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Re: Tax Treatment of Deferred Exchange Proceeds Held by a Qualified Intermediary

Dear Sirs:

We are writing to provide additional input into the exchange of views that took place in 20031 regarding the proper tax treatment of sale proceeds held by a qualified intermediary ("QI") involved in a deferred exchange of properties under section 1031 of the Internal Revenue Code (the "Code") that does not involve a qualified escrow or qualified trust established under Treasury Regs. § 1.1031(k)-1(g)(3). We believe that interest should not be imputed under section 7872 in these transactions. First, such arrangements do not fundamentally represent loans from a taxpayer to a QI. Second, even if such a transaction is treated as involving a loan, section 7872 should not apply to impute interest because doing so would have no significant tax effect on any party involved. Finally, the section 1274 exclusion for short-term debt indicates that Congress did not perceive that these types of transactions, in which a QI holds proceeds for an average of 60 to 90 days, should be subject to interest imputation.

I. Facts

The following example illustrates a typical transaction in which a taxpayer ("T") engages the services of a QI to facilitate a section 1031 deferred exchange transaction. In the first stage of the transaction, T enters into a sales contract with unrelated party B to sell the relinquished property to B. Thereafter but prior to conveyance of the relinquished property, T enters into an exchange agreement with QI. T assigns to QI the rights of T under the sales contract, including the right to receive the proceeds of the sale (the "Proceeds"). Pursuant to provisions in the section 1031 regulations eliminating the requirement of double deed, T usually transfers title to the relinquished property

directly to B.2 The exchange agreement expressly provides that the QI is not acting as agent of the taxpayer. Under the section 1031 regulations, QI is treated as the transferee of the relinquished property and in that capacity receives payment of the Proceeds directly from B. Consequently, T never actually or constructively receives the Proceeds. Subject to its contractual obligations to acquire replacement property or deliver an amount equal to unspent Proceeds following the expiration of periods set forth in Treas. Regs. § 1.1031(k)-1(g)(6), there is no limitation on QI's rights to obtain access to or to utilize the Proceeds.

In the second stage, T enters into a purchase contract with unrelated party S to purchase replacement property from S. T assigns to QI all of the rights of T under the purchase contract. Pursuant to its obligations under the exchange agreement, QI deposits funds, up to the amount of the Proceeds, into the settlement or closing for the purchase of the replacement property from S. Again, to avoid double deeding, S usually transfers title to the replacement property directly to T. If the exchange succeeds, T never receives anything other than the replacement property.³

In connection with the exchange, T will enter into an agreement to pay QI a fee as compensation for its services of acting as an intermediary. In addition, QI may agree to pay T an amount, sometimes referred to as the "growth factor," that is equal to the product of (i) a specified rate, (ii) the amount of the Proceeds, and (iii) the length of time the QI holds the Proceeds. The rate may be either a flat rate (e.g., 2.0%) or a certain percentage of a variable rate (e.g., 60% of the published 4-week T-Bill rate). We understand that on average, a QI holds the Proceeds between 60 and 90 days before T acquires the replacement property.⁴

II. Analysis

In 2003, two taxpayer representatives wrote to you suggesting that where a QI is treated as owning the Proceeds in a section 1031 deferred exchange, the taxpayer should be treated as having "loaned" the Proceeds to the QI, and that under section 7872 the taxpayer should have imputed interest under this "loan." We respectfully disagree with that position, and urge you instead to provide guidance clarifying that section 7872 does not apply to impute interest in section 1031 deferred exchange transactions.

A. The Transaction is Fundamentally Not a Loan.

We do not intend to repeat the discussion of this specific issue contained in prior submissions. We do, however, wish to note a point that in our view may not have been sufficiently emphasized. The arrangements that permit the QI to retain the Proceeds of a sale of relinquished property pending the purchase of a replacement property are not fundamentally a lending transaction. These arrangements are but one aspect of a tax deferred exchange. Although the QI is obligated to pay an amount equal to the Proceeds to the taxpayer if a suitable replacement property cannot be found, the expectation of the

parties is that the taxpayer will receive back an item of property, and not a sum certain amount of cash.

This analysis is consistent with the rules under section 1031. In order for a transaction to qualify as a deferred exchange under section 1031, the taxpayer may not have actual or even constructive receipt of the Proceeds prior to an event described in Treas. Reg. § 1.1031(k)-1(g)(6). In other words, the regulations establish a construct under which the taxpayer is treated as never receiving the Proceeds. In order to treat the transaction as a loan from the taxpayer to the QI, the government would presumably need to treat the taxpayer as having received the Proceeds, followed by a deemed transfer of the Proceeds from the taxpayer to the QI. We do not believe, that there is any rationale or need for inventing these additional steps, which would depart from the structure established under the section 1031 regulations.

B. Section 7872 Should Not Apply.

1. Background

Even if a section 1031 deferred exchange transaction that does not use an express trust or escrow arrangement is treated as involving a loan from T to QI, we believe that section 7872 has no application to the arrangement. Section 7872 requires that interest be imputed in the case of certain below market loans. The legislative history explains that section 7872 was enacted because "Congress believed that, in many instances, the failure of the tax laws to treat [below market loan] transactions in accordance with their economic substance provided taxpayers with opportunities to circumvent well-established tax rules."⁵ The history specifically refers to three perceived loopholes. First, section 7872 was to address situations where "loans between family members (and other similar loans) were being used to avoid assignment of income rules and the grantor trust rules." *Id.* Second, Congress was concerned that "loans from corporations to shareholders were being used to avoid requiring the taxation of corporate income at the corporate level." *Id.* at 528. And finally, "loans to persons providing services were being used to avoid rules requiring the payment of employment taxes and rules restricting the deductibility of interest in certain situations by the person providing the services." *Id.*

Section 7872 applies only to the loans in one of the categories listed in section 7872(c), which are: gift loans, corporation- shareholder loans, compensation-related loans, tax-avoidance loans, significant tax effect" loans and loans to continuing care facilities. If a loan does not fall within one of the listed categories, section 7872 is inapplicable. The only categories of section 7872 loan into which the transaction between a taxpayer and a QI described above might fall are "compensation-related" loans and "significant tax effect" loans. § 7872(c)(1)(B), (E). If section 7872 applies to impute interest on a compensation-related loan, the imputed amount is treated as compensation paid to the independent contractor. Prop. Reg. § 1.7872-4(c)(1).

Section 7872(h)(1)(C) provides regulatory authority to exempt from the application of section 7872 "any class of transactions the interest arrangements of which have no significant tax effect on any Federal tax liability of the lender or the borrower." Of course, any loan exempted under section 7872(h)(1)(C) would also not be a significant tax effect loan under section 7872(c)(1)(E). The legislative history explains that "Congress anticipated that, in appropriate circumstances, compensation-related loans . . . may be exempted by these regulations."⁶

Reg. § 1.7872-5T(a)(1) provides that section 7872 does not apply to "loans listed in [Reg. § 1.7872-5T(b)] because the interest arrangements do not have a significant effect on the Federal tax liability of the borrower or the lender." Reg. § 1.7872-5T(b) provides fifteen examples of transactions that are per se exempt. Among the exempted transactions is: "Accounts or withdrawal shares with a bank (as defined in section 581), or an institution to which section 591 applies, or a credit union, made in the ordinary course of its business." Reg. § 1.7872-5T(b)(2). Another exemption is described in Reg. § 1.7872-5T(b)(14): "Loans the interest arrangement of which the taxpayer is able to show have no significant effect on any Federal tax liability of the lender or the borrower, as described in [Reg. § 1.7872-5T(c)(3)]." Reg. § 1.7872-5T(c)(3) provides: "Whether a loan will be considered to be a loan the interest arrangements of which have a significant effect on any Federal tax liability of the lender or the borrower will be determined according to all the facts and circumstances." Among the relevant factors are:

- (i) whether items of income and deduction generated by the loan offset each other;
- (ii) the amount of such items;
- (iii) the cost to the taxpayer of complying with the provisions of section 7872 if such section were applied, and
- (iv) any non-tax reasons for deciding to structure the transaction as a below-market loan rather than a loan with interest at a rate equal to or greater than the applicable Federal rate and a payment by the lender to the borrower. *Id.*

2. Section 7872 Should Not Apply to Impute Interest in Section 1031 Deferred Exchange Transactions.

a. The Arrangement under which the QI Is Entitled to Hold the Proceeds Temporarily Should Not Be Treated As a Loan as Defined in Section 7872.

Prop. Reg. § 1.7872-2(a)(1) states that the term "loan" is to be interpreted broadly to implement the anti-abuse intent of the statute. As discussed below, however, an arrangement between a taxpayer and a QI is far removed from the type of abuse Congress was concerned with in enacting section 7872.

Prop. Reg. § 1.7872-2(b)(2) says that permitting an agent or intermediary to retain funds for a period is a loan from the principal to the agent or intermediary. This proposed regulation is of course not the law and to our knowledge has never been applied. In many transactions, middlemen are permitted to keep cash for a short period and earn a "float" without having to compensate the ultimate recipient of the cash. If interest were imputed in every such situation, the burden on the tax system would be huge and the revenue effect relatively minor. It makes sense to construe the concept of a "loan" broadly to prevent abuses, but not to interfere with common, nonabusive transactions.

b. The Exemption in Described in Section 7872(h)(1)(C) and Reg. § 1.7872-5T(a)(1) Should Apply

Treating a taxpayer that engages in a section 1031 deferred exchange transaction as having made a below market loan subject to 7872 would not have a significant effect on the Federal tax liability of the taxpayer or QI. In other words, the Federal tax liability of the taxpayer and the QI would not be significantly affected if the IRS were to change the current industry-wide practice by requiring application of the section 7872 interest imputation rules. Therefore, the exception provided in section 7872(h)(1)(C) and Reg. § 1.7872-5T(a)(1) should apply to exempt section 1031 deferred exchanges from section 7872.

Imposition of section 7872 on section 1031 deferred exchanges would not have a significant effect on Federal income tax liability because the amounts that would be imputed would largely offset and cancel each other out. To illustrate, suppose that in the example above: (1) the Proceeds are \$1,000,000, (2) QI invests the proceeds in short-term U.S. Treasury Bills yielding a 4% annual rate, (3) QI credits T's account an amount based on a 2% annual return,⁷ and (4) the replacement property is purchased after 72 days. QI earns \$8,000 on the Treasury Bills,⁸ which it includes as income. QI pays \$4,000 to T,⁹ which both parties treat as deductible by QI and includible in income by T. QI gives a Form 1099 to T for the \$4,000 payment. If the transaction is not subject to section 7872, no interest or compensation payments are deemed to be made. The tax consequences to QI and T are as follows:

	QI	T
Gross Income	—	\$8,000
Deduction	(\$4,000)	(\$0)
Net Income	\$4,000	\$4,000

Now suppose that section 7872 were to apply: the parties would need to calculate and take into account imputed interest and deemed cash flows, but in the end the tax consequences would not be materially different. Specifically, there would be no different net tax consequences to QI and minimal different net tax consequence to T. If section 7872 applied, T would be treated as having made a loan with a principal amount of \$1,000,000 to QI for 72 days. Assume that the relevant imputation rate is 4.25%,¹⁰ and that QI is treated as having paid \$4,500 of interest to T (in addition to the \$4,000 actually

paid).¹¹ T would be treated as having paid the \$4,500 back to QI as compensation for services.

Section 7872 interest imputation has no net effect on QI's taxable income. QI would still have \$8,000 taxable income from the Treasury Bill investment and a \$4,000 deduction for the payment actually made to T. QI would also have a \$4,500 deduction for the imputed interest deemed paid to T, and would include \$4,500 in income as deemed compensation for services. The imputed interest and deemed compensation always offset, and QI's net income remains \$4,000¹² -- the same as if section 7872 did not apply.

Application of section 7872 would have timing consequences for T, but it would not change the total amount of T's taxable income over the life of the replacement property. T would still have \$4,000 of income from the interest actually received from QI. T would also have \$4,500 in income for the interest that QI is deemed to have paid, and the \$4,500 that T is deemed to have paid to QI as compensation for services would be added to T's basis in the replacement property. T would have \$4,500 more net income in the year of the exchange, as well as additional \$4,500 in basis that would be recovered as the replacement property is depreciated. T's net income over the life of the replacement property is the same as if section 7872 did not apply; the only effect would be a timing difference.

As described above, Reg. § 1.7872-5T exempts a number of specific transactions from the application of section 7872 on the ground that the interest arrangements do not have a significant effect on the Federal tax liability of the borrower or the lender. Among the exempted transactions are bank accounts (including checking accounts), made in the ordinary course of the bank's business. Reg. § 1.7872-5T(b)(2). Of course, a zero-interest checking account is a compensation-related loan in the broad sense; the customer allows the bank to use her money interest-free in exchange for the services the bank provides. If interest were imputed on such accounts, the interest would be taxable and the deemed service charges would be nondeductible.

The exemption for bank accounts is based on the premise that such deemed interest income and nondeductible expense would not have a significant effect on the depositor's Federal tax liability, but no dollar limit or time limit is placed on the exemption. Thus, a taxpayer that maintains an average checking account balance of \$10,000 for an entire year would have imputed interest income (at the same 4.25% rate used above) of \$425 and, unlike the section 1031 exchange case, no offsetting deduction ever. A permanent difference in income of \$425 year after year on a \$10,000 deposit could have a more significant tax effect than a one-time timing difference of \$4,500 on a \$1 million section 1031 deferred exchange transaction. Moreover, many more taxpayers have zero-interest or low-interest checking accounts than engage in section 1031 exchanges.

The listed exemptions in Reg. § 1.7872-5T(b) also indicate that making a loan available to the public in the ordinary course of a taxpayer's trade or business (i.e., in an arm's-length transaction) is an indicator that the interest arrangements do not have a significant tax effect on any party. See, e.g., Reg. § 1.7872-5T(b)(1) (loans made available to the

general public "consistent with the lender's customary business practice"), and Reg. § 1.7872-5T(b)(4) (loans made by a life insurance company "in the ordinary course of its business"). These exempted "ordinary course" transactions are in marked contrast to the related party transactions that concerned Congress when it enacted section 7872 (e.g., loans to family members, corporation-shareholder loans, etc.)

The foregoing analysis shows that the exemption listed in Reg. § 1.7872-5T(b)(14) should apply to exclude section 1031 deferred exchanges from section 7872. The parties in such a transaction do take into account the QI's retention of the proceeds when determining the QI's fees, but the parties involved in a bank deposit transaction take into account very similar considerations when determining fees, and the latter transaction is exempted from section 7872. And like several of the per se exemptions listed in the regulations, section 1031 deferred exchange transactions are offered to the public in the ordinary course of a QI's trade or business. This all supports the conclusion that the interest arrangements involved in a section 1031 deferred exchange transaction do not have a significant effect on the tax liability of any party involved in the transaction.

That result is confirmed by the factors set forth in Reg. § 1.7872-5T(c)(3) ("Loans without significant tax effect"). First, for the most part the "items of income and deduction generated by the loan offset each other." Second, the amount of such items is relatively small because of the short time periods involved (\$4,500 in the example with a \$1,000,000 property exchange). Third, application of section 7872 to section 1031 deferred exchange transactions would increase the cost and administrative burden of compliance, as described below. Finally, taxpayers and QIs have structured section 1031 deferred exchanges in the manner set forth above for many years without any tax motivation for doing so.

Moreover, a section 1031 deferred exchange transaction is fundamentally different than the transactions Congress was concerned about when it enacted section 7872. Each of the perceived abuses at which section 7872 is aimed involve related taxpayers trying to "game" the system to significantly reduce their tax liability. For example, compensation-related loans allowed taxpayers to "avoid rules requiring the payment of employment taxes and rules restricting the deductibility of interest in certain situations by the person providing the services."¹³ Because of the way the industry is structured, the only party in a section 1031 deferred exchange transaction who would be in a position to "game" the system would be the QI. And as we have seen, a QI gains no tax advantage whatsoever by avoiding the imputed interest rules.

c. Applying Section 7872 Would Impose Undue Additional Costs of Compliance

If section 7872 were to apply, each affected QI would, for each section 1031 deferred exchange transaction, need to: (i) determine whether there is adequate stated interest on a "loan"; (ii) calculate the amount of interest, if any, that should be imputed; (iii) report the imputed interest to each taxpayer; and (iv) record such amount as compensation that the taxpayer is deemed to pay back to the QI. As described above, none of that would have any effect whatsoever on the QI's net taxable income. However, each taxpayer participating in one of these transactions would need to report and include the "phantom"

interest income, and would need to add that to basis to be recovered over the depreciable life of the replacement property.

C. The 6-Month Exception to Section 1274 Indicates That Interest Should Not Be Imputed in Section 1031 Deferred Exchange Transactions

Unlike section 1274, section 7872 does not contain an explicit exception for short-term debt. Congress may have been concerned that the types of transactions at which section 7872 is aimed would be susceptible to abuse if a similar bright line exception applied -- for example, a short-term loan between related parties could be "rolled over" indefinitely. Therefore, instead of such a bright line test, section 7872 exempts transactions the interest arrangements of which have no significant tax effect.¹⁴ We believe, however, that the principle behind both the 6-month exclusion of section 1274 and the "significant tax effect" exclusion of section 7872 is the same: complex interest imputation rules should not apply to transactions where application of those rules will not significantly affect the tax liability of any party.

The section 1274 exclusion for short-term debt provides guidance for section 1031 deferred exchange transactions in two ways. First, section 1274 could be found to be directly applicable if the transaction is characterized as a transfer of property (either the relinquished property or the taxpayer's rights under the sales contract) to the QI in exchange for a debt instrument. In that case, section 1274 would not impute interest because none of the payments are due more than 6 months after the sale or exchange (and it would be unusual indeed for section 7872 to, in effect, supersede section 1274 in that circumstance).¹⁵

Second, even if not directly applicable, the 6-month exception to section 1274 indicates that Congress did not perceive interest-free loans of less than 6 months as being abusive in the context of property transactions. Congress may have chosen not to extend the explicit 6-month exclusion to section 7872 because of the greater possibility of abuse in transactions between related parties (e.g., the "rollover" discussed above). But there is no possibility of such abuse in section 1031 deferred exchange transactions. The participants are, and must be,¹⁶ unrelated parties in arm's length transactions, and the section 1031 deferred exchange rules prevent extensions beyond 6 months. Indeed, in section 1031 deferred exchange transactions a qualified intermediary holds the Proceeds for only 60 to 90 days on average. Therefore it is logical and consistent with section 1274 to exempt these short-term transactions from the section 7872 imputation rules.

III. Summary

Application of section 7872 interest imputation to section 1031 deferred exchange transactions is an unnecessary solution to a non-existent problem. Section 1031 deferred exchange transactions do not constitute loans from a taxpayer to a QI. But even if such transactions are classified as loans, imputing interest under section 7872 is inappropriate. As it did with section 1274, Congress enacted section 7872 to address certain perceived abuses, and it specifically provided for exceptions where these abuses do not exist. The

regulations under section 7872 reflect this and provide certain per se exemptions, such as bank account deposits, where section 7872 does not apply because of a lack of significant tax effect. These exemptions show that a loan being made in the ordinary course of a taxpayer's trade or business is an indicator that the loan does not have significant tax effect. Section 1031 deferred exchange transactions, which are made in the ordinary course of a QI's business, are similar to the exempted transactions. If anything, section 1031 deferred exchange transactions have even less tax effect than many of the per se exemptions because the time periods involved are so short: a QI cannot, by law, retain Proceeds for more than 180 days, and in fact QIs retain Proceeds for an average of only 60 to 90 days.

Given that there is no abuse in these transactions, as demonstrated by the fact that application of section 7872 would not have any tax effect on QIs and would have no significant tax effect on taxpayers participating in section 1031 exchanges, the Government should not act to introduce additional complexity to these transactions. Treasury and the IRS have taken significant steps in recent years to simplify compliance with the Internal Revenue Code, and we believe that applying section 7872 interest imputation here would be a major step backwards. The only significant consequence would be to impose higher costs of compliance on taxpayers and QIs.

We therefore respectfully request that you provide guidance clarifying that the section 7872 imputation rules do not apply to the temporary holding of proceeds of section 1031 deferred exchanges by qualified intermediaries. If this is not feasible in the short run, we request that at least the IRS refrain from issuing guidance specifically making section 1031 transactions subject to section 7872.

We would be pleased to meet with you and your colleagues to discuss this most important issue at greater length. Also, should you have any questions about this submission or about this issue generally, please do not hesitate to contact Glenn Carrington at (202) 327-6268.

Very truly yours,

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FOOTNOTES

1 2003 TNT 172-37 (Release Date: Aug. 26, 2003); 2003 TNT 177-41 (Release Date: Sep. 10, 2003).

2 See Reg. § 1.1031(k)-1(g)(4).

3 If the transaction does not succeed, the QI must pay an amount equal to the Proceeds to the taxpayer.

4 As reported by the Federation of Exchange Accommodators.

5 DEFRA Bluebook (H.R. 4170, 98th Cong., P.L. 98-369) at 527; see also Preamble to proposed section 7872 regulations (85 TNT 163-18).

6 Blue Book at 538.

7 Either 50 percent of the rate earned on the short-term Treasury Bills or a fixed 2% rate.

8 $\$1,000,000 \times 4\% \times (72/360) = \$8,000$.

9 $\$1,000,000 \times 2\% \times (72/360) = \$4,000$.

10 For certain short-term loans, interest can be imputed at the "alternative test rate." See Reg. § 1.1274-4(a)(2)(iii).

11 The loan should be treated as a demand loan because it does not have a definite term. For simplicity, the example assumes that only a single AFR is relevant for determining the rate of imputed interest.

12 $\$8,000 - \$4,000 - \$4,500 + \$4,500 = \$4,000$.

13 See Blue Book at 538 and discussion of section 7872, *supra*.