

Installment Land Sales Contracts

An installment land sales contract (also known as a contract for deed or a contract of sale) is an agreement between the Seller and the Buyer for the purchase of real property in which the payment of all or a portion of the purchase price is deferred. The purchase price may be paid in installments over the period of the contract, with the balance due at maturity. When the Buyer completes the required payments, the Seller must deliver good legal title by a deed. During the period of the contract in which the Buyer is making the installment payments on the purchase price, the Buyer is entitled to possession of the property and equitable title to the property, while the Seller holds legal title and continues to be liable for payment of any underlying mortgage.

The issue is whether either the Seller or Buyer in an installment land sale contract can exchange their interest under IRC §1031 and defer the capital gain taxes. Exchanges of “beneficial interests” are expressly disqualified under §1031. Although no published case has considered whether a Buyer under a land sales contract has more than a “beneficial interest,” for purposes of Federal income tax, a sale is determined based on the transfer of the benefits and burdens of ownership rather than on the technical requirements for the passage of title under State law. *Derr v. Commissioner*, 71 T.C. 708, 723-724 (1981). Where transfer of legal title is delayed to secure payment of the purchase price, the courts look to the intent of the parties. *Deyoe v. Commissioner*, 66 T.C. 904, 910 (1976). Thus, under a land contract where the Seller retains bare legal title, under the doctrine of equitable conversion the **Buyer** is treated as the equitable owner of the property. *Olson v. C.I.R.*, T.C. Memo. 1991-325 (1991); *Awalt v. C.I. R.*, T.C. Memo. 1987-42 (1987). If the Buyer adopts this theory of equitable conversion, then the Buyer could exchange his/her interest in the property under IRC §1031 for like-kind replacement property. See *Starker v. United States*, 602 F2d1341 (9th Cir 1979); *Biggs v. C.I.R.*, 632 F2d1171 (5th Cir 1980). For purposes of tax deferred exchanges, the issue of determining the rights created in the property, and thereby the character of the property that is owned, turns on when the benefits and burdens of ownership of the property have shifted.

Conversely, under the doctrine of equitable conversion, the **Seller** under an installment land sale contract is viewed as retaining only a limited interest in the property. The Seller in essence owns the purchase price with an equitable lien on the property for the unpaid balance. Although the Seller retains legal title, the Seller is viewed as holding it in trust for the Buyer. The Seller’s interest in the property is similar to that of a beneficiary under a promissory note secured by a deed of trust or a mortgage, which is specifically excluded under §1031. Therefore, an argument could be made that the Seller under an installment land sale contract should be excluded from exchanging his or her interest under §1031. Consequently, it is unlikely that the Seller under an installment land sale contract would be able to successfully defend the tax deferred exchange treatment for their transaction if challenged by the IRS.

Brief Exchanges

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