



Dora
Department of Regulatory Agencies

Office of Policy, Research and Regulatory Reform

2008 Sunrise Review: Qualified Intermediaries

January 4, 2008



STATE OF COLORADO

DEPARTMENT OF REGULATORY AGENCIES
Office of the Executive Director

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Bill Ritter Jr.
Governor

January 4, 2008

Members of the Colorado General Assembly
c/o the Office of Legislative Legal Services
State Capitol Building
Denver, Colorado 80203

Dear Members of the General Assembly:

The mission of the Department of Regulatory Agencies (DORA) is consumer protection. As a part of the Executive Director's Office within DORA, the Office of Policy, Research and Regulatory Reform seeks to fulfill its statutorily mandated responsibility to conduct sunrise reviews with a focus on protecting the health, safety and welfare of all Coloradans.

DORA has completed its evaluation of the sunrise application for regulation of Qualified Intermediaries and is pleased to submit this written report. The report is submitted pursuant to section 24-34-104.1, Colorado Revised Statutes, which provides that DORA shall conduct an analysis and evaluation of proposed regulation to determine whether the public needs, and would benefit from, the regulation.

The report discusses the question of whether there is a need for regulation in order to protect the public from potential harm, whether regulation would serve to mitigate the potential harm, and whether the public can be adequately protected by other means in a more cost-effective manner.

Sincerely,

A handwritten signature in black ink, appearing to read "D. Rico Munn".

D. Rico Munn
Executive Director

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The Sunrise Process

Background

Regulation, when appropriate, can serve as a bulwark of consumer protection. Regulatory programs can be designed to impact individual professionals, businesses or both.

As regulatory programs relate to individual professionals, such programs typically entail the establishment of minimum standards for initial entry and continued participation in a given profession or occupation. This serves to protect the public from incompetent practitioners. Similarly, such programs provide a vehicle for limiting or removing from practice those practitioners deemed to have harmed the public.

From a practitioner perspective, regulation can lead to increased prestige and higher income. Accordingly, regulatory programs are often championed by those who will be the subject of regulation.

On the other hand, by erecting barriers to entry into a given profession or occupation, even when justified, regulation can serve to restrict the supply of practitioners. This not only limits consumer choice, but can also lead to an increase in the cost of services.

There are also several levels of regulation. Licensure is the most restrictive form of regulation, yet it provides the greatest level of public protection. Licensing programs typically involve the completion of a prescribed educational program (usually college level or higher) and the passage of an examination that is designed to measure a minimal level of competency. These types of programs usually entail title protection – only those individuals who are properly licensed may use a particular title(s) – and practice exclusivity – only those individuals who are properly licensed may engage in the particular practice. While these requirements can be viewed as barriers to entry, they also afford the highest level of consumer protection in that they ensure that only those who are deemed competent may practice and the public is alerted to those who may practice by the title(s) used.

Certification programs offer a level of consumer protection similar to licensing programs, but the barriers to entry are generally lower. The required educational program may be more vocational in nature, but the required examination should still measure a minimal level of competency. Additionally, certification programs typically involve a non-governmental entity that establishes the training requirements and owns and administers the examination. State certification is made conditional upon the individual practitioner obtaining and maintaining the relevant private credential. These types of programs also usually entail title protection and practice exclusivity.

While the aforementioned requirements can still be viewed as barriers to entry, they afford a level of consumer protection that is lower than a licensing program. They ensure that only those who are deemed competent may practice and the public is alerted to those who may practice by the title(s) used.

Registration programs can serve to protect the public with minimal barriers to entry. A typical registration program involves an individual satisfying certain prescribed requirements – typically non-practice related items, such as insurance or the use of a disclosure form – and the state, in turn, placing that individual on the pertinent registry. These types of programs can entail title protection and practice exclusivity. Since the barriers to entry in registration programs are relatively low, registration programs are generally best suited to those professions and occupations where the risk of public harm is relatively low, but nevertheless present. In short, registration programs serve to notify the state of which individuals are engaging in the relevant practice and to notify the public of those who may practice by the title(s) used.

Finally, title protection programs represent one of the lowest levels of regulation. Only those who satisfy certain prescribed requirements may use the relevant prescribed title(s). Practitioners need not register or otherwise notify the state that they are engaging in the relevant practice, and practice exclusivity does not attach. In other words, anyone may engage in the particular practice, but only those who satisfy the prescribed requirements may use the enumerated title(s). This serves to indirectly ensure a minimal level of competency – depending upon the prescribed preconditions for use of the protected title(s) – and the public is alerted to the qualifications of those who may use the particular title(s).

Licensing, certification and registration programs also typically involve some kind of mechanism for removing individuals from practice when such individuals engage in enumerated proscribed activities. This is generally not the case with title protection programs.

As regulatory programs relate to businesses, they can enhance public protection, promote stability and preserve profitability. But they can also reduce competition and place administrative burdens on the regulated businesses.

Regulatory programs that address businesses can involve certain capital, bookkeeping and other recordkeeping requirements that are meant to ensure financial solvency and responsibility, as well as accountability. Initially, these requirements may serve as barriers to entry, thereby limiting competition. On an ongoing basis, the cost of complying with these requirements may lead to greater administrative costs for the regulated entity, which costs are ultimately passed on to consumers.

Many programs that regulate businesses involve examinations and audits of finances and other records, which are intended to ensure that the relevant businesses continue to comply with these initial requirements. Although intended to enhance public protection, these measures, too, involve costs of compliance.

Similarly, many regulated businesses may be subject to physical inspections to ensure compliance with health and safety standards.

Regulation, then, has many positive and potentially negative consequences. Colorado law, section 24-34-104.1, Colorado Revised Statutes (C.R.S.), requires that individuals or groups proposing legislation to regulate any occupation or profession first submit information to the Department of Regulatory Agencies (DORA) for the purposes of a sunrise review. The intent of the law is to impose regulation on occupations and professions only when it is necessary to protect the public health, safety or welfare. DORA must prepare a report evaluating the justification for regulation based upon the criteria contained in the sunrise statute:¹

(I) Whether the unregulated practice of the occupation or profession clearly harms or endangers the health, safety, or welfare of the public, and whether the potential for the harm is easily recognizable and not remote or dependent upon tenuous argument;

(II) Whether the public needs, and can reasonably be expected to benefit from, an assurance of initial and continuing professional or occupational competence; and

(III) Whether the public can be adequately protected by other means in a more cost-effective manner.

Any professional or occupational group or organization, any individual, or any other interested party may submit an application for the regulation of an unregulated occupation or profession. Applications must be accompanied by supporting signatures and must include a description of the proposed regulation and justification for such regulation.

Methodology

DORA has completed its evaluation of the proposal for regulation of Qualified Intermediaries. During the sunrise review process, DORA performed a literature search, contacted and interviewed representatives of the Federation of Exchange Accommodators, reviewed licensure laws in Nevada, attempted to interview the administrator of that program, interviewed members of the Colorado Realtors Association, and attempted to contact representatives of the Colorado Bar Association.

¹ § 24-34-104.1(4)(b), C.R.S.

Profile of the Profession

A Qualified Intermediary (QI) (also known as an Exchange Facilitator) is a neutral third party who assists a property owner in deferring capital gains tax, to be paid to the Internal Revenue Service (IRS), by holding the sale proceeds of an investment property, then transferring the funds for the purchase of a new investment property.

The investment property owner is required to purchase a “like-kind” investment property in order to qualify to defer capital gains tax. In the aforementioned transaction, the QI acts as a safe harbor for a person who sells an investment property. In other words, the QI safely shields the investment property funds from capital gains tax.

This process is called a 1031 exchange, which refers to the section of the IRS tax code that enables it. As outlined in the IRS tax code, the seller of an investment property(ies) cannot be in control (constructive receipt) of the funds from the property that has been sold. If an investment property owner complies with the parameters outlined above, the transaction qualifies as a 1031 exchange.

Additionally, in order for a 1031 exchange to avoid capital gains tax, two major rules must be followed:²

- The total purchase price of the replacement “like-kind” property must be equal to, or greater than the total net sale price of the relinquished, investment property.
- All the equity received from the sale of the relinquished investment property must be used to acquire the replacement, “like-kind” property.

A “like-kind” investment is a property(ies) of the same nature or character, regardless of whether or not it differs in grade or quality.³ It is important to note that “like-kind” does not mean that a person who sells property is required to purchase the same exchange property. There are currently two types of property that qualify as “like-kind”:

- Property held for investment; and
- Property held for a productive use, as in a trade or business.

² 1031 Exchange Made Simple. *1031 Exchange – Considering A Tax Deferred “1031 Exchange?”* Retrieved November 2, 2007, from <http://www.1031exchangemadesimple.com/>

³ 1031 Exchange Made Simple. *Frequently Asked Questions on 1031 Exchanges.* Retrieved November 2, 2007, from <http://www.1031exchangemadesimple.com/1031-faq.html>

An example of a property held for investment is as follows. A person owns a duplex that was purchased in 1986 and it has served as a rental property since the time it was purchased. The person sells the duplex and purchases a condominium in another state to be used as a rental property.⁴

This example illustrates an investment property owner who sold one kind of property (a duplex) and purchased a different kind of property (a condominium). As long as the new property is held for investment, the transaction qualifies for a 1031 exchange.

Additionally, examples of exchanges of property of a “like-kind” for productive use are outlined in section 1031 of the IRS tax code. Specifically, section 1031(c)(1) within the IRS tax code states:

An investment property owner exchanges property held for productive use in his trade or business, together with cash, for other property of “like-kind” for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose.

The following types of property do not qualify for a 1031 exchange:⁵

- Stocks;
- Bonds;
- Partnership or Limited Liability Company interests;
- Personal residences; and
- Stock in trade or inventory.

In a 1031 exchange, the QI is responsible for performing the following activities:⁶

- Acquiring the relinquished investment property from the property owner;
- Transferring the relinquished investment property to the buyer;
- Acquiring the replacement real investment from the seller; and
- Transferring the replacement investment property to the buyer.

⁴ SB&OH Exchange Accommodators, LLC. *1031 Exchange Handbook*. Retrieved November 9, 2007, from http://www.sbohexchange.com/default_print.cfm?pageid=23

⁵ AllStates1031 Exchanges. *Frequently Asked Questions*. Retrieved on November 10, 2007, from <http://www.allstates1031.com/1031-exchanges/1031-exchanges-faqs.php#6>

⁶ 1031 Exchange Made Simple. *1031 Exchange Accommodators and Qualified Intermediaries (QI)*. Retrieved November 2, 2007, from <http://www.1031exchangemadesimple.com/intermediary.html>

In order to avoid capital gains tax on the sale of an investment property, the investment property owner must adhere to the timelines required in section 1031 of the IRS tax code. The first deadline is the 45-day identification period. This is the crucial period during which the party selling a property must identify other replacement properties that the property seller wishes to buy.⁷

The identified properties are not necessarily property(ies) that the investment property owner intends to buy, but merely properties that the investment property owner is interested in.⁸ By the 45th day after an investment property owner sells his or her investment property, the investment property owner must provide a list of potential replacement properties to someone involved in the 1031 exchange. This could be the title company or escrow agent, but is typically the QI who facilitated the 1031 exchange.⁹ The seller of the property can identify up to three potential properties without regard to the value of the properties on the list.¹⁰

If the seller wishes to identify more than three potential replacements, the IRS requires that the total value of everything identified be less than double the value of the property or properties sold.¹¹ This is commonly known as the 200 percent rule.

If an investment property owner submits a list of prospective properties to the QI after the 45-day timeframe, the proceeds from the 1031 exchange must be returned from the QI to the investment property owner and the sale of the investment property does not meet the requirements for a tax deferred 1031 exchange. If such occurs, the investment property owner will be required to pay capital gains tax to the IRS.

Additionally, the IRS requires investment property owners to close on a replacement property within 180 days (of the investment property owner closing on the sale of his or her investment property). If the investment property owner fails to comply with the 180-day requirement, the sale of the old investment property no longer qualifies as a 1031 exchange, and is subject to capital gains tax.

There are several different varieties of 1031 exchanges that QIs facilitate, including:

- Forward or Straight;
- Consolidation;
- Diversification;
- Reverse;
- Construction; and
- Improvement.

⁷ 1031 Exchange Made Simple. *1031 Exchange – Considering A Tax Deferred “1031 Exchange?”* Retrieved November 2, 2007, from <http://www.1031exchangemadesimple.com>

⁸ Gorman, G. (2005). *Exchanging Up!* SuccessDNA. p.21.

⁹ Gorman, G. (2005). *Exchanging Up!* SuccessDNA. p.22.

¹⁰ SB&OH Exchange Accommodators, LLC. *1031 Exchange Handbook*. Retrieved on November 9, 2007, from http://www.sbohexchange.com/default_print.cfm?pageid=24

¹¹ SB&OH Exchange Accommodators, LLC. *1031 Exchange Handbook*. Retrieved on November 9, 2007, from http://www.sbohexchange.com/default_print.cfm?pageid=24

Forward or Straight exchanges entail a property owner selling his or her investment property and purchasing a new investment property.¹² For example, an investment property owner sells his or her duplex and buys a new office building.¹³ In this example, the QI receives the funds at the closing of the duplex and holds the funds for the seller until the seller closes on the new office building. At that time, the QI will send, often by electronic transfer, the funds to the closing agent, who in turn, delivers the deed to the seller.

Consolidation exchanges occur when an investment property owner sells more than one investment property and purchases one investment property. For example, an investment property owner owns 10 rental houses. The investment property owner chooses to sell all 10 properties and purchase a single property. He or she is consolidating the number of investment properties he or she owns; therefore, participating in a consolidation exchange.

Diversification exchanges are the antithesis of consolidation exchanges. A diversification exchange seeks to expand the number of investment properties for an investment property owner. For example, an investment property owner has one large rental property and sells the property and buys 10 smaller rental properties. As long as the 10 smaller rental properties are equal to or larger than the total net sale price of the relinquished property, it would qualify as a 1031 exchange.

Reverse exchanges occur when the replacement property is purchased first and the sale of the relinquished property occurs afterwards.¹⁴ Reverse exchanges are often used to make improvements to replacement property before transferring it to the buyer.¹⁵

Construction exchanges occur when an investment property owner sells his or her old property and uses part of the proceeds to buy a piece of bare land and the balance of the proceeds to build a structure on the property.¹⁶

Improvement exchanges are the final type of 1031 exchange. Improvement exchanges are similar to a construction exchange. An improvement exchange occurs when an investment property owner sells his or her old investment property and, in turn, uses a portion of the proceeds to buy a structure that needs improvements and the balance of the proceeds to pay for the improvements.¹⁷

¹² Gorman, G. (2005). *Exchanging Up!* SuccessDNA. p.4.

¹³ Gorman, G. (2005). *Exchanging Up!* SuccessDNA. p.4.

¹⁴ Exchange Guide – Info Guide to the 1031 Tax Exchange for Real Estate. *1031 Exchange Glossary*. Retrieved December 12, 2007, from <http://www.1031exchangeguide.com/1031-exchange-glossary.htm>

¹⁵ Exchange Guide – Info Guide to the 1031 Tax Exchange for Real Estate. *1031 Exchange Glossary*. Retrieved December 12, 2007, from <http://www.1031exchangeguide.com/1031-exchange-glossary.htm>

¹⁶ Gorman, G. (2005). *Exchanging Up!* SuccessDNA. p.5.

¹⁷ Gorman, G. (2005). *Exchanging Up!* SuccessDNA. p.5.

Additionally, the QI in a 1031 exchange is responsible for ensuring that the following documentation is in place before the property that the investment property owner is selling closes:

- The exchange agreement;
- An assignment; and
- The notice.

The exchange agreement is a contract between the QI and the client that outlines the rules which must be followed in order to complete the 1031 exchange.¹⁸ The exchange agreement also includes fees the QI charges in a 1031 exchange (typically between \$500 and \$1,000).

The assignment of the sales contract to the QI must also be in place because in order for the client to avoid capital gains tax, the QI must technically sell the property.¹⁹ The assignment documentation enables the QI to receive the proceeds on behalf of the seller of the property.

The notice documentation advises the other side of the transaction (the buyer of the property) that the transaction is a 1031 exchange.²⁰ The purpose of notification to the other party is to prove that the 1031 exchange was in place at closing.²¹

The QI profession is largely unregulated. However, the IRS clearly delineates who cannot act as a QI in a 1031 exchange. Persons who are disqualified from acting as a QI are:²²

The investment property owner's spouse, siblings, ancestors, descendants, employees, attorney, accountant, investment banker, realtor or broker who has provided a service in a two-year period prior to the transfer date of the first relinquished property.

¹⁸ How to Select a Section 1031 Qualified Intermediary. Retrieved September 19, 2007, from http://www.ree.com/ree/articles/article.asp?article_id=21&PrintMode=true

¹⁹ How to Select a Section 1031 Qualified Intermediary. Retrieved September 19, 2007, from http://www.ree.com/ree/articles/article.asp?article_id=21&PrintMode=true

²⁰ How to Select a Section 1031 Qualified Intermediary. Retrieved September 19, 2007, from http://www.ree.com/ree/articles/article.asp?article_id=21&PrintMode=true

²¹ How to Select a Section 1031 Qualified Intermediary. Retrieved September 19, 2007, from http://www.ree.com/ree/articles/article.asp?article_id=21&PrintMode=true

²² 1031 Accommodators, LLC. *FAQ The "How To" of Real Property Exchanges*. Retrieved December 7, 2007, from <http://www.freec.net/FAQ.html>

Current Federation of Exchange Accommodators Certification Program

The Federation of Exchange Accommodators (Applicant) is a national trade association organized to represent professionals who conduct 1031 exchanges.²³

The Applicant offers a certification program for QIs. The certification program, Certified Exchange Specialist (CES), is designed to provide a baseline for competency for QIs. This is illustrated in the CES Candidate Bulletin of Information, which outlines the purposes of the CES program, including:²⁴

- Establish nationally recognized standards of knowledge for exchange specialists;
- Assess the level of knowledge demonstrated by exchange specialists in a valid and reliable manner;
- Encourage professional development in the exchange accommodation field;
- Formally recognize professional individuals who meet the requirements set by the Applicant; and
- Serve the public by encouraging quality section 1031 exchange services.

In order to qualify to receive a CES certification by the Applicant, a candidate must pass an examination. The examination is a single, two and one-half hour session, consisting of 120 multiple-choice questions.²⁵ The examination consists of four content areas, including:²⁶

- Exchange procedures;
- Third-party relationships;
- Legal, compliance and technical issues; and
- Ethical and professional standards.

²³ Federation of Exchange Accommodators. Professional Trade Association of Qualified Intermediaries Under IRS section 1031. Retrieved December 12, 2007, from <http://www.1031.org>

²⁴ Federation of Exchange Accommodators. *CES 1031 Candidate Bulletin of Information*. (2007). p.5.

²⁵ Federation of Exchange Accommodators. *CES 1031 Candidate Bulletin of Information*. (2007). p.8.

²⁶ Federation of Exchange Accommodators. *CES 1031 Candidate Bulletin of Information*. (2007). p.9-11.

The Applicant requires candidates to meet the following requirements in order to apply to sit for the CES examination:²⁷

- Must have earned a high school diploma or General Educational Development.
- Must have a minimum of three years out of the past seven of full-time equivalent work experience at a Qualified Escrow, Trust or Intermediary Company as defined below.
 - A Qualified Escrow, Trust or Intermediary company, as defined under Treasury Regulation Section 1.1031(k)-1(3) and (4), is any sole proprietorship, partnership, limited liability company, trust, corporation, association, or any other going concern whose primary business is that of facilitating like-kind exchanges under IRS tax code Section 1031 and the Treasury Regulations promulgated thereunder.
- Must not have any prior felony convictions for any crime involving fraud, embezzlement, misappropriation of funds, or conversion of property of another.
- Must be an owner or employee of a company who is a member in good standing of the Applicant.

Once a candidate determines whether he or she is eligible to sit for the CES examination, he or she must complete an application and submit applicable fees. The Applicant charges a \$500 fee to take the CES examination.

²⁷ Federation of Exchange Accommodators. *CES 1031 Candidate Bulletin of Information*. (2007). p.6.

Proposal for Regulation

The Federation of Exchange Accommodators (Applicant) has submitted a sunrise application to the Department of Regulatory Agencies (DORA) for review in accordance with the provisions of section 24-34-104.1, Colorado Revised Statutes (C.R.S.). The application identifies state licensure of Qualified Intermediaries (QIs) as the appropriate level of regulation to protect the public.

According to the sunrise application, licensure of QIs will:

- Promote investment property owner safeguards by registering persons or entities who facilitate “like-kind” exchanges pursuant to section 1031 of the Internal Revenue Service (IRS) tax code.
- Impose standards to safeguard investment property owner funds entrusted to QIs.
- Establish standards to demonstrate that such persons or entities have appropriate levels of competency to act as facilitators.

The Applicant also submitted model legislation with its sunrise application to license QIs in Colorado. While the Applicant is not legally bound to the model legislation it submitted, it provides an excellent starting point for discussion.

Although the sunrise application requests licensing of QIs, the model legislation creates a registration program. This is due to the fact that there are no entry requirements related to minimum skills, training or education. A copy of the Applicant’s model legislation is included in Appendix A on page 24.

The model legislation requires that any person who desires to be licensed as a QI in Colorado must complete an application. Specifically, section 4 within the model legislation illustrates the information that must be included in the application, including:

- The name and business address of the applicant;
- The name of the owner (in the case of a sole proprietorship), managing partners, principal officers, directors and any person who is more than a 10 percent owner, member or shareholder of the applicant, unless the applicant is a publicly traded corporation or a subsidiary of a publicly traded corporation;
- A summary description of the business of the applicant;
- A list of any similar licenses obtained and maintained in other states, and information regarding revocation of any such license;
- The tax identification number of the applicant;

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- A current certificate of good standing for the applicant from the state in which the applicant is formed; and
 - Current fingerprint cards for each person or officer who will be conducting the business of the applicant in Colorado and who has the authority to deposit, transfer and disburse exchange funds held by the applicant.

Additionally, the model legislation outlines the licensing requirements for QIs, which are as follows:

- Every licensed QI must have and maintain a principal place of business in Colorado, or in lieu thereof, maintain a registered agent in Colorado;
- Licensed QIs must notify the State of Colorado in writing within 10 business days if any change in the location of his or her principal place of business occurs;
- A licensed QI is permitted to establish more than one branch office as long as written notice is provided to the State of Colorado;
- A licensed QI must prominently display his or her State of Colorado license at his or her place of business;
- A licensed QI can delegate duties of the business to an Exchange Facilitator Officer (EFO). The EFO must be an attorney or Certified Public Accountant admitted to practice in any state or territory in the United States, a Certified Exchange Specialist (CES) by the Applicant, or an individual person who has been actively conducting the business of exchange facilitation as defined as working full-time for three years immediately preceding his or her EFO designation by a licensed QI; and
- A licensed QI is required to notify the State of Colorado and all existing exchange customers whose relinquished property is located in Colorado, or whose replacement property held under a Qualified Accommodation Agreement is located in Colorado, of any change in control of the QI business.

The Applicant's model legislation also requires QIs to, at a minimum, possess one of the following:

- Maintain a minimum of \$1 million fidelity bond or bonds, which are executed by an insurer authorized to do business in Colorado;
- Have \$1 million in cash, securities or irrevocable letters of credit in an interest bearing account or in a money market account; or
- Deposit all exchange funds into a qualified escrow or qualified trust account, and any withdrawals require the investment property owner's and the QI's written authorization.

Further, the Applicant's model legislation requires QIs to maintain a minimum of \$250,000 errors and omissions insurance, or a minimum of \$250,000 in cash, securities or irrevocable letters of credit.

Under the Applicant's model legislation, QIs are required to account for money and property they have concerning professional dealings. Specifically, the model legislation states that licensed QIs must invest exchange funds in investments which meet a "prudent person standard." The model legislation outlines that a grounds for discipline is warranted if:

- Exchange funds are knowingly commingled by the QI with the operating accounts of the QI business;
- Exchange funds are loaned or otherwise transferred to a person or entity that is affiliated with or related to the QI, except a transfer or loan to a financial institution that is the parent of or related to the QI; or
- Exchange funds are invested in a manner that does not allow the QI to retrieve funds in accordance with the QI's contract with his or her client.

Summary of Current Regulation

The Colorado Regulatory Environment

The Internal Revenue Service (IRS) tax code governs the general parameters of what constitutes a 1031 exchange, as well as a number of issues that highlight what property qualifies as a 1031 exchange, and provides information regarding acceptable 1031 exchanges.

However, the IRS tax code does not address minimum competency requirements to operate as a QI nor does the existing federal code have a structured disciplinary process for QIs who violate the IRS tax code. As a result, QIs are largely unregulated.

Key provisions within section 1031 of the IRS tax code include:

- 1031 exchanges apply to property held for productive use in a trade or business.
- Property held for investment qualifies for a 1031 exchange, except:
 - Stocks in trade or other property held primarily for sale;
 - Stocks, bonds or notes;
 - Other securities or evidences of indebtedness or interest;
 - Interests in a partnership; or
 - Certificates of trust or beneficial interests.
- Defining “like-kind” as reference to the nature or character of the property and not to its grade or quality.
- Defining a person who is disqualified to function as a QI, including a person who has acted as the investment property owner’s:
 - Attorney;
 - Accountant;
 - Investment banker or broker; or
 - Real estate broker or agent within a two year period.

Regulation in Other States

Nevada is the only state that currently regulates QIs. The Nevada legislature, in 2007, passed a bill requiring QIs to obtain a license prior to facilitating a 1031 exchange. According to staff within Nevada's Division of Financial Institutions, the State of Nevada has not begun licensing QIs.

Key provisions within Nevada's law licensing QIs include:

- QIs are required to possess a minimum of \$250,000 errors and omissions insurance coverage.
- Requiring all 1031 exchange funds to be kept separate from money belonging to the licensee and must be deposited in a financial institution that is federally insured or insured by a private insurer. 1031 exchange funds may be deposited in an alternative account if the investment property owner agrees and submits a request in writing to the QI.
- A licensee who establishes more than one office in the state of Nevada is required to notify, in writing, the Division of Financial Institutions within 30 days.
- The Commissioner of Financial Institutions has the authority to impose fines of up to \$200 per day for violations of the current statute.
- The Commissioner of Financial Institutions has the authority to suspend, revoke or deny the renewal or place conditions on a licensee.

Analysis and Recommendations

Public Harm

The first sunrise criterion asks:

Whether the unregulated practice of the occupation or profession clearly harms or endangers the health, safety or welfare of the public, and whether the potential for harm is easily recognizable and not remote or dependent on tenuous argument.

Before moving forward in the analysis of harm to the public, it is important to identify what constitutes harm to investment property owners who use 1031 exchanges to defer capital gains tax on their investment property. The harm incurred by investment property owners related to Qualified Intermediaries (QIs) could be identified as financial in nature. That is, QIs could inappropriately invest client funds, steal money from clients or mismanage client funds. The end result is that clients could potentially suffer a financial loss due to the actions of QIs.

The Federation of Exchange Accommodators (Applicant) submitted a number of newspaper articles to the Department of Regulatory Agencies (DORA) related to harm incurred by investment property owners who have used 1031 exchanges. The aforementioned newspaper articles identified four instances where investment property owners were harmed financially in the 1031 exchange process. In all four instances, it is possible that the harm could be attributable to QIs.

It is important to note that all of the examples, if true, entail the investment property owner(s) losing their 1031 exchange funds, but also missing the 180-day deadline to purchase a new “like-kind” investment property. As a result, the investment property owner not only lost his or her existing funds, but because he or she missed the 180-day deadline, he or she is responsible for paying the capital gains tax to the Internal Revenue Service (IRS).

The four cases of harm to investment property owners regarding QIs and 1031 exchanges and their outcomes are presented below.

Case 1

Incident: A practicing attorney in Colorado was operating as a QI for a number of clients. The attorney vanished with his clients’ 1031 exchange funds. According to newspaper accounts, the attorney allegedly stole between \$500,000 and \$600,000 of 1031 exchange funds. To date, the attorney and the missing funds have not been found.

Outcome: The attorney's license was suspended. Also, law enforcement is actively pursuing the attorney in an attempt to recover his clients' 1031 exchange funds; however, in this case, all of the investors have missed the 180-day deadline to purchase a replacement investment property. As a result, the investment property owners are responsible for paying capital gains tax to the IRS.

Case 2

Incident: This case involves a large bankruptcy case that is currently in the federal bankruptcy courts in New York. Several Colorado investment property owners are affected by this case.

A 1031 exchange company in Richmond, Virginia controlled 16 subsidiary 1031 exchange companies. One of the subsidiary companies was based in Denver, Colorado. It is estimated that the parent company controlled more than \$150 million in clients' 1031 exchange funds.²⁸ The owner of the parent company borrowed money from the parent company in order to fund real estate investments made by another company controlled by the same owner.²⁹ In other words, the owner of the parent company used the funds held in accounts within the subsidiary companies to invest in real estate ventures. Over time, the parent company was unable to continue to replace the funds to the subsidiary companies. As a result, the parent company filed for Chapter 11 bankruptcy protection.

There are several Colorado investors who have lost a great deal of money in this case. In fact, according to one interested party interviewed for this sunrise review, there are more than 80 Colorado investors who are affected by this case.

Outcome: As of the time of this writing, this case is currently in the federal bankruptcy court in New York. Therefore, the outcome has not been determined. However, investment property owners have missed the 180-day deadline and are now required to pay capital gains tax to the IRS.

²⁸ Rocky Mountain News. *No Cure for Rogues*. (May 31, 2007).

²⁹ The Wall Street Journal Online. *Tax Strategy for Real Estate Hits Rocky Turf*. Retrieved November 9, 2007, from <http://online.wsj.com/articleSB118013507992815239.html>

Case 3

Incident: This case involves a QI in Colorado who, according to newspaper accounts, transferred clients' 1031 exchange funds to a company that promoted investments in duplex rental projects. Investment property owners who secured the QI in this case were not aware that their 1031 exchange funds were being transferred. The QI currently faces 27 criminal charges, including 13 counts of theft, 11 counts of securities fraud, one count of violation of Colorado's Organized Crime Control Act and two counts of conspiracy to commit securities fraud.³⁰

In January 2006, the company that promoted investments in duplex rental projects filed for bankruptcy. The founder of the company faces 67 felony counts for allegedly defrauding investors out of millions of dollars they believed were going to build duplex rental projects.³¹

Outcome: The QI in this case pleaded not guilty to 26 of the 27 criminal charges against him. As of this writing, the case had not been adjudicated.

It is important to note that the QI and the founder of the company that filed for bankruptcy each have prior convictions for fraud. For instance, the QI, in 1999, pleaded guilty to fraud. In 1987, the founder of the company pleaded no contest to 10 counts of securities fraud in Boulder County.³²

For some investors in this case the 180-day requirement to purchase an investment property has not passed. However, unless the aforementioned investment property owners recover their lost investment funds and reinvest those funds within the 180-day timeframe, they will be responsible for paying capital gains tax to the IRS.

Case 4

Incident: This case includes a QI company in Nevada that filed for bankruptcy. The company, based in Henderson, Nevada, was forced into liquidation in spring 2007 owing investors approximately \$100 million.³³ Various lawsuits involving the exchange allege that its ex-chairman used investor escrow deposits to finance the expansion of his MediCor's Ltd. company, a Las Vegas-based maker of breast implants, also now in bankruptcy.³⁴

³⁰ Denver Business Journal. *Darrow Pleads 'Not Guilty' in Mile-High-Related Case*. Retrieved December 6, 2007, from <http://www.denver.bizjournals.com/denver/stories/2007/10/29/story8.html>

³¹ Denver Business Journal. *Darrow Pleads 'Not Guilty' in Mile-High-Related Case*. Retrieved December 6, 2007, from <http://www.denver.bizjournals.com/denver/stories/2007/10/29/story8.html>

³² Denver Business Journal. *Darrow pleads 'Not Guilty' in Mile High-Related Case*. Retrieved on December 6, 2007, from <http://www.denver.bizjournals.com/denver /stories/2007/10/29/story8.html>

³³ CoStar Group. *Updated: Investors Still Ensnared in 1031 Exchange Collapses*. (2007).

³⁴ CoStar Group. *Updated: Investors Still Ensnared in 1031 Exchange Collapses*. (2007).

Outcome: At the time of this writing, the bankruptcy case is in the federal bankruptcy courts. As a result, clients that had used the QI's company are still waiting to learn whether they will recover any of their lost funds. In the interim, clients have missed the 180-day deadline to purchase new investment property(ies), and are now responsible for paying capital gains tax on their respective property investments.

The examples of harm submitted by the Applicant illustrate that financial harm has occurred in 1031 exchanges. As a result, investment property owners have lost investment funds and are responsible for paying capital gains tax to the IRS.

Need for Regulation

The second sunrise criterion asks:

Whether the public needs and can reasonably be expected to benefit from an assurance of initial and continuing professional or occupational competence.

This criterion addresses the proposition of whether the state should require a certain level of education and/or impose a requirement that QIs pass an examination before being licensed to practice in Colorado.

From the information provided to DORA for this sunrise review, no evidence has been presented that QIs do not possess adequate skills, education or competence necessary to practice safely. This review uncovered no significant evidence of harm to the public resulting from lack of education of practitioners.

Rather, the harm was caused by stealing investment property owner's 1031 exchange funds or inappropriately investing client funds without his or her knowledge or permission.

According to the Applicant, the vast majority of 1031 exchanges in Colorado are completed by QIs who possess the voluntary, Certified Exchange Specialist (CES), certification offered through the Applicant. As previously outlined in this report, in order to obtain a CES certification, the QI must pass a written examination, which demonstrates a minimum level of competency to conduct a 1031 exchange. This reflects a commitment to provide quality service to the public, and to continue to improve quality standards.

Alternatives to Regulation

The third sunrise criterion asks:

Whether the public can be adequately protected by other means in a more cost-effective manner.

As outlined earlier in this sunrise report, the Applicant does offer a voluntary certification, the CES. In order to obtain a CES certification from the Applicant, a candidate must pass a two and one-half hour examination. The examination tests for competency on the following issues:

- Exchange procedures;
- Third-party relationships;
- Legal, compliance and technical issues; and
- Ethical and professional standards.

It is clear that an alternative to a governmental licensure program is already available to QIs. Further, according to some Applicant members, the vast majority of 1031 exchanges are facilitated by QIs who do, in fact, possess a CES certification through the Applicant.

Another alternative to licensure is registration. Although in its application, the Applicant proposed a statutory scheme that would “license” QIs, the model statute provided by the Applicant more closely resembles a registration program. This is an important distinction to make so as to avoid confusion by consumers. “Licensure” indicates that the state has verified a practitioner’s competency whereas “registration” carries no such authority.

Licensure is the most restrictive form of regulation and requires a demonstration of competency prior to obtaining a license to practice. An example of a licensing program would be the Board of Medical Examiners where the state requires license candidates to complete a certain level of education and pass certain examinations that establish minimum competency.

Implementing a licensure program for QIs could potentially cause an unnecessary barrier to entry since the harm identified in this review is not attributable to a lack of competency, but rather to financial malfeasance.

As a result, a registration program, such as that proposed by the Applicant, may be more appropriate for QIs. A registration program is less restrictive than a licensure program; however, it still protects the public. Specific to this sunrise review, QIs would be required to register with the State of Colorado, and maintain a bond worth at least \$1 million and maintain at least \$250,000 of errors and omissions insurance. Under a registration program, QIs would also be subject to investigation and disciplinary action.

Grounds for disciplinary action under a registration program could include:³⁵

- Making material misrepresentations concerning a QI transaction which is intended to mislead an investment property owner;
- Pursuing a continued or flagrant course of misrepresentation or making false statements through advertising;
- Failing to account for any monies or property belonging to investment property owners;
- Engaging in any conduct constituting fraudulent or dishonest dealings;
- Conviction of any crime involving fraud, misrepresentation of funds, robbery, or other theft of property; or
- Material failure to fulfill contractual duties to the investment property owner to deliver property or funds unless such failure is due to circumstances beyond the control of the QI.

Conclusion

Many Coloradans have chosen to use the services of QIs in 1031 exchanges in order to defer capital gains tax on the sale of investment property. In the aforementioned cases, there is evidence that investment property owners have been harmed financially by QIs. As a result, millions of dollars could have potentially been lost. In addition to potentially losing his or her investment property funds, the investment property owner is required to pay the capital gains tax if he or she does not adhere to the 180-day requirement. The lack of regulation of QIs in Colorado has left investors vulnerable to losing their investment funds and possibly having to pay capital gains tax.

There are a number of safeguards the State of Colorado should require in order to provide protection to consumers, including:

- QIs must register with the Division of Registrations;
- Dual signatures (the QI and the investment property owner) prior to transferring 1031 exchange funds;
- QIs must maintain a bond worth at least \$1 million and maintain at least \$250,000 of errors and omissions insurance;
- QIs must provide consent form to consumers disclosing where 1031 investment funds will be held (pooled or segregated); and
- QIs, officers within a 1031 exchange company and company shareholders with more than 10 percent equity must complete a criminal background check.

³⁵ Federation of Exchange Accommodators Model Legislation. Section 15.

Similar to the model legislation presented by the Applicant to DORA in its sunrise application, the State of Colorado should require all QIs who are facilitating 1031 exchanges in Colorado to register with the Division of Registrations. Requiring QIs to register will provide a central resource to track QIs and investigate complaints, and if necessary, impose discipline.

An additional layer of regulation that would provide protection to the investment property owner is a dual signatures requirement prior to transferring funds. Dual signatures would require signatures from both the QI and the investment property owner prior to funds being transferred. Although signatures may not completely eliminate funds from being transferred without the knowledge of the investment property owner, it provides an additional layer of protection for the investment property owner.

In all of the cases of harm presented by the Applicant, 1031 exchange funds were transferred without the investment property owner's knowledge. It is important to note that a dual signature would not eliminate fraud by QIs. A QI could still forge a signature in order to transfer funds; however, a dual signature requirement might have served as a deterrent to transferring the funds of Colorado 1031 exchange investors.

Additionally, the State of Colorado should require all QIs doing business in Colorado to maintain a bond worth at least \$1 million and maintain at least \$250,000 of errors and omissions insurance. It is important to note that if an incident occurs that triggers opening a bond and/or filing a claim on an errors and omissions insurance policy the amount of coverage may not cover all of the loss of each customer.

According to the Applicant, all CES certified QIs in Colorado possess both a bond and errors and omissions insurance; however, due to the fact that it is unclear how many QIs are providing services in Colorado, it is impossible to know if all QIs possess a bond and errors and omissions insurance.

Also, requiring QIs to provide a consent form, which discloses where an investment property owner's 1031 exchange funds will be held, could potentially lessen any confusion regarding where the investment property owner's funds are located. For example, the QI should be required to disclose whether an investment property owner's 1031 exchange funds will be pooled (held in an account with other exchange funds) or held in a separate (segregated) escrow or trust account.

Another layer of protection to the investment property owner could potentially be realized by requiring QIs to complete a criminal background check prior to providing services to Colorado investment property owners. Disqualifications to work as a QI in Colorado could include, but would not necessarily be limited to; conviction of a crime, an essential element of which includes:

- Fraud;
- Theft;
- Deceit;
- Misrepresentation; or
- Breach of a fiduciary duty.

In sum, the evidence presented in the cases of harm submitted by the Applicant demonstrates financial harm to Coloradans. As a result, the State of Colorado should implement several regulatory processes, as outlined above, in an attempt to mitigate financial harm to investment property owners by QIs. The aforementioned regulatory recommendations would increase public protection in the least restrictive manner without imposing unnecessary regulation.

Recommendation – Require all QIs facilitating 1031 exchanges in Colorado to register with the Division of Registrations. Require dual signatures for both the QI and the investment property owner in order for 1031 exchange funds to be transferred. Require QIs to maintain a bond worth at least \$1 million and maintain at least \$250,000 of errors and omissions insurance prior to facilitating 1031 exchanges in Colorado. Require QIs to provide a consent form highlighting where an investment property owner’s 1031 exchange funds will be invested. Require QIs, officers within a 1031 exchange company and company shareholders of 10 percent or more equity to complete a criminal background check prior to providing services in Colorado.

Appendix A – Applicant’s Model Legislation

**A BILL FOR AN ACT REGULATING EXCHANGE FACILITATORS
FOR IRC §1031 TAX DEFERRED EXCHANGES**

BE IT ENACTED BY _____:

SECTION 1. The legislature finds that presently there are no statutory requirements for the monitoring and licensing of persons or entities who facilitate like-kind exchanges pursuant to Section 1031 of the Internal Revenue Code of 1986, as amended (“IRC §1031”) and the Treasury Regulations promulgated thereunder. The purpose of this bill is to create a law which imposes safeguards ensuring that persons or entities acting as qualified escrows, qualified trusts, qualified intermediaries and exchange accommodation titleholders (“EATS”) as defined under Treas. Reg. §1.1031(k)–1(g)(3) and (g)(4) and IRS Revenue Procedure 2000-37 respectively (collectively referred to from time to time as “Exchange Facilitators” and/or “EATS”) are regulated while they are acting as Exchange Facilitators in IRC §1031 exchanges. Legislation should provide that Exchange Facilitators must be licensed, thereby providing taxpayers with legal recourse if the Exchange Facilitator fails to fulfill its material contractual obligations to deliver property or funds to a taxpayer or misappropriates a taxpayers’ funds. This bill ensures users of Exchange Facilitator services that their Exchange Facilitator has been duly licensed in this State and that there are legal channels to follow in the event of a material breach of contractual provisions to deliver property or funds to a taxpayer or misappropriation of funds by the Exchange Facilitator during the

exchange process. This bill also requires that Exchange Facilitators possess a level of competency defined herein.

SECTION 2. _____ is amended by adding a new chapter to be appropriately designated and to read as follows:

CHAPTER _____

EXCHANGE FACILITATORS FOR IRC §1031 TAX DEFERRED EXCHANGES

§ 1 Definitions: As used in this chapter:

(a) "Commissioner" means _____.

(b) "Exchange Facilitator" means a person as defined herein who:

(1) For a fee facilitates an exchange of like-kind property by entering into an agreement with a taxpayer by which the Exchange Facilitator acquires from said taxpayer, the contractual rights to sell said taxpayer's relinquished property located in this state and transfer a replacement property to said taxpayer as a qualified intermediary as that term is defined under Treasury Regulation §1.1031(k)-1(g)(4), or enters into an agreement with a taxpayer to take title to a property in this state as an Exchange Accommodation Titleholder ("EAT") as that term is defined in IRS Revenue Procedure 2000-37, or enters into an agreement with a taxpayer to act as a qualified trustee or qualified escrow holder as those terms are defined under Treasury Regulation §1.1031(k)-1(g)(3), except as otherwise provided in subsection (b)(5) below;

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- (2) Maintains an office in this State for the purpose of soliciting business as an Exchange Facilitator; or
- (3) Holds themselves out as an Exchange Facilitator by advertising their services or soliciting customers in printed publications, direct mail, television or radio advertisements, telephone calls, facsimile transmissions, or other electronic communications directed to the general public in this State; and
- (4) Is not the taxpayer or disqualified person as that term is defined under Treasury Regulation §1.1031(k)-1(k) seeking to qualify for the nonrecognition provisions of IRC §1031.
- (5) "Exchange Facilitator" shall not include any financial institution as defined herein that is merely acting as a depository for exchange funds, or that is acting solely as a qualified escrow holder or qualified trustee as those terms are defined under Treasury Regulation §1.1031(k)-1(g)(3), and is not otherwise facilitating exchanges as defined herein.
- (6) "Exchange Facilitator" shall not include advertising for and teaching seminars or classes, or otherwise giving presentations to attorneys, accountants, real estate professionals, tax professionals or other professionals where the primary purpose is to teach the professionals about tax deferred exchanges or train them to act as Exchange Facilitators.
- (7) "Exchange Facilitator" shall not include a qualified intermediary as that term is defined under Treasury Regulation §1.1031(k)-1(g)(4) who holds

exchange funds received from the disposition of relinquished property located outside this State.

(8) For purposes of subsection (b) (1), "Fee" shall mean compensation of any nature, direct or indirect, monetary or in-kind, that is received by a person or a related person as defined in IRC §267(b) or §707(b) for any services relating to or incidental to the exchange of like-kind property under IRC §1031.

(c) "Financial Institution" means any bank, savings and loan association, savings bank or trust company, doing business in this State whose accounts are insured by the full faith and credit of the United States of America, the Federal Deposit Insurance Corporation, the National Credit Union Share Insurance Funds or other similar or successor programs of federal insurance and are operating under state or Federal charter.

(d) "Person" means, in addition to the singular, persons, groups of persons, cooperative associations, limited liability companies, firms, partnerships, corporations, or other legal entities, and includes the agents and employees of any such person.

(e) "Licensee" means any person duly licensed by this State under this Act to conduct business as an Exchange Facilitator.

(f) "Related Company" means any cooperative associations, limited liability companies, firms, partnerships, corporations, or other legal entities owned by a licensee to further the licensee's business as an Exchange Facilitator and at least 80 percent in value of the outstanding stock, shares or similar certificates of

ownership in the Related Company are owned, directly or indirectly, by or for the licensee.

§ 2 Rules: The Commissioner may adopt rules in accordance with (cite to the rulemaking authority in the State), as the Commissioner deems necessary for the effective administration and enforcement of this chapter.

§ 3 License Required to Act as an Exchange Facilitator: No person shall act as an Exchange Facilitator unless the person is licensed by the Commissioner as an Exchange Facilitator or is a wholly owned subsidiary of a person which is so licensed by the Commissioner. If the Exchange Facilitator is not a natural person or a publicly traded corporation or a subsidiary of a publicly traded corporation, each shareholder, member or other owner who owns 10 percent or more of the voting stock, shares or other ownership interest of the Exchange Facilitator must be licensed.

§ 4 Application for License: Any person desiring to be licensed as an Exchange Facilitator shall file an application and pay a prescribed fee to the Commissioner as set forth herein. The application shall set forth:

- (a) The name and business address of the applicant; and
- (b) The name of the owner (in the case of a sole proprietorship), managing partners, principal officers, directors and any person who is more than a 10 percent owner, member or shareholder of the applicant, unless the applicant is a publicly traded corporation or a subsidiary of a publicly traded corporation; and
- (c) A summary description of the business of the applicant; and
- (d) A list of any similar licenses obtained and maintained in other states, and

information regarding revocation of any such licenses; and

- (e) The tax identification number of the applicant; and
- (f) A current certificate of good standing for the applicant from the state in which the applicant is formed; and
- (g) Current fingerprint cards for each person or officer who will be conducting the business of the applicant in this State and who has the authority to deposit, transfer and disburse exchange funds held by the applicant. "Officer" is defined as president, vice president, secretary, or treasurer in the case of a corporation, general partner in the case of a limited partnership, or manager or managing member in the case of a limited liability company.

§ 5 Investigation and Ruling: The Commissioner shall investigate the information furnished by the applicant and may require the applicant to furnish additional information. When the applicant has submitted a complete application, complied with the provisions of Section 6 (a) herein, provided satisfactory evidence of the fidelity bond or bonds ("Bonds") and errors and omissions insurance ("Insurance"), or cash or securities deposits ("Deposits") or irrevocable letters of credit permitted in lieu thereof, as provided in Sections 8 (b) and 10 (b) herein, and otherwise complied with the provisions of this chapter the Commissioner shall within 45 days of such submission approve the application. Any decision of the Commissioner adverse to the applicant shall be reviewable upon appeal to _____ as provided in _____.

§ 6 Licensing Requirements:

(a) Every person desiring to be licensed as an Exchange Facilitator shall have and maintain a principal place of business in this State, or in lieu thereof, maintain a registered agent in this State.

(b) Every licensee shall notify the Commissioner in writing within 10 business days of any change in the location of its principal place of business in this State or its designated registered agent in this State and shall promptly provide other information as may be required by the Commissioner.

(c) A licensee may establish one or more branch offices in this State provided written notice thereof is received by the Commissioner within thirty (30) days after establishment of each branch office.

Any Exchange Facilitator whose principal place of business is located outside this State and desires to establish a branch office within this State must first obtain a license under this chapter to transact business as an Exchange Facilitator in this State.

(d) A license issued under this chapter shall be prominently displayed in the primary place of business of the Exchange Facilitator and copies thereof shall be prominently displayed in each branch office.

(e) The Exchange Facilitator business shall be conducted under the direct management of an officer, or an employee, designated by the licensee as an Exchange Facilitator Officer ("EFO") for the licensee. Such EFO shall be an attorney or CPA admitted to practice in any state or territory of the United States, a Certified Exchange Specialist ("CES") as certified by the Federation of

Exchange Accommodators, or an individual person who has been actively conducting the business of exchange facilitation as defined herein full-time for the three (3) years immediately preceding their EFO designation by the licensee. If the EFO terminates employment with the licensee, the licensee shall immediately notify the Commissioner in writing of the termination of the EFO. The licensee shall also immediately inform the Commissioner in writing of any newly designated EFO for the licensee, setting forth the experience and relevant competency qualifications of the newly designated EFO, and shall provide any other information required by the Commissioner, including current fingerprint cards for such EFO.

(f) A licensee shall notify the Commissioner and all existing exchange customers whose relinquished property is located in this State, or whose replacement property held under a Qualified Exchange Accommodation Agreement is located in this State, of any change in control of the Exchange Facilitator. Such notification shall be made 1) to the Commissioner not less than 10 business days prior to the effective date of such change in control either by hand delivery, facsimile or e-mail transmission or by overnight mail, and 2) to customers within 10 business days following the effective date of such change in control either by facsimile or e-mail transmission, or by first class mail, and by posting on the Exchange Facilitator's website for a period ending not sooner than 90 days after the change in control. Such notification shall set forth the name, address and other contact information of the transferees and in the case of the notice to the Commissioner shall include all documents required for licensing if the transferees

are not currently licensed in this State and are required to be licensed under the provisions of this chapter. For such purposes, change in control shall mean any transfer of more than 50% of the assets or ownership interests, directly or indirectly, of the Exchange Facilitator over a period of 12 months.

§ 7 Issuance and Renewal of License: Immediately upon the approval of the application and payment of the license fee, the Commissioner shall issue to the applicant a license to act as an Exchange Facilitator. The license shall be effective only upon the applicant's filing with the Commissioner evidence that Bonds and Insurance, or Deposits or irrevocable letters of credit permitted in lieu thereof, as provided in Sections 8 (b) and 10 (b) herein, have been obtained. An Exchange Facilitator license is nontransferable. The license shall be renewed annually, as of July 1, upon payment of the annual renewal fee and the finding of the Commissioner, from the information contained in an annual renewal application of the licensee or investigation or hearing, that the licensee:

- (a) Continues to meet the qualifications for licensing; and
- (b) Has continued in force the Bonds and Insurance or the Deposits permitted in lieu thereof as provided in Section 8 (b) and 10 (b) herein.

§ 8 Fidelity Bonds, Deposits or Letters of Credit, or Qualified Escrows or Trusts:

A licensed Exchange Facilitator at all times shall either:

- (a) Maintain a fidelity bond or bonds ("Bonds") in an amount of not less than \$1,000,000 executed by an insurer authorized to do business in this State and approved by the Commissioner; or

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- (b) Deposit an amount of cash or securities ("Deposits") or irrevocable letters of credit equivalent to the sum set forth in Section 8 (a) above under such terms and conditions as are acceptable to the Commissioner, in an interest-bearing deposit account or in a money market account with a Financial Institution of Exchange Facilitator's choice, with the interest earned on such account accruing to Exchange Facilitator. Notwithstanding Section 8 (a) above or the previous sentence, the Exchange Facilitator may maintain Bonds, Deposits, or irrevocable letters of credit in excess of the amounts required by the Commissioner; or
- (c) Deposit all exchange funds in a qualified escrow or qualified trust as those terms are defined under Treasury Regulation §1.1031(k)-1(g)(3), with a Financial Institution, and any withdrawals from such qualified escrow or qualified trust require the taxpayer's and the Exchange Facilitator's written authorization.

§ 9 Action on Bonds, Deposits, or Letters of Credit: The Commissioner, or any person claiming to have sustained damage by reason of the failure of the Exchange Facilitator to comply with the provisions of this chapter, may file a claim against the Exchange Facilitator to recover from the Bonds, Deposits or letters of credit the damages incurred.

§ 10 Errors and Omissions Insurance, Deposits or Letters of Credit: A licensed Exchange Facilitator at all times shall either:

- (a) Maintain a policy of errors and omissions insurance ("Insurance") in an amount not less than \$250,000 executed by an insurer authorized to do business in this State and approved by the Commissioner; or

(b) Deposit an amount of cash or securities ("Deposits") or irrevocable letters of credit equivalent to the sum set forth in Section 10 (a) above under such terms and conditions as are acceptable to the Commissioner. Notwithstanding Section 10 (a) above or the previous sentence, the Exchange Facilitator may maintain Insurance, Deposits or irrevocable letters of credit in excess of the amounts required by the Commissioner.

§ 11 Cancellation of Bonds or Insurance; Withdrawal of Deposits: The Bonds or Insurance, Deposits or irrevocable letters of credit in lieu thereof required by this chapter shall not be cancelled or withdrawn as to future accruing liability except upon thirty (30) days prior written notice to the Commissioner. The license of any licensee shall be suspended upon the occurrence of either:

- (1) The cancellation of any Bond or Insurance, unless irrevocable letters of credit or an equivalent amount of cash or securities in lieu thereof have been deposited with the Commissioner on or before the date of cancellation, or
- (2) The withdrawal of any Deposits or irrevocable letters of credit in lieu thereof required by this chapter.

§ 12 Waiver of Bonds or Insurance: If the Commissioner determines that such Bonds or Insurance are not commercially, reasonably available, the Commissioner shall waive or modify the requirement for such Bonds and/or Insurance for a period of time to be determined by the Commissioner.

§ 13 License Fees: The following license fees shall be submitted by the Exchange Facilitator to the Commissioner to be deposited into the general fund:

- (a) \$500.00 for filing and investigation of an Exchange Facilitator's application for license;
- (b) \$200.00 for initial issuance and annual renewal of an Exchange Facilitator's license;
- (c) \$200.00 for initial issuance and annual renewal of each branch office license; and
- (d) \$200.00 for re-issuance of a license or endorsement on the license for the change in the business address of a licensee's office.

§ 14 Accounting for Monies and Property: Every licensee under this chapter shall have the responsibility to act as a custodian for all exchange funds, being money, property, other consideration or instruments received by the licensee from, or on behalf of the client, except funds received as the licensee's compensation. Every licensee shall invest exchange funds in investments which meet a "Prudent Person Standard" and satisfy investment goals of liquidity and preservation of principal. For purposes of this section, a "Prudent Person Standard" shall be violated if:

- (a) Exchange funds are knowingly commingled by the Exchange Facilitator with the operating accounts of the Exchange Facilitator; or
- (b) Exchange funds are loaned or otherwise transferred to any person or entity affiliated with or related to the Exchange Facilitator except that this subsection (b) shall not apply to a transfer or loan made to a Financial Institution which is the parent of or related to the Exchange Facilitator; or

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- (c) Exchange funds are invested in manner that does not provide sufficient liquidity to meet the Exchange Facilitator's contractual obligations to its clients or does not preserve the principal of the exchange funds.

§ 15 Revocation and Suspension of License: The Commissioner may revoke any license issued hereunder, or suspend the right of the licensee to use the license, for any of the following actions:

- (a) Making any material misrepresentations concerning any Exchange Facilitator transaction which are intended to mislead another;
- (b) Pursuing a continued or flagrant course of misrepresentation, or making of false statements through advertising or otherwise;
- (c) Failing, within a reasonable time, to account for any monies or property belonging to others that may be in the possession or under the control of the licensee;
- (d) Engaging in any conduct constituting fraudulent or dishonest dealings;
- (e) Conviction of the licensee and, in the case of an entity, conviction of its owners, officers, directors or employees of any crime involving fraud, misrepresentation, deceit, embezzlement, misappropriation of funds, robbery, or other theft of property, except that conviction of such crime by an officer, director or employee shall not be cause for revocation or suspension if the employment or appointment of such officer, director or employee has been terminated and no clients of the licensee were harmed, or full restitution has been made to all harmed clients;

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- (f) Material failure to fulfill its contractual duties to the taxpayer to deliver property or funds to the taxpayer unless such failure is due to circumstances beyond the control of the licensee;
 - (g) Appointment of a receiver or conservator to take control of the assets of the licensee, dissolution of the licensee entity or bankruptcy of the licensee; or
 - (h) Material violation of any of the provisions of this chapter or the rules adopted pursuant hereto.

No license shall be suspended for more than two (2) years. No person whose license has been revoked shall be eligible to apply for a new license until the expiration of two (2) years from the date of revocation.

§ 16 Power to Investigate: If the Commissioner has probable cause to believe that a licensee has violated the provisions of this chapter or the rules adopted pursuant hereto, or that any license issued under this chapter may be subject to suspension or revocation, the Commissioner may undertake such investigation as the Commissioner deems reasonably necessary. The Commissioner is hereby granted the power to examine the licensee's offices, and places of business, books, accounts, records, papers, files, safes and vaults, which are necessary to carry out the investigation. In the event the licensee's license is suspended or revoked or there is a final determination that the licensee has violated this chapter or the rules adopted pursuant hereto the licensee shall bear the reasonable expenses of the investigation.

§ 17 Penalty: Any person who violates Sections 3 and 15 (a)-(f) of this chapter shall be subject to an administrative penalty of \$200 per day for each day that the violation continues, or subject to a civil proceeding by the Commissioner for injunctive relief, or

both. Any action taken to impose or collect the penalty provided for in this subsection shall be considered a civil or administrative action.

Any revocation, suspension or penalty levied under Section 15 and this Section shall be subject to appeal by the licensee pursuant to the rules set forth in _____.

§ 18 Reciprocity:

(a) Any person who, as determined by the Commissioner, has been licensed as an Exchange Facilitator or its equivalent in any other state or territory of the United States and is not otherwise required to be licensed under the provisions of this chapter may make application to be licensed as an Exchange Facilitator in this State upon the following conditions:

- (1) The applicant is licensed in a jurisdiction that grants reciprocal licensing to licensed Exchange Facilitators of this State.
- (2) The reciprocal jurisdiction has requirements for licensing that are equal to or greater than the requirements set forth in Sections 6, 8 and 10 of this chapter.
- (3) The applicant provides evidence to the Commissioner of the requisite fidelity bond, cash deposits or irrevocable letters of credit and errors and omissions insurance as set forth in Sections 8 and 10 of this chapter.
- (4) The applicant has paid a fee equal to \$150 to the Commissioner.
- (5) The applicant shall designate the Commissioner as its representative to receive service of process for matters arising in this State.

(6) The applicant does not maintain an office in this State in connection with the conduct of the business of an Exchange Facilitator.

(b) The Commissioner shall undertake necessary and sufficient measures to identify reciprocal jurisdictions as they meet the requirements of a reciprocal jurisdiction under subparagraph (a)(2) and from time to time the Commissioner shall publish a list of those reciprocal jurisdictions that meet the requirements of said subparagraph (a)(2).

(c) Each license granted under this Section 18 may be renewed annually upon the timely payment of a \$150 fee provided that the applicant's original license remains in good standing under the rules of the reciprocal jurisdiction and the reciprocal jurisdiction continues to meet the requirements of subparagraphs (a)(1) and (2).

SECTION 3: This Act shall take effect on _____, 200_.