



Is Property in Guam, Northern Mariana Islands, Puerto Rico, and Virgin Islands Considered Like-Kind Property under Section 1031?

The United States Treasury (Treasury) expanded the range of investment property located outside the United States for which tax deferral may be permitted under Internal Revenue Code (IRC) Section 1031. Since the Internal Revenue Service issued a private letter ruling in 1990 approving a 1031 exchange of property located in the U.S. for property in the U.S. Virgin Islands, the 1031-oriented tax community has generally understood that a 1031 exchange involving property located in the U.S. for property located in the Virgin Islands could be accomplished. But what about the other U.S. Territories? In 2005, the Treasury adopted a temporary regulation under §935 that appears to extend the application of 1031 deferral to exchanges of U.S. property to property situated in Guam and the Northern Mariana Islands.

The fact that §1031 might apply to an exchange of property located within the U.S. for property outside the U.S. is a bit surprising given that the statute itself at subparagraph (h) flatly states that “[r]eal property located in the United States and real property located outside the United States are not property of a like kind.” The IRC specific definition of “United States” when used to describe a geographic area includes only the 50 states and the District of Columbia. See §7701(a)(9). So, how can property inside the U.S. ever be like-kind to property outside the 50 states? The answer is hinted at in the legislative history accompanying the adoption of §1031(h) where the committee recommended the adoption of that subsection stating that “no inference [from the adoption of 1031(h)] is intended to override or otherwise modify Code Sec. 932” (Conference Committee Report No. 101-386 (PL 101-239) at p. 614). Section 932 provides rules intended to coordinate the application of U.S. tax laws with those of the Virgin Islands. It is important to understand that the Virgin Islands, although a U.S. Territory, has an independently elected government and taxing powers independent of the U.S. Consequently, coordination of the U.S. income tax laws and those of the Virgin Islands is necessary to avoid confusion and duplication of tax for individuals who are subject to tax in both jurisdictions.

Section 932(a)(3) generally provides that the U.S. shall be treated as including the Virgin Islands if the requirements of §932(a) are met. Section 932 applies to an individual citizen or resident of the U.S. (other than a bona fide resident of the Virgin Islands during the entire taxable year) who (i) has income derived from sources

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within the Virgin Islands, or effectively connected with the conduct of a trade or business within such possession, for the taxable year, or (ii) such individual files a joint return for the taxable year with such an individual. Consequently, if a person is subject to the coordinating provisions of §932 (a person subject to tax in both the U.S. and the Virgin Islands) then the term “Unites States”, as used in the IRC, includes the Virgin Islands. Section 932(c) provides reciprocal treatment for bona fide residents of the Virgin Islands. Until 2008, only property located in the U.S. Virgin Islands enjoyed this status for purposes of §1031.

Effective April 29, 2008, the Treasury adopted final regulations under §935 that provide identical treatment for residents of Guam and the Northern Mariana Islands. See Treas. Reg. §1.935-1T--Coordination of Individual Income Taxes with Guam and the Northern Mariana Islands (temporary). Accordingly, a U.S. citizen or resident domiciled in the U.S. who exchanges investment property situated in the U.S. for replacement property located in the Virgin Islands, Guam or the Northern Mariana Islands (collectively, the Coordinated Territories) may do so only if the person is subject to tax in both the U.S. and the respective Coordinated Territory for the year in which the exchange is completed. That would be the case if, for example, the property acquired in a Coordinated Territory is expected to produce income taxable in that Coordinated Territory. The same may be true for an individual who is a resident of the Coordinated Territory (although a resident of Guam is a U.S. citizen, they are afforded separate tax treatment if they are a “bona fide resident of the Territory”) who could sell property located in the Coordinated Territory for income producing investment property located in the U.S.

Adding the Northern Mariana Islands and Guam along with the U.S. Virgin Islands to the list of properties that may be acquired in a 1031 exchange creates a significant opportunity for U.S. taxpayers to diversify real estate portfolios on a tax-deferred basis with property in markets distinct from the U.S. Property in Puerto Rico is not included in the list of Coordinated Territories and is not considered part of the United States under the special rules that exist under §932 and §935 that apply narrowly to the Northern Mariana Islands, Guam, and the U.S. Virgin Islands.

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