Failure of IRC §1031 Exchange Qualified Intermediary Highlights Risks and Is a Reminder of the Importance of Due Diligence When Selecting a Qualified Intermediary

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Related Services

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Failure of LandAmerica 1031 Exchange Services

LandAmerica 1031 Exchange Services Company, Inc. (LAE) filed bankruptcy on Friday, November 24, 2008, and has terminated operations. LAE issued a statement that the total value of its customers' IRC §1031 exchange funds is sufficient to cover the exchange account balances. The statement explains that a portion of customers' exchange funds were invested in now-illiquid auction rate securities and, due to the recent freeze in the credit markets, LAE has been unable to sell or borrow against the usually-liquid auction rate securities. Under the circumstances, LAE was forced to seek bankruptcy protection as it has been unable to meet the liquidity requirements created by its customers' withdrawal demands. The exchange funds are now frozen and claims must be filed with the bankruptcy court.

Because the exchange proceeds are frozen, customers in the middle of an IRC §1031 exchange with LAE as their Qualified Intermediary may be unable to complete their exchanges within the required exchange period. If so, the result is simple: a taxable transaction occurred when the relinquished property was sold. Consequently, LAE's customers who are unable to complete their exchanges will end up with a tax liability due to the failed exchange. Worse yet, the tax liability will arise in the tax year in which the relinquished property was sold, but customers may have no money to pay the tax since their exchange proceeds will likely be tied up in the bankruptcy proceedings.

If LAE's customers are unable to recover their exchange proceeds in full, they may be able to claim a loss deduction for the unrecovered amount. Any loss deduction will not help the current tax sting, however, as it would likely be available only after the bankruptcy proceedings are final-a later tax year than the year of the taxable sale.

Importance of Conducting Due Diligence When Selecting a Qualified Intermediary

LAE's failure is an important reminder of the importance of conducting due diligence when selecting a Qualified Intermediary. Taxpayers should review several Qualified Intermediaries and advisors should thoroughly research companies before proceeding with an exchange.

Most taxpayers would be reluctant to allow an investment advisor to manage their retirement funds without a thorough due diligence review of the advisor and his/her investment company. The same logic should apply when taxpayers park their IRC §1031 proceeds with a Qualified Intermediary and ask the Qualified Intermediary to facilitate a very complex transaction.

Generally, when performing due diligence, taxpayers should ask the Qualified Intermediary the following questions:

What is your financial condition?

Are you affiliated with a title insurance company? If so, are the exchange proceeds maintained in accounts separate and apart from the title insurance company? How many persons have access to the exchange funds, and how many signatures are required to access such funds? What is the financial condition of the affiliate title insurance company? Is a guarantee by the affiliate available?

What is the annual volume of exchanges you handle in terms of dollars?

Do you maintain a fidelity bond? If so, how much and with which insurance company? Does the bond cover theft, embezzlement or misappropriations? Is the bond coverage "per occurrence" or merely "in the aggregate?" Does the bond only cover the Qualified Intermediary or are the coverage limits shared with affiliates?

Do you perform background checks on your employees? Do you maintain employee theft insurance? If so, how much and with which insurance company? Does the insurance only cover the Qualified Intermediary or is the coverage shared with affiliates?

Do you maintain errors and omissions insurance? If so, how much and with which insurance company? Does the insurance only cover the Qualified Intermediary or is the coverage shared with affiliates?

What is the expertise of your staff? Are they attorneys, accountants, Certified Exchange Specialists, etc.? Do you have continuing staff training programs?

How long have you been in this line of business?

Has a qualified tax practitioner thoroughly reviewed your exchange documents?

Are you annually audited by an independent auditor? If so, who?

Additionally, the LAE bankruptcy highlights the importance of the liquidity of the exchange funds held by the Qualified Intermediary. Taxpayers should inquire as to the nature of the investments into which the Qualified Intermediary is investing the taxpayers' exchange funds. Taxpayers who are not comfortable with the liquidity of such investments should require the Qualified Intermediary to invest their exchange funds in one or more taxpayer-selected FDIC insured bank accounts at banks with which the taxpayer is comfortable.

Additional Information Regarding the LandAmerica Bankruptcy

LAE customers may obtain additional information about the bankruptcy as follows:

LandAmerica 1031 Bankruptcy Hotline: 212.728.3827

- U.S. Bankruptcy Court: www.vaeb.uscourts.gov
- (Case #08-35995 / Case: in re LandAmerica 1031 Exchange Services, Inc.)

LAE's Bankruptcy Counsel: McGuire Woods, 804.775.1144