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Where can §1031 replacement property be located? - by Pamela Michaels

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Since the Tax Cut and Jobs Act of 2018, real estate investors in the Northeast have had significantly increased appetites for purchasing replacement property in low or no income tax states. Many might say investors are flocking to Florida from New York and New Jersey since state and local taxes are no longer deductible over the new $10,000 limit and Florida's tax regime is not so punitive economically.

While 1031 exchanges permit the sale of relinquished property anywhere in the U.S. and the purchase of replacement property anywhere in the U.S. and accordingly would allow a real estate investor to sell investment property in New York and buy investment property in Florida, purchasing replacement property outside the U.S. is not generally permitted. Some investors might want to know if they can sell New York investment property in a 1031 exchange and buy in Puerto Rico or Cuba, two very popular destinations with New Yorkers. However, neither Puerto Rico or Cuba properties will not qualify as like-kind replacement property in qualifying a §1031 exchange.

Prior to 1989, investors could exchange U.S. property for property outside of the U.S. However, for all exchanges occurring after July 10, 1989, only U.S. property can considered "like-kind" for purposes of IRC §1031. So, what locations besides property located in the continental U.S. is considered U.S. property that qualifies in a §1031 exchange?

In 1990, the U.S. Treasury expanded the range of investment property located outside the U.S. for which tax deferral may be permitted in a §1031 exchange. Since the IRS issued a private letter ruling in 1990 approving a §1031 exchange of property located in the U.S. for income producing 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 income producing property located in the U.S. Virgin Islands could be accomplished. But what about the other U.S. Territories? In 2005, the Treasury adopted a temporary regulation under §935 that extends 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). §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, have 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.

§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. §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 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 “United States,” as used in the IRC, includes the Virgin Islands. §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 U.S. 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 U.S. 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.

For these reasons, a §1031 tax deferred exchange is not feasible for NY investors seeking to sell relinquished property in NY and buy replacement property in Puerto Rico or Cuba. As always, review your specific 1031 exchange scenario with tax and/or legal advisors.

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