

## State guidelines proposed for 1031 tax exchanges

By Katherine Conrad

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If a bill currently winding its way through the state Senate had been law even a year ago, Bay Area investors would not have lost millions of dollars when they entrusted their money to 1031 Advance of San Jose.

The bill, SB 1007, introduced by state Sen. Michael Machado, D-Stockton,, and scheduled to get its first hearing Wednesday, would impose guidelines on an industry that handles tens of thousands of transactions every year and yet has operated under the radar for decades.

Named after the IRS tax code that permits such transactions, 1031 exchanges allow investors to defer paying taxes on property they buy and sell as long as the transactions occur within a 180-day time span and the funds are placed with a so-called "exchange facilitator."

Despite the fact that these facilitators handle large sums of money, they're not regulated either at the state or federal level, except in Nevada and recently Idaho. Investors choose an unregulated facilitator over a bank, accountant or title company - all of which are regulated - because the facilitator is cheaper.

"Personally I went through a 1031 exchange and I did not give a second thought to the qualifications of the person doing it," Machado said. "Then when I read about the abuses that could happen, it scared me. We're trying to plug those holes."

If SB 1007 becomes law, California would become only the third state to regulate the industry that many believe should be regulated at the federal level since so many transactions occur across state lines.

The bill, to be heard before the Senate's Banking, Finance and Insurance Committee, seeks to require exchange facilitators to purchase \$250,000 in errors and omissions insurance; purchase a \$1 million fidelity bond; agree to a set of principles forbidding stealing from or misleading clients; and to refrain from commingling funds with those of their clients. Violation of SB 1007 is grounds for a civil lawsuit.

"The gist is you've got to prove you've got the financial capacity to engage in this business," Machado said. "This bill corrects a loophole to make (rules governing exchange facilitators) consistent with the same type of fiduciary responsibility that you would place on any other agent providing financial services."

The bill is in response to the bankruptcy filing by 1031 Tax Group, based in Richmond, Va., in May, after authorities say founder Edward Okun allegedly stole about \$151 million from 300 clients' property sales nationwide. Dozens of Bay Area investors are still out millions of dollars after they entrusted their money to one of the company's affiliates, San Jose-based 1031 Advance.

The crisis prompted Machado to introduce his bill in May. In August, Rep. Zoe Lofgren, D-San Jose, introduced the 1031 Regulation Act of 2007, which would require facilitators in a 1031 exchange to be insured by the Federal Deposit Insurance Corp. or the Federal Credit Union Act.

Dennis Helmick, who runs Exchange Facilitator in Seattle and who helped Nevada draft its law, called Machado's bill a "real step forward."

"Essentially, it's a bill to define good practices. It sets forth a standard of conduct by which a qualified intermediary's work will be judged," Helmick said.

Machado said he hopes the bill would go to the Assembly sometime in the spring and then to the governor's desk for the hoped-for signature.

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Contact Katherine Conrad at [kconrad@mercurynews.com](mailto:kconrad@mercurynews.com) or (408) 920-5073.