Episode 7: Can You Seller-Finance a Property and Still Do a 1031 Exchange?

Seller Financing + 1031 Exchanges

FAQ & Practical Primer.

Quick Primer: What is Seller Financing?

Seller financing (or a seller carryback) means the seller agrees to receive part or all of the purchase price in the form of a promissory note instead of cash, with cash payments by the buyer/borrower made at a later date. The seller effectively becomes the buyer's lender. The note may specify interest, payment timing, maturity, and security such as a mortgage or deed of trust. Some investors use this tool to help bridge a financing gap for the buyer, expand the buyer pool, or create more flexible deal terms.

Seller Financing + 1031 Exchange FAQ	
Can seller financing be used in a 1031 exchange?	Yes. The key issue is how the promissory note is structured and who receives it at closing.
What if the seller keeps the note?	The QI can receive any cash exchange proceeds while the seller receives the note directly. The note then sits outside the exchange and is *not* eligible for 1031 deferral; the seller and tax advisor can separately evaluate installment-sale treatment.
Can the QI hold the note instead?	In many cases, the note can be issued to the QI so it remains inside the exchange safe harbor. The practical challenge is liquidity: the QI is holding a note, but the investor likely needs cash to buy replacement property.
How can a note inside the exchange become usable value?	Common possibilities: the buyer pays it off; a third party purchases it; the exchanger purchases it from the QI with outside funds; or, less commonly, the replacement-property seller accepts the note as payment for the replacement property.
When should this be planned?	Before the relinquished-property closing. The exchange documents and flow of consideration need to match the intended structure, and when the purchase agreement is being negotiated is usually the best time to work through the options.

Practical Considerations:

- **Credit risk:** If the seller ultimately owns the note, they are taking the risk that the buyer may not pay as expected.
- **Tax coordination:** Seller financing can raise installment-sale and other tax issues even before the 1031 exchange is considered.
- **Documentation:** Raise seller financing with the QI, tax advisor, and legal counsel before closing.
- **Timing:** If the note must be converted to cash, will that happen before the replacement property needs to close?
- **Liquidity:** If the exchanger plans to buy the note from the QI, do they actually have outside cash available?
- **Marketability:** A third-party buyer may discount the note based on credit, collateral, rate, payment history, and maturity.