Tax Tip

What Happens When You Receive a Promissory Note for Your Relinquished Property in a Section 1031 Exchange?

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Most like-kind exchanges of real estate that take place today are accomplished as deferred exchanges that are designed to comply with the requirements of Code Sec. 1031(a)(3) and the safe-harbor provisions of Reg. §1.1031(k)-1(g). A simple example best illustrates the procedures that are most commonly followed to accomplish these exchanges. The taxpayer ("TP") owns undeveloped real property ("Relinquished Property") that is unencumbered and has been held by TP for investment purposes for more than five years. The fair market value of Relinquished Property is $1 million and TP has a tax basis in Relinquished Property of $100,000. TP has found a buyer ("Buyer") who has entered into a contract with TP ("Contract for Sale") to purchase Relinquished Property for $1 million in an all-cash transaction. TP, however, would like to dispose of the Relinquished Property in a tax-deferred exchange under Code Sec. 1031 in order to defer the recognition of its $900,000 gain. In order to do so, TP enters into an exchange agreement with a qualified intermediary (the "QI"), as defined in Reg. §1.1031(k)-1(g)(4)(iii), in which the QI agrees to acquire the Relinquished Property from TP, convey it to Buyer in accordance with the Contract for Sale, hold the sales proceeds in a qualified escrow account or a qualified trust (as such terms are defined in Reg. §1.1031(k)-1(g)(3)), acquire "like-kind" real property identified by TP (the "Replacement Property") using the funds held by QI in the qualified escrow or trust account and convey the Replacement Property to TP to close out the exchange.[1] If these procedures are followed, TP will not recognize any of its realized gain on the disposition of the Relinquished Property except to the extent of any "boot" received.[2] "Boot" is any property received in the exchange that is not "like-kind" to the Relinquished Property or that is of a type that is otherwise not permitted to be received as qualifying replacement property in a Code Sec. 1031 exchange.

The format described in the example above is relatively easy to follow and enjoys predictable results under the user-friendly Treasury regulations applicable to these types of exchanges.[3] From a practical perspective, a key aspect that facilitates the accomplishment of these deferred exchanges is that the QI receives cash from the sale of the Relinquished Property, which it then redeploys in the acquisition of one or more Replacement Properties identified by TP. If we revisit the example above but assume instead that the Buyer only pays $750,000 in cash at closing and gives a promissory note for $250,000 with a payout that extends well beyond the 180-day exchange period for the Relinquished Property, what impact will this have upon TP's ability to accomplish a Code Sec. 1031 exchange? There are several possible answers to this question, which will be discussed below. In all of the possible scenarios, however, it is highly unlikely that a seller of Replacement Property will accept an assignment of Buyer's promissory note held by the QI as either full or even partial consideration for Replacement Property. Consequently, this possibility will not be considered.

[T]he receipt of a promissory note from the buyer of relinquished property will not necessarily preclude the taxpayer from accomplishing a deferral of all or a portion of its realized gain in a Code Sec. 1031 exchange.

Partial Code Sec. 1031 Exchange with Installment Reporting of Boot

One possible answer is that TP may identify a Replacement Property that can be acquired for $750,000. The QI would then be instructed to acquire the Replacement Property and have it conveyed to TP as part of a Code Sec. 1031 exchange. At the end of the 180-day exchange period,[4] the QI would close out the qualified escrow or qualified trust by assigning the Buyer's promissory note to TP. The promissory note, which was issued by Buyer to QI in connection with Buyer's purchase of the Relinquished Property, is not "like-kind" to the Relinquished Property and is also a type of property that is specifically excluded from nonrecognition treatment under Code Sec. 1031(a)(2)(B). Consequently, the promissory note will be treated as boot. When boot is received by a taxpayer in addition to qualifying like-kind replacement property in a Code Sec. 1031 exchange, any gain realized by the taxpayer ($900,000 in our example) must be recognized to the extent of the fair market value of the boot received ($250,000).[5] Fortunately for TP, however, special rules apply that will enable TP to report the gain attributable to the receipt of the promissory note on the installment basis.[6] Under Code Sec. 453, which governs the treatment of a taxpayer who receives a purchase money promissory note (an "installment note") in a sale of eligible property, a taxpayer will be taxed on the gain realized from such sale only as "payments" are received. The receipt of an installment note will not be regarded as a "payment" for purposes of the installment sale rules unless such note is payable on demand or is readily tradable.[7] Receipt of a promissory note issued by a party other than the purchaser of the taxpayer's property will, however, be treated as a "payment," and the amount of such payment will be equal to the fair market value of the note.[8] Reg. §1.1031(k)-1(j)(2)(iii) creates a special exception to this third-party note rule that applies when a deferred exchange is accomplished through the use of a qualified intermediary. In such a case, if the qualified intermediary receives an installment note from the ultimate purchaser of the relinquished property and transfers the installment note to the taxpayer, the note will be regarded as a note received by the taxpayer from the "buyer" of the taxpayer's property (even though the QI, not the ultimate purchaser, is the "buyer" of the taxpayer's property).[9]

If we vary the facts of the example above by assuming that TP identified a Replacement Property with a fair market value of $1 million and instructed the QI to acquire such property for the $750,000 held by the QI as a result of the sale of the Relinquished Property and borrow an additional $250,000 from a bank or other third-party lender, would this produce a different result? Under these revised facts, TP will receive, from or through QI, Replacement Property with a value of $1 million but encumbered by a $250,000 mortgage that will be assumed by TP. In addition, TP will also ultimately receive the installment note held by QI. The issue in this revised example is whether TP can use the "boot netting" provisions of Reg. §1.1031(b)-1 to offset the boot received in the form of the $250,000 installment note with the assumption by TP of the $250,000 mortgage encumbering the Replacement Property. Unfortunately for TP, a taxpayer who receives cash or nonqualifying property cannot offset such boot by boot given in the form of an assumption of mortgage debt by the taxpayer.[10] Thus, TP in this revised example will still have $250,000 of boot gain to report as and when payments of principal are made on the installment note. The only difference in the result is that TP's tax basis in the Replacement Property will be increased in the amount of the $250,000 mortgage debt assumed.

TP Loan to Buyer of Relinquished Property

Assume now that TP identifies the same Replacement Property with a fair market value of $1 million, but wishes to defer all recognition of gain inherent in the Relinquished Property. How may TP avoid reportable boot gain under Code Sec. 1031 when Buyer is only willing to pay $750,000 at the closing of the purchase of the Relinquished Property? One possibility is for TP or a related party to loan Buyer the funds necessary to effectuate an all-cash sale. In our example, TP (or a related party) would loan Buyer the $250,000 previously covered by Buyer's promissory note. The loan would be made either at or prior to closing of the Relinquished Property. In return, TP (or the related party) would receive a $250,000 promissory note from Buyer secured by a mortgage on the Relinquished Property. Buyer would then pay the full $1 million in cash to QI, hopefully resulting in no boot received in the form of a note. Assuming compliance with the other requirements of Code Sec. 1031, recognition of the entire $900,000 of gain in the Relinquished Property would be deferred. It is possible that TP's loan and Buyer's subsequent use of the loan proceeds to pay the sales price of the Relinquished Property may be collapsed into one transaction under the step-transaction doctrine. In such a case, however, TP should nevertheless be able to offset Buyer's note with the cash loan made to Buyer under the boot netting rules.[11] This risk can be minimized if the lender is a related party (rather than TP) that ideally is both a substantial entity and is not a "conduit" of TP.

Sale of Installment Note by QI

An alternative, and perhaps more attractive, method of avoiding reportable boot gain is through the sale of Buyer's installment note by QI to TP (or to a related party). Under this alternative, Buyer's $250,000 note, which is payable to QI, will be sold by the QI to TP (or to a related party) for full fair market value. If this approach is followed, it is recommended that the taxpayer obtain an appraisal prepared by a qualified appraiser to establish the fair market value of the installment note, and the purchase price should be tied to this appraised value. In addition, the purchase of the installment note should be timed to coincide with the acquisition of the Replacement Property to negate, if possible, the argument that TP has received the benefit of property (*i.e.*, the installment note) prior to the occurrence of one of the events described in Reg. §1.1031(k)-1(g)(6). This method enjoys two advantages over a direct loan to Buyer. First, in the event TP lacks the liquidity to make a $250,000 loan to Buyer, it gives TP additional time to generate the funds. Second, in the event TP fails to find suitable Replacement Property, it gives TP the option of reporting a portion of its boot gain on the installment method. By contrast, if a related party loans Buyer the $250,000 at or before closing and TP fails to find Replacement Property, the sale is fully taxable and TP cannot report any portion of its gain on the installment method. Thus, TP's purchase of Buyer's note from QI provides two additional advantages while continuing to achieve the goal of avoiding reportable boot.

Conclusion

In summary, the receipt of a promissory note from the buyer of relinquished property will not necessarily preclude the taxpayer from accomplishing a deferral of all or a portion of its realized gain in a Code Sec. 1031 exchange. If the buyer pays a sufficiently large portion of the purchase price for the relinquished property at closing and the installment note represents only a minor part of the total consideration, the cash receipt from the buyer can be rolled over into one or more replacement properties and the taxpayer would then be able to report its boot gain on the installment method. If, on the other hand, the taxpayer desires to fully defer its realized gain through a Code Sec. 1031 exchange, it may opt instead to cause a related party to make a loan to the buyer of the relinquished property or, in the alternative, it may arrange to purchase (or have a related party purchase) the installment note from the QI for a price equal to its full fair market value. Each of the latter two alternatives has risks that may at least be minimized by taking the extra precautions mentioned above.

ENDNOTES

1 TP will also be required to (i) assign the Contract for Sale to the QI, with a notice of such assignment to Buyer; (ii) identify one or more Replacement Properties to the QI within 45 days after the closing on the sale of the Relinquished Property, as required under Code Sec. 1031(a)(3)(A) and Reg. §§1.1031(k)-1(b), (c) and (e), and (iii) receive the Replacement Property on or before the earlier of 180 days after conveyance of the Relinquished Property or the due date of TP's tax return for the tax year in which the Relinquished Property was disposed of, including for this purpose any extension of time for filing actually received by TP, as required by Code Sec. 1031(a)(3)(B) and Reg. §§1.1031(k)-1(b) and (d). In addition, in most cases the QI will require that TP direct deed the Relinquished Property to Buyer at

the closing, and also require the seller of the Replacement Property to convey title to the Replacement Property directly to TP in order to keep the QI out of the chain of title. These "direct deeds" are specifically permitted in Reg. §§1.1031(k)-1(g)(4)(iv)(B) and (C).

[2] Code Sec. 1031(b).

[3] *See* Reg. §§1.1031(k)-1(a) through (k).

[4] For most of the safe harbors described in Reg. §1.1031(k)-1(g), the exchange agreement must specify that the taxpayer shall have no right to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent held by the QI or in a qualified escrow or qualified trust until one of the events described in Reg. §1.1031(k)-1(g)(6) have occurred. Although a plausible argument can be made that the promissory note is not a "cash equivalent," it is best to assume that the promissory note is considered a "cash equivalent" and TP should be precluded from having access thereto until one of the events described in Reg. §1.1031(k)-1(g)(6) has occurred. Although this column refers to a distribution of the promissory note at the expiration of the 180-day exchange period, if TP only identified one Replacement Property and the Replacement Property was acquired and conveyed by the QI to TP prior to the expiration of such exchange period, Reg. §1.1031(k)-1(g)(6)(iii)(A) would permit TP to receive the promissory note from the QI immediately after the receipt by TP of the Replacement Property because TP would be deemed to have received "all of the replacement property to which [TP] is entitled . . ."

[5] Code Sec. 1031(b); Reg. §1.1031(b)-1.

[6] TP could, however, elect out of installment reporting under Code Sec. 453(d).

[7] Code Sec. 453(f)(3) and (4).

[8] Temporary Reg. §15A.453-1(b)(3).

[9] When a taxpayer receives both qualifying like-kind property and an installment note in connection with a Code Sec. 1031 exchange, special rules apply under Code Sec. 453(f)(6), which effectively result in allocating all tax basis available under Code Sec. 1031(d) to the qualifying Replacement Property up to, but not in excess of, the fair market value of such Replacement Property. Thus, under the facts set forth in this example, the $100,000 of tax basis will be allocated fully to the qualifying Replacement Property and no basis will be allocated to the installment note. Thus, each and every payment of principal on the installment note will be fully taxable to TP.

[10] Reg. §1.1031(d)-2, Ex. 2; *E.T. Barker*, 74 TC 555, Dec. 37,002 (1980); *E.P. Coleman, Jr.*, CA-8, 50-1 USTC ¶9254 , 180 F2d 758.

[11] *See* Rev. Rul. 72-456, 1972-2 CB 468; *F.B. Biggs*, 69 TC 905, Dec. 35,035 (1978). *Aff'd*, CA-5, 81-1 USTC ¶9114, 632 F2d 1171.