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Safeguarding Exchange Funds in the Current 1031 Exchange Environment

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The 1031 exchange industry was shocked when LandAmerica 1031 Exchange Services, Inc. ("LandAmerica"), which acted as a qualified intermediary for 1031 exchanges, filed for Chapter 11 bankruptcy in November of 2008. Even more shocking was the bankruptcy court's ruling that the exchange funds held by LandAmerica were part of the bankruptcy estate and were not being held in trust for the benefit of the taxpayers. This ruling alarmed taxpayers and qualified intermediaries alike, and left the trade association of qualified intermediaries, the Federation of Exchange Accommodators ("FEA"), with the daunting task of calming taxpayers' fears over the safety of their exchange funds while working to put legislation or regulations into place to counter this ruling.

The LandAmerica Case

LandAmerica invested a substantial portion of its exchange funds in auction-rate securities that became illiquid when the auction process failed, resulting in LandAmerica's eventual inability to make exchange funds available to its clients for the purchase of replacement property. LandAmerica filed for bankruptcy, and its exchange clients began to sue for the return of their funds. The bankruptcy court decided to hear five select cases to determine if the funds deposited with LandAmerica were held in trust for the taxpayer or should be included in the bankruptcy estate.

Surprisingly, the Court ruled against the taxpayers, even though the funds had been held in segregated sub-accounts for the benefit of the taxpayer. LandAmerica and its customers entered into exchange agreements whereby the taxpayer disclaimed all "right, title and interest" in and to the exchange funds and gave LandAmerica the exclusive rights of "dominion, control and use" over the exchange funds. Presumably, these provisions were incorporated to comply with § 1031 regulations, to prevent the taxpayer's constructive receipt of funds; however, the wording concerning ownership of the funds was apparently overbearing. The Court ruled that because the funds were under the complete control of LandAmerica, and because the taxpayers could not show that they retained a right to the funds, the funds were not held in trust for them and were part of LandAmerica's bankruptcy estate. The Court also noted that the taxpayers were sophisticated, had independent counsel, and could have availed themselves of the qualified trust safe harbor but chose not to do so.

The FEA is currently working with Congress and the IRS to propose legislation that will clarify ownership of the assets by the taxpayer. There are inherent conflicts between 1031 regulation requirements restricting the taxpayer's receipt of the exchange funds, and bankruptcy considerations of who "owns" the funds.

Safety of Exchange Funds

There is currently no federal regulation of the qualified intermediary profession and, to date, only a handful of states (California, Colorado, Idaho, Maine, Nevada & Washington) have enacted legislation that regulates qualified intermediaries in their state. Therefore, it is up to the taxpayer to conduct appropriate due diligence to evaluate the stability, integrity, and professionalism of the qualified intermediary ("QI") chosen to hold his exchange funds. The taxpayer should consider the following factors when evaluating a QI:

(1) *How the QI will hold the money:* The taxpayer should look for a QI that utilizes financially appropriate instruments or accounts to hold funds during the transaction. Preservation of principle and liquidity should be primary considerations so that the funds will be available when needed. A tradeoff in interest earned may be necessary to secure these primary goals;

(2) *Safety of funds from threat of theft or embezzlement:* Because there is little regulation of QIs, almost anyone can serve as a QI. An institutional level QI will offer the following advantages in this regard:

If the QI is part of a publicly-traded company, then it will be subject to external audits by public accountants and also will have to comply with the financial control and reporting provisions of the Sarbanes Oxley Act and Securities and Exchange Commission.

If the QI is of sufficient size to employ multiple exchange personnel, then more robust internal financial controls can be put into place to guard against embezzlement and employee theft. Examples of relevant controls include segregating duties and requiring dual signatures for check or wire remittances.

(3) The likelihood of bankruptcy: A QI should have a strong balance sheet and sufficient capital to operationally withstand a downturn in the business cycle. Additional safeguards may also be employed to protect taxpayer funds in the event of a qualified intermediary's bankruptcy and are discussed below.

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The Qualified Intermediary Safe Harbor

The most commonly used safe harbor is the qualified intermediary safe harbor ("QI safe harbor") set forth in Treas. Reg. §1.1031(k)-1(g)(4). Under the QI safe harbor, the taxpayer and QI enter into an exchange agreement whereby the QI takes assignment of the taxpayer's interest in both the relinquished and replacement property contracts, with written notice of both assignments given to all parties to each contract. The QI then exchanges the old property for the new property by transferring the old property to the ultimate buyer, holding the net proceeds from the sale in an account to be used for the purchase of replacement property, and transferring the new property to the taxpayer. The exchange agreement obligates the QI to return to the taxpayer any sales proceeds from the relinquished property that are not used to acquire replacement property, but limits the taxpayer's right to access the funds during the exchange period.

The Qualified Trust Safe-Harbor as Further Bankruptcy Protection

The taxpayer may also wish to add an extra layer of security to his exchange by utilizing the qualified trust safe harbor in conjunction with the QI safe harbor. The Court in the LandAmerica case, as substantiation for denying the taxpayer's claim that the QI was holding his exchange funds in trust, pointed out that the taxpayer could have also used the qualified trust safe harbor, but chose not to do so. Treas. Reg. §1.1031(k)-1(g)(3) sets forth the qualified trust safe harbor.

This safe harbor requires a qualified trust agreement that expressly limits the taxpayer's right to access funds and is executed by the taxpayer, the QI, and the trustee. There is generally an additional expense to the taxpayer – a fee to the trustee in addition to the QI fee. Due to this additional expense, the use of a qualified trust safe harbor may be most practical for large exchange transactions.

When the qualified trust safe harbor is used, the exchange funds would be placed in a trust account with the taxpayer being named as the beneficiary and retaining the ability to direct how funds are invested. The QI, however, would be responsible for directing disbursements of the funds for purchase of the replacement property, with taxpayer approval, to prevent the constructive receipt of funds by the taxpayer. The trust account should be bankruptcy remote, since the account is set up under the qualified trust safe harbor as an asset held for the benefit of the taxpayer.

It is important to note that the trustee, just like the QI, may not be a disqualified person. A disqualified party is an agent of the taxpayer at the time of the exchange, and includes related parties, as well as anyone who has acted as the taxpayer's attorney, accountant, realtor, investment banker, or employee within the past two years. Routine financial, title insurance, escrow or trust services provided to the taxpayer by a financial institution, title company, or escrow company would not disqualify such a company from acting as trustee.

Additional Safeguards in the Event of a QI Bankruptcy

In light of the LandAmerica ruling, Jerry Long and Mary Foster suggest in their treatise *Tax-Free Exchanges under Section 1031 (West)*, that the exchange agreement should state the following: (1) that the intermediary is only holding the funds to accommodate the exchange, and that the intermediary does not have exclusive control or ownership of the funds; (2) that the intermediary shall not withdraw, invest, encumber, or pledge the exchange funds without the taxpayer's written consent; and (3) that the funds are being set aside for the taxpayer's exchange and shall not be deemed a part of the QI's general assets or subject to the claims of its creditors. Including the above provisions in the exchange agreement may protect a taxpayer's funds in the event of a QI bankruptcy.

In the wake of the uncertainty generated from the current recessionary environment, taxpayers should pay extra attention to all available options for safeguarding exchange funds. There are important questions to ask as well as planning strategies to consider. As always, we recommend that any taxpayer contemplating a 1031 exchange retain competent legal and tax counsel who can assist them in evaluating QIs and in implementing relevant planning strategies to minimize the risk of loss of personal assets.

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