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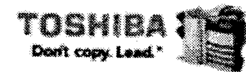

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Risky '1031s' Have Safeguards

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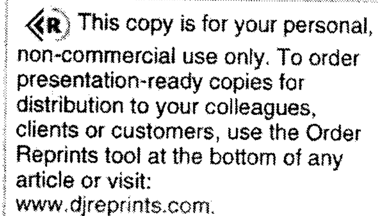

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By RACHEL EMMA SILVERMAN
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A popular tax strategy used by real-estate investors has gotten riskier, but there are steps you can take to help safeguard your money.

So-called 1031 exchanges allow participants to defer, or sometimes even avoid, capital-gains taxes when they quickly replace certain business or investment property they have sold with similar assets of equal or greater value.

But the deals, long subject to complex rules and deadlines, have recently faced new challenges. In the past few months, several companies that help facilitate the transactions, also known as like-kind exchanges, have drawn legal and regulatory scrutiny.

To comply with the tax laws, most 1031 exchanges use a middleman, called a "qualified intermediary," or QI. These intermediaries hold the proceeds of the sale until the new property is purchased. Qualified intermediaries should be independent -- they shouldn't be the seller's lawyer, tax adviser or broker.

The QI industry is largely unregulated, which means there are generally few rules on what a qualified intermediary can do with your money. (Only one state, Nevada, has any laws governing the industry.)

"In general, anyone can throw out a shingle and say that they are a QI," says Adam Handler, a principal and leader of the like-kind exchange tax-consulting services at PricewaterhouseCoopers in Los Angeles. In light of recent industry setbacks, some states are beginning to look at ramping up regulation.

One case involves 1031 Tax Group LLC, which filed for bankruptcy-court protection in New York on May 14. More than 300 investors across the country are owed an estimated $151 million by 1031 Tax Group, according to court filings. Another involves two qualified-intermediary companies, Southwest Exchange Inc., based in Henderson, Nev., and Qualified Exchange Services Inc., based in Santa Barbara, Calif. The companies allegedly misappropriated more than $95 million of customers' proceeds to fund other business and personal activities, according to a lawsuit brought this year by several investors and now in federal court in Los Angeles. (Lawyers for these companies didn't return calls seeking comment.)

Although troubles in the 1031 industry have so far been rare, there are some strategies investors can take to reduce the risk of their cash disappearing. For starters, experts recommend carefully

vetting the qualified intermediary. Ask about the company's history and its investment choices and avoid choosing a provider simply because it offers the lowest fees. (Fees for simple exchanges range from about $500 to $1,000.) Also request that the company provide regular statements so you can see how your money is performing.

While there are lots of very reputable independent qualified intermediaries, some investors might feel more comfortable with a QI that is affiliated with a large bank or title-insurance company, as those entities are less likely to enter a bankruptcy situation.

For added security, some experts also recommend setting up a "qualified escrow" or "qualified trust" account with the intermediary. By setting up such an account, you can segregate your money and designate how it is to be invested, rather than having your money be pooled with other accounts, explains Lou Weller, national director of like-kind exchange services at Deloitte Tax LLP in San Francisco. Such accounts, which require extra documentation and possible extra legal work, may cost an additional several hundred dollars, depending on the facilitator.

The Federation of Exchange Accommodators, a trade group for qualified intermediaries, requires background checks of all members except those that are subsidiaries of publicly traded parent corporations.

There are other things that investors need to watch out for. In deferred exchanges, the most common type of deal, sellers have 45 days to identify potential replacement properties and 180 days to complete the purchase of the new property. If the investor misses a deadline, the tax break is forfeited.

Only certain business and investment assets qualify for the exchanges. In general, say advisers, your personal residence or car isn't eligible for an exchange, but a rental apartment complex or a business jet generally is. Stocks, bonds or interests in partnerships or LLCs don't qualify for the tax break, nor does property that is held as inventory, such as houses built by a home builder that intends to sell them on completion.

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