1031 Exchange: Seller Financing

Seller financing comes up most frequently where the seller is the taxpayer under an exchange, and the taxpayer is providing some seller financing to the buyer. However, it can also come up where the taxpayer is receiving seller financing from the seller of the replacement property.

What is seller financing?

Seller financing occurs when a person selling real estate is willing to let the purchaser pay the purchase price over time. This can be done for a wide variety of reasons such as the buyer cannot qualify for a conventional loan, or the economics of the deal require a lower interest rate compared to an outside lender. In this case the seller "holds the paper" requiring the taxpayer to pay the seller over time on specified terms. In general, it will also allow the seller to report the income from the periodic payments in the year in which they are received rather than all in the year of an outright sale.

How does seller financing work?

Seller financing can be structured in a couple of ways. One allows the buyer to receive title to the property at the time of closing and the other allows the buyer to take title upon payment of the last installment. More specifically, the first way would be documented with a promissory note from the buyer to the seller. This note would specify the interest rate, the length of time over which the loan was amortized, and the monthly payment amount. The note would typically be secured by a mortgage in favor of the seller as a lien against the property. In some jurisdictions the security interest used may be referred to as a trust deed or deed of trust.

The second way of documenting the transaction would entail some kind of installment contract between the parties. Again, there are regional differences regarding the name of that contract. It can be called an Installment Agreement for Deed or a Contract for Deed or Articles of Agreement for Deed. For tax and exchange purposes they are all the same. Generally, there would be some money paid down from the buyer to the seller and the balance financed over time. Sometimes it will be paid off at the time of the last fixed payment and in other instances it has a balloon payment for the final lump sum.

Whether the transaction is documented by a deed transfer at the time of the initial closing and secured by a note and mortgage or the deed passing upon final payment the tax treatment is the same. The buyer still owns the property either way, but subject to all payments being made. An analogy can be made to buying a new car with some dealer financing. In the case of an installment contract, the buyer owns the car but will not get clear title until it is paid off.

Regardless of the structure, the documents should show the funds payable to the Qualified Intermediary. Funds paid to the taxpayer would constitute "boot" and therefore taxable.

How does seller financing work with an exchange if the taxpayer is financing the buyer?

This can be a bit tricky. For §1031 purposes, a taxpayer only has 180 days from the date of sale of the relinquished property to acquire the replacement property. For there to be total tax deferral, the full value of the sale property must be reinvested into the replacement property. But when seller financing is involved, the seller does not have the full value to roll over. There are times when the full value will be paid into the exchange account within the 180 day window but more often than not, it will be paid after the 180 day exchange period. So, payments coming into the exchange account can be used towards the acquisition of replacement property, but funds payable after that 180 day term cannot.

Although there are various ways to deal with this, the most common one is for the seller to "advance" the balance due for the replacement property with personal funds. Those funds can come from the taxpayer directly or can be borrowed by the taxpayer. The exchange balance plus the additional funds are used to acquire the replacement property. The note and mortgage or the installment sale agreement is then assigned from the Qualified Intermediary to the taxpayer. Since the necessary value was invested on a timely basis into the replacement property, the receipt by the taxpayer of principal payments over time under the financing document are not taxable.

How does seller financing work with an exchange if the taxpayer is financing the buyer?

This situation is not as complicated as when the taxpayer is financing the buyer. In any exchange, in order to have complete deferral, a taxpayer has to reinvest all the net proceeds from the sale and have equal or greater new debt compared to debt paid off at the relinquished property closing. Debt in the form of the balance due under the seller financing structure counts just like conventional financing, so it would typically offset the debt requirement to have equal or greater debt on the replacement property.

Summary

Seller financing is a part of many real estate transactions. However, due to the rules around §1031 exchanges, some special steps need to be taken on account of the seller financing. If the taxpayer is selling, the loan must be documented so that the exchange company is the payee of the loan, and the applicable security interest should correspond. Once the loan document is monetized from a cash infusion by the taxpayer, the necessary amount can be exchanged into the replacement property. Ultimately, the security interest is assigned to the taxpayer and the taxpayer will not recognize any tax on the principal received over time due to the advancement of the funds at the time of the exchange. In the event the taxpayer is receiving the seller financing in connection with the purchase of the replacement property, such debt obligation is treated no differently than any other loan from a conventional financing source. The seller financing debt will offset debt paid off upon closing of the relinquished property.