THE EXETER

EXCHANGE

The Newsletter for Customers of Exeter 1031 Exchange Services, LLC Volume II Issue I

It's 3:00 in the morning ...
Will your QI pick up the telephone?

We can't always choose when an idea or a burning question will pop into our heads. And it's not unusual for that to happen after one's head has hit the pillow and the light is switched off. "If I could only call now," one laments, "I have to know or I won't rest."

How many of your vendors and business partners would pick up the telephone in the middle of the night ready to answer a question or take on a new challenge? In a global economy where business is transacted around the clock, is it so far-fetched to expect a response as soon as you dial a number or click a "submit" button? Is Exeter's 24/7 availability way over the line?

New standards for choosing a provider

The recent upheaval in real estate is causing consumers and businesses to question how they select providers. As we watch the titans of industry testify before Congress about their business practices, or downsize to the point where the company is a shell of its former self or even shutter their doors, it begs the question: is bigger really better? Or safer?

Today, a growing number of business relationships are being established on the basis of accessibility, reliability, dependability, familiarity and proximity, and less-so on size of operation or price. Money center financial institutions are being challenged by community banks as the go-to source for financial services. Independent service providers are usurping large vendor managers by demonstrating that "getting it right" is more important than "getting it done."

Still, some segments of real estate are dominated by scale businesses; that is, they are served by large firms offering capacity, price discounts and a national presence. Is the trend towards the large, national provider waxing or waning?

In this issue of The Exeter Exchange, we explore the differences between working with independent Qualified Intermediaries versus providers that are divisions of larger, multi-service firms (also known as "captives"). While we admit that our analysis is partially derived from first hand experience working for large companies, regional operations and start-ups, it is also supported by interviews conducted over the past several years with investors, escrow officers, real estate agents and lenders who have commissioned or referred the services of Qualified Intermediaries and have shared with us their experiences.

Do you have an opinion? If so, log on to the Exeter Discussion Board at exeterboard.com and share it with the group.

Ten key questions to ask when choosing a Qualified Intermediary

A little diligence can pay off when you ask the right questions before choosing a QI. We offer the following questions as a service to our readers:

1. Are you an independent QI or are you affiliated with or captive by another business?

This may or may not be significant, but it could reveal a broader agenda for securing other business you bring to the table, such as title, escrow or deposits. Evaluate those relationships as carefully as you evaluate the QI.

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In search of the exceptional Qualified Intermediary

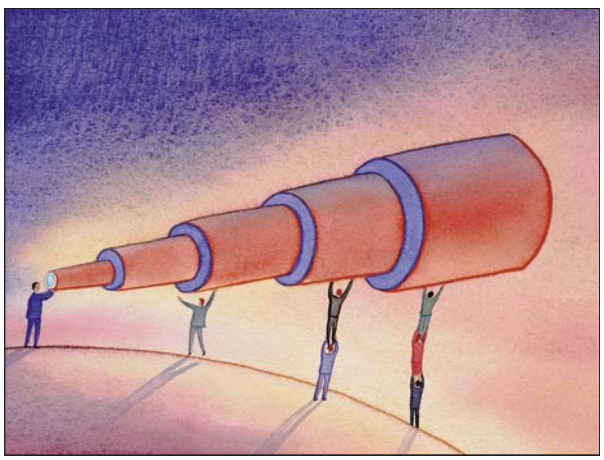
Thinking outside the box

There is a memorable scene in the movie, *Apollo 13,* when NASA engineers challenge themselves to develop an oxygen scrubber for the crippled lunar module carrying astronauts home from an aborted moon mission.

The engineers dump cardboard boxes holding items aboard the module; filters, hoses, wires and parts of space suits cover the table.

The chief engineer begins: "The people upstairs have handed us this and we gotta come through. We gotta find a way to make this," (holds up a square filter), "fit into the hole that holds this," (holds up a round filter), "using nothing but that," (gestures to materials on the table).

Every Qualified Intermediary has faced a challenge that appears to be impossibly complex: a taxpayer wants to transact an exotic exchange and needs a QI to help structure and administer the transaction.



The risks, though not life-threatening, are not trivial: the taxpayer might incur the wrath of the IRS if the exchange is challenged, a wholly unpleasant experience. The QI can face potential litigation involving an angry investor.

In our experience, QI's who are captives of large companies are less likely to embrace the exceptional exchange. Nobody in the chain of command wants his or her name associated with a high-risk transaction and General Counsel would see only downside.

The account executive would be told to focus on the easier, cookie-cutter deals that are process oriented because that's where the money is.

It's likely such a company has a software platform that programmatically determines the kinds of exchange transactions they can process; they couldn't do the transaction if they wanted to.

It's the smaller, more entrepreneurial QI that will usually step to the plate to address such a challenge. The downside is the same, but in the mind of the independent QI, the risk can be mitigated by working with the right attorney or accountant.

This clean-sheet-of-paper approach is exactly what today's investors are seeking. They need answers to difficult questions, advice on how to plan, options for "best execution" and solutions that work to their advantage, not the convenience of the QI. They need a 1031 exchange advisor and not just a processor.

As in health care, seeking a second opinion on how best to structure an out-of-the-ordinary 1031 exchange can be a good idea, particularly if the tax liability is significant. When you do, be sure to consult an independent QI with a track record and reputation for experience. Ask your tax or legal advisors for references.

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The beauty of personalized service

Is anyone home?

One casualty of our increasingly automated economy is personal service.

From pumping your own gasoline to completing application forms online, companies have increasingly turned over to the customer the tasks related to consummating the purchase.

Got a question? Good luck finding a telephone number. If you do, odds are the phone will ring in Bangalore.

True, poor or non-existent customer service is not the exclusive domain of big, multiline companies. You could easily be dissatisfied with the service quality of an independent firm. The difference is in the leverage you command as a customer.

Independent QI companies have to work harder to earn your business; unlike institutional QIs, you are their sole source of income, which means that customer satisfaction is a core element of their value proposition.

Institutional QIs tend to operate on the basis of scale, which means that order economics drives customer service, and you can't speak to the actual person administering your 1031 exchange.

Independent QI companies are created by professionals, many of whom once worked in institutional QI firms, who have technical skills and a vision of providing services not offered by the larger companies.

The chief executive officer is usually on the front line of sales and customer support. As a result, customers' issues tend to be resolved quickly and are not subject to protracted review by executive management.

In short, the difference is in the level of customer intimacy.

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You are more likely to interact directly with the executive officers and management (not a service center) and command more leverage when you work with an independent QI.

Is bigger necessarily safer?

There is a long-standing business axiom that large companies provide employees and customers stability because of their ability to absorb losses and weather calamity. But the headlines belie this.

Since 2000, we have seen market share giants either collapse or be swallowed by their competition in the energy, telecommunications, mortgage lending and investment banking industries. The fact is that pressure to achieve quarter-over-quarter growth in earnings causes large companies to take aggressive market positions and create risks that independent businesses consciously avoid.

When markets contract, as they are doing now, it is much more difficult for a large company to re-size to achieve equilibrium. Often, the subject matter experts that provide core services are among the first to leave or be laid off. Many of us have worked in that atmosphere, and we can guarantee you that at the first hint of downsizing, the internal focus shifts from customer intimacy to self-preservation.

Which brings us to the question: do institutional QI firms provide greater security in an exchange? We think not. Security is not solely a function of capital adequacy. It is also influenced by bonding and insurance carried by the QI, the experience and expertise of the firm's management and staff and by institutional controls – the checks and balances – ingrained in business processes.

Taken together, these three elements represent a sound strategy for protecting the taxpayer/investor funds and ensuring compliance.

Avoiding conflicts of interest

In the past decade we've seen the rise of the "one stop shop" for real estate and mortgage services dominated by the large title brands. In theory, the customer has one, enterprise-level relationship manager and a master agreement giving them advantaged pricing on a family of products and services, often delivered through a dedicated platform.

The vendor enjoys a competitive advantage by consolidating the customer's business into one master relationship, boxing out specialty and niche providers.

On occasion these relationships can give rise to conflicts of interest. An independent escrow office may be reluctant to refer business to a QI that is captive to a title company having in-house escrow, or a bank may balk at referring business to a QI owned by another bank: those are opportunities reserved for related businesses.

If you're held captive, be sure that the businesses that serve you meet or exceed standards for service, safety and competitive fees or rates in their categories and that you're not being disadvantaged by the referral.

When you work with an independent QI you have no conflicts. Their sole agenda is to generate income by providing expert QI services. There is no cross-selling agenda or attempt to secure other lines of business using the QI as a lead service.

The business model is simple: they succeed when they've met or exceeded your expectations for service and performance in a 1031 exchange transaction.

10 questions

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2. What kinds of 1031 exchanges can you structure and administer?

Simultaneous exchanges are relatively straightforward: both the relinquished and replacement properties have been identified and the exchange is instantaneous. But some taxpayers can benefit from more sophisticated strategies such as a reverse 1031 exchange, where you acquire the replacement property and have up to 180 days to sell it. In a build-to-suit exchange, you can use exchange funds to improve a like-kind replacement property.

A personal property exchange allows you to exchange personal property such as aircraft, machinery, even collectibles. And 1031 exchanges of non-domestic (foreign) assets provide other avenues for consideration. A QI who is experienced in a wide range of exchanges is more likely to recommend a strategy consistent with your financial goals and that passes IRS qualifying standards.

3. How does your fee structure work?

A good sign of a consumer-friendly company is its willingness to be transparent; that is, to have no hidden agenda. If your QI is willing to explain how he prices an exchange, that's a favorable quality.

4. Will you review all of the documents relating to my exchange—even ones prepared by the escrow company, title company or closing agent?

Your QI is the 1031 exchange expert and part of the value they create is in verifying that your transaction complies with the Federal tax code, regulations and rulings applicable for 1031 exchanges. Some QI's balk at this because they fear they are incurring a liability. We say expect this service. The reward to you, the taxpayer/investor, far outweighs the risk to the QI.

5. Do you have errors and omissions insurance?

The policy should cover at least your potential tax liablility. If the QI is a captive of a larger business, ask if the policy covers only the 1031 exchange operation or the entire enterprise, which can include non-1031 exchange businesses such as title and escrow. If it's the latter, the protection for 1031 exchange funds is diluted by the risks incurred in other lines of business.

6. What is your Fidelity bond coverage?

The same principles apply to fidelity bonding: look for coverage of $20 million to $30 million or more on a per occurrence basis and whether the policy covers the entire enterprise. All other things being equal, single occurrence coverage affords the taxpayer/investor more protection. Two or three claims in an unrelated line of business may affect the security of 1031 exchange funds held by a captive or institutional QI.

7. How much experience does your staff have in structuring and administering 1031 exchange transactions?

You'd like to think that your QI has weathered at least one business cycle. It suggests your QI team can execute a 1031 exchange under adverse market conditions and has the experience to spot problems before they can affect the viability or efficacy of your transaction. To that end, we recommend you work with a QI team that has a minimum of 10 years of experience processing exchange transactions.

8. What kinds of internal process controls do you have?

The first line of protection for the taxpayer/investor is in the QI's operating policies and procedures. The company should employ a trust accounting system for logging and tracking individual taxpayer deposits; provide internal and external audit controls that track the flow of money; balance and reconcile funds each day; and require multiple approval levels for disbursing funds.

9. What additional services do you offer?

This reveals the level of experience or sophistication of the QI. For example, experienced QIs may offer consulting on planning and structuring 1031 exchanges; expert testimony in legal cases, and may make available to clients counsel from independent law firms.

10. Are you available after hours or on weekends if I have a question?

As a society we are growing increasingly accustomed to a 24/7 economy. Choose a QI who can be contacted when you have a question, not when it's convenient to him to give you an answer.

Pricing a 1031 exchange

The independent QI's business model is straightforward: they make money on exchange fees and on interest earned on proceeds held on behalf of the taxpayer. Captive QIs may use 1031 exchange business as a means to garner deposits or secure title insurance underwriting or escrow services, so their pricing can be influenced by these parallel lines of business.

For the most part, transaction fees cover the cost of administering a 1031 exchange and interest earned on deposits produces the margin.

Like anything else in this world, fees are negotiable, although it may be more difficult to negotiate with a captive QI who has an inherently rigid fee structure defended by layers of management. Independent QIs tend to be more open to discussing fees and interest and be willing to explain their pricing schedule. Most taxpayers focus on the fees and assume all QIs are equal in technical capability, experience and service. That's not true for accountants, attorneys and financial advisors for any other service business, and it's not true here.

Intelligently selecting a QI requires that a taxpayer consider qualities and capabilities in addition to price. So spend the extra time getting to know the QI you're about to entrust with a small fortune.