



Your Choice for §1031 Exchange Properties

Senate Bill 1007: A Good Start on Regulations for 1031 Exchanges

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After reading the draft of the proposed legislation by State Senator Michael Machado, D-Stockton, he has proposed that two new regulations be instituted:

- 1) A Fidelity bond in the amount of \$1,000,000 or deposit an amount of cash or securities in an amount determined by the commissioner but not less than \$1,000,000
- 2) Maintain an E&O policy in an amount determined by the commissioner but not less than \$250,000 or deposit cash of not less than \$250,000.

For the purpose of discovering violations, the commissioner may at any time, but not less than every 3 years, examine the books, records and files of every person engaged in the business of an exchange facilitator. The commissioner may revoke or suspend the license of a licensee for various infractions of 7 itemized rules.

Although the above is a start, it doesn't cover the most basic concerns of an individual in the process of an exchange. The most critical piece of an exchange is the timing of identifying a replacement property for the investors existing rental property. The new regulations must contain provisions to ensure that the investors funds will be available to complete the funding at the close of escrow when needed. Investors must identify a replacement property within 45 days of the close of escrow of their rental property and then have the proceeds available to close on the replacement property. Sometimes this all may occur before the end of the 45 day ID period. Major title companies currently pledge their whole net worth behind this transaction and guarantee the close. If the investor doesn't meet this deadline, the whole gain, including recapture of depreciation, is taxable. The IRS has NO exceptions to this rule.

A fidelity bond, in my opinion, is of very little value in most cases. A fidelity bond may return the investors money but not in time to meet the strict IRS rules for closing on the replacement property. Also, a fidelity bond for \$1,000,000 is too small. Many exchanges are far in excess of this amount and if there are a group of investors who lose money, the fidelity bond goes into the pool of money and investors get their proportionate share. For example, if 20 investors are involved with a firm who loses their money and is controlling \$10,000,000, the \$1,000,000 bond will only return 10% of investors money. In the same way the E&O policy is not nearly enough to cover these transactions.

A new law should have much more stringent penalties as we are usually talking about investors retirement money and a substantial portion of their net worth. I would recommend substantial monetary damages as well as jail time for offenders in this type of offense.

The uncertainty in the business of real estate exchanges is a major detriment to all levels of the economy. Investors hold back because of the fear of losing money resulting in the slowing of the

real estate market. Realtors and Financial advisors lose business because of the slowdown and finally governments lose revenue because no new sales result in flat property tax revenue instead of a continuing increase.