

# Seller Financing in a 1031 Exchange

Seller financing can be a powerful tool in a 1031 exchange—but how the installment note is handled determines whether taxes are deferred or triggered.

## What Is Seller Financing in a 1031 Exchange?

Seller financing occurs when the seller accepts an **installment note** from the buyer rather than receiving all cash at closing. In a 1031 exchange, this creates special tax considerations because receiving a note can be treated as **taxable boot** unless structured correctly. Below is a clear overview to help taxpayers understand their options and the related tax consequences.

### THREE WAYS AN INSTALLMENT NOTE CAN BE TREATED

#### 1. Installment Note Outside the Exchange

##### Tax Impact: Partially Taxable

- The taxpayer receives the note directly at closing
- The note is considered taxable boot
- Capital gain tied to the note is reported over time under **IRC §453**
- Interest received is taxed as ordinary income

##### Considerations:

- Taxes are spread over time
- Gain is not deferred under §1031 Option

#### 2. Cash Loan Structure at Closing

##### Tax Impact: Generally Deferred, Structurally Sensitive

- The taxpayer lends cash to the buyer at closing
- The buyer issues a note to the taxpayer
- Sale proceeds and loan funds are transferred to the **Qualified Intermediary (QI)**

##### Considerations:

- May preserve exchange deferral
- Requires precise documentation to avoid constructive receipt

#### 3. Installment Note Included in the Exchange

##### Tax Impact: Potentially Fully Deferred

- The **Qualified Intermediary** is named as the beneficiary of the installment note
- This prevents the taxpayer from having actual or constructive receipt
- Taxes are deferred only if the note is successfully converted into exchange value

### HOW AN INSTALLMENT NOTE CAN BE USED TAX-FREE

When the QI holds the note, it may be applied toward the replacement property in several IRS-acceptable ways:

#### 1. Apply the Note Toward the Purchase Price

- The seller of the replacement property accepts the note as partial consideration

#### 2. Convert the Note to Cash During the Exchange

The note may be:

- Paid off by the buyer within the 180-day exchange period
- Sold to a third party (often at a discount)
- Proceeds are added to exchange funds and used for the replacement property

#### 3. Taxpayer Purchases the Note from the QI

- The taxpayer buys the note during the exchange period, and the QI uses the funds to complete the replacement property purchase

### WHAT IF THE NOTE CANNOT BE USED?

If none of the conversion options are completed within the exchange period:

- The QI assigns the note back to the taxpayer
- The taxpayer reports income using the installment sale method under IRC §453
- Taxes are paid gradually as payments are received

### KEY POINTS

- Receiving a note directly usually triggers tax
- Naming the QI as note beneficiary preserves deferral
- Interest on the note is always taxable at ordinary income rates
- Timing and execution matter

If the Note is not liquidated to cash during the Exchange Period, a significant portion of the value may remain outside the exchange and be treated as taxable boot. This could result in substantial immediate tax exposure. In that case, the benefits of a partially deferred exchange may not justify the transactional complexity from a tax perspective.

A properly structured transaction can mean the difference between current tax liability and long-term tax deferral.

This Seller Financing explanation is for informational purposes only and should not be construed as tax advice. Seller financing within a §1031 exchange involves technical compliance risks, and taxpayers should seek counsel with a qualified tax and legal advisor experienced in **§1031 and §453 planning**.