1031FEC 1031 STRATEGY

Seller Financing Strategies and 1031 Exchanges

In this real estate market where financing is sometimes not readily available, sellers who are motivated to sell may offer to finance a portion of the purchase price. At the closing, the buyer deposits some cash and signs a seller carryback note for the balance. If structured as an installment sale under IRC Section 453, the seller pays tax on any gain as the payments are received rather than paying tax on the gain in the year of sale for the entire purchase price.

If the seller is also contemplating a tax deferred exchange under IRC § 1031, he will have to decide how to treat the seller carryback note. The note can either be kept outside of the exchange or, under the limited conditions described below; it can be included in the exchange.

NOTE IS NOT INCLUDED IN THE EXCHANGE

In most cases where there will be seller carryback financing, the note is not included in the 1031 exchange. The note is taxable boot, but the tax is paid over time as payments are collected. For example, if you sign a five year note and pay a portion of the principal balance each year, the tax obligation will also be spread out over that five year period.

When the note is not a part of the exchange, it should be payable to the seller and delivered directly to the seller at the time of closing. Only the cash proceeds received from the sale are delivered to the Qualified Intermediary (QI) and used as exchange funds.

NOTE IS INCLUDED IN THE EXCHANGE

If an investor wants to defer all of the gain in a 1031 exchange, including the amount represented by the note, he has several options. In each case, the note should be made payable to the QI. The QI collects all of the payments during the term of the exchange and they become part of the exchange proceeds.

In order for the note to be used as part of the exchange, it must either be converted to cash prior to the purchase of the replacement property or the seller of the replacement property must agree to accept the note as payment for the property.

Convert the Note to Cash

There are several ways in which an investor may be able to convert the note to cash prior to his purchase of the replacement property. First, the note can be a short term note that matures before the investor intends to buy the replacement property. The note payments are made to the QI and they become exchange proceeds. Once the note is paid in full, the QI uses that cash to purchase the replacement property. Because the note would have to be completely paid during the exchange period, the maximum term of the note is the earlier of 180 days or when the replacement property closing occurs.

The second option is for the investor to buy the note from the QI. In order to avoid the possibility of constructive receipt, most tax advisors recommend that this occur at the closing of the replacement property. The QI then uses the funds to purchase the replacement property at that closing.

Finally, the investor can arrange for an unrelated third party to buy the note. The proceeds from the sale would go directly to the QI as exchange proceeds, and the QI uses those proceeds to buy the replacement property.

Use the Note to Purchase Replacement Property

Occasionally, a seller is able to use the note as partial payment for the replacement property. In this scenario, the QI assigns the note to the seller of the replacement property at the closing.

HARD MONEY LOANS

Some sellers elect to lend the money to the buyer of the relinquished property up front as a "hard money loan" rather than through seller carryback financing. Using this option, the seller acts as a third party lender and deposits cash in the amount of the loan into escrow. The buyer uses the loan funds to acquire the property, and then escrow delivers those funds to the QI for use in the exchange.

CONCLUSION

When combining a seller carryback note with a 1031 exchange, it's important to carefully examine all the options and consult with your tax advisor and First American Exchange prior to setting up the transaction.

Structuring 1031 Exchanges for Farms and Ranches

Selling a farm or ranch, like selling any business, often involves real estate, equipment, livestock, crops, inventory and intellectual property. Investors interested in exchanging a farm or ranch property in a tax deferred exchange under Internal Revenue Code §1031 need to focus on the particular property being bought or sold in order to maximize the amount of gain that they will be able to defer.

EXCHANGEABLE ASSETS

The first and most important step when exchanging a farm or ranch is to itemize the various assets and determine which of those assets are exchangeable. Real property and many types of personal property can be exchanged under Internal Revenue Code §1031; however, real property can only be exchanged for like kind real property, and personal property for like kind personal property. In addition, certain assets such as goodwill and inventory are not exchangeable.

EXCHANGING REAL PROPERTY ASSETS

Real Estate and Buildings: The real estate assets of a farm or ranch include the land and any improvements attached to the land such as a house or a barn. If a house on the farm is occupied by a tenant, worker or caretaker on the property, it is considered investment property or property used in a trade or business and is exchangeable under §1031. On the other hand, if the owner lives in a house on the property and it is considered the owner's primary residence, there are advantageous tax strategies that can be implemented in conjunction with the 1031 exchange. When a property is held partially for personal use and partially for investment, such as a working farm or ranch with an owner occupied home, a portion of the gain from the sale of the personal residence is exempt from tax under IRC §121 and the remaining tax can be deferred under §1031. Revenue Procedure 2005-14 clarifies how Sections 121 and 1031 can be used at the same time in connection with the disposition of the same property.

Crops: Harvested crops are considered inventory and are not exchangeable under §1031. It is possible to exchange unharvested crops when they are sold with the land, at the same time and to the same person, provided that the land was held by the owner for investment purposes for more than one year. In addition, in order to trade the unharvested crops for real estate, the unharvested crops must be considered to be real estate under state law.

EXCHANGING PERSONAL PROPERTY ASSETS

Personal property is everything that is not real property, and typically includes furniture, equipment, airplanes, trucks and computers. Personal property that is held for productive use in a trade or business or for investment purposes can be exchanged for like kind replacement personal property. The Federal Regulations provide a safe harbor for personal property in the same asset class; meaning that assets that fall within the same **asset class** are deemed to be like kind. If the assets do not fall within the same asset class, they may still be considered “like kind” if they fall within the same **product class**.

Even if personal property assets are not in the same asset class or product class, the assets still may be considered like kind for purposes of the exchange if the assets are similar enough to each other. For example, an SUV has been held to be like kind to a passenger automobile, and fishing permits for a particular species and a particular location have been held to be like kind to fishing permits for another species and location.

Personal property that is not like kind under the rules described above cannot be exchanged. For example, an investor may own a tractor worth $50,000 and an airplane worth $95,000. The tractor can be exchanged for another tractor, and the airplane for another airplane. However, because a tractor and an airplane do not fall within the same classification and are not similar enough to be like kind, the investor cannot combine the proceeds of the sale of these two items to purchase an airplane worth $145,000 and successfully defer taxes on all of his gain.

Farm Equipment: Machinery such as combines, cotton gins, feed processing equipment, planters, plows, farm tractors, haying machinery, milking machines, and poultry feeding and watering equipment all fall under the same product class. Therefore, items within this product class can be exchanged for each other. For example, a $50,000 combine and a $25,000 plow can be exchanged for a $75,000 haying machine.

Livestock: Livestock held for sale in the ordinary course of business is inventory and cannot be exchanged; however, livestock that is owned for a dairy operation or for breeding purposes can be exchanged. The like kind requirements for livestock are very particular. For example, one-half blood heifers have been held to be like kind to three-quarter blood heifers, but under §1031(e) livestock of different sexes are not considered like kind.

IDENTIFICATION

As with any 1031 exchange, the investor must identify in writing what he intends to buy by signing a written notice within 45 days of the date the relinquished property closes. The identification rules that apply to other exchanges also apply to exchanges of a ranch or farm. This identification requirement applies to both the real property and personal property.

If the value of the personal property is minimal compared with the real property being sold, there is a special exception to the requirement that each replacement property must be identified. Personal property that is typically transferred together with real property does not need to be separately identified provided that the aggregate fair market value of the personal property does not exceed 15% of the aggregate fair market value of the real property.

CONCLUSION

The 1031 exchange of a farm or ranch typically involves more than just an exchange of real property. It is important for an investor to analyze the types of property being sold and pre-plan their exchange by consulting with their tax advisor to maximize their tax deferral. Our professionals at First American Exchange are available to assist you with the tax deferral process.

References: Revenue Procedure 2005-14. IRC §1231(b)(4). The asset classes are described in Revenue 87-56. Product classifications can be found under Sections 31, 32 and 33 of the North American Industry Classification System ("NAICS"), set forth in the Executive Office of the President, Office of Management and Budget, North American Industry Classification System, United States, 2002, as periodically updated (also called the NAICS Manual).

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