SELLER CARRYBACK FINANCING

What is Seller Carryback Financing?

In a real estate transaction, a seller is occasionally asked to finance a portion of the purchase price in the form of a "seller carryback note." At the closing, the buyer gives the seller the agreed upon down payment and pays the balance over time, as described in the note. If structured as an installment sale under IRC Section 453, the seller pays tax on the payments as they are received rather than paying tax on the gain for the entire purchase price. If the seller is also contemplating a tax deferred exchange under IRC § 1031, he will have to decide how to treat the seller carryback note. The note can either be kept outside of the exchange or, under the limited conditions described below, it can be included in the exchange.

Note is Received Outside the Exchange

In most cases where there will be seller carryback financing, the note is not included in the 1031 exchange. The note is taxable boot, but if structured properly under IRC § 453, the tax is paid over time as payments are collected. When the note is not a part of the exchange, it should be payable to the seller and delivered directly to the seller from escrow. Only the cash proceeds received from the sale are delivered to the exchange company and used as exchange funds. It is important for investors to discuss IRC § 453 with their tax advisors because there are specific rules addressing how much of the investor's gain can receive installment sale treatment.

Note is Taken into the Exchange

If an investor wants to use a seller carryback note as part of his exchange proceeds, and therefore defer all tax on the sale (including the amount represented by the note), he has several options. In each case, the note will need to be made payable to the intermediary. At the close of escrow, the note becomes part of the exchange and is held by the intermediary. Any payments made on the note while the intermediary is in possession of the note are made to the intermediary and the payments become part of the exchange proceeds. The most important rule to remember is this: In order for the note to be used as part of the exchange, it must either be converted to cash prior to the purchase of the replacement property or the seller of the replacement property must agree to accept the note as payment for the property..

Convert the Note to Cash

There are several ways in which an investor may be able to convert the note to cash prior to his purchase of the replacement property. First, the note can be a short term note that matures before the investor intends to buy the replacement property. The note payments are made to the intermediary and they become exchange proceeds. Once the note is paid in full, the intermediary uses that cash to purchase the replacement property. Because the note would have to be completely paid during the exchange period, the maximum term of the note is the sooner of 180 days or when the replacement property closing occurs. The short time frame makes this a difficult option for many investors. The second option is for the investor to buy the note from the intermediary. In order to avoid the possibility of constructive receipt, this should occur at the closing of the replacement property. The intermediary then uses the funds to purchase the replacement property at that closing. Finally, the investor can arrange for an unrelated third party to buy the note. The proceeds from the sale would go directly to the intermediary as exchange proceeds. This solution is possible but is fairly uncommon.

Use the Note to Purchase Replacement Property

Occasionally, a seller is able to use the note as partial payment for the replacement property. In this scenario, the intermediary pays the purchase price by delivering any cash exchange proceeds to escrow and assigning the note to the seller of the replacement property at the final closing. The recipient of the note likely would not get installment sale treatment of the note payments.

Hard Money Loans

If the investor has cash available, an alternative structure may be for the investor to loan the money to the buyer of the relinquished property up front as a "hard money loan" rather than through seller carryback financing. Using this option, the seller acts as a third party lender and deposits the full amount of cash into escrow. This structure results in cash proceeds which are delivered to the intermediary for use in the exchange. The investor should discuss this solution with his tax advisor before setting up the exchange.

Conclusion

Often investors try to use a seller carryback note as part of an exchange, but end up unable to do so, because they cannot convert the note to cash or use the note as partial payment for the replacement property. When this happens, the intermediary will assign the note to the taxpayer at the end of the exchange period and the note will be considered boot. In order to avoid the additional costs and procedures involved with combining seller carryback financing and a 1031 exchange, investors should carefully examine their options and consult with their tax advisor prior to setting up the exchange.