

## Important Topics to Consider When Selecting a Qualified Intermediary for a 1031 Exchange

The Qualified Intermediary (“QI”), sometimes known as an accommodator or facilitator, is a critical part of a 1031 exchange. Choosing the right provider is key to executing a successful transaction.

In order to complete a 1031 exchange, an investor must not take “constructive receipt” of the proceeds from the sale of the relinquished property. Constructive receipt is a tax concept in which a taxpayer is liable for income, which may not have been physically received, but has been credited to the taxpayer’s account or otherwise becomes available for him or her to draw upon in the future. The QI is an entity (person or company) who, for a fee, acts to facilitate the 1031 exchange by entering into a contractual agreement for the exchange of properties, avoiding constructive receipt. Neither the taxpayer nor a “disqualified person” may serve as a QI.

A “disqualified person” is someone who is the agent of the exchanger at the time of the exchange. A person who has acted as the taxpayer’s employee, attorney, accountant, investment banker or broker, or real estate agent or broker, within the two-year period preceding the date of the transfer of the first relinquished property, is treated as an agent of the exchanger, and thereby a disqualified person. If an attorney has provided tax or legal services to the exchanger within the prescribed two-year period, the attorney is a disqualified person.

### The 1031 exchange QI is responsible for:

- preparing the 1031 exchange legal agreements and related transaction documents in order to properly structure the transaction;
- receiving, holding and safeguarding the 1031 exchange funds throughout the transaction; and
- advising, coordinating or consulting on the implementation of the 1031 exchange transaction to ensure compliance with the Internal Revenue Code, Treasury Regulations and related Revenue Rulings and Procedures.

A significant amount of care should be taken to select a QI because of the crucial role this entity plays in the administration the 1031 exchange transaction. This particular industry is unregulated and has some pitfalls that could put the investor at risk of a failed exchange, so it is advised not to simply select a QI with the lowest fees.

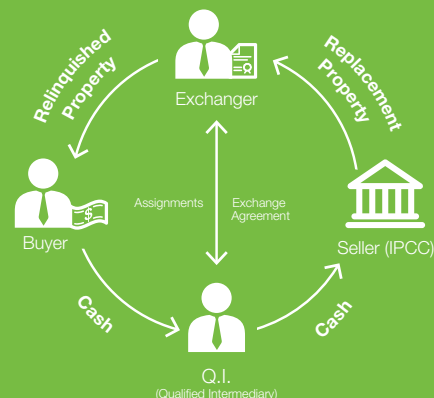
### Established and Experienced

The 1031 exchange process is involved and it takes a competent, well-established QI to provide services for an investor that comply with the requirements. Investors are advised to ensure the QI has many years of experience and understands the 1031 exchange requirements so they can easily guide clients through a transaction.

## How does a 1031 exchange work?

### There are three basic steps in any 1031 exchange:

- Exchanger sells property and proceeds are escrowed with a Qualified Intermediary.
- Qualified Intermediary transfers funds for purchase of replacement property.
- In an exchange that involves an investment in a Delaware statutory trust, exchanger receives beneficial interest in a Delaware statutory trust.



### **Policies, Procedures and Internal Audit Controls**

Detailed policies, procedures and internal audit controls are critical in minimizing the risk of loss to 1031 exchange funds and assets while being held by the QI. Established providers will have sophisticated processes that typically include multiple checks and balances to ensure the QI is taking into consideration the needs and interests of clients first.

### **Separate, Segregated Qualified Trust Accounts**

It is typical for an active QI to facilitate multiple 1031 exchanges simultaneously. That being said, it is important that the QI segregates the funds for each exchange into separate accounts that are held distinctly for the benefit of each individual exchanger. Segregated accounts guard the funds of the QI's clients in the event that a QI runs into financial difficulty or declares bankruptcy.

### **Safety of 1031 Exchange Funds**

Another important element is the protection of the 1031 exchange funds while being held and managed by the QI. Fidelity bonding safeguards against intentional wrongful acts, such as fraud, theft and forgery. A selected QI ought to maintain fidelity bonding from a reputable provider to transfer the risks associated with deliberate wrongful acts to another party.

### **Errors and Omissions**

QIs should maintain an errors and omissions (E&O) insurance policy from a reputable insurance provider. E&O insurance protects the 1031 investor and the QI from risks associated with actual or perceived errors and omissions performed by the QI during the exchange period. Although sophisticated internal controls and processes can minimize the risk of loss, mistakes are always possible.

It is always acceptable – and encouraged – for a potential client to request a copy of the QI's insurance policies, both E&O insurance and fidelity bonding, in order to verify the insurance underwriter, the policy limit, and policy term/expiration date, to ascertain whether the policies are sufficient. It is also important in regard to the fidelity bonding to

note whether the policy limit is “per occurrence” (applies to each individual incidence) or “in aggregate” (the total or maximum coverage available to investors for the 12 month policy period regardless of the number of losses).

While it is clear that QIs are essential to the 1031 exchange process, there are several considerations an investor must be aware of when selecting a QI for an exchange. In addition to complying with the IRS guidelines for completing a successful exchange, it benefits the investor to know what to look for in a QI to protect their capital and their tax-deferred status during the exchange process. Referring to the key components discussed here can help investors pick a QI that will not put their investment at undue risk.

## **5** Key Questions to Ask

- How many years have you been administering 1031 exchange transactions?
- Do you hold clients' 1031 exchange funds in a segregated Qualified Trust Account or a Qualified Escrow Account?
- Do you maintain fidelity bond insurance coverage?
- Do you maintain sufficient errors and omissions (E&O) insurance coverage?
- What type of processes and internal audit controls have you implemented to protect my 1031 exchange assets?

### **Important Risk Factors to Consider**

- No public market currently exists, and one may never exist, for the interests of any Inland Private Capital Corporation (IPCC)-sponsored program. The purchase of interests in any IPCC-sponsored program is suitable only for persons who have no need for liquidity in their investment and who can afford to lose their entire investment.
- IPCC-sponsored programs offer and sell interests pursuant to exemptions from the registration provisions of federal and state law and, accordingly, those interests are subject to restrictions on transfer.
- There is no guarantee that the investment objectives of any particular IPCC-sponsored program will be achieved.
- The actual amount and timing of distributions paid by IPCC-sponsored programs is not guaranteed and may vary. There is no guarantee that investors will receive distributions or a return of their capital.
- Investments in real estate are subject to varying degrees of risk, including, among other things, local conditions such as an oversupply of space or reduced demand for properties, an inability to collect rent, vacancies, inflation and other increases in operating costs, adverse changes in laws and regulations applicable to owners of real estate and changing market demographics.
- IPCC-sponsored programs depend on tenants for their revenue, and may suffer adverse consequences as a result of any financial difficulties, bankruptcy or insolvency of their tenants.
- IPCC-sponsored programs may own single-tenant properties, which may be difficult to re-lease upon tenant defaults or early lease terminations.
- Continued disruptions in the financial markets and challenging economic conditions could adversely affect the ability of an IPCC-sponsored program to secure debt financing on attractive terms and its ability to service that indebtedness.
- The prior performance of other programs sponsored by IPCC should not be used to predict the results of future programs.
- The IPCC-sponsored programs do not have arm's length agreements with their management entities.
- The IPCC-sponsored programs pay significant commissions and fees to affiliates of IPCC, which may affect the amount of income investors earn on their investment.
- Persons performing services for the managers of the IPCC-sponsored programs perform services for other IPCC-sponsored programs, and will face competing demands for their time and service.
- The acquisition of interests in an IPCC-sponsored program may not qualify under Section 1031 of the Internal Revenue Code of 1986, as amended (the “Code”) for tax-deferred exchange treatment.
- Changes in tax laws may occur, and may adversely affect an investor's ability to defer capital gains tax and may result in immediate penalties.
- The DST structure is inflexible and, in certain events, may be converted to a LLC structure, which would have a tax impact on investors.

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