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Section 1031 Update 2010

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The Exchange Facilitators Act

By John W. Anderson

Recent rulings by the U. S. Bankruptcy Court in the Eastern District of Virginia have prompted the Virginia General Assembly to enact legislation affecting Internal Revenue Code Section 1031 tax-deferred exchange transactions (sometimes called "Starker Exchanges" after the Court case that first established the underlying precedent). The LandAmerica 1031 Exchange Services, Inc. ("LES") bankruptcy cases resulted in a ruling that exchange funds, held by LES in 1031 exchange transactions, constituted property of the LES bankruptcy estate. *Millard Refrigerated Servs. v. LandAmerica 1031 Exch. Servs. (In re LandAmerica Fin. Group, Inc.),* 412 B.R. 800 (Bankr. E.D. Va. 2009); *Frontier Pepper's Ferry, LLC v. LandAmerica 1031 Exch. Servs. (In re Landamerica Fin. Group, Inc.),* 2009 Bankr. LEXIS 4133 (Bankr. E.D. Va. 2009). The result of these rulings was that many investors were left without the funds that they thought they were placing safely in escrow with LES to hold as a Qualified Intermediary. While the Virginia legislature had been previously considering similar legislation, these cases made the Exchange Facilitators Act a priority.

The Exchange Facilitators Act (§§55-525.1 through 55-525.7 of the 1950 Code of Virginia, as amended) (the "Act") is effective July 1, 2010. It is designed to protect a taxpayer's interests when using an Exchange Facilitator (which is essentially synonymous with the term "Qualified Intermediary" as defined in the Internal Revenue Code) in a Section 1031 tax-deferred exchange transaction ("Exchange Transaction"). The Act requires Exchange Facilitators to take extra steps beyond what was previously required to ensure that the taxpayer's money and property are protected. The Act also prohibits certain actions to further that same goal.

The goal is achieved by clearly identifying the manner in which taxpayer's funds in an Exchange Transaction are to be held, and by confirming that the funds are at all times the property of the taxpayer.

Requirements of the Act:

1) Notify taxpayers of a change in control of the Exchange Facilitator.

When an Exchange Facilitator has experienced a change in control, it is required to notify all existing taxpayers who are utilizing the services of that Exchange Facilitator and who have either Relinquished Property (property sold as a part of an Exchange Transaction) or Replacement Property (property acquired as a part of an Exchange Transaction to replace the Relinquished Property) within the Commonwealth of Virginia. This notification must occur within ten (10) business days of the change in control. In addition, the Exchange Facilitator must publish on its website (if it has one) notice of the change in control. This notification must remain in place on the website for at least ninety (90) days. A change in control is defined as any transfer within twelve (12) months of more than fifty percent (50%) of the assets or ownership interests, direct or indirect, of the Exchange Facilitator.

2) Maintain taxpayer proceeds from disposition of Relinquished Properties in separately identified deposit accounts or in a qualified escrow or qualified trust.

A separately identified account is defined in Treasury Regulation §1.468B-6(c)(ii). This Regulation defines a separately identified account as an account that is established under the taxpayer's name and taxpayer identification number with a depository institution. Subaccounts may be used if the depository institution identifies them by the taxpayer's name and taxpayer identification number. In addition any earnings must be credited specifically to the subaccount.

The separately identified accounts must require that any withdrawals can only be made with the written authorization of the taxpayer and the written acknowledgement of the Exchange Facilitator. These authorizations can be delivered by any commercially reasonable means.

An Exchange Facilitator may deposit funds in a deposit account in either a qualified escrow or a qualified trust as those terms are defined under Treasury Regulation §1.103 (k)-1(g)(3).

An escrow account is qualified if (1) the escrow holder is not the taxpayer or disqualified person and (2) the escrow agreement limits the taxpayer's right to receive, pledge, borrow, or otherwise obtain benefits of the cash or cash equivalent.

A trust account is qualified if (1) the trustee is not the taxpayer or a disqualified person and (2) the trust agreement limits the taxpayer's right to receive, pledge, borrow, or otherwise obtain benefits of the cash or cash equivalent.

All deposit funds are required to be deposited with a financial institution. Any interest earned on the accounts will accrue according to the agreement between the Exchange Facilitator and the taxpayer. The taxpayer may request, in writing, that the Exchange Facilitator invest the proceeds in a manner designated by the taxpayer. The Exchange Facilitator must give written acknowledgement and confirmation to the taxpayer as to how the proceeds are invested.

3) An exchange facilitator is required to maintain errors and omissions insurance or cash equivalent.

An Exchange Facilitator at all times shall maintain either (1) a policy of errors and omissions insurance of at least $250,000 executed by an insurer authorized to transact business in the Commonwealth of Virginia, or (2) deposit an amount of cash or provide irrevocable letters of credit equivalent to at least $250,000.

(Comment: The author is of the opinion that this amount of "protection" is typically below the dollar values involved in many Exchange Transactions and should be increased via future amendments to the Act in order to provide adequate protection to more taxpayers.)

4) Accounting of money and property.

An Exchange Facilitator must account for and hold all property related to the exchange taxpayer on the taxpayer's behalf, except funds received as the Exchange Facilitator's compensation. *Exchange funds are not subject to execution or attachment or to any claim against the Exchange Facilitator*.

Prohibitions.

An exchange facilitator *shall not* (1) commingle exchange funds with the operating accounts of the Exchange Facilitator, (2) lend or transfer funds to any person or entity affiliated or related to the Exchange Facilitator except to a parent or affiliated financial institution or when it is required under the exchange contract, (3) designate money in an account as belonging to an exchange taxpayer unless the money equitably belongs to the taxpayer and was actually entrusted to the Exchange Facilitator by the taxpayer, (4) make material misrepresentations or false statements intended to mislead others, (5) pursue a continued course of misrepresentation or making false statements through advertising or otherwise, (6) fail to account for, within a reasonable time, any money or property that belongs to others that are under the control of or in the possession of the Exchange Facilitator, (7)

engage in fraudulent or dishonest dealings or commit certain crimes, and (8) fail to fulfill any contractual duties to an exchange taxpayer.

Penalty.

There is a civil penalty of up to $2,500 for each violation of the Act by the Exchange Facilitator or any other person engaged in an act or practice in violation of these statutes. The Commonwealth may also recover costs, reasonable expenses, and attorney's fees.

If you are involved in or about to become involved in, a Section 1031 tax-deferred exchange transaction, be certain to inquire as to whether your Qualified Intermediary is in compliance with the Exchange Facilitator's Act and carefully review the Exchange Agreement to confirm that the protective provisions of the Act are incorporated into the language of that document. Please feel free to contact me with any comments or questions. John W. Anderson, (804)697-2020 or janderson@spottsfain.com.

(Assistance from Thomas R. Stevens, Jr., a rising second year law student at T. C. Williams School of Law at the University of Richmond is gratefully acknowledged.)
