

The NATIONAL EXCHANGER

1031

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April 2009



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Convictions and Recoveries for prior §1031 Exchange Nightmares

By James I. Miller, Esq., Vice President, Regional Manager, IPX1031®

2007 was a very bad year for investors who failed to conduct some basic due diligence on the Qualified Intermediaries they used to facilitate their §1031 exchanges. In that year there were two major misappropriations of §1031 exchange funds creating a combined loss of nearly a quarter of a billion dollars. In January 2007, the owner of Southwest Exchange (a Qualified Intermediary based in Henderson, Nevada) is alleged to have used investor's funds to support a lavish lifestyle and an attempt to take a breast implant company public. When Southwest closed its doors, investors had lost in excess of \$97 million.

A few months later, The 1031 Tax Group and 15 of its subsidiaries filed bankruptcy in the Southern District of New York. It was alleged that the owner, Edward Okun also used §1031 funds to support a lavish lifestyle and on failed real estate developments without the knowledge or consent of the investors. The resulting losses are estimated at \$132 million. In 2008, he was charged with multiple felony counts, including wire and mail fraud, money laundering, currency smuggling and perjury before US Bankruptcy Court.

In both situations, the owners were conducting "Ponzi" schemes for their personal benefit instead of properly safeguarding the money entrusted to them.

Within the past few months, both of these cases have made their way through the legal system (one in criminal court and the other in civil court).

In mid March 2009, Edward Okun was convicted of 23 felony counts and faces a maximum of 400 years in prison

when he is sentenced in August 2009. As a consequence, it is very likely that he will spend his remaining days on earth in prison.

In January 2007 legal settlements were reached with more than 130 clients to recover \$91.7 million of the \$97.5 million lost in the collapse of Southwest Exchange. While it is very positive that the investors will receive over 94% of the money taken from them they still have losses. Since they did not have a successful §1031 exchange, they had to pay capital gain tax on the sale of their relinquished property.

As a result of these defalcations and other losses, many investors and their tax advisors have wondered if they should take the "risk" of doing a §1031 exchange. Some attorneys and accountants have taken the position that their clients should not do a §1031 exchange but instead pay the taxes. Personally, I believe this blanket approach borders on malpractice. There are many factors involved and a "one size fits all" approach may not be in the best interest of an individual client. Although there are situations in which a taxpayer should not do a §1031 exchange (carry forward losses, wanting to exit real estate, etc.), the benefits of a §1031 exchange remain valid and if somebody conducts basic due diligence, risk is minimized (if not eliminated). It is much better to reinvest all of your equity rather than just the "after tax equity."

Any person considering a §1031 exchange should ask the potential Qualified Intermediary a few questions:

- 1) Do you have a guarantee of funds? If yes, who is it from and is the guarantor profitable and solvent;

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- 2) Do you have a fidelity bond and are you insured for errors and omissions? Verification of insurance is available by obtaining a Certificate of Insurance which is issued by an independent third party (the authenticity of which can be verified by them);
- 3) How are the exchange funds invested? Since the funds must be liquidated in a short period of time, they must be invested in a manner that is both liquid AND secure; and
- 4) Does the Exchange Agreement require the written authorization of the exchanger to disburse funds? It is important that the exchanger knows when and how the exchange funds are disbursed.

In addition, if the Qualified Intermediary is a publicly traded company (or a subsidiary of one) then federal laws commonly known as "Sarbanes-Oxley" require annual audits and a financial transparency that is not available for privately held entities. If the Qualified Intermediary is reluctant to provide any requested information, then the investor should be concerned. Security of funds is, and should be, an open book; if you are not comfortable, consider this a "red flag!"

When selecting a Qualified Intermediary, many factors should be taken into account. But of all of these, the two most critical factors for evaluation are: safety and security of exchange funds; and competency of the staff. If properly trained in the legal requirements of the §1031 regulations, there is no reason that a successful deferral of taxes cannot occur.

Jim Miller is the attorney manager of the Southwest Region for Investment Property Exchange Services, Inc. (IPX1031®). IPX1031®, a Qualified Intermediary, is the national leader in §1031 tax deferred exchange transactions and a subsidiary of Fidelity National Financial, Inc.