Seller Financing Combined with a Tax Deferred Exchange

IPX 1031® Exchange Topics

Sometimes it is necessary or desirable for an Exchanger to accept payment from the Relinquished Property purchaser in the form of cash and a promissory note. Treas. Reg. §1.1031(k)-(1)(j)(2) provides guidance for coordinating the tax deferral benefits of IRC §1031 with the installment sale benefits of IRC §453.

There are three basic scenarios in which an Exchanger may combine the benefits of seller financing with a §1031 exchange. For each scenario below, assume that the Exchanger sells Relinquished Property for $100. The Buyer wishes to pay $20 cash and give a promissory note for the balance of $80.

1. **Exchanger has access to additional cash and desires an income stream.** Exchanger funds $80 cash at closing of the Relinquished Property sale, representing Exchanger's loan to the buyer. (Exchanger may borrow the cash necessary to loan to Buyer.) Qualified Intermediary receives $100 cash from sale of Relinquished Property. Exchanger receives the buyer's note (payable to Exchanger) and security instrument outside of the exchange. Exchanger's basis in the note is $80; principal payments on the note are nontaxable as return of principal, interest payments are taxable as ordinary income, as received. Qualified Intermediary uses $100 to buy Replacement Property, allowing for a completely tax-deferred exchange.
2. **Exchanger does not have cash to fund the loan to the Buyer outside of the exchange.** Upon closing the sale of the Relinquished Property, Qualified Intermediary receives the $20 cash and a promissory note (and security instrument, if any) from the buyer for $80, payable to the Qualified Intermediary. When the Exchanger is ready to acquire Replacement Property, Exchanger can arrange for Qualified Intermediary to sell the note (1) to Exchanger for the remaining principal balance due on the note (Exchanger may borrow the cash necessary to purchase the note), OR (2) to a third party note buyer (but any discount will be treated as boot and will reduce the amount of gain deferred), OR (3) to the lender that will make the loan to the Exchanger for purchase of the Replacement Property. Qualified Intermediary then has $100 cash with which to buy Replacement Property allowing the Exchanger to defer all of the gain. If the Exchanger has purchased the note, Exchanger will have an $80 basis in the note. Principal payments on the note will be non-taxable as return of principal; interest payments will be taxable as ordinary income, as received. Alternatively, Exchanger can arrange for the Qualified Intermediary to assign the note to the Replacement Property seller as part of the purchase price, along with the $20 cash, resulting in complete deferral of gain.
3. **Exchanger does not have cash to fund the loan to the Buyer outside of the exchange and the exchange partially or completely fails.** The Qualified Intermediary is holding $20 of Exchange Funds and the buyer's note, but the Exchanger is unable to fully complete the exchange and carries back (i.e. retains) the $80 promissory note as a result. Qualified Intermediary uses $20 cash to acquire Replacement Property, but the Exchanger is unable to identify and acquire any additional Replacement Properties. Upon termination of the exchange, the Qualified Intermediary assigns the note and security instrument to the Exchanger. Basis in the Relinquished Property will be allocated first to the Replacement Property, with any basis in excess of $20 allocated to the note. To the extent that Exchanger's basis in the Relinquished Property was less than $20, gain that was rolled into the Replacement Property will be deferred indefinitely. Recognition of the gain attributable to the note will be spread over the life of the note. Pursuant to the installment rules under IRC §453, the Exchanger will recognize and pay capital gains tax on the gain allocated to the note incrementally, and ordinary income tax on the interest, as the payments are received.

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