

Seller Financing

Numerous Options are Available in 1031 Exchanges

1031

Knowledge

When a taxpayer elects to provide seller financing by carrying back a note (as consideration for the purchase of the relinquished property), there are basically three options for treatment of the note:

1. Do not include the note in the exchange and pay any taxes that may be due. The taxpayer would receive the note as the beneficiary at the closing and pay taxes on this portion of the capital gain under the installment sale method which is specified in IRC Section 453.
2. The taxpayer provides a cash loan to the buyer at the closing of the relinquished property. The cash is brought to the closing and is shown as a line item on the sale Settlement Statement. The taxpayer is shown as the beneficiary on the installment note and receives the note, while the cash proceeds from the sale and the cash for the note are transferred to the qualified intermediary.
3. Include the note in the exchange by initially showing the qualified intermediary as the beneficiary on the installment note and possibly defer the capital gain taxes.

In option 1, the taxpayer is electing to take the installment note method pursuant to §453. The note is made payable to the taxpayer and is received by the taxpayer at the closing of the relinquished property sale.

In option 3, the taxpayer has four different alternatives for attempting to use the note as part of the consideration for purchasing replacement property in a 1031 exchange. To avoid "constructive or actual receipt" by the taxpayer, the qualified intermediary is named as the beneficiary on the installment note.

USE THE NOTE TOWARDS THE DOWN PAYMENT ON THE REPLACEMENT PROPERTY

The seller of the replacement property accepts the installment note as partial consideration towards the purchase price of the replacement property. In this scenario, the note is assigned to the seller of the replacement property by the qualified intermediary and delivered to the seller at the replacement property closing.

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TAXPAYER PURCHASES INSTALLMENT NOTE FROM THE QUALIFIED INTERMEDIARY

The taxpayer purchases the installment note from the qualified intermediary. The sale of the installment note to the taxpayer takes place during the exchange period, thus allowing the qualified intermediary to apply the note proceeds towards the replacement property purchase.

THE PAYER ON THE INSTALLMENT NOTE PAYS OFF THE INSTALLMENT NOTE PRIOR TO CLOSING ON THE REPLACEMENT PROPERTY

The installment note is paid off during the 180-day exchange period. This approach works only on short-term notes due within the 180-day exchange period. The payer pays off the installment note directly to the qualified intermediary, the holder of the installment note. The qualified intermediary adds the payoff proceeds to the existing exchange proceeds in the qualified intermediary's account where funds are being held for the benefit of the taxpayer. When the replacement property is ready to close, all proceeds in the qualified intermediary's account are wired to the closing officer handling the purchase of the replacement property.

SELLING THE NOTE ON THE SECONDARY MARKET

The taxpayer finds an investor willing to purchase the installment note, thereby replacing the note with cash. The installment note sale proceeds are added to the existing exchange proceeds in the qualified intermediary's account and all proceeds are applied to the purchase of the replacement property. Typically the installment note will need to be sold at a discount, often from 15% – 30%. If the installment note is discounted, the discounted amount may be considered a selling expense.

If the taxpayer chooses option 3 (having the qualified intermediary as the beneficiary on the installment note) and then is unsuccessful with any of the four alternatives shown above, the qualified intermediary will assign the installment note back to the taxpayer. The taxpayer will then continue to receive the tax benefits of the installment note method in §453 as shown under option 1.

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