
Tax Management Memorandum

Vol. 47 No. 15

July 24, 2006

ADVISORY BOARD ANALYSIS

**A (Necessary) View of the Re-Proposed Prop. Regs. §1.468B-6 on Interest Earned
from §1031 Exchange Accounts**
by Howard J. Levine 307

WASHINGTON ITEMS

Fifteen Percent Nonmember Income Threshold Under §501(c)(7) Based Exclusively on
Gross Receipts 314

Gift to Country Club Is Gift to Entity, Not Members 315

Back to Back Loans Found Not to Create Shareholder Basis in Indebtedness of S
Corporation 315

Inclusion of Taxes in Simplified Service Cost Calculation Not Allowed 317

MEMORANDUM

*A (Necessary) View of the Re-Proposed Prop. Regs.
§1.468B-6 on Interest Earned from §1031 Exchange
Accounts*

by Howard J. Levine
Roberts & Holland LLP
Washington, D.C.1

Major References:

I.R.C. §468B; Prop. Regs. §1.468B-6.

INTRODUCTION

As of the beginning of June 2006, over 50 letters have been received by the IRS and Treasury in opposition to the recently re-proposed regulations under §468B² (referred to herein as the "New Regulations"), dealing with interest earned from §1031 exchange accounts.³ The various arguments made in these letters are consistent with a recent article written by Louis Weller and Kelly Alton⁴ titled the "Treatment of Section 1031 Exchange Intermediaries as Borrowers Under New Prop. Reg. §1.468B-6."⁵ The thrust of the letters, as well as the article, is that: (1) the inclusion of deferred exchanges arrangements and non-segregated exchange funds within the scope of the new §468B regulations is not justified by the language of §468B or its legislative history, (2) the loan characterization in the New Regulations is inconsistent with "established tax principles" on which the deferred exchange regulations are based, (3) a deferred exchange transaction is not a loan transaction, (4) if the loan characterization is retained, it was not intended to be covered by §7872, (5) the choice of the 182 day rate for §7872 testing is inappropriate, and (6) the New Regulations confer a "significant competitive advantage" on bank QIs.

This article presents a much different (and, in terms of the public debate, a necessary) view of the New Regulations. In this connection, I am using Mr. Weller's⁶ article for purposes of presenting the arguments made in opposition to the New Regulations because it generally reflects a summary of the arguments that have been made in the various letters to date. Finally, this article also discusses some technical problems with the New Regulations that will in any event need to be clarified in the final regulations.

SECTION 468B

Although §468B⁷ is titled "Special Rules for Designated Settlement Funds," §468B(g), which was later added to §468B by the Technical and Miscellaneous Revenue Act of 1988, was intended to address the taxability of not only settlement funds but also escrow accounts and "similar funds." Section 468B(g) provides:

Nothing in any provision of law shall be construed as providing that an escrow account, settlement fund or similar fund is not subject to current income tax. The Secretary shall prescribe regulations providing for the taxation of any such account or fund whether as a grantor trust or otherwise.

The first sentence addresses the concern that perhaps an arrangement could be structured so that no one might be currently taxable on income earned in such funds, i.e., so called "homeless income." The second sentence, however, clearly is not limited to addressing homeless income but also directs the Secretary to provide rules on the current taxation of income of such funds. The Committee Report expressly stated that "[T]he bill also authorizes the Secretary of the Treasury to *prescribe regulations that identify the person that is subject to current tax on the income from such account or fund.*"⁸

Moreover, the applicability of §468B(g) to deferred exchanges clearly is not a new concept. When the deferred exchange regulations were issued in 1991, everyone should

have understood *at that time*, because of the Preamble to the regulations, that guidance on the proper manner of reporting interest earned on deferred exchange accounts would be issued by the IRS in the future as part of general, comprehensive regulations to be issued under §468B(g).⁹

THE DEFERRED EXCHANGE SAFE HARBORS

Mr. Weller emphasizes in his article that the safe harbor regulations "endorse and adopt the premise on which intermediaries had operated since 1979 to facilitate delayed exchanges; that the QI acts as a principal in transferring relinquished property, receiving exchange proceeds, acquiring replacement property and transferring it" to the taxpayer. He goes on to say that "through the execution of the exchange agreement with the [taxpayer], the assignment of the rights of the [taxpayer] under the purchase and sale contracts to the QI, and the notification of the assignment to the other parties, to those contracts, *the QI becomes a principal in the exchange.*" (Emphasis Added.)

Mr. Weller presumably picked 1979 as the time intermediaries began operating because of *Starker v. U.S.*,¹⁰ the first case that dealt with the question of deferred exchanges, but in reality, intermediaries have been utilized (with non-deferred multi-party exchanges) for over 50 years. The case law always has been clear that in order for the exchange to work from a tax viewpoint, the intermediary *had to be a real principal* in the transaction, which means he had to have real benefits and burdens of ownership.¹¹ Moreover, it generally was understood that the intermediary also had to be the party to the various sales and purchase contracts; not only because it was thought necessary to establish risk for purposes of the benefits and burdens test, but also to avoid a *Court Holding*¹² issue which certainly would otherwise be present if the taxpayer negotiated and signed the various contracts.

The safe harbor regulations that were introduced in 1991 were an attempt by the Internal Revenue Service (IRS) and Treasury to greatly simplify §1031 exchanges. A QI who (1) has no real benefits and burdens associated with ownership of the property, (2) does not enter into or even negotiate the contract to sell the relinquished property or the contract to purchase the replacement property, but merely has the rights of the taxpayer assigned to it without any of the burdens or obligations of the contracts, and (3) is fully indemnified by the taxpayer, is not a real principal in the transaction. That clearly was recognized by the IRS and Treasury in the Preamble to the safe harbor regulations, where it was indicated that a QI might be treated as an agent of the taxpayer under local law (but that it would not adversely affect the safe harbor).¹³

To suggest that the safe harbor regulations merely "endorsed" and "adopted" the substantive rules under which intermediaries previously operated is just plain wrong. The Treasury attorney who was involved in the drafting and promulgation of the safe harbor regulations said it best¹⁴ when he wrote:

The final Regulations thus remove the substance from deferred exchanges occurring through qualified intermediaries. All that matters is that (1) the intermediary not be a disqualified person, (2) the identification and receipt requirements be met, (3) the relinquished and replacement properties be of a like kind..., (4) the holding requirements be satisfied, and (5) the transaction be documented correctly.

Another possible argument that Mr. Weller appears to be making (or if not, could be

making) is that even if the QI would not otherwise be considered a real principal in the transaction for federal income tax purposes, the safe harbor treats him as a principal and therefore he should be treated that way for all tax purposes. This argument can quickly be dismissed because the safe harbor regulations themselves state that the QI will not be considered the agent of the taxpayer "for purposes of [§]1031(a)," i.e., solely for purposes of determining exchange qualification. Thus, e.g., a taxpayer in receipt of an evidence of indebtedness of the QI's transferee is considered to have received an evidence of indebtedness of the transferee of the relinquished property for purposes of the installment sale rules under §453, even though for §1031(a) purposes the QI is treated as having acquired and transferred the relinquished property.¹⁵

To rely on the fiction in the safe harbor regulations is reminiscent of attempts made by some to rely on the safe harbor provided by Rev. Proc. 2000-37¹⁶ concerning parking arrangements, for purposes that were not intended. An example of this was an Exchange Accommodation Titleholder (EAT) building improvements on taxpayer's own land and using it as replacement property in a §1031 exchange, even though it was well known that the IRS's long standing position was to the contrary in connection with a forward exchange. The argument was that the revenue procedure created a fiction that the EAT was a principal and the IRS was required to treat the EAT as the principal for all purposes. The IRS shut that down in Rev. Proc. 2004-51.¹⁷

The bottom line is that safe harbors are just that, i.e., safe harbors for a specific purpose and limited to the purposes intended.

THE QI INDUSTRY AND QI FEES -- DISAGREEMENT AMONG THOSE OPPOSING THE REGULATIONS

Mr. Weller, in his section on "The QI Industry and QI Fees," does not explain how a QI earns its fees although this is an important point in understanding the New Regulations as well as some of the points being made by those who are opposing the regulations. This may be because, strange as it seems, the opponents of the regulations seem to be in disagreement over what a QI does and the value of the QI services. Some of the lobbyists representing the QIs who oppose the regulations claim that the QI essentially acts just as a financial intermediary or middleman and (1) the fixed fee paid to the QI by the taxpayer compensates the QI for such service, and (2) the income earned by the QI which is not paid over to the taxpayer (which can be all or some portion of the interest earned on the exchange account), i.e., the so called "spread," cannot possibly be attributable to just acting as a financial intermediary or middleman.¹⁸ The argument the lobbyists are making is that the proceeds held by the QI cannot be a "compensation related loan" for purposes of §7872 since the QI is only performing middleman or financial type services and the income earned by the QI from the exchange proceeds cannot be attributable to such minimal passive type services.

The QIs who oppose the regulations, however, have argued strenuously that they perform very valuable services for the income they earn. They say they spend countless hours providing non-legal advice to the taxpayers throughout the entire exchange process, which is often essential because most taxpayers who do exchanges, and in particular in the smaller exchanges, proceed without the advice of counsel. In addition, they say they act as a "gatekeeper" for the IRS, in the sense that the QIs help to make sure the taxpayers are properly complying with the law and the reporting requirements as well as preventing overly aggressive or less sophisticated taxpayers from engaging in exchanges that clearly are in violation of the §1031 requirements. QIs also make the point that they spend countless hours keeping current on developments relating to exchanges so that they can properly assist their taxpayer-customers. The numerous letters that have been written to the IRS and Treasury since the issuance of the New

Regulations consistently have made these points.

As between the lobbyists and their clients, it should go without saying that clients know their business better than the lobbyists. In this regard also, can there be any doubt that the characterization of the holding of the proceeds as "compensation related" is correct or that the QIs believe (rightly so) that they perform very valuable and significant services for the income received?

THE 1999 REGULATIONS

The first set of proposed regulations, which were issued in 1999 and were withdrawn as a result of the New Regulations, applied literally only to qualified escrow accounts and qualified trusts used in deferred exchanges.¹⁹ It is not clear why these regulations did not also apply to accounts held directly by QIs, but it is believed the IRS incorrectly assumed at that time that all safe harbor deferred exchanges utilized a qualified escrow or qualified trust.²⁰ The thrust of the 1999 regulations was that, except in situations described below, the taxpayer is the owner of the funds and the taxpayer must take into account in computing its tax liability "all items of income, deduction, and credit...of the qualified escrow account or qualified trust."²¹

The exception to the above general rule was a situation where the QI (or the transferee) "had *all the beneficial use and enjoyment* of assets of a qualified escrow account or qualified trust." The requirement of having *all the beneficial use and enjoyment* of the assets is consistent with the traditional benefits and burdens test referred to above to determine if one is a principal or an agent. The regulations went on to state that the test is a facts and circumstances test and that the following factors, among others, would be considered:

- (i) Which person enjoys the use of the earnings of the account or trust,
- (ii) Which person receives the benefit from the appreciation, if any, in the value of the assets of the account or trust, 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 or trust.

The proposed regulations also expressly stated that if the QI is treated as the owner under the facts and circumstances test, "[§]7872 may apply if the deferred exchange involves a below market loan from the taxpayer to the owner."

Had the IRS immediately finalized the regulations,²² it is doubtful there would be any real issue today as to who must report all the income from the exchange account and whether §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 QIs to take aggressive and (among QIs in general) inconsistent positions.

MR. WELLER'S EXAMPLES

Mr. Weller sets forth 13 examples to illustrate how the new regulations would work. Examples 12 and 13 assume the QI is affiliated with a bank. In Example 12, the QI sets up a separate passbook savings account and pays all the interest to the taxpayer, but the bank obviously earns income on its own investments, which includes amounts that are held by the bank on deposit. There is an implication here that something is wrong because the bank, which is an affiliate of the QI, is earning income from its own activities

which are not required to be taken into account under the new regulations. This is a non-starter; independent QIs who pay over all the interest they receive from banks and financial institutions are in exactly the same situation. Thus the fact that the bank is affiliated with the QI is irrelevant. Moreover, it is not possible for banks to discriminate in favor of or against certain QIs, since the banks, as well as their affiliated QIs, are heavily regulated by the Office of the Comptroller of the Currency.

Example 13 involves the payment of a so-called 12b-1 fee. In the example, the QIs exchange funds "are invested in a money market fund managed by a bank affiliate that pays the QI a 12b-1 fee." Mr. Weller states that "all the earnings" are considered to be paid by the QI to the taxpayer even though the QI receives additional revenue by way of the 12b-1 fee. The problem with this example is that it bears no relationship to the actual facts or the law regarding 12b-1 fees. In this connection, it is important to understand the nature of 12b-1 fees and under what circumstances they can be paid.

QIs often will invest exchange proceeds in highly liquid money market mutual funds. When an investment is made in such a fund, two distinct kinds of payments may be made by the mutual fund. Commissions may be paid to dealers and/or brokers that handle the sale and purchase of the mutual fund's shares. These payments only can be made to registered broker-dealers. Payments to non broker-dealers can be made only for services actually rendered to the mutual fund for clerical and ministerial services such as maintaining shareholder records, statement generation, tax reporting, and transaction processing. Payment for these services also is regulated under Rule 12b-1 of the Investment Company Act of 1940 and are referred to as "Rule 12b-1 fees." Mutual funds often contract out to third parties some or all of the clerical and ministerial services. In such cases, the mutual fund pays Rule 12b-1 fees to the third parties who perform the clerical and ministerial services. Payments of Rule 12b-1 fees must be disclosed to mutual fund investors.

Pursuant to contracts with various mutual funds, some QIs perform clerical and ministerial services for which the QI receives Rule 12b-1 fees from the mutual funds. Specifically, if a taxpayer requests that some or all of its exchange proceeds be invested in a mutual fund for which the QI performs clerical and ministerial services, the QI provides accounting, statement generation, tax reporting, and transaction processing services to the taxpayer on behalf of the mutual funds. In turn, the QI receives Rule 12b-1 fees from the mutual funds for the services the QI performs for or on behalf of the mutual fund.²³ The right to perform clerical and ministerial services for mutual funds is not the exclusive right of a bank affiliated QI.

It is important to note that the clerical and ministerial services for which mutual funds pay Rule 12b-1 fees are clerical and ministerial services that *must* be performed. If those services are not performed by the QI, they *will* be performed by someone else. In other words, the Rule 12b-1 fees that the QI receives from the mutual funds are *not* investment earnings on the mutual fund or bank accounts that otherwise would have been paid to the taxpayer if the fees had not been paid to the QI. In the same sense, the Rule 12b-1 fees paid by the mutual funds are not "earnings attributable to a taxpayer's exchange funds" within the meaning of Prop. Regs. §1.468B-6(c)(2).

The 12b-1 fees described above for actual services rendered must be distinguished from any kind of "marketing" or "referral" fee that a QI may receive. Such fees should not be treated as part of the "earnings attributable to a taxpayer's exchange funds."

THE PROBLEMS WITH THE NEW REGULATIONS ACCORDING TO MR. WELLER

Mr. Weller sets forth six specific problems that he sees with the New Regulations which he calls "A Panoply of Problems." The preceding sections of this article should make the responses to the cited "problems" almost self evident.

The Scope Problem

Mr. Weller says that the inclusion in the regulations of secured deferred exchange arrangements and non-segregated exchange funds held by QIs "is not justified by the language of [§]468B or its legislative history;" they are not within the definition of "qualified settlement funds under [§]468B(d)(2);" they are not "accounts in the sense contemplated by Congress;" and they do not represent "homeless income that was the impetus behind the enactment of [§]468B(g)." This has been responded to in detail above and will not again be repeated.

Mr. Weller also says that the present system has not led to failures to report the full amount of earnings by QIs 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 and the assignment of income doctrine would be written out of long established tax law. That is in fact, however, what has been happening. Taxpayers and QIs have been determining between themselves who will be taxable on the income. This in turn has led to significant inconsistency among reporting by QIs.²⁴

Characterization Issues and Transaction Substantively Not a Loan

The argument here is that under the regulations, the QI is treated as having entered into a reciprocal transfer of property and that the loan characterization is inconsistent with "the established tax principles on which the deferred exchange regulations are based." The contention essentially is that deferred exchange regulations "ratified prior practice" that the QI is a principal in the transaction; that the QI is treated as a principal in the transaction under the regulations; and that the loan characterization ignores the QI's status as a principal.

Again, the response should be self evident from the detailed discussion above. The QI would not otherwise be considered a principal in the transaction; the treatment of the QI as a principal under the deferred exchange regulations is nothing more than an administrative fiction; and it never was intended that this fiction be applied for purposes other than qualification of the exchange under §1031(a).²⁵

Moreover, those who are saying the proceeds are not loaned by the taxpayer to the QI but somehow instead just magically make their way to the QI, have to answer the obvious question: *How did the QI get ownership of the proceeds?*

It is interesting that some of the same practitioners and members of the industry who are now arguing that the proceeds somehow are owned by the QI previously had argued the exact opposite in a different context. Several years ago, I obtained a private letter ruling which concluded that an exchange agreement could not provide that a taxpayer can have a right to demand a distribution of the proceeds in the event the taxpayer is unable to acquire replacement property after good faith efforts to do so have failed and there is no realistic possibility of doing so. The ruling was thought necessary in order to clarify what a QI is permitted to do under the regulations.

After the ruling was made public, I received numerous telephone calls, letters, and e-mails from members of the industry, telling me that obtaining the ruling was a big mistake because the cash belongs to the taxpayer and if the taxpayer wants to give up his

exchange and trigger a taxable event, he should be able to do so. Interestingly, Mr. Weller wrote an article on the ruling, in which he presented a contrary view to that expressed in a prior article I wrote on the ruling.²⁶ In that article, Mr. Weller stated the following:

In no public or private forum have government officials indicated that the deferred exchange regulations should put QI's in a position where they must keep *taxpayer funds* beyond the point where a taxpayer is prepared to walk away from [§]1031 treatment and treat a transaction as a sale. The creation of the mechanical rules relating to QI's as a safe harbor from constructive receipt of replacement property sales proceeds is in no way inconsistent with the rights of the parties, following implementation of a safe harbor structure, to change their minds about its maintenance. (Emphasis Added).

Query how Mr. Weller's statement above can be reconciled with Mr. Weller's notion that the QI is the owner of the exchange proceeds?

The Application of §7872

The argument here appears to be that if the loan characterization is retained, §7872 should not apply because it does not come within any of the three "areas of perceived abuses" that are mentioned in the legislative history. However, §7872 is not a discretionary provision. If the loan is a below market loan and any of the circumstances set forth in §7872(c) is applicable (and no exception applies), it is clear that §7872 will apply. Aside from his general argument that §7872 should not apply, it is not clear if Mr. Weller is arguing that the loan does not meet the definition of being a "compensation related loan" as provided in §7872(c)(1)(C). Indeed, given the position of the QIs as to the value and significance of their services, as set forth above, it would not seem possible to make such an argument.

Rates

Mr. Weller argues that a clear "misfire" is the choice of the 182 day Treasury bill rate for testing under §7872. He states that exchange funds generally are held in demand deposit accounts with low interest rates for 60-90 days and must be kept liquid. Aside from the fact that the 182 day rate does not assume the funds will be kept on deposit for 182 days, but merely that they could be held that long²⁷ (just as the federal short-term AFR does not assume the loan necessarily will be maintained for three years), QIs generally do not keep their funds in these low-interest bearing passbook type checking and savings accounts. Instead, QIs often maintain the funds in highly liquid mutual fund money market investments that pay a relatively high rate of interest.

The "Fairness" Issue

Finally, Mr. Weller says that the New Regulations confer a competitive advantage on bank-owned QIs which is inconsistent with the notion that regulations "should not create winners and losers." This perceived imbalance apparently has to do, in part, with the exemption from §7872 banks have as a result of Regs. §1.7872-5T(b)(2). Mr. Weller says that a bank owned QI can deposit its client's exchange funds in its parent bank where the funds can be aggregated with other deposits to earn higher rates of return, while the QI avoids loan treatment under the regulations by paying over all the interest earned "typically at a low passbook rate."

First, Mr. Weller simply is pointing out what all banks do to make money, i.e., banks aggregate deposits to earn higher rates of return. The banks are doing the exact same thing with deposits that are made by independent QIs. Moreover, it is inaccurate to say that bank-owned QIs "typically pay at a low passbook rate." To the extent they are depositing the funds with their parent bank, the funds typically are invested in highly liquid mutual fund type money market funds which pay a relatively high rate of interest.

In addition, Mr. Weller also points out that the QI industry is "an unregulated market driven industry." That is true for independent QIs but not for Bank owned QIs. The bank owned QIs, like their parent bank companies, are heavily regulated by the Office of the Comptroller of the Currency, which is an important safeguard and protection for taxpayers as consumers. Such protection is not available for independent QIs which has led to problems for some taxpayers because of bankruptcy and embezzlement.²⁸

TECHNICAL PROBLEMS WITH NEW REGULATIONS

Finally, there are in fact some technical issues within the New Regulations that need to be clarified in the final regulations:

1. Regs. §1.1031(k)-1(g)(5) and (h), which are labeled "Interest and growth factors," do not expressly state that interest on an exchange account which straddles two taxable years is reportable in the year the interest is earned or credited to the taxpayer's account as opposed to the year in which it is paid to the taxpayer. The examples set forth in the initial set of proposed regulations made it clear that such interest was reportable in the year earned or credited to taxpayer's account (not in the later year when paid to the taxpayer). However, the examples set forth in the New Regulations do not deal with this question and may lead to some confusion as to why the references to the year of reporting were eliminated. This should be clarified in the final regulations.

2. Prop. Regs. §1.468B-6(b)(2) states that "Exchange funds" means cash, etc., "that secures an obligation of a transferee to transfer replacement property, or proceeds from a transfer of relinquished property" It is assumed that whether the cash held in a qualified account or fund is legally securing (or even intended to secure) the obligations of the transferee is irrelevant. The phrase "that secures an obligation of a transferee to transfer replacement property" should be struck in the final regulations.

3. Prop. Regs. §1.468B-6(f)(2) provides that with respect to transfers of property made after August 16, 1986, but on or before the date the regulations become final,

the Internal Revenue Service will not challenge a reasonable, consistently applied method of taxation for income attributable to exchange funds. This language is somewhat vague and it would be very helpful for the IRS to provide examples (and/or some criteria) to determine what would be considered a "reasonable, consistently applied method."

CONCLUSION

The Treasury Department and the IRS should be commended for eliminating the subjective "facts and circumstances" approach from the prior regulations, which had caused so much confusion and uncertainty and which in turn led to inconsistent reporting treatment among taxpayers, QIs, and others. The objective approach utilized in the New Regulations (i.e., the proceeds are treated as loaned except where all the earnings are to be paid over to the taxpayer) is a very thoughtful and easily administrable approach.

The IRS's approach clearly is supported by well established principles of federal income tax law concerning disguised or imputed forms of payment of compensation for services rendered, dating back to the 1929 Supreme Court decision in *Old Colony Trust Co. et al. v. Comr.*²⁹ The treatment of the loan as a demand loan under §7872, where not all the earnings from the account are paid to the taxpayer makes sense (how else does the QI obtain the proceeds?) and is consistent with the 1999 regulations.

Moreover, the objective rules are fair. QIs, trustees, escrowees, and other holders of exchange funds have tremendous flexibility since they can choose whether to come under the general rule (by retaining part or all of the earnings) or instead choose not to have the general rule apply (by simply paying over all the earnings). Taxpayers will greatly benefit from the New Regulations because it likely will result in greater transparency, safer accounts (because more accounts are likely to be segregated) and consistency in reporting.

Footnotes

¹ Howard J. Levine, a partner in the Washington, D.C. and New York law firm of Roberts & Holland LLP, is the author of 567 T.M., *Taxfree Exchanges Under Section 1031*. 2006 by Howard J. Levine.

²Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

³The New Regulations essentially treat the exchange proceeds held by a Qualified Intermediary (QI) as having been loaned to the QI, except where all the earnings from the exchange account are to be paid over to the QI. The loan must then be tested under §7872 as a compensation related loan, but with a 182 day Treasury bill test rate.

⁴Throughout this article, references to "Mr. Weller" should be read to include Ms. Alton, unless the context suggests otherwise.

⁵Vol. 104, No. 6 *J. Tax'n* (June 2006).

⁶In the interests of fairness and full disclosure, it should be noted that Mr. Weller and I generally have represented members of the QI industry who have opposing views on this issue. I primarily (but not exclusively) currently represent QIs who are affiliated with banks. Mr. Weller, it is believed, is primarily representing QIs who are not affiliated with banks, i.e., so called "independent QIs." However, at the time I testified at the hearings on the first set of regulations issued in 1999, and for some extended period of time thereafter, I *only* represented independent QIs; and my position on these regulations has been consistent throughout. Mr. Weller stated, incorrectly in his article, that those who agreed with the 1999 proposed regulations were "largely representing bank QI interests." In fact, at the time of the 1999 proposed regulations, I was not, nor, I believe, were any of those who testified or filed comments in support of the regulations, representing bank interests.

⁷Section 468B was added by the Tax Reform Act of 1986, §1807(a)(7)(A).

⁸S. Rep. No. 445, 100th Cong., 2d Sess. 469 (1988) (emphasis added).

⁹See Preamble to the final deferred exchange regulations, T.D. 8346, 56 Fed. Reg. 19933 (5/1/91).

¹⁰602 F.2d 1341 (9th Cir. 1979).

¹¹See the history of multi-party exchanges discussed in Levine, 567 T.M., *Taxfree Exchanges Under Section 1031*.

¹²*Court Holding Co. v. Comr.*, 324 U.S. 331 (1945). The issue referred to above is that the purchase of the replacement property from the seller and/or sale of the relinquished property to the buyer may be attributed to the taxpayer rather than the intermediary.

¹³See T.D. 8346, 56 Fed. Reg. 19933 (5/1/91). See also PLR 200148042 at n.2.

¹⁴Handler, "Final Reg. On Deferred Like-Kind Exchanges Provide Additional Clarifications," 75 *J. Tax'n* 10 (July 1991).

¹⁵See Regs. §1.1031(k)-1(j)(2).

¹⁶2000-2 C.B. 308.

¹⁷2004-2 C.B. 294.

¹⁸See, e.g., the May 8, 2006 letter to the IRS and Treasury written by Glenn Carrington and David Garlock on behalf of the Federation of Exchange Accommodators ("The QI is simply providing a service as a middleman.") and comments made by Mr. Garlock on a panel at the Financial Transactions meeting of the American Bar Association Tax Section on May 5, 2006.

¹⁹For a detailed discussion of these regulations, see Levine & Weintraub, "Tax and Reporting Rules for escrows and Trusts Used in Deferred Like-Kind Exchanges," 90 *J. Tax'n* 332 (June 1999).

²⁰This is based on conversations the author had with IRS National Office attorneys at the time of the issuance of the first set of regulations, as well as the implications from the language of the regulations. See former Prop. Regs. §1.468B-6(c), withdrawn by REG-113365-04, REG-209619-93, 71 Fed. Reg. 6231 (2/7/06).

²¹This position also was consistent with *Helvering v. Horst*, 311 U.S. 112 (1940) and *Old Colony Trust Co. v. Comr.*, 279 U.S. 716 (1929).

²²But with necessary clarification once the IRS understood that not all exchanges involve a qualified escrow or trust account.

²³The receipt of such fees for services is expressly disclosed by the QI.

²⁴The consequence to the taxpayer is not the same. If all the earnings from the account are taxable to the taxpayer, the earnings received that are then paid to the QI as compensation must be capitalized by the taxpayer.

²⁵Nor was it intended that the fiction would be applied to claim that §1274 is applicable to treat the QI as having issued a debt instrument for the purchase of property (so that §7872 would not be applicable).

²⁶See Weller, "Early Distributions from 1031 Exchange Accounts -- Another Look at a Strange New Ruling," 93 *J. Tax'n* 73 (Aug. 2002); Levine, "Premature Distributions from 1031 Exchange Accounts -- New Ruling Provides Guidance," 93 *J. Tax'n* 7 (July 2000).

²⁷Ignoring the fact that the funds could only be kept up to 180 days, which is not significant here.

²⁸See, e.g., *In re Sale Guaranty Corp.*, 220 B.R. 660 (B.A.P. 9th Cir. 1998).

²⁹279 U.S. 716 (1929).