

SECTION 1031 QIS IN THE NEW ECONOMY

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Recent events and the new economy promise to alter the manner in which section 1031 qualified intermediaries function and the expectations property owners will have for qualified intermediaries. Section 1031 allows property owners to exchange property tax free. Rarely do property owners swap properties, so to qualify for section 1031 tax-free treatment property owners generally use a qualified intermediary structure to avoid prohibited constructive receipt of exchange funds.¹ The qualified intermediary structure interposes the qualified intermediary as an exchange facilitator. An exchanger in effect transfers relinquished property to the qualified intermediary. In exchange, the qualified intermediary agrees to acquire replacement property for the exchanger. The qualified intermediary transfers the relinquished property to the buyer and takes possession of the exchange funds. At the exchanger's direction, the qualified intermediary uses the exchange funds to acquire replacement property and transfer it to the exchanger.²

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¹ See Treas. Reg. § 1.1031(k)-1(f)(2) (as amended in 2008) (providing that the constructive receipt of exchange proceeds will trigger gain recognition). Exchange funds are the proceeds the purchase of relinquished property pays to acquire the property.

² In practice, qualified intermediaries rarely, if ever, take title to property. Instead, the qualified intermediary structure relies upon provisions in the section 1031 treasury regulations that allow the exchanger to directly deed property to the purchaser of relinquished property and to acquire title directly from the seller of the replacement property. See Treas. Reg. § 1031(k)-1(g)(4)(iv) (as amended in 2008).

In good economic times, the flow of exchange deals was good. Qualified intermediaries held significant amounts of exchange funds, the deals flowed in with no apparent end in sight, the number of qualified intermediaries proliferated, and qualified intermediaries began to look to ways to increase their profitability. The qualified intermediary industry is unregulated. The lack of regulation presented opportunities for schemes and lax investment practices that ultimately depleted the exchange fund balances of some prominent qualified intermediaries and cost exchangers hundreds of millions of dollars of exchange proceeds. In hindsight, exchangers and qualified intermediaries could have taken steps to avoid those problems. The knowledge gained from the recent qualified intermediary collapses provides insight into actions that qualified intermediaries should take to tighten their operations and precautions exchangers should take in choosing a qualified intermediary.

Three recent qualified intermediary failures drew national attention and jeopardized half a billion dollars of exchange proceeds or more and inflicted other damages to exchangers. Two collapses involve owner/manager wrongdoing, and third appears to be the result of mismanagement of exchange funds. The first major collapse, resulting from owner/manager wrongdoing, was Southwest Exchange, Inc., which occurred in January 2007. Reportedly, Southwest Exchange, Inc. lost \$97.5 million of exchange funds. The owner of Southwest Exchange, Donald McGhan pleaded guilty to several counts of wired fraud for defrauding exchangers of \$95 million.³ McGhan admitted that he used \$40 million of the exchange funds to acquire a breast implant manufacturing company and that he continued to market the exchange company as financially secure and stable even though he knew it was insolvent.⁴ One employee,

³ See Mary Manning, *Southwest Exchange Owner Pleads Guilty to Wire Fraud*, LAS VEGAS SUN, June 8, 2009.

⁴ See *id.*

McGhan's daughter, has been indicted on several counts of embezzlement and unlawful intermediary conduct under state law.⁵ Although there is no indication that the exchange company has any assets available for distribution, third parties, such as insurance companies and brokers, have paid close to \$92 million to settle claims brought by Southwest Exchange exchangers.⁶

The second major collapse, also resulting from owner/manager wrongdoing, occurred later in 2007. That collapse was the result of a scheme that led to the conviction of Ed Okun of 23 charges that included wire and mail fraud, money laundering, currency smuggling, and making a false statement.⁷ Okun purchased regional exchange companies (six in total) and raided the exchange funds of the companies for personal reasons and to purchase other companies to keep his scheme running.⁸ One witness testified that Okun spent \$35 million of exchange proceeds on a divorce settlement, jewelry, and boats.⁹ Reports claim that Okun and others (three of whom pleaded guilty prior to Okun's conviction) took about \$126 million of exchange funds.¹⁰ Okun's sentence is scheduled for August 2009, and he faces up to 400 years in prison.¹¹

⁵ See John G. Edwards, *Former Southwest Exchange Boss Accepts Plea Deal*, LAS VEGAS REVIEW-JOURNAL, June 9, 2009.

⁶ See Jeff German, *Southwest Exchange Settlement: \$91.7 million*, LAS VEGAS SUN, Jan. 27, 2009.

⁷ See Frank Green, *Jury Convicts Okun in \$126 million Fraud Case*, RICHMOND TIMES-DISPATCH, Mar. 20, 2009.

⁸ See *id.*

⁹ See *id.*

¹⁰ See *id.*

¹¹ See *id.*

The third major collapse is in its early stages and appears to be the result of mismanagement of exchange proceeds, but civil claims have been filed suggesting wrongdoing on the part of the exchange company and its bank.¹² LandAmerica 1031 Exchange Services filed for bankruptcy in November 2008. This was the largest qualified intermediary failure to date. LandAmerica 1031 Exchange Services had 450 customers and more than \$330 million of claims from those customers.¹³ LandAmerica 1031 Exchange Services had invested exchange proceeds in auction-rate securities, the market for which froze, leaving the assets illiquid. The illiquidity of its investments made it impossible for LandAmerica 1031 Exchange Services to meet obligations to its exchangers.¹⁴

The bankruptcy filing stayed all distributions from the LandAmerica 1031 Exchange Services and started a series of hearings and proceedings to resolve the claims of all of the exchangers. Those proceedings may last for years, but some initial rulings and actions provide some insight into the rights of exchangers to assets held by a defunct qualified intermediary or in trust to secure the qualified intermediary's obligations. For example, one of LandAmerica 1031 Exchanger Services' clients had structured the arrangement using a qualified escrow account. Pursuant to that arrangement, the exchanger had directed the purchaser of the relinquished property to deposit \$137 million of exchange funds with into a qualified escrow account at a

¹² See *Arthur v. SunTrust Banks*, No. 09-cv-0054 (S.D. Cal. Jan. 14, 2009) (claiming that the qualified intermediary operated a Ponzi scheme by using the exchange proceeds of new clients to satisfy obligations to old clients and the qualified intermediary's bank was aware of the scheme and aided and abetted that scheme).

¹³ See Emily C. Dooley, *Bankruptcy Sheds Light on Industry*, RICHMOND TIMES-DISPATCH (Dec. 28, 2009)

¹⁴ See Bradley T. Borden, Paul L.B. McKenney & David Shechtman, *Like-Kind Exchanges and Qualified Intermediaries*, 124 TAX NOTES 55 (July 6, 2009).

bank. The funds secured the obligation of LandAmerica 1031 Exchange Services to acquire replacement property, but qualified intermediary did not hold the funds.¹⁵ During preliminary hearings, the bankruptcy judge did not allow the bank to distribute the exchange funds from the qualified escrow. Subsequently, however, the parties agreed to a distribution of the funds to the exchanger in exchange for the exchanger paying \$2 million to the bankruptcy estate.¹⁶ Thus, the exchanger who used a qualified escrow account, instead of entrusting funds to the qualified intermediary, received 98% of its exchange funds in settlement. Other exchangers have not been so fortunate.

LandAmerica Exchange Services provided three different structures to its clients. The qualified escrow account arrangement was one of the structures it provided. It also provided held exchange funds in commingle accounts and segregated accounts. Exchangers had the option to choose from one of these three types of accounts. Under the commingled account structure, LandAmerica 1031 Exchange Service held exchange funds in an account in its name. It made no effort to trace funds going in or coming out of that account. When it deposited exchange funds for an exchanger in the commingled account, it recognized that it had an obligation to pay an equal amount of funds out of the commingled account at some point in the future. Under the segregated account alternative, LandAmerica 1031 Exchange Services formed a master account and used bookkeeping entries to identify specific balances of exchangers. Under the segregated account structure, it could track the date on which it received funds, and

¹⁵ For a discussion of the various exchange structures, include qualified escrow account structures, see BRADLEY T. BORDEN, TAX-FREE LIKE-KIND EXCHANGES, ¶ 4.4 (2008).

¹⁶ See *In Re LandAmerica Financial Group*, No. 08-35994-KRH (Bankr. E.D. Va., Apr. 15, 2009), Joint Motion Pursuant to Rule 9019, APN 08-03149.

how the funds were invested. It could therefore recognize any fluctuations that may have occurred with respect to the investment of any particular exchanger's funds.

One question before the bankruptcy court was whether LandAmerica 1031 Exchange Services held the money in the commingled accounts and the segregated accounts in trust for the exchangers. The bankruptcy judge held that LandAmerica 1031 Exchange Services did not hold the money in the segregated accounts in trust for exchangers.¹⁷ Presumably it does not hold the money in the commingled accounts in trust either. The upshot of that holding is that all money held in segregated accounts and commingled accounts is property of the bankruptcy estate. If the funds held in those accounts are not sufficient to satisfy all of the exchangers' claims, the exchangers will likely receive only a portion of the funds that LandAmerica 1031 Exchange Services held for them. Thus, expectations for exchangers who chose such structures are not high. They likely will not receive anything for several months, and then only a fraction of what they entrusted to the qualified intermediary.

In addition to losing exchange funds, the clients of failed qualified intermediaries may face other legal costs and negative tax consequences. Collateral legal costs may include damages for breach of contract related to the acquisition of replacement property. For example, prior to LandAmerica 1031 Exchange Services' bankruptcy filing, many of its clients probably had no idea that it was in financial trouble. Some may have entered into contracts to purchase replacement property and were preparing to close on the acquisition of that property when they learned that funds may not be able to fulfill their obligations under the contract. The seller of the replacement property may not be sympathetic to the exchanger's situation and could sue for

¹⁷ See *Millard Refrigerated Services v. LandAmerica 1031 Exchange Services*, APN 08-03147-KRH (Bankr. E.D. Va., Apr. 15, 2009).

specific performance. Such a suit could put the exchanger in a difficult situation if exchange funds represented the exchanger's only resources available to acquire the replacement property. If the exchanger had entered into financing agreements with a lender for a portion of the replacement property purchase price, the exchanger may be liable for breaching the contract with the lender. Thus, the qualified intermediary's failure may cause damages to exchangers in excess of exchange funds they have deposited with the qualified intermediary.

To add insult to injury, an exchanger who cannot obtain exchange funds from a qualified intermediary may suffer negative tax consequences. The purpose for structuring a section 1031 exchange is to defer gain recognition and the accompanying taxes. Qualified intermediaries help exchangers accomplish that purpose by taking possession of exchange funds. Generally, exchangers structure the arrangement with the qualified intermediary such that the arrangement terminates at the end of the section 1031(a)(3)(B) 180-day exchange period. Upon termination of the arrangement, the qualified intermediary should transfer any unused exchange funds to the exchanger. Even if the qualified intermediary fails to transfer the exchange funds, the exchanger can demand the transfer of the funds, and therefore tax law would treat the exchanger as being in constructive receipt of the exchange funds at the end of the 180-day exchange period. The consequent may be that when the 180-day exchange period expires, the IRS may claim that an exchanger is in constructive receipt of exchange proceeds, even if the qualified intermediary has declared bankruptcy. Apparently, no legal authority directly addresses this issue. Thus, if the IRS were to make such an assertion, an exchanger may be able to argue that it cannot access exchange funds held by the bankrupt qualified intermediary, and therefore is not in constructive

receipt of those funds.¹⁸ This latter conclusion appears to be supported in theory because the exchanger cannot access funds held in a bankruptcy estate.

If an exchanger recognizes gain at the end of the 180-day exchange period based upon the full amount of exchange funds deposited with the qualified intermediary, it will have to pay tax on such gain during the year in which the 180-day exchange period expires. If, at the conclusion of the bankruptcy proceeding, the exchanger receives a portion of its exchange funds, it may be able to deduct as a loss the difference between the original exchange balance and the distributed exchange funds. With no authority addressing the character of that loss, exchangers must determine whether the loss is a bad debt deduction, a theft loss, or some other type of loss. If the loss is a bad debt deduction, the loss would be a short-term capital loss if the exchanger could not establish that the arrangement with the qualified intermediary is business debt.¹⁹ With no guidance on this issue, as of the date of this article, exchangers must proceed with caution in reporting the tax consequences of an exchange that fails on account of a defunct qualified intermediary. Perhaps the IRS will respond to requests from exchangers and others and provide guidance soon regarding the proper tax treatment for this class of taxpayer.

¹⁸ See Treas. Reg. § 1.1031(k)-1(f)(2) (as amended in 2008) (providing that a taxpayer is “in constructive receipt of money or property at the time the money or property is credited to the taxpayer’s account, set apart for the taxpayer, or otherwise made available so that the taxpayer can draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given”). An exchanger cannot draw upon exchange fund held by a bankrupt qualified intermediary until the bankruptcy judge grants a distribution from the bankruptcy estate, or all relevant parties agree to such distributions.

¹⁹ See I.R.C. § 166(d)(1)(B) (2006).

While those embroiled in the three recent qualified intermediary collapses work to resolve the exchangers' claims and rectify resulting harms, other exchangers and qualified intermediaries should look for ways to avoid similar occurrences in the future. A primary objective of such consideration should be to protect exchange funds. Protecting exchange funds requires two assurances: (1) the security of exchange funds and (2) the stability of the qualified intermediary. Securing exchange funds will ensure that the exchanger receives them at some point. If the qualified intermediary is not stable, however, difficulties of the qualified intermediary, such as bankruptcy, can delay the distribution of the exchange proceeds. As discussed above, the delayed distribution of exchange proceeds may cause negative tax consequences and other damages if exchangers are unable to complete planned acquisitions of replacement property. Thus, focusing solely on the security of exchange funds is not sufficient.

The settlement in the LandAmerica 1031 Exchange Services bankruptcy indicates that money held in a qualified escrow account should not be part of the bankruptcy estate. Based on that observation, exchange funds held in properly structured qualified escrow accounts should be secure, even if a qualified intermediary encounters financial difficulties. To help ensure the security of the funds in a qualified escrow account, exchangers must arrange for exchange funds to go directly from the purchaser of the relinquished property to the escrow account. If the funds first pass to the qualified intermediary, perhaps they could become part of the qualified intermediary's bankruptcy estate, if the qualified intermediary later fails. Some practitioners believe that a qualified trust will provide even greater security for exchange funds. Although these structures are more costly than merely using a segregated account or a commingled account, they provide the greatest security for exchange proceeds.

Qualified intermediaries also should consider how they may avoid the pitfalls encountered in the recent qualified intermediary failures. Market forces will probably prohibit the use of qualified escrow accounts and qualified trusts for every exchange. The cost to structure arrangements with qualified escrow accounts and qualified trusts would be cost prohibitive for many exchanges. Thus, many qualified intermediaries will continue to use segregated accounts. Some may even continue to use commingled accounts. The use of such accounts should not be problematic, if the qualified intermediary properly invests the funds. As the Okun and McGhan cases illustrates, the personal use of exchange proceeds will surely lead to a failed qualified intermediary. The failure of LandAmerica 1031 Exchange Services illustrates that mismanaging exchange funds may also cause an exchange company to fail. LandAmerica 1031 Exchange Services was the subsidiary of the country's third largest title company before its failure. The size of the company does not ensure the stability of the company. Exchangers must do due diligence when selecting a qualified intermediary, including inquiring about the investment practices of the qualified intermediary. If the qualified intermediary inappropriately invests the exchange funds, then it could become unstable and jeopardize the security and availability of all funds associated with the qualified intermediary. Qualified intermediaries therefore have a vested interest in adopting conservative practices for ensuring the security of all exchange funds and in communicating those practices to exchangers.