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Seller Financing and 1031 Exchanges

Some real estate sale transactions require the seller to "carry back", or personally loan, a part of the purchase price as financing to assist the buyer in purchasing the property. If the note is payable to a seller who is entering into a 1031 exchange, it will be subject to tax. So, what are the options of the exchanging party?

Fully Taxable

In lieu of doing a 1031 exchange, the seller could sell the property on the installment method recognizing gain when principal payments under the note are received.

Partly Taxable

Combine the seller financing portion of the sale with a tax deferred exchange. The gain resulting from the seller financed portion could be reported on the installment method, while the capital gain realized from the sale of the non-financed portion could be used to purchase replacement property in a 1031 exchange.

No Tax – Complete Deferral

Include the seller financing with the exchange by making the note payable to the qualified intermediary. The note would then need to be converted to "exchange equity" by any of the following methods:

A. The note could be assigned to the seller of the replacement property at closing. Depending on a number of factors, including the credit worthiness of the note maker and the goals of the seller of the replacement property, this alternative may be difficult to implement. Also, the seller of the replacement property would not be able to use the installment method for the note, due to the fact that the note was not from the buyer of the seller's property.

B. The intermediary could sell the note to a third party. The note sale proceeds would be used to acquire the replacement property. Any commercial buyer of the note would purchase the same on a discounted basis. The seller would need to compare the capital gains savings against the discount to determine if this method is beneficial.

C. The intermediary could sell the note to the taxpayer and use the sales proceeds to purchase the replacement property. This is the best alternative provided the seller has the liquidity necessary to buy the note.

Avoid Receipt of Buyer's Note

The seller could restructure the transaction to avoid receiving a note:

A. The seller could lend funds to the buyer prior to the closing of the relinquished property. The buyer would then apply the proceeds toward the purchase price of the property, securing the note with a mortgage on the relinquished property at closing.

B. The seller could refinance the property before sale and have the purchaser assume the new debt as an alternative to taking the buyer's note.

All States 1031 Exchange Facilitator, LLC is a leading provider of Internal Revenue Code Section 1031 exchange consulting and Qualified Intermediary services. Our mission is to provide timely, accurate, and personal exchange services to our clients and their professionals in order to assist them through the 1031 exchange process in a manner that develops mutual trust based upon our experience.

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