Using a Seller Carry-Back Note in the Exchange

Often, an Exchanger is asked to help his buyer finance the purchase of the relinquished property. Under those circumstances, the Exchanger is given a Seller Carryback Promissory Note ("Note"), secured by a deed of trust or mortgage against the relinquished property. Unfortunately, the Seller Carry-back Note—if drawn in the name of the Exchanger—will be considered cash boot and taxable just as if the Exchanger actually received cash from the sale. To avoid this result, the Note may be handled in one of three ways. Please note that each option requires that the Note first be drawn in the name of the Qualified Intermediary ("QI").

Option One: Sell the Note to a Third Party. The Note is drawn in favor of the QI as the beneficiary. At the relinquished property closing, the Note is delivered directly to the QI along with any cash proceeds. During the exchange period, the buyer makes any payments due to the QI. The QI then adds the Note payments to any cash proceeds already held in the exchange account. Prior to acquiring any replacement property,

the Exchanger searches for someone to purchase the Note. If the Exchanger is successful, the QI sells and assigns the Note to that buyer. The funds paid by that buyer to purchase the Note are then deposited into the exchange account and applied towards the purchase of identified replacement property.

If the Exchanger cannot find someone to purchase the Note and the Note is not paid until after them exchange is concluded, any Note proceeds later received may not be used to pay down the loan against the replacement property to readjust the equities. Rather, such proceeds will be considered cash boot.

Option Two: Give the Note to the Seller of Replacement Property. Same as option one, however, the Note is not sold. Rather, the Exchanger negotiates with the seller of the replacement property to receive the Note as part of the replacement property purchase price. If successful, the QI then assigns the Note directly to the seller.

Option Three: The Buyer Pays Off the

Note During the Exchange Period. Same as Option One, except that the terms of the Note provide that it will be due and payable within the exchange period. The Note payoff funds are then paid to the QI and added to the exchange account to be held for the subsequent purchase of the identified replacement property.

If the Exchanger is unsuccessful in negotiating any of the above options, the QI will assign the Note to the Exchanger upon the expiration of the exchange period and the Note amount will be treated as receipt of taxable cash boot. Fortunately, however, an Exchanger may elect to have receipt of the Note fall under the installment sale rules of IRC §453, which provide that the Exchanger must—each tax year—report only the gain attributable to the principal payments actually received on the Note. Therefore, unless an Exchanger elects out of installment sale reporting, he/she will only pay capital gains on the principal payments received during the course of the taxable year, thus extending the time for the payment of a portion of the capital gains tax.

FOR MORE INFORMATION, CONTACT:

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