context of how we have to operate on a day-to-day basis. They don't understand competitive markets; they don't understand creating value propositions for consumers. And unfortunately, as a result, they have come out with a ruling that—or a proposed regulation change that would prejudice the industry towards one particular group. I do not believe that was their intent, but it is certainly the result.

Ms. BORDALLO. Thank you.

And one more quick question, Mr. Chairman, for Mr. Sullivan.

In the testimony before the IRS, former Treasury Assistant Secretary Pam Olson cited complaints of small businesses as disingenuous, and that the assertion that the IRS has not complied with the Regulatory Flexibility Act is a red herring. I take it from your testimony and your comments that you do not feel the same way.

Mr. SULLIVAN. Congresswoman, not only do I not feel the same way, but I think the chief counsel Don Korb's letter to the Chairman saying that they could do a better job on the Regulatory Flexibility Analysis refutes that point of view.

Ms. BORDALLO. What is Advocacy doing to improve the process in which the IRS considers the impacts its rules and regulations have on small businesses?

Mr. SULLIVAN. Well, Congresswoman, we are working to try to get a better understanding with IRS on what it takes to have a full-blown and complete Regulatory Flexibility Analysis. Prior to this hearing, actually prior even to the consideration of this hearing, the chief counsel and I have met and have exchanged commitments to continue to work toward improving the Regulatory Flexibility Analysis they conduct. So I was optimistic then; I am optimistic by the chief counsel's comments today that we will move forward in better working relationships in compliance with the Regulatory Flexibility Act over at IRS.

Ms. BORDALLO. Thank you.

Thank you, Mr. Chairman.

Chairman MANZULLO. Mr. King.

Mr. KING. Thank you, Mr. Chairman.

First, I would direct my first question to Mr. Halloran, and that is, consumers—first of all, I would like to know from you, are you confident and to what degree are consumers advised of the rate they might receive on their nonbank QIs on bank deposits? And also, how many small businesses make up the industry percentage of exchangers or customers?

Mr. HALLORAN. To your first question, the majority of QIs that I know of disclose the fact that this is our fee, and that we make some interest on the spread. Again, consumers are aware of it not only because it is only logical that companies make money—and certainly some organizations, mine included, charge very low fees. We created a very low-fee structure so that we could assist smaller consumers who could not normally afford \$1,000-plus fee. And the larger customers that we have basically help cover those costs through the spread. But our largest customers, they are all aware that we make money in the spread. We fully disclose it both in our conversations with the consumers and actually contractually in our exchange agreements.

Mr. KING. Can you give us some idea of the range of that return rate?

Mr. HALLORAN. Depending on the individual exchanger and the size of the deposits, for instance, our largest depositor right now earns 425 basis points on their funds, which is a very competitive rate, and they are comfortable with that. They know that, it is fully disclosed to them, they know what the rates are out in the marketplace.

Our smallest exchanger earns 1-1/2 percent. The average that we pay out corporately is somewhere around 2-3/4 percent.

Mr. KING. That helps.

Then about what percentage do you think are handled then by nonbank?

Mr. HALLORAN. Of the total transactions in the marketplace? I couldn't tell you the total market share numbers. There are two large bank-owned QIs—

Mr. HALLORAN. There are two large bank-owned QIs of substance, maybe four, that as you start to aggregate them all and their meaningful volume, the majority are small businesses.

Mr. KING. I sit and listen to the exchange between the witnesses and the panel. I am thinking in terms of, there is a pot of money that comes from the sale of some real property, most likely. That goes into the hands of maybe yourself or Mr. Levine. And then there is a disagreement then between the two of you on whether this is actually two incomes or one out of that.

I would direct this to Mr. Levine kind of in this way, say, for example, I had a horse, and I needed that horse boarded for a while. And I would go to my neighbor and say, will you feed that horse and take care of that horse and then when I am ready to transfer him over into another property or sell him, will you keep that horse for me, feed him and do what you want to with him while I am gone, take him to the horse show or whatever you want to do?

Now, is there income off of that horse? Then should that be taxable? And the next question is, if you take him to the horse show and then make a little money on the side, why do I care about that, and why is that not taxable as the income that you would receive as managing that 1031?

Mr. LEVINE. In the examples you gave, effectively, you are renting that horse to the individual, whoever it is, that is boarding it. If you are allowing that person not only to board it but do whatever it wants with that horse, then, from a Federal income tax viewpoint, that person is like a lessee in the sense that you are renting that horse to that person. Whatever income that is earned from that horse—it is like real estate. If I let you use my real estate, you can do whatever you want with it, keep the income from that real estate, I am renting, I am leasing that real estate.

Mr. KING. Whether or not you take him to the horse show or not? That depends on the original transaction or—

Mr. LEVINE. Right. If I give you the ability to do whatever you want with the real estate or with the horse, I am in effect leasing or renting that horse or real estate to you.

Mr. KING. And if I own that horse for business purposes, I can write off the expense of that lease.

Mr. Halloran, how would you respond to that.

Mr. HALLORAN. I would think you are doing him a favor by taking care of the horse.

Mr. KING. At this point of levity in this particular discussion, I would point out these things: We are in, the Federal Government is in this business of taxing all productivity in America. And that is what we are asking here: Is there productivity here, or is there not productivity there? Because if it is interest income, dividend income, wage income, we tax it all. Uncle Sam is standing there with his hand out every Monday morning when people punch the time clock at whatever time it is in the morning, and the Federal Government has the first lien on all productivity in America. And what we are sitting here doing is determining whether we think that is really productivity.

My point to this is, more than any other, so we get down to the weeds, into the minutia of all of this because we have such a convoluted Tax Code that nobody can understand, no two people will come to the same conclusion on any kind of complicated tax policy, and that is my point for tax reform.

I thank all of you gentlemen for your testimony and your responses and I yield back to the gentleman.

Chairman MANZULLO. A horse? You ever try to feed a horse, Mr. Levine?

Mr. LEVINE. Not recently, no.

Chairman MANZULLO. If you had to feed a horse, I don't think that you would consider that to be a great business transaction.

Mr. LEVINE. Well, if the horse was a Kentucky Derby winner, and you allowed me to do whatever I could do with that horse, I may be very grateful to you.

Chairman MANZULLO. Mr. Gohmert, you have questions?

Mr. GOHMERT. Thank you, Mr. Chairman. And with regard to the horse, being a freshman here, having been a judge for a number of years, I have become more familiar with dealing with part of a horse since I have been here in Washington.

But, anyway, Doctor, there seems to be significant feeling that the new regulations will drive QI business into the bank. So I just had a question for Mr. Korb and Mr. Sullivan. If that were to happen, QI business is driven to banks, would you consider that a good thing or a bad thing?

Mr. KORB. I really don't know in my role that I am sitting here that I can form a judgment on that.

Mr. GOHMERT. Do you need to change seats and sit somewhere else?

Mr. KORB. I think so. I am the tax administrator right here, remember what the rule is. The rule is, what Congress has enacted here with the Federal Regulatory Flexibility Act is sunshine. It is transparency. The idea is to present before the public certain ramifications. Okay? And then those ramifications are taken into account as we finalize the regulations.

I would really prefer, in fact I think I would be doing a disservice to everybody if I formed a judgment at this point in time in the middle of the process. It would be like asking a judge how he is going to decide a case before the case is through.

Chairman MANZULLO. Would the gentleman yield?

Mr. GOHMERT. Let me follow up on that metaphor. Actually it is more like questioning a juror to see if they would be fair before they make the final decision is what it is really more akin to. I yield to the Chairman.

Chairman MANZULLO. I think that is a valid question, Mr. Korb, because the question is—restate the question again.

Mr. GOHMERT. Well, if this business is driven into banks would you consider that to be a good thing, good for the economy?

Chairman MANZULLO. But the small businesses closing up? QIs?

Mr. GOHMERT. Merging into the banks.

Chairman MANZULLO. I think that is a valid question. That goes not only to the heart of the RFA but goes to the heart of the issue if there are just a few people that are left in the industry.

Mr. KORB. I am not so sure my judgment matters on that point.

Chairman MANZULLO. But you are the one who makes the decision. Your judgment is important.

Mr. KORB. My decision will be based on what the law is.

Chairman MANZULLO. Well, it will be based upon the impact of the law. That is the RFA, and that is why I have this hearing going on. Mr. Gohmert I took your time.

Mr. KORB. I am not trying to be cute about it. I am trying to give you my honest answer.

Mr. GOHMERT. Well, if you were trying to be cute, it did not work. Because you suffer from my problem, you are not going to be cute no matter what you do.

Mr. KORB. You are right about that.

Mr. GOHMERT. You and I are in the same boat.

Mr. Sullivan, you had a comment?

Mr. SULLIVAN. I would like to expand on the juror analogy that you mentioned. I think a key point for this committee and the Regulatory Flexibility Act is, how would a juror respond to the question, I don't have enough information in front of me to make a decision? And I think that, from the Regulatory Flexibility Act perspective, that seems to be my office's stance on whether or not it is a good idea or a bad idea. We prefer not to say that, but we do prefer—the Reg Flex Act demands that there be enough information so that the commenting public can actually help IRS decide whether or not it is a good idea or a bad idea.

Mr. GOHMERT. But as I understood, these could go into effect tomorrow. That possibility exists; is that right?

Mr. SULLIVAN. The Regulatory Flexibility Act, the spirit of it, would be that a thorough regulatory flexibility analysis precede the finalization of a rule. Because, again, you want the public to comment on a thorough analysis. You want the jury to deliberate on the facts—as many of the facts and circumstances of the case before making a decision. It would be unfortunate if IRS finalized the rule without having the opportunity of a more thorough regulatory flexibility analysis out for comment.

Mr. GOHMERT. Mr. Halloran, that would help your feelings, would it not? If they went ahead and made this in effect tomorrow and could pass on to you it really is unfortunate that it just killed your business, you would feel better; right?

Mr. HALLORAN. Yeah, I would see if I could come work for you.

Mr. GOHMERT. I don't think you would for the wages you get paid up here. But still, I am troubled, on the one hand, I am hearing that we want to make sure there is a thorough review and we gather all the evidence. But then, on the other hand, I was under the impression that we were near the end of the evidence gathering and we were about to have a verdict, whether there had been sufficient evidence or not.

Mr. KORB. That is not true at all. That is not true at all. We are not near the end. I told Chairman Manzullo's tax counsel that the other way. I made it very clear to him. There is no way this reg is going to be finalized tomorrow.

Mr. GOHMERT. I didn't say it was going to be.

Mr. KORB. I committed to—I committed to Mr. Manzullo's tax counsel, as I did here publicly, that we are going to perform a revised IRFA. So you don't have to worry about—I mean, this is not



going to happen immediately. Take a look, I lay out in the testimony—I wasn't able to cover everything, but I go through the entire process. And we are really at the beginning of that stage of the process.

Mr. GOHMERT. Well, regardless of the credibility, you might assess or attach to the comments information that has been gleaned so far.

If I could ask this one further question, Mr. Chairman, I know I have a red light there. Okay. Thank you. How would you summarize the evidence and information that has been gleaned so far? You don't have to—credibility, I understood we had 138 comments, and 135 were negative. But how would you assess the information gleaned so far?

Mr. KORB. Well, with respect to the 135, quite a few of them were identical comments. I think the best answer to your question is sitting on the panel here. Mr. Weller has 30 years of experience in this business. Okay? He was chairman of the ABA committee, wrote books. He has one view.

Mr. Levine has got 30 years of experience, chairman of some other ABA committee, wrote other books. He has got a different view. That shows you how tough this decision is.

Mr. GOHMERT. And that is your summary of what you have heard so far is, it is just tough?

Mr. KORB. I think it just points out, there are two sides to this. I think these gentlemen did an excellent job of summarizing both sides this afternoon.

Mr. GOHMERT. So thank you. So there are two ends to every horse; I appreciate that.

Mr. KORB. That is right.

Mr. GOHMERT. Thank you.

I yield back.

Chairman MANZULLO. Thank you.

Mr. Korb, we gave you a document on July 14th asking for documents relating to Treasury's research on the Regulatory Flexibility Act; do you recall that?

Mr. KORB. Yes, sir, I received a fax from your tax counsel.

Chairman MANZULLO. Right. You talked to our tax counsel, Mr. Westmoreland and Mr. Pineles.

Mr. KORB. I actually talked to both of them.

Chairman MANZULLO. Right. And did you not advise them that you were going to seek out these documents?

Mr. KORB. Absolutely.

Chairman MANZULLO. And I just received documents, but these are documents that were up on the Internet. They are simply the letters that are in favor or against the regulation; is that correct?

Mr. KORB. That is exactly right.

Chairman MANZULLO. Now, I call this a subpoena duces tecum. I gave you this thing instead of serving a subpoena thinking that you had given me documents, which you did not.

Mr. KORB. Were those indicated to be all that we were going to give you or just the first group of documents?

Chairman MANZULLO. Maybe you could tell me. Usually you have documents before you go to trial. You are an attorney. I would anticipate that when a committee chairman requests documents, that

you would bring those documents before the hearing. Would you not anticipate that?

Mr. KORB. We have been working expeditiously to respond fully. This effort—

Chairman MANZULLO. Come on. I have been waiting for you to go get the documents.

Mr. KORB. There are several different lawyers who have been responsible for this.

Chairman MANZULLO. Could you give me the names of the lawyers?

Mr. KORB. Our efforts—

Chairman MANZULLO. Mr. Korb, I am asking the questions.

Mr. KORB. Okay.

Chairman MANZULLO. What are the names of the lawyers who did the work on this?

Mr. KORB. The names?

Chairman MANZULLO. Yeah, who actually did the work on it. Because I guess I will have to subpoena them at a future hearing date.

And, Phil, could you give me a hearing date in September? I don't think we are done with this, and we will have to serve a subpoena to Mr. Solomon at that time.

Mr. KORB. The names of the lawyers listed here in the regulation, page 584 and 585, are—your tax counsel has access to this—A. Katharine Jacob Kiss and Rebecca Asta. They are the lawyers who are listed who worked on the—

Chairman MANZULLO. Are any of those people here? Are any of those people mentioned in the room today from the IRS? They are not here? Did you ask them for documents?

Mr. KORB. Well, here is the problem we have right now.

Chairman MANZULLO. No, the problem is, I am the one that asks the questions. All right?

Mr. KORB. I put in—

Chairman MANZULLO. You are the one that answers them.

Mr. KORB. Okay. Let me answer it.

Chairman MANZULLO. Go ahead and answer it.

Mr. KORB. We put in process as soon as that document arrived from Mr. Westmoreland and Mr. Pineles, whenever it arrived. Okay? Our efforts have been made extremely difficult by the—

Chairman MANZULLO. Get your wading boots.

Mr. KORB. By the flood. I have been frank with your staff from the very beginning. The moment that arrived, I told them it was highly unlikely that we would have those documents by today.

Chairman MANZULLO. What documents are there? Do you know?

Mr. KORB. I don't know.

Chairman MANZULLO. I don't think there are any.

Mr. KORB. We will find out.

Chairman MANZULLO. I really don't think there are any, Mr. Korb, and I will tell you why.

Mr. Sullivan, would you take a look at the attempt to comply with the RFA that appears on the page of the regulation which says, Initial Regulatory Flexibility Analysis. Do you see that?

Mr. SULLIVAN. Yes, sir, Mr. Chairman.

Chairman MANZULLO. Here it is on page 6, 234, and there is one paragraph at the bottom there. Then it goes to, I think the total is about three paragraphs. Is that correct?

Mr. SULLIVAN. The entire section entitled, Initial Regulatory Flexibility Analysis, appears to be about seven or eight paragraphs.

Chairman MANZULLO. All right. And it is pretty small. Is that correct?

Mr. SULLIVAN. It is about seven or eight paragraphs.

Chairman MANZULLO. Okay. And you said in your testimony it is up to the agency to come up with the data and to show what the impact would be and then for the entities to comment on the impact as opposed to the entities coming up and saying what the impact will be; isn't that correct?

Mr. SULLIVAN. Ideally, that is the way the process would work under the Reg Flex Act.

Chairman MANZULLO. Mr. Korb, did you have staff trying to find that? Trying to find that data? Or was this done under your control and supervision?

Mr. KORB. No.

Chairman MANZULLO. So you really can't answer that.

Mr. KORB. I really cannot.

Chairman MANZULLO. Mr. Solomon could.

Mr. KORB. I really can't speak for Mr. Solomon.

Chairman MANZULLO. That is why we needed Mr. Solomon here, and we are going to prepare a subpoena to have him here. I may have to bring in the new Secretary of Treasury to sit next to him also. Does that indicate to you, Mr. Korb, about the attitude of the Treasury, the fact that Mr. Solomon is not here?

Mr. KORB. No, not at all.

Chairman MANZULLO. Do you want to comment on that? You don't have to. If I could walk you through the written testimony, I appreciate that it is very thorough, Mr. Korb, on page 9.

Mr. KORB. Of my written testimony?

Chairman MANZULLO. Yes, sir. On page 4, where it says, the drafting process—this is your testimony.

Mr. KORB. Right, I am getting it.

Chairman MANZULLO. Page 4, where it says, the drafting process.

Mr. KORB. This is in general. This is how the process works. Remember, I wasn't at the Service during most of this.

Chairman MANZULLO. I understand, I understand.

Mr. KORB. So all I can do is tell you how it would normally work.

Chairman MANZULLO. I appreciate that. It says: "Chief Counsel staff identifies the issue in each regulations project and makes recommendations for possible solutions." Then it says, last sentence of the paragraph, "If an IRFA must be prepared"—and your testimony goes back and forth as to whether or not there was in fact any obligation on behalf of the IRS to prepare anything.

Mr. KORB. No, no, that is not true. That is not true at all. As Chief Counsel Sullivan said, in this particular case, the Service recognized the need to prepare, and they did. In fact, you said that in your letter to me as well.

Chairman MANZULLO. This may be the first time at least that I know of that the IRS even attempted to comply with the Regulatory Flexibility Act.

Mr. KORB. In your office, Congressman, I told you things are going to be different with me.

Chairman MANZULLO. This is not a training ground. This is not a school. This is a hearing before the United States House of Representatives Small Business Committee as to whether or not at least 350 companies are going to be wiped out. And that is why we asked you to withdraw this regulation and start all over again, because you admit that it is far from perfect. In fact, your testimony says: "If an IRFA must be prepared, the drafting team researches the population of small businesses that would be affected, the cost the regulations would impose and whether less burdensome alternatives exist."

Now, if I take you to page 6, 234, I don't really find any of those three items except the attempt to say that all you had was 200 or 300 of these qualified intermediaries. There is nothing there that talks about the cost the regulations would impose or whether less burdensome alternatives exist. And by your own statement, you say that this is what you must put in the IFRA.

Mr. KORB. Let me see here. Let's go through it. The first thing is, we have to determine, we have to research the population of small businesses, and so what they did is they called up FEA and got a number. The FEA represented that was 80 percent of the industry.

Chairman MANZULLO. I understand that.

Mr. KORB. That is 325. That is in there.

Chairman MANZULLO. Can I stop you right there?

Mr. KORB. Sure.

Chairman MANZULLO. No, go ahead and finish.

Mr. KORB. Then the cost the regulations would impose. What they did, which you can ask Chief Counsel Sullivan, is an appropriate way to respond when you don't have the right data in your IRFA. It says comments are requested on the nature and extent of the economic burden imposed on small entities by these rules.

Chairman MANZULLO. But you are supposed to have that in your document. You don't get that from comments. What you do is you sit down with the different parties and figure out what this is going to cost. Then that goes into your IRFA. You do not have that in there.

Mr. KORB. Well, Mr. Sullivan's pamphlet here that we used to comply with this indicates that if you can't get that information, one way to get at it is to—

Chairman MANZULLO. But you don't know if it was ever asked.

Mr. KORB. Personally, you are exactly right.

Chairman MANZULLO. Mr. Solomon would know that, and he is not here to testify.

Mr. KORB. I cannot speak for Mr. Solomon.

Chairman MANZULLO. Mr. Solomon can't speak for himself either.

Mr. KORB. On whether less burdensome alternatives exist, there is a paragraph. It's the fourth paragraph in and lists alternatives

as I indicated to you in my letter of June 10th. Maybe we could have done a better job of talking about other alternatives.

Chairman MANZULLO. I think you could have done a better job altogether on this thing.

Mr. KORB. I do not disagree with you.

Chairman MANZULLO. These small businessmen who have come to me as a last resort because there isn't one person in this town that will listen to them and will touch this issue. Desperate to save their family businesses. Don't you think you owe it to them to give them your highest and best and most educated and most scholarly IFRA before you go any further with this?

Mr. KORB. We are going to do it. No doubt about it. And I told your tax counsel absolutely—

Chairman MANZULLO. But it should be in this document. You should have the facts before you draw the regulations. You should know the impact before you draw the regulations.

Mr. KORB. We can't change what has already happened.

Chairman MANZULLO. Yes, you can. You can withdraw this piece of junk. Mr. Sullivan called it garbage in and garbage out. You sit there and say that the IRS has failed to follow the law. You have failed miserably.

Mr. KORB. I did not say that.

Chairman MANZULLO. You did, too.

Mr. KORB. No, I did not.

Chairman MANZULLO. Let me read your letter. I disagree with you, Mr. Korb, but you are honest. That is good, because you make no qualms as to what happened—

Mr. KORB. I have the letter right here.

Chairman MANZULLO. All right your July 10th letter states: "I am writing to follow up on our meeting of June 27th, 2006, and your letter dated May 8, 2006, regarding proposed regulations. At our meeting, you expressed concern about the Initial Regulatory Flexibility Analysis, IRFA, prepared with respect to these proposed regulations. At the meeting, I told you I would review the IRFA in order to make my own evaluation of whether it did in fact comply with the requirements of the RFA. After looking into the matter, I have concluded that the IRS and Treasury Department made a good-faith effort to comply with the Regulatory Flexibility Act and that the IRFA that was published with the proposed regulations was technically in compliance with the law. Nonetheless, I have also determined the IRS and Treasury Department could have done better with respect to certain aspects of the IRFA. For example, regarding industry size standards, you suggest we should have used NAICS 523991—that is what we suggested in my letter to you, that the size standards be determined by trust, fiduciary and custodial activities—rather than NAICS 531390 relating to real estate related services, such as escrow services."

You know that half of these 1031 exchanges involve personal property? Were you aware of that?

Mr. KORB. I have been told that, yes.

Chairman MANZULLO. But what you used here was NAICS 531390, relating to real estate related services, such as escrow services. What is at stake here is you don't even know the players that are impacted.

Mr. KORB. But they still came up with the 320.

Chairman MANZULLO. That is the group here. But there is another group that Mr. Levine came up with. And Pam Olson, who was at Treasury, when she testified—I believe it was on June 6th—on page 4 of her testimony, she says: “The true small business interests are the individuals and businesses who rely on the services of a qualified intermediary to effect their 1031 exchanges.”

So it is the customers. Do you know how many people are impacted by this besides these qualified intermediaries? Did it ever occur to you that it would be the people who were involved in the like-kind exchanges that would be in the population that would be impacted?

Mr. KORB. I think Mr. Levine mentioned that this morning. Although, I would point you to page 20 of Chief Counsel Sullivan’s pamphlet here which notes—and again, we are just following the pamphlet that was put out—that the courts have held that the RFA requires an agency to perform a regulatory flexibility analysis of small business impact only when the rule directly affects them.

Chairman MANZULLO. That is correct. I would think that, if you are an investor and you may have to go 200 or 300 miles to find a qualified intermediary, a qualified intermediary might charge you more because the market has been narrowed down to one or two or three qualified intermediaries throughout the country. That those would be impacted people.

Mr. KORB. Congressman, you raise an interesting point here. In preparation for this hearing, I went through all the comments again before the package was brought up for you. I found a letter from a lawyer in Philadelphia from Ballard Spahr—I don’t know him—Ted Hirsh. His letter is very interesting. What his letter says, he talks about the number of letters going back and forth and whole history—

Chairman MANZULLO. Does this relate to the question of the investor?

Mr. KORB. Yes, absolutely. Absolutely. What he basically says is: A pox on both your houses; if Congress was really interested in small business, they would change the law so that you could do a rollover like-kind exchange and you would not need to pay any of these fees, which I thought was an interesting proposition, and that would clarify—

Chairman MANZULLO. You can share that with Mr. Thomas, because we are not the committee that determines that.

Mr. KORB. I thought that was interesting.

Chairman MANZULLO. It is interesting, because the question is—

Mr. KORB. I think it relates to this question; doesn’t it?

Chairman MANZULLO. My question to you is, in your attempt to come up with a new RFA, are you going to be looking at impact on the investor?

Mr. KORB. I can’t sit here and tell you—

Chairman MANZULLO. Mr. Korb, you can do that. We are looking at the population. The purpose of this hearing is to review your fulfillment of the RFA.

Mr. KORB. We will do whatever is required by the law.

Chairman MANZULLO. No, that is not sufficient. That really isn’t sufficient.

Mr. KORB. That is all I can tell you.

Chairman MANZULLO. But that is the whole point. That is the whole point. I am going to ask you right now, do you have a way of knowing who all of these investors are that made the like-kind exchanges?

Mr. KORB. No, I don't.

Chairman MANZULLO. You don't? The IRS has no way of knowing that?

Mr. KORB. Not that I am aware of.

Chairman MANZULLO. Do you know what a Form 8824 is?

Mr. KORB. Actually, I have a copy of that.

Chairman MANZULLO. Yeah, why don't you tell us what that does? You know what it does; don't you?

Mr. KORB. What?

Chairman MANZULLO. Form 8824.

Mr. KORB. Yes, I know. You want me to read it.

Chairman MANZULLO. You don't have to read it. Just tell us what it does.

Mr. KORB. It is a reporting form that is used to report, I guess, like-kind exchanges.

Chairman MANZULLO. Right. Everybody who does that, whether it is real estate or personal property, has to file one with the IRS. Isn't that correct?

Mr. KORB. Right. Let me go through this here.

Chairman MANZULLO. You don't have to because you have already answered my question.

Mr. KORB. No, I did not.

Chairman MANZULLO. Yes, you did. Let me ask the questions; all right? The next question is, how many—do you have a way to quantify how many people filed Form 8824?

Mr. KORB. Yes, I do.

Chairman MANZULLO. That is pretty simple, isn't it?

Mr. KORB. That is what I was going to tell you. In 2003, 236,073 of these forms were filed. But that does not present an accurate picture of the number of transactions. Taxpayers must file the form for 2 years after the transaction is completed. Some portion of the forms filed in 2003 reflect transactions that occurred in 2000 and 2001. Taxpayers who have more than one exchange per year may file a summary form—

Chairman MANZULLO. I understand. Mr. Korb, what I am telling you is, there is a sizable population out there, isn't there?

Mr. KORB. Sure sounds like it.

Chairman MANZULLO. You do not know whether it is 100,000 or 200,000. And Pam Olson, what was her position before she left the IRS?

Mr. KORB. She was at the IRS about 20 years ago. I think she was the assistant to the chief counsel.

Chairman MANZULLO. No, she was there recently.

Mr. KORB. No, she wasn't.

Chairman MANZULLO. I'm sorry, Treasury.

Mr. KORB. At Treasury, I think she was, I think, assistant secretary.

Chairman MANZULLO. And the fact that she says that this is a significant population that should be examined, don't you find that to be of interest?

Mr. KORB. I suppose.

Chairman MANZULLO. Okay. And then the fact that Mr. Levine says that these are important people. Wouldn't you agree that they are impacted?

Mr. KORB. I am not going to sit here and tell you that until I think about it.

Chairman MANZULLO. I tell you what, why don't you think about it? How much time do you need? What does it take to get you to say you are going to do everything you can to make a thorough analysis as possible?

Mr. KORB. I told you that three times.

Chairman MANZULLO. I understand that, but I ask you these questions, and you say—

Mr. KORB. We are going to do what is required by the law.

Chairman MANZULLO. Required by law. How about doing what the community out here requires? How many out here—raise your hands—would like to see as part of the population examined on the impact the people that do the investing? Raise your hands, everybody in the audience. I think that is pretty significant. Mr. Levine, you would like to see that also; wouldn't you?

Mr. LEVINE. Do you mean in terms of the RFA?

Chairman MANZULLO. Both.

Mr. LEVINE. I am not an expert in the RFA, but yes, I do think that investors will benefit, will absolutely benefit—

Chairman MANZULLO. That is your opinion, and I appreciate that. But there should be an analysis as to that; shouldn't there?

Mr. LEVINE. I am not an expert in the RFA, Congressman. I can't answer that.

Chairman MANZULLO. Mr. Sullivan?

Mr. SULLIVAN. We are talking about what the Regulatory Flexibility Act requires and the chief counsel at the IRS was correct. By law and the way the courts have interpreted it, it does require only the analysis of those most directly impacted by a proposed rule.

Now, different question, would it be nice to inform commenters on how this may foreseeably and reasonably impact customers and consumers? Those are nice things to also have. The Reg Flex Act does not legally require it, but it is nice to have in an initial regulatory flexibility analysis.

Chairman MANZULLO. Don't you feel that a person who is a customer who may end up paying a higher rate of interest would be somebody who is directly impacted by this regulation because of lack of competition?

Mr. SULLIVAN. Actually, I think the regulation specifically and directly impacts QIs, and their customers are secondarily impacted.

Chairman MANZULLO. But they are also impacted by RFA. That is a pretty narrow—

Mr. SULLIVAN. I don't know how the court would interpret—

Chairman MANZULLO. I don't care about the court. I helped draw the law.

Mr. SULLIVAN. I know that the law requires those that are directly impacted, and there are actually bills in the House and Sen-



ate that extend that to require analysis for those reasonably foreseeable—

Chairman MANZULLO. Do you see under these circumstances, as Mr. Weller says, you could end up with a handful of companies nationwide that are the only QIs left?

Mr. SULLIVAN. Mr. Chairman, from a pragmatic perspective, it would be good to have a more full-blown analysis of those directly impacted. You walk before you run, I guess. And then, ultimately, I would love to work with Chief Counsel Korb and others to see if we can go even further and look at those in future rulemakings that impact secondary impact. For the time being, the law does require the analysis of those directly impacted by the rule.

Chairman MANZULLO. Let me continue with Mr. Korb's letter of July 10th. So you are going to look at whether or not you used the right NAICS code; is that correct?

Mr. KORB. To be honest with you, I need to talk to Counsel Sullivan to understand the full impact of that. As I see it, the fact that they came up with the 325, that is just the way to get to the 325. But maybe I don't fully understand how the law works.

Chairman MANZULLO. As a person who has worked with that law, and I appreciate Mr. Sullivan's thinking, I think the impact on the taxpayer should be considered. It isn't just the qualified intermediaries; the taxpayers are the people who are doing the exchanges. I don't think it is a stretch of the imagination or the regulations to take into consideration the impact on everybody involved in these transactions. There are the only three parties, the big guys, the little guys and the investors.

Mr. KORB. Is there an NAICS Tax Code for taxpayers? I don't know if there is or not.

Chairman MANZULLO. Excuse me? These are all taxpayers, somewhere along the line. Everybody in here pays taxes.

Mr. KORB. That is why I am confused.

Chairman MANZULLO. I don't think you are confused, Mr. Korb. I am trying to get some straight answers. My question is, it may be more appropriate to use some kind of a composite—

Mr. KORB. Uh-huh.

Chairman MANZULLO. Which means the population that is impacted by this.

Mr. KORB. Could be. Again, this came out of Chief Counsel Sullivan's—

Chairman MANZULLO. No, this is your letter.

Mr. KORB. But I turned to his book for the guidance. Those are the rules that we are trying to follow.

Chairman MANZULLO. I understand that. Now what type of composite would you use?

Mr. KORB. I don't know.

Chairman MANZULLO. Continuing with your letter: "Similarly, you raised questions about the accuracy of our estimate of the number of small businesses in the qualified intermediary industry. In preparing the IFRA, we arrived at our estimate of 325 businesses affected based on information provided to us by the Federation of Exchange Accommodators. Testimony at the hearing held on June 6th suggests that there may be more than 325 small busi-

nesses in the QI industry. We are going to research the matter further."

How are you going to do that?

Mr. KORB. I don't know how we are going to do it. But the story changed a little bit, so we thought we better follow up and make sure we had the right number here.

Chairman MANZULLO. Continuing with your letter: "You also criticized the IRFA for failing to discuss alternatives." There are none in the proposed regulations.

Mr. KORB. The IRFA alternative.

Chairman MANZULLO. One alternative is to do nothing. Continuing with your letter: "Although the IRFA discussed the alternative of retaining the facts and circumstances test under the 1999 proposed regs, we agree that other alternatives could have been explicitly addressed." What would they be? You are admitting here that you could have discussed—but you did not do it.

Mr. KORB. And we will do that.

Chairman MANZULLO. You don't understand. It was supposed to be in this document. I mean, your own guideline says to put it in this document.

Mr. KORB. We are going to.

Chairman MANZULLO. I have it right here. It is not here.

Mr. KORB. I am following—

Chairman MANZULLO. Don't say that you are following the law, because you are not.

Mr. KORB. I am going to follow what Chief Counsel Sullivan—

Chairman MANZULLO. Don't go to him on that. I understand he is the expert on it. But this is very simple. The alternatives are supposed to be in here.

Mr. KORB. They are going to be in the IRFA.

Chairman MANZULLO. In where? Are you going to have another one?

Mr. KORB. I told your tax counsel—

Chairman MANZULLO. Tell me.

Mr. KORB. There is going to be another one.

Chairman MANZULLO. When? What, when you publish the final regulations? Attach it to that at the time when nobody can do anything?

Mr. KORB. Ask Mr. Westmoreland what I told him. I said we are going to publish a revised IRFA.

Chairman MANZULLO. When?

Mr. KORB. Not in the final regulations. Before we turn to the final regulations. I made that very clear to him.

Chairman MANZULLO. Say that again, because that is good.

Mr. KORB. I will read it to you. Bear with me. This is to confirm that as communicated to your chief—

Chairman MANZULLO. What are you reading from? Could you identify what the document is?

Mr. KORB. It is just a draft.

Chairman MANZULLO. It is a draft? Was it sent to us?

Mr. KORB. No, it wasn't sent to you.

Chairman MANZULLO. You are a lawyer. Tell us what you are reading from.

Mr. KORB. It is a draft.

Chairman MANZULLO. Of what? A draft of what?

Mr. KORB. Of this statement.

Chairman MANZULLO. What statement?

Mr. KORB. The statement I am going to read to you right this minute. This is to confirm that as I communicated to your chief tax counsel, John Westmoreland, last Friday, I have determined that we will prepare a new IRFA for this regulation project to ensure that we obtain as much information as possible about the effect of these regulations on small qualified intermediaries. This analysis will be published before any decisions are made about the substance of the final regulation. As I told John, I have already directed my staff to begin this analysis.

Chairman MANZULLO. All right. Are you open that they would take a look at the taxpayers, the people that are exchanging the property?

Mr. KORB. I am open for them to look at whatever is necessary.

Chairman MANZULLO. Continuing with this letter: "We will expand our discussion of alternatives in the next IRFA or in the final Regulatory Flexibility Analysis that we will publish in connection with this regulation project.

"Lastly, you chastised us for failing to provide an estimate of the costs of complying with the proposed regulation. We acknowledge the responsibility to do so either in the revised IRFA or in the final RFA for this regulation project and will provide an estimate of those compliance costs at that time. As you can see from the text of the Preamble to the proposed regulations, because we were unable to develop a reasonably reliable estimate of the compliance costs when we published the IRFA, we requested comments regarding the nature and extent of the economic impact on small entities, which we will carefully consider when working on this regulation project."

You are at a disadvantage because you were not intimately involved in the drawing of these regulations or in the RFA; is that correct?

Mr. KORB. I appreciate you for making that point.

Chairman MANZULLO. Okay. All right. That could account for some of your evasive answers.

Continuing with your letter: "I would like to thank you for bringing to my attention your concerns regarding the adequacy of the IRFA relating to these proposed regulations. As I told you during our meeting on June 27, I commit to you that we will take appropriate steps to address them along with the other comments that we received, either in a revised IRFA or in the final RFA."

Now, your letter is different from what you told me just now when you read from that draft of a statement.

Mr. KORB. That is exactly right. This letter was sent on June 10th; I read the statement today.

Chairman MANZULLO. I appreciate that.

Continuing with your letter: "Also, as I discussed with you are at our meeting, we are undertaking a training program at the IRS concerning the requirements of the Regulatory Flexibility Act to ensure that those requirements are adhered to."

Why are you having a training program?

Mr. KORB. As I told you when I met you in your office, I had lunch on May 25th with Chief Counsel Sullivan, and we talked about putting together a program to make sure that we do a better job with these. So that was already in the works when I came.

Chairman MANZULLO. You are the IRS. You have 2,433 employees working for you; of which, 1,550 are lawyers.

Mr. KORB. Right.

Chairman MANZULLO. Right. That is in your written statement. You mean to tell me that you have to bring in somebody from the SBA to tell you how to comply with the law when you have all those lawyers working with you?

Mr. KORB. He offered.

Chairman MANZULLO. That is because you needed it.

Mr. SULLIVAN. Mr. Chairman, we have trained personnel at IRS a few years ago on RFA, and we actually welcome the opportunity to train more in the regulatory process over at IRS. So the chief counsel is right. We did offer, and we would actually prefer to go and help train rather than them doing it themselves.

Chairman MANZULLO. Mr. Sullivan, when was RFA passed?

Mr. SULLIVAN. 1980, and it was amended to be judicially reviewable in 1986.

Chairman MANZULLO. That is SBRFA. So since 1980, the IRS has had the opportunity to develop protocol, training, in order to follow a law that was specifically passed to help the little guys, and now you need training courses?

Mr. KORB. I just took the job 2 years ago. I can't speak for the last 25 years.

Chairman MANZULLO. That is a good answer, Don. I appreciate that.

I guess what really bothers me—first of all, I want to commend you for your candor. I don't really like some of your answers, but at least you are here. You are answering questions I think to the best of your ability, and I appreciate that. Thank you for coming.

But the fact that Mr. Solomon isn't here, who could answer these questions, that bothers me to no end. Because this is a committee process, and we have a process here. It is called oversight. And every day, we have little guys that come to us that have been killed by the federal government. I could take you into medicine, little people that come in our office and they bang on the door and say, Mr. Chairman, would you help me because there is nobody here who is advocating on our behalf?

That was the purpose, and continues to be the purpose, of the Regulatory Flexibility Act. There are a lot of little people out there that need some protection because they don't have lobbyists of the nature that the big guys do. Sometimes they get together, but it is on an ad hoc basis as opposed to a continuum.

What is Executive Order 13272? You made reference to that in your main testimony.

Mr. KORB. Yes, I did. I guess that would be better directed to Chief Counsel Sullivan, I think.

Chairman MANZULLO. Go ahead. I think you did answer. It is in the first—Mr. Korb, it is on the first full paragraph of page 6.

But Mr. Sullivan, if you want to take a whack at that, go ahead.

Mr. SULLIVAN. Executive Order 13272 is the proper consideration of small entities in agency rulemaking.

Chairman MANZULLO. Okay. And in Mr. Korb's language, it says it seeks to minimize, consistent with statutory requirements and sound regulatory policy, the compliance and paperwork burdens of all regulations on small businesses, small not-for-profit enterprises and small governmental jurisdictions. I mean, that is—do you know why that was given, Mr. Sullivan?

Mr. SULLIVAN. Yes, actually, I do.

Chairman MANZULLO. You drafted it, didn't you?

Mr. SULLIVAN. The President drafted it and signed it, and I am happy that it was intended to give new attention to the Regulatory Flexibility Act. The reason that the President signed the Executive Order was an acknowledgement that the Regulatory Flexibility Act maybe isn't working as well as it could, and so this certainly brings the RFA to the attention of agencies.

It also actually tasks my office with training government agencies on how to comply. And this is I guess more responsive to your last set of questions, Mr. Chairman. Not only is it a good idea for the Office of Advocacy to train agency personnel on how to comply with the Reg Flex Act; the Executive Order in fact requires us to. And so we have been doing that. And we welcome the opportunity to train more staff at IRS.

Chairman MANZULLO. Well you have listened to the letter that Mr. Korb sent and to his testimony saying that the IRS could have done a better job. How many people are qualified intermediaries? Raise your hands. All right. Where did you guys all come from, just tell me. These people are from everywhere here. They did not come here by happenstance. They came here because their businesses are severely threatened. And their message to you is that you really have to go back and start all over again.

You have an alternative don't you? You could withdraw this regulation and start all over again; couldn't you do that? Mr. Korb?

Mr. KORB. It is not our practice to withdraw regulations.

Chairman MANZULLO. I don't care what your practice is. You could do that. You could withdraw the regulation and start all over again. Could you answer my question?

Mr. KORB. I guess we have the authority, yes.

Chairman MANZULLO. Okay. And whenever you have a document that is based upon— we could do better, we have to go to school, you could have looked at a different population, we promise that we will follow the law— whenever you have a document that is based upon an admittedly imperfect analysis, would you not want to start all over again?

Mr. KORB. We are going to start all over again with the IRFA.

Chairman MANZULLO. That is a good place to start. You start with the IRFA, then you see the impact that these regulations may have on small businesses.

Mr. KORB. That is the way the system is supposed to work.

Chairman MANZULLO. Are you going to have a revised proposed rule?

Mr. KORB. No.

Chairman MANZULLO. You are going to have a new IRFA before a revised proposed rule?

Mr. KORB. We will have a new IRFA. That is right.

Chairman MANZULLO. Before a revised proposed rule?

Mr. KORB. We may not have to revise the rule. The rule isn't final. As I explained in my testimony, this is a process that is going on.

Chairman MANZULLO. You have that authority.

Mr. KORB. Authority; what?

Chairman MANZULLO. To keep the same rule and do a new study. But you also said that before any—

Mr. KORB. Yes, that's right.

Chairman MANZULLO. —before any regulation would take effect, that you will file an IRFA; right?

Mr. KORB. That is what I said. I think there is some real misinformation here.

Mr. MANZULLO. What is that?

Mr. KORB. I think these people feel that this rule is effective right now, and that is not true.

Chairman MANZULLO. Do you know what the impact of that rule has been out there? Mike, why don't you tell us. Listen very closely to what the impact of this rule has been.

Mr. HALLORAN. From a practical business perspective, the impact of the rule is to try and evaluate whether or not there are any alternatives, should the rule go final, to our business continuing on.

Chairman MANZULLO. I am talking about the big guys trying to buy the little guys out.

Mr. HALLORAN. That has certainly happened, although I have not personally experienced it. A number of banks have approached qualified intermediaries saying, if 468B went through, they should be rolled up and bought by the bank. And that has been a relatively common occurrence from what I understand.

Chairman MANZULLO. Have you heard that before?

Mr. KORB. Yes, you told me that.

Chairman MANZULLO. Would that be of significance to you in the IRFA, the fact that the population we agree upon is the center of this may have the big banks threaten them to buy their book?

Mr. KORB. I am a tax lawyer. I am not a regulatory lawyer.

Chairman MANZULLO. Yes, but, I—

Mr. KORB. I am learning. Congressman, Mr. Chairman, it is very difficult for me to tell you what is going to be done specifically in this new IRFA. All I can commit to you is it is going to be done correctly. I am going to be personally involved, and so we are going to get it right. That is all I can commit. I can't tell you what we are going to look at exactly. Can't do that right now. I just don't have the knowledge to be able to do that.

But I have got some good help here with Chief Counsel Sullivan. We have, as I committed to you, we have a program being developed to make sure that something like this does not happen again.

Chairman MANZULLO. Well, it is extremely unfortunate, because with this regulation hanging out there, there are big banks out there that are buying up these little guys. And I guess the premise is, if you don't sell now, you may not have anything left after the regulation goes into effect. Is that right, Mr. Halloran?

Mr. HALLORAN. I don't know of any transactions that have actually transpired, but certainly, there is a conversation regarding should this go final.

Chairman MANZULLO. Is there anybody in the audience who could tell us personally about that? Yes, sir, stand up and give us your name. Sit in Mr. Solomon's chair. Finally, we will have somebody there. And you remove that. You want to sit down and give us your name and who you are. I guess that is the same thing; isn't it? The name of the company you represent.

Mr. DANCE. Richard Dance from Seattle, Washington.

Chairman MANZULLO. How do you spell your last name for the record?

Mr. DANCE. D-A-N-C-E.

Chairman MANZULLO. And you came all the way out here for this hearing?

Mr. DANCE. Yes, I just received a letter 2 days ago asking if I wanted to be bought out. There is a concerted effort, and I will introduce the testimony, I brought it, not intending to use it, but I could find it for you. It came probably to quite a few of us as QIs just 2 days ago.

Chairman MANZULLO. You own a QI, Mr. Dance?

Mr. DANCE. Yes, I do.

Chairman MANZULLO. What is the name of it?

Mr. DANCE. The name is 1031 Exchange Coordinators. And I actually brought one 11-by-17 sheet on it in which I have tried to carefully explain the quantitative and numeric impact of everything that I see coming as a result of this particular rule.

Chairman MANZULLO. How many employees do you have?

Mr. DANCE. I have eight.

Chairman MANZULLO. Go ahead.

Mr. DANCE. I am looking for the particular letter. It is right here.

Chairman MANZULLO. And who wrote the letter to you?

Mr. DANCE. Looks like an investment group, Elan, USA, Inc., investment group.

Chairman MANZULLO. How do you spell that?

Mr. DANCE. E-L-A-N, USA, Inc.

Chairman MANZULLO. Do you want that made part of the record?

Mr. DANCE. Certainly.

Chairman MANZULLO. Okay. Without objection.

Mr. DANCE. I am writing at the request of one of my clients who has embarked on a plan to consolidate qualified intermediaries into a vertically integrated company.

He goes on: The acquisition is currently ongoing. He has very specific design criteria in evaluating the viability of companies that are acquired. It allows principals to continue operating the company for a term favorable and desired by the QI owner. Each acquisition will close quickly within 30 days.

It goes on: So the idea is, let's get them now while you can. I have been authorized to evaluate each interested QI and will do so under a confidentiality nondisclosure. If you would consider a purchase of your company, please contact my office immediately.

Chairman MANZULLO. Who signed the letter?

Mr. DANCE. Mitchell—and I can't pronounce his last name—V-O-Y-N-O-V-I-C-H.

Chairman MANZULLO. Where is he from?

Mr. DANCE. Florida.

Chairman MANZULLO. Phil, would you issue a subpoena? I want him here at the next hearing. I want to know who he is representing.

Mr. LEVINE. Congressman, may I make a comment?

Chairman MANZULLO. Yes.

Mr. LEVINE. Two points. One, until you read that, I was under the impression you were telling us that he received a letter from a bank. How do you know that investment banker was representing a bank?

Chairman MANZULLO. Who do you think it is?

Mr. LEVINE. I have been involved—I will tell you—I have been involved in transactions for some nonbank QI clients where they have been looking to acquire other banks. If you take a look, Congressman, at some of the prices that have been paid for some of the acquisitions, not by banks, just where some nonbank QIs have been acquiring banks over the last few years, irrespective of those regulations, they have been tremendous values. Tremendous prices that have been going in the marketplace. They have nothing to do with banks.

Chairman MANZULLO. I am just saying that the testimony here is that the only ones who will be left are the banks.

Mr. LEVINE. The testimony is incorrect.

Chairman MANZULLO. Mr. Weller, in paragraph 6 of your two-page testimony, you said that these regulations are so written that, in the end, the only QIs that will be left are the banks; is that correct?

Mr. WELLER. I don't think I go that far, no. My view is that the large companies which can aggregate capital either by big banks or being able to make money on large aggregations of capital can survive. I cast it more as big versus little rather than banks versus nonbanks. Banks I believe are the most likely survivors, but not just banks.

Chairman MANZULLO. This could be a bank or a big bank. Maybe we should write and find out whom he is representing. I think this is significant.

Mr. DANCE, what is the significance of these big guys trying to buy out the little guys? What does that mean to you or anybody else here?

Mr. DANCE. You have to consider: Do I want to sell out now, or do I want to keep with my employees? What is going to happen? I would like to give this to you also. I tried to go through on the nuts and bolts of what it daily means to me to abide by these regulations. I have gone so far and tried to figure out, how many bank accounts do I need to open?

Chairman MANZULLO. Go ahead. I think that is significant for the Regulatory Flexibility Act.

Mr. KORB. It might be significant for the underlying rule.

Chairman MANZULLO. That is correct.

Mr. KORB. Did you testify at the hearing?

Mr. DANCE. Yes, but I have worked on it since then.

Mr. KORB. Have we received that?



Mr. DANCE. You received the original. I would be happy to give you—

Mr. KORB. You should. You should supplement that.

Chairman MANZULLO. Could you give Mr. Korb a copy of that today? If you want to share some highlights on that, go ahead.

Mr. DANCE. If I could please pass it out, I have a hundred, I have enough for everybody.

Chairman MANZULLO. Staff will pass it out. Go ahead. Mr. Dance, why don't you talk? Mr. Dance, they will take care of that. Why don't you sit down and tell us about the impact of this proposed regulation on your small business.

Mr. DANCE. Yes, and I don't speak for anybody but myself. I try to be—

Chairman MANZULLO. I understand. I will give you 5 minutes.

Mr. DANCE. Thank you. I tried to look primarily at the impact on banking, accounting and systems, and then tried to go a little bit further and even give some possible solutions for me and my company, not speaking for anybody else. On the upper righthand corner, you see I have a quick index that is indexed to everything that is there. And, basically, what I say as an overall assessment is that we have about twice the workload with half the revenues to get the job done.

Now, in a lot of cases, there is a lot more to be done. But basically, the impact, if you are to look at banking, we obviously need to set up a separate bank account for all clients. I am not saying that is necessarily bad, except right now, one of our great tools to help our clients is to know that we have got all the funds in the bank. And the way to make most of the banks set up right now, if you set up all of these individual accounts, you have no way to know what your total is. Very few banks have that opportunity to tell you other than once a month what your total is. I don't rely on that total in the bank daily. I know what we have in the bank right now as we are speaking. I know if there is anything leaving. That is a great source of help.

We need to maintain thousands of accounts and subaccounts, and I try to explain in here how some clients have two exchanges going at the same time. If you were to code that into separate bank accounts, they don't allow you to transfer it. You, basically, in the banking, end up—if you turn to page 2—our bank on the top line there, Frontier Bank, and says, basically, opening accounts. That was in color; would be in yellow. It is a hassle to open accounts because you have to follow the PATRIOT Act. You can't just open it any way you want.

Chairman MANZULLO. I voted against it.

Mr. DANCE. Thank you. If you look at reconciling accounts, there is no way we can reconcile individual accounts. We can't print blank checks if we set up separate accounts for all of these clients. Interest, they can't compute the average daily balance being requested by the IRS, and there is no way to allocate any miscellaneous charges, and so I have to change banks. I took a look at five or six other banks to see if it would be easier, if the big banks are better. And they read faster than you can speak.

Mr. DANCE. But, basically, I have said, I have got to change banks, and I don't know if this will be any easier or better.

When I go to section—page three, on the accounting consequences, I say, well, maybe I want to stay with the bank; maybe I can just do this on a spreadsheet. And I figured out that I am being asked to do about a million transactions, calculations a year on a spreadsheet. That is a disaster. And there is no way, if I do my internal accounting on any sort of spreadsheet, it will ever be possible because there are such simple things as timing differences. I have an illustration here. When we get a check written on April 28th for a million dollars, it comes to us on May 1st. It doesn't get deposited until May 2nd. If I have my own internal accounting system, what do I do with the float? The same thing when I send a check out. My accounting system would not agree with the interest the bank had. So little things like that I tried to point out just so you could realistically see here is what the impact of this is

The other thing I tried to point out is that in exchange—you say you only have an account open for a period of time, but we get holdbacks. We get releases. We get things sometimes months and months and months after an exchange has ended that, rightfully blind to the clients, that we have to keep their account open. Well, do we track interest on \$2? We have got \$20. We have got \$400. We got—there are all sorts of things that, by reading this, I think you understand the predicament we are in.

If you turn to the back page, the last page, I try to say, okay, let's assume that we changed banks. We realized that we couldn't do it internally, let's go out and buy a system. I actually employed a firm, a very reputable systems firm, to go out and make a system analysis all over the United States. I told them, no holes barred, I want to know what is out there because if I have these go into effect on the date they are published in the Federal Register, I have got to have a new system. They came back, gave me a short list, which I have given you here, and basically said the cheapest one would be \$10,000, and most of them would require \$75,000 to \$100,000 just for the customization. And we, as QIs, are used to spending about \$750 to \$1,000 for a system, not \$10,000, not \$50,000, not \$100,000.

And so it came down to solutions, and I said, whatever we do has to greatly reduce the volume of work and the interest loss being required. Whatever we do, if we reduce the volume of the work and the interest loss being required by the present regulations, we would be making some forward progress. And I tried to tender five ideas just that would help us as a personal firm in there for what can happen and said, you know, like a threshold period of time. You see in the chart below, the days and exchanges open for us is only 53 days. Within 53 days, we have opened an account. We have done all the work. We have written all their checks. We have sent everything back. We sent their money back to them, and their new replacement property they are buying, and except for all the holdbacks and anything like that, it is pretty much done. So if we can have some—

Chairman MANZULLO. Richard, I don't have time to go through all five, but I will make this part of the record.

This is very meaty. This is the type of stuff that—I can't speak for Mr. Korb, but I do know it is the type of stuff he will consider.

Mr. KORB. Absolutely. These are good ideas. This is exactly what this system is, this process is supposed to produce. The system is working; the process is working.

Chairman MANZULLO. Well, I don't—Don, come on. I mean, I saw your letter. I mean, it is—

Mr. KORB. The right process is working. This is great for us to consider.

Chairman MANZULLO. Do you know what saves the day for you? It is your honesty.

Mr. KORB. I am what I am.

Chairman MANZULLO. You bet, you bet. And I appreciate that.

But, Richard, I have one more question for you. Are you saying that you have to make these changes but the large banks do not? The banks are already set up for that?

Mr. DANCE. I don't know. I tried to say the impact—

Chairman MANZULLO. This is just for you.

Mr. DANCE. So, realistically, what is the real impact on one QI without—

Chairman MANZULLO. With how many employees?

Mr. DANCE. Eight employees.

Chairman MANZULLO. And, obviously, a larger institution could absorb these costs a lot easier than you can.

Mr. DANCE. I assume so, but I was just working on myself.

Chairman MANZULLO. You sound like Mr. Korb there.

Mr. DANCE. Remember, I am taking Mr. Solomon's place.

Chairman MANZULLO. Well, you have more wisdom than Mr. Solomon, I can tell you now.

I am going to make this document from Elan USA, Inc., part of the record. I think we can send them a letter asking them whom they are representing, and they will probably say it is none of your business. That may be the case. All we can do is ask.

[Mr. Dance's testimony and letter may be found in the appendix.]

Chairman MANZULLO. I am at the end of the questions that I have here. What I would like to do is leave the record open for 5 more days just in case there are any questions that we wanted to ask that have not been asked here.

I want to thank you all for your patience. Mr. Korb, I want to thank you particularly for making the statement to us that there would be a new IFRA issued before any regulations are even considered to take effect. That is a tremendous consolation to the people here. Do you guys understand what he meant by that? You can thank him on the way out because he didn't have to say that. He did that because it is the right thing to do, and I appreciate it.

I want to thank all of you for coming out, especially those that traveled long distances for the hearing. This hearing is adjourned.

[Whereupon, at 4:23 p.m., the committee was adjourned.]

DONALD A. MANZULLO, ILLINOIS  
CHAIRMAN

NYDIA M. VELÁZQUEZ, New York

**Congress of the United States**  
**House of Representatives**  
108th Congress  
**Committee on Small Business**  
2361 Rayburn House Office Building  
Washington, DC 20515-6515

Committee on Small Business  
Hearing - *Failure to Comply with the Regulatory Flexibility Act: IRS  
Endangering Small Businesses Yet Again*  
Room 2360, Rayburn House Office Building  
July 25, 2006, 2:00 PM

Opening Statement of Chairman Manzullo

Good afternoon and welcome to this important hearing. On February 3, 2006, the IRS and Treasury released proposed regulations that substantially change the rules governing taxation of funds used during deferred exchanges of like-kind property under section 1031 of the Internal Revenue Code. If finalized, I believe these proposed regulations would have a devastating impact on the hundreds of small qualified intermediary businesses in this industry and increase costs for investors.

Only Chicago Deferred Exchange, a wholly-owned subsidiary of LaSalle Bank, desires the completion of the proposed regulations. The rest of the businesses in this industry, most of which are small, are simply trying to stay in business. Worse, this situation has been created by Treasury and the IRS in a case where no regulations are needed. There simply is no "homeless" income here. Thus, one must ask why these proposed regulations are being pursued when they are so devastating to small businesses. In addition to these problems, Mr. Don Korb, the Chief Counsel of the IRS, has admitted in a letter to me that the IRS and Treasury did a sloppy job of complying with the Regulatory Flexibility Act by failing to complete a full Initial Regulatory Flexibility Analysis. Because of the impact on small businesses and the failure to comply with the RFA, I have requested that the proposed regulations be withdrawn. I have been joined in this effort by no less than six senators. Still, the IRS and Treasury have not responded.

This hearing is about the survival of small businesses and the refusal of an agency to follow the law, which mandates the study of the impact of regulations on small businesses. I am simply astonished that the IRS and Treasury would move forward in this manner, especially in the face of the 2005 US Court of Appeals for the DC Circuit Opinion in *United States Telecom Ass'n v. FCC*, which empowers the courts to set regulations aside for failure to comply with the Regulatory Flexibility Act.

I now yield to the ranking minority Member, Rep. Velázquez of New York, for her opening comments.

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## 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

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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


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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.

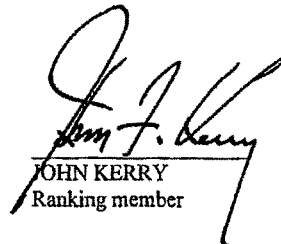
We have heard from small businesses providing QI services from across the country. They have explained to us the devastating impact that the proposed regulations would have on their industry. We have also heard the impact the proposed regulations would have on consumers that are served by small business 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



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JUNE 21, 2006 WEDNESDAY

**DEPARTMENT:** Official Announcements, Notices, and News Releases; Treasury Tax Correspondence

**CITE:** 2006 TNT 119-24

**LENGTH:** 602 words

**HEADLINE:** 2006 TNT 119-24 SENATORS SEEK WITHDRAWAL OF PROPOSED REGS ON TAXATION OF ESCROW ACCOUNTS, OTHER FUNDS. (Section 1031 -- Like-Kind Exchanges;) (Release Date: JUNE 07, 2006) (Doc 2006-11951)

**CODE:** Section 1031 -- Like-Kind Exchanges;  
Section 468B -- Designated Settlement Funds;  
Section 7872 -- Below-Market-Rate Loans

**ABSTRACT:** North Carolina Republican Sens. Richard **Burr** and Elizabeth Dole have expressed concerns that proposed regulations on the taxation of escrow accounts and other funds used in like-kind property exchanges will result in reduced competition in the qualified intermediary market and higher consumer costs.

**SUMMARY:**

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North Carolina Republican Sens. Richard **Burr** and Elizabeth Dole have expressed concerns that proposed regulations (REG-113365-04) on the taxation of escrow accounts and other funds used in like-kind property exchanges will result in reduced competition in the qualified intermediary market and higher consumer costs.

**AUTHOR:** **Burr**, Sen. Richard;  
Dole, Sen. Elizabeth  
Senate

**GEOGRAPHIC:** United States

**REFERENCES:** Subject Area:  
Real estate tax issues;  
Settlements and dispute resolution;  
Trusts and estates taxation

Cross Reference:  
For REG-113365-04, see Doc 2006-2169 or 2006 TNT 24-18.

**TEXT:**

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June 7, 2006

The Honorable John Snow

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Secretary of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220-0001

Dear Secretary Snow,

We are writing to express our serious concerns regarding regulations recently proposed by the IRS. On February 3, 2006, the IRS and the Treasury Department issued proposed regulations under the Internal Revenue Code relating to the taxation of income earned on escrow accounts, trusts, and other funds used during deferred exchanges of like-kind property. These proposed regulations substantially revise the treatment of escrow accounts, trusts, and other funds used during deferred exchanges of like-kind property, and the treatment of below-market loans associated with the exchanges.

Currently, a business may avoid taxes on a land sale if the proceeds are subsequently used to purchase other land. During this process, the proceeds of the initial sale are held by businesses or banks that function as qualified intermediaries. These intermediaries invest the funds collected from the land sale until such time as the funds are used to purchase new land. In most cases, interest earned by a non-bank intermediary is split between the intermediary and the business that is making the land swap. Existing regulations require that both parties pay taxes on the interest they receive under such arrangements.

The IRS has proposed changes to the regulation to require that all interest earned by an intermediary during the holding process be turned over to the seller of the land. This proposed rule will hurt the ability of non-bank qualified intermediaries to compete against banks. Banks engaging in this type of transaction normally pay all "interest" earned on the funds to the entity making the land swap. The banks profit from this arrangement by depositing such funds into an interest bearing account that pays a lower interest rate than the bank will actually earn on the money. Non-bank qualified intermediaries compete in this sector by investing the funds and retaining a portion of their interest. If non-bank qualified intermediaries are unable to retain any part of the accrued interest, they will have to raise the fees they charge to businesses engaged in land swaps. As a result, non-bank qualified intermediaries will be placed in a competitive disadvantage to banks in this market.

We are concerned that these proposed regulations will result in reduced competition in the qualified intermediaries market, resulting in less innovation and higher costs for consumers. These proposed regulations (REG-113365-04) were issued under Sections 468B and 7872 of the Internal Revenue Code. Section 1031 of the Internal Revenue Code covers the deferred exchanges of like-kind property.

We encourage you to withdraw this anti-competitive rule. Thank you for giving your attention to this matter. Should you have any questions, or if we may be of any assistance to you in the future on any other matter, please do not hesitate to ask.

Sincerely,

Richard Burr  
United States Senator

Elizabeth Dole  
United States Senator

\*\*\*\*\* End of Document \*\*\*\*\*



CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

July 10, 2006

The Honorable Donald A. Manzullo  
Chairman  
Committee on Small Business  
U.S. House of Representatives  
Washington, DC 20515

Dear Mr. Manzullo:

I am writing to follow up on our meeting on June 27, 2006, and your letter dated May 8, 2006, regarding the proposed regulations under section 468B relating to the tax treatment of funds held by qualified intermediaries in connection with deferred exchanges of like-kind property. At our meeting you expressed concern about the initial regulatory flexibility analysis (IRFA) prepared with respect to these proposed regulations and you pointed out several perceived deficiencies with the IRFA. At our meeting, I told you that I would review the IRFA in order to make my own evaluation of whether it did in fact comply with the requirements of the Regulatory Flexibility Act.

After looking into the matter, I have concluded that the IRS and Treasury Department made a good faith effort to comply with the Regulatory Flexibility Act and that the IRFA that was published with the proposed regulations was technically in compliance with the law. Nonetheless, I have also determined that the IRS and Treasury Department could have done better with respect to certain aspects of the IRFA. For example, regarding industry size standards, you suggest that we should have used NAICS 523991 relating to trust, fiduciary and other custody activities, rather than NAICS 531390 relating to real estate related services, such as escrow services. While we recognize that like-kind exchanges are not limited to real estate transactions, we believe that neither code adequately describes the qualified intermediary industry because both codes are under-inclusive as well as over-inclusive. Hence, it may be more appropriate to use some kind of a composite.

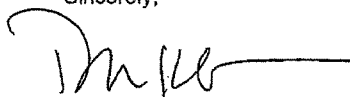
Similarly, you raised questions about the accuracy of our estimate of the number of small businesses in the qualified intermediary industry. In preparing the IRFA, we arrived at our estimate of 325 businesses affected based on information provided to us by the Federation of Exchange Accommodators, which told us they represented 80 percent of the qualified intermediary industry. Testimony at the hearing held on June 6, 2006, suggests, however, that there may be more than 325 small businesses in the qualified intermediary industry. We are going to research the matter further.

You also criticized the IRFA for failing to discuss alternatives. Although the IRFA discussed the alternative of retaining the facts and circumstances test under the 1999 proposed regulations, we agree that other alternatives could have been explicitly addressed. We will expand our discussion of alternatives in the next IRFA or in the final regulatory flexibility analysis (FRFA) that we will publish in connection with this regulation project.<sup>1</sup>

Lastly, you chastised us for failing to provide an estimate of the costs of complying with the proposed regulations. We acknowledge our responsibility to do so either in a revised IRFA or in the FRFA for this regulation project and will provide an estimate of those compliance costs at that time. As you can see from the text of the Preamble to the proposed regulations, because we were unable to develop a reasonably reliable estimate of the compliance costs when we published the IRFA, we requested comments regarding the nature and extent of the economic impact on small entities, which we will carefully consider as we continue working on this regulation project.

I would like to thank you for bringing to my attention your concerns regarding the adequacy of the IRFA relating to these proposed regulations. As I told you during our meeting on June 27<sup>th</sup>, commit to you that we will take appropriate steps to address them, along with the other comments that we received, either in a revised IRFA or in the FRFA for this regulation project. Also, as I discussed with you at our meeting, we are undertaking a training program at the IRS concerning the requirements of the Regulatory Flexibility Act to insure that those requirements are adhered to.

Sincerely,



Donald L. Korb  
Chief Counsel

cc: Eric Solomon

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<sup>1</sup> At this stage of the process, the IRS and Treasury Department could incorporate new information and analysis into a revised IRFA, prior to promulgating any final regulations, or, in the alternative, into the FRFA. No decisions have been made by the IRS and Treasury Department at this time regarding how we will approach this issue.

**WRITTEN TESTIMONY OF  
CHIEF COUNSEL OF  
THE INTERNAL REVENUE SERVICE  
DONALD KORB  
BEFORE  
THE HOUSE COMMITTEE ON SMALL BUSINESS  
July 25, 2006**

**Introduction**

Chairman Manzullo, Ranking Member Velázquez and members of the Subcommittee, I am here this morning to talk about our regulatory flexibility act (RFA) analysis in the proposed regulations on Escrow Accounts, Trusts and other Funds Used During Deferred Exchanges of Like-Kind Property (REG-113365-04 and REG-209619-93, 2006-10 I.R.B. 580, 71 F.R. 6231) (the “2006 proposed regulations”). The burden that our complex tax system places on taxpayers, and on individuals and small businesses in particular, is an issue that everyone who is involved in writing, implementing, and administering the tax laws should be concerned about. I certainly am.

In my role as Chief Counsel of the Internal Revenue Service I serve as the chief law officer for the Internal Revenue Service and legal advisor to the Commissioner. I supervise 2,433 employees, of which 1,550 are lawyers. One of the important functions of my office is to make sure the IRS, working hand-in-hand with the Office of Tax Policy of the Department of the Treasury (OTP), identifies needed guidance, determines the content of that guidance, and issues the guidance under appropriate procedures. Among other things, those procedures ensure that my organization and the Department of the Treasury (Treasury) act within our legal authority, understand the effects of the guidance on taxpayers and other stakeholders, and weigh important policy and administrative considerations appropriately. A significant part of my testimony today will involve outlining those procedures for you.

I am not in a position to discuss my view of, or position on, the 2006 proposed regulations. You have asked me to testify here today after expressing concerns, both in writing and in the setting of a public hearing on the regulations held on June 6, 2006, about the substance of the 2006 proposed regulations and the procedures under which they were issued. The regulatory process requires me to suspend judgment on finalizing proposed regulations until all internal and public comments have been carefully considered and addressed through a rigorous process involving both the IRS and Treasury. We have not yet reached the stage at which the information received from the public comments process has been sufficiently analyzed so that I can make a judgment about the proper course of action. Accordingly, I am sure you understand that it would be inappropriate for me to make any comments about the substance of the 2006 proposed regulations and how they might change.

My testimony today is possible only because of the diligence and hard work under adverse conditions of several IRS lawyers, who, due to the flood at the main IRS building, have had to operate away from their usual workstations, without many of the usual resources on which they rely, and without full access to many of the background materials that would have been helpful. We are recovering very quickly from the flood, and will be back to normal soon, but I wanted to call your attention to the unusual circumstances under which we are operating and express my gratitude to our outstanding lawyers and other staff.

My testimony on the application of the RFA to the 2006 proposed regulations will focus on four topics: First, recent IRS efforts to reduce compliance burden for small businesses; second the IRS process for drafting and issuing regulations; third, the RFA and how it applies to the rules promulgated by the IRS; and finally, the process for issuing the 2006 proposed regulations, the initial regulatory flexibility analysis (IRFA) performed in the context of that process, and reactions to that process.

#### **IRS Focus on Easing Tax Compliance Burdens for Small Business**

This Committee's work is critical for the wellbeing of this country's small businesses. We in Washington are sometimes criticized for our "inside-the-beltway" insensitivity to the problems of mainstream Americans. Let me assure you that having spent my entire private sector career in Cleveland, Ohio, and having worked with numerous small business clients throughout that time, I have a healthy appreciation for the critical role small businesses play in our nation's economy. Small businesses represent more than 99 percent of all employers, employ half of all private-sector workers, and create two-thirds of the net new jobs in our economy. As President Bush's Small Business Agenda says, "small businesses are the heart of the American economy." I subscribe to that view wholeheartedly.

The IRS as an organization has made reduction of burden for small business a priority. The more resources small businesses have to invest in their products and services, rather than tax compliance, the more these businesses will continue to flourish. In that regard, the IRS has undertaken several initiatives in the past year to help ease the burden small businesses face in complying with federal tax laws. These initiatives include:

**Simplified Calculation of Domestic Production Deduction:** Final regulations under Section 199 of the Internal Revenue Code (the Code) provide a simplified deduction calculation for employers with \$100 million or less in annual gross receipts. This threshold allows 99.5 percent of taxpayers to qualify for a simplified method. According to the Small Business Administration Office of Advocacy, this will substantially reduce compliance costs for approximately 2.2 million employer firms.<sup>1</sup>

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<sup>1</sup> Letters expressing appreciation for this approach from the House Committee on Small Business Chairman, and from the Small Business Administration Office of Advocacy are attached hereto as Appendix A and B, respectively.

**Streamlined Extension of Time to File:** New regulations allow taxpayers to request an automatic, six-month tax-filing extension for most common individual and business returns.

**Simplified Tax Filing Requirements for Small Employers:** Beginning January 1, 2006, certain employment tax filers are able to file the new Form 944, Employer's Annual Federal Tax Return, once a year rather than filing Form 941, Employer's Quarterly Federal Tax Return, four times a year.

**Revised Schedule K-1 for Partnerships, S Corporations and Trusts:** The Internal Revenue Service has simplified Form 1041 Schedule K-1 for this year's filing season. The schedule has been simplified to reduce common errors and the burden associated with preparation and filing requirements. Schedule K-1 for Forms 1065 and 1120S were revised last year.

**AMT Assistant for Individual Taxpayers:** The AMT Assistant is a new online tool that helps individual taxpayers determine whether they are potentially subject to the alternative minimum tax (AMT).

**Disaster Relief:** The IRS has taken significant steps to help taxpayers affected by disasters, many of which are small businesses. Some examples of our extensive efforts to help last year's hurricane victims include:

- Extended deadlines for filing returns and making payments, suppressed correspondence, suspended compliance activities, temporarily waived certain rules, increased the standard mileage rate, and arranged expedited free copies of federal tax returns and transcripts.
- On-site assistance in dozens of FEMA disaster recovery centers aiding taxpayers with filing claims and amended returns and obtaining transcripts and copies of tax returns. The IRS distributed more than 227,000 disaster kits and other outreach materials to individual and business taxpayers.
- More than 38 small business outreach events and seminars to help taxpayers, especially small business owners, understand the special tax benefits and incentives.
- Over a dozen legal guidance documents and 30 news releases announcing various details on relief made available to affected people, including small businesses.

### **The Process of Issuing Regulations under the Internal Revenue Code**

The following is a general discussion of the process under which tax regulations are drafted and published. Each project, however, is somewhat different.

**The Notice of Proposed Rulemaking .** The general public, IRS, and OTP suggest areas where guidance would be helpful and appropriate. Preliminarily, areas requiring guidance are added to the yearly guidance priority list. At that point, a regulations project may be opened with approval from the Associate Chief Counsel who has subject matter jurisdiction over the matter at issue and OTP. The Associate Chief Counsel assigns a drafting team to begin researching the issues while coordinating involvement across other Associate Chief Counsel and Division Counsel offices that may have an interest in the regulations project.

The drafting team prepares an initial draft of the regulations, usually in the form of a Notice of Proposed Rulemaking (NPRM) that clearly states the legal basis for the NPRM, describes the relevant law, seeks to minimize litigation, and specifies any preemptive effects the regulations may have.

The NPRM announces that the agency is considering modifying existing regulations or addressing new issues. The NPRM states the proposed regulatory text, requests public comments, and may also contain a Notice of Hearing. An NPRM has no legal effect unless and until it is adopted as final regulations.

In addition, the NPRM describes the agency's compliance with Federal statutory and Executive Branch mandates governing the regulatory process. These mandates include allowing interested parties to comment on proposed regulations under the Administrative Procedure Act, subjecting regulations to comment from the Chief Counsel for Advocacy of the Small Business Administration regarding its impact on small businesses under Section 7805(f) of the Code, requiring regulatory assessments to be prepared for "significant regulatory actions" under Executive Order 12866, and preparing regulatory flexibility analyses if the regulations are deemed to have a significant economic impact on a substantial number of small entities under the RFA.

**The Drafting Process.** Chief Counsel staff identifies the issues in each regulations project and makes recommendations for possible solutions. Significant regulatory projects are usually briefed to IRS and Treasury executives at the early stages of the drafting process. It is during this process that the drafting team evaluates whether the regulations have a significant economic impact on a substantial number of small businesses and whether an IRFA is required. If an IRFA must be prepared, the drafting team researches the population of small businesses that would be affected, the costs the regulations would impose, and whether less burdensome alternatives exist.

**Circulation and Review.** Once the regulations are drafted, the draft is circulated first to members of the drafting team, which includes OTP attorneys and the relevant Associate Chief Counsel. Once the draft is ready for wider exposure, it is circulated to a



number of other officials, which usually includes the Treasury Inspector General for Tax Administration (TIGTA), the Treasury Deputy Assistant Secretary (Regulatory Affairs), the Treasury Tax Legislative Counsel (TLC)/Benefits Legislative Counsel/International Tax Counsel, the appropriate OTP Advisors, the National Taxpayer Advocate, and executives within the IRS and Chief Counsel's office.

Internal comments and questions on the draft NPRM package are collected and reviewed. In some cases, the consideration given to the comments requires significant redrafting of the regulations and recirculation for review. During this time the drafting team continues to evaluate whether an IRFA is required and to investigate the questions that must be answered to complete the IRFA. After all comments have been agreed upon and reflected in the draft, the version of the NPRM to be published is sent through a clearance process. This includes final sign-off by the Treasury Assistant Secretary (Tax Policy) and the Treasury's General Counsel and Executive Secretary. Once cleared, the signed regulations package is returned to the drafting attorney for publication in the Federal Register.

Written comments received from the public on the NPRM are made available for public inspection and sent to members of the drafting team. The team adds them to the regulations file and prepares a summary of the comments for use at the public hearing. Hearing notices are published in the Federal Register.

**Final Regulations.** After compiling the comments on the NPRM, the drafting team may need to address new issues, policy considerations, or technical errors. In general, the same review procedures used for the NPRM are used to review the final regulations, including briefings of the Treasury Assistant Secretary (Tax Policy), the Chief Counsel, and other reviewers as necessary. The preamble to the final regulations summarizes the regulations and the comments, discusses any significant differences between the final regulations and the NPRM, explains the reasons for any changes, and also explains why some comments were adopted and others not.

It is important to understand that there is no established time frame between the issuance of an NPRM and final regulations. This process can take as long as several years and may even lead to the issuance of another NPRM.

#### **Regulatory Flexibility Act As Applied to Tax Regulations**

Mr. Chairman, as I have assured you privately, I take IRS obligations under the RFA very seriously. As my description of the regulatory process at the IRS demonstrates, the requirements of the RFA are considered both during the process of drafting and reviewing of proposed regulations and during the review and revision of those regulations before they are made final.

Congress enacted the RFA (5 U.S.C. 601) in 1980 to reduce the regulatory burden on small businesses. Section 603 of the RFA required agencies to prepare a regulatory

flexibility analysis of proposed and final regulations (other than interpretive regulations, which are not required to be issued for notice and comment), assessing their impact on small businesses. In 1996, Congress passed the Small Business Regulatory Fairness and Enforcement Act (SBRFEA) (5 U.S.C. 801), amending the RFA, pursuant to which the RFA became applicable to interpretative rules (proposed on or after March 29, 1996) involving the internal revenue laws of the United States, but only to the extent they impose a collection of information requirement on small businesses.

Executive Order 13272, published in the Federal Register on August 16, 2002, requires each agency to establish procedures and policies to promote compliance with the RFA. The mandate under E.O. 13272 is clear: Seek to minimize, consistent with statutory requirements and sound regulatory policy, the compliance and paperwork burdens of all regulations on small businesses, small not-for-profit enterprises, and small governmental jurisdictions.

A detailed discussion of the requirements of the RFA is included in the Chief Counsel Directives Manual (CCDM). Three offices within the IRS and the Treasury are responsible for reviewing regulations for compliance with the RFA. Moreover, Section 7805 of the Code requires the IRS to send every published NPRM to the Chief Counsel for Advocacy of the Small Business Administration (SBA) for comment, and the IRS is required to respond to any comments in the final regulations.

An agency is not required to prepare a regulatory flexibility analysis if the agency certifies that the collection of information requirement (for interpretative regulations) or the regulations itself (for legislative regulations) will not impose a significant economic impact on a substantial number of small entities. The CCDM instructs drafting teams to request comments on the accuracy of such certifications if there is doubt. If an NPRM contains a certification that it will not, if finalized, have a significant economic impact on a substantial number of small entities, the IRS or Treasury, before issuing final regulations, may subsequently find that the regulations are likely to have a significant economic impact on a substantial number of small entities, and at that point the drafting team is instructed to notify the Treasury Senior Advisor to the General Counsel for Regulatory Affairs.

If a regulatory flexibility analysis is required under the RFA, the drafting team must prepare a regulatory flexibility analysis for the regulations. Normally this is done both when the regulations are issued as proposed regulations and when they are issued as final regulations.

To evaluate the application of the RFA to regulations, the drafting team must determine whether the regulations are interpretative or legislative. Additionally, the drafting team must determine who is affected by the regulations, and, if the regulations affect small entities, the nature (quantified to the extent practicable) of that effect.

Executive Order 13272 requires that agencies notify the Chief Counsel for Advocacy of the SBA of NPRMs that require the preparation of an IRFA prior to publication.

The contents of the IRFA to be included in an NPRM are delineated in Section 603(b)-(c) of the RFA. Section 603 requires the IRFA to contain –

- (1) a description of the reasons why action by the agency is being considered;
- (2) a succinct statement of the objectives of, and legal basis for, the proposed rule;
- (3) a description of and, where feasible, an estimate of the number of small entities to which the proposed rule will apply;
- (4) a description of the projected reporting, recordkeeping and other compliance requirements of the proposed rule, including an estimate of the classes of small entities which will be subject to the requirement and the type of professional skills necessary for preparation of the report or record;
- (5) an identification, to the extent practicable, of all relevant Federal rules which may duplicate, overlap, or conflict with the proposed rule.

Each IRFA is also required to contain a description of any significant alternatives to the proposed rule that accomplish the stated objectives of applicable statutes and that minimize any significant economic impact of the proposed rule on small entities.

#### **The History of the 2006 Proposed Regulations**

The 2006 Proposed Regulations can be traced back to 1986, when Section 468B was added to the Code by Section 1807(a)(7)(A) of the Tax Reform Act of 1986 (Pub. L. No. 99-514, 100 Stat. 2814), 1986-3 C.B. 731. In 1988, Section 468B(g), Clarification of Taxation of Certain Funds, was added by Section 1018(f)(5)(A) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647, 102 Stat. 3582), 1988-3 C.B. 242. Section 468B(g) provides that no law can be construed to provide an income tax exemption to escrow accounts, settlement funds, or similar funds, and that the Secretary of the Treasury shall prescribe regulations providing for taxation of such accounts or funds.

On February 13, 1992, proposed regulations were issued creating “qualified settlement funds” (Prop. Reg. Secs. 1.468B-0 through -5). The IRS received comments on those proposed regulations requesting additional rules be issued to cover escrow accounts used in the sale of property and Section 1031 escrow or trust accounts. A decision was made at the time these 1992 regulations were finalized to address the latter issues in a separate regulations project.

These issues arise because in a deferred like-kind exchange the transferee, usually a qualified intermediary (QI), provides collateral to secure its obligation to transfer new property to the taxpayer within 180 days, consistent with Section 1031 of the Code. This security is often in the form of cash invested either in a segregated qualified escrow or trust account, or in an account held by a QI.

In 1993 the IRS opened a regulations project on the taxation of various types of accounts and funds under Section 468B(g), including escrow and trust accounts used in Section 1031 deferred like-kind exchanges. It was not until 1999, however, that proposed regulations addressing the taxation of these accounts were issued. In general, under Proposed Regulations Sec. 1.468B-6 (1999) (the "1999 proposed regulations") the transferor of property in a like-kind exchange is considered the owner of the assets held in an escrow or trust account in connection with the exchange, and must therefore take into account all items of income associated with the account. The regulations provided an exception if the transferee has all the beneficial use and enjoyment of the account determined under a facts and circumstances test.

The 1999 proposed regulations identified the following factors relevant to whether the transferee or the taxpayer was the owner of the funds held in escrow or trust: (i) which person enjoys the use of the earnings on the account; (ii) which person receives the benefit from appreciation, if any, in the value of the assets held in the account; and (iii) which person is subject to a risk of loss from a decline if any, in the value of the assets of the account. The 1999 proposed regulations contained an example in which the earnings of the fund are kept by the QI as compensation. The example concludes that the taxpayer is the owner because the earnings are used to satisfy the taxpayer's obligation to compensate the transferee for services performed in connection with the deferred like-kind exchange. The example reflects the application of well established legal doctrine. See Old Colony Trust v. Commissioner, 279 U.S. 716 (1929).

The 1999 proposed regulations stated that if the transferee is the "owner" of the account, Section 7872 may apply if the deferred like-kind exchange involves a below-market loan from the taxpayer to the transferee.

Between 1999 and 2002 the project moved through the process toward finalization. In 2003 commentators again focused on the proposed regulations and various QIs and their representatives began sending comment letters explaining their differing interpretations of the 1999 proposed regulations. From April through December of 2003, the Chief Counsel's Office received 13 comment letters and an email regarding the taxation of earnings retained by QIs as provided under the 1999 proposed regulations. Several more emails and two more comment letters were received in 2005. These commentators presented different and conflicting views of the application of the 1999 proposed regulations and of the proper approach for future guidance.

Some QIs were interpreting the 1999 proposed regulations as allowing the QI to "own" the funds held in connection with the deferred like-kind exchange and to characterize the arrangement between the taxpayer and the QI as not subject to Section

7872. Others commented that the independent QIs were incorrectly interpreting the 1999 proposed regulations and gaining a tax advantage based on this interpretation.

Between late 2002 and early 2006 Chief Counsel and OTP staff studied these comments and independently investigated the response of QIs to the 1999 proposed regulations. This investigation included extensive contacts between the IRS and various affected taxpayers or their representatives. A significant source of information for the IRS was the Federation of Exchange Accommodators (FEA), which indicated that it is the leading industry association for QIs.

During this time, Chief Counsel drafting team members undertook a year-long study of the business models and fee structures of QIs. Among other efforts, drafting team members placed numerous telephone calls questioning industry representatives, including the FEA, about the details of QI business models and, in September of 2003, participated in a teleconference with QIs selected by the FEA to explain the business models employed. The drafting team solicited and reviewed examples of the contracts QIs have with customers, and visited websites maintained by many QIs, both large and small. Attempting to corroborate the anecdotal evidence collected from practitioners, the drafting team members also researched the websites maintained by the SBA and the Census Bureau, but could find no QI industry-specific data. Finally, prior (and subsequent) to the publication of the proposed regulations in February 2006, members of the drafting team conducted several outreach efforts by participating in panel discussions at industry-related continuing professional education functions.

In preparing the IRFA, the drafting team identified questions that would help it determine the population of QIs and estimate the burden on those entities. These questions included the number of QIs and independent QIs, the number of small QIs, the number of deferred like-kind exchanges that occur each year, the amount of principal QIs hold in exchange funds on average, and the average interest rate earned on the funds. When government and publicly available sources of information, including the SBA and Department of Commerce websites, did not provide answers to these questions, the drafting team turned to industry resources, and specifically the FEA, as contemplated by the RFA.

The FEA provided information on the number of its members, the number of those that constitute QIs, and its estimate of the percentage of the industry that belongs to the FEA. This information was reiterated by the FEA numerous times and formed the basis of the IRFA estimate of 325 small businesses providing services as QIs. The FEA did not provide any other information that would help in estimating the impact of the regulations on small entities, nor did it suggest alternative sources for the information. Because the drafting team was unable to learn the financial details necessary to estimate impact of the regulations on small entities, the decision was made to specifically request

comments on the extent of the economic burden and on alternatives to it in the IRFA to be included in what became the 2006 proposed regulations.<sup>2</sup>

Based on its study, Chief Counsel and OTP determined that the facts and circumstances test in the 1999 proposed regulations was inadequate given the competing interpretations of the regulations expressed by affected taxpayers or their representatives. To enhance administrability, provide greater certainty, and ensure consistent treatment of taxpayers, it was decided that new proposed regulations should clarify that the earnings on the funds held in connection with the deferred like-kind exchange either were taxable to the taxpayer under Section 61 general tax principles, or were taxable to the QI because the exchange funds had been loaned to the QI. If the latter and the QI does not pay sufficient interest to the taxpayer, the loan is subject to Section 7872 of the Code.

This decision was made only after long discussion, debate, and negotiation among many lawyers at many levels from the Chief Counsel's Office and Treasury. The proposed regulatory language was commented on, redrafted, and recirculated numerous times over a period of several years.

The 2006 proposed regulations were published in the Federal Register on February 7, 2006. The preamble included a section containing the IRFA. Since that time the IRS has received 138 comment letters, 135 of which are from the private sector. Of the private sector letters, five endorsed the approach of the 2006 proposed regulations, and 133 were opposed. Many of the letters written in opposition were substantially similar or identical, suggesting a coordinated letter-writing campaign by a certain segment of the QI industry. A hearing on the proposed regulations was held on June 6, 2006, and 20 private sector interests asked to speak. We also had the benefit of Chairman Manzullo's comments. Overall, six persons spoke in favor of the proposed regulations, and 14 spoke in opposition.

Prior to the hearing, Chairman Manzullo sent a letter<sup>3</sup> questioning the adequacy of the IRFA in the 2006 proposed regulations. As I hope I have made clear, substantial efforts were made to investigate the number of taxpayers affected by the proposed regulations and to quantify the burden created by the proposed regulations. Since insufficient data was found to enable us to quantify that burden, following standard practice the preamble to the 2006 proposed regulations requests comments on the subject. The drafting team is in the process of evaluating those comments to collect all the information it can about the potential impact of the proposed regulations on small entities.

In my written response to Chairman Manzullo's letter,<sup>4</sup> I maintained that the IRS and Treasury had met their legal obligations under the RFA, but I acknowledged that they

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<sup>2</sup> This approach to the analysis of potential impact is endorsed by the Small Business Administration Office of Advocacy. See A Guide for Government Agencies, How to comply with the Regulatory Flexibility Act, pg. 9 and 30, n. 92 (May 2003).

<sup>3</sup> A copy is attached hereto as Appendix C.

<sup>4</sup> A copy is attached hereto as Appendix D.

could have done a better job. I still hold that view, and believe it is supported by the details I have provided today on the process involved in issuing the 2006 proposed regulations. I also committed to Chairman Manzullo that we will do a better job in the future on our Regulatory Flexibility Act analysis. Part of that will include additional training for our drafting teams.

Thank you for inviting me to testify this morning. I would be happy to respond to your questions.

Appendix A



DONALD A. MÁNZULLO, ILLINOIS  
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

**Congress of the United States**  
**House of Representatives**  
108th Congress  
**Committee on Small Business**  
2361 Rayburn House Office Building  
Washington, DC 20515-6515

June 27, 2006

**VIA HAND DELIVERY**

The Honorable Donald L. Korb  
Chief Counsel  
Internal Revenue Service  
1111 Constitution Ave, NW Room 3026  
Washington, DC 20224

The Honorable Eric Solomon  
Acting Deputy Assistant Secretary (Tax Policy)  
The United States Department of the Treasury  
1500 Pennsylvania Ave., NW, Room 3120  
Washington, DC 20220

**RE: Section 199 Final Regulations (71 Fed. Reg. 31268, June 1, 2006)**

Dear Sirs:

I am writing to commend each of you for your leadership in finalizing the regulations under section 199 of the Internal Revenue Code (71 Fed. Reg. 31268, June 1, 2006). The proposed rules under section 199 provided for a simplified deduction method calculation for employers that generated \$25 million or less in annual gross receipts (70 Fed. Reg. 67220, November 4, 2005). Under the final regulations, the accessibility of the simplified deduction method calculation is expanded to include employers that generate annual gross receipts of \$100 million or less. This expansion was requested by me in a letter to Treasury on May 27, 2005, and I appreciate your efforts to ensure that smaller companies are not overly burdened in taking advantage of the deduction under section 199.

The expansion in the final regulations allows approximately 2.2 million employer firms engaged in the permitted production activity to use a far less complicated method to determine their deduction. The exact amount of regulatory savings this provides is not known at this time but increasing the simplified deduction method availability to 99.5 percent of the employer firms engaged in the permitted activities should amount to a great savings to those firms.

I look forward to continuing to work with you to develop tax policies that promote our nation's small businesses. Please do not hesitate to contact me or John Westmoreland, my Chief Tax Counsel, at (202) 225-5676 if we can be of assistance.

Sincerely,

A handwritten signature in black ink, appearing to read "D. Manzullo".

Donald A. Manzullo  
Chairman

cc: The Honorable Henry M. Paulson, Jr., Secretary (nominee), Department of Treasury  
The Honorable Mark Everson, Commissioner, Internal Revenue Service

Appendix B



*Advocacy: the voice of small business in government*

June 9, 2006

**VIA FACSIMILE and Email**

The Honorable Donald L. Korb  
Chief Counsel  
Internal Revenue Service  
1111 Constitution Ave, NW Room 3026  
Washington, DC 20224

The Honorable Eric Solomon  
Acting Deputy Assistant Secretary (Tax Policy)  
The United States Department of the Treasury  
1500 Pennsylvania Ave., NW, Room 3120  
Washington, DC 20220

**RE: Income Attributable to Domestic Production (71 Fed. Reg. 31268, June 1, 2006)**

Dear Sirs:

We are writing commend the U.S. Department of the Treasury (Treasury) and Internal Revenue Service's (IRS) recent rule finalizing proposed rules (70 Fed. Reg. 67220, November 4, 2005) under section 199 of the Internal Revenue Code. The proposed rule provided for a simplified deduction method calculation for employers that generated \$25 million or less in annual gross receipts. Under the final rule the accessibility of the simplified deduction method calculation is expanded to include employers that generate annual gross receipts of \$100 million or less.

The expansion in the final rule allows approximately 2.2 million employer firms engaged in the permitted production activity to use a far less complicated method to determine their deduction. The exact amount of regulatory savings this provides is not known at this time, but increasing the simplified deduction method availability to 99.5 percent of the employer firms engaged in the permitted activities should amount to a great savings to those firms.

In particular, the Office of Advocacy appreciates the efforts of George Manousos, Tax Specialist in Treasury's Office of Tax Legislative Counsel; Heather Maloy, IRS Associate Chief Counsel (passthroughs and special industries) and Acting Deputy Chief Counsel (technical); Paul Handleman, Senior Technician Reviewer (passthroughs and special

industries); David Schneider, Special Counsel to the Associate Chief Counsel (passthroughs and special industries) and all of the staff of the Treasury and IRS who worked hard to ensure that smaller companies are not overly burdened in taking advantage of the section 199 domestic production activity deduction.

The Office of Advocacy looks forward to working closely with the IRS and Treasury on issues of concern to small businesses. Please do not hesitate to contact Candace B. Ewell, Assistant Chief Counsel for Tax for additional information on my office or our involvement in tax regulatory issues at (202) 401-9787 or [Candace.Ewell@sba.gov](mailto:Candace.Ewell@sba.gov).

Sincerely,

/s/

Thomas M. Sullivan  
Chief Counsel for Advocacy

/s/

Candace B. Ewell  
Assistant Chief Counsel for Tax

Appendix C

DONALD A. MANZULLO, ILLINOIS  
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

# Congress of the United States

House of Representatives

109th Congress

Committee on Small Business

2361 Rayburn House Office Building

Washington, DC 20515-0515

May 8, 2006

*fm: M. Korb*  
*5/11/06*

VIA ELECTRONIC MAIL  
The Honorable Eric Solomon  
Deputy Assistant Secretary (Tax Policy)  
U.S. Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

The Honorable Mark W. Everson  
Commissioner  
Internal Revenue Treasury  
Post Office Box 7604  
Ben Franklin Station  
Washington, DC 20044

The Honorable Donald Korb  
Chief Counsel  
Internal Revenue Service  
1111 Constitution Ave., NW  
Washington, DC 20224

OFFICE OF CHIEF COUNSEL  
2006 MAY 11 P 4:14  
RECEIVED

**RE: Escrow Accounts, Trusts, and Other Funds Used During Deferred Exchanges of Like-Kind Property, 71 Fed. Reg. 6231 (REG-113365-04 and REG 209619-93)**

Dear Sirs:

The Department of Treasury (Treasury) and the Internal Revenue Service (IRS or Service) issued a proposed rule modifying the tax treatment of funds held by qualified intermediaries under § 468B of the Internal Revenue Code. 71 Fed. Reg. 6231 (Feb. 7, 2006). Treasury and the IRS prepared an initial regulatory flexibility analysis (IRFA) pursuant to section 603 of the Regulatory Flexibility Act, 5 U.S.C. §§ 601-12 (RFA). *Id.* at 6234.<sup>1</sup> While

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<sup>1</sup> Treasury and the IRS also determined that the regulation was not a significant rulemaking under Executive Order 12,866 which requires agencies to perform a cost-benefit analysis on any regulation that will have an annual effect on the economy of more than \$100 million or represents an important policy question. 71 Fed. Reg. at 6234. This conclusion is simply incorrect. Under the Executive Order, a significant regulatory action includes one that affects an identifiable sector of the economy. E.O. 12,866, § 3(f)(1), *reprinted in* 58 Fed. Reg. at

this represents a substantial change from the typical policy of Treasury and the Service, these efforts at compliance with the requirements of the RFA simply do not satisfy the analytical requirements mandated by Congress. Treasury and the Service should withdraw the proposed rule until it has collected sufficient data to prepare an adequate IRFA as mandated by the RFA. Failure to do so may result in challenges to the compliance of Treasury and the IRS, and the courts enjoining enforcement of the regulations against small businesses until Treasury complies with the RFA.

#### I. Triggering Compliance with the RFA for Rules Implementing or Interpreting the Internal Revenue Laws of the United States

The RFA applies "whenever an agency is required by section 553 of this title [Title 5], or any other law, to publish general notice of proposed rulemaking...." 5 U.S.C. § 603(a). If Treasury and the IRS are required by the Administrative Procedure Act to conduct notice and comment rulemaking, Treasury and the IRS must prepare an initial regulatory flexibility analysis or certify, pursuant to § 605 of the RFA, that the rule will not have a significant economic impact on a substantial number of small entities.

Normally, Treasury and the Service concludes that its regulations are interpretative and therefore do not *require* notice and comment rulemaking under § 553(b) of the Administrative Procedure Act (APA). However, in the proposed rule at issue, Treasury and the Service take a surprisingly different approach; Treasury and the Service prepared what they styled an IRFA. Thus, Treasury and the Service must be assuming that this proposal constitutes legislative or substantive rulemaking, thereby triggering the requirements for both notice and comment and compliance with the analytical requirements of the RFA. Treasury and the Service should be applauded for recognizing the reality that the proposed rule constitutes substantive rulemaking that will, upon promulgation, affect the rights and responsibilities of those in the qualified intermediary industry.

#### II. Treasury and the Service did not Comply with the Requirements of Section 603 of the RFA

Although Treasury and the Service recognized that the proposed rule was a legislative rule requiring notice and comment rulemaking thereby necessitating compliance with the analytical requirements of the RFA, efforts of the Treasury and the Service at compliance fail to satisfy the basic strictures of the RFA and the guidance provided by the Office of Advocacy pursuant to Executive Order 13,272.<sup>2</sup> The failures do not demonstrate that Treasury and the IRS made even a reasonable effort to comply with the RFA as required by *United States Cellular Corp. v. FCC*, 254 F.3d 78, 88 (D.C. Cir. 2001); *Associated Fisheries of Maine v. Daley*, 127 F.3d 104, 114

51,738. Clearly, qualified intermediaries constitute a sector of the economy. I strongly urge Treasury and the IRS to perform the analysis mandated by the Executive Order.

<sup>2</sup> The President directed the Chief Counsel for Advocacy to provide training on compliance with the RFA. E.O. 13,272, § 2, *reprinted in* 3 C.F.R. at 247 (2002). In carrying out this mandate, the Chief Counsel for Advocacy published A GUIDE FOR GOVERNMENT: HOW TO COMPLY WITH THE REGULATORY FLEXIBILITY ACT (2003) upon which the training mandated by the E.O. is based. Treasury and the IRS has received this training and thus is fully aware of the requirements needed to comply with the RFA.



(1st Cir. 1997). Failure to make reasonable efforts at compliance will result in courts enjoining enforcement of the rule against small businesses as authorized by § 611(a)(4) of the RFA. *See, e.g., United States Telecom Ass'n v. FCC*, 400 F.3d 29, 43 (D.C. Cir. 2005); *Southern Offshore Fishing Ass'n v. Daley*, 995 F. Supp. 1411, 1436-37 (M.D. Fla. 1998).

The requirements of the IRFA are delineated in § 603(b)-(c) of the RFA. When an agency finds that a proposed rule will have a significant economic impact on a substantial number of small entities, the agency is required to:

- 1) describe the reasons for the agency taking action;
- 2) provide a succinct statement of the objectives and legal basis for the proposed rule;
- 3) describe and estimate, to the extent possible, the number of small businesses affected by the proposal;
- 4) specify the anticipated reporting, recordkeeping, and other compliance costs of the proposal, including an analysis;
- 5) identify, to the extent possible, all conflicting and overlapping federal rules; and
- 6) specify alternatives that will reduce the potential burdens on small businesses.

A cursory examination of the IRFA of Treasury and the IRS demonstrates that they "utterly failed to follow the RFA." *United States Telecom Ass'n*, 400 F.3d at 41. This failure is more troubling because it also contradicts the specific education provided to the agency by the Chief Counsel for Advocacy.<sup>3</sup>

Section 605(a) of the RFA permits an agency to satisfy the requirements of an IRFA with other analyses so long as those analyses also meet the requirements of § 603. *Accord Associated Fisheries of Maine*, 127 F.3d at 115. Treasury and the IRS cross-reference the preamble to demonstrate that it meets the first and second requirements enumerated above. A quick perusal of the preamble reveals that Treasury and the IRS describe the reasons for the agency taking action, the objectives of the proposed rule, and the legal basis for it.

#### A. Treasury and the Service did not properly identify the affected industry

A key element in compliance is the estimation of the number of businesses affected by the proposed rule. To carry out this task, the agency is required, absent procedures not relevant to the proposal by Treasury and the IRS, to adopt the size standards of the Small Business Administration (SBA). *See Northwest Mining Ass'n v. Babbitt*, 5 F. Supp. 2d 9, 15 (D.D.C. 1998) (finding failure to comply with RFA due to use of invalid size standard). Therefore, as an initial proposition, compliance with the RFA requires the agency to adopt an appropriate size standard in developing its IRFA.

<sup>3</sup> A detailed explication of the requirements for an IRFA are set forth in chapter 2 of A GUIDE FOR GOVERNMENT: HOW TO COMPLY WITH THE REGULATORY FLEXIBILITY ACT (2003).

The SBA enumerates industry size standards pursuant to the North American Industry Classification System (NAICS).<sup>4</sup> In developing its IRFA, Treasury and the Service state that they used NAICS 531390 to develop their analysis. According to the NAICS, this code is defined as "establishments primarily engaged in performing real estate related services (except lessors of real estate, offices of real estate agents and brokers, real estate property managers, and offices of real estate appraisers)." OFFICE OF MANAGEMENT AND BUDGET, NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEM 712 (2002). Illustrative examples of this industry classification include real estate escrow services. Thus, one might conclude that Treasury and the Service adopted the correct industrial classification. However, Treasury and the Service had comments from a 1999 proposed rule in which qualified intermediaries stated that their primary line of business was banking or other financial services. Furthermore, the data that the Service and Treasury possess provides that a significant portion of transactions under § 1031 involve items other than real estate. Given this information, Treasury and the Service should have done an analysis to determine whether a more appropriate industrial classification for qualified intermediaries was NAICS 523991 (trust, fiduciary, and other custody activities).<sup>5</sup> Of course, it would be difficult to estimate or even describe the number of small businesses in the industry, as required by the RFA, if Treasury and the IRS do not select the appropriate industrial classification.

Selection of the appropriate industrial classification in this context is actually fairly significant. The size standard for NAICS 523991 is \$6.5 million dollars. The number of small businesses affected by the proposed rule may be dramatically increased if Treasury and the IRS adopt this code rather than the one for real estate escrow services.

Even if we assume that Treasury and the IRS are correct in limiting their analysis to NAICS 531390, Treasury and the Service state that the size standard is \$1.5 million. 71 Fed. Reg. at 6234. However, the size standard for that NAICS code is actually \$2 million. 13 C.F.R. § 121.201 (2006).<sup>6</sup>

In short, for Treasury and the IRS to prepare an adequate IRFA, they must reexamine the description of the industry and select a more appropriate industrial classification. Such selection should be done after consultation with the Chief Counsel for Advocacy to ensure that the most appropriate industrial classification is selected.<sup>7</sup>

<sup>4</sup> The NAICS breaks down the American economy into major sectors or two-digit NAICS codes and further delineates the major sector by industry within those major sectors using a six-digit code. See generally OFFICE OF MANAGEMENT AND BUDGET, NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEM (2002).

<sup>5</sup> According to the NAICS, code 523991 consists of "establishments primarily engaged in providing trust, fiduciary, and custody services to others as instructed, on a fee or contract basis, such as bank trust office and escrow agencies (except real estate)." OFFICE OF MANAGEMENT AND BUDGET, NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEM 695 (2002).

<sup>6</sup> The size standards were last modified on December 6, 2005. See 70 Fed. Reg. 72,583. This was two months before publication of the proposed rule by Treasury.

<sup>7</sup> Consultation with the Chief Counsel also will benefit Treasury by allowing it access to the Office of Advocacy's economic databases which provide data on the number of small businesses in each industrial classification at the six-digit level.

**B. Treasury and the Service failed to determine the number of small businesses in the industry**

Ignoring for the moment the failure to identify correctly the affected industry, Treasury and the Service conclude that there are 325 small businesses that will be affected by the proposed rule. Treasury does not specify how it reached that figure and thus makes it impossible for commenters to determine whether the estimate is accurate.

Even assuming that Treasury and the Service are correct, and there are 325 small businesses affected by the proposed rule, there is still a failure to comply with the requirement of the RFA that they estimate the number of small businesses involved in the industry. As the Chief Counsel for Advocacy stated:

Classification requires the development of a profile for the affected industry or industries and categorization by various size classes affected by the rule. Specifically, if the agency imposes a compliance requirement on a class of small entities, it must identify the classes of small entities.

OFFICE OF ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, A GUIDE FOR GOVERNMENT: HOW TO COMPLY WITH THE REGULATORY FLEXIBILITY ACT 33 (2003).

The IRFA of Treasury and the Service makes no effort to stratify the small businesses affected by the proposal. As a result, Treasury cannot assess whether the impacts will be the same for all small businesses in the industry or whether those impacts will vary depending on the type of transactions or other services provided by the small businesses. Thus, Treasury and the IRS cannot describe the impacts on small businesses affected by the proposed rule.

More significantly, Treasury and the IRS fail to describe the number of small businesses in reference to the number of large businesses in the industry. Discussions with industry, at least on a preliminary basis, reveal that the number of businesses that have gross revenue of less than \$6.5 million (the size standard for NAICS 523991) represents only about 75 percent of the 325 businesses identified by Treasury as being in the industry. Thus, Treasury and the IRS conflate both large and small businesses and assume the entire industry is small. This action prevents Treasury and the IRS from properly identifying whether there is any disparate impact on small businesses affected by the proposed rule. Absent this type of categorization, Treasury and the IRS will never be able to assess adequately the required impact of the proposal on small qualified intermediaries.

**C. Treasury and the Service failed to estimate the compliance cost of the proposal**

Although the RFA speaks in terms of recordkeeping and reporting requirements, compliance costs cover a far broader spectrum. Compliance costs also include: the costs associated with modifying procedures to comply with the proposed rule; opportunity costs from lost profits or

sales ensuing from the proposal; and short and long-run costs from changes in industry structure as a result of the proposal.

The extent of the assessment of Treasury and the Service is encapsulated in this finding: "[t]he 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." 71 Fed. Reg. at 6234. From the inability to provide a precise estimate (not required by the RFA), Treasury and the IRS go in the diametrically opposite direction of providing no estimate at all, even one subject to significant qualifications. The lack of providing any estimate at all fails to comply with the RFA.

More troubling is the fact that Treasury and the Service cannot determine the number of transactions that will be affected by the proposed rule. In fact, Treasury and the Service have access to cumulative data that could easily provide an estimate of the proposal's impact. When a business undertakes a like-kind exchange, it must file a Form 8824 with its tax return. Thus, Treasury and the IRS can calculate the total number of transactions and even the cumulative dollar total by simply counting the number of Forms 8824 filed and the total dollar value included in such forms. Treasury and the Service also keep detailed sources of income data by industrial classification. Using this data, the total number of businesses in the industry and the total revenue can be determined. The Office of Advocacy and the Bureau of the Census maintain data on the number of businesses in industries by size. With minimal effort, Treasury and the IRS can provide estimates on the scope of the businesses affected. They can calculate more detailed estimates by making certain assumptions about revenue distribution. For Treasury and the IRS to assert that precise estimates cannot be made does not absolve them from making estimates at all.<sup>4</sup>

#### D. Treasury and the Service did not identify overlapping or inconsistent federal law

The Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980), prevents the federal government from regulating the interest rates that the financial institutions, such banks, may charge for their services or pay in interest rates on deposits. Under the proposed rule, Treasury and the Service would impute an interest rate for the services provided non-financial institutions that provide exchange facilitation services but such charges would not apply to banks. The IRFA of Treasury and the Service does not address this issue or its differential impact on non-financial institutions. The proposal would be even more troubling if Treasury and the Service interpreted their proposal as applying to banks because then it would directly conflict with the Congressional mandate that interest rates charged by banks not be subject to any federal control.

<sup>4</sup> Under this rationale, an agency required to prepare an environmental impact statement would not have to assess environmental consequences because they could not be detailed precisely. An agency that made such an argument for its failure to comply with the National Environmental Policy Act (NEPA) would be unsuccessful. Given the parallels between the NEPA and the RFA, see *National Ass'n of Home Builders v. United States Army Corps of Engineers*, 417 F.3d 1272, 1286 (D.C. Cir. 2005); *Associated Fisheries of Maine*, 127 F.3d at 114 (noting parallels between NEPA and RFA), that argument simply is baseless.

#### E. Treasury and the Service do not discuss any meaningful alternatives

The RFA was modeled on the language of NEPA. See *Associated Fisheries of Maine*, 127 F.3d at 114. Therefore, it is important to understand the strictures of NEPA to fully grasp the RFA requirements. In particular, NEPA requires a federal agency to consider the environmental consequences of its actions before committing resources. *Robertson v. Methow Valley Citizens Council*, 490 U.S. 332, 349 (1989). Evidence that the agency considered environmental consequences of its proposed action is the preparation and analysis of alternatives that will mitigate adverse environmental consequences. As the Supreme Court noted, "omission of a reasonably complete discussion of possible mitigation measures would undermine ... NEPA. Without such a discussion, neither the agency nor other interested groups and individuals can properly evaluate the severity of the adverse effects." *Id.* at 352. Thus, many courts conclude that the keystone or linchpin to NEPA compliance is the development and discussion of alternatives. See, e.g., *Lee v. United States*, 354 F.3d 1229, 1238 (10th Cir. 2004); *Citizens Against Burlington, Inc. v. Busey*, 938 F.2d 190, 195 (D.C. Cir.), *cert. denied*, 502 U.S. 994 (1991); *Grazing Farm Fields v. Goldschmidt*, 626 F.2d 1068, 1072 (1st Cir. 1980); *Monroe County Conservation Council, Inc. v. Volpe*, 472 F.2d 693, 697-98 (2d Cir. 1972), *cert. denied*, 435 U.S. 1006 (1978).

Given that RFA was modeled after the NEPA, the linchpin of an IRFA is the consideration of alternative to the proposed rule. Close examination of the proposal shows a complete absence of a discussion of alternatives.<sup>9</sup> This lack of discussion of alternatives does not comply with the RFA.

In sum, Treasury and the IRS recognize that the proposed rule requires RFA compliance. However, the complete lack of analysis by Treasury and the Service demonstrates that they have little interest in complying with the RFA – a position the agency has taken since the enactment of the statute in 1980. Treasury and the Service should take this opportunity to change course and begin compliance with the RFA.

<sup>9</sup> Discussion of alternatives should include an assessment of take no-action. OFFICE OF ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, A GUIDE FOR GOVERNMENT: HOW TO COMPLY WITH THE REGULATORY FLEXIBILITY ACT 36 (2003).

Thank you for the opportunity to comment in this proceeding. I look forward to working with you and the staff of Treasury and the IRS in improving their compliance with the RFA. Should your staff have any questions concerning these comments, please direct them to Barry Pineles, the Committee's regulatory counsel or John Westmoreland, the Committee's tax counsel at 202-225-5821.

Sincerely,

A handwritten signature in black ink, reading "Donald A. Manzullo". The signature is written in a cursive style with a large, sweeping initial "D".

Donald A. Manzullo  
Chairman

Appendix D



CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

July 10, 2006

The Honorable Donald A. Manzullo  
Chairman  
Committee on Small Business  
U.S. House of Representatives  
Washington, DC 20515

Dear Mr. Manzullo:

I am writing to follow up on our meeting on June 27, 2006, and your letter dated May 8, 2006, regarding the proposed regulations under section 468B relating to the tax treatment of funds held by qualified intermediaries in connection with deferred exchanges of like-kind property. At our meeting you expressed concern about the initial regulatory flexibility analysis (IRFA) prepared with respect to these proposed regulations and you pointed out several perceived deficiencies with the IRFA. At our meeting, I told you that I would review the IRFA in order to make my own evaluation of whether it did in fact comply with the requirements of the Regulatory Flexibility Act.

After looking into the matter, I have concluded that the IRS and Treasury Department made a good faith effort to comply with the Regulatory Flexibility Act and that the IRFA that was published with the proposed regulations was technically in compliance with the law. Nonetheless, I have also determined that the IRS and Treasury Department could have done better with respect to certain aspects of the IRFA. For example, regarding industry size standards, you suggest that we should have used NAICS 523991 relating to trust, fiduciary and other custody activities, rather than NAICS 531390 relating to real estate related services, such as escrow services. While we recognize that like-kind exchanges are not limited to real estate transactions, we believe that neither code adequately describes the qualified intermediary industry because both codes are under-inclusive as well as over-inclusive. Hence, it may be more appropriate to use some kind of a composite.

Similarly, you raised questions about the accuracy of our estimate of the number of small businesses in the qualified intermediary industry. In preparing the IRFA, we arrived at our estimate of 325 businesses affected based on information provided to us by the Federation of Exchange Accommodators, which told us they represented 80 percent of the qualified intermediary industry. Testimony at the hearing held on June 6, 2006, suggests, however, that there may be more than 325 small businesses in the qualified intermediary industry. We are going to research the matter further.

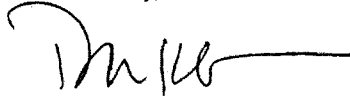


You also criticized the IRFA for failing to discuss alternatives. Although the IRFA discussed the alternative of retaining the facts and circumstances test under the 1999 proposed regulations, we agree that other alternatives could have been explicitly addressed. We will expand our discussion of alternatives in the next IRFA or in the final regulatory flexibility analysis (FRFA) that we will publish in connection with this regulation project.<sup>1</sup>

Lastly, you chastised us for failing to provide an estimate of the costs of complying with the proposed regulations. We acknowledge our responsibility to do so either in a revised IRFA or in the FRFA for this regulation project and will provide an estimate of those compliance costs at that time. As you can see from the text of the Preamble to the proposed regulations, because we were unable to develop a reasonably reliable estimate of the compliance costs when we published the IRFA, we requested comments regarding the nature and extent of the economic impact on small entities, which we will carefully consider as we continue working on this regulation project.

I would like to thank you for bringing to my attention your concerns regarding the adequacy of the IRFA relating to these proposed regulations. As I told you during our meeting on June 27<sup>th</sup>, I commit to you that we will take appropriate steps to address them, along with the other comments that we received, either in a revised IRFA or in the FRFA for this regulation project. Also, as I discussed with you at our meeting, we are undertaking a training program at the IRS concerning the requirements of the Regulatory Flexibility Act to insure that those requirements are adhered to.

Sincerely,



Donald L. Korb  
Chief Counsel

cc: Eric Solomon

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<sup>1</sup> At this stage of the process, the IRS and Treasury Department could incorporate new information and analysis into a revised IRFA, prior to promulgating any final regulations, or, in the alternative, into the FRFA. No decisions have been made by the IRS and Treasury Department at this time regarding how we will approach this issue.



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*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**

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*.<sup>1</sup> 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.

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<sup>1</sup> 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.<sup>2</sup>

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

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<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup> 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.

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<sup>3</sup> 71 Fed. Reg. 6231, 6234 (February 7, 2006).

<sup>4</sup> 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.

TESTIMONY OF LOUIS S. WELLER  
BEFORE THE U.S. HOUSE OF REPRESENTATIVES  
SMALL BUSINESS COMMITTEE  
HEARING ON PROPOSED TREASURY REGULATIONS §1.468B-6  
JULY 25, 2006

Chairman Manzullo and Members of the Committee:

My name is Louis S. Weller. I am pleased to appear before you in connection with your inquiry into Proposed Treasury Regulations Section 1.468B-6, dealing with the taxation of qualified intermediaries, qualified escrows and qualified trusts utilized in deferred like-kind exchanges under Internal Revenue Code Section 1031. I am a principal in the professional services firm of Deloitte Tax, LLP, where my professional practice focuses primarily on advising the firm's clients on tax consequences of transactions involving acquisitions and disposition of business assets. I appear before you today at the request of this Committee. The views I express reflect my experience in this industry. They should not be taken as representing Deloitte Tax LLP or any of its clients.

For almost 30 years of professional practice I have been involved in advising clients on the rules relating to Section 1031 like-kind exchanges. My professional background in this regard is more fully described in the Curriculum Vitae included with the written record of my testimony.

While I have written a number of articles and outlines on various topics relating to Section 1031, the most recent is an article published in the June 2006 issue of *Journal of Taxation*, co-authored with my colleague Kelly Alton, dealing with the subject matter of this hearing. That article expresses my personal views on these proposals, which can be summarized as follows:

1. The general attempt to create rules for various types of funds which are not "qualified settlement funds" is an appropriate exercise of regulatory authority by the Treasury Department.
2. Prop. Regs. §1.468B-6 addresses a set of issues which section 468B was not intended to address.
3. By characterizing deferred exchange arrangements as loans, the proposal inappropriately draws a distinction between the status of qualified intermediaries for section 1031 purposes and section 468B purposes.
4. Application of the rules of Section 7872 to qualified escrow, trust and intermediary arrangements is inappropriate as a technical matter.
5. The short term nature of deferred exchange arrangements justify excluding them from the Section 7872 regime.

6. The proposed testing rate for application of Section 7872 principles does not appear consistent with the nature of the underlying transactions to which this rate would be applied.
7. The projected effect of the proposal which favors financial institution-owned qualified intermediaries needs to be carefully weighed in determining whether it should be adopted as proposed.

These points are expanded upon in the article, which is submitted for the record.

I will be happy to address any questions which the members of the Committee wish to pose.



U.S. HOUSE OF REPRESENTATIVES  
SMALL BUSINESS COMMITTEE  
HEARING ON PROPOSED TREASURY REGULATIONS §1.468B-6  
JULY 25, 2006

TESTIMONY OF MICHAEL HALLORAN

### **INTRODUCTION**

Chairman Manzullo and Members of the Committee:

Thank you for the opportunity to speak with you today. My name is Michael Halloran, I am the President and CEO of Nationwide Exchange Services (NES). NES is a Qualified Intermediary under section 1031 of the IRS code. We provide investors and corporations with 1031 tax deferred exchange services on a national basis and maintain operations in California, Illinois and here in Washington DC.

My comments today are not only on behalf of Nationwide Exchange Services, but also reflect the interests and business practices of the majority of qualified intermediaries in the 1031 industry. A number of the executives of these companies have traveled to the Capital to attend this hearing today and are in the audience.

We at NES believe that the proposed changes:

1. Fail to identify and substantiate a specific deficiency;
2. Are unnecessary to address ambiguously stated concerns;
3. Would effectively eliminate the current free market competitive environment;
4. Run counter to the interests of individual consumers, commercial investors, and corporations;
5. Would result in the closing of hundreds of companies and the loss of thousands of jobs;
6. Ultimately would result in lowered tax revenue to the federal government.

I would like to state that NES is in business because of the IRS and the tax code. The Service is not our adversary. To the contrary, qualified intermediaries act on a daily basis as the first line of defense for the IRS regarding 1031 exchanges. We play a critical role in educating and advising exchangers in the proper application of the 1031 provisions. If it were not for the intermediary industry the service would be plagued with frequent and substantially incorrect executions of 1031 exchanges, inadvertent or fraudulent. The IRS and the qualified intermediary industry have a long track record of a mutually beneficial co-dependency. Our industry would like nothing better than to have a meaningful opportunity to address any valid and substantiated deficiencies identified by the IRS, in a way that would be balanced and equitable. We believe that the current proposed regulation changes do not accomplish this objective and would result in a decisive competitive advantage for a handful of bank-owned qualified intermediaries.

### **THE BUSINESS PRACTICES OF A 1031 QUALIFIED INTERMEDIARY (QI)**

QIs process 1031 tax deferred exchange transactions for taxpayers (individuals, commercial investors, and corporations) by educating, advising, producing the necessary legal and tax documentation, and acting as a disinterested third party custodian [fiduciary?] holding the proceeds through the transaction while ensuring security and immediate liquidity of exchanger assets.

Throughout the industry, QIs subsidize these mission-critical services through a combination of a competitive fees charged to the exchanger and retention of a portion of the interest received on the funds under fiduciary management. The latter is commonly referred to as the spread.

In the current 1031 environment, the exchanger is not in constructive receipt of the funds as mandated by IRC 1031. Thus the QI, in its custodial role and as fiduciary, holds exchanger assets and creates scale by aggregating those assets in financial instruments that conform to all regulatory and fiduciary obligations. Aggregation of assets allows the QI to earn interest at the highest available rate for funds requiring daily liquidity. A portion of that interest - at a rate defined by the market - is paid to the consumer. The remainder is used by the QI to cover operations, marketing, ongoing training, bonding, transaction execution, reporting and customer service costs. All of the aforementioned elements are highly dynamic and subject to constant competitive pressure in the QI industry - resulting in lower processing fees, higher interest rates paid to exchangers and increasing levels of customer service and financial security.

In this environment, the exchanger receives a 1099 from the QI for the interest that the QI pays them. The retained interest is treated as gross revenue to the QI and, after operation and execution costs are deducted, income tax is paid on any operating profits. There is no homeless income, or untimely payment. Costs are represented most significantly in payroll, marketing, education, and transaction processing - all representing sources of tax revenue to federal and state agencies.

#### **THE PROPOSED CHANGES**

- 1) The IRS proposed revisions provide that all interest earned on exchanger assets be taxed as income directly to the exchanger, whether received or not, regardless of the fact that the exchanger is not and cannot be in constructive receipt of their own exchange proceeds to earn interest.
- 2). The IRS proposes that the only legitimate form of income for the QI is in the form of exchange fees, and that all such fees must be set up-front regardless of any variable cost burden of executing the exchange transaction and ignoring competitive drivers.
- 3). The IRS states that in the event the QI utilizes any of the interest earned on assets to cover transactional expenses or operating costs, exchange proceeds will be treated as below market loans and the taxpayer will recognize imputed income at a rate equivalent to the 6-month treasury rate- regardless of the fact that deposits must be held as demand deposits and on average are seldom held longer than 90 days with many called in a shorter timeframes.
- 4) The IRS goes on to define the only form of acceptable transactional costs that can be deducted from interest proceeds of exchanger assets as hard costs directly attributable to the specific exchange and paid to a third party vendor.
- 5) The proposed revisions eliminate the ability of the QI to aggregate funds, create scale, attain a higher interest yield, utilize a portion of that yield to subsidize costs in educating, marketing, executing, insuring, and supporting exchange transactions, and use the balance of the yield to deliver a competitively high interest rate to consumer or corporate clientele."

6) The proposed revisions are held not to be a significant regulatory action as defined in Executive Order 12886 despite the fact that they would fundamentally change the operational makeup of all but a small number of QIs within the US.

#### **NO ESTABLISHED DEFICIENCY**

In NES' view, no deficiency has been identified or established to support the proposed changes. The IRS maintains that the changes are proposed to provide *certainty and consistency of treatment*" (emphasis added) - in fact the opposite effect would result.

#### **ADVANTAGE BANK-OWNED QUALIFIED INTERMEDIARIES**

Should 468B be enacted in current proposed form, a bank owned QI could offer to perform a tax-deferred exchange for a low fee of \$750. The proceeds of the exchange would be deposited in an account with the banking parent, providing daily liquidity and a moderate interest yield. Lacking competitive pressures by the elimination of independent QIs the interest rate paid to the consumer could be paid at the lowest rate available from the parent banking institution (currently about 1%). The parent would be able to utilize those deposits in traditional lending and credit activities, generating yield on those funds (8.9% using B of A's 2005 return on deposits as an example: this is approximately twice the yield available to non-bank QIs). The parent bank would be able to utilize funds generated by the yield to subsidize operations, personnel, and marketing expenses of the subsidiary 1031 operation.

The independent QI, no longer possessing the ability to generate revenue on exchange proceeds, would be forced to charge a non-competitive exchange fee in the of thousands of dollars to fund operations, personnel, marketing, transaction insurance, training, etc. required to facilitate exchanges.

A decisive and fatal advantage would be awarded to bank-owned QIs, which would be able to continue to operate very profitably with a considerably lower fee structure. Why would any consumer, when presented with the option of a \$750 fee versus a \$3,000 fee, opt for the latter? Furthermore, the lack of competition would result in lower rates of interest paid to the exchanger [the consumer] and therefore reduce tax revenue for the IRS. Bank-owned QIs would experience no adverse impact whatsoever from the proposed revisions but would, conversely, quickly eliminate all non-bank competition.

#### **IMPACT OF PROPOSED CHANGES**

The proposed 468B changes will have a dramatic impact on the majority of QIs [non-bank QIs] by eliminating major components of revenue that are used directly to subsidize 1031 exchange execution, operations, jobs, ongoing 1031 education, basic consumer protections, lower fees and interest paid to consumers. The IRS has stated that the proposed revisions are intended to ensure that all providers of 1031 services are treated in a uniform manner. The practical result is that a handful of bank-owned QIs would be left as the only QIs In addition:

##### **Interest rates will no longer be set by competition in a free market environment**

In today's 1031 market environment interest paid on exchange transactions is determined by free market competition, where intermediaries attempt to provide the most attractive combination of fee charged and interest paid to the exchanger. With the effective elimination of 95% of QIs, competitive pressures will be virtually non-existent and bank-owned QIs would have little incentive to put consumer assets in anything other than the lowest yielding daily liquidity

investment mechanism. Consumers will receive markedly less interest income and the result will be a reduction in income tax from 1031 transactions.

**QIs would be forced to take additional risks, at the expense of the consumer**

The current 1031 marketplace acts as fiduciary for billions in assets placed in conservative investment vehicles that provide daily liquidity for the exchanger. The proposed revisions, in particular the imputed 6-month treasury rate, forces intermediaries who attempt to remain in business to generate much higher interest yields to cover costs and keep fees competitive. The risks attending such a strategy are inconsistent with the letter and spirit of 1031, and would constitute a disservice to providers and consumers alike.

**Interest earned is the principal industry mechanism for subsidizing operations**

Identical to the financial services industry, return on assets held is the principal tool for covering operational costs, variable transaction costs, sales, marketing, and industry education. The largest operating cost for QIs is payroll, which generates substantial income tax revenue for the federal government. The proposed revisions preserve this revenue for bank owned QIs, and no others.

**Scale advantages removed from independent QI industry segment**

Traditional advantages of operational scale would be entirely removed by the proposed revisions. By effectively eliminating the ability to aggregate assets and negotiate favorable interest rates, the proposed revisions harm both the business and consumer. The business loses the ability to garner scale through higher revenue, which can be put back into operations, and the consumer loses the ability to benefit from a higher interest rate being paid to the consumer. Larger and more scaleable businesses result in more jobs (income taxes), more profit (corporate income taxes), and higher interest paid to consumer (taxable income), all of which result in greater tax revenue for federal and state government.

Thus, the proposed changes will provide a conclusive competitive advantage to a very small minority sector of the QI industry: most others will be forced out of business. To NES' knowledge, these changes are proposed without substantial case for or analysis of a tax benefit at the federal level. In addition, to NES knowledge, no formal, comprehensive impact analysis for the applicable business sectors and the consumers that use them has been performed. However, the proposed revisions have been characterized as insignificant in these regards and we believe strongly that this characterization is simply wrong.

It is the position of Nationwide Exchange Services that the proposed changes are not justified, are anti-competitive, are anti-consumer, and will have a devastating impact on hundreds of small businesses and their employees.

NES respectfully requests, therefore, that the proposed revisions be withdrawn.

Thank you for the opportunity and your attention.

I am more than happy to address any of your questions.

**TESTIMONY OF HOWARD J. LEVINE BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES, COMMITTEE ON SMALL BUSINESS, JULY 25, 2006.**

**Hearings on Re-Proposed Regulations Under Internal Revenue Code Section 468B(g)**

Good afternoon and thank you for inviting me to present testimony. My name is Howard Levine. I am a partner in Roberts & Holland, LLP, a Washington DC and New York law firm which limits its practice to tax law.

My interest in the like kind exchange area spans more than 30 years. I was the chairman of the ABA Tax Section Sales, Exchanges & Basis Committee, which has primary jurisdiction over §1031. I am the author of the BNA Tax Management Portfolio on §1031, which, for more than 25 years has been the most widely used treatise around the country on like kind exchanges. I have also been an adjunct professor at both George Washington University Law School and Georgetown University Law School and I am on the boards of several tax journals.

**In the limited time that I have to speak, I have five points that need to be made.**

**1. The Re-Proposed Regulations are correct, both as a matter of substantive tax law and as a mater of tax policy.**

The general rule in the re-proposed regulations, that the funds will be treated as loaned to the QI unless all of the interest is paid over to the taxpayer, is absolutely consistent with, and in fact required by, long established case law that a taxpayer must have the benefits and burdens of ownership of property in order to be taxed on the income derived from that property.

Contrary to what some have claimed, it is also consistent with the intent of the original set of regulations that were proposed in 1999 which also set forth a burdens and benefits test and a general rule that the taxpayer would be considered the owner of the funds. The 1999 regulations, however, set forth an exception based on a facts and circumstances test with no further elaboration. In addition, the 1999 regulations stated that if there was a circumstance where the exception was to apply, the rules of section 7872 were to be taken into account.

Had the IRS immediately finalized the 1999 regulations, it is doubtful there would be any real issue today as to who must report all the income from the exchange account and whether Section 7872 can be applicable if somehow (although unlikely) the QI were considered the owner. However, the IRS took no action to finalize the regulations for seven years and this had the practical effect of allowing many QI's to take aggressive and (among QI's in general) inconsistent positions.

From a substantive tax law viewpoint and a tax policy viewpoint, the bottom line is this: **The funds are simply the proceeds from the sale of the taxpayer's property.** If the Funds are somehow to be treated as owned by the QI, one must answer the question: **How did the QI get ownership of the funds?** The answer can only be by way of a loan.

The present system has not led to failures to report the full amount of investment earnings by QI's and their clients." However, the concern is not just making sure that all of the income is being reported by someone. If that were the case, parties would be free to determine between themselves who would be taxable on income. That is in fact, however, what has been happening. Taxpayers and QI's have been determining between themselves who will be taxable on the income. This in turn has led to significant inconsistency among reporting by QI's.

## **2. THIS IS NOT ABOUT BIG VS. LITTLE QI'S; NOR IS IT ABOUT BANK AND TITLE INSURANCE QI'S VS. ALL OTHERS.**

Contrary to the way this is being portrayed by some, this debate clearly is not about the big QI's and their affiliates versus the little QI's. At the forefront of those opposing and lobbying against the regulations are the very large title insurance companies and their financial parent companies, which in terms of revenues and assets far eclipse all other QI's and their affiliates.

Nor is the debate about banks or banks and title insurance companies vs. all others. In my 30 years of experience in the like kind exchange area, I have represented all kinds of QI's. When the original set of regulations was proposed in 1999, I testified before the IRS in favor of the regulations, although I suggested some clarifications. I did not at that time represent any QI affiliated with banks or title insurance companies, yet at that time I strongly supported the 1999 regulations. Since 1999, I have represented QI's that have been independently owned, title insurance company affiliated, and bank owned. Irrespective of the type of ownership of my clients, I have consistently supported the 1999 proposed regulations and I strongly support the re-proposed regulations because I believe they are consistent with and required by established case law.

Moreover, as evidenced from the submissions that have been made to the IRS and Treasury, and as admitted by those opposing the regulations, there are clearly QI's who are not affiliated with any bank or title insurance company who support the regulations.

Therefore, what this debate is really about is a difference in business models, as explained more fully in the attached article.

## **3. The Re Proposed Regulations Will Benefit Most Small Businesses**

The purpose of this hearing is to determine whether the re-proposed Regulations under 468B will be harmful to small business. It is true that many (but not all) of the few hundred or so QI's around the country may end up deciding to change their business model as a result of the proposed regulations. However, it is important for the Committee

to understand that there are many more small business interests who will benefit from the finalization of the Re-Proposed Regulations, namely the many thousands of taxpayers who do exchanges each year who are customers of these QI's. The small business owners, restaurateurs, hoteliers, real estate owners and operators, those investors whose nest eggs are comprised of a single piece of investment real estate – are largely unaware of this debate. These many thousands of small business taxpayers are giving up, often unwittingly, millions of dollars of interest income. For those thousands of small business taxpayers, these regulations will provide greater security for their funds and real transparency.

#### **4. The Re-Proposed Regulations Will Foster Greater Consumer Protection**

There are many reported instances of QIs sustaining losses on investments made with Taxpayers' exchange proceeds, a number of which resulted in bankruptcy filings and the loss of the Taxpayers' equity. This is because the funds that belonged to the QI's customers were not kept in segregated accounts and had all been commingled. The courts have said that under such circumstances, the funds were not directly traceable to the sale proceeds of a particular taxpayer's property. The re-proposed regulations will strongly encourage QI's to segregate a customer's funds and not co-mingle, thereby providing much greater protection against the funds becoming part of the estate of the QI in the event of bankruptcy.

#### **5. The Re-Proposed Regulations Will Lead to Greater Transparency as to the Amount Being Paid for QI Services**

The large company who does a 1031 exchange typically has sophisticated counsel and advisors who make sure that the QI's do not retain any of the interest earned on their funds. Most exchanges, however, are not done with taxpayers being represented by such advisors and such taxpayers do not really understand how much interest they are losing or they simply are not in a position to negotiate with the QI's, particularly the very large title insurance affiliated QI's. The re-proposed regulations should eliminate this problem because they will encourage QI's to pay over all the interest earned from the taxpayer's own funds to the taxpayer.

I am attaching as part of the record an article that I wrote which will be published next week on the proposed regulations which in much more detail responds to the various points made by those opposing the regulations.

Thank you for the opportunity to speak to you this afternoon. I would be happy to answer any questions you may have.

Attachment



ELANUSA GROUP, INC.



July 13, 2006

D. Richard Dance  
1031 Exchange Coordinators  
14100 SE 36th Street NE  
Bellevue, WA 98006

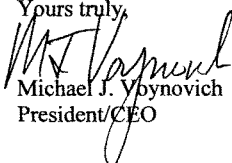
Dear D. Richard Dance,

I am writing at the request of one of my clients who has embarked on a plan to consolidate qualified intermediaries into a vertically integrated company in combination with a 1031 Syndication company, a Broker/Dealer, and a bank. This acquisition mode is current and on-going.

My client has very specifically designed criteria in evaluating the viability of the companies that are acquired, and allows the principals to continue operating the company for a term favorable and desired by the QI owner. Each acquisition will close quickly (within 30 days) and with confidentiality, with exceptional future growth potential as being a part of a nationwide network.

I have been authorized to preliminarily evaluate each interested QI and will do so under confidentiality and non-disclosure agreements as desired. This "directive" requires an immediate response as the plan calls for all acquisitions to take place by the end of the third quarter, 2006.

If you would consider a purchase of your company, please contact my office immediately. Only a select number of QI's will be acquired in each market area.

Yours truly,  
  
Michael J. Ypynovich  
President/CEO

17131 SR 54, LUTZ, FL 33549  
(888) 783-7773, EXT. 82 • FAX (813) 315-6435 • [WWW.ELANUSA.COM](http://WWW.ELANUSA.COM)



1031 Exchange Coordinators  
 Testimony to the Committee on Small Business  
 Rayburn House Office Building, Room 2360  
 Tuesday July 25, 2006 2:00pm

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**A White Paper Presenting Several Banking, Accounting, and Systems Consequences of the Proposed Regulation 468B on Small Qualified Intermediaries (QIs)**

The purpose of this white paper is (I) to describe what I see as the overall impact of the proposed 468B regulations on small Qualified Intermediaries, (II) provide a breakdown of the specific impact in the areas of (A) banking, (B) accounting, and (C) systems, (III) touch upon some ideas for possible solutions, and (IV) issue brief closing remarks. An executive summary equals the bolded titles of this white paper.

**I. IMPACT on small QIs is at least twice the workload with half the revenue to comply**

To try and assess what the meaning of all these requirements are on 1031 Exchange Coordinators we prepared the following comparison table of the current and proposed state of affairs. Based upon the sheer numbers in the chart below the increased workload is more than two hundred times what it is now for the tasks identified, and when coupled with all the other work of running an exchange business means that our workload appears to be doubled. Alone, this is a significant enough impact by itself, but when coupled with a 50% decrease in revenue from the interest that we retain -- the proposed 468B regulations become unsustainable.

Category	Item	Current Workload	Proposed Workload	Calculations
A. Banking	Trust accts to set up per year	3	500	3/yr vs. 1/new client
	Bank statements to receive in the mail and individually reconcile	6	600	1 stmt/client/mo is a huge load for small QIs to reconcile properly
	Check stock to maintain	500 checks	4,800	Min 8 checks per client in a packet
	Interest calculations per year	600	219,000	1/client/exchange vs. avg. daily bal
	Bank charge allocations	12	7,200	1/mo vs. 1/client/mo
B. Accounting	Estimated # of problems to resolve each year	12	600	1/mo vs. 1/client/yr
C. Systems	Approximate system costs	\$750	\$50,000	A new software system that has not been created yet is required.
	<b>TOTAL NUMBERS (excluding dollars)</b>	<b>1,133</b>	<b>232,700</b>	An increased workload of 200x is estimated for these specific tasks

**II. BANKING, ACCOUNTING, & SYSTEMS CONSEQUENCES**

**A. BANKING CONSEQUENCES make it much more difficult to setup, maintain, and ensure that client balances are accurate. Additionally we may have to change banks.**

Our current systems are very efficient and effective in ensuring client balances are accurate. Currently we have a few trust accounts into which we deposit and withdraw all client funds. Individual sub-accounts for each client's exchange are maintained in our accounting system. It is very efficient and effective to look online daily and make sure the total of the few trust fund accounts equal the total in the accounting system. At the end of the exchange all client balances are reconciled to zero with the corresponding exchange paperwork. If there is an error in posting among client accounts it shows up as a non-zero balance and can be easily detected and fixed within our accounting system. Interest is calculated once at the end of the exchange. A summary letter and account reconciliation is sent to each client.

The five new banking requirements implicit in the proposed 468B regulation make it much more difficult to ensure client balances are correct. If the regulations passed as proposed, we would need an account or sub-account with each client's name and federal ID number so that 1099-Interest forms could be generated each year by the bank. This creates five new requirements that we asked our bank and others about so we could get a sense of the regulation's impact on our business. The five requirements are:

- 1) Set up a separate bank account for each client
- 2) Maintain and reconcile separate accounts
- 3) Print checks on individual client check stock
- 4) Allocate average daily balance interest to each client
- 5) Assign direct and allocate indirect bank charges to each client

**1.) How can we open hundreds of separate bank accounts quickly and still be in compliance with the Patriot Act?**

The Patriot Act usually requires a bank to identify all new customers and gather a multitude of personal information including, but not limited to: name, social security #, date of birth, physical address, and documentary identification with photo. How would your bank open an account in compliance with the Patriot Act without our clients having to personally identify themselves in a visit to your bank? Can you open and close accounts fast enough to handle exchanges that open and close in a day or two?

**2.) How can we maintain and reconcile thousands of accounts or sub-accounts without daily total balances being visible?**

Our experience tells us that banks typically treat accounts as entirely separate unrelated entities. In QI work this is not the case. Accounts have a relationship to each other and to the total business. Several of our clients have multiple exchange accounts at one time and at times we need to reconcile among their accounts to see if funds were appropriately coded. At times this creates negative balances within an individual sub-account. At times funds come into our account without proper identification and are essentially homeless funds in suspense. Other funds may come months before or after an exchange. Our clients, their agents and escrow always need to know the balance of exchange funds. Hence the need to diligently track and reconcile all sub-accounts to the total funds for about one year and make transfers between sub-accounts when appropriate and be able to reconcile them on any given day. How would your bank help us handle homeless funds, sub-to-total fund reconciliation and negative sub-accounts? Would we get an account statement per month by account and sub-account or is there an easier way to reconcile daily to the grand total of all accounts? How soon could we close an account?

**3) How do we print checks for thousands of accounts without maintaining check stock for each client?**

How do you write a check and appropriately code it to a sub-account on only one check stock without the bank running a parallel accounting system or having special coding or MICR printers? We know it can be done by large corporations, but how about the average exchange facilitation company with less than 10 employees? How would your bank suggest we print checks for individual clients? What is required?

**4) How do we calculate average daily balance interest calculations without going to a large bank?**

Currently we pay a stated interest rate to some clients. This allows us to quote lower fees as interest subsidizes 50% our fees. The proposed regulations basically cause an exchange facilitator to pay "all interest" out on an average daily balance method. Three factors complicate this: a) exchange facilitators typically aggregate fees into longer-term CD's or other instruments that don't pertain to individual clients, and b) frequent adjustments are made to accounts (such as the posting of homeless funds), and c) after an exchange is complete and all interest has been paid out, escrow refunds and other items continue to arrive for the benefit of the client for up to months after the property settlement date. How would your bank allocate interest to clients on an average daily basis method, handle interest on homeless funds in suspense, and make corrections to and among clients after-the-fact?

**5) How do we allocate general bank charges if it is illegal to treat them as interest?**

The volume of accounts required by 468B impacts bank operations significantly and results in an increase in new bank charges to QIs. If QIs are to pay out "all interest" to clients, we would also need to charge "all bank fees" to clients so we ended up zeroing out all bank fees. However, bank fees are typically zeroed out by keeping certain sums in demand deposits that do not earn interest. If it is illegal to pay interest on demand deposits, how would you propose that we allocate earnings credits and general bank charges to individual client accounts? What monthly fees per account must be paid while the account is open?

Here are the Bank Responses obtained by inquiry: (White or Light Green is optimistic, Light Grey or Yellow is cautious, and Dark Grey or Red won't work without increasing the workload)

	1. Opening	2. Reconciling	3. Printing	4. Interest	5. Charges
<b>Small Banks:</b> Frontier (our current bank)	Need photocopy of client DL + SSN to open.	No way to reconcile individual accts to balance total.	No blank checks are available anymore. Initial packet has 8.	Their systems can't compute avg daily balances.	No way to allocate earnings credit to clients
Columbia	Set up money mrkt accts over the Internet	Master account may provide some ways to reconcile.	Money market or checking account still need checks.	Accrued daily, pd monthly. No system for client.	No way to allocate general fees.
Matrix Capital	Need picture ID & exchange agreement	Omnibus accounts exist with some reconciliation.	Need to maintain individual entity coding.	Has a flexible client interest rate, but not avg daily balance.	No bank service charges if balances over 3 million.
First Mutual Bank	After we sent them the list of inquiry questions for Reg 468B we didn't hear from them in time. I think they found out that there would be quite a bit more requirements than they thought. It is not easy for a small community bank to meet the sophisticated requirements, nor is it that easy for a large bank.				
<b>Large Banks:</b> Bank of America	Master accounts just started this week. Take 1 hr to open	Individual accts, no way to see balance of all in master accts No commingling.	Few encoding machines around due to fraud potential.	Avg daily balance system isn't set up yet for what we need.	Illegal to pay interest on demand deposits. Service charge each month.
Deutsche Bank (This is a non-branch bank with HQ in NY)	Just as onerous Need a W-9 Setup over fax/phone 1hr in NY	Consolidated offline report monthly. No total balance online or txfr among accts.	Don't have a satisfactory answer yet.	Take snapshot each day, apply fed funds. Correct errors with adjustments.	Only charges are direct fees to each account. No general fees
JP MorganChase				Has earnings allocation module	

Based upon our bank not being able to meet 4 of the 5 new requirements at all, we may have to change banks. 1031 Exchange Coordinators has been one of Frontier Bank's ([www.frontierbank.com](http://www.frontierbank.com)) largest sources of funds for 15 years. The strict requirements of section 468B may cause us to change our banking relationship. Frontier is a regional bank in the State of Washington with 45 branch offices and deposits of \$2.06 billion. They have been in business for 27 years and had total interest income of \$178 million in 2005. They went public on the NASDAQ in 1998. Frontier's loan portfolio for 2005 is classified as follows: Real estate related loans 83.2%, other loans 14.8%. Commercial real estate, construction and land development loans have historically represented the largest portion of Frontier's loan portfolio. These loans consist of a wide cross-section of retail, small office, warehouse, and industrial type properties within the State of Washington. Frontier is an important bank to our local economy.

**I am concerned about the integrity of our client funds if we have to implement the 5 new banking requirements**

Our relationship with Frontier is one of our strengths. They are a strong bank, safer for our clients than big banks. They give us the "high touch" that our clients need to be assured that the funds with us are safe and properly accounted for. We receive personal phone calls when any funds leave our account or questionable transactions occur. With just a few accounts to manage we know our bank balances. We can see daily if the aggregate trust funds agree with our accounting system sub-account total. I cannot imagine the loss of confidence that our clients would have in us and the increase in the amount of errors and corrections necessary after implementing the proposed regulations. If our clients understood that we would not have a reliable way of easily ensuring that their constantly changing balances were correct they would vote against the proposed regulation.

**Does 468B favor large banks? Is this an impact of the proposed 468B?**

Do these proposed 468B regulations then favor larger banks and shut smaller banks out of being 1031 company depositories? I believe the answer is yes. My only proof is limited discussions with larger banks and research with JP MorganChase in the area of interest allocations. They bought out SymPro software in 2003 which developed an Earnings Allocation Module for public agencies and has 350 clients, most of which have hundreds of millions to several billion dollars being managed. See the following link to the old SymPro website which redirects you to JP MorganChase ([www.sympro.com](http://www.sympro.com)). I think that this question is an area that ought to be brought within the scope of the Initial Regulatory Flexibility Analysis done by the IRS and Treasury.

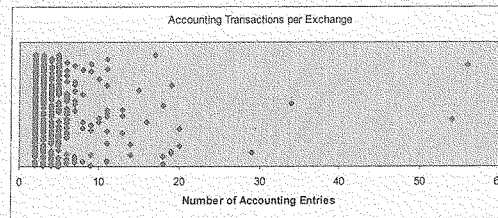
**B. ACCOUNTING CONSEQUENCES make it impossible to use a spreadsheet to comply with 468B**

Let us assume that we wanted to stay with Frontier Bank and decided to take on the 468B accounting as a QI. What problems does that cause? Consider example 6 of the proposed regulations, which shows how "All earnings attributable to commingled exchange funds paid to the taxpayer" is to be calculated. As a CPA for the past 30 years I'd like to share practical accounting problems that this causes and why a simple spreadsheet solution will not work.

**1) The volume of transactions becomes overwhelming and rises up to nearly one million per year**

There might be a mistaken belief that there are only two transactions in an exchange – the funds come in and the funds go out. This is not the case for a multitude of reasons: (1) Exchange funds consist of the initial deposits and all the corrections and holdbacks that come after the fact such as escrow errors. (2) While the funds are in our possession, they can be used for acquisition costs such as earnest money, inspections, repairs before closing, along with loan fee deposits. (3) Many times, multiple properties are sold and bought in an exchange. (4) If improvements are made to the exchange properties the amount of transactions per exchange increases.

Below is a graph of our company's past 450 transactions. It shows a range of 2-56 transactions per exchange with an average of 4.54.



Assume for calculation purposes that a small QI has 600 clients doing an exchange with 4.54 transactions per exchange = 2,724 transactions to record. This might not seem like a lot, but when you add in the requirement for each to have an average daily suddenly there are 994,260 (2,724\*365) possibilities for error -- a spreadsheet nightmare. This is especially so if the data needs to tie into or be reconciled to other systems or represents duplicate entry that is constantly changing.

**2) Timing issues become a thorny problem as there is no good way to handle interest float coming or going.**

If the bank is not doing the accounting, what are the dates that funds come in and go out of the system? Wire transfers are easy -- they are usually on the same day if sent out before 2pm. But what about checks received and checks sent out? A recent check was written to us for \$1,133,820 on April 28, 2006 that we posted into our system on May 1st but did not start earning interest in our trust fund until May 2nd. We also write checks each day that are posted that day, but get cashed and get deducted from bank trust funds balances anywhere from one day to one year later. If QIs are doing their own accounting and issuing their own 1099-Int forms, at what point in time are deposits or checks considered in the average daily balance requested in Example 6 of 458B and how is it reconciled to the actual interest paid by the bank?

**3) Adjustments need to be made to accounts which would cause reiterative interest calculations**

Homeless funds without identification (i.e. a wire without correct references or checks without proper ID) currently go into our general account and start earning interest, but for no one in particular. Since we don't have to account for all of the interest by client each day, we can correct that client's account later on and don't have to attribute it to the average daily balance that affects other clients' percentages. We also get overpayments/underpayments from escrow on items they did not intend to send us. This might be non-exchange funds, or funds for debts which came to escrow's attention after the first close. As in the first instance, we currently can correct a client's account in arrears because it does not affect anyone else's balance. These two examples would require reiterative average daily balance interest calculations.

**4) Holdback releases and corrections are made after payout dates which would require secondary interest payments**

Excess exchange credits are paid out when all identified properties have been purchased or when the exchange period ends. We usually wait about 6 to 8 weeks to issue summary letters and payouts. If the proposed 468B regulations take place and everyone expects interest as a part of their exchange, they will be demanding it shortly after the exchange ends. Sometimes holdback releases and account corrections occur many weeks after an exchange has officially ended. If we have to make quick payouts, then every time after the payout date that there is a system bug fix, correction, or a late holdback release, we will need to recalculate the average balance, the allocations to all clients and the interest earned. We would then need to either (1) issue another check for the additional interest, or (2) send our clients a bill because we overpaid their interest in the initial payout.

**5) 1099 interest forms are issued yearly, but exchanges can overlap calendar year end causing more chance for errors**

1099s are calculated on a yearly basis, so any exchange that goes over a year end will need two 1099s and the prior year interest subtracted from the exchange total. This is just another calculation that is simple to do now but could go awry on a spreadsheet approach that also has to figure in complex average daily balance calculations on a reiterative basis.

**Summary of Accounting Consequences**

Nearly one million calculations per year caused by the requirement for average daily balance calculations with timing, adjustments, secondary interest payments, and 1099s is too much to expect any internal spreadsheet to accomplish with any reliable degree of success.

**Current accounting has been satisfactory for our clients**

What works right now is (1) calculating a client's a stated interest once at the end of the exchange, (2) keeping some of the interest as QI revenue, (3) not reconciling all interest to a grand total, and (4) not calculating anything like an average daily balance. This makes the workload manageable, reduces the chance for error in client accounts, allows us to tell clients with confidence the balance of exchange funds, and has kept our clients satisfied.

**C. SYSTEMS CONSEQUENCES would cause QIs to buy expensive software not available now**  
 If we don't want to change banks (Consequence A) and can't rely on an internal spreadsheet to meet 468B requirements (Consequence B), then small QIs will be forced to buy software systems. Nothing exists on the market now for QIs to use off-the-shelf.

**1) General systems used by QIs are quite simple and inexpensive, yet effective**  
 Like most small businesses in America, qualified intermediaries do not employ directors of information services nor have huge servers or expensive accounting software. We talked with multiple QIs that have been interested in what system software is used in our industry. We learned that for the most part, QIs cobble together in a homegrown fashion three pieces of software:

Accounting Software	Customer Relationship Software	Other Software
QuickBooks Pro	ACT!	1099 Software

The rest of QI work is done on Microsoft Word, Excel, or PowerPoint. That's it.

**2) Very few off-the-shelf packages are available now to help QIs and most aren't a good fit**  
 To find out what off-the-shelf software was available to help with the accounting and tax demands imposed by the proposed 468B regulations, we commissioned SoftResources LLC ([www.softresources.com](http://www.softresources.com)) to do a Software Research Study for us. They have done over 500 software evaluation and selection projects with companies and government entities both large and small throughout North America, Europe and Asia. They started out looking into 42 categories of software. After reviewing all potential categories the search was pared down to the top 6 most likely categories. These were: 1031 Exchange Software, Banking Software, Escrow Management Software, Investment & Treasury Management Software, Legal Trust Accounting Software, and Trust Accounting Software. Here is their chart of finalists:

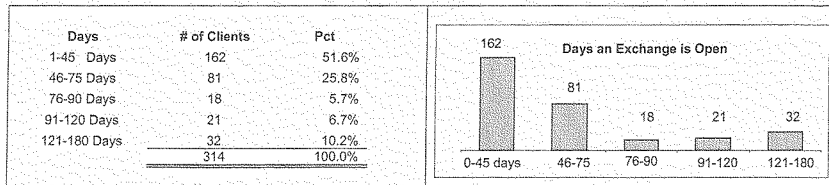
Company	Software	Web Address
Nastel	AutoPilot™ - Transaction Management for Banking	nastel.com
Callatay & Wouters	Thaler - Universal Banking Engine	callatay-wouters.com
Portfolio Systems	Portfolio Director	scscompany.com
Blackbaud	Blackbaud Analytics	blackbaud.com
ByAllAccounts	WebPortfolio - Transactions View	byallaccounts.com
Investment Mgt. Systems	Isis Financial Systems	isisfs.com
SS & C	DBC Finance - AdvisorWare	ssctech.com
Enable Point	Real Estate Escrow Tracking	enablept.com
Captools	Captool Professional Investor	captools.com
JPMorgan Chase	SymPro - Earnings Allocation	sympro.com

**The findings of system research show nothing is available currently at any reasonable price for small QIs**  
 There is no software that meets our needs at an affordable price for small QIs. According to SoftResources, about the lowest potential solution would be \$10,000 and many would require \$75,000 to \$100,000 for customization before consideration of the initial software cost, training, annual maintenance and personnel involved. The likelihood of this approach being as successful as current practice is very slim.

**III. ALL POSSIBLE SOLUTIONS must greatly reduce the volume of work and interest loss being required**  
 I cannot speak for the Federation of Exchange Accommodators (FEA) and other QI's, but if 468B is still to be seriously considered, I do know that all solutions must greatly reduce the volume of work and interest loss the proposed regulation requires. Here are 5 thoughts:

1. A threshold period of time that money can be held before interest accrues, e.g. 75 days based upon our analysis below.
2. A de minimis transaction amount before interest applies especially to holdback releases, adjustments, and corrections, e.g. \$20,000.
3. A reasonable transition period before the regulation becomes effective, e.g. 12 months + for software to be written.
4. A reasonable stated local minimum interest rate or percentage of the full interest rate that leaves plenty of room for aggregation and miscellaneous interest for the QI, e.g. the premium savings rate for the bank where the funds are deposited.
5. A solution far less onerous than an average daily balance calculation, e.g. one interest calculation at the end of the exchange for the minimum interest rate required

**A random sample of 314 exchanges we facilitated shows 53 days as the average active open period**  
 We took a random sample and discovered that our average exchange was actively open for 53 days. Looking at the chart below shows that 77.4% of exchanges are over within 75 days. So, as recommended in possible solution #1 above, if 468B applied only to exchanges going over 75 days, we could probably live with it. This would mean that 20-25% of exchanges would be subject to the proposed regulation.



For your information, we also sampled 455 exchanges by size of cash equity involved and observed that a small size exchange was \$21,215 for us, a large exchange was \$10 million, and the average amount of exchange proceeds was \$339,321 per exchange.

**IV. CLOSING REMARKS emphasize the need to learn more of the impact and how it can be minimized**  
 I believe that the banking, accounting, and systems consequences being prescribed by the proposed 468B regulations and examples have a more detrimental effect on small QIs than anyone thought. We are trying to learn more about the impact of Regulation 468B and how it can be minimized for all parties involved. If there are questions, corrections, or comments you have please contact me at [rdance@1031eci.com](mailto:rdance@1031eci.com).  
 D. Richard Dance, CPA, President of 1031 Exchange Coordinators at 914 - 140<sup>th</sup> Ave NE, Suite 201 Bellevue, WA 98005

*D. Richard Dance*

FROM IP: 67.188.114.48  
DATE: July 29, 2006 11:14 AM  
NAME: James Litschi  
ADDR1: 26423 Anacapa Ct  
ADDR2:  
ADDR3:  
CITY: Los Altos Hills, Ca 94022  
STATE: Illinois  
ZIP: 61008  
PHONE:  
EMAIL: jllitschi@strarker.com

msg:

I attended the hearing on July 25, 2006 regarding proposed legislation by the IRS concering Qualified Intermediaries. First of all I would like to thank you for your support to get 1.468B-6 overturned.

I am an employee of Starker Services, Inc. There were four of us from the company that attended the meeting, three from California and one from Atlanta. Starker Services is taking this proposal from the IRS very seriously.

I just wanted to comment on Howard Levine's Testimony, although he is a very forceful speaker, I do have to disagree on some of his points. First of all, maybe I am over simplifying the issue, but it seems it comes down to reporting income. Mr. Levine stated that if the Intermediary is earning interest of e.g.5% on deposited funds and paid the exchangor all the interest, then the Intermediary would pay taxes on the interest earned and the exchangor would pay tax on that same interest. But the Intermediary would pay no tax on that interest because they have the off setting expense of giving all the interest to the client. Currently if the Intemediary earns 5% interest on the funds deposited and pays the client 4%, the Intemediary would pay tax on the 1% profit and the exchangor would pay tax on the 4% earned. I do not see how there is tax avoidance in the current working model.

Mr. Levine stated that he knew of Intermediaries buying banks, I think he has his facts backward. I know of banks buying up Intermediaries, but have never have heard of the opposite.

Mr. Levine stated that some of his clients who are privately held Intermediaries are supporting the proposed legislation. I know of none. Please ask him to provide backup.

Lastly, Mr. Levine stated that Bank of America is paying 8% on deposited funds. I would like to know his banker. Currently Bank of America is paying 3.75% on my personal short term interest.

Thank you for the opportunity to speak my mind.  
Sincerely  
James Litschi