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QI Questions

What should investors know before hiring qualified intermediaries?

by James W. Freeman, CPA, and Ricky B. Novak, JD

The unregulated Section 1031 exchange industry has suffered instances of misappropriated client funds, breaches of fiduciary duty, theft, and qualified intermediary bankruptcy filings. The task of qualifying a QI has become paramount for real estate investors and their advisers. Understanding the industry's current troubles and considerations to make when selecting a QI may help investors safeguard their exchange proceeds in the future.

QI Qualifications

Recent examples of intermediary failures include bankruptcies of both regional and national exchange firms, illustrating that the larger QIs are not necessarily better or safer.

Despite these problems, the 1031 QI industry remains self-regulated. Only California, Colorado, Idaho, and Nevada have considered or implemented minimum registration standards, which is by no means an inference of a QI's good standing or trustworthiness. Therefore, investors must rely on qualified attorneys, CPAs, bankers, financial planners, and other real estate professionals to assist in evaluating their QI options. While by no means an exhaustive list, the following qualifications

should be considered when evaluating potential QIs.

Knowledge. In a professionally managed firm, the principals should possess specialized industry credentials, such as being tax attorneys or Certified Public Accountants. Addi-

The IRS may increase reviews of 1031 exchange compliance.

tionally, the intermediary should understand how the 1031 exchange affects, or is affected by, other areas of tax law, wealth planning structures, and other business objectives.

The QI should seek to work with the investor's advisory team in developing and executing a strategic plan that utilizes 1031 exchanges to enhance overall wealth planning. Oftentimes, QIs simply function in a reactionary mode and have little interest in understanding the overall planning strategy. Without an understanding of the investor's comprehensive strategy, a QI is not in a position to provide accurate advice or propose efficient structuring alternatives.

Security. Investors should ask how client funds are invested, whether the process is completely transparent,

and if investors can provide input. It's also critical to understand what security measures and technologies are in place to ensure asset principal protection and liquidity of the funds.

Ideally, accounts should be segregated instead of comingled. Depending on the QI, investors may be able to direct which financial institutions are used and the type of accounts in which the funds are held. Holding options may even include qualified escrows or trusts, fully FDIC-insured accounts, and electronic dual-signature accounts. QIs should be fully transparent in how the firm is holding the funds and how it is earning revenue. The QI should provide the client with proof of insurance coverage and be able to clearly outline other internal controls that have been implemented to protect investment funds.

If funds are pooled by the intermediary, the Internal Revenue Service deems that the investment funds are held as a loan to the QI, with the client treated as a general creditor. Segregated accounts provide an additional layer of security in the event of a QI bankruptcy. While treated as a loan to the QI

for tax purposes, segregated funds are not part of the general asset pool and are not subject to access by the QI's business creditors should the QI file bankruptcy.

Service/Structure. QIs should be able to clearly explain their compensation models, which may include transaction fees, hourly exchange consulting fees, and interest sharing on deposits. As the investor or adviser seeks to build a relationship with a QI, he must determine whether the QI can handle all potential exchange needs.

Many QI firms, especially title companies and banks, only perform straightforward exchanges because they do not understand complex exchange structures or they lack the tax or real estate knowledge to pro-

pose structures that might best fit the client's objectives. Additionally, many of the large title company and bank-owned QIs use a model whereby the client does not have access to the same person throughout the exchange process: These QIs use a sales representative to sell the client exchange services and turn the client over to a back office that is often located in another state.

Boutique QI firms typically offer a higher level of exchange sophistication. The better QIs are less reactionary and more proactive in their approach to assisting clients. The QI should ultimately understand the client's business objectives outside of the 1031 transaction so as to offer advice on how to best implement exchange strategies.

Disinterested Third Party. In order to act as a QI for a client, the intermediary must not have performed in any agency capacity for the investor for the preceding two-year period. In addition, the QI truly must be a disinterested third party, otherwise the tax-deferral benefit for the investor can be invalidated by the IRS.

This restriction generally disqualifies any attorneys, CPAs, brokers, agents, banks, and other service providers. Note that the intermediary may not act as the client's tax adviser; however, this should not prevent the intermediary from understanding and offering exchange structuring alternatives in collaboration with the client's team of investment advisers.

1031 Exchanges Going Forward

The failures of many high-profile QIs may push the federal government and more state governments to better regulate the 1031 industry. Many believe that the process should be similar to a 401(k) rollover; however, the nuances of holding exchange funds coupled with increased tax avoidance behavior and tax complexity warrant the continued use of QIs.

In an effort to raise revenue, the IRS has added numerous new enforcement agents during the past few months, and a published report by the Treasury Inspector General for Tax Administration in late 2007 openly encouraged the IRS to

increase reviews of 1031 exchange compliance by taxpayers.

It is expected that a handful of large banks and title companies might enter the 1031 industry or seek to gain a stronger foothold as these firms value the retention of large cash deposits. At the same time, many smaller QI firms are exiting the market due to the significant erosion of transactional exchange volume. However, new firms surely will enter the market once this volume returns.



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For more details about the Section 1031 exchange transaction process, visit www.sea1031.com.

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