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Estimating deposit risk in a tax deferred exchange

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Imagine setting up a like-kind exchange, and later having the qualified intermediary go out of business, steal the funds, or invest the funds in an improper investment. These sad stories are well documented. A casualty loss deduction is small comfort when the money is gone. How could this have been avoided?

To date, not a single investor that selected a bank qualified intermediary has lost exchange funds. Yet, the financial crisis has weakened public faith in banks. If a bank QI fails, the taxpayer should benefit from FDIC insurance coverage. However, FDIC insurance is limited to \$250,000 per account beneficiary. This would cover only a small portion of most exchange balances. Even if the exchange funds are held in an escrow or trust instrument instructing the escrow agent/trustee to invest the funds in a bank deposit account, the same \$250,000 per beneficiary limit applies.

Here are some strategies to deal with the issue of limited FDIC insurance:

1. If a bank subsidiary, like Compass, is QI, make sure that the funds are held by the parent bank in an escrow or trust arrangement. These arrangements will generally qualify for pass-through FDIC insurance coverage.
2. Do your homework on the financial institution. Is the bank or its holding company publicly traded, and if so, how has the company performed? All insured depository institutions must file reports of their financial condition (Call or Thrift Reports) with the FDIC. See: http://www2.fdic.gov/call_tfr_rpts/. There are also private rating services like Bankrate.com. If your bank holds more than \$250,000 of your funds, you are an unsecured creditor relying on the strength of the bank's balance sheet.
3. Consider having the exchange funds invested in a non-interest bearing transaction account. Under Dodd-Frank Â§343, UNLIMITED FDIC insurance is available through December 31, 2012. In order to qualify the account must be non-interest bearing and the funds must be available to the customer on demand without notice. There are also programs like CDARS that invest funds in a series of CDs all below the FDIC insurance limit at a number of financial institutions. As time deposits, CDARS may be impractical to use.
4. Ask the bank to collateralize exchange funds. Most banks will refuse to do this except for large deposits held for an extended period of time. Expect to pay for this service. Banks are prohibited from collateralizing with their own stock, but may collateralize with treasuries or municipal securities. Banks may also have a collateralized cash sweep product. Make sure that the agreement gives you a security interest, and the collateral is specifically identified in a transaction confirmation. Before you begin your next exchange make sure you have done everything you can to eliminate the risk of principal loss, and sleep well at night.

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