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The importance of due diligence before recommending a 1031 Qualified Intermediary

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Have you examined your qualified intermediary (QI) lately? Are you sure your 1031 exchange funds are secure? New England real estate investors, and their tax/legal advisors, should be aware of the importance of proper due diligence before selecting a QI.

Although a small number of states nationally, and nearby in Connecticut, have enacted regulations governing IRC Section 1031 exchange QI companies (see Asset Preservation's website, www.apixchange.com, for more information on various state QI regulations), there are no federal regulations regarding QI's and the safeguarding of exchange funds. Accordingly, it is important for both the taxpayer and the taxpayer's tax/legal advisors to perform due diligence before choosing a QI company.

The importance of this can be seen in *Winters v. Dowdall* (*Winters v. Dowdall* 63 A.D. 3d 650 (2009) 882 N.Y.S. 2d 100). In this Northeast case, the investor sold a relinquished property in New York and retained Dowdall and Associates, P.C. (Dowdall), purported experts in the field, to provide legal advice regarding their 1031 exchange, and specifically with the selection of a QI.

Dowdall selected Atlantic Exchange Company, LLC (AEC) to act as QI. During the course of the exchange, the investor's proceeds were stolen by AEC. The investor's loss was over \$604,000. The investor argued that his loss was caused by Dowdall's legal malpractice, including:

- * Failure to properly investigate AEC before selecting them as QI;
- * Failure to confirm that AEC was sufficiently bonded before recommending AEC as the QI; and
- * Failure to confirm that the investor's exchange proceeds were deposited into an account on behalf of the investor as required by the terms of the exchange agreement.

The court determined that Dowdall committed malpractice for negligently failing to perform adequate due diligence on the QI prior to recommending the QI to the investor. Dowdall had represented that they were experts on the subject of Section 1031 tax-deferred exchanges, and the investor had relied upon these representations in hiring Dowdall. The court specifically determined that the advice given by Dowdall was negligent, and was the proximate cause of the damage to the investor.

Tax, legal and financial advisors in New England should realize the importance of performing sufficient due diligence before recommending a QI to facilitate a 1031 exchange on behalf of their clients. This due diligence should consist of an examination of the practices of the QI regarding the handling of client funds, and the security measures offered by the QI in the event of loss, including but not limited to:

- * Funds deposited in a separate account on behalf of the investor;
- * Provision of a written guarantee of exchange proceeds (or other security mechanisms safeguarding the exchange proceeds);
- * Adequate insurance on exchange funds;

* Depository information regarding the type of depository account into which exchange funds will be deposited; and

* Financial strength of the QI.

Taxpayers and their advisors should pay particular attention to conducting due diligence with regard to the QI they plan to use in a Section 1031 tax-deferred exchange. Such due diligence is essential for a successful exchange and for the protection of exchanger assets.

This information is not intended to replace qualified legal and/or tax advisors. Every taxpayer should review their specific transaction with their own legal and/or tax counsel. ©2014 Asset Preservation, Inc. All rights reserved.

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