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SELLER FINANCING IN A 1031 EXCHANGE

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Taxpayers considering structuring a 1031 exchange sometimes want to know if they can provide seller financing to the buyer of their relinquished property, usually because the buyer is unable to obtain financing from a traditional lender. Such seller financing is very tricky to structure within a 1031 exchange and there is limited guidance from the IRS on how taxpayers can combine Section 1031 with installment sale rules. To qualify as a like-kind exchange, the taxpayer must receive like-kind property; gain may be recognized to the extent "boot" is received in the transaction. One problem with seller financing is that a note received from a buyer is not like-kind to real property and will be treated as cash boot in the transaction. Because of this issue, it is usually recommended that a seller avoid taking a note from the buyer. Sometimes, however, this cannot be avoided. Various methods that have been used by taxpayers to accomplish different tax goals are discussed below.

1. General Rule for Recognition of Gain in an Installment Sale

For starters, it's important to remember the general tax treatment of the receipt of a note when a seller engages in seller financing. Under installment sale rules set forth in Internal Revenue Code § 453, the gain is generally prorated over the life of the note. (Certain rules and exceptions for some transactions apply.) The proration will occur by applying a **Gross Profit Percentage** to each principal payment received. The Gross Profit Percentage = Gross Profit ÷ Contract Price. For instance, if a taxpayer is selling property for a total contract price of $500K, that has an adjusted basis of $100K, he has a **Gross Profit** of $400K. The $400K gross profit, divided by the $500K contract price, creates a Gross Profit Percentage of 80%. ($400K/$500K = 80%.) Let's say the taxpayer has agreed to seller financing, requiring $50K down at closing, and an additional $50K payment each year for the next 9 years, plus interest. The seller will recognize gain in the amount of $40K each year for 10 years, calculated by applying the gross profit percentage of 80% to each $50K principal payment received, in the year it is received. If, however, in the fifth year after closing the purchaser refinances and pays off the entire remaining principal balance of $250K, the taxpayer will recognize $200K capital gain that year, i.e., 80% of the principal amount received that year. An installment sale, like a §1031 exchange, is a method of *deferring* recognition of gain rather than recognizing all the gain at the time of the sale.

2. Combination 1031 Exchange and Installment Sale

Internal Revenue Code Section 453(f)(6) deals with installment sales that also include a like-kind exchange component. Combining a 1031 exchange with an installment sale will not result in the same gross profit percentage discussed above. As an example, let's assume a taxpayer wants to seller-finance $300K of the same $500K sale, which has a $100K basis. He intends to acquire replacement property worth $200K (the amount of the sales proceeds to go to the Qualified Intermediary at closing), and intends to defer gain on the remaining $300K note, to be recognized over the life of the note. Under the rules for combining a 1031 exchange with an installment sale, *the like-kind property is not considered an installment payment received*[1], rather the note is considered boot in the 1031 exchange. The gain deferred in the exchange, therefore, is $400K (realized gain), minus $300K (boot from the note) = $100K. To calculate the gross profit percentage to be applied to payments received under the note, *the contract price is reduced by the amount of like-kind property received*[2]. So, the contract price used in calculating the gross profit percentage is $500K, minus $200K replacement property = $300K. *The gross profit for the note is calculated by reducing the gain not recognized because of the 1031 exchange*[3], i.e. $400K (gross profit) - $100K (gain deferred in exchange) = $300K. So the gross profit percentage (gross profit/contract price) is $300K/$300K, or 100%. All of the principal payments received under the note will be taxed as gain, and only $100K can be deferred under Section 1031. The net effect to remember is that as a result of the combination of a 1031 exchange with seller financing, the note is considered boot, and gain goes first to the note. Only any remaining gain may be deferred under Section 1031. If a taxpayer did not seek guidance as to the nuances of combining a 1031 exchange with an installment sale, he might believe he could apply the normal 80% gross profit percentage and defer $160K gain in the exchange and $240K gain under the note. He would be wrong! In fact, this combination of an exchange and seller financing only benefits the taxpayer if the gain realized in the transaction is greater than the amount of the note.

[1] I.R.C. § 453(f)(6)(C)
[2] I.R.C. § 453(f)(6)(A)
[3] I.R.C. § 453(f)(6)(B)

continued on page 2

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So, are there any methods of structuring combined seller financing and a 1031 exchange to avoid characterization and treatment of the note as "boot"? Section 453(d) permits a taxpayer to opt out of installment sale treatment. The remaining methods of dealing with seller financing assume that the taxpayer has opted out of installment sale treatment, and must find a way to avoid receipt of the note as boot in the transaction. The note must be converted to cash in the qualified intermediary's hands to be used to purchase replacement property.

3. Cash Loan from Taxpayer to Buyer

If the taxpayer has cash available, some authorities suggest he could use that cash to make a separate loan to the buyer, which is, in essence, a loan like any other third-party loan[4]. This loan will, presumably, not result in taxable boot to the taxpayer because the loan funds are coming out of his own pocket, not out of the relinquished property equity. This will allow all of the equity from the relinquished property to go to the qualified intermediary, to be used toward the purchase of replacement property. It may also be preferable for someone related to the taxpayer, such as a non-title-holding spouse, sibling, parent, or controlled entity to act as the lender in this situation. In this scenario, the taxpayer's receipt of the note, theoretically, would not be boot, because it is not true seller financing – the QI has received cash from the purchaser, generated by a true cash loan. Although various experts have suggested this method, there have been no IRS rulings allowing or disallowing this structure.

4. Note Made Payable to the Qualified Intermediary Who Sells the Note to the Taxpayer

As discussed above, if the note is made payable to the taxpayer, it will be taxable boot to him. One way to avoid this boot characterization would be to have the note from the buyer made payable not to the taxpayer, but to the qualified intermediary. Any payments due on the note during the exchange period should be made to the qualified intermediary, not the taxpayer, and these payments can be used toward the purchase of replacement property. This method is especially useful if the buyer just needs seller financing for a short period of time, as a bridge loan. If the buyer pays off the loan before the acquisition of replacement property, it has been converted to cash in the qualified intermediary's hands, for the purchase of the replacement property. However, if it is long-term financing, prior to or at the closing of the replacement property, the taxpayer typically buys the note from the qualified intermediary at face value and the cash paid by the taxpayer will be used to purchase replacement property. This results in all of the equity from the relinquished property being transferred to the replacement property. Although this method also requires the taxpayer to put money into the transaction, he has the advantage of a little more time to come up with the cash.

5. Note Made Payable to the Qualified Intermediary Who Sells the Note to a Third Party

Just as in the preceding option, the buyer will make the note payable to the qualified intermediary and any payments due on the note during the exchange period should be made to the qualified intermediary, not to the taxpayer. Again, this prevents constructive receipt of the note by the taxpayer, which would be boot in the exchange. In this case, instead of the taxpayer buying the note for cash, a third party will buy the note for cash, usually for less than face value. The cash generated from the sale will then be used to purchase replacement property. This option presents two problems; however: 1) how does the taxpayer report the qualified intermediary's sale of the note at a discounted price on Form 8824 when he reports his exchange on his tax return; and 2) is the qualified intermediary required to report the sale of the note on its tax return?

6. Note Made Payable to the Qualified Intermediary Who Uses the Note to Buy Replacement Property

Once again, the note should be made payable to the qualified intermediary with any payments due going to the intermediary, not the taxpayer. This option may be useful if the taxpayer does not have the cash available to purchase the note from the qualified intermediary. At the replacement property closing, the qualified intermediary can simply assign the note to the seller as partial payment for the replacement property. While this option sounds like a good idea, it is usually tough to accomplish in reality because most sellers aren't willing to accept a note in lieu of cash as payment for their property.

All of the options discussed above show just how difficult it can be to attempt seller financing in a 1031 exchange. It is preferable for the taxpayer to require that the buyer obtain conventional financing from a third-party lender. If that is not possible, it may still be better for the taxpayer to find another buyer who will not require seller financing. However, in today's difficult real estate lending market, exchangors may increasingly turn to creative methods, such as seller-financing, as borrowers look to alternative ways to finance their purchases. Although Investors Title has seen these methods used by taxpayers, we neither endorse, encourage, nor discourage their utilization. It is important to note that the IRS has offered so little guidance in this arena, that it is absolutely critical for the taxpayer to consult with his tax advisor on such a complex issue.

[4]*Tax-Free Exch Under § 1031 § 9:21, Long & Foster (West.)*