Things You Should Know Before You Choose A Qualified Intermediary

From the desk of David Wieland

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David Wieland, CEO
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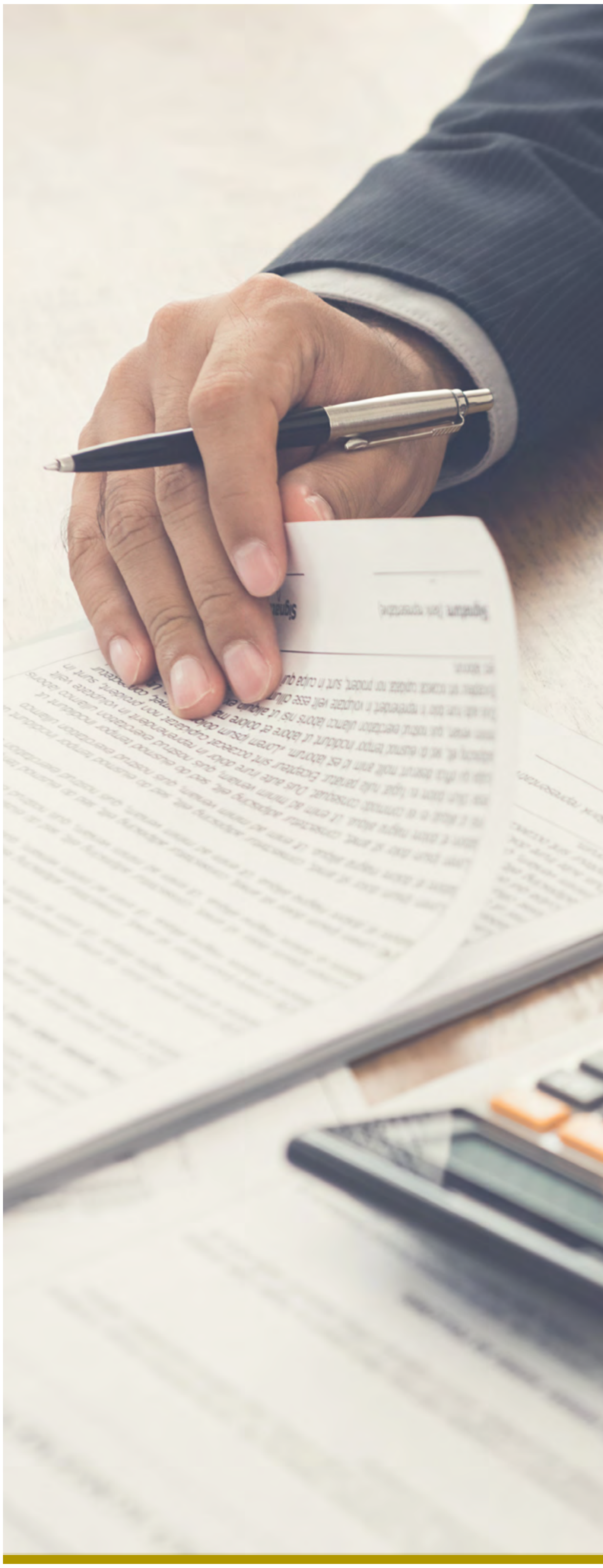

When an investor approaches the 1031 Exchange process, they are greeted by a variety of choices. One of the most important of these is selecting a **Qualified Intermediary** (QI)—also known as a 1031 Exchange Accommodator. These parties have three primary responsibilities, which are intended to ensure compliance with the IRS's rules in a 1031 Exchange. These responsibilities are:

01 Holding the investor's cash proceeds from the sale of property in escrow as required by the IRS.

02 Documenting the investor's identification of replacement property within the investors' 45-day identification period as required by the IRS.

03 Facilitating and documenting the investor's purchase of replacement property by transferring investors' funds to the title company/seller.

The following are some common questions about Qualified Intermediaries, defining their importance and the value they add to your 1031 Exchange process.

Why Is It Important For An Investor To Choose A Qualified Intermediary That Is Both Experienced And Trustworthy?

First, your Qualified Intermediary holds the cash from the sale of your property. Second, your QI helps you comply with the IRS's 1031 rules, thereby deferring capital gains taxes. 1031 Exchange Accommodators are not regulated by the Federal Government and there is no national standard or licensing. Regulations vary state-by-state, but most states do not require Qualified Intermediaries to be licensed, bonded/insured, audited, or otherwise monitored by the government in any way. It is particularly important to **do your homework** when selecting a Qualified Intermediary for your 1031 Exchange.

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Does My Qualified Intermediary Prepare My 1031 Exchange Paperwork For The IRS?

Your Qualified Intermediary prepares the forms and documentation necessary to ensure your exchange remains within the rules and timelines stipulated by the IRS. However, you—the taxpayer—are responsible for submitting this information to the IRS. Major items that the Qualified Intermediary needs to document are:

> Formal identification of potential replacement properties on or before midnight on the 45th day following the sale of a property.
>
> A full accounting of exactly how the 1031 Exchange funds are reinvested.
>
> 1099 forms (submitted to you and the IRS).

Selecting a trustworthy, knowledgeable Qualified Intermediary is one of the most important decisions an investor can make when executing a 1031 Exchange. It is imperative to work with someone who:

> Will hold your funds in an FDIC-insured bank account.
>
> Understands the various intricacies involved in submitting all documentation required by the IRS.
>
> Has a clear direction on how to facilitate the purchase of your replacement property and transfer funds to the title company.

Doing so can potentially save you hundreds, or thousands, of dollars in the long run.

When Is A Qualified Intermediary Necessary?

As a general rule, Qualified Intermediaries are required when executing a 1031 Exchange. The only situation in which a QI is not necessarily needed in a 1031 Exchange is when the money is being processed on the same day — also known as a Simultaneous Exchange. Even so, it is still beneficial to use a Qualified Intermediary. They can not only offer valuable guidance when navigating the complicated exchange process, but they help alleviate the risks associated with the 1031 Exchange should an error occur.

When funds are processed on the same day, there's always the risk that a wire transfer doesn't go through, or that a delay in funds transfer may result in a failed 1031 Exchange. If this happens, the IRS may accuse you of taking constructive receipt of the 1031 funds, which can void the exchange altogether or make you liable for paying the capital gains taxes you were trying to defer in the first place. The significant tax implications are not worth the "reward" of saving between $1,000 and $2,000 — the average cost of using a Qualified Intermediary.

From the date you sell your property, you have 45 calendar days to identify replacement properties, and 180 calendar days from the date of sale to close on properties you identified in the initial 45 days.

During both of these timeframes, your Qualified Intermediary should be working behind the scenes to both protect your funds and assist with the completion of the paperwork required by the IRS to process your exchange.

How Does A Qualified Intermediary Protect My Funds?

Again, most Qualified Intermediaries are not regulated like other institutions (banks, savings & loans, brokerage firms) that are holding your hard-earned money. As such, a Qualified Intermediary should hold your 1031 funds in a "segregated account" with a large FDIC insured bank. It is recommended that you confer with a Qualified Intermediary about the manner in which your funds will be held as per the exchange agreement in order to mitigate this risk.

The significant tax implications are not worth the "reward" of saving between $1,000 and $2,000 — the average cost of using a Qualified Intermediary.

Who Cannot Be My Qualified Intermediary?

There are many rules governing who can and can't be a Qualified Intermediary, so it is best to review the disqualified parties first. According to the IRS, a Qualified Intermediary cannot be an employee, family member, financial connection, or agent of the taxpayer.

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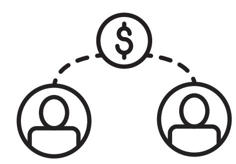
FAMILY MEMBERS & EMPLOYEES

To break that down a bit further, the taxpayer cannot ask siblings, spouses, ancestors, or descendants to act as their Qualified Intermediary. Beyond family members, the taxpayer's employees are also not allowed to serve as their Qualified Intermediaries.



FINANCIAL CONNECTIONS

The next rule is a bit more involved. If an individual has had any financial relationship with the taxpayer within the last two years, they cannot be their Qualified Intermediary.

Additionally, someone who is a fiduciary or beneficiary of a trust that you are involved with cannot be your Qualified Intermediary.

AGENTS

CPAs, attorneys, investment bankers, and real estate agents/brokers fall under the 'agent' category, so they cannot act as your Qualified Intermediary.

Additionally, any business or individual who is affiliated with the agent also cannot act as a Qualified Intermediary. For example, if your real estate agent owns a property management company, every employee who works for that property management company cannot be your Qualified Intermediary.

Who Can Be My Qualified Intermediary?

As long as the individual doesn't fall into the family, financial relationship, agent, or employee categories, they can be your Qualified Intermediary.

If they don't fall into those categories, they must apply for Qualified Intermediary status, which involves receiving a QI-EIN, which is a unique number assigned to the Qualified Intermediary by the IRS (EIN stands for "Employer Identification Number").

While agents, by and large, are unable to be your Qualified Intermediary, there are some exceptions to this rule. Agents who conduct 'routine' services such as creating escrow accounts, forming trusts, or securing title insurance are permitted to become Qualified Intermediaries because these are considered 'routine' financial services.

The second exception is not quite as clearly defined by the IRS. Let's break it down:

> This exception allows agents to act as intermediaries in a 1031 Exchange if they are working on a specific property type.
>
> The specific property type refers to the transactions where there will be no "gain or loss" on the property when the exchange occurs.
>
> This exception only applies to agents who have not worked with the taxpayer within the last two years.

Why Is A QI-EIN Necessary?

In every 1031 Exchange, there is always a 'withholding agent' (the individual who distributes payment when the exchange closes). In order for the payments to be released, the Qualified Intermediary must provide a formal document, called a Form W-8IMY, to the withholding agent. The QI-EIN must be used on this document.

The Qualified Intermediary will be responsible for filing many other forms with the IRS when executing the 1031 Exchange, including a 1042, 1042-S, 1042-T, 1099, 945, and 1096. The QI-EIN must be used on all of these forms. Additionally, the QI-EIN can only be used when the individual is acting in its capacity as a Qualified Intermediary, so it may be necessary for the QI to obtain an additional Employer Identification Number when he/she is not acting as a Qualified Intermediary.

A Qualified Intermediary can request a QI-EIN by submitting a document titled Form SS-4 to the IRS. After the IRS receives the application, a QI-EIN will be issued to the applicant.

Final Takeaways

A Qualified Intermediary is one of the most critical parts of a 1031 Exchange, as the transaction almost always cannot be completed without a QI present. When conducting an exchange, it is imperative to ensure that the Qualified Intermediary is experienced and thoroughly understands the various tax codes involved. It is equally essential to ensure that your Qualified Intermediary has not been financially connected to you within the last two years and is not considered a relative, employee, or agent. The IRS does not take these factors lightly; failure to comply with what is mentioned here may lead to hefty penalty fees – or the IRS may prohibit the exchange from occurring altogether. It is not worth the risk!

It is equally as essential to ensure that your Qualified Intermediary has not been financially connected to you within the last two years and is not considered a relative, employee, or agent.

Qualified Intermediary Requirements

A Qualified Intermediary **plays an integral role** in ensuring there are no hiccups in the exchange process and that you meet the IRS guidelines. There are a variety of duties they are responsible for handling, ranging from preparing relevant documentation to holding thousands (or even millions) of dollars in proceeds in an insured account. This article will discuss the various duties of a Qualified Intermediary so that you can ensure they are truly doing their part on your behalf.

Deadline Advisory

One of the most important (and stressful!) aspects of a 1031 Exchange is meeting the strict deadlines. Your Qualified Intermediary will play an integral role in ensuring that you are on track to meet all deadlines and that you submit the necessary documentation.

Identification & Close Periods

45-DAY IDENTIFICATION PERIOD

After selling the initial property in a 1031 Exchange (referred to as the “relinquished property”), you will have 45 days to find a new property (referred to as a “replacement property”) to secure the exchange. This period of time is known as the “identification period.” The documents must be signed and delivered to the individuals handling your exchange by the 45th day after closing on your relinquished `property, even if that day is a holiday or weekend.

180-DAY CLOSE PERIOD

Your Qualified Intermediary will meet with you to ensure that you meet all identification requirements. This requirement, as defined under IRC Section 1031, states that the exchanger has 180 calendar days from the close date on the relinquished property to complete the acquisition of a replacement property. It’s important to clarify that this clock begins upon the sale of the relinquished property concurrent with the 45-day identification period, not at the time identification is made on a replacement property. These dates cannot be extended under any circumstances, unless there is a natural disaster that affects the properties involved.

Three Property Rule

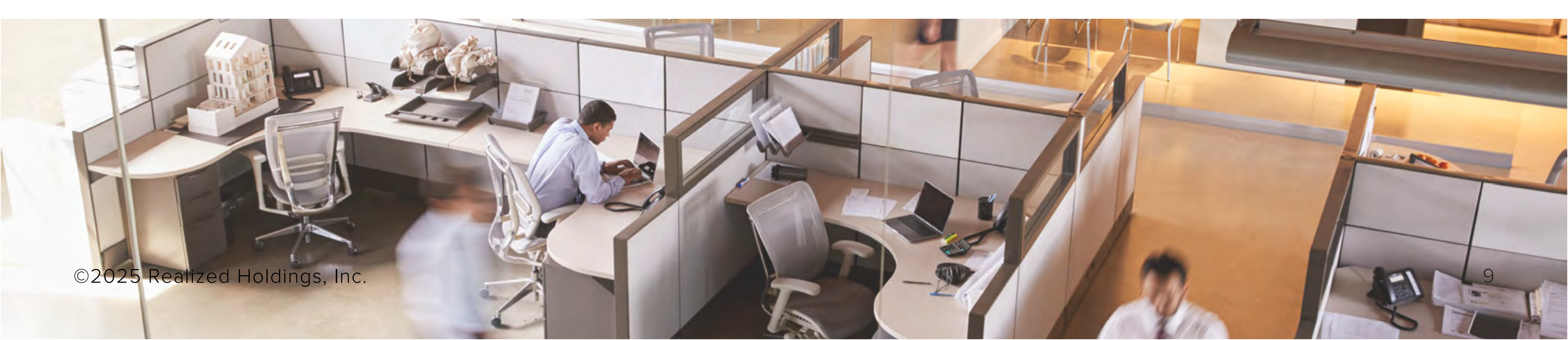
When identifying a property, you may find that you can’t decide between a number of properties. If that is the case, you are allowed to identify up to three properties that you plan on purchasing in the 1031 Exchange. Bear in mind that you do not have to purchase all three of these properties–you can just move forward with one or two if you choose–but you are allowed to identify up to three.

200% Rule

There is one exception to this, which is referred to as the 200% Rule. This means that if the combined value of all three properties does not exceed 200% of the sale value of your original property, you can identify more than three properties. For example, if you sell a multi-family building for $2M, you can identify more than three properties in the exchange as long as the combined value doesn’t exceed $4M.

95% Rule

There are some caveats to this 200% Rule, which is why many investors shy away from exchanging more than three properties at a time. The caveat, referred to as the 95% Rule, states that if you choose to identify more than three properties, you must close 95% of the value of all combined properties within 180 days, or you will be required to pay capital gains tax to the IRS. Closing on several properties in such a short time frame can be intimidating to many investors, which is why they typically tend to shy away from going this route.



Holding Exchange Proceeds

When the relinquished property is sold in a 1031 Exchange, you as the investor are not allowed to have access to the bank account holding the funds until after the replacement property has been identified and the sale is closed. As a result, the Qualified Intermediary will be responsible for holding the exchange proceeds in a highly-rated FDIC-insured bank account. When the relinquished property is closed, an investor will assign the bill of sale to the Qualified Intermediary and will hold the funds until the replacement property's closing.

In addition, Qualified Intermediaries help guard investors from constructive receipt. Section 1.1031(k)-1(f)(2) states that a "taxpayer is in constructive receipt of money or property at any time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time." A breach of this guideline, whether intentional or not, will result in the exchange being disqualified. Qualified Intermediaries monitor the entire process in an effort to ensure no constructive receipt is taken.

Preparing Relevant Exchange Documents

The Qualified Intermediary will also prepare all required exchange documents and ensure their validity, including an Exchange Agreement, Assignments of Purchase, Sale Agreements, and any other documents relevant to the exchange.

Two important details to note: your Qualified Intermediary may be holding millions of dollars in proceeds, so it is important to verify that your funds are being held in a separate, highly-rated, FDIC-insured bank account. Additionally, a Qualified Intermediary must be an independent party to the exchange and should not give any investment advice to you, as that is not their responsibility or their area of expertise.

When hiring a Qualified Intermediary, it is important to work with someone who is organized and has an in-depth understanding of the process. This will help make the complicated 1031 Exchange process far more manageable for you and everyone involved.

Qualified Intermediary Fees

You have just closed on your property and are looking to execute a 1031 Exchange. Per IRS regulations, you need to establish a Qualified Intermediary (QI) and record another expense to complete the transaction.

Although many other fees related to the transaction are standard and well-defined, it can be frustrating to gauge the cost for the services of a Qualified Intermediary. In order to understand what amounts to an appropriate fee owed to a QI, it is important to consider the services the QI provides and the risks it encounters in helping to execute a 1031 Exchange.

There are two types of Qualified Intermediaries, institutional and non-institutional, and they typically vary in their fee structure. Institutional QIs are generally subsidiaries of banks or title insurance companies. Their fee structure typically exists in two sets, and can vary depending on the complexity of the deal and the number of funds involved in a 1031 Exchange.

Non-institutional QIs are independent companies. Their fees are typically lower than institutional QIs, and vary similarly to Institutional QIs depending on the deal complexity and fund quantities in the exchange.

With both institutional and non-institutional QIs alike, investors should consider depth of experience in conducting 1031 Exchanges of similar characteristics. It is integral that an experienced QI is selected to hold the funds during the period between the sale of a relinquished property and the purchase of a replacement property/properties.

Set-up and Administrative Fees

Institutional Qualified Intermediaries typically charge set-up and administrative fees that cover the sale of the relinquished property and the purchase of the replacement property, which tend to range between $800 to $1,200 for the initial transaction in addition to a $300 to $400 charge for each additional property processed in the exchange.

Conversely, non-institutional Qualified Intermediaries will seek to differentiate themselves from institutional QIs by charging less for set-up and administrative fees, typically between $600 and $800. These set-up and administrative fees tend only to amount to about one-third of revenues generated in this type of transaction for both institutional and non-institutional QIs. Thus, it is important to take inventory of the fees for which a non-institutional QI charges for other services.

A large portion of a Qualified Intermediary's role in a 1031 Exchange is holding funds obtained from the sale of the relinquished property in escrow until a replacement property is identified and purchased.

Interest Income

Approximately two-thirds of income generated by Qualified Intermediaries in 1031 Exchanges are earned via interest income.

Consequently, Qualified Intermediaries earn a large portion of their fees via interest income from these funds.

Qualified Intermediaries can either offer lower set-up fees and take a higher percentage of interest income or charge a higher set-up fee and take a lower portion of interest income.

Some non-institutional QIs advertise lower prices on set-up and administrative costs. This is an effort to differentiate themselves from institutional QIs. In these cases, it is extremely important for the investor to thoroughly understand QI fee structures. A side-by-side look at the fee structures of various QIs (institutional and non-institutional) can help an individual better identify the best choice for their transaction. A side-by-side look at fee structures offered by differing types of Qualified Intermediaries can help an individual better identify the best choice for a particular transaction.

Note, in instances where a Qualified Intermediary returns a portion or all interest income generated from funds held in escrow, the Qualified Intermediary will provide a Form 1099-INT to the individual or entity to file with his or her tax return.

Fee Structures

Institutional Qualified Intermediary

- Classified as a subsidiary of a bank or title insurance company.
- Standard upfront fees for the exchange of direct property range between $800-$1,200.[1]
- Subject to retaining a portion of the interest income earned.
- Typically, Institutional QI's charge higher set up fees and take a lower portion of interest income.
- Potential for additional fees based on the specific nature of exchange.

Non-Institutional Qualified Intermediary

- Independent or unrelated to a larger financial institution.
- Advertise slightly lower upfront or administrative fees between $600-$800.
- Subject to retaining a portion of the interest income earned.
- Typically, Non-Institutional QI's charge lower set up fees and take a larger portion of interest income.
- Potential for additional fees based on the specific nature of exchange.

[1] Estimated costs associated with delayed exchanges, NOT reverse or improvement exchanges.

Other Fees

While a large majority of a Qualified Intermediary's income is generated via interest income and set-up and administrative fees, there are other miscellaneous items for which a Qualified Intermediary may bill a client. Qualified Intermediaries conducting 1031 Exchanges on a will for a deceased relative or spouse charge transactional fees for wire transfers, overnight deliveries, courier charges, facsimile costs, and other miscellaneous items. For Qualified Intermediaries conducting more complex 1031 Exchanges, these miscellaneous items that appear on the bill may include fee structures for seller carry-back financing and other legal fees that are incurred because of the specific nature of the transaction.

It is important to understand the various components of Qualified Intermediary fees. Due diligence in identifying the Qualified Intermediary that is most capable of properly conducting a 1031 Exchange is of the utmost importance. You should also seek to understand the fee structures offered by the array of Qualified Intermediaries on the market to avoid frustrations when the QI's bill arrives following the completion of the transaction. It may be beneficial to obtain and compare fee structures that different types of Qualified Intermediaries are offering in order to choose the best QI for your specific exchange.

Know Your Risks

What happens if your Qualified Intermediary fails to adequately perform one or all of the responsibilities listed above? The **risks** are profound:

01 Your money may be stolen.

02 Your exchange will be disqualified by the IRS, and you will owe taxes.

03 You will likely spend considerable resources defending your position in a federal audit.

These instances are admittedly rare, and the vast majority of 1031 facilitators are honest and take their fiduciary responsibility very seriously. Even so, in 2012 the Federal Trade Commission reported that it was aware of 23 instances where investors lost an estimated $250 million as a result of fraud and negligence by qualified intermediaries.

Equally telling, the IRS provides the following **warning** on their website:

“Be careful in your selection of a qualified intermediary as there have been recent incidents of intermediaries declaring bankruptcy or otherwise being unable to meet their contractual obligations to the taxpayer. These situations have resulted in taxpayers not meeting the strict timelines set for a deferred or reverse exchange, thereby disqualifying the transaction from Section 1031 deferral of gain. The gain may be taxable in the current year while any losses the taxpayer suffered would be considered under separate code sections.”

Ironically, even experienced investors spend less time **researching a qualified intermediary** than they would buying a dishwasher or a smartphone. Accommodators are more than just an expensive escrow agent; they provide very specialized services. For example, if you’ve ever done your own taxes, you know how easy it is to overlook a rule, misinterpret the instructions, or forget to include a form. The point is this: just because a Qualified Intermediary can legally handle your exchange doesn’t mean they are actually “qualified.”

What Questions Should You Ask Before Choosing A Qualified Intermediary?

QUESTION 01

How long has the qualified intermediary been in business?

As a general rule, the longer the QI has been in business, the better, because it means she or he has experience both in terms of handling exchanges and understanding the laws and regulations that govern them.

QUESTION 02

How many exchanges has a QI completed in the last five years, and what is the aggregate dollar amount of exchanges in each of these years?

Dividing each year's dollar amount by the number of exchanges gives you the average. Hopefully, this is not significantly less than the amount you have to exchange.

QUESTION 03

What percentage of a QI's business is traditional delayed/forward exchanges versus more complex types, like reverse or improvement exchanges?

There's no right answer here, but a firm that regularly completes more complex exchanges may have greater technical prowess. Another good indicator of experience is the qualifications of the CPAs and tax attorneys they use. Many firms have these functions in-house. Basic QI services do not include tax advice, but these services could be invaluable if you have a tax issue that comes up.

QUESTION 04

How will my funds be held?

It's prudent to insist your funds be held in a Segregated Qualified Trust Account or a Segregated Qualified Escrow Account. Avoid the low cost option of a commingled account and QIs that promise to pay a high interest rate.

QUESTION 05

Where will my funds be held?

The best answer is that the 1031 funds will be kept in a large, reputable FDIC-insured bank. Remember that FDIC insurance is generally limited to $250,000 per account holder. If you are concerned about the health of the bank where the QI is holding funds, you can require that they be held at another bank.

QUESTION 06

Can I have a written copy of your internal controls?

Internal controls are the policies and procedures that protect your funds against theft or fraud by the firm's employees. The objective is to understand the approvals, oversight, and steps required to move or release your money. No single employee should have that authority. Best practices are to require your signature, followed by multiple written approvals within the QI's organization, which makes it difficult for any one or two employees to access your funds. Finally, at a minimum, the QI should be completing regular background checks on all employees. Don't be intimidated: reputable firms take their fiduciary responsibility seriously and will gladly provide you with a copy of their internal controls. If they do not, be very wary.

QUESTION 07

What types and amounts of insurance does the firm carry?

A QI's insurance coverage protects your money from being stolen, or shelters you if IRS-imposed 1031 Exchange deadlines are missed and the sale of your property is taxed. At a minimum, your account should be protected by fidelity bond coverage and Errors & Omissions (E&O) insurance. More importantly, how does the fidelity bond and E&O coverage compare to the QI's average amount of 1031 funds on deposit for all their exchangers? To calculate the QI's average 1031 funds on deposit, divide the aggregate dollar amount by the number of exchanges (see question 2).

For example, let's say that a QI did $240 million of exchanges in each of the last two years. Assuming on average, a QI holds exchange funds for 120 days (365/120 = ~3), their average 1031 funds on deposit is $80 million ($240M/3). There's no hard and fast rule, but if a QI has a $1 million fidelity bond and $250,000 in E&O insurance, that's not much coverage against $80 million.

QUESTION 08

What if I wanted to purchase a replacement property prior to selling my currently owned investment property because it was an attractive opportunity? Can a QI handle that?

In certain instances, QIs also perform reverse exchanges. The above steps vary when investors decide to purchase a replacement property prior to selling their relinquished property, or if they want to make improvements to their property. For more information regarding those more specific scenarios, a Qualified Intermediary should be contacted directly in order to properly identify the steps to take.

The Exchange Agreement With The Qualified Intermediary: Read It!

After you've done your due diligence on a QI, read your Exchange Agreement (and have your attorney read it). The Exchange Agreement is a contract that governs the relationship between you and the QI. It should be consistent with what you've learned during your due diligence. If there's an inconsistency, raise the issue before you sign your Exchange Agreement.

The Exchange Agreement spells out the exact nature of the QI's fees, including any interest that might be earned during the exchange period. A thorough exchange agreement should accomplish **three important steps**, including:

> a) Specification of the fund treatment.
>
> b) Provision of a fair and transparent fee structure.
>
> c) Clarification of the property identification rule in play.

What Happens If Your QI Files Bankruptcy?

When you're trying to close on the sale of a property the last thing you're probably thinking about is choosing a **Qualified Intermediary** (also referred to as an "accommodator" or "facilitator") for a 1031 Exchange.

It's so easy to go with the 1031 Accommodator suggested by your title company, real estate broker, attorney, friend, uncle, etc. After all, if your 1031 funds are held by a reputable qualified intermediary, there's no need to worry, right?

Philosopher Georg Hegel once said: "We learn from history that we do not learn from history." To prove Hegel at least partially wrong, here's a recap of what happened to a group of 1031 investors when their **qualified intermediary failed** them.

On the morning of November 26, 2008, LandAmerica Financial Group filed for bankruptcy protection. At the time, LandAmerica Financial Group (NYSE: LFG) was a Fortune 500 company, the third largest title company in the U.S., and recognized as one of America's most admired companies.[2]

[2] LandAmerica files for bankruptcy, sells businesses (Reuters).

That same day, LandAmerica Exchange Services (LES), a subsidiary of LandAmerica Financial Group, also filed for bankruptcy. LES was one of the larger U.S. Qualified Intermediaries and very well-respected. When LES filed Chapter 11, it was holding 1031 proceeds for 450 investors, totaling $450 million. All of the company's accounts, including those with 1031 funds, were immediately subject to bankruptcy proceedings.

The 1031 investors were stunned. LFG and LES both appeared too big to fail. In the week after the bankruptcy, LES continuously reassured customers that their 1031 funds would be made available shortly after the bankruptcy court's initial review of the case. Weeks turned into months, and the investors' hope for a quick resolution faded as reports surfaced that they may never recover their money. To add to their misery, the 180-day deadline for completing their respective 1031 Exchanges was rapidly approaching, or in many instances, already past. This meant that they legally owed the taxes they had set out to defer—but had no money to pay them.

The next blow came on April 15, 2009 (ironically, the day taxes are due), when the bankruptcy court ruled that the exchange proceeds belonging to 400 of the 450 investors were assets of LES—and therefore available to settle the claims of LES creditors.

Imagine the investors' disbelief upon learning that instead of being among the first to recover their money, they would receive distributions pro-rata along with all of the other unsecured creditors of LES!

How could this happen, and what went wrong? Unfortunately for these 400 investors, they had signed an exchange agreement with LES that did not require their 1031 proceeds to be held in a "segregated account." Instead, without understanding the risks, they opted for a "commingled" or "pooled" account, presumably because this option was $500 less expensive. It was cheaper because the exchange agreement legally allowed LES to invest the money in commingled accounts—and keep the interest it earned. Shocking? Remember: qualified intermediaries are unregulated.

> It's estimated that these unfortunate investors ended up with about 40% of their 1031 proceeds — after paying taxes, attorney fees, and interest.

All of this could have been avoided if investors had stipulated a segregated account, LES would have had to establish accounts under each investor's name with an FDIC-insured bank: "For the benefit of XYZ Investor." A fortunate 50 investors—out of a total of 450—had requested a segregated account, so it was clear to the bankruptcy judge that their 1031 proceeds were being held in trust.

Conversely, the exchange agreements for the other 400 investors contained language giving LES legal control of the escrowed funds, leading the court to conclude that the legal nature of the investors' relationship was that of a creditor.

Closing Comments[3]

In early 2013, Gerard A. McHale Jr., the bankruptcy trustee for LES, proudly announced that the final distribution had been made to LES investors, "resulting in a 100% recovery" of their 1031 funds. Conspicuously absent from the press release was any mention of the 4+ years of court proceeding the investors endured, which likely cost upwards of $40 million in attorneys' fees.

You are probably wondering what happened to the investors' 1031 Exchanges. To the IRS' credit, it issued a revenue ruling that granted special relief to the LES customers and any future 1031 Exchangers who are unable to complete an exchange because of their qualified intermediary's bankruptcy. Pretty nice, right? Well, not so fast. The IRS went on to say that the taxes must be paid—but only as investors are repaid, plus imputed interest, beginning when LES filed for bankruptcy protection.

It's estimated that these unfortunate investors ended up with about 40% of their 1031 proceeds—after paying taxes, attorney fees, and interest. If you are considering a 1031 Exchange, please take the time to complete the requisite due diligence. Read the fine print in your exchange agreement with your attorney. Above all, pay the extra cost to have your very own separate account with your qualified intermediary.

[3] Please note that the example used in this section is the exception, and not the rule.

RISK FACTORS

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