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## Valuable Information for Real Estate Professionals and their Clients

# SELLER CARRYBACK FINANCING

A common misconception is that seller financing and 1031 exchanges are exclusive and cannot be utilized together on the same property. However a seller carryback Note can be combined with a 1031 exchange, but advanced planning and structuring must take place to ensure a smooth transaction.

### SELLER FINANCING/1031 EXCHANGE OPTIONS

Prior to closing on the relinquished property, the Exchanger must decide whether or not they wish to include the Note in the 1031 exchange transaction. The Exchanger has two options at closing:

- (1) DO NOT include the Note in the 1031 exchange and pay any taxes that may be due under the Installment method, as specified in IRC §453. The balance of the sale is still eligible for tax deferred treatment; OR
- (2) Include the Note in the 1031 exchange by structuring the transaction to have the Qualified Intermediary (QI) listed as the Beneficiary. The Note then becomes part of the qualified escrow held by the QI. However, the Note must be disposed of during the 180 day exchange time frame and utilized to acquire replacement property within the same time frame.

If the Note is included in the exchange and the Exchanger cannot dispose of the Note within the 180-day time frame, then the QI will assign the Note back to the Exchanger. The Exchanger still retains all the tax benefits of the Installment method. Many investors choose the second option as it provides many methods, but does not penalize the taxpayer if the method fails.

### METHODS TO DISPOSE OF THE NOTE

The Note, as part of the 1031 exchange transaction can be disposed by one of the following methods:

- ▶ Use the Note as consideration for the acquisition of replacement property. The Seller of the replacement property accepts the Note as partial payment towards the purchase price. At settlement the Note is endorsed to the Seller of the replacement property by the QI.
- ▶ The Exchanger may purchase the Note from the QI during the exchange period. This allows the QI to utilize the Note proceeds in acquiring the replacement property.
- ▶ The original buyer may payoff the Note prior to closing on the replacement property. The QI adds the payoff proceeds to the existing proceeds in the 1031 exchange account. All proceeds are sent to the closing officer for the acquisition of the replacement property.
- ▶ The Note may be sold to an outside investor, typically this is done at a discount. The cash proceeds are added to the qualified escrow account. If the Note is discounted, the discounted amount may be considered a selling expense.

Regardless of the chosen method, the Exchanger should always consult with their legal and tax advisors, as well as their Qualified Intermediary, prior to completing a seller carryback installment sale as part of their 1031 exchange transaction.