

## BILL ANALYSIS

Department, Board, Or Commission	Author	Bill Number/Version Date
<b>Franchise Tax Board</b>	<b>Assembly Committee on Budget</b>	<b>AB 92</b>

### SUBJECT

Like-Kind Exchange Information Reporting

### SUMMARY

This bill would provide an annual information reporting requirement for like-kind exchanges when California property is exchanged for property located outside of California.

This bill's other provisions relating to liquidation of encumbrances and property tax allocations and transfers would not affect the department and are not addressed in this report.

### REASON FOR THE BILL

The reason for the provision of the bill that would impose a like-kind exchange reporting requirement is to reduce the number of out-of-state taxpayers that fail to report California-source gains deferred by like-kind exchanges when those deferred gains are later recognized.

### EFFECTIVE/OPERATIVE DATE

As an act that would provide for an appropriation and would be identified as related to the Budget Bill, this bill would become effective immediately upon enactment. The like-kind exchange reporting requirement would be operative for exchanges of property that occur in taxable years beginning on or after January 1, 2014.

### ANALYSIS

#### FEDERAL/STATE LAW

#### **Like-Kind Exchanges**

##### *In General*

Under federal and state law, an exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a like kind that is to be held for productive use in a trade or business or for investment; such an exchange is referred to as a "like-kind exchange."<sup>1</sup>

Generally, no gain or loss is recognized at the time of the exchange. The amount of unrecognized gain or loss is deferred, and will generally be recognized upon the sale of the property acquired in the exchange, unless a taxpayer subsequently exchanges property acquired in an exchange for another property of like kind. However, if, as part of the exchange, a taxpayer also receives other (not like-kind) property or money, gain is recognized to the extent of the other property and money received, but a loss is not recognized.

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<sup>1</sup> The federal rules for like-kind exchanges are under Internal Revenue Code (IRC) section 1031, to which California generally conforms under Revenue and Taxation Code (R&TC) sections 18031 and 24941.

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There are no restrictions on the type of taxpayer who can enter into a like-kind exchange: individuals, corporations, partnerships, and estates and trusts may all engage in like-kind exchanges.

### *Basis of Property Received*

The basis of property acquired in a like-kind exchange (i.e., the replacement property) will generally be equal to the basis of the property transferred, with certain adjustments; basis in the replacement property is increased by any gain recognized in the exchange and by any exchange expenses incurred,<sup>2</sup> and is decreased by any money received in the exchange.

### *Qualifying Property*

To be qualifying property eligible for nonrecognition of gain or loss in a like-kind exchange, both the property transferred and the replacement property must be held for investment or for productive use in a trade or business. Land, buildings, machinery, automobiles, and rental houses are examples of property that would generally be qualifying property in a like-kind exchange. Certain types of property are specifically not qualifying property for purposes of a like-kind exchange, including inventory, stocks, bonds, notes, other securities or evidence of indebtedness or interest, interests in a partnership, certificates of trusts or beneficial interest, or choses in action.<sup>3</sup>

### *Like-Kind Property*

To be eligible for nonrecognition of gain or loss, the qualifying property exchanged must be like-kind property. Like-kind properties are properties of the same nature or character, even if they differ in grade or quality. For example, the exchange of land improved with an apartment house for land improved with a storage building would qualify as a like-kind exchange.<sup>4</sup> Conversely, an exchange of personal property for real property would not qualify as a like-kind exchange; for example, an exchange of a piece of machinery for a storage building would not qualify as a like-kind exchange.

Special rules apply to exchanges of multiple properties and to exchanges of property between related persons.

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<sup>2</sup> Exchange expenses are generally the closing costs paid on the exchange. They include such items as brokerage commissions, attorney fees, and deed preparation fees.

<sup>3</sup> IRC section 1031(a)(2).

<sup>4</sup> Real properties are generally of like kind, regardless of whether or no they are improved or unimproved; however, real property in the United States and real property outside of the United States are not like-kind properties.

### *Identification Requirement*

Taxpayers must identify the replacement property within 45 days after the date of the transfer of the property given up in the exchange. This period is called the identification period. Any property received during the identification period is considered to have been identified.

### *Receipt of Replacement Property*

The replacement property must be received by the earlier of 180 days after the date on which the property given up in the exchange is transferred, or the due date, including extensions, for the tax return for the tax year in which the transfer of the property given up occurs.

### *Qualified Intermediaries*

Taxpayers commonly use a qualified intermediary to facilitate a like-kind exchange. An intermediary, often called an exchange facilitator, acts as a middle man in an exchange transaction, generally managing all aspects of the exchange, including facilitating document signatures and the timely cooperation and performance of the parties to the exchange.

### *Reporting Requirements*

For federal purposes, taxpayers are required to report the exchange of like-kind property, even though no gain or loss is recognized, on federal Form 8824, Like-Kind Exchanges, for the taxable year in which the exchange occurs, and attach that form to their federal tax return.

For California purposes, taxpayers are similarly required to report the exchange of like-kind property, even though no gain or loss is recognized, on federal Form 8824, Like-Kind Exchanges, using California amounts, for the taxable year in which the exchange occurs, and attach that form to their California tax return.

### *California Source Gains and Losses*

Because California law conforms to federal law with respect to like-kind exchanges, taxpayers are allowed to exchange California property for out-of-state property, as long as the exchange meets the federal like-kind exchange requirements. A gain or loss from the exchange of real or tangible personal property located in California is sourced to California at the time the gain or loss is realized, regardless of whether or not the taxpayer that realized the gain is residing in or doing business in California at the time that the gain is recognized.

For example, if an individual is a California resident that exchanges real property located in California for real property located outside of California, the deferred gain or loss is California source income. Even if that individual moves to another state and resides there for several years before the gain or loss is recognized, that individual is required to report to California the deferred California-sourced gain or loss in the year the gain or loss is recognized, and pay any California tax attributable to the recognition of that gain or loss. This is an unusual recordkeeping burden on that individual, as tax records may not generally be retained beyond the normal four-year statute of limitations, and that individual may not have had a California filing requirement for several years. Thus, it is not uncommon for such individuals to neglect to file a California return and report that California-sourced gain or loss in the year it is recognized. Additionally, it is challenging for the Franchise Tax Board (FTB) to track deferred gains or losses of individuals who have been nonresidents for several years and have not been required to file California income tax returns.

### **California Rules for the Failure to File a Return**

If any taxpayer fails to file a California return, or files a false or fraudulent California return with intent to evade the tax, for any taxable year, the FTB may, at any time, require a return or an amended return under penalties of perjury or may make an estimate of the net income, from any available information, and may propose to assess the amount of tax, interest, and penalties due.<sup>5</sup>

### **THIS BILL**

This bill would provide an annual information reporting requirement for taxpayers that claim nonrecognition of gain or loss for a like-kind exchange when property in California is exchanged for property located outside of California. For such an exchange, taxpayers would be required to file an information return in the taxable year of the exchange and in each subsequent taxable year in which the gain or loss attributable to the exchange has not been recognized.

For taxpayers that fail to comply with that reporting requirement and fail to file a return to properly report the recognition of the gain or loss attributable to the exchange, the FTB could make an estimate of the net income from the exchange using any available information, including the amount of deferred gain or loss reported in the year of the exchange, and may propose to assess the amount of tax, interest, and penalties due in the same manner as assessments that are proposed for the failure to file a return.

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<sup>5</sup> R&TC section 19087.

**OTHER STATES’ INFORMATION**

A review of other states’ laws found that two states, *Montana* and *Oregon*, have laws that specifically apply to like-kind exchanges when in-state property is exchanged for out-of-state property. *Montana* law specifically provides that when *Montana* property is relinquished in a like-kind exchange, the gain realized is *Montana*-source income, and nonresidents who recognize such a gain are required to report it to *Montana* when the gain is recognized for federal tax purposes.<sup>6</sup> *Oregon* law provides that its Department of Revenue may require taxpayers owning property acquired in a like-kind exchange that is located outside of *Oregon* to file an annual report on the acquired property.<sup>7</sup>

**FISCAL IMPACT**

Implementing this provision would result in costs of approximately \$362,000 and \$62,000 for fiscal years 2013/14 and 2014/15, respectively, for information technology system programming changes and additional personnel hours.

**ECONOMIC IMPACT**

Revenue Estimate

Estimated Revenue Impact of the Like-Kind Exchange Provision of AB 92 As Amended June 12, 2013 For Taxable Years Beginning On or After January 1, 2014 Assumed Enactment After June 30, 2013		
2013-14	2014-15	2015-16*
\$0	+ \$200,000	+ \$600,000

\*The like-kind exchange provision would result in an estimated revenue gain of \$17 million in fiscal year 2024-25, when the program would be fully phased in.

This estimate does not account for changes in employment, personal income, or gross state product that could result from this bill.

**APPOINTMENTS**

None.

**SUPPORT/OPPOSITION**

Support: None on file.

Opposition: None on file.

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<sup>6</sup> Administrative Rules of Montana, section 42.2.308(3).

<sup>7</sup> Oregon Revenue Statute section 316.738.

**VOTES**

Concurrence	06/14/13	Y: 55	N: 23
Senate Floor	06/14/13	Y: 37	N: 1
Assembly Floor	05/13/13	Y: 51	N: 24*

\* The bill voted on by the Assembly on 05/13/13 contained legislative intent language to enact statutory changes relating to the Budget Act of 2013.

**LEGISLATIVE STAFF CONTACT**

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