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Security of funds in an exchange: Federation of Exchange Accommodators requirements

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In most instances, successful completion of an IRC Section 1031 tax-deferred exchange requires the use of a Qualified Intermediary (QI). An experienced QI can significantly reduce the complexity of an exchange by assuring the proper execution of required documentation. More importantly, since the QI industry is not regulated nationally, the careful selection of a QI is critical to ensure the security of funds.

Perhaps as a result of the stressed economy, the QI industry has recently experienced several situations where a QI has not been able to produce exchange proceeds in a timely manner for its clients to purchase replacement property. Problems have ranged from QI liquidity issues to outright fraud and loss of exchange proceeds.

The QI's involved with these problems have shared several characteristics:

*The QI commingled their clients' exchange funds;

*The QI had full control over their clients' exchange funds;

*The QI invested clients' exchange funds in illiquid, high risk investments; and

*The QI had not been regulated in any way.

Most of these issues can be avoided by following best practices established by the Federation of Exchange Accommodators (FEA).

Federation of Exchange
Accommodators Requirements

The FEA code of ethics requires, among other things, that "Every Exchange Accommodator shall have the responsibility to act as a custodian for 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.

Every Exchange Accommodator 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:

*Exchange funds are knowingly commingled by the Exchange Accommodator with the operating accounts of the Exchange Accommodator; or

*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 a transfer or loan made to a financial institution which is the parent of or related to the Exchange Accommodator or to a transfer from an Exchange Accommodator to an EAT as required under the exchange contract; or

*Exchange funds are invested in a manner that does not provide sufficient liquidity to meet the Exchange Accommodator's contractual obligations to its clients and does not preserve the principal of the exchange funds.

Choosing the right

Qualified Intermediary

Choosing the right Qualified Intermediary (QI) to handle your exchange is probably the most important part of the exchange process. The QI should have demonstrable experience, expertise and references.

Most importantly, the QI should have the following security controls in place:

*The QI should deposit all clients' exchange funds in a segregated client account or subaccount under the client's tax ID number and in the name of the client;

*Each segregated account should require dual signatures of the client and a representative of the QI for the financial institution to release funds;

*The QI should be a regulated financial institution or a subsidiary thereof; and

*Funds should be deposited on the books of a FDIC-insured bank as a demand deposit.

Tax deferral under section 1031 is a terrific investment tool that has been in place for a long time. These recent developments have not changed that. However, they remind us that ensuring the security of exchange funds is the most important aspect of any exchange.

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