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What Investors Should Know about 1031 Exchange Intermediaries

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In order to avoid paying federal and state capital gain taxes when you sell an investment property, you will need to do a 1031 tax-deferred exchange into another investment property. The IRS does not allow you to have constructive receipt, i.e. direct control, of your sale proceeds. This means you need to hire a qualified intermediary or 1031 exchange company as a custodian for your exchange fund. Otherwise, your transaction may not be qualified for 1031 tax deferment. The exchange company will hold all of the money from the sale of the relinquished property for up to 180 days while you are looking for a replacement property to complete the exchange. When you need to have access to your fund money after you are in contract to buy the replacement property, e.g. make an earnest deposit to purchase a new property, you instruct the exchange intermediary to wire the deposit to the title company. That's what no direct control of your proceeds means.

Many investors do not know these companies are in a business that is not regulated by both the IRS and any of the 50 states. This means these exchange companies can use your money to invest in anything they want. They don't need to disclose where they invest, what they invest or the risks of their investments. The State of California passed Senate Bill 1007 on September 30, 2008. This bill requires exchange companies doing business in the state of California to invest your funds in investments that "meet the prudent investor standard". This bill provides investors with some protection.

Occasionally there have been sad stories about exchange companies losing investors money in risky investments and then declaring bankruptcy. Investors can only recover a fraction of their money. On top of that, they may have to deal with capital gain taxes because they do not complete the transaction within 180 days! For ex-

ample, in 2008 LandAmerica 1031 Exchange Services, a subsidiary of LandAmerica, a major provider of title insurance company, www.landam.com, filed petitions for Chapter 11 bankruptcy protection. As a result, all open 450 1031 exchange accounts with 420 million dollars were put on hold. The bankruptcy trustee claimed that the customers' documentation with LandAmerica never established trust or escrow accounts. As a result, the customers were general unsecured creditors to be paid after LandAmerica's secured creditors get paid.

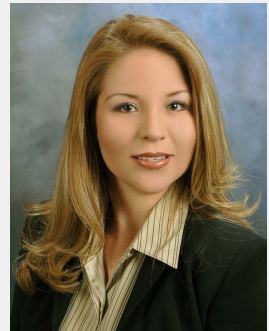
So how do you avoid being a victim? To answer this question, you will need to understand a little bit about the exchange business. Most exchange companies make money by charging a fee per transaction. They in turn invest your money somewhere with higher returns, pay you low .5-1% interests, and pocket the difference. This is how exchange companies normally make most of the profits. In the case of LandAmerica, it put much of the customers' money in high-yield auction-rate securities backed by federally-insured student loans. However, these securities became very difficult to convert to cash due to the tight credit market at that time. LandAmerica had to sell these securities for less than the value of the securities when the exchange customers needed money to complete the exchange. As a result, it did not have enough money to cover its obligations and had to declare bankruptcy.

There are 3 main types of exchange companies:

1. Some exchange companies are just a division or subsidiary or an entity owned by an escrow or title insurance company. For example



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- First American Exchange Company (FAEC), www.firstexchange.com is a separate Limited Liability Company (LLC) owned by First American which is also in the title & escrow business. FAEC occupies the same office as the First American Title office.
 - Old Republic Exchange, www.oldrepublicexchange.com, is a member of The Old Republic International Corporation.
2. Some banks also offer 1031 exchange services. For example
- Citi National Bank, www.cnb.com.
 - Bank of California, www.bancofcal.com.
3. Companies that specialize in 1031 exchanges. They could be a mom-and-pop company or a franchise with offices in many states. For example:
- Investment Property Exchange Services, Inc. www.ipx1031.com
 - Exeter 1031 Exchange Services. www.exeterco.com
 - Asset Preservation, Inc., www.apixchange.com.

The fees generally charged by these companies can vary from \$500 to \$1500 per transaction. However, there are different restrictions:

1. The company that charges low fee often does not pay interest on your fund or only pays interest if your fund is above a certain amount. If your sales proceed is significant, e.g. several hundred thousand dollars, you may save on the fee but may lose a significant amount on the interest payment. For example, First American Exchange does not pay any interest if your exchange fund is less than \$1,000,000.00.
2. Some companies may offer to pay savings account rate while another may pay higher money market rate.

During the economic downturn many big companies faced big losses and failed. You should choose an intermediary on 2 factors:

1. The most important factor is which company can provide safety, security and timely disbursements of your funds. When the amount of money is substantial, e.g. several million dollars, this is even more critical.
2. Fees, interest rates, and staff competency should be a distant secondary requirement.

To ensure your money is safe, you should ask the exchange company if

1. Your money is FDIC-insured. When it comes to deposit insurance of your bank accounts, it's not possible to find a replacement for FDIC. The account is insured up to \$250K per customer. So, if the exchange account is under both husband and wife's names, it's insured up to \$500K. When you have more than \$500K you want the qualified intermediary to instruct the bank to put your money in a Certificate of Deposit Account Registry Service, or CDARS account. Your money is deposited in multiple banks to be insured up to \$250K per customer per bank for up to \$50

Million. CDARS account is a CD account so you probably want a short term CD to make sure you don't pay penalty for early withdrawal. An intermediary may advertise that it carries \$100M in fidelity bond. However, this bond is intended to protect the company against theft or embezzlement, not investment losses. It may also say that your account is guaranteed by the assets of its publicly-traded parent company. If you believe this guaranty is strong enough, make sure it has a lot more assets than Lehman Brothers which filed for chapter 11 in September 2008!

2. Your money is deposited in the operating (comingled) account or in separate, segregated, qualified trust accounts under your name and social security number/Tax ID. When the money is in the operating account, the exchange company can use it for anything; e.g. pay salary for its employees or invest in the stock market in China. In addition, the money in the operating account belongs to the company. Should the company declare bankruptcy, it's harder to prove whether the money in the account is your money. On the other hand, the separate trust account keeps your funds separate from the company and others. Should the company declare bankruptcy, it's easier and faster to recover your money from your separate trust account. The fact your money is in a separate account does not make your money safer, just easier and faster to claim it's your money. Normally if you don't say anything, your money may be deposited in a general account.

- The separate, segregated account is called a qualified trust account if the funds are deposited and held by a bank or trust company as trustee. The account name should be something like "ABC Company as Qualified Intermediary for John & Jane Smith Trust Account" with your tax ID. This trust account is regulated by the government and the exchange company cannot use money for its business.
 - The separate, segregated account is called a qualified escrow account if the funds are deposited and by a title insurance company or escrow company as escrow agent. The account is under your name and tax ID. This account is not regulated by the government. The exchange company can still invest in the way as other non-segregated accounts if you don't specify anything.
3. Where your money is invested, e.g. money market. Again, since this is an unregulated business, it does not need to provide you a prospectus and does not necessarily need to invest in where it says it does. If the money is invested outside the US in which you probably don't know anyway, there may be a delay from the time you request your money to the time you actually get it.

Conclusion: when you choose an exchange company, you should consider its fees, services, and most importantly the safety, security and timely disbursements of your funds. You may want to consider an exchange intermediary located in California in which where your account is partially regulated and is a bit safer.