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INSTALLMENT EXCHANGE OVERVIEW

Many taxpayers who are offering financing to their buyer ask if they can still perform an exchange with this structure. Oftentimes, the assumption made by the taxpayer is that when the note is paid-off by the buyer/borrower, the taxpayer can then enter into an exchange agreement and complete their exchange transaction. This is a dangerous assumption to make, as the timeline for a tax-deferred exchange begins on the original transfer date - when the buyer receives the relinquished property.

A taxpayer can, however, do an exchange using the buyer's down-payment and take an installment sale election for the note balance. When structuring a transaction this way the note would be taxable, and would not be subject to 1031 exchange treatment.

Another option for taxpayers offering financing may include placing the promissory note into the exchange (in the name of the QI) and having the note redeemed during the exchange period. Timing may be an issue with this structure, but many exchanges incorporating this structure do close successfully. How does this work?

To avoid a taxable event, the note can be made in the name of the QI:

- The replacement property can be acquired by assigning the interest of the note to the seller for part/all of the equity in the replacement property (3rd party paper).
- The QI can sell the note and trust deed to a third party. This will allow the exchangor to have all cash from the note to acquire the replacement property.

  Note: If the note is sold at a discount, there is a taxable event!

If the note is <u>not</u> redeemed during the exchange period:

- The note can be held by the QI until the end of the exchange period, and then assigned back to the exchangor. The will result in boot, and the exchangor will have to file an installment sale.

When is an installment exchange most common?

- Uninformed seller – "I can't exchange equity I don't have?"
- Property doesn't qualify for financing
- Very adverse loan terms discourages borrowing

How to avoid an installment exchange:

- Ask for all cash or ask buyer to obtain their own financing
- Seller funds the buyer's loan by depositing funds into the escrow: Seller transfers all of their equity to QI, and retains note secured by relinquished property.

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