

Date of Hearing: June 10, 2013

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 139 (Hill) – As Introduced: January 29, 2013

SENATE VOTE: 38-0

SUBJECT: Exchange facilitators

SUMMARY: Repeals the sunset date on provisions of law that regulate exchange facilitators.

EXISTING FEDERAL LAW:

Provides under Internal Revenue Code 1031 that real property for use as an investment or investment property may be exchanged for like-kind property without incurring tax liability from the exchange. Simply stated, instead of selling an investment property or business property and paying taxes on the sales proceeds, a property owner may exchange that property for like-kind property and defer the tax liability. In a 1031 exchange replacement property must be acquired within 180 days.

EXISTING STATE LAW (Financial Code Section 51000 et seq.) provides for all of the following, through December 31, 2013:

- 1) Defines an exchange facilitator (EF) as a person who does any of the following:
 - a) Facilitates, for a fee, an exchange of like-kind property, through an agreement with a taxpayer to:
 - i) Sell a taxpayer's property that is being relinquished in this state;
 - ii) Take title to a property in this state on behalf of a taxpayer as an exchange accommodation titleholder (EAT); or
 - iii) Act as a qualified trustee or qualified escrow holder, as specified.
 - b) Maintains an office in this state for the purpose of soliciting business as an EF; or
 - c) Holds himself, herself, or itself out as an EF by advertising services or soliciting customers through various means.
- 2) States that an EF is not any of the following:
 - a) The taxpayer or a disqualified person as those terms are defined under specified Treasury regulations;
 - b) A financial institution that is not facilitating exchanges, but is acting as a depository for exchange funds or is acting solely as a qualified escrow holder or qualified trustee, as

those terms are defined under specified Treasury regulations;

- c) A title insurance company or escrow company that is not facilitating exchanges, but is acting solely as a qualified escrow holder or qualified trustee, as defined;
 - d) A person that teaches professionals about tax-deferred exchanges or trains them to act as EFs;
 - e) A qualified intermediary (QI) who holds exchange funds from the disposition of relinquished property located outside this state; or
 - f) An entity in which an EAT has a 100% ownership interest and which is used by the EAT to take title to a property in this state.
- 3) Requires an EF to comply with one or more of the following at all times, to provide a source of funds for persons who sustain damage as a result of a violation of Division 20.5 of the Financial Code by an EF:
- a) Maintain a fidelity bond or bonds of at least \$1 million, executed by an insurer admitted to do business in California. This requirement is satisfied if the EF is named as a listed insured on one or more fidelity bonds totaling at least \$1 million;
 - b) Deposit an amount of cash or securities or irrevocable letters of credit of at least \$1 million in an interest-bearing account or money market account with the financial institution of the EF's choice;
 - c) Deposit all exchange funds in a qualified escrow or qualified trust, as those terms are defined in Treasury regulations, and provide that any withdrawals from those accounts require the client's and the EF's written authorization.
- 4) Requires an EF to comply with one or more of the following at all times:
- a) Maintain a policy of errors and omissions insurance of at least \$250,000, executed by an insurer admitted to do business in California. This requirement is satisfied if the EF is named as a listed insured on one or more policies of errors and omissions totaling at least \$250,000;
 - b) Deposit an amount of cash or securities or irrevocable letters of credit of at least \$250,000 in an interest-bearing account or money market account with the financial institution of the EF's choice.
- 5) Requires an EF to notify its clients in writing within ten days of the effective date of any change in control, as defined, of the EF.
- 6) Requires an EF to act as a custodian for all exchange funds, as specified, to invest exchange funds in investments that meet a prudent person standard, and satisfy investment goals of liquidity and preservation of principal. For purposes of existing law, a prudent person standard is violated if any of the following occurs:

- a) Exchange funds are knowingly commingled by the EF with the EF's operating accounts;
 - b) Exchange funds are loaned or otherwise transferred to any person or entity affiliated with or related to the EF;
 - c) Exchange funds are invested in a manner that does not provide sufficient liquidity to meet the EF's contractual obligations to its clients and does not preserve the principal of the exchange funds.
- 7) Provides that exchange funds are not subject to execution or attachment on any claim against an EF.
- 8) Prohibits an EF from knowingly keeping or causing to be kept any money in any bank, credit union, or other financial institution under a name designating the money as belonging to a client of the EF, unless the money does belong to that client and was actually entrusted to the EF by that client.
- 9) Prohibits an EF from doing any of the following:
- a) Making any material misrepresentations that are intended to mislead, concerning any like-kind exchange transactions;
 - b) Pursuing a continued or flagrant course of misrepresentation or making false statements;
 - c) Failing, within a reasonable time, to account for any moneys or property belonging to others that may be in the possession of or under the control of the EF;
 - d) Engaging in any conduct constituting fraudulent or dishonest dealings;
 - e) Committing any crime involving fraud, misrepresentation, deceit, embezzlement, misappropriation of funds, robbery, or theft; or
 - f) Materially failing to fulfill its contractual duties to the client to deliver property or funds, unless such failure is due to circumstances beyond the control of the EF.
- 10) Provides that the aforementioned provisions may be enforced via civil suit in a court of competent jurisdiction.

FISCAL EFFECT: None

COMMENTS:

SB 1007 (Machado, Chapter 708, Statutes of 2008) codified a series of rules and industry best practices for the EF. Section 1031 of the Internal Revenue Code permits individuals and businesses to exchange similar real or personal property without triggering a taxable event. In order to defer the capital gain from the sale of property under Section 1031, the taxpayer cannot receive funds from the sale. The United States Treasury identified several safe harbors that taxpayers could use to exchange like property and avoid a taxable event. Among the safe harbors are the use of a QI and the use of a qualified trustee or escrow holder, both commonly

referred to as an EF. In the 1031 exchange proceeds from the sale would go to the EF who holds them until they are needed to acquire a replacement property, then the funds are delivered to the closing agent. An EF can generally hold distributed funds for up to 180 days while the exchange is completed.

SB 139 would only remove the sunset date from the existing statute.

REGISTERED SUPPORT / OPPOSITION:

Support

Escrow Institute of California
Federation of Exchange Accommodators (FEA)
Investment Property Exchange Services, Inc. (IPX)

Opposition

None on file.

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