

Death and Taxes —

A monthly column on tax issues and estate planning

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Swapping Mainland Business or Investment Property for a Piece of Paradise

Mike Mainland owns an apartment building in North Carolina that he would like to exchange for an investment villa on St. John currently owned by Bonnie Beach – and the properties are equal in value. Under section 1031 of the Internal Revenue Code of 1986, Mike and Bonnie can exchange their properties without recognizing any gain or loss as long as they hold the properties individually or through “flow through” entities such as partnerships – with some important tax planning.

Specifically, Code section 1031(a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of a like kind that is to be held either for productive use in a trade or business or for investment. Until 1989, qualifying real property in the United States could be exchanged by individuals for qualifying foreign real estate – including Virgin Islands real estate – without any limitations. However, the Revenue Reconciliation Act of 1989 added new Code section 1031(h), providing that “for purposes of this section, real property located in the United States and real property located outside the United States are not property of a like kind.”

The Conference Committee Report that accompanied the enactment of Code section 1031(h) stated that no inference was intended to override or otherwise modify Code section 932 (involving the tax treatment of U.S. and Virgin Islands residents). In turn, Code section 932 provides that for

a U.S. resident with income from the Virgin Islands, “the United States shall be treated as including the Virgin Islands.” The Conference Report did, however, leave open the question of whether a U.S. resident who exchanged business or investment U.S. real property for business or investment Virgin Islands real property would fall within the Conference Report “safe harbor” because the taxpayer would probably not have any Virgin Islands income – and thus would not fall under the provisions of Code section 932(a) – at the time of the exchange.

The IRS addressed this issue in a private letter ruling (PLR 9038030) that involved a taxpayer who owned a rental house in the United States and wanted to exchange that property for a condominium unit, also a rental property, in St. Thomas, in a like-kind exchange under Code section 1031(a). The taxpayer did not have any income from Virgin Islands sources before the exchange although the condominium unit would be producing income during the taxable year of the exchange – but only after the exchange. The IRS held that if the individual involved in the exchange is a U.S. citizen or resident and has Virgin Islands income for the taxable year of the exchange, then Code section 932(a) applies to that individual and the term “United States” includes the Virgin Islands. The ruling held that “property located in the States or in the District of Columbia and property located in the U.S. Virgin Islands shall be considered as property of like-kind for that particular individual and Section 1031(a) applies.”



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The ruling did not deal with an exchange of property that does not produce income by the end of the taxpayer’s taxable year because it is held for investment purposes. In this case, a U.S. taxpayer would not fall within Code section 932(a) after the like kind exchange without obtaining income from other Virgin Islands sources. Code section 932(a) does not set any requirements as to the amount or type of Virgin Islands income that a U.S. resident or citizen must receive to fall within its parameters. For example, interest on a savings account in a Virgin Islands bank constitutes Virgin Islands source income and a taxpayer with such income falls within Code section 932(a). A taxpayer desiring to receive Virgin Islands investment property in an exchange could therefore establish an interest-bearing account in the Virgin Islands before the end of the tax year in which the like-kind exchange takes place or seek another source of Virgin Islands income (such as providing consulting services in the Virgin Islands) before the end of the tax year.

No parallel to Code section 932(a) exists for U.S. “C” corporations and a U.S. corporation cannot exchange U.S. real property for Virgin Islands real property in a tax-free Code section 1031 exchange.

Suggestions for future columns should be sent to AskJorie@TradewindsHouseandHome.com.

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