



## Seller Carry Back Notes and 1031 Exchanges: Rules, Structure, and Planning

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If you're selling investment real property and the buyer is not able to secure conventional financing, you may end up holding a promissory note, often referred to as a seller carry-back note or seller financing. Seller carryback financing is common in real estate, especially during challenging markets that involve high interest rates, economic downturns or tight lender underwriting requirements.

Seller carry-back installment notes can be very powerful sales tools when negotiating and structuring real estate sale transactions. This financing arrangement can be the difference between a stalled listing and a sold property. Seller promissory notes can also be a very effective income tax and estate planning strategy if you do not want to reinvest in replacement properties through a 1031 tax deferred exchange transaction.

This article is for real estate investors who are considering seller carry-back financing as part of a rental or investment property sale, desire to defer the payment of their capital gain and depreciation recapture taxes through a 1031 exchange and want to understand their options before closing. You'll learn what seller carryback notes are, how they fit inside a 1031 exchange and the complications created, the critical difference between including and excluding the installment note from your exchange, and the tax-deferral consequences of each path.

### Complications With Seller Financing and 1031 Exchanges

What's less commonly understood is how seller financing works with a 1031 tax-deferred exchange and whether it triggers any taxable gain that you weren't expecting. The widespread belief is that seller carry back financing and 1031 exchanges cannot be used together. This is simply not true. Sellers can structure a 1031 exchange when a seller carry-back note is part of the sale transaction.

However, using them together is considerably more complex and requires careful planning to ensure a smooth and successful 1031 exchange transaction. Seller financing is extremely beneficial to the buyer while the seller assumes all of the risks. Sellers should therefore always discuss these transactions with their own legal, tax and financial advisors in conjunction with a sophisticated and experienced Qualified Intermediary, such as Exeter 1031 Exchange Services, LLC, before entering into any purchase and sale agreement.

### What Is a Seller Carry-Back Note?

A seller carryback note is a promissory note (i.e., a promise to pay) that the buyer gives to the seller in exchange for deferred payment for part of the purchase price. Instead of the buyer getting a bank loan or contributing out-of-pocket cash for the full purchase amount, the seller effectively becomes the lender for a portion of the sale price.

Here's a simple example: You sell a commercial property for \$1,000,000. The buyer puts in \$400,000 in cash and gives you a promissory note for the remaining \$600,000, promising to repay it with interest over five years. You receive the cash at closing, and the note pays out over time.

Seller carry-back arrangements can help close deals that might otherwise fall apart. They're especially common when buyers face financing constraints or when sellers are willing to accept installment-style payments. The



challenge arises when that sale involves a 1031 exchange—because the note represents real value with real tax consequences.

### **How Seller Carry-Back Financing Works Inside a 1031 Exchange**

A 1031 exchange allows you to defer some or all of your taxable gain when you sell real estate that has been held for rental, investment or use in a trade or business if you reinvest in a [like-kind replacement property](#). One of the IRS requirements is that you reinvest all of the net proceeds in replacement property to achieve full tax deferral. That's where the seller carry-back note becomes a challenge.

When a buyer gives you a seller carry-back note, that installment note is considered part of the net proceeds from the sale of your relinquished property. Your net proceeds therefore include both the cash received and the face value of the installment note received at closing. If you want to defer all of your taxable gain, you must reinvest both—the seller carry back note and the cash.

The key decision every investor faces is this: Do you include the promissory note inside the exchange, or exclude the note from the exchange? Each path has different consequences, and the wrong choice—or no choice at all—can result in an unexpected tax liability.

### **Including the Seller Carry-Back Note in the Exchange**

When you include the seller carry-back note inside your 1031 exchange, you treat the note as part of the net proceeds or total value being reinvested. To accomplish this, the promissory note must be drafted in the name of your Qualified Intermediary (QI), or if you are working with a best practices QI, in the name of the trustee of the [qualified trust account](#) or the escrow agent of the qualified escrow account, so that the installment note is included as part of the exchange transaction.

For example, Exeter 1031 Exchange Services, LLC (Exeter1031™), as a [best practices Qualified Intermediary](#), holds all net proceeds, including any seller carry back notes, inside the separate, segregated, dual-signature, restricted [qualified trust account](#) set-up for your 1031 exchange transaction. This means the [legal beneficiary vesting](#) of the note is drafted in the name of Exeter Trust Company as trustee of the qualified trust account for the benefit of the client.

By including the note inside your 1031 exchange transaction, you essentially defer the gain associated with that portion of the sale price. You are not receiving the promissory note as taxable boot (i.e., taxable proceeds that fall outside the exchange), so the tax deferral remains intact for that value. This approach works well when you want to maximize the amount of gain you defer and you plan to reinvest the equivalent value into replacement property (i.e., you are trading equal or up in value based on the net sale price of your relinquished property).

One important detail: when you include the note in the 1031 exchange, your Qualified Intermediary (or the trustee of the qualified trust account) holds the note. This means payments on the note—principal and interest—flow through and are managed in accordance with the exchange structure. Working with an experienced QI, such as Exeter1031™, who understands how to properly handle seller financing is essential.

The key takeaway: Including the note defers more gain, but it requires careful coordination with your Qualified Intermediary and your legal, tax and financial advisors before closing.

### **Three (3) Options or Strategies for Including the Note Inside the Exchange**

Sellers (exchangors) generally have three (3) options or strategies to choose from when structuring a seller carry-back note in conjunction with a 1031 tax deferred exchange on the sale of their relinquished property. These three (3) options include:

#### **Seller Funds the Note After Closing**



The seller carry-back note is drafted in the name of the Qualified Intermediary, or when working with a best practices Qualified Intermediary, in the name of the trustee of the qualified trust account. This ensures that the installment note is part of the like kind exchange transaction. The sale closes and the Qualified Intermediary (or the trustee of the qualified trust account) receives and holds the net proceeds from the sale (i.e., cash and the seller carry-back note) inside the 1031 exchange account.

The seller, or an affiliate of the seller when using best practices, deposits cash into the 1031 exchange account (boot paid in) before closing on the purchase of the replacement property. The tax-deferred exchange now has all of the required cash to purchase one or more replacement properties and complete the like-kind exchange transaction.

The seller carry-back note is endorsed (assigned or transferred) to the seller after his or her 1031 exchange has been completed (boot received). The boot paid in and boot received by the seller net to zero so that there is no tax consequence triggered by the seller financing. Although not technically accurate, this structure is often described as the seller purchasing the promissory note out of their own 1031 exchange account.

However, sellers are often unable to raise the needed cash and are therefore unable to deposit funds into their 1031 exchange to implement this seller-financing solution, so the following two (2) structures might be viable alternatives in these cases.

#### **Seller Sells the Installment Note After Closing**

Just like the strategy discussed above, the seller note is drafted in the name of the QI, or when working with a best practices accommodator, in the name of the trustee of the qualified trust account. This ensures that the installment note is part of the like-kind exchange transaction. The sale closes and the QI (or the trustee of the trust account) receives and holds the net proceeds from the sale, including the installment note, inside their 1031 exchange account.

The seller then arranges for the Qualified Intermediary (or trustee of the qualified trust) to sell the promissory note to a note investor or note buyer to convert the note to cash. The QI is now holding all cash and can complete the 1031 exchange by acquiring the identified replacement property(ies). This can be an expensive option as note buyers are looking for higher yields and generally expect a significant discount to purchase the seller carry-back note.

#### **Seller Uses the Note as Payment for the Replacement Property**

The final option also involves the seller carry-back note being drafted in the name of the QI (or in the name of the trustee of the qualified trust account). The sale closes and the Qualified Intermediary (or the trustee of the qualified trust account) receives and holds the sale proceeds from the sale of the relinquished property, including the promissory note.

The exchangor, now the buyer of the replacement property, locates and identifies one or more replacement properties. The seller carry-back note is endorsed (assigned or transferred) to the seller of the replacement property as part of the payment for the purchase of the replacement property. The seller of the replacement property must be willing to accept an endorsement of the note as part of the consideration for the purchase of the replacement property. Most sellers are not interested in accepting third party promissory notes.

#### **Excluding the Seller Carry-Back Note from the Exchange**

Including the note inside a 1031 exchange is complicated and often will not work and may require the seller to exclude the note from the tax-deferred exchange. When you exclude the seller carry-back note from the exchange, you receive it outside of the exchange structure—essentially treating it as a separate financial instrument.

The seller carry-back note is drafted in the name of the seller or exchangor as the beneficiary or lender, instead of the Qualified Intermediary, and only the equity portion (net cash proceeds) generated from the sale of the



relinquished property is included in the 1031 tax deferred exchange. The note represents net proceeds generated from the sale of the relinquished property that are not reinvested and are therefore “taxable boot.”

Promissory notes that are excluded from the 1031 exchange are usually, but not always, taxable under the installment sale rules pursuant to Section 453 of the Internal Revenue Code (IRC). Generally, the portion of the taxable gain realized by excluding the seller carry-back note from the 1031 exchange is deferred over the term of the installment note and recognized (taxable) on a prorata basis based on the percentage of principal payments made on the installment note each year. The remainder of any deferred gain will be immediately recognized (taxable) when the entire outstanding principal balance of the installment note is paid off.

The consequence? The face value of the installment note is treated as boot—a taxable item that may trigger recognition of capital gain and depreciation recapture taxes. Depending on the amount of taxable gain, excluding a large seller carry back note could mean recognizing a significant portion of that gain, or all of the gain, in the year of the sale.

Consider this scenario: You sell a property for \$800,000 that has a \$400,000 taxable gain. The buyer pays \$600,000 in cash and gives you a \$200,000 seller carry-back note. If you exclude the note from the exchange, that \$200,000 note will be treated as taxable boot and subject to capital gain and depreciation recapture tax—even though you haven't received the full \$200,000 in value yet.

The key takeaway: Excluding the note is simpler at closing, but it likely triggers taxable gain—sometimes substantially more than investors anticipate.

### **Practical Considerations Before You Close**

If seller carry-back financing is part of your upcoming sale, these are the planning steps that matter most:

- Engage your Qualified Intermediary early. Before your purchase agreement is signed, your QI and your escrow, settlement agent or closing attorney needs to know a seller carry-back note is involved. The structure of the transaction and documentation must be set up correctly from the beginning.
- Work with a tax advisor who knows 1031 exchanges. The interaction between installment sale rules and 1031 exchange rules is not straightforward. You need someone who handles these transactions regularly.
- Understand the note's value relative to your total gain. The larger the note and the larger the embedded gain or profit on the sale, the higher the stakes of getting this wrong.
- Review your purchase agreement carefully. The note must be properly drafted based on whether you are including or excluding the note in your 1031 exchange. Your qualified intermediary should provide you with very specific [legal beneficiary vesting](#) instructions if the note is to be included in the tax-deferred exchange.
- Do not wait until closing to ask these questions. Once the transaction closes in a way that excludes the note unintentionally, the tax consequences cannot be undone.

Seller carry-back financing doesn't disqualify you from doing a 1031 exchange—but it does add a layer of complexity that demands careful planning.

### **Why Experienced Guidance Matters Here**

The rules governing 1031 exchanges are precise, and the IRS offers little flexibility when transactions aren't structured correctly. Seller carry-back notes introduce variables—timing, drafting, installment sale elections, and reinvestment requirements—that experienced advisors navigate regularly but that can trip up investors who treat them as an afterthought.



Working with a Qualified Intermediary that has deep 1031 exchange expertise means having a partner who can identify these issues before they become problems. The right QI will walk you through the implications of including or excluding the note, coordinate with your tax and legal advisors, and ensure the transaction is structured to protect your tax deferral.

### **The Bottom Line**

Seller carry-back notes are a legitimate and sometimes useful tool in real estate transactions—but they require deliberate handling inside a 1031 exchange. Your net proceeds include both the cash at closing and the face value of the note, and how you treat that note determines how much gain you defer.

Including the note in your exchange offers the strongest path to full deferral. Excluding it will likely trigger recognition of some or all of the associated gain, with limited relief available through installment sale treatment under complex IRS rules.

If a seller carry-back note is part of your transaction, the best next step is a direct conversation with a knowledgeable Qualified Intermediary, such as the [1031 specialists](#) at Exeter1031™, and your tax advisor—before the purchase agreement is signed. Structuring this correctly from the start protects your deferral and eliminates costly surprises at tax time.

## **Frequently Asked Questions (FAQs) on Seller Carry Back Notes and 1031 Exchanges**

### **What is a seller carry back note?**

A seller carry back note is a financing arrangement in which the seller of a property acts as the lender, financing a portion of the purchase price for the buyer rather than receiving the full amount in cash at closing.

The buyer makes payments to the seller over time, typically secured by a promissory note paired with a deed of trust or mortgage. Seller carry back notes—also called seller carry back financing or seller financing—are especially valuable during periods of rising interest rates, tight credit markets, or economic downturns when buyers may struggle to qualify for traditional financing.

### **How does a seller carry back note affect a 1031 exchange?**

A seller carry back note adds complexity to a 1031 exchange because all net proceeds from the sale of the relinquished property—including both cash and the note—must be reinvested into like-kind replacement property to fully defer your taxable gain.

Contrary to common belief, seller financing and 1031 exchanges can be combined successfully. However, doing so requires careful planning and coordination with a knowledgeable and best practices Qualified Intermediary. The note can either be included in the exchange (tax-deferred) or excluded from it (taxable), and that decision cannot be changed once the sale of the relinquished property closes.

### **What is "boot" and how does it relate to seller financing?**

In a 1031 exchange, "boot" refers to any portion of the sale proceeds that is not reinvested into like-kind replacement property and is therefore subject to taxation. When a seller carry back note is excluded from the exchange, it is treated as boot. The note represents net proceeds that have not been reinvested, which triggers recognition of some or all of your taxable gain. Notes excluded from the exchange are generally taxed under the installment sale rules of IRC Section 453.

### **How can I avoid boot when using a seller carry back note in a 1031 exchange?**

To avoid taxable boot, you must include the seller carry back note within your 1031 exchange so that all net proceeds—both cash and the note—are reinvested into like-kind replacement property. This is typically achieved through one of several structuring strategies, such as funding the note with your own cash so the Qualified Intermediary has all cash at closing, selling the installment note to an investor, or applying the note itself toward



the purchase of replacement property. Each approach has distinct tax implications, so coordination with your Qualified Intermediary and tax advisor is essential before closing.

### **What are the strategies for handling a seller carry back note in a 1031 exchange?**

There are several recognized strategies for including a seller carry back note in a 1031 exchange. The three most common are:

- The seller funds the note with cash. The seller contributes out-of-pocket cash into their 1031 exchange account to "fund" the note, allowing the Qualified Intermediary to receive all cash and complete the exchange. This is the cleanest and most efficient approach.
- The note is used to purchase replacement property. The note is endorsed and assigned to the seller of the replacement property as part of the purchase consideration, provided that the seller is willing to accept a third-party note.
- The note is sold on the secondary market. The Qualified Intermediary sells the note to a third-party note buyer or note investor to convert it to cash. Note buyers typically expect a significant discount, which can make this an expensive option.

A seller may also exclude the note from the exchange entirely, though this results in taxable boot under installment sale rules.

### **Can a seller carry back note be used as currency to purchase a replacement property?**

Yes. A seller carry back note can be assigned and applied directly toward the purchase of replacement property as part of the consideration, alongside any cash proceeds. In this strategy, the note is drafted in the name of the Qualified Intermediary, held within the exchange, and then endorsed to the seller of the replacement property. This approach allows for complete deferral of gain, but it requires that the replacement property seller agree to accept the note as part of the purchase price.

### **What are the risks for sellers who carry back a note?**

The seller assumes most of the risk in a seller carry back arrangement, primarily the risk of buyer default, which could lead to foreclosure and the seller regaining possession of the property. Additional risks include:

- Reduced liquidity: Funds tied up in the note may limit the seller's ability to invest elsewhere.
- Market deterioration: If the buyer defaults, the seller may struggle to resell the property, particularly if market conditions have declined or the buyer has failed to keep the property in good condition.
- Tax complexity: Improper structuring can unintentionally create taxable boot or trigger depreciation recapture.

### **What are the risks for buyers using seller financing?**

While seller financing is highly beneficial to buyers—often providing access to financing they could not otherwise obtain—buyers should still carefully evaluate the terms of the arrangement. Key considerations include the interest rate, repayment schedule, and balloon payment provisions, all of which should be clearly defined in comprehensive loan documents that protect both parties. Buyers should consult their own legal and tax professionals to fully understand their obligations before entering into a seller financing agreement.

### **What is a Qualified Intermediary and what role do they play?**

A Qualified Intermediary (QI) is an independent third party that facilitates a 1031 exchange by holding the proceeds from the sale of the relinquished property and using them to acquire the replacement property, ensuring the exchanger never takes constructive receipt of the funds. A Qualified Intermediary has three critical responsibilities:



- Preparing the documents necessary to structure the 1031 exchange.
- Coordinating with the investor and their legal, tax, and financial advisors to ensure a compliant transaction.
- Receiving, holding, and safeguarding the investor's 1031 exchange funds throughout the transaction.

When a seller carry back note is involved, the QI often holds the note within the exchange and structures its treatment. Because the industry has no universal licensing body, investors should select a QI with [regulatory oversight](#), robust insurance, and qualified trust accounts. Exeter 1031 Exchange Services, LLC, for example, holds client funds in separate, segregated, dual-signature, restricted qualified trust accounts through Exeter Trust Company, which is licensed, regulated, and audited by the Wyoming Division of Banking.

#### **What are best practices for combining seller financing with a 1031 exchange?**

The most important “best practice” is to plan ahead and assemble the right team before closing, since the decision to include or exclude the note from your exchange cannot be reversed once the relinquished property sale has closed. Recommended best practices include:

- Decide treatment early. Determine whether the note will be included in or excluded from the exchange before drafting the purchase and sale agreement.
- Draft documents correctly. Promissory notes are drafted differently depending on whether the note is held by the seller or the Qualified Intermediary.
- Engage your advisors. Consult your legal, tax, and financial advisors alongside your Qualified Intermediary throughout the process.
- Select a reputable Qualified Intermediary. Choose a QI with regulatory oversight, strong internal controls, significant insurance, bonding and equity capital, and qualified trust accounts to safeguard your funds.