

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

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**.

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