
Business & Financial Services Committee

SSB 6295

Brief Description: Modifying certain exchange facilitator requirements and penalties.

Sponsors: Senate Committee on Financial Institutions, Housing & Insurance (originally sponsored by Senator Morton).

Brief Summary of Substitute Bill

- Modifies provisions regarding fidelity bonds required for an exchange facilitator.
- Requires an exchange facilitator and their client to independently authenticate a withdrawal from a qualified escrow account or qualified trust.
- Requires additional disclosures.
- Expands criminal penalties to include an exchange facilitator who fails to comply with the requirements regarding a fidelity bond, disclosure provisions, or withdrawal of funds.

Hearing Date: 2/16/12

Staff: Jon Hedegard (786-7127).

Background:

The Internal Revenue Code (26 U.S.C. 1031) (Code) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business, or for investment. A tax-deferred exchange is a method by which a property owner trades one or more relinquished properties for one or more "like-kind" replacement properties.

This enables a property owner to defer the payment of federal income taxes on the transaction. If the replacement property is sold (as opposed to making another qualified exchange), the property owner must pay tax on the original deferred gain plus any additional gain realized since the purchase of the replacement property. Section 1031 of the Code does not apply to exchanges of

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inventory, stocks, bonds, notes, other securities or evidence of indebtedness, or certain other assets.

There are Internal Revenue Code provisions regarding the exchange process. If these provisions are not met, the exchange does not qualify to defer the taxation.

State Regulation of 1031 Exchange Facilitators.

In 2009 the Governor signed legislation that established a regulatory framework for exchange facilitators. Exchange facilitators are not directly regulated by a state agency. There are a number of provisions related to exchange facilitators.

Financial Security - Fidelity Bond.

Each person in the exchange facilitator business ("facilitator") must:

- maintain a fidelity bond or bonds in an amount of not less than \$1 million; or
- deposit an amount of cash and securities or irrevocable letters of credit equivalent to \$1 million into an interest-bearing deposit or money market account at a financial institution of the facilitator's choice. The interest accrues to the facilitator.

Compliance with Financial Security Requirements and Claims Against the Financial Security.

A facilitator must demonstrate compliance with the fidelity bond and other insurance requirements upon the request of a current or prospective client. Any person claiming to have sustained damage by reason of the failure of a facilitator to comply with this chapter may seek to recover damages from the facilitator's insurance, fidelity bond or bonds or the deposits, or the letters of credit maintained in lieu of the insurance, bond, or bonds.

Custodian of Funds.

A facilitator must act as a custodian for all exchange funds, property, and other items received from the client. The exchange funds must be held in a manner that provides liquidity and preserves principal. An exchange facilitator must provide the client with written notification of how the funds are invested or deposited. If invested, the facilitator must invest the exchange funds in investments that meet a prudent investor standard and that satisfy the goals of liquidity and preservation of principal. A prudent investor standard is violated if any of a number of standards are violated.

Prohibited Practices.

A facilitator must not, knowingly or with criminal negligence, commit specified prohibited practices related to a like-kind transaction. These prohibited practices include:

- making false, deceptive, or misleading material statements;
- making deceptive or misleading material statements in advertising;
- engaging in unfair or deceptive acts;
- commingling of funds, except as allowed;
- loaning or transferring money to a person or entity affiliated with the facilitator, except as allowed;
- keeping exchange funds under a client's name;
- material failure to fulfill contractual duties to deliver funds or property unless the failure is due to a cause that is beyond the control of the facilitator;
- failure to provide required disclosures;

- negligently making a false statement or willfully omitting a material fact in a report or investigation; and
- committing certain crimes.

Criminal Penalties.

It is a Class B felony to commit certain prohibited practices related to a like-kind transaction.

These prohibited practices include:

- making false, deceptive, or misleading material statements;
- making deceptive or misleading material statements in advertising;
- engaging in unfair or deceptive acts;
- commingling of funds, except as allowed;
- loaning or transferring money to a person or entity affiliated with the facilitator, except as allowed;
- keeping exchange funds under a client's name; and
- material failure to fulfill contractual duties to deliver funds or property unless the failure is due to a cause that is beyond the control of the facilitator.

It is a misdemeanor to commit certain prohibited practices related to a like-kind transaction.

These prohibited practices include:

- fail to make disclosures required by any applicable state or federal law; or
- negligently make any false statement or knowingly and willfully make any omission of material fact in connection with any reports filed by an exchange facilitator or in connection with any investigation conducted by the Department of Financial Institutions.

Consumer Protection Act.

Violations of the chapter are violations under the Consumer Protection Act.

Summary of Bill:

An intent section makes a number of findings regarding exchange facilitators.

Financial Security - Fidelity Bond.

The fidelity bond must be maintained for the benefit of a client of the facilitator that suffers a loss as a result of the exchange facilitator's covered dishonest act. The fidelity bond must cover the acts of employees of a facilitator and any owners of a nonpublicly traded facilitator.

Cash or irrevocable letters of credit are no longer allowed as an option instead of a fidelity bond.

Qualified Escrow Accounts and Qualified Trusts.

A qualified escrow account or qualified trust must provide that a withdrawal from that escrow account or trust requires the facilitator and the client to independently authenticate a record of the transaction.

Disclosure.

A facilitator must include a specific disclosure statement on the facilitator's web site and in contracts. If recommending other products or services, the facilitator must disclose to the client that the facilitator may receive a financial benefit as a result of the recommendation. The facilitator must not recommend or suggest to a client the use of services of another organization

or business entity in which the facilitator has a direct or indirect interest without full disclosure of the interest.

Penalties - Civil and Criminal.

Failure to fulfill the bond and disclosure requirements is prima facie evidence that the facilitator intended to defraud a client who suffered a subsequent loss of the asset entrusted to the facilitator.

The list of Class B felonies is expanded to include a person who fails to comply with the fidelity bond, disclosure, or withdrawal requirements. However, a facilitator is not guilty of a class B felony for failure to comply with the fidelity bond requirements if:

- the failure to comply is due to an action by the bond issuer; and
- the facilitator: (1) takes all reasonable steps to comply with the statutory requirements within 30 days; and (2) deposits any new exchange funds into a qualified escrow account or qualified trust until a fidelity bond that meets statutory requirements is obtained.

Damages awarded in a civil suit filed for a violation of the financial security requirements include treble damages and attorneys' fees.

Task Force.

A task force is established to identify effective regulatory procedures for the 1031 exchange facilitator industry. The task force includes the Department of Financial Institutions, the Office of the Insurance Commissioner, facilitators, and title holders. Issues for discussion must include, but not be limited to:

- the feasibility and cost of regulation;
- regulatory and enforcement standards;
- certification or licensing options; and
- the feasibility of adopting provisions within the Escrow Agency Act.

Specific recommendations on these issues are due to the Legislature by December 1, 2012.

Appropriation: None.

Fiscal Note: Available.

Effective Date: The bill takes effect 90 days after adjournment of the session in which the bill is passed.