



CALIFORNIA ENACTS QUALIFIED INTERMEDIARY LEGISLATION

On September 30, 2008, California became one of the first states to regulate IRC Section 1031 qualified intermediaries. This state activity follows the defalcation of several qualified intermediaries, and the loss of hundreds of millions in exchange funds, across the U.S. SB 1007 governs "exchange facilitators" (qualified intermediaries or "QIs") who facilitate exchanges, including reverse exchanges, of property located in California as well as those who maintain offices or advertise in California.

California has now placed conditions upon QIs which it hopes will help protect consumers from poor investment decisions and/or misappropriation of exchange funds. These conditions speak to the issues of QI company ownership, insurance and exchange fund investment. QIs desiring to do business in California, as outlined above, are required to:

1. Notify existing clients of any change in control (transfer of more than 50% interest or assets);
2. Maintain a fidelity bond of at least \$1,000,000 and an errors and omissions insurance policy (as a named insured) of at least \$250,000. In lieu of the fidelity bond or errors and omissions insurance policy, a QI may maintain at least \$1,000,000 or \$250,000 (cash, securities or irrevocable letters of credit), respectively, on deposit with a financial institution. The fidelity bond requirement may also be satisfied by holding all exchange funds in qualified trust or qualified escrow accounts with a financial institution (withdrawals must require QI's and taxpayer's written authorization);
3. Act as custodian of the exchange funds on behalf of the taxpayer and invest exchange funds in investments meeting the California Uniform Prudent Investor Act¹ standard for liquidity and preservation of capital.

California now specifically prohibits the following actions by QIs:

1. Commingling exchange funds with operating funds;
2. Loaning or transferring exchange funds to a person affiliated or related to the QI (other than a financial institution or reverse exchange Exchange Accommodation Titleholder);
3. Investing exchange funds without maintaining liquidity and/or preservation of capital;
4. Subjecting exchange funds to claims against the QI.
5. Engaging in misrepresentative, fraudulent, dishonest, criminal conduct; or
6. Failing to (a) account for money or property of others or (b) fulfill its contractual duties to a client due to circumstances within its control.

Exchange Services, LLC, is required to comply with California's new law and easily satisfies the requirements with a \$50,000,000 fidelity bond and errors and omissions insurance policy and the use of a qualified trust arrangement, with an Exchange Services affiliated bank as Trustee and the taxpayer as beneficiary. In California, exchange funds are held in fully liquid deposit or money market accounts with an Exchange Services affiliated bank, thus meeting the requirements of a custodial relationship and the California Uniform Prudent Investor Act.

¹Uniform Prudent Investor Act (Article 2.5, Chapter 1, Part 4, Division 9 of the California Probate Code).

Contact us for more information (877) 596-1031

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