

# Intermediary Behavior

**2009 was a tough year that thinned the ranks of 1031 qualified intermediaries. Those who are left are dedicated to create a stronger, more efficient industry.**

Ricky B. Novak and James W. Freeman

As real estate investors, developers, and professional advisors look back on 2009 and the years that preceded it, each now recognizes numerous deficiencies that existed in the industry. These deficiencies include questionable underwriting practices within the capital markets, flaws within the valuation system, and a general lack of adherence to fundamental commercial real estate development and investing principals. The resulting fallout from the market correction exposed other defects within the greater system, such as questionable practices and poor decision-making by ancillary service providers. Prominent examples of misjudgments by service providers are evidenced in two areas of commercial real estate that took harsh financial and reputational beatings in 2009: 1031 Qualified Intermediaries ("QIs") and Tenancy-In-Common ("TIC") syndicators. It is important that commercial real estate professionals understand the drivers behind these issues and the questions that need to be addressed going forward. This article will focus on the 1031 qualified intermediaries, while next month, we will tackle the bigger issue of TIC syndicators.

Tax-deferred exchanges under Section 1031 of the Internal Revenue Code have been employed by savvy real estate investors for decades. Many investors have completed basic forward exchanges, while a small percentage of real estate investors

and developers have completed more sophisticated reverse, construction/build-to-suit, leasehold and multi-asset exchange transactions. The 1031 exchange is a significant tax strategy tool that all prudent investors and developers should understand. The industry, however, has been recently wrought with misappropriation of client funds, breaches of fiduciary duty, theft and bankruptcy filings by intermediaries. The burden of "qualifying" one's 1031 qualified intermediary has become critical for the real estate investor and the allied professionals that advise them.

1031 exchange activity generally follows the transactional real estate market. As such, the significant decline in real estate sales and, therefore, exchange volume, has resulted in a sharp reduction in the number of QI firms in operation around the country. Many smaller boutique firms have been forced to close their doors, while larger firms have reduced sales and support staff. Though many of these QI firm closings are attributable to an inability to generate revenue, there are several instances where firm closings were the result of inappropriate QI behavior.

Examples of intermediary failures over the past 18 months include the bankruptcies of Atlanta-based Real Estate Exchange Services ("REES") and national exchange giant LandAmerica 1031 Exchange Services. Both QI's were forced into bankruptcy as a result of commingling client funds and investing those funds into auction-rate security assets that ultimately became illiquid. Since the QI typically paid the client a fixed interest rate, these higher-yielding investments enabled the QI to earn and keep a greater interest spread on the invested client exchange funds. Therefore, in most instances the QI invested in this manner not for the benefit of the client, but to instead benefit its own bottom line. This illiquidity not only resulted in the failure of numerous client exchanges and significant capital gain tax being realized by clients, but also left the QI with the



Novak

inability to return the principal exchange funds it had invested.

Another example of inappropriate QI behavior includes the misappropriation of more than \$97.5 million in client exchange funds by the management of Nevada-based Southwest Exchange Inc. Further, 1031 Tax Group principal Ed Okun was indicted and recently sentenced by a federal grand jury in Virginia for mishandling more than \$126 million in client funds. These are but a few of the unfortunate recent circumstances that have negatively impacted the QI industry. The 1031 industry as a whole continues to strive for establishing more stringent regulation to protect taxpayers against these risks.

However, the 1031 industry remains fairly self-regulated despite the numerous high profile QI bankruptcies and consistent industry oversight requests to several Federal government agencies. Only recently has the U.S. House of Representatives passed a bill (H.R. 4173: Wall Street Reform and Consumer Protection Act of 2009) to create the Consumer Financial Protection Agency. Among other responsibilities, this agency would act as the primary regulatory authority for the 1031 exchange industry. Details on how this oversight would function are not yet clear, and it is expected that the bill will face heavy scrutiny and changes in



Freeman

**QUALIFYING THE QI: WHAT QUESTIONS DO YOU NEED TO ASK?**

**R**egardless of whether you are a real estate investor or developer, or an affiliated professional advising them, diligence must be taken when determining which QI to retain. QI qualification concerns can be condensed into two main categories: knowledge and security. Below is a brief discussion of issues that should be addressed prior to accepting a QI onto your trusted team of advisors. While not an exhaustive discussion, it highlights fundamental areas of concern.

**Knowledge.** It is important that the QI be a dedicated expert in the field of 1031 exchange and not simply an entrepreneur looking to earn additional income by “also performing 1031 exchanges” as an add-on practice area. It is common to find CPAs, banks, attorneys and real estate brokers who advertise intermediary services as a part of their practice. Often, these part-time QIs neglect to closely monitor regulatory changes and “best practices” within the industry, a habit that can prove disastrous for the taxpayer.

When selecting a QI, it is recommended that the client inquire as to whether the firm is professionally managed by principals that are held to a higher fiduciary or ethical responsibility because of a degree or other license — such as being a member of the state bar (attorney) or regulated by the state board of accountancy (CPA). Many QIs only understand the fundamentals associated with basic forward exchanges, and lack an understanding of more complex exchange issues and structures. This may result in the client receiving advice that is not the most accurate or effective for their situation. Further,

the QI should also understand how a 1031 exchange affects or is affected by other areas of tax law and other business objectives, and it should seek to work with the advisory team in developing and implementing a strategic plan that utilizes 1031 exchanges for overall wealth planning. Finally, the QI should understand the nuances of real estate development and investment in order to offer proactive strategies that go beyond basic exchange concepts. With limited understanding of a client’s comprehensive strategy, the QI will be unable to provide accurate advice.

**Security.** It is important to understand how the intermediary will invest client exchange funds held on behalf of the client during the exchange process. It is advised that the client use a QI who has adopted a fully transparent investing process that allows input from the client. The QI should also adhere to security measures that ensure and insure asset principal protection and liquidity of funds. The client should confirm that the QI carries both errors & omissions insurance, as well as a fidelity crime bond. Internal controls are a critical aspect that all QIs should adopt, so be certain to understand what controls the intermediary has implemented. This might include the use of segregated accounts, qualified escrow or trust accounts, or dual-signature accounts. Client funds should not be pooled or commingled, as funds that are held in this manner are at risk should the QI file bankruptcy. The client should also inquire as to whether the QI offers an option for the client to direct which financial institution will hold the proceeds.

the U.S. Senate. At the state level, only a handful of states have considered or implemented minimum registration or consumer protection standards. However, these registration standards are by no means an inference of QI good standing or trustworthiness.

While 2010 is expected to be another challenging year for qualified intermediaries and transaction service providers, the 1031 sector is an important factor for commercial real estate deal volume. Because commercial real estate values are at historic lows, investors who buy real estate in 2010 should be viewed as prime candidates for 1031 exchanges in the future. **SCB**

**Ricky B. Novak is president and James W. Freeman is CFO of Atlanta-based Strategic 1031 Exchange Advisors. Freeman is a licensed CPA in multiple states, while Novak is a licensed attorney in the state of Georgia. Freeman can be reached at [jwfreeman@sea1031.com](mailto:jwfreeman@sea1031.com), and Novak can be reached at [rbnovak@sea1031.com](mailto:rbnovak@sea1031.com).**