1031 Exchanges and Investor Due Diligence

—Loss in excess of $83 Million brings unprecedented scrutiny to 1031 Industry

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By Lori De Martini

Over the last five years, real property owners have experienced unprecedented market appreciation of their investments. In addition to benefiting from market conditions, many owners have substantially enhanced the value and size of their portfolios by simply exchanging their investment property under Section 1031 of the Internal Revenue Code for like-kind investment property. By exchanging instead of selling, these investors avoid having to use any cash equity appreciation to pay capital gains taxes and can then invest outside the real estate market.

In short, IRC Section 1031 allows a taxpayer to avoid paying steep capital gains tax by simply re-investing in other replacement investment property. Thus, through an exchange, a taxpayer can build wealth by reinvesting anywhere between 15 and 35 percent or more of the gain that would otherwise disappear into the pocket of the IRS and state tax authority.

For example, a taxpayer who purchased a $500,000 piece of real property in 1986 and now wishes to sell in 2007 will probably face a substantial capital gains tax. If that same taxpayer sells for $4,000,000, the resultant gain of $3,500,000 (assuming no capital improvements and no depreciation) will be taxed at the federal level at 15 percent or $525,000 and at the state level (for example, in California) at 9.3 percent or $325,500, leaving only $3,149,500 to reinvest. Alternatively, replacing the property with like-kind investment property under Section 1031 allows the taxpayer to reinvest the entire $4,000,000.

Although the benefits are obvious, the taxpayer must adhere to specific rules in order

to defer payment of capital gains tax. Specifically, the 1991 Treasury Regulations governing Section 1031 provide rules that taxpayers must follow to ensure that they are not required to pay capital gains tax. One of those rules is that the taxpayer may not have actual or constructive receipt of the proceeds.

The Treasury Regulations provide several types of arrangements that will satisfy that requirement. One of those arrangements is the use of a Qualified Intermediary (also known as an "accommodator," "facilitator," or "QI") to hold the proceeds and reinvest them in replacement property for the taxpayer's benefit. The QI can be anyone who is not an agent of the taxpayer at the time of the transaction. Treasury Regulation Section 1.1031 (k)-(k)(2) specifies that persons who have acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period ending on the date of the transfer of the relinquished property are considered agents of the taxpayers for purposes of the disqualified person definition. Attorneys who have performed only exchange related services for the taxpayer or have performed other legal services more than two years prior to the sale of the relinquished property will not be considered disqualified persons.

In addition, there are strict rules regarding timing of the exchange and identifying replacement property. Taxpayers have only 180 days to complete their exchange and within the first 45 days, must identify like-kind property. "Identify" means a document signed and dated by the taxpayer specifying the intended replacement property. This identification notice must be sent to someone involved in the exchange (it may not be a disqualified person) on or before the 45th day. Also, the taxpayer is restricted in the number of properties they may list as potential replacement properties. They may identify three properties of any value or they may identify any number of properties as long as their total value does not exceed 200 percent of the value of the relinquished property.

The vast majority of exchanges are delayed exchanges, in which the property the taxpayer intends to dispose of—the relinquished property—is sold and cash derived from the sale is held by the QI while the exchanger locates and identifies like-kind replacement property. The QI then uses the exchange proceeds to acquire the replacement property before the end of the exchange period.

Except for the requirement that the QI cannot be an agent of the taxpayer, there is no limitation on who can serve this function. Most major title companies have an affiliated company specializing in exchanges. There are, however, hundreds of QIs nationwide that provide this service on a regular basis. Not only is there a minimal criterion for serving this function, there is no state or federal regulation of this industry. What does that mean for investors? How can investors ensure that their funds remain safe and available to acquire replacement property? The recent closure of a Nevada-based independent exchange company, Southwest 1031 Exchange, underscores the need to examine these questions.

Southwest's Sudden Closure

In late January 2007, Southwest 1031 Exchange, a Nevada corporation providing QI services under Section 1031, abruptly closed its doors leaving both its exchangers and local authorities searching for their exchange proceeds. According to news accounts, Southwest Exchange's clients claim that their requests to Southwest Exchange to wire their exchange proceeds to acquire replacement properties were initially delayed and then ultimately not honored.

Some news reports indicate that as many as 70 or more investors had pending exchanges and millions of dollars is unaccounted for after Southwest Exchange's sudden closing. Lawyers for some of the aggrieved investors have estimated potential losses in excess of $83 million dollars. Some believe it may be the largest loss of consumer funds in American history.

Clients of Southwest Exchange have filed civil actions. Local authorities and the FBI are investigating, and on February 6, 2007, Clark County District Court Judge Mark Denton named Larry Bertsch as receiver for Southwest Exchange. As receiver, Bertsch will take possession of the Southwest Exchange's business and records, investigate the status of the missing funds, and report his findings to the court. The Federation of Exchange Accommodators (FEA), a national trade organization, officially suspended Southwest Exchange from its membership rolls, pending further investigation of the matter.

The investigation into Southwest Exchange's sudden closure and the missing exchange proceeds will undoubtedly continue for some time. Southwest Exchange's situation has understandably prompted investors to raise appropriate questions about the security of their exchange proceeds.

QI Industry Is Unregulated

Although the Treasury Regulations must be followed for the taxpayer to get the benefit of tax deferral, the QI industry itself is currently unregulated. Although some states require a QI to post a bond to do business in their state, there is otherwise no oversight by any regulatory body. Reputable QIs, and there are many, conduct their business in accordance with sound business practices and facilitate their client's exchanges in strict compliance with the Treasury Regulations governing section 1031 exchanges. With no regulatory oversight, however, prudent exchangers must conduct their own due diligence to ensure that their selected QI can maintain the integrity of their exchange proceeds.

What Is Appropriate Due Diligence?

When considering a QI for your transaction, in addition to assessing their general business reputation, there are a number of specific questions to ask:

- What is the QI's financial strength? Obtain a copy of the QI's annual financial statement.

- Does the QI have a fidelity bond? If so, what is the amount?
- Does the QI have professional liability insurance? If so, what is the amount?
- Can the QI provide a written guarantee? – i.e., a commitment by the QI and/or its parent company to reimburse the client for any loss of funds due to the fraud or dishonesty of the QIs employees or the QIs failure to comply with the terms of the exchange agreement?
- Where is the QI holding the funds?—in an investment account or bank account?
- Is an account summary available on demand?
- Is the QI subject to and compliant with Sarbanes-Oxley?
- Is the QI an independent organization/entity or is it affiliated with a larger corporate parent and/or sister company(ies) with substantial assets?

Southwest Exchange's Closure and its Effect on the QI Industry

Certainly the due diligence an investor undertakes when selecting a QI is of paramount importance. However, for those investors who fail to undertake such precautionary measures, regulation by a federal and/or state regulatory body would be undeniably beneficial. Had a larger fidelity bond been in place for Southwest Exchange's benefit, many investors might not be facing such a devastating loss. Instead, Southwest Exchange's sudden closure has left many investors frantically seeking return of their exchange funds. Moreover, not only will many—if not all—of these exchangers fail to recover their funds, they will also be faced with paying capital gains tax.

Most reputable QIs meet the due diligence standards discussed above and are, in essence, self-regulating by their adherence to strict accounting procedures and their compliance with Sarbanes-Oxley and with the rules and regulations governing Section 1031 exchanges. These QIs would welcome regulation, which would eliminate some of the uncertainty created by inconsistencies in the industry and would also eliminate those QIs with less-than-reputable practices.

OREXCO is a California corporation that has handled more than 100,000 exchanges since its incorporation in 1993. OREXCO has 27 offices nationwide. It is a wholly owned subsidiary of Old Republic International (NYSE: ORI)—a $12 billion multi-line insurance company. OREXCO has an $80 million fidelity bond and a $30 million professional liability policy. For more information on 1031 exchanges, visit OREXCO's Web site at www.orexco1031.com or call its corporate headquarters at (800) 738-1031.