

HOUSE BILL REPORT

HB 1078

As Reported by House Committee On:
Financial Institutions & Insurance

Title: An act relating to exchange facilitators.

Brief Description: Concerning exchange facilitators.

Sponsors: Representatives Kelley, Roach, Kirby, Warnick, Bailey and Sells.

Brief History:

Committee Activity:

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

Brief Summary of 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)

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

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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 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. 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; or
- 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.

Prohibited Practices.

A person engaged in business as a facilitator must not:

- make any false, deceptive or misleading misrepresentations concerning a like-kind exchange transaction;
- make any false, deceptive or misleading misrepresentations through advertising or other means;
- fail to account for any moneys or property belonging to others that may be in the possession of, or under control of, the facilitator;
- obtain property by fraud or misrepresentation;
- knowingly commingle funds;
- engage in any conduct constituting fraudulent or dishonest dealings;
- keep exchange funds under a client's name;
- fail to provide required disclosures;
- negligently making a false statement or willfully omitting a material fact in a report or investigation;
- commit any crime involving fraud, misrepresentation, deceit, embezzlement, misappropriation of funds, robbery, or theft; or
- materially fail to fulfill its contractual duties to a client to deliver property or funds to the client, unless that failure is due to circumstances beyond the control of the person engaging in business as a facilitator.

Segregation of Accounts.

All accounts above \$500,000 must be segregated and the client must receive the interest.

Criminal Penalties.

It is a Class B felony to:

- make a false, deceptive, or misleading material representation, directly or by implication, concerning a like-kind exchange transaction;
- engage in any unfair or deceptive practice toward any person;
- obtain property by fraud or misrepresentation;

- make a false, deceptive, or misleading material representation, directly or by implication, in advertising or by any other means, concerning a like-kind exchange transaction;
- fail to account for any moneys or property belonging to others that may be in the possession or under the control of the exchange facilitator;
- knowingly commingle funds held for a client in any account that holds the exchange facilitator's own funds;
- knowingly keep, or cause to be kept, any money in any bank, credit union, or other financial institution under a name designating the money as belonging to the client of any exchange facilitator, unless that money belongs to that client and was entrusted to the exchange facilitator by that client;
- fail to fulfill its contractual duties to the client to deliver property or funds to the taxpayer in a material way unless such a failure is due to circumstances beyond the control of the exchange facilitator; or
- not appropriately segregate a client account with a value of \$500,000 or more.

It is a misdemeanor to:

- 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 (DFI).

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.

Substitute Bill Compared to Original Bill:

The substitute removes category qualifying a person to directly manage an exchange facilitator if they belong to a specific, private trade association. A new category is created that qualifies a person to directly manage an exchange facilitator passing a test specific to the subject matter of exchange facilitation. A provision is created precluding a facilitator from suing a client for compensation unless the facilitator proves their compliance with this act. A facilitator must demonstrate compliance with the fidelity bond and insurance requirements upon the request of a current or prospective client. An injured party may make a claim against the insurance. Specified investment violations are defined as violations of the prudent investment standard including: knowingly commingling client and facilitator funds; an improper loan or transfer; or an investment that doesn't preserve principle. The substitute bill adds new prohibited practices including: a knowing commingling of funds; keeping exchange funds under a client's name; a failure to provide required disclosures; and negligently making a false statement or willfully omitting a material fact in a report or investigation. Representations no longer need to be intended to deceive in order to be a violation; they only need to be false, deceptive or misleading. A representation no longer

needs to be part of a continued course of misrepresentation in order to be a violation. All accounts above \$500,000 must be segregated and the client must receive the interest. There are criminal penalties (Class B felonies) for most prohibited practices. It is a misdemeanor to violate the disclosure or the reporting provisions. Facilitators must file a report with the DFI by December 31, 2009. It is exempt from public disclosure, and will be compiled by the DFI for reporting to the Legislature. Additional language and grammar changes are made.

Appropriation: None.

Fiscal Note: Available.

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

Staff Summary of Public Testimony:

(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.

Persons Testifying: 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 Signed In To Testify But Not Testifying: None.