

*NOTE: This handout is intended only for purposes of facilitating discussion at the Interested Parties Meeting scheduled for December 20, 2022.*

## **EXPLANATION OF DRAFT TEXT**

The purpose of this Interested Parties Meeting (IPM) is to receive input from the taxpayer community regarding the proposed adoption of a regulation to be included in Title 18 of the California Code of Regulations (CCR), at section 17951-7, and the proposed amendment to CCR section 25137, adding new subsection (e). The following documents are available to the public for the December 20, 2022, IPM: the IPM Notice; Draft Text; and this Explanation of Draft Text.

### **Discussion of proposed addition of CCR section 17951-7**

CCR section 17951-7, as proposed, will provide California's rules for sourcing gains and losses realized and deferred upon the voluntary or involuntary disposition of real or tangible personal property located in this State in an exchange that qualifies for deferral under section 1031 or 1033 of the Internal Revenue Code (IRC), as conformed to by Revenue and Taxation Code section 18031 and section 18031.5. This proposed regulation will apply to nonresidents of California.

The proposed regulation sets forth how to calculate gain or loss to be recognized as California source income upon the sale or other disposition of replacement property, as defined in the regulation at subsection (b). Income from property that is in California at the time of its sale or other disposition, even if deferred, is from sources in this State and must be recognized when gain or loss is recognized for federal purposes.

In summary, the gain or loss realized when a taxpayer relinquishes California property will retain its California source when the California property is exchanged for replacement property in another state. Similarly, when California replacement property is sold or otherwise disposed of in a transaction in which gain or loss is recognized for federal income tax purposes, the realized gain or loss for California income tax purposes will be based on the appreciation of the California property, pursuant to the proposed regulation. When gain or loss is ultimately recognized from the exchange, the California recognized gain or loss will be the lesser of the gain or loss recognized for federal purposes, or the California realized gain or loss. If a loss is recognized for federal purposes and there is a realized gain on California property, no gain or loss will be recognized for California purposes. If a gain is recognized for federal purposes and there is a realized loss on California property, no gain or loss will be recognized for California purposes.

In a series of exchange transactions, the recognized gain or loss for California purposes will be tied to the recognized gain or loss for federal recognition purposes. In cases where the gain recognized for federal purposes is less than the total realized gain in California plus other states, as determined pursuant to the proposed regulation, the federal recognized gain will be prorated between California and the other states with realized gain.

### **Discussion of proposed adoption of CCR section 25137, new subsection (e)**

The December 20, 2022, IPM will focus on the language prepared for CCR section 17951-7. Language for the amendment to CCR section 25137, adding subsection (e), for 1031 Exchanges in an apportioning taxpayer context is still in progress and will be presented in a subsequent IPM.