>In the Know...

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Exchange Financing aka Seller Carry-Back

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What to consider if you are going to carry-back or provide financing on your sale and do a 1031 Tax Deferred Exchange?

The terms of a normal exchange agreement call for the Qualified Intermediary to step into the Seller's (Exchangor's) position prior to closing. **If the Purchase Contract calls for seller financing, the Qualified Intermediary should then become the recipient of the note.** However**,** if the Exchangor wants to have the proceeds taxed when the principal is paid (installment sale IRC §*453)*, then the Exchangor must instruct the settlement agent and the Qualified Intermediary that only the portion of the sales price that is not financed will apply to the exchange. The Qualified Intermediary will then prepare the exchange documents accordingly and the financing documents will name the Exchangor as beneficiary at closing *(Le. $100,000 safe, $20,000 financed, Q.I. assigned in to 80% of sale).*

If the Exchangor intends to defer the gain on the entire sale, including the financing, the Qualified Intermediary MUST be named as the Beneficiary in the financing documents (the note and deed of trust or mortgage) PRIOR to closing.
The Exchangor then has the following options to consider:

Assignment to Seller of Replacement Property:

If the Seller of the Replacement Property agrees to accept financing secured by the Exchangor's Relinquished Property as part of the purchase price, Qualified Intermediary will assign the financing documents to the Seller and deliver them to the Replacement Property settlement agent for recordation at closing. In this event, the financed portion of the bale proceeds is deferred and the Seller of the Replacement Property will receive all payments and principal on the amount financed.

Sold to Third Party:

If, prior to the acquisition of the Replacement Property, the Exchangor can arrange to have the financing documents purchased from the Qualified Intermediary the gain is deferred. (The buyer and the purchase price are determined by the Exchangor.) Funds are deposited into the exchange and the documents are assigned to the buyer. The funds are combined with the Exchangor's other proceeds and used to acquire Replacement Property.

Paid in full prior to acquisition of Replacement Property:

If the financing is paid off within 180 days of the Exchangor's sale, prior to closing on the Replacement Property, funds can be deposited with the Qualified Intermediary and used to acquire the new property.

Sold to Exchangor;

If the Exchangor has another source of funds and wants to buy the financing documents from the Qualified Intermediary, the Exchangor may, prior to closing the Replacement Property. The Qualified Intermediary then assigns the financing documents to the Exchangor and uses the funds to acquire the Replacement Property. When the financing is paid to the Exchangor, it is a reimbursement of other funds advanced, not proceeds of sale.

If none of the above options are done prior to the completion of the Exchange (the 180th day), the Qualified Intermediary assigns the financing documents to the Exchangor and that portion of the sale reverts back to installment sale status.

If a Seller (aka Exchangor) plans to complete a §1031 Tax Deferred Exchange and intends to offer financing to the Buyer of the relinquished property, the Seller is combining an exchange with an installment sale *(§453).* Both have very different tax consequences and the Seller should consult their tax advisor before the sale closes.

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