

**MINUTES OF THE  
SENATE COMMITTEE ON COMMERCE AND LABOR**

**Seventy-fourth Session  
February 7, 2007**

The Senate Committee on Commerce and Labor was called to order by Chair Randolph J. Townsend at 8:46 a.m. on Wednesday, February 7, 2007, in Room 2135 of the Legislative Building, Carson City, Nevada. The meeting was videoconferenced to the Grant Sawyer State Office Building, Room 4412E, 555 East Washington Avenue, Las Vegas, Nevada. [Exhibit A](#) is the Agenda. [Exhibit B](#) is the Attendance Roster. All exhibits are available and on file in the Research Library of the Legislative Counsel Bureau.

**COMMITTEE MEMBERS PRESENT:**

Senator Randolph J. Townsend, Chair  
Senator Warren B. Hardy II, Vice Chair  
Senator Joseph J. Heck  
Senator Michael A. Schneider  
Senator Maggie Carlton

**STAFF MEMBERS PRESENT:**

Kelly Gregory, Committee Policy Analyst  
Wil Keane, Committee Counsel  
Scott Young, Committee Policy Analyst  
Gloria Gaillard-Powell, Committee Secretary  
Jeanine Wittenberg, Committee Secretary

**OTHERS PRESENT:**

David W. Turner, CPA, Turner, Loy & Company, LLC  
Mendy K. Elliott, Director, Department of Business and Industry  
Gail J. Anderson, Administrator, Real Estate Division, Department of Business and Industry

**CHAIR TOWNSEND:**

We will now open the meeting to the discussion of Qualified Intermediaries (QIs). This Committee has a responsibility for public policy. We will learn and analyze this topic and the current situation and do the best we can as a Committee. Qualified Intermediaries are firms that assist individuals in legally

deferring capital gains taxes on real property transactions under Section 1031 of the *Internal Revenue Code*. The Committee has been provided with copies of the *Nevada Revised Statutes* (NRS), the *Nevada Administrative Code* (NAC) and newspaper articles relating to this ([Exhibit C](#), original is on file in the Research Library). This issue came to our attention as a result of a company named Southwest Exchange, Incorporated, based in Henderson. Southwest Exchange, closed without notifying customers or returning funds they were holding for future transactions. Southwest Exchange, Incorporated, advertises its intermediary services as being secured by a \$50 million fidelity bond per transaction. Staff is attempting to verify this advertised bond is in place. The Real Estate Division (RED), Department of Business and Industry, served a Summary Suspension of Registration to them and their three registered intermediaries on February 5 2007.

DAVID W. TURNER (CPA, Turner, Loy & Company, LLC):

For the record, I would like to disclose that Senator Townsend and several members of this legislative body are clients of my firm.

I would like to provide some background on how we got to existing federal law on deferred exchanges. You should be aware that a 1031 exchange is not restricted to real estate. You can do "like-changes" with many types of property. Property being sold and the property being acquired must meet one of two criteria. It has to be property that is held for investment or, in the alternative, for the production of income. A personal residence or second home specifically does not qualify. Also, it does not have to be real estate. In 1979, there was a high-profile case in Oregon involving an exchange. Two individuals by the name of Starker, a father and son, sold property to one of the major lumber companies. At that time, there was no codification regarding deferred exchanges and how they worked. There were some real old cases that said you did not need to do a simultaneous exchange, you could do a deferred exchange. The transaction for the Starkers' was that they sold a property and did not take the money. They made an arrangement with the lumber company that at some point in the future they would identify property they wanted the lumber company to purchase for them. After a few years, they identified property to purchase, and the lumber company purchased it. The Internal Revenue Service (IRS) audited both the father and the son. Each one had different agents auditing them. For one of the audits, the agent stated what was done worked. For the other audit, the agent said what was done did not work. The Starker Exchange court decision was a result of the litigation that

ensued. The case that went to trial really had nothing to do with exchanges; it was collateral estoppel, which means the IRS cannot treat one taxpayer differently than another, especially in the same transaction. Because the Starker litigation gained such notoriety, deferred exchanges became known as Starker Exchanges. In the late 1980s, the IRS got the U.S. Congress to enact legislation that set rules and guidelines for deferred exchanges. They specified that the property to be acquired in replacement of the property sold had to be identified within 45 days. They allowed the identification of more than one property. The 45-day clock starts on the date escrow closes for the property sold. The second rule is that the completion of the transaction must take place within 180 days of the date of sale or, if sooner, the due date of the taxpayer's tax return including extensions. Both sides of the exchange must be reported on a timely return for the year of which the sale occurred, regardless of the year the replacement took place or there is no exchange and it is taxable. The third rule provided that the seller cannot have constructive receipt of the proceeds. The proceeds had to be held in an escrow account. That is what brought us the industry today of QIs, of which Southwest Exchange is a part. Rules were created for who could be a QI. They must be an independent third party of which the client has no control nor has any family relationship.

Nevada is the only state in the nation that has any regulation of QIs. There are no other rules in the United States regarding intermediaries and criteria they must meet. Nevada requires licensure and bonding. California has discussed it but has not enacted law. Cross-border exchanges require Nevada licensure even though the person may not reside in this State. The IRS will not extend time periods in federal statute. The only exemptions to that are in the case of natural disaster, members of the armed forces serving in hazardous areas and contractors working in those areas for the U.S. Government. The extension only allows an extra 120 days from the 180-day rule. Since the investors who used Southwest Exchange have no idea where their money is, they will most likely be taxed for capital gains if they do not meet the IRS timelines. We are talking about potentially substantial amounts of money. The loss that these people may incur will not be deductible until the final loss is determined.

SENATOR HARDY:

Are there any federal regulations on this type of business beyond IRS regulations?

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MR. TURNER:

Federal law only defines who can qualify to be an intermediary.

SENATOR HARDY:

Are there any sanctions or bonding requirements?

MR. TURNER:

No.

SENATOR HARDY:

Is it fair to say that beyond IRS regulations, this industry is not regulated?

MR. TURNER:

There are other laws that allow for prosecution of a crime they may have committed.

SENATOR HARDY:

The violation for that would not be a violation of the IRS regulations.

MR. TURNER:

Correct. There may be theft in this case and that is why the Federal Bureau of Investigation (FBI) is involved.

SENATOR HARDY:

I was stunned to learn that we are the only state to regulate QIs. This seems to be a prime opportunity for someone who wants to bilk investors. Are there things that need regulation beyond fraud? I have a hard time understanding why this company came to do business in the only state that regulates this.

MR. TURNER:

At this time, we do not know if this was done with intention to defraud. Southwest Exchange was a credible entity that changed ownership last July.

SENATOR HARDY:

That is the reason for my questions. I think we should be careful not to focus too much on the potential fraud and spend some time and attention to the way these businesses are conducted. If there are not sufficient safeguards and auditing set up to make sure these people are conducting business appropriately, it could happen to an otherwise honest business.

MR. TURNER:

I would hope that we get additional legislation as a result of this. The national association has drafted what they hope to be model language for regulation and have presented it to several states. You may want to consider a system of internal control which is passed on by a regulatory agency such as what the State Gaming Control Board has in place.

SENATOR HARDY:

Do you have an opinion as to why this industry is not more of a target for people seeking to defraud investors?

MR. TURNER:

I am aware that there have been a few other cases of this nationally.

SENATOR CARLTON:

Could you provide me with an example of how the transaction works?

MR. TURNER:

As an example, I own black acre and want to sell it. I have owned it for many years and originally paid \$1,000 for the property. In today's market, it is worth \$100,000. If I sell it outright, I am going to pay federal income taxes on a \$99,000 profit at 15 percent. As an alternative, if I take the sale proceeds of black acre and purchase white acre, a replacement property, then I have replacement property for black acre. Since I did not pay taxes on the \$99,000 profit, that deferred gain is not part of my purchase price for federal tax purposes. People that do this are trading up and federal tax law allows that. Before 1997, this was allowed with personal residences. There was a rule in law concerning the profit made on the sale of a personal residence. If you purchased a new personal residence within two years, with a cost more than the selling price of the previous residence, you would not have a tax liability. Your cost basis on the new residence did not give you the increase in purchase price because you did not pay tax on the money that was used for purchase. That is section 1034 of the *Internal Revenue Code*. Section 1031 of the *Internal Revenue Code* is the only code with constructive receipt issues that creates a need for an intermediary.

SENATOR SCHNEIDER:

A year-and-a-half ago my wife and I did an exchange with Southwest Exchange that went fine. To make it simple for Senator Carlton, you sell your property and

sign the necessary paperwork for notification of a 1031 exchange and escrow allows you to choose a QI and at the close of escrow, the escrow company transfers the funds to the QI. The QI warehouses your money and files your necessary IRS paperwork at an additional cost. Your money can be sitting for 180 days with the QI. The QI pays you interest on your money while in their possession. When you identify another property for purchase, escrow then notifies the QI and requests the funding to close escrow. It is a simple process that should be safe.

MR. TURNER:

It is possible for your name to be on the account even though you do not have withdrawal privileges. There are a few ways to ensure your money is safe. It could be in a separate certificate of deposit or bank account so that you would get statements and be able to monitor your account activity.

SENATOR CARLTON:

Can a 1031 exchange be done on a primary residence?

MR. TURNER:

No. A personal residence or a second home does not qualify for a 1031 exchange. A 1031 exchange applies to properties that are for the production of income.

CHAIR TOWNSEND:

Mr. Turner, would you please discuss the other industry that relates to what we just discussed?

MR. TURNER:

This relates to the payroll service industry. I am aware of two companies in Nevada that have had problems in the last year. In Nevada and 47 other states, there is no regulation of this industry. The way the industry works is the payroll service is contracted by an employer to provide the necessary paperwork and funds to the proper reporting agencies. I have a large client in southern Nevada with 150 employees and 9 doctors who make very good money. Therefore, they have a large payroll and chose to move to a payroll service. Everything worked well for the first year. Beginning in November 2006, the payroll service company did not send all the money to the IRS they were supposed to on behalf of this client. Owing payroll taxes to the IRS is not debt you can even discharge in bankruptcy. The fact that even though the funds came out of the client's

bank account and were transferred to the payroll service does not alleviate the client's obligation to pay the IRS. To disguise this, the payroll service actually filed a different return in the first quarter of 2006 with the IRS than what they provided to the client to match their records. Payroll figures reported to the IRS was understated by \$500,000. Over a seven-month period of time, the funds that were supposed to be paid to the IRS amounted to \$700,000.

There was also another payroll service in northern Nevada that recently embezzled several million dollars. With the exception of four states, this is a totally unregulated industry. Regulation in those four states varies and some of the regulation is so onerous that small business cannot afford to be in the industry. In our State, the only thing required of a payroll service is a business license issued by the State and the jurisdiction in which they conduct business. Bonding and auditing is not required.

I would be happy to ask people from both of the industries we spoke of today to assist you with future legislation.

CHAIR TOWNSEND:

This Committee needs to be provided with copies of the proposed model legislation on regulations of QIs. We also need copies of the regulations for the four jurisdictions that regulate payroll services.

SENATOR HARDY:

Do 1031 exchanges have to be an exact purchase as the type of property that was sold?

MR. TURNER:

No. In 1031 exchanges it only has to be a like-kind exchange, that is real estate for real estate.

CHAIR TOWNSEND:

It is my intention today for the Committee to become educated about the mechanics of the industries about which we are speaking.

MENDY K. ELLIOTT (Director, Department of Business and Industry):

I have prepared a hard-copy PowerPoint presentation for the Committee as well as my written testimony ([Exhibit D](#)). This information is provided to assist and educate the Committee on 1031 exchanges. Mr. Turner has done a phenomenal

job this morning explaining this. I spoke with Hugh Pollard, President, Federation of Exchange Accommodators, yesterday. He is located in Chicago and his industry has been proactive and has drafted model legislation.

The Federation recommends requiring licensure of QIs. One of the things that Nevada does require, and they also propose this, is fingerprinting and background checks on any agency employee who has the ability to move money. As we discussed, the nuance to the QIs is that they have cash and 180 days to flip that money, based on the wishes of the owner of the funds.

The Federation recommends a \$1 million fidelity bond rather than a surety bond, \$250,000 in errors and omissions insurance and developing a mechanism for notification of any changes in the company structure. Nobody knew that Southwest Exchange had changed ownership last year.

The Federation recommends granting State power to investigate and examine and mandate that the company have liquidity. What happened in the Southwest Exchange incident is that there was a \$22 million transaction that occurred. The owners were trying to close escrow on a like-kind property and the money did not arrive.

The Federation recommends specifying who is in charge. Mr. Pollard emphasized that the chief financial officer of the QI must be an attorney, certified public accountant, certified financial planner, certified exchange specialist or someone with three years of experience in the industry.

The Federation recommends continuing education requirements.

Mr. Pollard's organization is willing to work with this Committee if it desires to move forward on additional legislation for this industry. If the Committee does decide to move forward, it will be setting the best practice for the country.

CHAIR TOWNSEND:

In [Exhibit D](#), number 5 on the second page reads, "Develop a mechanism for notification of any changes in the company, whether it's been moved or sold, etc." If someone who has their money currently housed with the QI is notified of sale and the individual is not trusting of the new buyers, can they remove the money or does that trigger the taxable responsibility? Can the money be moved to a different QI?



MR. TURNER:

I have not seen a ruling that they can change QIs. I do not have a reason for why they could not.

CHAIR TOWNSEND:

Mr. Turner, based on your experience, right now Southwest Exchange is housed in this State so it is our responsibility. Some of these transactions may have occurred in other jurisdictions which triggers a federal responsibility. Do you have any insight on this?

MR. TURNER:

I think it must be because the FBI is involved in this. For them to become involved, it must be interstate.

CHAIR TOWNSEND:

Ms. Anderson, I do not know if you spoke with the judge on this case yesterday. Based upon the 9 a.m. hearing on this, Southwest Exchange has been placed in receivership. Is that accurate?

GAIL J. ANDERSON (Administrator, Real Estate Division, Department of Business and Industry):

I was not present at the hearing, but that is my understanding.

SENATOR HARDY:

Ms. Elliott, in your experience, is there any reason that this has not happened in the industry before this?

MS. ELLIOTT:

Part of the opportunity here is that it is such a short-term transaction. The maximum term is 180 days. I hate to say that maybe we have been lucky until now, but because of the short duration of the transaction, that makes it less desirable.

The other opportunity is not only are there QIs, but you are also dealing with law firms, title companies and banks that are involved in the transactions.

SENATOR HARDY:

Mr. Turner, do you have any sense that if we regulate or overregulate, we could possibly diminish people's desire to reinvest in Nevada?

MR. TURNER:

I do not think you will drive people from Nevada who want to invest, only people who would want to come to Nevada to become QIs.

SENATOR HARDY:

The other side of the coin could be that it may actually attract people to invest here because of the QI regulations.

SENATOR HECK:

What is the benefit of using an independent QI instead of using a financial institution or title company?

MR. TURNER:

I do not know that there is an answer one way or the other on that. Most title companies in Nevada have subsidiaries that provide these services. The industry is very specialized. Most QIs represent people who are not represented by legal counsel.

SENATOR HARDY:

What would be the consequences of eliminating QIs? How many companies would be affected?

MS. ANDERSON:

There are currently 52 QIs registered in the State.

SENATOR HARDY:

Do we have any complaint records on any of the other 51 companies?

MS. ANDERSON:

Since I have been with the RED, there have been no other complaints until this incident happened.

My comments have been triggered by previous discussion. In the NAC, the definition to act as a QI is defined. I believe that Nevada could enact legislation that would protect citizens in these transactions. The current definition captures anyone entering into an agreement with a client who wishes to relinquish or acquire real property located in Nevada as part of an exchange. While there are transactions that are not completely transacted in Nevada, the current

requirement for registration as a QI captures both sides of relinquishing or acquiring business in Nevada or having a business here.

SENATOR HARDY:

If you retain a QI from Arizona but the property being acquired is in Nevada, does that QI have to be licensed in Nevada?

MS. ANDERSON:

The QI must be registered in Nevada. Hearsay is that there is probably unregistered QI activity going on in this State. If we learn of it, we would issue a cease-and-desist order. I would like to clarify that this is a registration and we distinguish between a registration and a license in a couple of ways. Licensing involves pre-licensing education, examination and continuing education. Registration involves statistical data and background investigation. There have also been discussions and considerations of surety and fidelity bond requirements. Audit is always good. I would ask your consideration of disallowing the commingling of funds unless that is a practice that the exchange is allowed to do. This requires that the money not be used for any other purpose. As of yesterday, the RED had received 28 written complaints in regard to Southwest Exchange. The complaints that included dollar amounts were running around \$22 million. We realize that is not the extent of things, but that is the information that we have at this time.

CHAIR TOWNSEND:

Have you been successful in contacting Brown & Brown of California, Incorporated, the purported insurance carrier of the bond?

MS. ANDERSON:

What I have verified is that Southwest Exchange has a certificate of deposit on file with the RED and this is an alternative.

CHAIR TOWNSEND:

I am referring to what Southwest Exchange has advertised. They advertise a \$50 million bond insured by Brown & Brown of California.

MS. ANDERSON:

We do not have an answer on that yet. I have a staff member working on it now.

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CHAIR TOWNSEND:

Please let us know immediately when you have an answer.

We will take further consideration on this topic in subcommittee next week.

There being no further business before the Committee this morning, the meeting is adjourned at 10:11 a.m.

RESPECTFULLY SUBMITTED:

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Jeanine Wittenberg,  
Committee Secretary

APPROVED BY:

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Senator Randolph J. Townsend, Chair

DATE: \_\_\_\_\_