JULY 21, 2012

Report Pursuant to Section 1079 of the Dodd-Frank Act

Consumer Financial Protection Bureau

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Introduction and Summary

Section 1079 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd- Frank Act), Pub. L. 111-203, calls for the Consumer Financial Protection Bureau (CFPB or Bureau) to submit a report to Congress by July 21, 2012, describing recommendations for legislation, regulatory updating, and new regulation "to ensure the appropriate protection of consumers who use exchange facilitators for transactions primarily for personal, family, or household purposes."[1] That section also requires the Bureau to review "all Federal laws and regulations relating to the protection" of such consumers,[2] and mandates that within two years of submission of the report, the Bureau "propose regulations or otherwise establish a program to protect consumers who use exchange facilitators."[3] The statute defines "exchange facilitator" for purposes of the section as a person who facilitates a tax-deferred exchange of property pursuant to Section 1031 of the Internal Revenue Code or solicits that business.[4]

While Section 1031 exchanges are available to any taxpayer seeking to exchange property "held for productive use in a trade or business or for investment," the report mandated by Section 1079 of the Dodd-Frank Act is statutorily limited to recommendations regarding the protection of "consumers who use exchange facilitators primarily for personal, family, or household purposes."[5] We interpret the statutory mandate to require a report regarding the protection of individual taxpayers who engage in Section 1031 exchanges with the assistance of exchange facilitators (as defined in Section 1079(d)) involving the exchange of investment property, not

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[1] Pub.L. 111-203, Title X, Section 1079 (b).

[2] Id., Section (a).

[3] Id., Section (c).

[4] Id., Section (d).

[5] Section 1079 (a)-(b).

property used in a trade or business. To take perhaps the most common example, this report would cover a consumer who purchased investment property and sought to use an exchange facilitator to avoid realizing a taxable event when exchanging such property for a similar property.

As set out below, the question of additional regulation of exchange facilitators has been thoroughly presented to and extensively considered on multiple occasions over the past five years by both the Internal Revenue Service (IRS or Service) and the Federal Trade Commission (FTC). Our review of that history and additional factual research leads us to conclude that we have no recommendations for additional legislation or regulation at this time. We reach this conclusion for three reasons: first, that the size of the problem currently does not warrant the cost of regulation; second, that the taxpayers who engage in Section 1031 transactions tend to be sophisticated individuals; and third, that the existing federal regulatory framework has responded adequately to date and has the capacity to respond further should the situation warrant it without additional legislation or regulation.

1. Background

1.1 SECTION 1031 EXCHANGE FACILITATORS

Section 1031 of the Internal Revenue Code[6] permits individuals and businesses to exchange similar real or personal property (e.g., one corporate headquarters for another, land for land) without triggering a taxable event and associated capital gains. For Section 1031 to apply, the exchange must be between two properties held for "productive use in a trade or business or for investment." Stocks, bonds and other securities are specifically excluded from this code section. An example of Section 1031 exchange would be a small businessman swapping a factory in Florida with another businessman who has a similar factory in Kansas without either party having to pay capital gains on the exchange.

While Federal tax law has permitted tax deferred swaps since 1921, the decision in *Starker v. U.S.*, 602 F.2d. 1341 (9th Cir. 1979), increased use of Section 1031. *Starker* held that non-simultaneous, delayed tax-deferred like-kind exchanges could qualify for non-recognition treatment. This decision provided investors with significantly more flexibility in the structuring of tax-deferred like-kind exchange transactions. The Tax Reform Act of 1986[7] further encouraged tax-deferred like-kind exchanges by significantly reducing the other tax benefits of owning real estate. The U.S. Treasury's (Treasury) subsequent adoption of regulations governing Section 1031 "Starker" exchanges in 1991 made the process more accessible and created a new industry of "exchange facilitators."

To defer the capital gain from the sale of property under Section 1031, the taxpayer cannot receive funds from the sale. To facilitate "deferred" 1031 exchanges -- in which the replacement property is acquired after the relinquished property is sold -- the

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[6] 26 U.S.C. 1031.

[7] Pub.L. 99-514.

Treasury regulations establish four safe harbors.[8] The IRS does not consider taxpayers to be in receipt of funds from a sale of property if one of these is used to accomplish the exchange. Two of the safe harbors are the use of a qualified intermediary (QI) and the use of a qualified trustee or escrow holder, both of which are commonly referred to as exchange facilitators. Proceeds from the sale of the relinquished property go to the exchange facilitator, who holds them until they are needed to acquire the replacement property, then delivers the funds to the closing agent who deeds the replacement property to the taxpayer. Exchange facilitators can generally hold distributed funds for up to 180 days while the exchange is completed.[9]

In 2000, Treasury and the IRS issued Revenue Procedure 2000-37 to create a similar safe harbor procedure applicable to so-called "reverse 1031 exchanges" – in which the replacement property is acquired before the relinquished property is sold. This safe harbor allows taxpayers to "park" either the desired replacement property or the relinquished property with an "exchange accommodation titleholder" (EAT) until the taxpayer can find a buyer for the relinquished property, when the exchange takes place. The revenue procedure provides that the exchange accommodation title holder is considered the beneficial owner of the parked property for federal tax purposes, allowing the taxpayer to get the benefit of Section 1031.[10]

For purposes of this report, the Dodd- Frank Act defines an "exchange facilitator" as a person that acts as a qualified intermediary under Section 1.1031(k) -1(g)(4) or as a qualified trustee or escrow holder under Section 1.1031(k) -1(g)(3), or who acts as an exchange accommodation titleholder under Revenue Procedure 2000-37.[11]

1.2 RECENT EFFORTS BY INDUSTRY TO INCREASE FEDERAL OVERSIGHT OF EXCHANGE FACILITATORS

The only trade organization for exchange facilitators is the Federation of Exchange Accommodators (FEA), founded in 1989. In recent years, the FEA has repeatedly pressed the FTC and the IRS to regulate exchange facilitators. These agencies are therefore familiar with the issues discussed in this report.

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[8] 26. C.F.R. 1.1031(k)-1(g)(2-5) provides four safe harbors the use of which will result in a determination that the taxpayer is not in receipt of the funds: security or guarantee arrangements, qualified escrow accounts and qualified trusts, qualified intermediaries, and interest and growth factors.

[9] 26 U.S.C. 1031(a)(3).

[10] Rev. Proc. 2000-37.

[11] Pub.L. 111-203, Section 1079(d).

Application for membership in the FEA requires entities to agree to the FEA's Code of Ethics, and specifically requires separate agreement in the membership form to the following provisions governing the holding of clients' funds:

> "Accounting for Monies and Property
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> (a) Every Exchange Accommodator shall hold all exchange funds, being money, property, other consideration or instruments received by the Exchange Accommodator from, or on behalf of the client, except funds received as the Exchange Accommodator's compensation, in a manner that provides liquidity and preserves principal. Every Exchange Accommodator that invests exchange funds shall invest exchange funds in investments which meet the "Prudent Investor Standard" and satisfy investment goals of liquidity and preservation of principal. For purposes of this section, the "Prudent Investor Standard" shall be violated if:
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>> (1) Exchange funds are knowingly commingled by the Exchange Accommodator with the operating accounts of the Exchange Accommodator; or
>>
>> (2) Exchange Funds are loaned or otherwise transferred to any person or entity affiliated with or related to the Exchange Accommodator except that this subsection shall not apply to i) a transfer made to a financial institution which is the parent of or related to the Exchange Accommodator for the purpose of placing a deposit or as required under the exchange contract, or ii) to a transfer from an Exchange Accommodator to an EAT as required under the exchange contract.
>
> (b) An exchange facilitator shall not knowingly keep or cause to be kept any money in any financial institution under any name designating the money as belonging to a client of the exchange facilitator unless the money equitably belongs to the client and was actually entrusted to the exchange facilitator by the client."[12]

Applicants are also required to divulge any prior arrests or conviction for financial crimes such as fraud or embezzlement.[13] The FEA provides for enforcement of the Code of Ethics through a complaint and adjudication process run by the Ethics Committee. The penalty for an adjudicated violation includes private and public reprimands as well as suspension or permanent expulsion from the FEA. The Ethics

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[12] FEA Membership Application, *available at* http://www.1031.org/pdf/2012/2012_Membership_Application.pdf.

[13] *Id.*

Committee may report suspected criminal activity to the Board which may report to law enforcement.[14]

Since 2007, the FEA has also sought to effectively codify the provisions of the Code of Ethics set out above as federal regulation. To this end, in August 2007 the FEA petitioned the Federal Trade Commission to adopt regulations that would require persons who seek to act as exchange facilitators to register with the FTC, impose standards on safeguarding consumer funds entrusted to exchange facilitators, and establish standards of competency for facilitators.[15] The petition identified 23 incidents since 1989 in which exchange facilitators have stolen funds or improperly used customer assets to fund personal ventures.[16]

The FTC determined that a rulemaking was not appropriate.[17] The agency found that a registration system and standards are unlikely to reduce the types of criminal conduct and violations of law identified in the petition. The FTC described the incidents as "isolated instances of embezzlement, theft, or other criminal conduct," and noted that most "resulted in criminal investigations or prosecutions as well as civil suits for recovery."[18] The FTC's review showed that the bad actors in these incidents willfully and knowingly violated the law, conduct which the agency found is unlikely to be deterred by a registration process. Further, the FTC found that few if any of the individuals involved had prior criminal records, so they would not have been screened out by registration.

In addition, the FTC found that the costs of registration and enforcement would impose significant costs on the industry, taxpayers, and consumers. The agency concluded that the proposed benefits of the rule did not outweigh the likely costs, nor did the incidence of the problem warrant a rulemaking proceeding.[19]

The FEA subsequently submitted a request for guidance to the FTC regarding the application of Section 5 of the Federal Trade Commission Act,[20] which prohibits unfair

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[14] FEA Code of Ethics Enforcements, available at http://www.1031.org/aboutFEA/ethics.htm.

[15] Letter from David A. Starr to Donald Clark, August 6, 2007, "Re: Petition for a Rulemaking to Establish a Registration Process and Appropriate Operational Standards for Exchange Facilitators." *See* "Commission Denies Petition for Rulemaking Related to 'Qualified Intermediaries' Under Internal Revenue Code Section 1031," (FTC Denial) *available at* http://www.ftc.gov/opa/2008/08/qis.shtm. This press release notes that the FEA's submissions to the FTC (FTC File No. P074807) are available from the FTC Consumer Response Center.

[16] Letter from David A. Starr to Donald Clark, December 13, 2007 (supplementing the August 6 letter) and Exhibit A (list of 23 incidents). *See* FTC Denial.

[17] Letter from Donald S. Clark to David A. Starr, August 18, 2008, "Re: Federation of Exchange Accommodators' Petition for Rulemaking," *available at* http://www.ftc.gov/os/2008/08/P074807fealetter.pdf.

[18] *Id*. at 2. The FTC was able to verify 16 of the incidents.

[19] *Id*.

[20] 15 U.S.C. 45(a)

or deceptive acts or practices to the investment and disclosure practices of persons or entities acting as qualified intermediaries in like-kind exchanges under Section 1031.[21] Specifically, the request asked for the FTC's views on whether Section 5 requires, absent disclosure and consumer consent, that an exchange facilitator hold taxpayer funds so as to provide sufficient liquidity and preserve principal.[22] The request noted that the FTC had not applied its Section 5 authority to qualified intermediaries in the context of Section 1031 exchanges.[23] The agency responded with a substantial discussion of its existing record as a basis for offering guidance to the 1031 exchange industry, but declined to opine on whether specific acts or practices would be unfair or deceptive in the abstract.[24] The FTC concluded that "the Commission's existing authority is sufficient to address deceptive or unfair practices in a broad array of industries, including the investment practices of the 1031 exchange industry. Furthermore, if a consumer's funds ultimately become unavailable as a consequence of criminal conduct – such as the embezzlement or theft of funds by a principal of the QI – that type of conduct is best addressed through enforcement by the appropriate criminal law enforcement agency."[25]

During the same period, in June 2008, the FEA submitted to Treasury and the IRS a proposed amendment to Treasury Regulation 1.103(k) -1(g) which would impose standards of funds management requiring investment goals of liquidity and preservation of principal.[26] The proposed amendment would:

1) Require that the written agreement between the taxpayer and the exchange facilitator contain an express covenant by the exchange facilitator to hold or invest exchange funds in a manner that preserves principal and provides sufficient liquidity.

2) Prohibit (a) commingling of taxpayer funds with the exchange facilitator's operating funds; and (b) lending taxpayer funds to parties related to the exchange facilitator (other than an exchange accommodation title holder or depositing the funds in a bank).

The FEA asserted that the proposed regulations would not be unduly burdensome or costly to administer for the Service since the proposal would only require the Service to review the text of agreement at issue, not how the funds are actually held or invested, or whether the goals of liquidity and preserving principal were achieved. The FEA proposed that if a safe harbor agreement contained the proposed language, but the

[21] Letter of June 25, 2008 from David A. Starr to Alice Hrdy.

[22] *Id*. at 3.

[23] To date, the FTC has not done so.

[24] Letter of March 30, 2009 from Peggy Twohig to David A. Starr.

[25] *Id*. at 6.

[26] Letter of June 2, 2008 from Joseph M. Mikrut to the IRS.

funds were not properly held or invested, the exchange would still qualify for tax-deferred treatment under Section 1031 and the taxpayer would have a breach of contract claim.[27]

The FEA repeated this submission to Treasury and the IRS the next year.[28] In the renewed submission the FEA addressed a reported concern of the Service that the standards were too vague and would be a problem for the IRS when confronted with requests for private letter rulings on whether an investment practice meets the proposed standard. The FEA suggested that the Service "could simply 'no rule' the issue, perhaps acknowledging that the investment standard is best interpreted through state law," and went on to note: "We recognize that it may seem strange for the IRS to promulgate an investment standard requirement and immediately disavow having to interpret the promulgated standard."[29] The FEA argued that the regulation would serve its purpose even if the IRS did not police the actual investment of funds, because "the purpose for our proposal is to create consumer awareness as to how exchange funds are invested and to provide consumers with a cause of action if funds are invested inappropriately and not available to complete a deferred exchange," adding "we believe most qualified intermediaries invest exchange funds appropriately."[30]

Each of the FEA submissions to Treasury were in response to the IRS' Notice requesting items for that tax year's Guidance Priority List. The Treasury's Office of Tax Policy and IRS use the Guidance Priority List each year to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidance. The IRS included the issue on the Guidance Priority Lists for 2008-09 and 2009 -10,[31] and in 2010, issued Revenue Procedure 2010-14, [32] which the Service stated addresses this item on the list.[33] The Guidance Priority Lists for 2010 -11 and 2011-12 do not contain any reference to Section 1031.

The Service's regulatory action in March 2010 did not adopt the FEA's proposal to regulate the content of the exchange agreement respecting the manner in which funds

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[27] *Id*. at 3.

[28] Letter of May 29, 2009 from Joseph M. Mikrut to the IRS.

[29] *Id*. at 3.

[30] *Id*. at 2.

[31] The Guidance Priority List for 2008-09 included: "Guidance under §1031 regarding the treatment of accounts held jointly by the taxpayer and a qualified intermediary." Guidance Priority List for 2008-09, *available at* www.irs.gov/pub/irs-utl/2008-2009pgp.pdf. The Guidance Priority List for 2009-10 included: "Guidance under §1031 regarding exchange fund accounts held by a qualified intermediary." Guidance Priority List for 2009-10, *available at* http://www.irs.gov/pub/irs-utl/2009_-_2010_priority_guidance_plan_initial.pdf.

[32] Released 3/5/10, published 3/22/10 in IRB 2010-12.

[33] First Periodic Update of the 2009- 2010 Priority Guidance Plan, March 16, 2010, *available at* http://www.irs.gov/pub/irs-utl/2009_-_2010_priority_guidance_plan.pdf.

are held, but did act to correct the federal tax consequences of exchange facilitators' default. Revenue Procedure 2010-14 addresses the situation of a taxpayer who initiates a deferred like-kind exchange under Section 1031 but fails to complete the exchange because the exchange facilitator defaults on its obligation to acquire and transfer property to the taxpayer. If the exchange facilitator enters bankruptcy or receivership, the taxpayer is likely to be prevented from obtaining immediate access to the proceeds of the sale of the relinquished property, and cannot complete the exchange, thus losing the ability to defer capital gain on the sale of the relinquished property. The Revenue Procedure provides that a taxpayer who in good faith sought to complete the exchange using the exchange facilitator, but who failed to do so because the facilitator defaulted on the exchange agreement and became subject to a bankruptcy or receivership proceeding, is generally not required to recognize gain from the failed exchange until the taxable year in which the taxpayer receives a payment attributable to the relinquished property. Further, to the extent the taxpayer recovers less in bankruptcy than the adjusted basis of the relinquished property, the taxpayer has a loss deduction.[34]

Additionally, the Service warns Section 1031 filers in its current tax guidance: "Be careful in your selection of a qualified intermediary as there have been recent incidents of intermediaries declaring bankruptcy or otherwise being unable to meet their contractual obligations to the taxpayer."[35]

1.3 STATE REGULATION OF EXCHANGE FACILITATORS

The FEA has also urged state legislation to license and regulate exchange facilitators. The FEA drafted a model law that the states of California, Colorado, Maine, Nevada, Oregon, Virginia and Washington have adopted with some slight variations.[36]

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[34] Rev. Proc. 2010-14. While the Service invited comments on whether additional guidance is appropriate to address the effect of a bankruptcy of a qualified intermediary on a taxpayer that is attempting to complete a like-kind exchange, the topics on which comment was invited did not include the FEA's suggestion to regulate the exchange agreement through the Tax Code.

[35] "Like-Kind Exchanges Under IRC Code Section 1031," FS 2008-18, (updated October 17, 2011), *available at* http://www.irs.gov/newsroom/article/0,,id=179801,00.html.

[36] California Financial Code, Section 51000 – 51015, Division 20.5, *available at* http://www.leginfo.ca.gov/cgi-bin/waisgate?WAISdocID=97179314043+0+0+0&WAISaction=retrieve; Session Laws of Colorado 2009, House Bill 09-1254, *available at* http://www.state.co.us/gov_dir/leg_dir/olls/sl2009a/sl_116.htm; Nevada Revised Statutes, Chapter 645G, *available at* http://www.leg.state.nv.us/NRS/NRS-645G.html; 75th Oregon Legislative Assembly – 2009 Regular Session, House Bill 3484, *available at* http://www.leg.state.or.us/09reg/measures/hb3400.dir/hb3484.intro.html; Virginia Acts of Assembly – 2010 Session, Chapter 409 (amending Title 55 of the Code of Virginia to add Chapter 27.1 Section 55-525.1- 55-525.7), *available at* http://lis.virginia.gov/cgi-bin/legp604.exe?101+ful+CHAP0409+pdf; Revised Code of Washington, Chapter 19.310, *available at* http://apps.leg.wa.gov/RCW/default.aspx?cite=19.310&full=true.

Exchange facilitators located in these states are among those listed on the FEA's 2007 list of those who had defaulted since 1989.[37] The Maine law, for example, defines exchange facilitators and accommodators, imposes licensure requirements, and prohibits commingling of taxpayer funds with those of the facilitator or lending taxpayer funds to parties connected to the facilitator. It also requires facilitators to maintain a fidelity bond of at least $250,000 and an errors and omissions insurance policy of at least $100,000.[38] Similar legislation has been introduced in Connecticut.[39]

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[37] Letter from David A. Starr to Donald Clark, December 13, 2007 (supplementing the August 6 letter) and Exhibit A (list of 23 incidents).

[38] Maine Public Law Chapter 61 LD 165, item1, 124th Maine State Legislature. "An Act to Supervise and Regulate Real Estate Settlement Agents and Exchange Facilitators in Order to Protect Consumers."

[39] H.B. 5415, "An Act Providing Consumer Protection to Clients of Exchange Facilitators for Tax Deferred Exchanges", introduced April 10, 2012.

2. Analysis

2.1 THE NUMBER OF AFFECTED CONSUMERS IS SMALL

As of 2008, the last year for which complete IRS data are available, the use of Section 1031 by individuals using exchange facilitators appears to be declining. Only some 0.09 percent of individual taxpayers (fewer than 130,000 individuals) filed for Section 1031 tax relief in 2008, and that number includes taxpayers who are outside the scope of this report because they did not use a facilitator or were not conducting the exchange for investment purposes. Data from industry for later years supports the view that facilitated 1031 transactions continue to decline.

IRS data indicates that the use of Section 1031 to defer capital gains seems to have peaked in 2004 and declined rapidly by 2008, the last year for which complete data are available. A taxpayer must report a Section 1031 exchange to the IRS on Form 8824, filed with the taxpayer's return in the year the exchange took place.[40] The IRS reported that in Tax Year 2004 taxpayers filed more than 338,500 Forms 8824, claiming deferred losses of over $73.6 billion, which represented a doubling of the number of 1031 exchanges reported since 1998 and a tripling of the dollar amounts involved.[41] By 2008, the total number of Forms 8824 filed had declined to 274,090.[42]

Additionally, the percentage of like- kind exchanges in which the taxpayer is an individual as opposed to a business appears to have declined between 2004 and 2008.[43]

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[40] 2011 Instructions for Form 8824, *available at* http://www.irs.gov/pub/irs-pdf/i8824.pdf.

[41] Final Audit Report, "Like-Kind Exchanges Require Oversight to Ensure Taxpayer Compliance," September 17, 2007, at 1, 3.

[42] Form 8824 Data for Tax Year 2008, attached as appendix 1. This data was provided to CFPB by the IRS Statistical Information Services from the Statistics of Income Division.

[43] In an informal survey conducted in spring 2012 ("FEA 2012 informal survey"), FEA members estimated that 60 percent of their clients are individuals, and 40 percent businesses. Meeting and correspondence with the FEA, May 9-10, 2012. We do not have data from the IRS or other sources to confirm this more recent estimate.

In 2004, the IRS reported that individual taxpayers filed approximately 65 percent of Forms 8824 (219,675 Forms 8824).[44] However, the IRS reported instances of only 128,114 individuals who filed for 1031 exchanges in 2008, less than half the total of 1031 filings in 2008.[45]

The percentage of individual taxpayers utilizing like-kind exchanges also appears to have declined between 2004 and 2008. The IRS reported that 132,226,042 individual returns were filed for tax year 2004,[46] so some 0.17 percent of individual taxpayers (219,675 taxpayers) filed Forms 8824 for that year. The IRS estimated 142,450,569 individual returns were filed for tax year 2008;[47] some 0.09 percent of individual taxpayers (128,114 taxpayers) filed Forms 8824 for that year. The number of transactions covered by this report is considerably smaller for two reasons: first, this report only deals with facilitated 1031 exchanges, but a considerable number of 1031 exchanges, including transactions involving consumers, are still conducted between two principals without an exchange facilitator;[48] second, this report only deals with exchanges used by individuals for investment purposes, but 1031 exchanges by individuals can also involve properties used in a trade or business.[49]

Supplementing this data, a survey conducted by the FEA in 2011 of its members indicated a steep decline in 1031 exchanges involving exchange facilitators between 2006 and 2011. The FEA reported a 60 percent decline in membership, from 374 to 150 members, due to lack of business.[50] Among the 70 survey respondents, the number of 1031 exchanges handled had dropped from a total of 47,319 in 2006 to only 9004 in 2010, a decline of 81 percent. More than half of these transactions were for a sale value of $500,000 or more.[51]

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[44] Final Audit Report at 1, fn.3.

[45] Form 8824 Data for Tax Year 2008, attached as appendix 1. See also 2008 Estimated Data Line Counts at 93, *available at* http://www.irs.gov/pub/irs-soi/08inlinecount.pdf.

[46] SOI Bulletin, Historical Table 3, *available at* http://www.irs.gov/taxstats/article/0,,id=175800,00.html.

[47] 2008 Estimated Data Line Counts Individual Income Tax Returns, at 1.

[48] While we have not been able to quantify the percentage of individual like-kind exchanges that do not involve an exchange facilitator, anecdotal evidence that these continue to exist can be found on many tax preparation assistance websites.

[49] In the FEA's 2012 informal survey respondents estimated that 80 percent of the transactions they facilitated for individual clients in 2011 were for purposes of investment as opposed to for trade or business. Meeting and correspondence with the FEA, May 9-10, 2012.

[50] FEA Report on Current IRC Section 1031 Exchange Activity, May 15, 2011at 1.

[51] *Id.* at 4.

2.2 INCIDENTS INVOLVING EXCHANGE FACILITATOR DEFAULTS ARE INFREQUENT

In the 2007 petition to the FTC, the FEA identified 23 incidents since 1989 in which individuals have misappropriated exchange funds or invested customer assets in risky investments that failed.[52] At our request, the FEA updated their list of incidents involving failed exchange accommodation companies to include the period 2007 to date. We were not able independently to confirm the accuracy of the additional reported failures prior to the deadline for submission of this report.[53] The updated list, indicates that there were an additional twelve incidents between 2007 and the present, for a total of 35 incidents. Including the unverified incidents, the FEA's information shows that since 1989, there have been less than two incidents per year (fewer than three incidents every two years).

According to the FEA's submissions, 14 of these instances involved losses of exchange funds under $2 million. With respect to all the incidents, it is not clear what part of the funds lost belonged to individual taxpayers as opposed to businesses, or how many individual taxpayers as opposed to business taxpayers lost funds in any of these incidents. Thus, we are unable to determine the amount of losses or number of affected taxpayers cognizable pursuant to the mandate of Section 1079.

2.3 MOST INDIVIDUALS DEFERRING CAPITAL GAINS THROUGH A LIKE-KIND EXCHANGE USING AN EXCHANGE FACILITATOR HAVE FINANCIAL SOPHISTICATION AND PROFESSIONAL RESOURCES

Individuals who enter into Section 1031 Exchanges to swap investment property using an exchange facilitator own investment property, are interested in exchanging it for similar property, and are retaining the services of an exchange facilitator to delay recognizing capital gain. These characteristics indicate that they have more assets, engage in more complicated tax reduction transactions, and obtain more professional assistance than many taxpayers. In other contexts, investors with these characteristics have been deemed less in need of regulatory protection. The longstanding theory of the regulatory exemptions for such investors is that they may be allowed to make riskier investments without the full protections of the securities laws because they can (a) do

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[52] As noted, the FTC staff was only able to verify 16 of these incidents.

[53] For example, one of the incidents is identified as "investigation pending" and no charges have reportedly been filed.

their own due diligence and (b) withstand the risk of loss better than other investors.[54] The fact that these investors have greater resources to protect themselves also argues against shifting the cost of protecting such investors onto the taxpaying public at large through additional regulation.

Indeed, a conservative statistical analysis indicates that the majority of individuals who might typically be in a position to engage in facilitated Section 1031 exchanges for investment purposes would meet the test for an "accredited investor" under Regulation D of the Securities Act of 1933 ("Reg D") and as such would be presumed not to need the same protections as other investors. Rule 501 (a) of Reg D sets out a variety of tests for an accredited investor.[55] With respect to individuals, the rule establishes two alternative tests:

(a) An individual whose net worth, or joint net worth with that person's spouse, at the time of the purchase, exceeds $1,000,000, excluding the value of the individual's primary residence;
(b) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.[56]

An analysis of data from the 2007 Survey of Consumer Finances (SCF)[57] confirms the notion that individuals who have investment property that might be exchanged using an exchange facilitator are likely to meet the test for an "accredited investor." For the individuals covered by the mandate of Section 1079, that is, individuals exchanging investment property, exchanges using an exchange facilitator are very likely to be exchanges of real estate held for investment.[58] Thus, it is reasonable to use the SCF's

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[54] Securities and Exchange Commission, Net Worth Standard for Accredited Investors, Final Rule. 76 FR 81793 (December 29, 2011) at 81794 ("One purpose of the accredited investor concept is to identify persons who can bear the economic risk of an investment in unregistered securities, including the ability to hold unregistered (and therefore less liquid) securities for an indefinite period and if necessary to afford a complete loss of such investment."). *See also id*. at n.17 at 41793 ("the accredited investor concept was intended to 'eliminate the need for subjective judgments by the issuer about suitability' because investors that met the definition of accredited investor would be presumed to meet the purchase qualifications").

[55] 17 C.F.R. 230.501(a). The standards for accredited investors under Reg D delineate investors to whom issuers may sell securities in specified private and other limited offerings without registration of the offering under the Securities Act of 1933. Accredited investor status also obviates the sophistication requirement that Rule 506 imposes on non- accredited investors in private offerings. *See* 17 C.F.R. 230.5065 (specifying as a condition that "each person who is not an accredited investor either alone or with his purchaser representatives(s) has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment. . . ."

[56] *See* 17 C.F.R. 230.501(a)(5), (6).

[57] Board of Governors of the Federal Reserve System, Survey of Consumer Finances, 2007 (latest available).

[58] The FEA surveyed their members in 2012 in response to our inquiry on the nature of property exchanged for individuals by facilitators. Members responded that they believed approximately 80%

property category of "other residential real estate" (that is, residential real estate that is not the individual's home) as a rough proxy for the property that could be used in 1031 exchanges of investment property by individuals using exchange facilitators. According to the 2007 SCF, only 14 percent of households own "other residential real estate."

As noted, over half the Section 1031 transactions using exchange facilitators in tax year 2010 involved a sale over $500,000.[59] The SCF shows that only 2.5 percent of households have "other residential real estate" worth at least $500,000.[60] Moreover, according to the SCF, individuals who own "other residential real estate" of $500,000 or more have a median net worth of over $2.25 million ($2,339,000), excluding the equity in their home. Three quarters (75.2 percent) of individuals or couples owning such property have a net worth (excluding home equity) of over $1 million, and 36.2 percent of them meet the income test for accredited investors.[61] A total of 76.0 percent of such households meet one or the other test for individual accredited investors.[62]

2.4 THE EXISTING REGULATORY STRUCTURE IS ADEQUATE TO RESPOND TO EXCHANGE FACILITATOR DEFAULTS

Exchange facilitator defaults can cause harm to consumers in several ways. As discussed below, most of those harms have been addressed through the existing regulatory structure. Moreover, federal and state regulators have adequate authority to

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of the exchanges facilitated for individuals involved replacement property acquired for investment purposes rather than for use in a trade or business. For purposes of this definition, 1-4 family rental properties were included within the definition of investment use. FEA 2012 Survey, Meeting and correspondence with the FEA, May 10, 2012.

[59] FEA Report on Section 1031 Exchange Activity, May 15, 2-011, at 4 (reporting results of 2011 survey).

[60] This amount could include multiple properties. Restricting attention to households that owned a single property (other than their home) worth at least $500,000 would yield an even more select group of households.

[61] The SCF estimates of income and net worth are household-level measures. It is not possible to reasonably distinguish the income and net worth of individual household members, and we do not attempt to do so. Similarly, because we cannot allocate income to individual household members, unmarried couples are treated similarly to married couples for the purposes of the income test. The SCF asks about not only total income in the previous calendar year but also what "normal" annual household income is if the previous-year's income was atypical. To approximate the income test's consideration of two years of income and of income expectations, we treat a household as meeting the income test if reported income in the prior year and "normal" income both exceed the relevant threshold.

[62] A more sophisticated analysis of individual taxpayers filing Forms 8824 would require specialized data from the IRS Statistics of Information Division. Due to resource constraints, the IRS was unable to undertake this data gathering in time for this report.

take further steps should the situation warrant it in future without additional legislation or regulation.

First, prior to March 2010, taxpayers whose exchange facilitator defaulted might have been unable to complete the exchange and risked incurring taxable capital gain on the sale of the relinquished property. When this problem of federal tax law was called to the attention of the IRS, the Service responded by issuing Revenue Procedure 2010 -14, which corrects it.

Second, consumers can be harmed by exchange facilitators who engage in criminal acts such as theft, embezzlement or misappropriation of funds. Several of the instances of exchange default involved exchange facilitators who absconded to parts unknown with the taxpayers' funds. As the FTC noted, flagrant criminal conduct of this nature is unlikely to be deterred by additional regulation and is best addressed by the appropriate criminal law enforcement agency. As the FTC notes in its submission to the FTC, criminal and civil action was taken against the wrongdoers in these cases. In addition, the FEA suspended the membership of companies that defaulted even prior to the filing of criminal charges, after receiving complaints.[63]

Third, consumers may be harmed by exchange facilitators who invest exchange funds in investments that fail, such as auction rate securities. The larger of the recent incidents – the bankruptcies of Land America and Summit Accommodations in 2008 – appear to fall into this category. Both the IRS and the FTC have been asked and have declined to set a federal standard in the abstract for what an appropriate investment of exchange funds might be.[64] However, the FTC asserts that its authority to address deceptive or unfair practices could be applied to the investment practices of the 1031 exchange industry,[65] reserving the option to opine that a particular investment practice is unfair or deceptive and thus provides guidance through rulings. In addition, the half dozen states that have concluded that the cost of regulation is worth the benefit in their particular exchange facilitator market have attempted to reduce risky investment by enacting state laws licensing exchange facilitators and imposing insurance and bonding requirements.[66]

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[63] See FEA website, *available at* http://www.1031.org/about/FEA/response.htm ("In both the Southwest Exchange and 1031 Tax Group situations, the FEA immediately reviewed the complaints that were filed and, after verifying their accuracy, suspended the membership of these two companies").

[64] Notably, the FEA has suggested that the IRS could reasonably decline to respond to requests for interpretation of the broad federal standard the FEA urges the Service to adopt -- "perhaps acknowledging that the investment standard is best interpreted through state law." Letter from Joseph M. Mikrut to the IRS, May 29, 2009, at 3.

[65] Letter of March 30, 2009 from Peggy Twohig to David Starr at 5.

[66] See footnote 36.

3. Conclusion

For the foregoing reasons, we have no recommendations for federal legislation or regulation of exchange facilitators by the CFPB at this time.[67] We recommend that other regulators with authority in this area take into consideration the factual findings in this report in any further regulatory action they may consider.

[67] We also decline to make recommendations regarding federal legislation or regulation by other agencies covering Section 1031 transactions outside the scope of Section 1079 as described above (i.e. that would cover businesses, or individual taxpayers using exchange transactions for trade or business purposes). In our view, the mandate and authority conferred on us by Section 1079 does not extend to recommendations regarding such transactions.

Appendix I

Attached are summary figures for Form 8824 filers for Tax Year 2008. Form 8824 is the filing form for Section 1031 filers. This data was provided to CFPB by IRS Statistical Information Services from the Statistics of Income Division.

Form 8824 Data for Tax Year 2008
(All money amounts are in thousands of dollars)

	Tax Year 2008						
		Individuals		**Corporations**		**Partnerships**	
Number of Forms 8824 filed for Tax Year 2008		128,114		73,669		72,307	
Item	**Line No.**	**Frequency**	**Amount**	**Frequency**	**Amount**	**Frequency**	**Amount**
FMV of other property given up	12	4,300	608,312	1,713	919,108	76	139,951
Adjusted basis of other property given up	13	1,703	349,418	973	543,324	73	53,446
Gain (or loss) recognized on other property given up	14	3,314	258,894	2,091	375,812	40	86,505
Cash received, FMV of other property received, plus net liabilities	15	17,742	2,306,575	3,703	3,055,207	5,416	1,289,340
FMV of like-kind property you received	16	111,132	29,028,074	57,516	48,263,420	57,932	34,995,242
Add lines 15 and 16	17	113,955	31,334,649	58,457	50,796,367	57,995	36,284,583
Adjusted basis of like-kind property you gave up	18	124,023	18,042,882	71,773	26,259,562	71,512	21,035,017
Realized gain (or loss)	19	120,569	13,291,768	70,689	30,317,934	70,596	17,302,622
Smaller of line 15 or 19	20	12,668	1,903,694	2,791	2,164,367	5,400	1,260,304
Ordinary income under recapture rules	21	1,721	52,555	1,468	668,507	4,811	33,660
Subtract line 21 from line 20	22	12,541	1,853,281	1,608	955,458	5,266	1,244,607
Recognized gain	23	12,710	1,905,836	2,789	1,683,194	9,821	1,278,268
Deferred gain (or loss)	24	118,228	11,385,931	69,805	28,650,087	70,235	16,024,354
Basis of like-kind property received	25	123,181	17,642,143	71,949	29,751,380	71,487	23,697,144