Like-Kind Exchange Corner

By Mary B. Foster

Code Sec. 1031 Exchanges of Precious Metals and Other Collectibles

a Wolters Kluwer business

The recent rise in the price of gold and other precious metals has resulted in questions about the exchange of precious metals. The current maximum federal capital gain rate for most collectibles is 28 percent.[1] Therefore, taxpayers have a significant incentive to structure a tax deferred exchange if the precious metal has appreciated significantly. Other types of collectibles, such as artwork and exotic cars, are also regularly exchanged under Code Sec. 1031.

For capital gain purposes, collectibles are defined under Code Sec. 408(m) as: (a) any work of art; (b) any rug or antique; (c) any metal or gem; (d) any stamp or coin; (e) any alcoholic beverage; or (f) any other tangible personal property specified by the Secretary of Treasury. To date, the Secretary of Treasury has not specified any other assets as collectibles under Code Sec. 408(m).[2] Collectibles are generally non-depreciable because they do not have a useful life and do not suffer wear and tear. However, musical instruments have been found to be depreciable by professional musicians.[3]

Collectibles as Qualified Property Under Code Sec. 1031

Code Sec. 1031(a)(1) provides that both the relinquished property and the replacement property must be "held for productive use in a trade or business or for investment." Collectibles used in a business, such as artwork held for display in an office, would clearly be exchangeable. Many collectibles, however, are not held as business property but are held by individuals for a combination of both investment and personal

Mary B. Foster is President of 1031 Services Inc. in Bellevue, Washington.

purposes. The investment intent must be the *primary* intent.[4] The taxpayer will have the burden of proving the investment intent outweighed the personal enjoyment of the collectible item. A taxpayer who displays the collectible in the taxpayer's home may have difficulty proving investment intent is primary, even if the taxpayer otherwise considers the item an investment.[5] A taxpayer will have a much lighter burden if the collectible is kept in storage so that the taxpayer does not appear to obtain much or any personal enjoyment from the item.[6]

Exchanges of Precious Metals

For Code Sec. 1031 to apply to an exchange of precious metals, the properties exchanged must be materially different in kind or extent. Otherwise, there would be no realization event under Code Sec. 1001 and therefore no gain to defer.[7] Many precious metal exchanges do apparently involve materially different properties because there are several IRS rulings and cases on the subject. The following guidelines can be gleaned from the existing authorities.

Noncirculating. If the precious metals are in the form of coins, then the coins must be noncirculating. Thus, Swiss francs were not like-kind to U.S. Double Eagle gold coins because the taxpayer could use Swiss francs in Switzerland's open market, but could only use U.S. Double Eagle gold coins as a collector.[8] The court stated that the U.S. Double Eagle gold coins are exchanged in the marketplace only by numismatists and are valued primarily for their rarity, while the Swiss francs are currently circulating currency and represent investments in the Swiss national economy.

Gold vs. Silver. According to a 1982 IRS revenue ruling, gold is not like-kind to silver.[9] The ruling states that gold and silver are intrinsically different metals and primarily used in different ways. The ruling reasons that while silver is essentially an industrial commodity, gold is primarily utilized as an investment in itself. Thus, the ruling states that an investment in one of the metals is fundamentally different from an investment in the other metal. Note that the ruling is 30 years old, and the uses of gold and silver have since changed such that gold has become more of an industrial commodity and silver has become more of an investment in itself.

Numismatic vs. Bullion. Precious metals can be held in various forms. The traditional form of gold investment is a gold bar, or bullion-type investment. Coins can be either bullion or numismatic. The value of bullion-type coins is determined solely on the basis of their metal content. The value of numismatic-type coins is determined by their age, number minted, history, art and aesthetics, condition and metal content. Because of the difference in determining value, the IRS has ruled that numismatic coins are not like-kind to bullion coins.[10] Thus, the IRS issued a revenue ruling holding that United States $20 gold coins (numismatic-type coins) are not like-kind to South African Krugerrand gold coins (bullion-type coins). The ruling states that although the coins both contain gold, they actually represent totally different types of underlying investment, and therefore are not of the same nature or character. The bullion-type coins represent an investment in gold on world markets rather than in the coins themselves.

Bullion-type coins are like-kind to other bullion-type coins. In a revenue ruling, Mexican 50-peso noncurrency bullion-type gold coins were found to be like-kind to Austrian 100-corona noncurrency.[11] The ruling finds that the gold coins minted in different countries differ primarily in size, shape, and amount of gold content. The nature or character of the gold coins, however, is the same, and thus they qualify as "like-kind" property. Gold bullion bars have also been found to be like-kind to South African Krugerrand gold coins[12] and Canadian Maple Leaf gold coins.[13]

Exchange Traded Funds. Exchange traded funds (ETFs) of precious metals currently are popular methods of owning precious metals by individuals and other investors. ETFs can invest directly in precious metals, sometimes known as "physically backed metal ETFs." ETFs are listed on the national stock exchanges and include SPDR Gold Trust (GLD), iShares Gold Trust (IAU) and iShares Silver Trust (SLV). An ETF can be structured as an investment trust if it has a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, and there is no power under the trust agreement to vary the investment of the certificate holders.[14] This type of trust is classified as a grantor trust for federal income tax purposes,[15] and the beneficiaries are treated, for federal tax purposes, as owning an undivided interest in the underlying precious metal held by the trust.[16]

Taxpayers holding appreciated shares of ETFs would like to exchange them under Code Sec. 1031. In a 2008 IRS Program Manager Technical Assistance (PMTA), the IRS stated that if the investor sells his or her interest in the ETF or the trust sells a portion of

CCH® a Wolters Kluwer business

©2012 CCH. All Rights Reserved.

the precious metal, the investor is treated as having sold, for capital gain purposes, all or a portion of his or her share of the precious metal held by the trust.[17] While a taxpayer may be tempted to rely on this PMTA as authority for an exchange of ETFs, it is merely an internal informal ruling, and no similar ruling has been issued stating that a share in an ETF may be exchanged under Code Sec. 1031.

A taxpayer desiring to exchange an ETF may be able to take comfort from Rev. Rul. 2004-86, which allows a taxpayer to treat a beneficial interest in a multi-owner Delaware Statutory Trust (DST) that owns rental real property as an interest in real property for Code Sec. 1031 purposes.[18] DSTs can be considered investment trusts if, like ETFs, all of the interests in the DST are a single class representing undivided beneficial interests in the assets of the DST, and the trustee has no power to vary the investment of the certificate holders to benefit from variations in the market.[19]

An ETF may be an undivided interest in the underlying precious metal for Code Sec. 1031 purposes, but it is also a security for federal securities law purposes. While Code Sec. 1031(a)(2)(C) specifically excludes "other securities" from tax-deferred treatment, the term "securities" in Code Sec. 1031 appears to encompass evidences of indebtedness and equity interests in financial enterprises rather than securities for federal securities law purposes.[20] In this regard, the IRS has allowed exchanges of syndicated tenancy-in-common interests (TICs) under Rev. Proc. 2002-22, and TICs can be securities for federal securities law purposes.[21] But TICs, to date, have not been traded on an established securities exchange, and under Rev. Proc. 2002-22, a TIC cannot have more than 35 investors. Further, Rev. Rul. 2004-86 specifically states that the DST interests in the ruling were not publicly traded on an established securities market. IRS personnel have also stated that they will not issue a ruling that an undivided interest in a publicly traded asset qualifies under Code Sec. 1031.[22] Therefore, a taxpayer exchanging an ETF should be aware of the risk that the IRS will disallow the exchange on the basis that EFTs are somehow excluded under Code Sec. 1031(a)(2)(C), and the taxpayer should be prepared to argue the case in court.

> A taxpayer will have a much lighter burden if the collectible is kept in storage so that the taxpayer does not appear to obtain much or any personal enjoyment from the item.

Storage in a Foreign Country. Code Sec. 1031(h)(2)(A) provides that personal property predominantly used within the United States and personal property predominantly used outside the United States generally are not property of a like-kind. This provision was added by the Taxpayer Relief Act of 1997 because "depreciation rules applicable to foreign- and domestic-use are sufficiently dissimilar so as to treat such property as not 'like-kind' property for the purposes of section 1031."[23] While precious metals are nondepreciable, this provision, on its face, appears to apply to both depreciable and nondepreciable properties, and would likely apply to precious metals.

Predominant use of relinquished property is determined based on the two-year period ending on the date of relinquishment, and predominant use of replacement property is determined based on the two-year period beginning on the date of acquisition. If a property is held less than two years (except in the case of an exchange which is part of a transaction, or series of transactions, structured to avoid the purposes of Code Sec. 1031), only the period the property was held by the taxpayer is taken into account.

There is no specific definition of "predominant use" in Code Sec. 1031(h).[24] One interpretation can be found in Reg. §1.48-1(g)(1)(i), which provides that the determination of whether property is used predominantly outside the United States during the tax year is made "by comparing the period in such year during which the property is physically located outside of the United States with the period during which the property is physically located within the United States. If the property is physically located outside the United States during more than 50 percent of the tax year, such property shall be considered used predominantly outside the United States." Thus, "predominant use" for precious metals could likely mean physical location and gold stored or physically located in Switzerland, for example, more than 50 percent of the relevant time period would not be like-kind to a precious metal stored or physically located in the United States more than 50 percent of the relevant time period. If the two-year period is used, then the gold would need to be located in the United States for more than one year to be considered like-

CCH® a Wolters Kluwer business

kind to other gold to be held in the United States.[25] Many ETFs may store the precious metals outside of the United States and thus could not be exchanged for precious metals to be held in the United States.

Like-Kind Standard for Artwork

There are no rulings addressing the like-kind standard for works of art. In an early private letter ruling under Code Sec. 1033, the IRS held that artwork in one medium would not be considered "similar or related in service or use" to artwork in a different medium. Thus, the taxpayer could not replace a lithograph that was destroyed in a fire with other artistic media such as oil paintings, watercolors, sculptures or other graphic forms of art."[26]

A taxpayer wanting to exchange an oil painting for a sculpture should note that the "similar or related in service or use" is generally considered stricter than the like-kind standard, so it is unclear if the IRS would issue the same ruling under Code Sec. 1031. Like-kind relates to "nature or character" and not "grade or class."[27] Does a painting have a different nature or character than a sculpture, or is it just a different grade or class of artwork? All real estate is basically like kind to all other real estate, but the same broad rule does not apply to personal property and therefore artwork. Most of the rulings on personal property exchanges do apply a stricter standard for personal property. For example, a car is not like-kind to a truck, but is like kind to an SUV or a light-duty truck.[28] And a copyright for a novel is not like-kind to a copyright for a song, presumably because a novel is not like-kind to a song even though both are art forms.[29] Gold bullion is not like-kind to silver bullion,[30] as discussed above. On the other hand, recent guidance by the IRS liberally stated that fishing permits are like-kind regardless of the species or fishery location.[31]

Structuring Issues

Collectibles often are sold at auction or on consignment and this can present challenges not found in a transaction with a formal two-party closing. For example, it may be difficult to determine the actual date of transfer of the relinquished property in order to calculate the 45-day deadline for the identification period and the 180-day deadline for the exchange period. The auction contract and process must be examined to determine when the benefits and burdens of ownership of the property transfer. This may depend on several factors, such as payment, transfer of possession or risk of loss.

If the taxpayer wants to effect a tax-deferred exchange that is not a two party swap or trade in, the taxpayer must use a "qualified intermediary" ("QI") and follow the QI safe harbor in Reg. §1.1031(k)-1(g)(4). This can also be challenging in an auction transaction. To meet the QI safe harbor, the QI must first enter into a written exchange agreement with the taxpayer. Then, as required by the exchange agreement, the QI must acquire the relinquished property from the taxpayer and then transfer the relinquished property to the transferee.[32] The QI safe harbor provides two methods that could possibly be used for the QI to meet the requirement of acquiring the relinquished property from the taxpayer and transferring it to the buyer at an auction.

Collectibles often are sold at auction or on consignment and this can present challenges not found in a transaction with a formal two-party closing.

The first method is the "Assignment Safe Harbor," in which the taxpayer's rights under the transfer agreement with the transferee are assigned to the QI and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of property.[33] The Assignment Safe Harbor is used in almost all "normal" deferred exchange transactions because it involves the least amount of cost and disruption to the actual sale of the property to the buyer. The taxpayer's rights in the sale agreement are simply assigned to the QI at closing, and the buyer receives a written notice of this assignment. The auction or consignment agreement and procedure must be examined to determine how best to create the assignment to the QI and the notice to the other parties to the transaction in accordance with the Assignment Safe Harbor. Assignments and notices can be built into the invoice to keep the process simple, but these steps cannot be skipped. The auctioneer may or may not want to cooperate in getting the necessary exchange documentation.

In some auction sales, there may be no transfer agreement with the buyer to assign to the QI and no feasible manner to create proper documentation

©2012 CCH. All Rights Reserved.

for the Assignment Safe Harbor. In such a situation, the exchange can be structured by transferring the asset to the QI by bill of sale prior to the auction or consignment to avoid relying on the Assignment Safe Harbor. Sales tax issues may arise in these exchanges, and the QI will need a sales tax exemption if taking title to the collectible as part of a deferred or reverse exchange.

Conclusion

Collectibles can be exchanged under Code Sec. 1031, but first they must past the test of being primarily held for investment and not for personal purposes. Then, the taxpayer must consider what types of property are like-kind to the collectible being disposed and if the collectible will be stored in the United States. Finally, the disposition and acquisition must be structured so that the exchange falls within the QI safe harbor, and this may take some analysis and creativity when the transaction is occurring in an auction.

CCH® a Wolters Kluwer business

Endnotes

1 Code Sec. 1(h)(5).
2 Notably, the list does not contain exotic cars, which can be sold for significant amounts.
3 *R.L. Simon*, 103 TC 247, Dec. 50,509 (1994); *B.P. Liddle*, 103 TC 285, Dec. 50,060 (1994), *aff'd* CA-3, 1995-2 USTC ¶50,488, 65 F3d 329.
4 *B.E. Moore*, 93 TCM 1275, Dec. 56,950(M), TC Memo. 2007-134.
5 *C.B. Wrightsman*, CtCls, 70-2 USTC ¶9519, 428 F2d 1316, 192 CtCls 772; *J.P. Hamilton*, 25 BTA 1317, Dec. 7547.
6 *G.F. Tyler*, 6 TCM 275, Dec. 15,671(M) (1947); *R.F. Reynolds*, 4 TCM 837, Dec. 14,736(M) (1945).
7 Reg. §1.1001-1(a); *Cottage Savings Ass'n*, SCt, 91-1 USTC ¶50,187, 499 US 554.
8 *California Federal Life Insurance Co.*, 76 TC 107, Dec. 37,624, *aff'd*, CA-9, 82-2 USTC ¶9464, 680 F2d 85.
9 Rev. Rul. 82-166, 1982-2 CB 190.
10 Rev. Rul. 79-143, 1979-1 CB 264.
11 Rev. Rul. 76-214, 1976-1 CB 218.
12 LTR 8117053 (Jan. 28, 1981).
13 Rev. Rul. 82-96, 1982-1 CB 113; LTR 8202101 (Oct. 16, 1981).
14 Reg. §301.7701-4(c).
15 Reg. §1.671-2(e)(3).
16 See Rev. Rul. 90-7, 1990-1 CB 153; Rev. Rul. 85-13, 1985-1 CB 184; and Rev. Rul. 84-10, 1984-1 CB 155.
17 PTMA 2008-01809 (May 2, 2008).
18 Rev. Rul. 2004-86, 2004-2 CB 191.
19 However, Rev. Rul. 2004-86 provides that the DST may be considered a partnership for federal tax purposes (or if so elected, a corporation) and therefore not exchangeable under Code Sec. 1031. This can happen if the trustee has additional powers under the trust agreement, such as the power to do one or more of the following: (i) dispose of the property and acquire new property; (ii) renegotiate the lease with the existing tenant or enter into leases with tenants; (iii) renegotiate or refinance the obligation used to purchase the property; (iv) invest cash received to profit from market fluctuations; or (v) make more than minor non-structural modifications to the property not required by law.
20 GCM 35242 (Feb 16, 1973); Rev. Rul. 78-135, 1987-1 CB 256.
21 NASD Notice 05-18.
22 Remarks of Stephen Toomey at ABA Taxation Section meeting, May 12, 2012.
23 H.R. Rep. No. 105-148, at 544 (1997).
24 Other than the reference to Code Sec. 168(g)(4), which applies only to aircraft registered with the FAA, rolling stock used within and without the US, and vessels documented under the laws of the US.
25 Code Sec. 1031(h)(2)(B).
26 LTR 8127089 (Apr. 10, 1981).
27 Reg. §1.1031(a)-1(b).
28 LTR 200912004 (Mar. 20, 2009).
29 Reg. §1.1031(a)-2(c)(3), ex. 2.
30 Rev. Rul. 82-166, 1882-2 CB 190.
31 IRS Fishing Audit Technique Guide (Aug. 2011).
32 Reg. §1.1031(k)-1(g)(4)(iii)(B).
33 Reg. §1.1031(k)-1(g)(4)(v).