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1031 Exchange funds – Are they safe and secure? - by Michele Fitzpatrick

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When it comes to ensuring the safety and security of your 1031 Exchange funds, it pays to do your due diligence. One of the most important decisions for all investors who are planning to defer taxes with a 1031 Exchange is which Qualified Intermediary (QI) to hire. The QI will be holding your funds from the proceed of the sale until you close on the replacement property, so you want to do everything you can to ensure your QI is keeping your funds safe and secure.

In order to accomplish a 1031 Exchange, an investor must enter into an exchange agreement with the intermediary, and the intermediary must hold the proceeds from the sale of the property until they are used to purchase replacement property.

The important thing to keep in mind is, with the exception of minimal regulations in some states, QI companies are not overseen by the federal government or any national regulatory entities. So, it's up to you to determine whether the company selected can provide sufficient protection and security before proceeding with any 1031 Exchange.

The following are a list of questions you should ask your potential QI to help you determine if the level of safety and security they provide meet your investment needs.

What is your QI's training and experience?

The security of the exchange funds is paramount to all other aspects of an exchange. Since QIs are not regulated or tested, ask how long the QI has been in business and the experience and training of their staff. You want to make sure there is a level of checks and balances within your QI company. Study the QI's Funds Management Policy and learn their financial strength and integrity.

Do they provide insurance?

Because QIs are not regulated by the federal government, they are not required to provide insurance or other protections for your exchange funds. If your funds are lost or misappropriated by a QI that does not provide insurance, it's your loss. Most highly rated U.S. banks provide insurance options to secure your funds, so it's good to keep that in mind when selecting a QI.

Do they have adequate fraud protection?

With wire fraud and cyber scams becoming more prevalent, bank wire transfers, particularly regarding real estate transactions where large sums of money are transferred, are increasingly targeted. Select a QI that has strong computer cyber security measures in place and stringent safety precautions for holding and transferring funds, as well as one that is financially secure.

How is the QI/financial institution rated?

There are many rating services that cover banks and other financial institutions. These services use a variety of criteria to assess a bank's financial condition. Check the rating services below (and others) to see how your QI/financial institution is rated.

A.M. Best Company: Rates U.S. banks and bank holding companies.

Bankrate, Inc.: Rates all U.S. federally insured banks, thrifts, and credit unions.

Bauer Financial, Inc.: Rates all federally-insured banks and credit unions.

FIS - Financial Information Systems, LLC: Rates U.S. banks, thrifts, credit unions, and bank holding companies.

Highline Financial LLC: Rates all U.S. federally insured banks, thrifts, credit unions and holding companies. Additional non-filing entities are also rated – via summed subsidiary data.

IDC Financial Publishing: Rates all FDIC-insured commercial banks and U.S. bank holding companies.

Is the QI audited by an independent third-party auditor?

Most banks are regularly audited by a third-party auditor. An independent audit enables investors to place a certain degree of trust in the integrity and accuracy of the financial statements issued by the reporting bank. Auditors follow a rigorous planning, testing and evidence gathering process and issue a report based on their findings. The type of opinion issued by the auditor will depend on whether the financial statements present fairly, in all material respects, the company's financial position, operational results and cash flows in accordance with the appropriate accounting standards.

Is the QI a member of the Federation of Exchange Accommodators (FEA)?

The FEA is a highly respected, reputable industry trade association. Check the FEA website to ensure that the QIs that you may be considering are members.

Successfully navigating a 1031 Exchange requires careful planning, attention to detail and a commitment to following the rules and regulations governing the process. By working with a reputable professional, staying organized and conducting thorough due diligence, investors can safeguard their 1031 Exchange funds and capitalize on the tax benefits while building a diversified real estate portfolio.

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