

# EFUNDING COMMERCIAL REAL ESTATE INVESTMENT

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## What Investors in 2009 Should Know about 1031 Exchange Intermediaries Before It's Too Late.

By David V. Tran

Today many investors often exchange their investment properties to avoid paying federal and state capital gain taxes. This 1031 exchange often requires the involvement of a qualified intermediary or 1031 exchange company to avoid constructive receipt. Otherwise your transaction may not be qualified for 1031 tax-deferred exchange. The exchange company will keep all of the money from the relinquished property for up to 180 days while you are looking for a replacement property to complete the exchange. Many investors do not know these companies are in a business that is not regulated by both the Federal government and any of the 50 states. There have been petitions over the years to the Federal Trade Commission (FTC) to regulate the industry. However, the FTC declined the petition as recent as August of 2008. This means these exchange companies can use your money to invest in anything they want. They don't need to disclose where they invest, what they invest or the risks of their investments. On September 30, 2008 State of California passed Senate Bill 1007 which provided some consumer protections for 1031 exchange investors. This bill prohibits exchange companies in California from

1. Comingling exchange funds with the operating accounts of the company.
2. Investing exchange funds in the manner that does not provide sufficient liquidity or does not preserve the principal.

Occasionally there have been sad stories about exchange companies losing investors money in risky investments and then declaring bankruptcy. Investors can only recover a fraction of their money. On top of that, they may have to pay capital gain taxes because they do not complete the transaction within 180 days! For example:

- On November 26, 2008, Land

America 1031 Exchange Services, a subsidiary of LandAmerica, a major provider of title insurance company, [www.landam.com](http://www.landam.com), filed petitions for Chapter 11 bankruptcy protection. As a result, all open 1031 exchange accounts are put on hold.

- On December 15, 2008 Summit 1031 Exchange, [www.summit1031.com](http://www.summit1031.com), announced that it has ceased all funding of existing accounts. Its balances were less than the total amount of all the open accounts!

So how do you avoid being a victim? To answer this question, you will need to understand a little bit about the exchange business. Most exchange companies make money by charging a fee per transaction. They in turn invest your money somewhere with higher returns, pay you low .5-1% interests, and pocket the difference. This is how exchange companies normally make most of the profits. In the case of LandAmerica, it put much of the customers' money in high-yield auction-rate securities backed by federally-insured student loans. However, these securities have become very difficult to convert to cash due to the tight credit market. LandAmerica had to sell these securities for less than the value of the securities when the exchange customers need money to complete the exchange. As a result, it did not have enough money to cover its obligations and had to declare bankruptcy.

There are 3 main types of exchange companies:

1. Some exchange companies are just a division or subsidiary or an entity owned by an escrow or title insurance company. For example
  - First American Exchange



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Company (FAEC), [www.firstexchange.com](http://www.firstexchange.com) is a separate Limited Liability Company (LLC) owned by First American which is also in title & escrow business. FAEC occupies the same office and even has the same phone number as the First American Title office.

- Old Republic Exchange, [www.oreexo1031.com](http://www.oreexo1031.com), is a member of The Old Republic Title Insurance group.

2. Some banks also offer 1031 exchange services. For example:

- Wachovia Bank, [www.wachoviasecurities.com](http://www.wachoviasecurities.com).
- Bay Commercial Bank, [www.baycommercialbank.com](http://www.baycommercialbank.com).
- Comerica Bank, [www.comerica.com](http://www.comerica.com).
- Washington Mutual, [www.wamu.com](http://www.wamu.com). Note: as of December 2008, Wamu does not accept new customers and is looking for a buyer for this division.

3. Companies that specialize on 1031 exchange. They could be a mom-and-pop company or a franchise with offices in many states. For example:

- IPX, Inc. [www.ipx1031.com](http://www.ipx1031.com)
- Equity 1031, LLC; [www.equity1031.com](http://www.equity1031.com).
- Equity Preservation, Inc.; [www.equitypreservation.com](http://www.equitypreservation.com).

The fees charged by these companies vary from \$200 to \$750 per transaction. However there are different restrictions:

1. The company that charges low fee often does not pay interest on your fund or only pays interest if your fund is above a certain amount. If your sales proceed is significant, e.g. several hundred thousand dollars, you may save on the fee but may lose a significant amount on the interest payment.
2. Some companies may offer to pay savings account rate while another may pay higher money market rate. Some companies charge higher fee, e.g. First American Exchange charges \$750, but may allow you to make as many offers as you want. Each time your offer is accepted, the exchange has to review the contract, and wire the money to the seller's escrow account.

During the economic downturn many companies faced big losses and failed. You should choose an intermediary on 2 factors:

1. The most important factor is which company can provide safety, security and timely disbursements of your funds. When the amount of money is substantial, e.g. several million dollars, this is even more critical.
2. Fees, interest rates, and staff competency should be a distant secondary requirement.

To ensure your money is safe, you should ask the exchange company if:

1. Your money is FDIC-insured (Federal Deposit Insurance Corporation, a US government corporation created by Glass-Steagall Act of 1933). When it comes to deposit insurance of your bank accounts, FDIC insurance probably provides the best protection for your money. The account is

insured up to \$250K per customer. So if the exchange account is under both husband and wife's names, it's insured up to \$500K. When you have more than \$500K you want the bank to put your money in a Certificate of Deposit Account Registry Service, or CDARS account. Your money is deposited in multiple banks to be insured up to \$250K per customer per bank for up to \$50 Million. CDARS account is a CD account so you probably want a short term CD to make sure you don't pay penalty for early withdrawal. An intermediary may advertise that it carries \$100M in fidelity bond. However, this bond is intended to protect the company against theft or embezzlement, not investment losses. It may also say that your account is guaranteed by the assets of its publicly-traded parent company. However, this guaranty does not mean much if the company has more liabilities and debts than assets

2. Your money is deposited in the operating (comingled) account or separate account under your name. When the money is in the operating account, the exchange company can use it for anything; e.g. pay salary for its employees or invest in the stock market in China. In addition, the money in the operating account belongs to the company. Should the company declare bankruptcy, it's harder to prove whether the money in the account is your money. On the other hand, the separate account is your account to keep your money for your own use. Should the company declare bankruptcy, it's easier and faster to recover your money from your separate account. The fact your money is in a separate account does not make your money safer, just easier and faster to claim it's your money. Normally if you don't say anything, your money is deposited in a general account.

- The separate account is called trust account if the exchange company is a subsidiary or a division of a bank. The account name should be something like "John & Jane Smith Trust Account" with your tax ID. This trust account is regulated by the government and the exchange company cannot use money for its business.

- The separate account is called segregated account if the exchange company is a subsidiary or a division of a title company. The account is under your name and tax ID. This account is not regulated by the government. The exchange company can still invest in the way as other non-segregated accounts if you don't specify anything.

3. Where your money is invested, e.g. money market. Again, since this is an unregulated business, it does not need to provide you a prospectus and does not necessarily need to invest in where it says it does. If the money is invested outside the US in which you probably don't know anyway, there may be a delay from the time you request your money to the time you actually get it.

**Conclusion:** when you choose an exchange company, you should consider its fees, services, and most importantly the safety, security and timely disbursements of your funds. You should consider an exchange intermediary located in California in which your account is FDIC insured.