2012

Washington State
Legislature

Exchange Facilitator
Taskforce

[EXCHANGE FACILITATOR TASKFORCE REPORT TO THE LEGISLATURE]

ACKNOWLEDGEMENTS

Washington State Legislature
Senator Bob Morton, Washington State Senate
Representative Joel Kretz, Washington State House of Representatives
Kimberlee Cusick, Washington State Senate
Edward L. Redmond, Senate Committee Services
Jackson Maynard, Senate Republican Caucus
Paulette Avalos, Senate Democratic Caucus
Jon Hedegard, Office of Program Research

Constituent
Howard Asmussen

Attorney General's Office
Mary Lovedell
Hunter Goodman

Department of Financial Institutions
Deb Bortner
Catherin Mele-Hetter

Office of the Insurance Commissioner
Jim Tompkins

Exchange Facilitators
Dennis Helmick
Suzanne Goldstein Baker
Mary Foster
Jeff Helsdon
Tom Oldfield
Toija Beutler

Escrow Agents
Tammy Warnke
Phillip Dryden

Table of Contents

Executive Summary 3
Background 4
Taskforce Meeting Minutes 6
May 17, 2012 6
Issues Addressed 6
Recommendations 11
July 24, 2012 12
Issues Addressed 12
Recommendations 19
September 25, 2012 20
Issues Addressed 20
Recommendations 22
Unresolved Issue 23
Appendix 25

Executive Summary

This report details the Exchange Facilitator Taskforce meetings that occurred over the 2012 interim and provides recommendations for potential amendments to the Exchange Facilitator Statute.

The Exchange Facilitator Taskforce group, headed by Senator Morton, convened for two hours on three different occasions during the interim: May 17th, July 24th, and September 25th. Between those meeting dates Taskforce members conducted further research and corresponded via group email with comments and recommendations. The following summarizes the recommendations of the Taskforce members:

A. Proposed amendments to the exchange facilitator statute:

- Require exchange facilitators to deposit client funds into a separately identifiable account;
- Provide the clients of exchange facilitator with independent access to the current account statement from the financial institution in order to verify that the exchange funds have been deposited by the exchange facilitator;
- The exchange facilitator must return to the client all earnings credited to the separately identified account;
- The exchange facilitator must provide the client with a disclosure document prior to any contractual agreement between the parties and post on their website a disclosure notice which explicitly states that exchange facilitator services are not regulated by any state agency;
- Provide that any bank within the United States be considered a "financial institution" for purposes of this statute;
- Remove the "knowingly or with criminal negligent" standard from section 19.310.100 concerning Consumer Protection and add it to section 19.310.120 concerning Prima facie evidence of fraud.

B. Unresolved Issue:

- Fidelity bond coverage

Background

The Internal Revenue Code (26 U.S.C. 1031) (Code) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment. A tax-deferred exchange is a method by which a property owner trades one or more relinquished properties for one or more like-kind replacement properties. This enables a property owner to defer the payment of federal income taxes on the transaction. If the replacement property is sold (as opposed to making another qualified exchange), the property owner must pay tax on the original deferred gain plus any additional gain realized since the purchase of the replacement property. Section 1031 of the Code does not apply to exchanges of inventory, stocks, bonds, notes, other securities or evidence of indebtedness, or certain other assets.

The 1031 exchanges require the assistance of an exchange facilitator (facilitator) or qualified intermediary. The facilitator holds proceeds from the sale of the original property until those funds are applied to the purchase of the replacement property. While in the possession of the facilitator, funds may be deposited in a financial institution or placed in another investment.

In 2009 the Legislature passed E2SHB 1078 (Chapter 70, Laws of 2009) to regulate the activities of facilitators, which was in response to their recent investment activities that resulted in significant asset losses to clients. Amongst other obligations, the Legislature required a facilitator to maintain a $1 million fidelity bond or deposit an equivalent amount of cash and securities into an interest-bearing or money market account; demonstrate compliance with the fidelity bond and insurance requirements if requested by a current or prospective client; and act as a custodian for all exchange funds, property, and other items received from the client. The Legislature also held a facilitator criminally and civilly liable for engaging in certain prohibited practices such as making false or misleading material statements; commingling of funds, except as allowed; and failing to make disclosures required by any applicable state or federal law.

Facilitators were required to submit a report on their activities to the Department of Financial Institutions (DFI) at the end of 2009, which was later submitted in a report to the Legislature by DFI.

In 2012 the Legislature passed SSB 6295 (Chapter 34, Laws of 2012) in response to white collar criminal activity by an exchange facilitator in the local exchange facilitator industry, resulting in over $800,000 of financial loss to residents of this state.

SSB 6295 (Chapter 34, Laws of 2012) provided that a person engaged in the facilitator business must either maintain a fidelity bond for at least $1 million which

covers the dishonest acts of employees and owners or deposit all exchange funds in a qualified escrow account or qualified trust. The qualified escrow account or qualified trust must require the exchange facilitator and the client to independently authenticate a record of any withdrawal or transfer from the account. Exchange facilitators must provide a disclosure statement on the company website and the contractual agreement regarding the fidelity bond and qualified escrow account or trust. Additionally, exchange facilitators must disclose any financial benefits they may receive for recommending other products or services to clients. Failure to comply with the requirements of the new law is prima facie evidence that the facilitator intended to defraud a client who suffered a subsequent loss of assets entrusted to the facilitator. With limited exceptions, an exchange facilitator is guilty of a class B felony for noncompliance. A current client of a facilitator may receive treble damages and attorneys' fees as part of the damages awarded in a civil suit against the facilitator for violation of these requirements.

SSB 6295 (Chapter 34, Laws of 2012) also provided that a stakeholder taskforce, comprised of DFI, the Office of Insurance Commissioner, exchange facilitators, and title holders, must convene to identify effective regulatory procedures for the exchange facilitator industry and provide specific recommendations to the Legislature by December 1, 2012.

SSB 6295 (Chapter 34, Laws of 2012) passed both Houses unanimously.

Taskforce Meeting Minutes

May 17, 2012

The following persons were in attendance:

Sen. Bob Morton, legislator
Rep. Joel Kretz, legislator
Kim Cusick, Senate Legislative Assistant
Howard Asmussen, Victim
Toija Beutler, Exchange Facilitators
Mary Foster, Exchange Facilitators
Jim Tompkins, Office of Insurance Commissioner (OIC)
Deb Bortner, Department of Financial Institutions (DFI)
Jeff Helsdon, Exchange Facilitators
Dennis Helmick, Exchange Facilitators
Mary Lovedell, Attoreny General's Office (AG)
Catherine Mele-Hetter, DFI
Dee Macomb
Suzanne Goldstein Baker, Exchange Facilitators
Tammy Warnke, Escrow agents
Hunter Goodman, AG
Edward Redmond, Senate staff
Jackson Maynard, Senate Republican Caucus staff
Paulette Avalos, Senate Democratic Caucus staff
John Gower, House staff

Issues Addressed

The meeting began at 9:06 am. Introductions were made and Sen. Morton began with some opening remarks thanking the participants. Edward Redmond provided an overview of the key provisions of SB 6295 (Chapter 34, Laws of 2012) and the goals of the task force per the legislation. Redmond then asked for comments on the bill.

Dennis Helmick began by suggesting that the bill went a long way in improving what was already strong legislation passed in 2009. He stated that legislation was more art than science and that the protections in law now go farther than any other state.

Jeff Helsdon indicated that he was shocked and horrified when he heard the news about Howard Asmussen and how he was cheated. He was pleased to be able to

participate in the deliberations of the bill and testify at the hearing. He was pleased to be included in the discussions.

Deb Bortner stated that the bill had good provisions which were followed by the good guys and will not be followed by the bad guys. She encouraged the group to think about the fact that someone has to make sure that exchange facilitators are following the law. She stated that DFI regulated escrow agents and took two years to verify that everyone had the proper bonds provided by the insurance industry which would cover both employers and employees. She indicated that it may be appropriate to see some sanctions other than criminal. Prosecutors will not take cases simply based on a consumer complaint for (as an example) failure to make a website disclosure.

Helmick posited that somebody must be watching over the required filings in current law. What about the AGs office?

Bortner stated that it is not a problem of receiving filings; rather, it is a problem of oversight.

Mary Lovedell indicated that an appropriate analogy may be to the used car industry: there is a race in regulation to the lowest common denominator. The argument goes that if the other company is not complying why should we? It defeats the purpose.

Jim Tompkins noted that one issue with the current law is that it is reactive. In other words, there is no point in suing when there's no money left.

Helmick asked about the regulation of escrow licenses. He asked how many were regulated by DFI.

Bortner stated that it was probably 100. She said they were not self-sustaining and that fees only covered 30% of the costs.

Helmick noted that there are still problems with fraud with escrow licenses even though there is regulatory oversight. His point was that regulation would not have prevented the fraud in Howard Asmussen's case.

Bortner stated that she could see something working similar to escrow licenses or something as simple as requiring everybody doing business to be registered. She stated that with escrows embezzlements were relatively rare.

Helsdon pointed out that a full regulatory scheme will not guarantee absence of fraud.

Suzanne Goldstein Baker concurred. She stated that the industry was chagrined and frustrated by Asmussen's case and that it was horrifying to everyone in the industry. They were appalled. However, she is concerned that if new regulations and fees are imposed, this would increase the costs to clients. She noted a saying that "People are honest until the day they are not." She questioned provisions such as requiring a particular bond or use of escrows and trusts at a bank. However, six months after reporting a dishonest person could skirt the requirement. She analogized it to driver's licenses: the law may require you to have one, but lots of people drive without it. She stated that they have worked hard as an industry since 2009. She said that there is already a requirement to post a copy of the bond on the website. Her company has a bond that insures against $100 million in claims.

Tompkins suggested that exchange facilitators could have a statute which requires them to provide the consumer with notice.

Dee Macomb said that there have been a number of regulatory discussions in the industry. But she would like to see more emphasis on the consumer as a controlling factor. She noted that there were already consumer tools like Angie's List which aid consumers.

Helsdon noted that the industry already considers contacting consumers. He said that in escrow or real estate licensing courses they are provided with referral sources in order to tell those agents what they should be looking at in an exchange.

Rep. Kretz asked whether it might be possible to attack the issue from a penalty standpoint. He asked whether having a mandatory sentencing provision with a 30 year maximum would be effective.

John Gower asked additional questions about the concept of a registration system. He asked whether the carrier could be required to provide notice of cancellation when an insurance company is dropping coverage. He suggested the company could be barred from doing business until coverage was restored.

Tompkins thought there was merit to the idea that someone with more expertise in the types of bonds in the industry could review the bond language on file.

Bortner stated that registration may be a cost effective way to get at regulation. The only way it could work is if there could be an entity to regulate financial services. She analogized it to a program that DFI had to refund anticipation loans. There was no authority to investigate complaints. She stated it would be advisable to avoid that type of scenario. She referred to the option under discussion as "regulatory lite." She said other industries pay thousands of dollars for their licenses. Here there would only be a few

cases, but there would have to be an analysis of the ½ or ¼ Full-Time Equivalent (FTE) position required to handle complaints.

Helmick stated that the industry has 15 companies doing this work in Washington State.

Bortner noted that if the company failed to maintain the bond then there could be a cease and desist letter and if the company failed to obtain the bond, an injunction.

Baker stated that the current law provided an alternative to a bond, there could be a cash deposit.

Bortner stated that if the company failed to either obtain a bond or have the required cash then an injunction could be obtained. The bond would require continuing coverage for all accounts during the period it was valid.

Gower noted that the bond would protect current accounts and current clients, but not new clients or accounts.

Baker asked how this would change current law. You could have a regulator shut down a business now. The AG's office already has power under the consumer fraud provisions.

Lovedell stated the AG's office does not conduct criminal prosecutions. It does not have jurisdiction for criminal matters. The proper agency to handle this would be either DFI or OIC, not the AG's office.

Redmond then turned the discussion to number four on the agenda: *Overview of Regulations by Other States and the Federal Government*.

Baker indicated that the Dodd Frank Act provided for the creation of a Consumer Financial Protection Bureau. The agency was tasked with studying the exchange facilitator industry and providing a report[1] with recommended legislation by the 21st of

[1]Section 1079 of the Dodd-Frank Wall Street Reform and Consumer Protection Act required the Consumer Financial Protection Bureau (CFPB) to submit a report to Congress describing recommendations for legislation, regulatory updating, and new regulation "to ensure the appropriate protection of consumers who use exchange facilitators for transactions primarily for personal, family, or household purposes." (Pub.L. 111-203, Title X, Section 1079 (b)) The report concluded that the CFPB had no recommendations for additional legislation or regulation at this time for the following three reasons: "(1) The size of the problem currently did not warrant the cost of regulation; (2) the taxpayers who engage in Section 1031 transactions tend to be sophisticated individuals; and (3) the existing federal regulatory framework has responded adequately to date and has the capacity to respond further should the situation warrant it without additional legislation or regulation." (CFPB, *Report Pursuant to Section 1079 of the Dodd-Frank Act*, July 21, 2012) See Appendix

July. The industry took the position that it should be regulated by the Federal Trade Commission (FTC). So there has been some activity on the federal level. On the state level, nine or ten states have adopted regulations including: California, Maine, Nebraska, Virginia, Oregon, Colorado, Idaho, Nevada, and Washington. Of these, Nebraska simply requires a statement to be provided to consumers by title insurance agents which notes that the industry is not subject to state or federal regulation. Idaho, Maine, and Nevada require registration. Washington State has the strictest law out of any state.

Jackson Maynard suggested that in considering whether and how to regulate the industry it may be appropriate to consider a range of possible regulation. Exchange Facilitators are involved in complicated transactions in which consumers are at a disadvantage and the potential harm is great if there is a bad actor. He suggested a scale range of regulation for consideration of the group as follows:

1. Keep current law and have only civil and criminal penalties for bad actors;
2. Have minimal regulation in the form of a registration list maintained by a state agency;
3. Have a state agency handle all aspects of regulation;
4. Bifurcated approach – state agency handles complaints, but brings them before a professional board for action. Similar to regulation of medical profession; or
5. Self-regulated profession- professional board given authority to license, investigate, and sanction professionals. Similar to state Bar.

A participant indicated that self-regulation was impractical because the industry was so small.

Asmussen suggested that it may be appropriate to have a mandatory minimum sentence.

One participant noted that several stiff prison sentences have already been issued. Edward Okun of the 1031 Tax Group, LLP recently received a 100 year sentence.

Bortner stated that up front regulation was cheaper than enforcement.

Lovedell stated that the regulations under the Internal Revenue Service and state law already require that section 1031 exchanges are subject to prudent funds management. There has been a huge attrition rate in the industry (up to 65% nationwide) from 2006 to today. Current law and regulations also already require liquidity.

Recommendations

Redmond turned the group's attention to #5 on the agenda: *Assignment of Tasks*. Redmond summarized the discussion as follows:

Define issues:

- Lack of regulatory oversight;
- Ineffective criminal sanctions;
- Better disclosure to consumers; and
- Referral sources need to be educated.

Possible Improvements:

- Listing exchange facilitators
  - Agency provided registration service
  - Escrow agencies not allowed to wire funds unless registered (escrow association reps expressed concern about this option);
- Agency regulation- agency reps and stakeholders to work on pros and cons for next meeting (DFI or OIC to handle regulation);
- Industry regulation- the group rejected continuing consideration of this option as impractical; and
- Stakeholders would be required to educate appropriate individuals- exchange facilitator stakeholders agreed to work on suggestions for this one.

Sen. Morton added a couple of thoughts. He boiled the discussion to three words : no easy answer. He wanted to know:

1. Is there a state where regulations work? One of the stakeholders suggested Maine's provisions be considered as a model.
2. Are penalties adequate at current law? He gave as an example his shock that the person who was involved in Mr. Asmussen's case was still out and apparently in business.

The group agreed to reconvene on July 24 from 9-11. The meeting concluded at 11:06 am.

July 24, 2012

The following persons were in attendance:

Sen. Morton, legislator
Kim Cusick, Senate Legislative Assistant
Howard Asmussen, constituent
Catherin Mele-Hetter, DFI
Deb Bortner, DFI
Tom Oldfield, Exchange Facilitators
Dennis Helmick, Exchange Facilitators
Jeff Helsdon, Exchange Facilitators
Jim Tompkins, OIC
Mary Foster, Exchange Facilitators
Mary Lovedell, AG's Office
Phillip Dryden, Escrow Agents
Suzanne Goldstein Baker, Exchange Facilitators
Tammy Warnke, Escrow Agents
Edward Redmond, Senate Staff
Jackson Maynard, Senate Republican Caucus Staff
Paulette Avalos, Senate Democratic Caucus Staff
Jon Hedegard, House Staff

Issues Addressed

Edward Redmond began the meeting by summarizing the previous key elements of the discussion at the last meeting including the definition of issues, federal and state regulations, and possible improvements.

Dennis Helmick passed out a copy of applicable provisions of the escrow statute to use as a guide for discussions on crafting language to regulate exchange facilitators.

Deb Bortner looked over provisions applicable to give DFI authority to investigate or regulate exchange facilitators. She looked to factors such a record keeping, prohibited practices and the amount of sufficient dues.
She said there were four things important to the department being able to regulate in a more limited fashion (coined “registration lite”):

1. Prohibited practices;
2. Record keeping;
3. Registration powers; and
4. Investigatory authority

She stressed that this scheme would not provide exam authority. There would be an initial registration in which the department could verify that the bonding or qualified escrow requirements were met. There would be no authority to cover the costs of investigation and no background checks would be performed.

Tammy Warnke requested a copy of the document Helmick passed out. She asked whether the authority to regulate would take legislation or a whether it could be accomplished by promulgation of a rule.

Bortner answered that it would require legislation. She stated that she had worked with Helmick on the Department's proposal but that it was in his individual capacity to assist them, not as an industry representative.

Helmick noted the existing framework under escrow was minimal. There were seven provisions in that statute which he felt could provide some guidance.

Warnke voiced a concern. While the escrow association was willing to provide guidance, they were opposed to anything which would get its members tangled in additional regulation. She stressed that any regulatory scheme involving exchange facilitators should leave escrow out.

Helmick indicated that the escrow provisions were only to be used as guidelines for discussion in crafting a separate provision regulating exchange facilitators. There was no intent to actually amend the provisions regulating escrow agents to give them responsibility for acts of exchange facilitators. The idea was to use them as a guideline to craft a minimal regulatory scheme by DFI.

Bortner noted that they had also considered estimate costs of regulation.

Redmond asked whether the AG or OIC had considered whether their respective agencies may be appropriate entities to regulate the industry.

Jim Tompkins responded that the position of the OIC is that DFI is the most appropriate entity to regulate the industry. He stated that this was something beyond what they would normally do. They did not want to add an entity which was not in insurance. The real issue was one of expertise.

Redmond asked whether they had considered costs.

Tompkins passed around some estimates they had done. He stated that they would assume some companies would be initially registered and that they would do the following to make sure they were still meeting requirements:

1. That the qualified bond remained in place; and
2. Confirm financial ability

Jeff Helsdon asked whether there would be adequate protection under the proposed regulations

Tompkins confirmed that the scheme they had discussed would involve an actual check of records. There could be a financial exam of between $50,000- $100,000 in cost.

One participant noted the cost of a $1M bond is about $7000 for qualified intermediaries, escrows and trusts. Beyond that the participant was not sure if the industry could handle the cost of the bond. As for examinations, while it is easy to evaluate whether the bond provides protection, the cost of a financial exam would be prohibitive.

Catherine Mele-Hetter asked whether there was a difference between a qualified trust for our purposes and the IRS.

Participant said they were the same.

Mele-Hetter asked whether they both required a dual signature.

Mary Foster confirmed they were creatures of the IRS and both required a dual signature.

Helmick indicated they actually require three signatures: exchange facilitator trustee, the account holder, and the exchange facilitator.

Redmond asked if there were any other comments on this proposal.

Helmick concluded that the OIC is not the best location for the regulation of this industry.

Tompkins agreed.

Mele-Hetter cautioned that DFI had a proposal but obviously they cannot predict what the new leadership may want to head.

Redmond noted that there seemed to be consensus to table the proposal that the OIC be the regulator. He asked whether the AG's Office had studied the pros and cons.

Mary Lovedell stated that they had one pro and a lot of cons. A list of pros and cons was distributed. She stated that it really does not fit with their legal expertise. They do not have the financial expertise of an auditor. It would be very expensive for them to provide that expertise and they agree with many of the reasons and rationales for why the OIC is not the agency to locate regulation; this rationale is also applicable to the AGs office.

Howard Asmussen stated that he had been listening to the discussion about costs and proposed that maybe everyone was going about this the wrong way. He noted that there was an IRS requirement. He thought that the policy should be changed where if you do not go through the exchange, you do not get the benefit of the tax write off.

Deb Bortner thought it would be difficult to get the IRS to change its policy and it would literally take an act of Congress to get that to happen.

Asmussen noted that the IRS was part of the people and should be acting on their behalf.

Mary Foster stated that the proposal may be good but it does not solve the problem of protecting the citizen. People lie on their taxes all the time; the IRS only reviews if it decides to audit them, which may not occur for two years.

Lovedell advocated for prudent fund management in regulations. The issue was failure to maintain standards which constitutes unfair and deceptive practices. The issue was protection for tax payers.

Asmussen responded that he was hearing more and more stories about people being defrauded by these investments. He heard about another one in Washington State who opted to let it go. He thought there should be a focus on the group and protecting life savings. These are white collar criminals who steal this money.

Mele-Hetter asked whether another proposal might be to require a qualified escrow for smaller transactions. That way smaller investors are protected at less expense and the larger investors could be protected by the bond.

Helmick said that might be a proposal which could provide protections. But in Asmussen's case that process would not have worked because it was subverted.

Mele-Hetter said every transaction would be protected at the least cost.

Suzanne Goldstein Baker works for a large company, Investment Property Exchange Services, Inc., owned by Fidelity National Financial, the parent of Fidelity Title, Commonwealth Title and Chicago Title. The company has a $100 million

fiduciary bond to cover these transactions. The problem with the suggestion to require escrow and trust accounts is that many banks do not provide that service. Bank of America and Citibank do not provide it. For their company they cannot use a small bank. Aggregate deposits would exceed assets in a small bank. Larger banks will provide it at a higher cost. For example, Union Bank charges $3500. Only four out of twelve banks they work with provide that service. There are institutional limits on what they are willing to do. It is not prudent to place assets in banks where they dwarf the assets. So in response to the suggestion the basic answer is that those accounts are not available on the scale necessary or would significantly add to the cost.

Bortner stated she was confused by this. There are 15 exchange facilitators in Washington and there is not capacity in the banks? That does not make sense.

Baker stated that: (1) it was hard to find banks to take the money, (2) It was hard finding bank willing to provide a Qualified Escrow, and (3) it was expensive to do either.

Foster stated that she had dealt with some banks who would not take a deposit greater than $5 million. US Bank and JP Morgan would provide a Qualified Escrow. It depends on the economy and these have been "unusual times." For smaller deposits, there did not seem to be an issue in obtaining these services. Aggregate deposits may exceed limits however.

Helsdon stated that smaller deposits were no problem. For example, Columbia Sterling mails a token to use an electronic signature in order to start wire process.

Tom Oldfield stated that large banks were lazy and do not want to handle the deposits. JP Morgan chase handled $223 Billion.

Helmick stated that his practice had been a qualified escrow (QE) for a long time. One state requires QEs – Nevada. In Washington state most are available already for large transactions.

Bortner stated that the goal was to protect the smaller investors.

Mele-Hetter asked whether there was already a provision in law outlining a standard for when QEs should be tied to the amount of the transaction.

Helmick pointed to RCW 19.310.110 which allows QEs for transactions over $500,000.

Helsdon stated that the focus of the task force should be on the consumer. He noted that the escrow wires into the account, the taxpayer signs the account, and the balance remains in escrow.

Baker stated that because of the volume the parent company requires audits. They practice closed-loop banking. When clearing accounts the funds must be deposited into a QE or segregated account. The audit then reconciles the accounts and traces the funds for the benefit of the client accounts. There are different strokes for different folks. Their company handled thousands of exchanges and every client had separate segregated account. There is already a requirement in the law to have a separate $500,000 threshold. The issue is how to protect against what happened to Asmussen. There were two clear violations of current law: (1) The funds were required to be held and (2) the funds were required to be liquid. She stated she does not know how to protect against people violating these restrictions.

Helmick stated that the OIC and the AG do not want to regulate these businesses. DFI may want to regulate these (depending upon the new leadership after elections). He stated he wanted to hear about the costs associated with their proposal keeping in mind the guidelines that the costs needs to be in accordance with the size of the company and transactions regulated.

Bortner stated that they had analyzed the amount of time and figured that they would need ¼ time for two people, which translates to $49,562. They would make up the difference in assessments to companies based upon their amount of business. There would be an application fee associated with an assessment on the amount of the business.

Helmick commented that $49,000 for regulation lite could be expensive if the licensees are to bear costs which he calculated at $3000 per facilitator.

Mele-Hetter said, for example, that fees for the Uniform Money Transmissions Act are tied to the volume of money transmission. There could be a registration fee and assessment based on volume. There could be an initial fee of $500 and in six month they would figure out how much additional to charge and what the total cost of the business is a spread across pro rata. This would constitute a more fair way of assessing the fee.

Baker asked what would be the total range of fees?

Bortner stated that, for example, fees for money transmitters pay fees based on volume from 500 - 100,000. Big exchange facilitators with large accounts would pay higher fees.

Baker wanted to make the group aware that Idaho and Maine have a licensing and registration framework and those states charge a $350 fee and renewal is $150. She was concerned that the amounts discussed in DFIs proposal might limit the pool of companies willing to do business in the state.

Helsdon stated that he was sitting here having worked on the previous bill, attended hearings, and does not know what he is doing here. His practice does not make any money on these transactions. They are busting his chops and his goals are to (1) Protect the consumer and (2) allow competition. He made a few hundred dollars on a recent transaction. The group must not lose sight of the unintended consequence of causing the number of honest facilitators to move away from doing business.

Bortner proposed a step in between. The web page disclosure does not cost anything.

Recommendations

Redmond summarized the new proposal for discussion as follows:

Best option

- Make all account separately identifiable;
- Send statements to clients and make disclosure online;
- "Self-police" neighborhood watch approach; and
- Continually educate consumers.

Sen. Morton indicated that he would like to see stiffer criminal penalties. He wanted substantial increases to get the attention of the industry.

Redmond asked if the group wanted to establish a new date to meet. The group set September 25th from 10 am – 12 pm as the next meeting time.

Baker wanted to comment about the increased criminal penalties. She stated that Washington state already had one of the strictest laws on the books.

The meeting concluded at 11:02 am.

September 25, 2012

The following persons were in attendance:

Howard Asmussen, Victim
Mary Foster, Exchange Facilitators
Suzanne Goldstein Baker, Exchange Facilitators
Jim Tompkins, OIC
Dennis Helmick, Exchange Facilitators
Catherine Mele-Hetter, DFI
Phillip Dryden, Escrow Agents
Tammy Warnke, Escrow Agents
Edward Redmond, Senate Staff
Jackson Maynard, Senate Republican Caucus
Paula Avalos, Senate Democratic Caucus
Jon Hedegard, House Staff

Issues Addressed

Edward Redmond requested that Jackson Maynard summarize the minutes from the last meeting. Maynard summarized the minutes. Dennis Helmick requested that the spelling of his name be corrected.

Redmond began a review of the draft legislation for consideration and comments. The group began discussing the change to page 3, line 12, which allowed for any bank within the United States to be covered under the definition of "financial institution." The group also discussed the language for the required notice. Industry representatives indicated they would provide additional suggested language to include in the notice to make it clearer.

The group also began an extended discussion of pages 5, line 12 through page 6, line 7 and whether it was necessary to delete the language in current law, which provided specific language on what constitutes a "prudent investor standard." It was eventually decided to retain the language in current law. The group then discussed in detail the changes in sections 5 and 7 and in general the policy goal of maintaining separately identified accounts, and whether it made sense to tie this requirement to a $500,000 or below threshold. Mary Foster argued that this would make it harder to pool funds and run a "Ponzi scheme."

The group then reviewed the comments to the legislation provided by the Attorney General's Office (AG's office). An extended discussion was held on the concern expressed by the AG's office that inclusion of the language in current law in Sec.

4 at page 6, line 13, which required that violations of the Consumer Protection Act (CPA) be proved as occurring "knowingly or with criminal negligence" may make violations harder to prove. The industry representatives maintained that the language would be necessary to avoid criminal liability for matters which could be simply accidental or unintentional. Other stakeholders thought that this language created additional protections for the industry inconsistent with other parties regulated under the CPA.

Recommendations

The group agreed on additional timelines for preparation of the final report.

Unresolved Issue

Fidelity Bond Coverage

Attorney General's Office Concerns:
The Attorney General's Office (AG's Office) has expressed the following concerns regarding the fidelity bond under the current statute:

- If the purpose of the bond is to cover "a loss" or monetary harm, then it should not be limited by a finding of a "dishonest act" or criminal liability. By limiting the bond, especially to "criminal acts," you leave victims at the mercy or local county prosecutors that may or may not have the resources to investigate and charge a crime.
- To the extent that the bonding provision could be applied to civil liability, the statute imposes a heightened standard, i.e. "dishonesty" or "criminal intent," to recover under the bond.
- There is also concern with limiting a claim on the bond to a "covered act." The term "covered" has been interpreted by the AG's Office to mean coverage under an insurance policy. By using this term, the AG's Office believes it is allowing an insurance company to set the terms and scope of recovery.

Attorney General's Recommendations:

- The bond should provide recompense to anyone that suffers a loss through a failure to comply with the mandatory provisions of the statute and the victim should be allowed to claim on the bond whether the victim's legal action is civil or criminal in nature.
- Amend RCW 19.310.040 as follows:
    - (1) A person who engages in business as an exchange facilitator must: (a)(1) Maintain a fidelity bond or bonds in an amount of not less than one million dollars executed by an insurer authorized to do business in this state for the benefit of a client of the exchange facilitator that suffers a loss as a result of the exchange facilitator's [**Delete "covered dishonest"**] act(s). Such fidelity bond must….
    - (d) Disclose on the company web site…"Washington State law, RCW 19.310.040, requires an exchange facilitator to either maintain a fidelity bond in an amount of not less than one million dollars that protects clients against losses caused by [**Delete "criminal"**] acts of the exchange facilitator, or to…"

Exchange Facilitators' Response:
The Federation of Exchange Accommodators (FEA) has provided the following comments in response to the Attorney General's concerns:

- Any changes regarding the fidelity bond wording in the statute is problematic;
- The FEA's insurance underwriter has verified that the present fidelity bond language reflects the only bond coverage, currently available, that protects customers of the exchange facilitator;
- The Attorney General's comments seem to misunderstand the difference between a surety bond and a fidelity bond, and that both are forms of insurance policies. Surety bonds provide a guarantee of performance or other obligation, while fidelity bonds, also known as crime policies, provide a source of funding when an employee causes a loss due to a criminal act, such as theft, embezzlement or fraud.
- Even if surety bond coverage were available, no facilitator company or its clients could afford surety bond coverage; the cost would be prohibitive;
- The fidelity bond coverage offered to FEA members is unique in that it covers client losses caused by not only employee defalcations, but also client losses caused by owner defalcations; and
- The current law, as amended in 2012, requires fidelity bond coverage which protects consumers. Those Amendments were adopted with exchange industry support.

Exchange Facilitator's Recommendations:

- The Exchange Industry cannot accept a change to the bond requirement that does not work in the real world;
- The present language of the statute reflects the only fidelity bond coverage currently commercially available to protect consumers;
- The statutory language needs to stay as is.

Appendix

Attached is the Federal Trade Commission, Consumer Financial Protection Bureau's *Report to Section 1079 of the Dodd-Frank Act*, issued on July 21, 2012.

JULY 21, 2012

Report Pursuant to Section 1079 of the Dodd-Frank Act

Consumer Financial Protection Bureau

Table of Contents

INTRODUCTION AND SUMMARY 3

1 . BACKGROUND 5

1.1 Section 1031 Exchange Facilitators 5

1.2 Recent Efforts by Industry to Increase Federal Oversight of Exchange Facilitators 6

1.3 State Regulation of Exchange Facilitators 11

2 . ANALYSIS 13

2.1 The Number of Affected Consumers Is Small 13

2.2 Incidents Involving Exchange Facilitator Defaults Are Infrequent 15

2.3 Most Individuals Deferring Capital Gains through a Like-Kind Exchange Using an Exchange Facilitator Have Financial Sophistication and Professional Resources 15

2.4 The Existing Regulatory Structure Is Adequate to Respond to Exchange Facilitator Defaults 17

3 . CONCLUSION 19

APPENDIX I 20

Introduction and Summary

Section 1079 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd- Frank Act), Pub. L. 111-203, calls for the Consumer Financial Protection Bureau (CFPB or Bureau) to submit a report to Congress by July 21, 2012, describing recommendations for legislation, regulatory updating, and new regulation "to ensure the appropriate protection of consumers who use exchange facilitators for transactions primarily for personal, family, or household purposes."[1] That section also requires the Bureau to review "all Federal laws and regulations relating to the protection" of such consumers,[2] and mandates that within two years of submission of the report, the Bureau "propose regulations or otherwise establish a program to protect consumers who use exchange facilitators."[3] The statute defines "exchange facilitator" for purposes of the section as a person who facilitates a tax-deferred exchange of property pursuant to Section 1031 of the Internal Revenue Code or solicits that business.[4]

While Section 1031 exchanges are available to any taxpayer seeking to exchange property "held for productive use in a trade or business or for investment," the report mandated by Section 1079 of the Dodd-Frank Act is statutorily limited to recommendations regarding the protection of "consumers who use exchange facilitators primarily for personal, family, or household purposes."[5] We interpret the statutory mandate to require a report regarding the protection of individual taxpayers who engage in Section 1031 exchanges with the assistance of exchange facilitators (as defined in Section 1079(d)) involving the exchange of investment property, not

---

[1] Pub.L. 111-203, Title X, Section 1079 (b).

[2] Id., Section (a).

[3] Id., Section (c).

[4] Id., Section (d).

[5] Section 1079 (a)-(b).

property used in a trade or business. To take perhaps the most common example, this report would cover a consumer who purchased investment property and sought to use an exchange facilitator to avoid realizing a taxable event when exchanging such property for a similar property.

As set out below, the question of additional regulation of exchange facilitators has been thoroughly presented to and extensively considered on multiple occasions over the past five years by both the Internal Revenue Service (IRS or Service) and the Federal Trade Commission (FTC). Our review of that history and additional factual research leads us to conclude that we have no recommendations for additional legislation or regulation at this time. We reach this conclusion for three reasons: first, that the size of the problem currently does not warrant the cost of regulation; second, that the taxpayers who engage in Section 1031 transactions tend to be sophisticated individuals; and third, that the existing federal regulatory framework has responded adequately to date and has the capacity to respond further should the situation warrant it without additional legislation or regulation.

1. Background

1.1 SECTION 1031 EXCHANGE FACILITATORS

Section 1031 of the Internal Revenue Code[6] permits individuals and businesses to exchange similar real or personal property (e.g., one corporate headquarters for another, land for land) without triggering a taxable event and associated capital gains. For Section 1031 to apply, the exchange must be between two properties held for "productive use in a trade or business or for investment." Stocks, bonds and other securities are specifically excluded from this code section. An example of Section 1031 exchange would be a small businessman swapping a factory in Florida with another businessman who has a similar factory in Kansas without either party having to pay capital gains on the exchange.

While Federal tax law has permitted tax deferred swaps since 1921, the decision in *Starker v. U.S.*, 602 F.2d. 1341 (9th Cir. 1979), increased use of Section 1031. *Starker* held that non-simultaneous, delayed tax-deferred like-kind exchanges could qualify for non-recognition treatment. This decision provided investors with significantly more flexibility in the structuring of tax-deferred like-kind exchange transactions. The Tax Reform Act of 1986[7] further encouraged tax-deferred like-kind exchanges by significantly reducing the other tax benefits of owning real estate. The U.S. Treasury's (Treasury) subsequent adoption of regulations governing Section 1031 "Starker" exchanges in 1991 made the process more accessible and created a new industry of "exchange facilitators."

To defer the capital gain from the sale of property under Section 1031, the taxpayer cannot receive funds from the sale. To facilitate "deferred" 1031 exchanges -- in which the replacement property is acquired after the relinquished property is sold -- the

---

[6] 26 U.S.C. 1031.

[7] Pub.L. 99-514.

Treasury regulations establish four safe harbors.[8] The IRS does not consider taxpayers to be in receipt of funds from a sale of property if one of these is used to accomplish the exchange. Two of the safe harbors are the use of a qualified intermediary (QI) and the use of a qualified trustee or escrow holder, both of which are commonly referred to as exchange facilitators. Proceeds from the sale of the relinquished property go to the exchange facilitator, who holds them until they are needed to acquire the replacement property, then delivers the funds to the closing agent who deeds the replacement property to the taxpayer. Exchange facilitators can generally hold distributed funds for up to 180 days while the exchange is completed.[9]

In 2000, Treasury and the IRS issued Revenue Procedure 2000-37 to create a similar safe harbor procedure applicable to so-called "reverse 1031 exchanges" – in which the replacement property is acquired before the relinquished property is sold. This safe harbor allows taxpayers to "park" either the desired replacement property or the relinquished property with an "exchange accommodation titleholder" (EAT) until the taxpayer can find a buyer for the relinquished property, when the exchange takes place. The revenue procedure provides that the exchange accommodation title holder is considered the beneficial owner of the parked property for federal tax purposes, allowing the taxpayer to get the benefit of Section 1031.[10]

For purposes of this report, the Dodd- Frank Act defines an "exchange facilitator" as a person that acts as a qualified intermediary under Section 1.1031(k) -1(g)(4) or as a qualified trustee or escrow holder under Section 1.1031(k) -1(g)(3), or who acts as an exchange accommodation titleholder under Revenue Procedure 2000-37.[11]

1.2 RECENT EFFORTS BY INDUSTRY TO INCREASE FEDERAL OVERSIGHT OF EXCHANGE FACILITATORS

The only trade organization for exchange facilitators is the Federation of Exchange Accommodators (FEA), founded in 1989. In recent years, the FEA has repeatedly pressed the FTC and the IRS to regulate exchange facilitators. These agencies are therefore familiar with the issues discussed in this report.

---

[8] 26. C.F.R. 1.1031(k)-1(g)(2-5) provides four safe harbors the use of which will result in a determination that the taxpayer is not in receipt of the funds: security or guarantee arrangements, qualified escrow accounts and qualified trusts, qualified intermediaries, and interest and growth factors.

[9] 26 U.S.C. 1031(a)(3).

[10] Rev. Proc. 2000-37.

[11] Pub.L. 111-203, Section 1079(d).

Application for membership in the FEA requires entities to agree to the FEA's Code of Ethics, and specifically requires separate agreement in the membership form to the following provisions governing the holding of clients' funds:

> "Accounting for Monies and Property
>
> (a) Every Exchange Accommodator shall hold all exchange funds, being money, property, other consideration or instruments received by the Exchange Accommodator from, or on behalf of the client, except funds received as the Exchange Accommodator's compensation, in a manner that provides liquidity and preserves principal. Every Exchange Accommodator that invests exchange funds shall invest exchange funds in investments which meet the "Prudent Investor Standard" and satisfy investment goals of liquidity and preservation of principal. For purposes of this section, the "Prudent Investor Standard" shall be violated if:
>
> > (1) Exchange funds are knowingly commingled by the Exchange Accommodator with the operating accounts of the Exchange Accommodator; or
> >
> > (2) Exchange Funds are loaned or otherwise transferred to any person or entity affiliated with or related to the Exchange Accommodator except that this subsection shall not apply to i) a transfer made to a financial institution which is the parent of or related to the Exchange Accommodator for the purpose of placing a deposit or as required under the exchange contract, or ii) to a transfer from an Exchange Accommodator to an EAT as required under the exchange contract.
>
> (b) An exchange facilitator shall not knowingly keep or cause to be kept any money in any financial institution under any name designating the money as belonging to a client of the exchange facilitator unless the money equitably belongs to the client and was actually entrusted to the exchange facilitator by the client."[12]

Applicants are also required to divulge any prior arrests or conviction for financial crimes such as fraud or embezzlement.[13] The FEA provides for enforcement of the Code of Ethics through a complaint and adjudication process run by the Ethics Committee. The penalty for an adjudicated violation includes private and public reprimands as well as suspension or permanent expulsion from the FEA. The Ethics

---

[12] FEA Membership Application, *available at* http://www.1031.org/pdf/2012/2012_Membership_Application.pdf.

[13] *Id.*

Committee may report suspected criminal activity to the Board which may report to law enforcement.[14]

Since 2007, the FEA has also sought to effectively codify the provisions of the Code of Ethics set out above as federal regulation. To this end, in August 2007 the FEA petitioned the Federal Trade Commission to adopt regulations that would require persons who seek to act as exchange facilitators to register with the FTC, impose standards on safeguarding consumer funds entrusted to exchange facilitators, and establish standards of competency for facilitators.[15] The petition identified 23 incidents since 1989 in which exchange facilitators have stolen funds or improperly used customer assets to fund personal ventures.[16]

The FTC determined that a rulemaking was not appropriate.[17] The agency found that a registration system and standards are unlikely to reduce the types of criminal conduct and violations of law identified in the petition. The FTC described the incidents as "isolated instances of embezzlement, theft, or other criminal conduct," and noted that most "resulted in criminal investigations or prosecutions as well as civil suits for recovery."[18] The FTC's review showed that the bad actors in these incidents willfully and knowingly violated the law, conduct which the agency found is unlikely to be deterred by a registration process. Further, the FTC found that few if any of the individuals involved had prior criminal records, so they would not have been screened out by registration.

In addition, the FTC found that the costs of registration and enforcement would impose significant costs on the industry, taxpayers, and consumers. The agency concluded that the proposed benefits of the rule did not outweigh the likely costs, nor did the incidence of the problem warrant a rulemaking proceeding.[19]

The FEA subsequently submitted a request for guidance to the FTC regarding the application of Section 5 of the Federal Trade Commission Act,[20] which prohibits unfair

---

[14] FEA Code of Ethics Enforcements, available at http://www.1031.org/aboutFEA/ethics.htm.

[15] Letter from David A. Starr to Donald Clark, August 6, 2007, "Re: Petition for a Rulemaking to Establish a Registration Process and Appropriate Operational Standards for Exchange Facilitators." *See* "Commission Denies Petition for Rulemaking Related to 'Qualified Intermediaries' Under Internal Revenue Code Section 1031," (FTC Denial) *available at* http://www.ftc.gov/opa/2008/08/qis.shtm. This press release notes that the FEA's submissions to the FTC (FTC File No. P074807) are available from the FTC Consumer Response Center.

[16] Letter from David A. Starr to Donald Clark, December 13, 2007 (supplementing the August 6 letter) and Exhibit A (list of 23 incidents). *See* FTC Denial.

[17] Letter from Donald S. Clark to David A. Starr, August 18, 2008, "Re: Federation of Exchange Accommodators' Petition for Rulemaking," *available at* http://www.ftc.gov/os/2008/08/P074807fealetter.pdf.

[18] *Id.* at 2. The FTC was able to verify 16 of the incidents.

[19] *Id.*

[20] 15 U.S.C. 45(a)

or deceptive acts or practices to the investment and disclosure practices of persons or entities acting as qualified intermediaries in like-kind exchanges under Section 1031.[21] Specifically, the request asked for the FTC's views on whether Section 5 requires, absent disclosure and consumer consent, that an exchange facilitator hold taxpayer funds so as to provide sufficient liquidity and preserve principal.[22] The request noted that the FTC had not applied its Section 5 authority to qualified intermediaries in the context of Section 1031 exchanges.[23] The agency responded with a substantial discussion of its existing record as a basis for offering guidance to the 1031 exchange industry, but declined to opine on whether specific acts or practices would be unfair or deceptive in the abstract.[24] The FTC concluded that "the Commission's existing authority is sufficient to address deceptive or unfair practices in a broad array of industries, including the investment practices of the 1031 exchange industry. Furthermore, if a consumer's funds ultimately become unavailable as a consequence of criminal conduct – such as the embezzlement or theft of funds by a principal of the QI – that type of conduct is best addressed through enforcement by the appropriate criminal law enforcement agency."[25]

During the same period, in June 2008, the FEA submitted to Treasury and the IRS a proposed amendment to Treasury Regulation 1.103(k) -1(g) which would impose standards of funds management requiring investment goals of liquidity and preservation of principal.[26] The proposed amendment would:

1) Require that the written agreement between the taxpayer and the exchange facilitator contain an express covenant by the exchange facilitator to hold or invest exchange funds in a manner that preserves principal and provides sufficient liquidity.

2) Prohibit (a) commingling of taxpayer funds with the exchange facilitator's operating funds; and (b) lending taxpayer funds to parties related to the exchange facilitator (other than an exchange accommodation title holder or depositing the funds in a bank).

The FEA asserted that the proposed regulations would not be unduly burdensome or costly to administer for the Service since the proposal would only require the Service to review the text of agreement at issue, not how the funds are actually held or invested, or whether the goals of liquidity and preserving principal were achieved. The FEA proposed that if a safe harbor agreement contained the proposed language, but the

---

[21] Letter of June 25, 2008 from David A. Starr to Alice Hrdy.

[22] *Id.* at 3.

[23] To date, the FTC has not done so.

[24] Letter of March 30, 2009 from Peggy Twohig to David A. Starr.

[25] *Id.* at 6.

[26] Letter of June 2, 2008 from Joseph M. Mikrut to the IRS.

funds were not properly held or invested, the exchange would still qualify for tax-deferred treatment under Section 1031 and the taxpayer would have a breach of contract claim.[27]

The FEA repeated this submission to Treasury and the IRS the next year.[28] In the renewed submission the FEA addressed a reported concern of the Service that the standards were too vague and would be a problem for the IRS when confronted with requests for private letter rulings on whether an investment practice meets the proposed standard. The FEA suggested that the Service "could simply 'no rule' the issue, perhaps acknowledging that the investment standard is best interpreted through state law," and went on to note: "We recognize that it may seem strange for the IRS to promulgate an investment standard requirement and immediately disavow having to interpret the promulgated standard."[29] The FEA argued that the regulation would serve its purpose even if the IRS did not police the actual investment of funds, because "the purpose for our proposal is to create consumer awareness as to how exchange funds are invested and to provide consumers with a cause of action if funds are invested inappropriately and not available to complete a deferred exchange," adding "we believe most qualified intermediaries invest exchange funds appropriately."[30]

Each of the FEA submissions to Treasury were in response to the IRS' Notice requesting items for that tax year's Guidance Priority List. The Treasury's Office of Tax Policy and IRS use the Guidance Priority List each year to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. The IRS included the issue on the Guidance Priority Lists for 2008-09 and 2009 -10,[31] and in 2010, issued Revenue Procedure 2010-14, [32] which the Service stated addresses this item on the list.[33] The Guidance Priority Lists for 2010 -11 and 2011-12 do not contain any reference to Section 1031.

The Service's regulatory action in March 2010 did not adopt the FEA's proposal to regulate the content of the exchange agreement respecting the manner in which funds

---

[27] *Id.* at 3.

[28] Letter of May 29, 2009 from Joseph M. Mikrut to the IRS.

[29] *Id.* at 3.

[30] *Id.* at 2.

[31] The Guidance Priority List for 2008-09 included: "Guidance under §1031 regarding the treatment of accounts held jointly by the taxpayer and a qualified intermediary." Guidance Priority List for 2008-09, *available at* www.irs.gov/pub/irs-utl/2008-2009pgp.pdf. The Guidance Priority List for 2009-10 included: "Guidance under §1031 regarding exchange fund accounts held by a qualified intermediary." Guidance Priority List for 2009-10, *available at* http://www.irs.gov/pub/irs-utl/2009_-_2010_priority_guidance_plan_initial.pdf.

[32] Released 3/5/10, published 3/22/10 in IRB 2010-12.

[33] First Periodic Update of the 2009- 2010 Priority Guidance Plan, March 16, 2010, *available at* http://www.irs.gov/pub/irs-utl/2009_-_2010_priority_guidance_plan.pdf.

are held, but did act to correct the federal tax consequences of exchange facilitators' default. Revenue Procedure 2010-14 addresses the situation of a taxpayer who initiates a deferred like-kind exchange under Section 1031 but fails to complete the exchange because the exchange facilitator defaults on its obligation to acquire and transfer property to the taxpayer. If the exchange facilitator enters bankruptcy or receivership, the taxpayer is likely to be prevented from obtaining immediate access to the proceeds of the sale of the relinquished property, and cannot complete the exchange, thus losing the ability to defer capital gain on the sale of the relinquished property. The Revenue Procedure provides that a taxpayer who in good faith sought to complete the exchange using the exchange facilitator, but who failed to do so because the facilitator defaulted on the exchange agreement and became subject to a bankruptcy or receivership proceeding, is generally not required to recognize gain from the failed exchange until the taxable year in which the taxpayer receives a payment attributable to the relinquished property. Further, to the extent the taxpayer recovers less in bankruptcy than the adjusted basis of the relinquished property, the taxpayer has a loss deduction.[34]

Additionally, the Service warns Section 1031 filers in its current tax guidance: "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."[35]

1.3 STATE REGULATION OF EXCHANGE FACILITATORS

The FEA has also urged state legislation to license and regulate exchange facilitators. The FEA drafted a model law that the states of California, Colorado, Maine, Nevada, Oregon, Virginia and Washington have adopted with some slight variations.[36]

---

[34] Rev. Proc. 2010-14. While the Service invited comments on whether additional guidance is appropriate to address the effect of a bankruptcy of a qualified intermediary on a taxpayer that is attempting to complete a like-kind exchange, the topics on which comment was invited did not include the FEA's suggestion to regulate the exchange agreement through the Tax Code.

[35] "Like-Kind Exchanges Under IRC Code Section 1031," FS 2008-18, (updated October 17, 2011), *available at* http://www.irs.gov/newsroom/article/0,,id=179801,00.html.

[36] California Financial Code, Section 51000 – 51015, Division 20.5, *available at* http://www.leginfo.ca.gov/cgi-bin/waisgate?WAISdocID=97179314043+0+0+0&WAISaction=retrieve; Session Laws of Colorado 2009, House Bill 09-1254, *available at* http://www.state.co.us/gov_dir/leg_dir/olls/sl2009a/sl_116.htm; Nevada Revised Statutes, Chapter 645G, *available at* http://www.leg.state.nv.us/NRS/NRS-645G.html; 75th Oregon Legislative Assembly – 2009 Regular Session, House Bill 3484, *available at* http://www.leg.state.or.us/09reg/measures/hb3400.dir/hb3484.intro.html; Virginia Acts of Assembly – 2010 Session, Chapter 409 (amending Title 55 of the Code of Virginia to add Chapter 27.1 Section 55-525.1- 55-525.7), *available at* http://lis.virginia.gov/cgi-bin/legp604.exe?101+ful+CHAP0409+pdf; Revised Code of Washington, Chapter 19.310, *available at* http://apps.leg.wa.gov/RCW/default.aspx?cite=19.310&full=true.

Exchange facilitators located in these states are among those listed on the FEA's 2007 list of those who had defaulted since 1989.[37] The Maine law, for example, defines exchange facilitators and accommodators, imposes licensure requirements, and prohibits commingling of taxpayer funds with those of the facilitator or lending taxpayer funds to parties connected to the facilitator. It also requires facilitators to maintain a fidelity bond of at least $250,000 and an errors and omissions insurance policy of at least $100,000.[38] Similar legislation has been introduced in Connecticut.[39]

---

[37] Letter from David A. Starr to Donald Clark, December 13, 2007 (supplementing the August 6 letter) and Exhibit A (list of 23 incidents).

[38] Maine Public Law Chapter 61 LD 165, item1, 124th Maine State Legislature. "An Act to Supervise and Regulate Real Estate Settlement Agents and Exchange Facilitators in Order to Protect Consumers."

[39] H.B. 5415, "An Act Providing Consumer Protection to Clients of Exchange Facilitators for Tax Deferred Exchanges", introduced April 10, 2012.

2. Analysis

2.1 THE NUMBER OF AFFECTED CONSUMERS IS SMALL

As of 2008, the last year for which complete IRS data are available, the use of Section 1031 by individuals using exchange facilitators appears to be declining. Only some 0.09 percent of individual taxpayers (fewer than 130,000 individuals) filed for Section 1031 tax relief in 2008, and that number includes taxpayers who are outside the scope of this report because they did not use a facilitator or were not conducting the exchange for investment purposes. Data from industry for later years supports the view that facilitated 1031 transactions continue to decline.

IRS data indicates that the use of Section 1031 to defer capital gains seems to have peaked in 2004 and declined rapidly by 2008, the last year for which complete data are available. A taxpayer must report a Section 1031 exchange to the IRS on Form 8824, filed with the taxpayer's return in the year the exchange took place.[40] The IRS reported that in Tax Year 2004 taxpayers filed more than 338,500 Forms 8824, claiming deferred losses of over $73.6 billion, which represented a doubling of the number of 1031 exchanges reported since 1998 and a tripling of the dollar amounts involved.[41] By 2008, the total number of Forms 8824 filed had declined to 274,090.[42]

Additionally, the percentage of like- kind exchanges in which the taxpayer is an individual as opposed to a business appears to have declined between 2004 and 2008.[43]

---

[40] 2011 Instructions for Form 8824, *available at* http://www.irs.gov/pub/irs-pdf/i8824.pdf.

[41] Final Audit Report, "Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance," September 17, 2007, at 1, 3.

[42] Form 8824 Data for Tax Year 2008, attached as appendix 1. This data was provided to CFPB by the IRS Statistical Information Services from the Statistics of Income Division.

[43] In an informal survey conducted in spring 2012 ("FEA 2012 informal survey"), FEA members estimated that 60 percent of their clients are individuals, and 40 percent businesses. Meeting and correspondence with the FEA, May 9-10, 2012. We do not have data from the IRS or other sources to confirm this more recent estimate.

In 2004, the IRS reported that individual taxpayers filed approximately 65 percent of Forms 8824 (219,675 Forms 8824).[44] However, the IRS reported instances of only 128,114 individuals who filed for 1031 exchanges in 2008, less than half the total of 1031 filings in 2008.[45]

The percentage of individual taxpayers utilizing like-kind exchanges also appears to have declined between 2004 and 2008. The IRS reported that 132,226,042 individual returns were filed for tax year 2004,[46] so some 0.17 percent of individual taxpayers (219,675 taxpayers) filed Forms 8824 for that year. The IRS estimated 142,450,569 individual returns were filed for tax year 2008;[47] some 0.09 percent of individual taxpayers (128,114 taxpayers) filed Forms 8824 for that year. The number of transactions covered by this report is considerably smaller for two reasons: first, this report only deals with facilitated 1031 exchanges, but a considerable number of 1031 exchanges, including transactions involving consumers, are still conducted between two principals without an exchange facilitator;[48] second, this report only deals with exchanges used by individuals for investment purposes, but 1031 exchanges by individuals can also involve properties used in a trade or business.[49]

Supplementing this data, a survey conducted by the FEA in 2011 of its members indicated a steep decline in 1031 exchanges involving exchange facilitators between 2006 and 2011. The FEA reported a 60 percent decline in membership, from 374 to 150 members, due to lack of business.[50] Among the 70 survey respondents, the number of 1031 exchanges handled had dropped from a total of 47,319 in 2006 to only 9004 in 2010, a decline of 81 percent. More than half of these transactions were for a sale value of $500,000 or more.[51]

---

[44] Final Audit Report at 1, fn.3.

[45] Form 8824 Data for Tax Year 2008, attached as appendix 1. See also 2008 Estimated Data Line Counts at 93, *available at* http://www.irs.gov/pub/irs-soi/08inlinecount.pdf.

[46] SOI Bulletin, Historical Table 3, *available at* http://www.irs.gov/taxstats/article/0,,id=175800,00.html.

[47] 2008 Estimated Data Line Counts Individual Income Tax Returns, at 1.

[48] While we have not been able to quantify the percentage of individual like-kind exchanges that do not involve an exchange facilitator, anecdotal evidence that these continue to exist can be found on many tax preparation assistance websites.

[49] In the FEA's 2012 informal survey respondents estimated that 80 percent of the transactions they facilitated for individual clients in 2011 were for purposes of investment as opposed to for trade or business. Meeting and correspondence with the FEA, May 9-10, 2012.

[50] FEA Report on Current IRC Section 1031 Exchange Activity, May 15, 2011at 1.

[51] *Id.* at 4.

2.2 INCIDENTS INVOLVING EXCHANGE FACILITATOR DEFAULTS ARE INFREQUENT

In the 2007 petition to the FTC, the FEA identified 23 incidents since 1989 in which individuals have misappropriated exchange funds or invested customer assets in risky investments that failed.[52] At our request, the FEA updated their list of incidents involving failed exchange accommodation companies to include the period 2007 to date. We were not able independently to confirm the accuracy of the additional reported failures prior to the deadline for submission of this report.[53] The updated list, indicates that there were an additional twelve incidents between 2007 and the present, for a total of 35 incidents. Including the unverified incidents, the FEA's information shows that since 1989, there have been less than two incidents per year (fewer than three incidents every two years).

According to the FEA's submissions, 14 of these instances involved losses of exchange funds under $2 million. With respect to all the incidents, it is not clear what part of the funds lost belonged to individual taxpayers as opposed to businesses, or how many individual taxpayers as opposed to business taxpayers lost funds in any of these incidents. Thus, we are unable to determine the amount of losses or number of affected taxpayers cognizable pursuant to the mandate of Section 1079.

2.3 MOST INDIVIDUALS DEFERRING CAPITAL GAINS THROUGH A LIKE-KIND EXCHANGE USING AN EXCHANGE FACILITATOR HAVE FINANCIAL SOPHISTICATION AND PROFESSIONAL RESOURCES

Individuals who enter into Section 1031 Exchanges to swap investment property using an exchange facilitator own investment property, are interested in exchanging it for similar property, and are retaining the services of an exchange facilitator to delay recognizing capital gain. These characteristics indicate that they have more assets, engage in more complicated tax reduction transactions, and obtain more professional assistance than many taxpayers. In other contexts, investors with these characteristics have been deemed less in need of regulatory protection. The longstanding theory of the regulatory exemptions for such investors is that they may be allowed to make riskier investments without the full protections of the securities laws because they can (a) do

---

[52] As noted, the FTC staff was only able to verify 16 of these incidents.

[53] For example, one of the incidents is identified as "investigation pending" and no charges have reportedly been filed.

their own due diligence and (b) withstand the risk of loss better than other investors.[54] The fact that these investors have greater resources to protect themselves also argues against shifting the cost of protecting such investors onto the taxpaying public at large through additional regulation.

Indeed, a conservative statistical analysis indicates that the majority of individuals who might typically be in a position to engage in facilitated Section 1031 exchanges for investment purposes would meet the test for an "accredited investor" under Regulation D of the Securities Act of 1933 ("Reg D") and as such would be presumed not to need the same protections as other investors. Rule 501 (a) of Reg D sets out a variety of tests for an accredited investor.[55] With respect to individuals, the rule establishes two alternative tests:

(a) An individual whose net worth, or joint net worth with that person's spouse, at the time of the purchase, exceeds $1,000,000, excluding the value of the individual's primary residence;
(b) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.[56]

An analysis of data from the 2007 Survey of Consumer Finances (SCF)[57] confirms the notion that individuals who have investment property that might be exchanged using an exchange facilitator are likely to meet the test for an "accredited investor." For the individuals covered by the mandate of Section 1079, that is, individuals exchanging investment property, exchanges using an exchange facilitator are very likely to be exchanges of real estate held for investment.[58] Thus, it is reasonable to use the SCF's

---

[54] Securities and Exchange Commission, Net Worth Standard for Accredited Investors, Final Rule. 76 FR 81793 (December 29, 2011) at 81794 ("One purpose of the accredited investor concept is to identify persons who can bear the economic risk of an investment in unregistered securities, including the ability to hold unregistered (and therefore less liquid) securities for an indefinite period and if necessary to afford a complete loss of such investment."). *See also id.* at n.17 at 41793 ("the accredited investor concept was intended to 'eliminate the need for subjective judgments by the issuer about suitability' because investors that met the definition of accredited investor would be presumed to meet the purchase qualifications").

[55] 17 C.F.R. 230.501(a). The standards for accredited investors under Reg D delineate investors to whom issuers may sell securities in specified private and other limited offerings without registration of the offering under the Securities Act of 1933. Accredited investor status also obviates the sophistication requirement that Rule 506 imposes on non- accredited investors in private offerings. *See* 17 C.F.R. 230.5065 (specifying as a condition that "each person who is not an accredited investor either alone or with his purchaser representatives(s) has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment. . . ."

[56] *See* 17 C.F.R. 230.501(a)(5), (6).

[57] Board of Governors of the Federal Reserve System, Survey of Consumer Finances, 2007 (latest available).

[58] The FEA surveyed their members in 2012 in response to our inquiry on the nature of property exchanged for individuals by facilitators. Members responded that they believed approximately 80%

property category of "other residential real estate" (that is, residential real estate that is not the individual's home) as a rough proxy for the property that could be used in 1031 exchanges of investment property by individuals using exchange facilitators. According to the 2007 SCF, only 14 percent of households own "other residential real estate."

As noted, over half the Section 1031 transactions using exchange facilitators in tax year 2010 involved a sale over $500,000.[59] The SCF shows that only 2.5 percent of households have "other residential real estate" worth at least $500,000.[60] Moreover, according to the SCF, individuals who own "other residential real estate" of $500,000 or more have a median net worth of over $2.25 million ($2,339,000), excluding the equity in their home. Three quarters (75.2 percent) of individuals or couples owning such property have a net worth (excluding home equity) of over $1 million, and 36.2 percent of them meet the income test for accredited investors.[61] A total of 76.0 percent of such households meet one or the other test for individual accredited investors.[62]

2.4 THE EXISTING REGULATORY STRUCTURE IS ADEQUATE TO RESPOND TO EXCHANGE FACILITATOR DEFAULTS

Exchange facilitator defaults can cause harm to consumers in several ways. As discussed below, most of those harms have been addressed through the existing regulatory structure. Moreover, federal and state regulators have adequate authority to

---

of the exchanges facilitated for individuals involved replacement property acquired for investment purposes rather than for use in a trade or business. For purposes of this definition, 1-4 family rental properties were included within the definition of investment use. FEA 2012 Survey, Meeting and correspondence with the FEA, May 10, 2012.

[59] FEA Report on Section 1031 Exchange Activity, May 15, 2-011, at 4 (reporting results of 2011 survey).

[60] This amount could include multiple properties. Restricting attention to households that owned a single property (other than their home) worth at least $500,000 would yield an even more select group of households.

[61] The SCF estimates of income and net worth are household-level measures. It is not possible to reasonably distinguish the income and net worth of individual household members, and we do not attempt to do so. Similarly, because we cannot allocate income to individual household members, unmarried couples are treated similarly to married couples for the purposes of the income test. The SCF asks about not only total income in the previous calendar year but also what "normal" annual household income is if the previous-year's income was atypical. To approximate the income test's consideration of two years of income and of income expectations, we treat a household as meeting the income test if reported income in the prior year and "normal" income both exceed the relevant threshold.

[62] A more sophisticated analysis of individual taxpayers filing Forms 8824 would require specialized data from the IRS Statistics of Information Division. Due to resource constraints, the IRS was unable to undertake this data gathering in time for this report.

take further steps should the situation warrant it in future without additional legislation or regulation.

First, prior to March 2010, taxpayers whose exchange facilitator defaulted might have been unable to complete the exchange and risked incurring taxable capital gain on the sale of the relinquished property. When this problem of federal tax law was called to the attention of the IRS, the Service responded by issuing Revenue Procedure 2010 -14, which corrects it.

Second, consumers can be harmed by exchange facilitators who engage in criminal acts such as theft, embezzlement or misappropriation of funds. Several of the instances of exchange default involved exchange facilitators who absconded to parts unknown with the taxpayers' funds. As the FTC noted, flagrant criminal conduct of this nature is unlikely to be deterred by additional regulation and is best addressed by the appropriate criminal law enforcement agency. As the FTC notes in its submission to the FTC, criminal and civil action was taken against the wrongdoers in these cases. In addition, the FEA suspended the membership of companies that defaulted even prior to the filing of criminal charges, after receiving complaints.[63]

Third, consumers may be harmed by exchange facilitators who invest exchange funds in investments that fail, such as auction rate securities. The larger of the recent incidents – the bankruptcies of Land America and Summit Accommodations in 2008 – appear to fall into this category. Both the IRS and the FTC have been asked and have declined to set a federal standard in the abstract for what an appropriate investment of exchange funds might be.[64] However, the FTC asserts that its authority to address deceptive or unfair practices could be applied to the investment practices of the 1031 exchange industry,[65] reserving the option to opine that a particular investment practice is unfair or deceptive and thus provides guidance through rulings. In addition, the half dozen states that have concluded that the cost of regulation is worth the benefit in their particular exchange facilitator market have attempted to reduce risky investment by enacting state laws licensing exchange facilitators and imposing insurance and bonding requirements.[66]

---

[63] See FEA website, *available at* http://www.1031.org/about/FEA/response.htm ("In both the Southwest Exchange and 1031 Tax Group situations, the FEA immediately reviewed the complaints that were filed and, after verifying their accuracy, suspended the membership of these two companies").

[64] Notably, the FEA has suggested that the IRS could reasonably decline to respond to requests for interpretation of the broad federal standard the FEA urges the Service to adopt -- "perhaps acknowledging that the investment standard is best interpreted through state law." Letter from Joseph M. Mikrut to the IRS, May 29, 2009, at 3.

[65] Letter of March 30, 2009 from Peggy Twohig to David Starr at 5.

[66] See footnote 36.

3. Conclusion

For the foregoing reasons, we have no recommendations for federal legislation or regulation of exchange facilitators by the CFPB at this time.[67] We recommend that other regulators with authority in this area take into consideration the factual findings in this report in any further regulatory action they may consider.

[67] We also decline to make recommendations regarding federal legislation or regulation by other agencies covering Section 1031 transactions outside the scope of Section 1079 as described above (i.e. that would cover businesses, or individual taxpayers using exchange transactions for trade or business purposes). In our view, the mandate and authority conferred on us by Section 1079 does not extend to recommendations regarding such transactions.

Appendix I

Attached are summary figures for Form 8824 filers for Tax Year 2008. Form 8824 is the filing form for Section 1031 filers. This data was provided to CFPB by IRS Statistical Information Services from the Statistics of Income Division.

Form 8824 Data for Tax Year 2008
(All money amounts are in thousands of dollars)

	Tax Year 2008						
		Individuals		Corporations		Partnerships	
Number of Forms 8824 filed for Tax Year 2008		128,114		73,669		72,307	
Item	**Line No.**	**Frequency**	**Amount**	**Frequency**	**Amount**	**Frequency**	**Amount**
FMV of other property given up	12	4,300	608,312	1,713	919,108	76	139,951
Adjusted basis of other property given up	13	1,703	349,418	973	543,324	73	53,446
Gain (or loss) recognized on other property given up	14	3,314	258,894	2,091	375,812	40	86,505
Cash received, FMV of other property received, plus net liabilities	15	17,742	2,306,575	3,703	3,055,207	5,416	1,289,340
FMV of like-kind property you received	16	111,132	29,028,074	57,516	48,263,420	57,932	34,995,242
Add lines 15 and 16	17	113,955	31,334,649	58,457	50,796,367	57,995	36,284,583
Adjusted basis of like-kind property you gave up	18	124,023	18,042,882	71,773	26,259,562	71,512	21,035,017
Realized gain (or loss)	19	120,569	13,291,768	70,689	30,317,934	70,596	17,302,622
Smaller of line 15 or 19	20	12,668	1,903,694	2,791	2,164,367	5,400	1,260,304
Ordinary income under recapture rules	21	1,721	52,555	1,468	668,507	4,811	33,660
Subtract line 21 from line 20	22	12,541	1,853,281	1,608	955,458	5,266	1,244,607
Recognized gain	23	12,710	1,905,836	2,789	1,683,194	9,821	1,278,268
Deferred gain (or loss)	24	118,228	11,385,931	69,805	28,650,087	70,235	16,024,354
Basis of like-kind property received	25	123,181	17,642,143	71,949	29,751,380	71,487	23,697,144