Legal 1031 Exchange Services, LLC
a Kensington Vanguard Company

Owner Carried Financing in 1031 Exchanges

If a seller carries back a note on their sale property, the IRS will treat this note as taxable, upon each installment received by the seller. Generally, under the installment method, the principal portion of each payment is subject to capital gains tax and the interest portion is subject to ordinary income tax, in the tax-year they are received. How can a seller include a note in the exchange and defer capital gains taxes indefinitely?

First, the note should be payable to the EA ("Exchange Accommodator") which puts the note in the exchange. The note must first be converted to cash before the exchanger can buy the new property. How does an exchange convert the note into cash?

There are three ways:

1. The exchanger buys the note from the EA for face value and the EA assigns the note back to the exchanger. Because the exchanger bought the note from the EA at face value, as they receive the principal payments, the payments are treated as a tax-free return of basis. The exchanger will pay income tax on the interest on the note as they receive it, but the principal payments are tax free. Meanwhile, in the exchange account the EA is holding the cash that the exchanger can now use to purchase the new property.

2. Find someone to buy the note. Unfortunately, because the note is unseasoned (i.e., is a brand-new note) a potential buyer of that note would demand a large discount.

3. Get the seller of the new property to agree to take the note as part of the purchase of the new property. As a practical matter, this rarely happens.

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