Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance

September 17, 2007

Reference Number: 2007-30-172

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

2(f) = Risk Circumvention of Agency Regulation or Statute (whichever is applicable)
MEMORANDUM FOR
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance (Audit # 200730003)

This report presents the results of our review to evaluate the Internal Revenue Service’s (IRS) oversight of the deferment of capital gains tax through like-kind exchanges. We also determined whether taxpayers’ use of this investment strategy is growing and whether this poses any specific problems for the IRS. This audit was conducted as a discretionary review as part of our annual audit coverage.

Impact on the Taxpayer

The practice of deferring capital gains tax through like-kind exchanges is increasing in popularity. However, if taxpayers do not specifically follow the rules for like-kind exchanges, they could be held liable for taxes, penalties, and interest on their transactions. Therefore, it is important for the IRS to provide specific and consistent guidance to taxpayers on this provision of the tax law.

Synopsis

Under normal circumstances, when a taxpayer sells a business or investment property, tax must be paid on the gain. A like-kind exchange allows an exception to payment of the capital gains tax. When taxpayers sell businesses or investment real estate and replace them with different businesses or investment properties using an exchange, they can defer payment of the capital gains tax. However, if taxpayers do not specifically follow the rules for like-kind exchanges, they could be held liable for taxes, penalties, and interest on their transactions. Therefore, it is important for the IRS to provide specific and consistent guidance to taxpayers on this provision of the tax law.

1 Also referred to as an Internal Revenue Code Section 1031 Tax Deferred Exchange.
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gains tax normally required on these sales. As long as a property used for business or investment
is replaced with a similar property, no gain or loss is recognized at that time; rather, it is deferred
until the eventual sale of the replacement property.

A taxpayer must report an exchange to the IRS on Like-Kind Exchanges (Form 8824), which is
filed with his or her tax return for the year during which the exchange took place. The IRS
Office of Research, Analysis, and Statistics reported that in Tax Year 2004 taxpayers filed more
than 338,500 Forms 8824 claiming deferred gains (or losses) of more than $73.6 billion. While
this represents a doubling of the number of like-kind exchanges reported in 1998, the total dollar
amounts deferred more than tripled.

There appears to be little IRS oversight of the capital gains (or losses) deferred through like-kind
exchanges. Some of the IRS guidance provided to taxpayers who sell real estate needs to be more consistent
and complete regarding like-kind exchange filing requirements. While the Internal Revenue
Code is not explicit with respect to the requirement to file Form 8824 per se, and there are
usually no penalties imposed if a taxpayer does not file the Form, other sections of the Code
provide the IRS with the legal authority to require the filing of Form 8824. Some IRS forms,
instructions, and publications do provide taxpayers proper guidance with respect to a
like-kind exchange and the requirement to file a Form 8824. However, other IRS guidance
needs revision to provide information regarding the use of this Form.

In addition, the IRS regulations for like-kind exchanges of second and vacation homes are
complex and may be unclear to taxpayers. While second and vacation homes used exclusively
by owners are not eligible for like-kind exchanges, the rules for like-kind exchanges of second
and vacation homes not used exclusively by owners are complex and little exists with respect to
a published position by the IRS on like-kind exchanges involving such properties. The absence
of clarification leaves unrebutted the sales pitch of like-kind exchange promoters who may
encourage taxpayers to improperly claim deferral of capital gains through “tax-free” exchanges.²

In a recent report, the Government Accountability Office (GAO)³ stated that, in reviewing
securities reporting compliance, it found taxpayers had misreported “capital gains for other
assets,” including residential rental property, business personal property, and real estate. The
report identified “capital gains for assets other than securities” as an area of individual taxpayer

² Many promoters of like-kind exchanges refer to them as “tax-free” exchanges not “tax-deferred” exchanges.
³ “Using Data from the Internal Revenue Service’s National Research Program to Identify Potential Opportunities to
noncompliance that is a promising target for additional research to improve reporting compliance. We agree with the GAO that this area poses risks that need to be addressed.

**Recommendations**

Based on the increase in the use of like-kind exchanges to defer capital gains tax, the dollar amounts deferred, and concerns expressed by IRS staff and the GAO, we recommended the Director, Research, Small Business/Self-Employed Division, conduct a study of issue-related returns selected by the National Research Program. At the conclusion of the study, the Research function would recommend to the Small Business/Self-Employed Division Examination function what particular data should be captured in future National Research Programs in order to ensure appropriate IRS oversight of taxpayer compliance with tax laws pertaining to like-kind exchanges. We also recommended the Commissioner, Wage and Investment Division, update some current guidance regarding the use of Form 8824 and provide additional guidance to taxpayers regarding the rules and regulations governing like-kind exchanges of second and vacation homes that were not used exclusively by owners.

**Response**

IRS management agreed with all of the recommendations. The IRS will conduct a research study of reporting and compliance issues associated with like-kind exchanges and share the results with the appropriate function. In addition, the IRS agreed to revise instructions for certain tax forms; update the information available on IRS.gov; and provide additional guidance on like-kind exchanges to taxpayers, practitioners, and stakeholders. Management’s complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-5894.

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4 The National Research Program is a comprehensive effort by the IRS to measure payment, filing, and reporting compliance for different types of taxes and various sets of taxpayers.
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Abbreviations

GAO Government Accountability Office
I.R.C. Internal Revenue Code
IRS Internal Revenue Service
SB/SE Small Business/Self-Employed
Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance

Background

Under normal circumstances, when a taxpayer sells a business or investment property, tax must be paid on the gain for the tax year of the sale. A like-kind exchange\(^1\) allows an exception to payment of the capital gains tax. When taxpayers sell businesses or investment real estate and replace them with different businesses or investment properties using an exchange, they can defer payment of the capital gains tax normally required on these sales. As long as a property used for business or investment is replaced with a similar property, no gain or loss is recognized at that time; rather, it is deferred until the eventual sale of the replacement property.

Taxpayers who take advantage of like-kind exchanges increase their purchasing power, as well as their financing and leverage capabilities, because payment of Federal tax on the gains is deferred. Taxpayers can use exchanges to acquire replacement properties with greater income potential (e.g., raw land can be exchanged for income-producing property and qualify as a like-kind exchange). With additional equity to reinvest, taxpayers can execute exchange after exchange to create a pyramiding effect. The tax liability may be forgiven upon the death of the investor because the heirs may qualify for a stepped-up basis on the inherited property.

Taxpayers must report a like-kind exchange to the Internal Revenue Service (IRS) on Like-Kind Exchanges (Form 8824), which is filed with their tax returns for the year during which the exchange took place. If taxpayers do not specifically follow the rules for like-kind exchanges, they could be held liable for taxes, penalties, and interest on their transactions. The IRS Office of Research, Analysis, and Statistics reported that in Tax Year 2004 taxpayers\(^2\) filed more than 338,500 Forms 8824 claiming deferred gains (or losses) of more than $73.6 billion.\(^3\) While this represents a doubling of the number of like-kind exchanges reported in 1998, the total dollar amounts deferred more than tripled.

This review was performed at the IRS office in Holtsville, New York. We discussed policy and procedures with IRS personnel from the Office of Chief Counsel; the Office of Research, Analysis, and Statistics; and the Submission Processing, Examination, and Compliance functions within the Small Business/Self-Employed (SB/SE), Large and Mid-Size Business, and Wage and Investment Divisions in Lanham, Maryland, and Washington, D.C. The audit was conducted from November 2006 through May 2007 in accordance with Government Auditing Standards. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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1 Also referred to as an Internal Revenue Code (I.R.C.) Section 1031 Tax Deferred Exchange.
2 Individuals, partnerships, and corporations.
3 In Tax Year 2004, individual taxpayers filed 219,675 Forms 8824 deferring $28.7 billion, partnerships filed 47,928 Forms 8824 deferring $25.9 billion, and corporations filed 70,963 Forms 8824 deferring $19.1 billion.
Results of Review

Like-Kind Exchanges Require Oversight to Ensure Taxpayers Are Complying With Tax Laws

There appears to be little IRS oversight of the capital gains (or losses) deferred through like-kind exchanges. 2(f).

The Office of Chief Counsel stated that, in circumstances involving a sequence of like-kind exchanges of depreciable property over a number of years, there is no readily available means for the IRS to determine what portion of any gain realized on a subsequent taxable sale is properly characterized. 4 Other IRS staff reported that potential abuses, such as transactions involving not like-kind properties; related party exchanges; incorrect property basis figures; partial, step, and bartering exchanges;[5] it appears the IRS is relying on taxpayers to voluntarily comply with the tax law, properly reduce the basis of their assets to recognize gains when the assets are sold, and subsequently pay the capital gains tax owed. As stated previously, the dollar amounts deferred have more than tripled from approximately $22.8 billion in 1998 to more than $73.6 billion in 2004, with individual

4 It would be necessary to reconstruct each of a series of like-kind exchanges to determine the correct amount of the gain that is subject to either depreciation recapture or treatment as unrecaptured L.R.C. Section 1250 gain.

5 Partial, step, and bartering exchanges are variations of techniques used in structuring like-kind exchanges.

6 The Large and Mid-Size Business Division provided some data with respect to a particular industry and the development of a Coordinated Issue Paper on like-kind exchanges for that industry. Large and Mid-Size Business Division staff stated their records indicated examinations of 6 exchanges that resulted in assessment of deficiencies totaling approximately $873 million.
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taxpayers filing approximately 65 percent of Forms 8824 in 2004 and accounting for 39 percent of the gains (or losses) deferred.

The Government Accountability Office also identified risks

In a recent report, the Government Accountability Office (GAO)\(^7\) stated that, in reviewing securities reporting compliance, it found taxpayers had misreported “capital gains for other assets,” including residential rental property, business personal property, and real estate. The report identified “capital gains for assets other than securities” as an area of individual taxpayer noncompliance that is a promising target for additional research to improve reporting compliance. We agree with the GAO this area poses risks that need to be addressed.

Recommendation

Recommendation 1: Based on the increase in the use of like-kind exchanges to defer capital gains tax, the dollar amounts deferred on Forms 8824, and the numerous concerns expressed by IRS staff and the GAO, the Director, Research, SB/SE Division, should conduct a study of issue-related returns selected by the National Research Program.\(^8\) At the conclusion of the study, the Research function would recommend to the SB/SE Division Examination function what particular data should be captured in future National Research Programs in order to ensure appropriate IRS oversight of taxpayer compliance with tax laws pertaining to like-kind exchanges.

Management’s Response: IRS management agreed with the recommendation. Management will conduct a research study of reporting and compliance issues associated with like-kind exchanges based on the issue-related returns selected by the National Research Program. The results will be shared with the office planning future National Research Program studies.

Taxpayers Should Be Given Consistent and Adequate Guidance on Like-Kind Exchange Filing Requirements

Some of the IRS guidance provided to taxpayers who sell real estate lacks adequate information about like-kind exchange filing requirements. While the Internal Revenue Code (I.R.C.) is not explicit with respect to the requirement to file Form 8824 per se, and there are usually no penalties imposed if a taxpayer does not file the Form, some sections of the I.R.C. provide the IRS with the legal authority to require the filing of Form 8824. Also, some IRS forms,

\(^7\) “Using Data from the Internal Revenue Service’s National Research Program to Identify Potential Opportunities to Reduce the Tax Gap,” (GAO-07-423R, dated March 15, 2007).

\(^8\) The National Research Program is a comprehensive effort by the IRS to measure payment, filing, and reporting compliance for different types of taxes and various sets of taxpayers.
instructions, and publications provide taxpayers proper guidance with respect to a like-kind exchange and the requirement to file a Form 8824. However, other IRS guidance needs revision to provide consistent and adequate information to taxpayers engaging in like-kind exchanges, to help meet the IRS mission (provide America’s taxpayers with top-quality service by helping them understand and meet their tax responsibilities and by applying the lax law with integrity and fairness to all).

**The I.R.C. is not explicit**

The Office of Chief Counsel stated “there is no explicit requirement in the I.R.C. Section 1031, or the regulations there under, that a taxpayer who was a participant in a like-kind exchange file a Form 8824.” However, the Office of Chief Counsel, as well as SB/SE Division Examination staff, pointed out that I.R.C. Sections 6011 and 6012 provide the IRS with the legal authority to require taxpayers involved in like-kind exchanges to file Forms 8824. Without mentioning forms specifically, these sections of the I.R.C. specify the persons required to file income tax returns and state that every person required to file a return or statement shall include the information required by such forms or regulations. Because the instructions for Form 8824 require the filing of the Form to allow the IRS to determine whether a taxpayer who was a participant in a like-kind exchange complied with the applicable provisions of the I.R.C. Section 1031 regulations, the IRS believes it has the legal authority to require a taxpayer to file a Form 8824.

**No penalty is usually imposed if a taxpayer does not file a Form 8824**

Form 8824 is considered an attachment to the income tax return. It is not an information return or a reporting document subject to any penalty. However, if a partially taxable like-kind exchange (that was not reported and not disclosed on a Form 8824) is identified during the course of an examination, accuracy-related penalties under the provisions of I.R.C. Section 6662 may be applicable.

**Various IRS instructions need to provide additional guidance to taxpayers participating in like-kind exchanges**

The instructions for Sales of Business Property (Form 4797) and Capital Gains and Losses (Schedule D) for the U.S. Individual Income Tax Return (Form 1040) specifically inform taxpayers they need to use Form 8824 to report like-kind exchanges. *Sales and Other Dispositions of Assets* (Publication 544) states under the section entitled “Nontaxable Exchanges” that taxpayers are to “report the exchange of like-kind property, even though no gain or loss is recognized, on Form 8824. . . and, if you have any recognized gain because you received money or unlike property, report it on Schedule D (Form 1040) or Form 4797 whichever applies.”
However, the IRS web site (IRS.gov) Section 11.4-Frequently Asked Questions, Sale or Trade of Business, Depreciation, Rentals, Sales, Trades, Exchanges, does not include Form 8824 as one of the necessary forms to fill out. Rather, it makes reference to Form 8824 and like-kind exchanges in a different Section entitled “Like-Kind Exchanges-Real Estate Tips.”

Copy B of Proceeds From Real Estate Transactions (Form 1099-S) is sent to taxpayers upon sales or exchanges of real estate. The “Instructions for Transferor” appear on the back of Copy B and state, “If the real estate was not your main home, report the transaction on Form 4797, Sales of Business Property, Form 6252, Installment Sale Income, and/or Schedule D (Form 1040).” However, there are no instructions that inform taxpayers they may be required to file a Form 8824 if a like-kind exchange was involved.

In addition, Your Federal Income Tax (Publication 17) informs taxpayers, “If you sold or traded reportable real estate, you generally should receive from the real estate reporting person a Form 1099-S showing the gross proceeds from the sale or exchange. Follow the instructions for Schedule D to report these transactions.” It is not clear that taxpayers need to use a Form 8824 to report a like-kind exchange.9

Consistent and adequate guidance, provided in part by Form 8824 and its instructions, helps ensure taxpayers are in compliance with tax laws covering like-kind exchanges. Also, information from Forms 8824 may help the IRS to accurately determine taxpayers’ tax liabilities and make determinations concerning taxpayers’ figures on the basis in replacement property or depreciation. Inadequate guidance may increase taxpayer burden and noncompliance with tax laws.

Recommendation

Recommendation 2: To ensure taxpayers are given adequate and consistent guidance with respect to like-kind exchange filing requirements, the Commissioner, Wage and Investment Division, should:

a. Revise IRS.gov Section 11.4-Frequently Asked Questions, Sale or Trade of Business, Depreciation, Rentals, Sales, Trades, and Exchanges, to include Form 8824 in the list of forms taxpayers may be required to file.

b. Add a sentence to the “Instructions for Transferor” on the back of Form 1099-S (Copy B), directing participants in like-kind exchanges to file Forms 8824.

c. Update Publication 17 to refer taxpayers to the instructions for Form 8824 in addition to its current reference to Schedule D instructions.

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9 Form 8824 is referred to on some pages in Publication 17 but not in the Section referred to above.
Management’s Response: IRS management agreed with this recommendation. Management submitted a request for change to the Office of Chief Counsel to include Form 8824 information in the Frequently Asked Questions. The Office of Chief Counsel has included this information in the 2008 IRS.gov Frequently Asked Questions (to be posted by January 1, 2008). Management agreed to add a sentence to Form 1099-S (Copy B) directing participants in like-kind exchanges to file Form 8824 and to update Publication 17 to refer taxpayers to the instructions for Form 8824, in addition to its current reference to Schedule D instructions.

The Rules and Regulations for Like-Kind Exchanges of Second and Vacation Homes May Be Unclear to Taxpayers

The Office of Chief Counsel stated that when a second or vacation home is used exclusively by the owner (related parties) I.R.C. Section 1031 like-kind exchange treatment is not available. However, the IRS rules and regulations for like-kind exchanges of second and vacation homes that were not used exclusively by the owners, or where there is some rental history or attempts by the taxpayers to rent the properties, are complex and little exists with respect to a published position by the IRS on like-kind exchanges involving such properties.

In our opinion, the absence of clarification on this issue leaves unrebutted the sales pitch of like-kind exchange promoters who may encourage taxpayers to improperly claim deferral of capital gains tax by selling non-qualifying second and vacation homes through “tax-free” exchanges.10

Many of these promoters advertise their services on the Internet and in various news publications. In addition, some promoters hold free seminars during which they inform taxpayers that second and vacation homes can be sold tax free using like-kind exchanges. Advice given to taxpayers includes how like-kind exchanges can be used to sell not only second

10 Many promoters of like-kind exchanges refer to them as “tax-free” exchanges not “tax-deferred” exchanges.
and vacation homes, including those never rented,¹¹ but also primary residences for which traditional sales would result in appreciation above the tax-free amounts¹² provided by law.¹³

Over the last few years, the concept and reality of “flipping” property throughout many parts of the country made like-kind exchanges popular with real estate speculators. Some people may not understand the IRS rules governing such exchanges and may trust the advice of realtors who may not be well versed in tax law. In some instances, amateurs buy and sell properties too quickly, running the risk that the IRS may deem the transactions a person’s trade or business with the gains taxed as ordinary income and subject to self-employment taxes. In other instances, taxpayers may take possession of the cash proceeds of the sales, in contradiction to IRS rules requiring that the money be placed in escrow or held by qualified intermediaries until the replacement properties are acquired.¹⁴

The real estate market has undergone a downturn and home prices have declined in many areas. This may serve to discourage taxpayers from investing in real estate. However, other taxpayers may see this as an opportunity to invest in second and vacation homes at reasonable prices. Given the lack of regulations, statutes, and court cases providing a definitive answer on the subject of like-kind exchanges with respect to second and vacation homes not used exclusively by owners, taxpayers and promoters may mistakenly take the position that any transaction not specifically prohibited by IRS guidance would be entitled to like-kind exchange treatment. While the absence of guidance may be a more effective deterrent to abuse than publication of guidance, in this case, unscrupulous or uninformed promoters are already taking advantage of the IRS’ silence. For example, one promoter advised that taxpayers could sell their vacation homes using like-kind exchanges even though the homes were never rented. The promoter indicated “attempts” to rent vacation homes could qualify these properties for like-kind exchanges and

¹¹ The Office of Chief Counsel stated there are other factors that need to be considered (e.g., the taxpayer’s treatment of mortgage interest on the property). The fact that property was purchased with the expectation it would appreciate is not sufficient to qualify the property for a like-kind exchange because most real property is purchased with the expectation that it will appreciate. The fact that the property is not rented is not indicative the taxpayer does not use the property for personal use.

¹² Under I.R.C. Section 121, the standard amount of tax-free capital gains allowed on primary residences is $250,000 for taxpayers who file as Single or Married Filing Separately and $500,000 for taxpayers who file as Married Filing Jointly.

¹³ Rev. Rul. 59-229, 1959-2 C.B. 180, is the closest thing the IRS has to a published position on I.R.C. Section 1031, exchange of a residence. This Revenue Ruling considers the tax treatment of residences (with mortgages thereon) exchanged with farm properties. It indicates that, if the residences are occupied by tenants acting, for example, in the capacity of caretakers or farm workers for the taxpayers, the exchange is treated under I.R.C. Section 1031(a) as “property used in trade or business” in the same manner as the exchange of the farm lands and buildings. However, when the dwellings are used as personal residences by the taxpayers who are parties to the exchange, an exchange thereof is treated as a separate transaction. Any resulting gain is subject to the provisions pertaining to the sale or exchange of a residence.

¹⁴ If taxpayers take possession of the cash, they are disallowed the tax advantages of the like-kind exchange provisions.
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attempts could consist of placing rental advertisements in distant cities. More taxpayers may take the advice of these promoters if the IRS fails to provide adequate guidance.

Recommendation

**Recommendation 3:** The Commissioner, Wage and Investment Division, should provide additional guidance to taxpayers regarding the rules and regulations governing like-kind exchanges with respect to second and vacation homes that were not used exclusively by owners.

**Management’s Response:** IRS management agreed with this recommendation. SB/SE Division Counsel has submitted a request for published guidance about like-kind exchanges with respect to second and vacation homes which are not used exclusively by the owner. Management will also provide a Tax Gap Fact Sheet to stakeholders and practitioners about the filing requirements for Form 8824. In addition, outreach will caution taxpayers to be wary of individuals promoting improper use of like-kind exchanges.
Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to evaluate the IRS’ oversight of the deferment of capital gains tax through like-kind exchanges. As part of this review, we also determined whether taxpayers’ use of this investment strategy is growing and whether this poses any specific problems for the IRS. To accomplish this objective, we:

I. Performed a risk assessment to identify any internal control weaknesses that needed to be included in our audit tests.

II. Gathered and reviewed information on the IRS’ collection and processing of data from Like-Kind Exchanges (Form 8824). We obtained the information from IRS management and staff and any findings and recommendations made in prior reviews that involved like-kind exchanges.
   A. Identified the numbers and dollars involved in such transactions for the latest years available to identify the growth in transactions.
   B. Contacted the IRS Office of Research, Analysis, and Statistics to obtain any current or historical data collected on Forms 8824.

III. Identified the information collected from Forms 8824 by the IRS and the purpose of collecting such data.
   A. Obtained information from IRS management and staff regarding the purpose and use of information collected from taxpayers’ Forms 8824.
   B. Determined how the IRS tracks the deferment of capital gains tax due to like-kind exchanges and ensures taxpayers are complying with tax laws.
   C. Determined how the IRS identifies noncompliance and ensures all taxpayers that should be filing Forms 8824 are doing so.

IV. Researched IRS, GAO, and Treasury Inspector General for Tax Administration reports to identify any findings/recommendations made with respect to like-kind exchanges.
   A. Determined whether the IRS has conducted or plans to conduct any research projects in the area of the deferment of capital gains tax through like-kind exchanges.
   B. Obtained information from IRS management and staff regarding past, current, or future projects in this area.
C. Contacted IRS management and staff to identify any concerns regarding like-kind exchanges.

D. Gathered and reviewed information on recent changes to or pending legislation affecting the tax laws concerning like-kind exchanges.
Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)
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MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kathy K. Petronchak
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance (Audit #200730003)

August 22, 2007

We have reviewed your draft report, "Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance." We understand that the number of taxpayers using Form 8824, "Like-Kind Exchanges," to claim deferred gains or losses is increasing and as a result, we agree with your recommendations.

We will conduct a research study of reporting and compliance issues associated with like-kind exchanges. In addition, we plan to revise instructions for certain tax forms including Form 8824, "Like-Kind Exchanges," and will update the information available on www.irs.gov. Finally, as appropriate, we will provide additional guidance on like-kind exchanges to taxpayers, practitioners, and stakeholders.

Attached is a detailed response outlining our corrective actions.

If you have any questions, please contact me or call Beth Tucker, Director, Communications, Liaison and Diedoaro, Small Business/Self Employed Division, at (972) 309-1876.

Attachment
Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance

Attachment

RECOMMENDATION 1:
Based on the increase in the use of like-kind exchanges to defer capital gains tax, the dollar amounts deferred on Forms 8824, and the numerous concerns expressed by IRS staff and the GAO, the Director, Research, Small Business/Self-Employed Division, should conduct a study of issue-related returns selected by the National Research Program (NRP). At the conclusion of the study, the Research function would recommend to the SB/SE Examination function what particular data should be captured in future NRP studies in order to ensure appropriate IRS oversight of taxpayer compliance with tax laws pertaining to like-kind exchanges.

CORRECTIVE ACTIONS:
We agree with the recommendation. We will conduct a research study of reporting and compliance issues associated with like-kind exchanges based on the issue-related returns selected by the NRP. Since Research, Analysis and Statistics has primary responsibility for planning future NRP studies, we will share the results of the study with that Office.

IMPLEMENTATION DATE:
August 15, 2008

RESPONSIBLE OFFICIAL:
Director, Research, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION(S) MONITORING PLAN:
The Director, Research, SB/SE, will advise the SB/SE Commissioner of any delays in implementing this corrective action.

RECOMMENDATION 2:
To ensure taxpayers are given adequate and consistent guidance with respect to like-kind exchange filing requirements, the Commissioner, Wage and Investment Division, should:

a. Revise IRS.gov Section 11.4-Frequently Asked Questions (FAQ), Sale or Trade of Business, Depreciation, Rentals, Sales, Trades, and Exchanges, to include Form 8824 in the list of forms taxpayers may be required to file.

b. Add a sentence to the "Instructions for Transferee" on the back of Form 1099-S (Copy B), directing participants in like-kind exchanges to file Forms 8824.

c. Update Publication 17 to refer taxpayers to the instructions for Form 8824 in addition to its current reference to Schedule D instructions.

1 The National Research Program (NRP) is a comprehensive effort by the IRS to measure payment, filing and reporting compliance for different types of taxes and various sets of taxpayers.
CORRECTIVE ACTIONS:
a. We submitted a request for change to Chief Counsel on July 25, 2007, to include Form 8824 information in the FAQ. Chief Counsel indicates information regarding Form 8824 has been included in the 2008 IRS.gov FAQs (to be posted by January 1, 2008).
b. We agree to add a sentence to Form 1099-S (Copy B) directing participants in like-kind exchanges to file Form 8824.
c. We agree to update Publication 17 to refer taxpayers to the instructions for Form 8824, in addition to its current reference to Schedule D instructions.

IMPLEMENTATION DATE:
b. December 15, 2007
c. December 15, 2007

RESPONSIBLE OFFICIAL:
a. Director, Customer Accounts Services (Accounts Management), Wage and Investment Division (W&I)
b. Director, Media and Publications, Wage and Investment Division (W&I)
c. Director, Media and Publications, Wage and Investment Division (W&I)

CORRECTIVE ACTION(S) MONITORING PLAN:
a. The Director, Customer Accounts Services (Accounts Management), W&I Division, will advise the W&I Commissioner of any delays in implementing this corrective action.
b. The Director, Media and Publications, W&I Division, will advise the W&I Commissioner of any delays in implementing this corrective action.
c. The Director, Media and Publications, W&I Division, will advise the W&I Commissioner of any delays in implementing this corrective action.

RECOMMENDATION 3:
The Commissioner, Wage and Investment Division, should provide additional guidance to taxpayers regarding the rules and regulations governing like-kind exchanges with respect to second and vacation homes that were not used exclusively by owners.

CORRECTIVE ACTIONS:
a. We agree with the recommendation. While there is published guidance under Internal Revenue Code Section 1031 that is applicable to residential property and case law on the issue of vacation homes used exclusively by the owner, there is presently no guidance addressing the specific issue of like-kind exchanges with respect to second and vacation homes which are not used exclusively by the owner. For this reason, SB/SE Division Counsel has submitted a request for published guidance about like-kind exchanges with respect to second and vacation homes which are not used exclusively by the owner.
b. We also will provide a Tax Gap Fact Sheet to stakeholders and practitioners about the filing requirements for Form 8824. In addition, outreach will caution taxpayers to be wary of individuals promoting improper use of like-kind exchanges.

IMPLEMENTATION DATE:
   a. Completed
   b. March 15, 2008

RESPONSIBLE OFFICIAL:
   a. N/A
   b. Director, Communications, Liaison and Disclosure (CLD), Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION(S) MONITORING PLAN:
   a. N/A
   b. Director, Communications, Liaison and Disclosure (CLD), Small Business/Self-Employed Division (SB/SE) will advise the Commissioner, SB/SE Division of any delays in implementing this corrective action.