

HOUSE BILL REPORT

E2SHB 1078

As Passed House:

March 9, 2009

Title: An act relating to exchange facilitators.

Brief Description: Concerning exchange facilitators.

Sponsors: House Committee on General Government Appropriations (originally sponsored by Representatives Kelley, Roach, Kirby, Warnick, Bailey and Sells).

Brief History:

Committee Activity:

Financial Institutions & Insurance: 1/22/09, 2/17/09 [DPS];

General Government Appropriations: 2/26/09 [DP2S(w/o sub FII)].

Floor Activity

Passed House: 3/9/09, 96-0.

Brief Summary of Engrossed Second Substitute Bill

- Affects specific persons who facilitate the exchange of property for tax purposes.
- Provides certain financial security standards.
- Establishes prohibited practices.

HOUSE COMMITTEE ON FINANCIAL INSTITUTIONS & INSURANCE

Majority Report: The substitute bill be substituted therefor and the substitute bill do pass. Signed by 8 members: Representatives Kirby, Chair; Kelley, Vice Chair; Hurst, McCoy, Nelson, Roach, Santos and Simpson.

Minority Report: Do not pass. Signed by 2 members: Representatives Bailey, Ranking Minority Member; Parker, Assistant Ranking Minority Member.

Staff: Jon Hedegard (786-7127)

HOUSE COMMITTEE ON GENERAL GOVERNMENT APPROPRIATIONS

This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.

Majority Report: The second substitute bill be substituted therefor and the second substitute bill do pass and do not pass the substitute bill by Committee on Financial Institutions & Insurance. Signed by 12 members: Representatives Darneille, Chair; Takko, Vice Chair; Hinkle, Assistant Ranking Minority Member; Blake, Dunshee, Hudgins, Kenney, Pedersen, Sells, Short, Van De Wege and Williams.

Minority Report: Without recommendation. Signed by 1 member: Representative McCune, Ranking Minority Member.

Staff: Steve Smith (786-7178)

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 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. There are no other federal or state laws specific to the exchange facilitators (also known as "qualified intermediaries" under federal law) required to facilitate the exchange.

Summary of Engrossed Second Substitute Bill:

Definitions.

Six definitions are included in the bill.

The exchange facilitator business must be under the direct management of an officer or an employee who is either:

- an attorney or certified public accountant admitted to practice in any United States state or territory; or
- has passed a test specific to the subject matter of exchange.

A facilitator may not sue their clients for compensation unless the facilitator proves their compliance with all the requirements in this act.

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.

Financial Security - Insurance.

Each facilitator must:

- maintain a policy of errors and omissions of not less than \$250,000; or
- deposit an amount of cash and securities or irrevocable letters of credit equivalent to \$250,000 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 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 (except the facilitator's compensation). 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 the following occurs:

- exchange funds are knowingly commingled by the facilitator with the operating accounts of the facilitator;
- exchange funds are loaned or otherwise transferred to any person or entity, other than a financial institution, that is affiliated with or related to the facilitator. This does not apply to the transfer of funds from a facilitator to an exchange accommodation titleholder under an exchange contract; or
- exchange funds are invested in a manner that does not provide sufficient liquidity or there is a loss of principal. This standard is not violated if the insufficient liquidity or loss of principal is due to events beyond the control of the facilitator or beyond the ability of facilitator to predict. It is also not violated if the investment was made at the specific request of the client.

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;
- a 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;
- a 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.

Accounts.

All accounts above \$500,000 must be placed in a separately identified account and the client must receive the earnings related to that account. Accounts of less than \$500,000 may be pooled with other client accounts if the client agrees, in writing, to the pooling. If the client does not agree, the funds must be placed in a separately identified account.

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
- a 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.

Department of Financial Institutions Report.

Facilitators must file information with the DFI by December 31, 2009. The information is exempt from public disclosure, and will be compiled by the DFI for reporting to the Legislature.

Appropriation: None.

Fiscal Note: Available.

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

Staff Summary of Public Testimony (Financial Institutions & Insurance):

(In support) This bill is another attempt to work with this industry on this subject. There was some unhappiness with the cost of the regulatory structure in last year's bill. This bill is based on, and similar to, the law in California. There is no current regulation of the facilitators involved in these transactions. Some facilitators do fail. A recent business headquartered in Bend, Oregon, failed and lost \$15 million. Then, not only do the consumers lose their money, but they may also have to pay the taxes that they intended to defer. There are no current standards or protections for client funds that apply to facilitators. No law will stop theft but most of the problems that have occurred have been due to inappropriate use of client funds. In the Bend, Oregon, case, the facilitator invested the money in their own real estate company. That would be a violation of the provisions of this bill. The bill has no fiscal impact to the state yet it provides protections for consumers. Internal Revenue Codes apply across the United States. It would be useful to maintain regulatory uniformity. A prudent investor standard would prevent some of the problems we have seen in the industry. Four states have standards regarding facilitators. This would make investing money with a Washington-based facilitator safer than investing it with a similar person in most of the United States. It may attract capital.

(In support with concerns) The state-chartered banks do not oppose the concept or protections in the bill. The bill itself is reasonable. The issue is parity. The federal Office of the Comptroller of the Currency has issued a letter saying that this business is a part of banking. That means that states cannot regulate any bank other than a state-chartered bank. No state charters act as facilitators today. State charters are always interested in maintaining a level playing field with other.

(Opposed) None.

Staff Summary of Public Testimony (General Government Appropriations):

(In support) There have been significant cases in which exchange facilitators have kept money and that this problem has been brought up in the policy committee. The industry needs to put a stop to these types of practices, and the industry generally has come forward in agreement against such practices. Although the industry is not happy with all of the aspects of this bill, they do accept it in the interest of working on resolving the problem, and in making additional changes. After five years of negotiations, the industry welcomes legislation addressing the problem.

(Opposed) None.

Persons Testifying (Financial Institutions & Insurance): Representative Kelley, prime sponsor; Dennis Helmick, Federation of Exchange Accommodators; Jeffery Helsdon, Oldfield and Helsdon; and Amy Gustin, 1031 Exchange Facilitators.

(In support with concerns) Brad Tower, Community Bankers of Washington.

Persons Testifying (General Government Appropriations): Mark Gjurasic, Facilities Exchange Association and Washington Apartment Association.

Persons Signed In To Testify But Not Testifying (Financial Institutions & Insurance): None.

Persons Signed In To Testify But Not Testifying (General Government Appropriations): None.