

1031 Exchanges and Seller Financing with a focus on Wisconsin Land Contracts

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Many real estate transactions, particularly those involving the sale of a business or investment real estate, involve some sort of seller financing. The reasons for the use of seller financing vary, however, the typical purpose is to allow the parties a degree of latitude to structure the terms of the sale to fit their needs. For instance, seller financing may allow a buyer to complete a purchase for which that buyer would otherwise be ineligible due to down payment, interest rate, pre-payment restrictions or other terms of conventional lender financing. Sellers often benefit by increasing the pool of potential buyers for their business or land.

One commonly used seller financing vehicle in Wisconsin is a land contract. Other states use the term “contract for deed” but the idea is the same. In a land contract, the buyer and seller enter into a contract whereby the buyer begins making payments to the seller and the seller delivers the deed to the property only after the payments under the land contract are made in full. Under Wisconsin law, the seller (known as the vendor) has conveyed his ownership interest in the property and retains “bare legal title” as the vendor’s security interest in the property. The buyer (known as the vendee) becomes, for all practical purposes, the owner of the real estate.

Taxation of a real estate sale

When selling real estate, sellers are obligated to pay capital gains tax and applicable depreciation recapture tax. Land contract deals are no exception. A nice benefit to land contract sales for sellers is that land contracts can be taxed on the installment method, allowing the taxpayer to pay capital gains tax as the funds are received over the years of the land contract and not entirely in the year of the sale. Unfortunately, any depreciation recapture is still due in the year of the sale. However, a seller under a land contract may utilize a 1031 exchange to completely defer payment of the capital gains and unrecapture taxes through some strategic planning.

A 1031 exchange, also known as a Starker Exchange (named from a landmark 9th Circuit Court case) or “like kind” exchange, is a method that allows any taxpaying individual or entity to defer paying capital gains and recapture taxes on the sale of real estate. As the name implies, the investor cannot sell the real estate outright. The property must be “exchanged” for other real estate. The property that is sold by the taxpayer is the relinquished property and the property acquired is the replacement property.

There are a couple 1031 exchange requirements that make land contract sales challenging. First, anytime a Seller is carrying out a 1031 exchange, the entire exchange process must be complete within 180 days (or less if the due date of the taxpayer’s tax return falls within the 180 days unless the taxpayer files for an extension). Second, the sale proceeds from the relinquished property must not be received by the taxpayer but instead must be held by a qualified intermediary.

Relinquished property and land contracts

A common misconception among parties to land contracts is that the “sale” has not yet occurred at the time the land contract is signed since the seller will not deliver the deed to the buyer until some point in the future. Actually, the sale of the property for tax purposes occurs when the land contract is executed and possession is delivered to the buyer. This is a particularly important point for sellers contemplating a 1031 exchange. Sellers should be careful to avoid thinking that they are able to begin a 1031 exchange at a point when a large balloon payment under an existing land contract is about to be received. At that point, the seller no longer has an interest in real estate and the ability to complete a 1031 exchange is lost. A 1031 exchange must be commenced at the time the land contract is executed.

The most viable option sellers have when entering a land contract sale, considering the 180 time frame and the restriction on receipt of funds (or other items of value), is to word the land contract in such a way that the right to receive payments under the land contract is directed to the intermediary. That way the taxpayer has not taken receipt of the right to the payments. Commonly, the taxpayer then uses other cash to “purchase” the land contract from the intermediary for its value. The cash now received by the intermediary is used to purchase the replacement property thereby deferring capital gain and recapture taxes. The taxpayer should only be taxed on the interest received from the land contract payments and not on the principal.

Replacement property and land contracts

The purchase of a replacement property to complete a 1031 exchange using a land contract is not as problematic as the sale of a relinquished property. The taxpayer is simply purchasing the property and financing the purchase through the seller instead of a conventional lender. The typical issue that arises is over-financing the replacement property purchase causing a failure to use all the exchange funds from the relinquished property sale.

Recall that in order for a taxpayer to have maximum tax deferral in a 1031 exchange, one of the important rules is for the taxpayer to avoid putting any cash into his pocket during the exchange. For instance, if a taxpayer has \$100,000 in exchange proceeds from the relinquished property sale, the down payment on the land contract must be at least \$100,000. If the down payment is less, the taxpayer will be pocketing and likely paying tax on the difference.

Summary

When combining a 1031 exchange with a land contract transaction, some careful consideration of 1031 exchange rules can assist with successful tax deferral treatment by the IRS. Of course the ultimate decision on whether and how to complete an exchange should be determined through planning with a tax professional.