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1031 Exchanges

How Investors are benefitting pg. 74

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PROFILE

Starker Services Inc.
www.starkerservices.com
Headquarters Los Gatos, Calif., and offices in 20 states
Services Independent qualified intermediary
Rochelle Stone, CEO "1031s have become a cornerstone of retirement planning and wealth transfer to future generations."

Starker Services is one of the nation's largest independent qualified intermediary companies.

EXTENSIVE EXPERTISE

Starker Services, an independent qualified intermediary, says 1031 exchanges are helping to efficiently facilitate real estate transfers.

Real estate purchases and exchanges have become big business in America. Once largely the domain of large corporations – or only very wealthy individuals with complex property arrangements – property acquisitions and sales have become a cornerstone of retirement planning and wealth transfer to future generations.

Today, the opportunities to participate in estate planning and management extend far down the economic ladder. Millions of Americans enjoy their piece of the real estate rock, with sizes and complexities of portfolios varying dramatically from the consortium-owned shopping center to the family owned duplex. And, with greater numbers of people turning to real estate as a mechanism for building wealth, a financial management industry that moves more than $200 billion worth of property each year has emerged as a player for facilitating these transfers efficiently, safely and inexpensively. This mechanism is known as the 1031 exchange.

INDUSTRY EVOLUTION

1031 exchanges have been part of the nation's tax code since 1921, but a U.S. Supreme Court case nearly 30 years ago made them an integral component of the nation's financial foundation. They provide a unique financial tool that allows the sale of property by an individual or company to leverage future purchases without paying taxes prematurely. With the increasing reliance upon real estate as a reliable means of wealth accumulation, it has become even more important for buyers and sellers to use appropriate experts to facilitate these specialized transfers.

The proliferation in the number of real estate transfers in recent years has led some investors to use their full-service banks or title companies for 1031 exchanges. In actuality, however, a unique category of exchange specialists has been operating for much longer than these institutions to assure facilitation of exchanges safely and at modest costs.

Qualified intermediaries – or "exchange accommodators" as they are sometimes called – represent a nimble arm of the real estate sector for individuals and institutions interested in leveraging the sale of property and other forms of ownership to acquisitions, while deferring tax responsibilities. Providing services similar to those offered by large banks and title companies as part of their larger operations, qualified intermediaries specialize in 1031 exchanges as their sole business enterprise, and therefore can apply their extensive expertise in a targeted manner.

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HOW 1031 EXCHANGES WORK

Originally conceived as a complicated way to place the proceeds of an investment property sale in neutral hands while securing another acquisition, 1031 exchanges are now used by millions of sellers and buyers. The number "1031" comes from a section in the Internal Revenue Service tax code, which was discussed in *Starker vs. U.S.*, a 1979 Supreme Court decision that determined the criteria for exchanges. As a result of the court's ruling, property owners may defer capital gains taxes from the profits of a sale if they identify property within 45 days of the sale, and purchase the property within a 180-day window, while the funds are held by a qualified, neutral third party.

1031 exchanges are phenomenal tools. They are used primarily as a means to move real estate investments; however, they can also be used for personal property that is used for business. The value of the new purchase must equal or exceed the value of the sale for the exchange to be fully tax deferred. Just as important, the process may be repeated with every sale until such time that the seller decides not to buy again. Only then will the investor be required to pay capital gains tax.

Let's say that someone purchased an office building for $200,000 in 1997 and is now about to sell it for $350,000 in 2007. After closing costs of $25,000, he has a profit of $125,000 that is subject to capital gains taxes. But instead of paying the taxes and reducing the size of the investment portfolio, he uses the entire amount – $325,000 – to buy another building, with the expectation of a larger profit down the road. By deferring the payment of taxes, the individual who employs the 1031 exchange has more money to leverage a larger investment, availing the opportunity of greater profits down the line. In other words, the 1031 exchange system allows the individual or company to keep more money in play.

The beauty of the 1031 exchange system is that it enables the investor to grow financial resources, rather than see some of those resources siphoned off prematurely in the form of capital gains taxes. It's similar to an individual rolling over an individual retirement account (IRA) in order to defer taxes, only in real estate with the qualified intermediary facilitating the transfer. All of this works if the investor completes the transaction within the 180-day window by having the qualified intermediary transfer to them a replacement property. That is why it is imperative for the investor to have a solid relationship with an exchange accommodator of unquestioned reputation and superior management skills.

ASSURING PROFESSIONALISM

Responsible qualified intermediaries take their fiduciary duties seriously. In 1989, several of these companies formed the Federation of Exchange Accommodators (FEA), which now has more than 330 members. With the maturation of the industry, the federation has developed standards for its members that include background checks, placement of client funds in independent FDIC-backed accounts, fiduciary performance bonds and multiple signature requirements for fund transfers. The FEA conducts member seminars on the latest changes in IRS regulations and court decisions, as well as legislative developments at the national and state levels.

To assure professionalism, integrity and sound fiscal management of its members, the FEA has created an expansive education program that includes professional training courses, continuing education seminars and a three-year program culminating with the award of a certified exchange specialist (CES) designation to participants who pass a rigorous industry examination. Applicants are eligible to take the CES examination only after working under the close supervision of experienced personnel for at least three years. Currently, 185 exchange accommodators operate with CES credentials. But, is this enough to protect an investor?

Earlier this year, two companies recently acquired by individuals with no industry experience jeopardized the funds of hundreds of investors who were in the midst of real estate transfers. Rather than abiding by the industry standard and place investor funds in independent accounts to assure prompt transparency and availability, these companies commingled proceeds with other funds. Further, they may have used investor funds for other purposes, an unacceptable industry practice and violation of the FEA Code of Ethics. Because they behaved in ways that jeopardized the

The opportunity to participate in estate planning and management has become big business for millions of Americans.

funds of their clients, the FEA Board of Directors suspended their memberships.

Even though qualified intermediary mistakes are few, all FEA members understand the importance of setting standards and monitoring the work of all exchange accommodators. Realizing that reputation is everything when it comes to financial management, industry members use FEA guidelines as the written word in their efforts to practice sound, conservative management for their clients.

LOOKING AT REGULATION

Some states are now considering regulations to further assure responsible qualified intermediaries. In June 2007, the Nevada legislature passed common sense standards that will require professional education, no commingling, rigorous accounting practices and bonding requirements. Other states, including California, have held hearings on a best-practices approach to the exchange accommodator industry. Idaho and Montana are also considering similar legislation.

FEA representatives of leading exchange accommodator companies have offered testimony and guidance with these legislative inquiries to help provide information on industry standards, problem areas, and ways to monitor practitioners in the field as well as fraudulent behavior, all as part of a rigorous effort to protect consumers. Most qualified intermediaries support this approach as a welcome step to help them safeguard the assets of their valued clients.

HOW THE BUYER SHOULD ALWAYS BEWARE

Beyond professional associations, self-monitoring and possible state legislation, the recent troubles of two exchange accommodators reminds us of a tried and true refrain: Investors should always be vigilant in checking out financial opportunities, whether the investment is stock, real estate, life insurance, a banking relationship, a 1031 exchange or any other deal. To that end, investors should go by the following guidelines:

- Ask people with similar investments who they trust about the services of their exchange accommodator. Were their questions always answered? Did they get prompt and accurate service?
- Get references for the exchange accommodator you have in mind. Any successful business should be more than willing to provide references, and that includes qualified intermediaries, or exchange accommodators.
- Find out whether the qualified intermediary is a FEA member in good standing. If that is the case, you will be working with a company who is part of a national professional organization concerned with education and the rigorous standards of the FEA for qualified intermediaries.
- Most of all, investors must do due diligence on the management practices of recommended, qualified intermediaries. The more experience with 1031 exchanges, the better.

More than anything, sound businesses rely upon reputation as the key to their continued successes. That reputation comes from following through day after day, with client after client, in exchange after exchange. But there is another side, as well. By being thorough in their research, investors will be more knowledgeable about their decisions and a lot more comfortable about how their financial affairs are being managed. This is the basis of the partnership between investors and qualified intermediaries, and the foundation of a well-managed financial portfolio.

Rochelle Stone, CES, *is CEO of Starker Services, one of the nation's largest independent qualified intermediary companies. She is co-author of* Real Estate Exchange: Using Tax-Deferred Exchange in Real Estate Investment Management *(Probus Professional Publishers). She has written articles in real estate magazines, testified before state legislative committees and teaches courses on the 1031 exchange process.*

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