Combining Seller Financing with Tax Deferred Exchanges

In most cases, it is preferable for the seller (Exchanger) to receive all cash for the sale of the relinquished property. However, many real estate sale transactions require the seller to "carry back" a part of the purchase price as financing to assist the buyer in purchasing the property. In this situation the Exchanger may elect to:

1. Sell instead of exchange. Treat the buyer's promissory note as an installment sale (IRC §453) and pay any capital gain taxes on the principal payments on the note when these payments are received by the Exchanger; or
2. Provide the funds required for the seller-financing from the Exchanger's own funds at the closing of the relinquished property, thereby acting as a "third-party lender" for the buyer; or
3. Combine the seller-financing portion of the sale with a tax-deferred exchange for the balance of the relinquished property (Treas. Reg. §1.1031(k)-1(j)(2)). The capital gain attributable to the portion of the relinquished property that was exchanged will be deferred into the replacement property and the capital gain that is attributable to the installment note will be deferred over the life of the note and recognized upon receipt of the principal. Generally, all of the basis on the sale property will be allocated to the replacement property and the installment note will have no basis; which means, all payments received will be fully taxable; or
4. Include the seller-financing note as part of the exchange by specifying the Qualified Intermediary as the payee of the note and beneficiary of any trust deed or mortgage at the close of the relinquished property. The value of the note must be converted to "down-payment equity" to be used by the Qualified Intermediary for the purchase of the replacement property (Treas. Reg. §1.1031 (k)-l(j)(2)). The Exchanger can then have the Qualified Intermediary use the note in several ways to defer the taxable gain into the replacement property:
   - (A) Assign the note to the seller of the replacement property. The result is a complete tax deferral into the replacement property. However, the seller of the replacement property does not get installment sale treatment on the receipt of the Exchanger's note.
   - (B) Sell the note to a third party for cash and then use the cash to purchase the replacement property. The Exchanger must consider whether a discount charged by the buyer of the note, if applicable, exceeds or is offset by the capital gain tax that would have been paid under the normal installment sale rules.
   - (C) Sell the note for cash to the Exchanger or to a friendly party and use the cash to purchase the replacement property.

While there is no legal authority as to whether the Exchanger can successfully use this option to defer the note proceeds into the replacement property, the approach is reasonable and if done properly should result in favorable treatment. However, the Exchanger should only use this method upon the advice of their tax or legal counsel. Also, the Exchanger or the friendly party should not purchase the note at a discount.

If the Qualified Intermediary is unable to utilize any of the above options, the note will be reassigned to the Exchanger at the termination of the exchange. The Exchanger will receive the same installment sale treatment under IRC §453 as if the Exchanger had not attempted to defer the note through the exchange. Moreover, the date for commencement for the installment sale treatment is the date the note is reassigned to the Exchanger from the Qualified Intermediary and not the date of sale of the relinquished property.

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