

# SELLER FINANCING

## "NUMEROUS OPTIONS ARE AVAILABLE IN §1031 EXCHANGES"



### Compliments of

When an Exchanger elects to carry back a Note on the relinquished property (the sale or Phase I Property), there are basically two options for treatment of the Note:

- (1) DO NOT include the Note in the exchange and pay any taxes that may be due. The Exchanger would receive the Note as the Beneficiary at the closing and pay taxes on this portion of the capital gain under the Installment method (as specified in IRC §453).
- (2) Include the Note in the exchange by initially showing the "Qualified Intermediary" as the Beneficiary and possibly defer the capital gain taxes.

In option number #1, the Exchanger is electing to take the Installment method per IRC Section 453. The Note is made payable to the Exchanger and is received by the Exchanger at the closing of the relinquished property. The drawback to this method is the capital gain taxes could become due in one lump sum if the Note allows for prepayments or if a balloon payment is required. In option number #2, the Exchanger has four different alternatives for attempting to use the Note as part of the tax deferred exchange. In order to avoid "constructive or actual receipt" by the Exchanger, the Intermediary is named as the Beneficiary on the Note.

#### (A) Use the Note towards the Down Payment on the Replacement Property Purchase

The Seller of the replacement property accepts the Note as partial payment towards the purchase price. In this scenario, the Note is assigned to the Seller by the Intermediary and delivered to the Seller at closing.

#### (B) Exchanger Purchases Note from Asset Preservation, Inc.

Essentially, the Exchanger purchases the note from the Intermediary. The purchase may include discounting the note to represent its fair market value at the time of purchase. The sale of the note to the Exchanger takes place during the exchange period, thus allowing the Intermediary to use the note proceeds towards the replacement property purchase.

#### (C) The Payer on the Note Pays Off the Note Prior to Closing on the Replacement Property

The Note is actually paid off during the exchange. This works only on short-term Notes due within the 180 day exchange period. The Payer pays off the Note directly to the Intermediary, the holder of the Note. The Intermediary adds the payoff proceeds to the existing proceeds in the Qualified Exchange Account. When the replacement property is ready to close, all proceeds are delivered to the closing officer.

#### (D) Selling the Note on the Secondary Market

The Exchanger finds an investor willing to purchase the Note, thereby replacing the Note with cash. The cash proceeds are added to the existing cash in the Qualified Exchange Account for purchasing the replacement property. Typically the Note will need to be sold at a discount, often anywhere from 15% – 30%. If the Note is discounted, the discounted amount may be considered a selling expense.

If the Exchanger chooses option #2 and then is unsuccessful with any of the four alternatives shown above, the Intermediary will assign the Note back to the Exchanger. The Exchanger has all the tax benefits of the installment method in Code §453 as shown under option #1 available. Many Exchangers choose option #2 because it allows for several alternatives of tax deferral, without penalizing the Exchanger.



ASSET PRESERVATION  
INCORPORATED

A National IRC §1031 "Qualified Intermediary"

National Headquarters

800-282-1031

Eastern Region Office

866-394-1031

apiexchange.com

info@apiexchange.com

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