

1031 Qualified Intermediary Questions???

These strategies can help investors evaluate qualified intermediaries.

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For investment property owners, the current top concern in a Section 1031 exchange transaction should be safety of the taxpayer's funds. In the past decade, mismanagement and malfeasance have resulted in a handful of high-profile qualified intermediary bankruptcies and restructurings, causing many investors to lose their sale proceeds and be held liable for taxes on the gains from their relinquished property sales. These cases have created an environment where commercial real estate investors must carefully scrutinize their options in the virtually unregulated QI industry. "Will my funds be secure?" is perhaps the most important question to ask a QI before entering into an exchange transaction.

Choose Wisely

Safe-harbor rules prohibit investment property owners from possessing or accessing funds generated from the sale of relinquished property in 1031 exchanges. Instead, a QI must hold sale proceeds. Additionally, investors are prohibited from using their own attorneys, accountants, brokers, or any related party as a QI; the 1031 exchange proceeds must be handled by an independent third party.

How can investors determine if their funds truly will be secure during a 1031 exchange? There are a number of ways to evaluate QIs, and each method has advantages and drawbacks. The following points are worth considering before entering into a transaction with a QI.

Segregated Accounts. Instead of co-mingling exchange funds, some QIs segregate client funds into separate bank accounts. Viewed by some as the ultimate form of protection, security of funds in segregated accounts is an illusion. Regardless of Federal Deposit Insurance Corp. protection, segregated accounts do not receive any protection from QI failure, malfeasance, or bankruptcy. If a QI files for bankruptcy, deposit holders in the midst of 1031 exchanges with the QI are classified as unsecured creditors under the U.S. Bankruptcy Code, placing them on the lowest rung in the ladder of payouts from the bankruptcy trustee. In these cases, unsecured creditors typically receive a fraction of lost sale proceeds. Unfortunately, this was reaffirmed in the most recent QI bankruptcy case. A QI that recently went bankrupt had segregated accounts that did not preserve investors' sale proceeds after the filing.

FDIC Insurance. Capped at \$100,000, FDIC insurance often is publicized as a source of protection for exchange funds. However, the \$100,000 insurance coverage provided is per depositor. Most QIs title accounts in their own names to meet federal rules that restrict investment property owners from accessing exchange funds. Thus, in cases of malfeasance or bankruptcy, the \$100,000 FDIC insurance is shared equally among all parties for whom the QI is holding funds. Moreover, there is no guarantee that a QI actually deposits funds from its 1031 exchanges in a bank. A few QIs have invested exchange funds in stocks, derivatives, hedge funds, and any other unregulated, uninsured investment vehicles without their clients' knowledge. While not illegal, this is considered bad business practice by reputable QIs.

Company Size. Another consideration for investment property owners is the size of the QI. Some believe that large companies are unlikely to fail or file for bankruptcy. However, recent failures of mega companies such as Worldcom, Enron, Barings Bank, and similar financial institutions have shaken the public's confidence in such giant enterprises. While some investors may believe that regulated industries afford a higher level of protection, the savings and loan crisis of the 1980s illustrates a wave of institution failures that cost taxpayers and depositors approximately \$150 billion.

Strong Current Ratio. More important than a company's size is its liquidity, or the amount of cash on the company's balance sheet. The cash should be compared to the current liabilities to determine the company's current ratio. A current ratio indicating that the company can weather at least six months of expenses before running out of cash is good evidence that exchange funds are likely to be secure, especially since 1031 exchanges must be completed within 180 days.

Bonding and Insurance. The ultimate protection for 1031 exchange proceeds is to use a QI that is bonded and insured. When assessing a QI's bonding or insurance limits, there are two important considerations: The amount of the bond or insurance and whether the coverage limits are aggregate or per occurrence.

Aggregate bonding or insurance refers to the total amount of coverage for which the QI is covered by the policy. For example, if a QI has an aggregate insurance policy for \$1 million, it means the maximum that the insurance company will cover is \$1 million in total losses, regardless of how many clients are involved or how much each client has lost.

The best coverage a QI can have is a large per occurrence policy. Per occurrence coverage provides bonding up to the amount identified for each client in the midst of a 1031 exchange. Using the prior example, a \$1 million per occurrence policy means the QI has \$1 million of protection from loss for each client in the midst of an exchange. The auditing and investigation process for large per occurrence policies is extremely strict and costly. However, QIs that provide a large per occurrence policy for each 1031 exchange are generally the safest place for transaction proceeds.

For optimum security of funds, savvy investors should insist that 1031 exchange proceeds be bonded and insured by a QI under a substantial per occurrence policy that exceeds the transaction amount. Investors also should ensure that the QI has sizeable assets and substantial liquidity as evidenced by a strong current ratio. Anything less constitutes an unnecessary risk not only with the hard-earned equity gained from the sale of an investment property but also the capital gains taxes deferred in the 1031 exchange process.