NOTE: This paper is intended only for purposes of facilitating discussion at the Interested Parties Meeting (IPM) scheduled for January 27, 2026.

EXPLANATION OF PROPOSED AMENDMENTS

California Code of Regulations, Title 18 ("CCR"), section 17951-7 sets forth a new regulation under California Revenue and Taxation Code ("R&TC") section 17951 as relates to the computation of gross income for California nonresidents derived from real property that qualify under like-kind exchanges or involuntary conversions pursuant to Internal Revenue Code ("IRC") sections 1031 and 1033.

The Franchise Tax Board ("FTB") is hereby proposing amendments to the prior version of the proposed regulation to implement and to clarify the application of the sourcing rules and limit the scope of the regulation to real property. FTB is hereby also proposing further amendments to revise the structure, syntax, cross-references, formatting, grammar, and punctuation in the regulation.

The proposed amendments to CCR section 17951-7 are now available on the Regulatory Activity page on the Franchise Tax Board's website at https://www.ftb.ca.gov/tax-pros/law/regulatory-activity/. The proposed amendments are each discussed briefly below, with accompanying explanations.

<u>Proposed Amendments:</u>

17951-7 Title:

The title of Regulation 17951-7 is revised from "Deferred gains and losses from exchanges of real or tangible property in this state" to "Gains or Losses Involving Real Property from Sources within this State." This change is necessary to reflect the regulation's revised scope, improve clarity, and maintain consistency with the revised language in this regulation.

Specifically, the term "deferred gains and losses" is changed to "gains and losses." The regulation now determines the source of income upon a recognition event. Based on this change in approach, the title is amended to accurately reflect both deferred gains and deferred losses as well as gains and losses. Changing the title to "gains and losses" more accurately includes both deferred gains and deferred losses as well as gains and losses from subsequent sales or other dispositions under IRC sections 1031 and 1033.

The term "tangible property" is removed from the title to reflect the revised scope of the regulation, which will no longer apply to tangible personal property. While the prior version of this regulation included tangible personal property, the scope is now limited to real property. On October 1, 2025, California passed Senate Bill 711 (SB 711), which updated California's date of conformity to the IRC. (*See* Stats. 2025, Ch. 231.) In general, for taxable years beginning on or after January 1, 2025, California law conforms to the IRC as of January 1, 2025. Therefore, as of January 1, 2025, California limits tax deferred like-kind exchanges to exchanges of real property only. As a result, it is necessary to limit this proposed regulation to the exchange of real property.

Finally, the term "from sources within this State" is added to clarify that this regulation's purpose is to source gains and losses from the exchange of real property in this State. This terminology, "from sources within this State," is necessary to maintain consistency and eliminate ambiguity regarding sourcing methodology.

Subsection (a): In General.

The phrase “Gain or loss realized and deferred upon the voluntary or involuntary disposition of real or tangible personal property located in this State” is replaced with “When gain or loss is recognized for federal income tax purposes on the exchange, sale, or other disposition of real property that is, or has been, involved.” The prior phrasing focused on gain or loss being "realized and deferred" under California's interpretation of federal law. The revised phrasing shifts the application of the regulation to when the gain or loss is "recognized, for federal income tax purposes." This change is necessary to clarify that the recognition of gains or losses are triggered by the federal recognition of gains or losses.

In addition, as previously discussed the term “tangible personal property” is removed from the proposed regulatory text, which is necessary to reflect the regulation’s narrowed scope to real property only.

The description of section 1033 conversions is clarified by replacing “section 1033” with “or involved in a compulsory or involuntary conversion under section 1033 of the Internal Revenue Code.” This change is necessary to improve clarity and align with the specific language used in IRC section 1033, which is incorporated by California Revenue and Taxation Code section 18031. This revised phrasing is necessary to ensure this regulation mirrors established statutory terminology, preventing ambiguity.

Consistent with the removal of "tangible personal property" from the scope of this regulation, the reference to Section 18031.5 of the Revenue and Taxation Code is also removed. After SB 711, like-kind exchanges are limited to real property as of January 1, 2025. Since the scope of this regulation is now explicitly limited to real property, the reference to section 18031.5 is no longer applicable and is removed for consistency and accuracy.

Next, is the addition of the sourcing provision "the amount of the gain or loss from sources within this State is determined pursuant to this regulation.” The prior version of this regulation did not explicitly state that the methodology for determining the source of income would be provided within this regulation. This addition is necessary to clarify and provide guidance that the determination of the California portion of the recognized gain or loss will be governed by this regulation.

Finally, the entire second sentence is deleted to eliminate redundancy and enhance conciseness. The second sentence described specific scenarios where gain would be recognized. The revision of the earlier sentence already clarifies that the recognition of gain from sources within this state is triggered by the federal recognition event, making the second sentence redundant.

Subsection (b)(1): Deferred Gain.

First, the verb "is" is replaced with "means." This change is made to align with standard regulatory drafting practices, where "means" is typically used to introduce a precise and exclusive definition. Using "means" ensures uniformity and consistency throughout this regulation, enhancing clarity and reducing potential ambiguity.

Second, the phrase "sale or other disposition" is replaced with "exchange." This revision directly incorporates the defined term, "exchange," in subsection (b)(3) of the regulation. The prior term, "sale or other disposition," is too broad. This change is necessary to eliminate ambiguity and confine the application of the definition exclusively to transactions that specifically qualify under IRC sections 1031 or 1033.

Third, the term “real or tangible personal property" is replaced with “property.” This change reflects the regulation’s narrowed scope. The regulation no longer applies to tangible personal property, and the removal of the term "tangible personal property" is necessary to reflect this revised scope. A new definition of “property” has been added to the regulation to restrict the term to “real property.”

Fourth, the phrase "as incorporated by section 18031 of the Revenue and Taxation Code" is added. This addition is necessary to clarify that the definition is based on California’s adopted version of federal tax provisions, rather than from interpretations of the IRC as a standalone federal statute.

Subsection (b)(2): Deferred Loss.

First, the verb "is" is replaced with "means." This change is made to align with standard regulatory drafting practices, where "means" is typically used to introduce a precise and exclusive definition. Using "means" ensures uniformity and consistency throughout this regulation, enhancing clarity and reducing potential ambiguity.

Second, the phrase "sale or other disposition" is replaced with "exchange." This revision directly incorporates the defined term, "exchange," in subsection (b)(3) of the regulation. The prior term, "sale or other disposition," is too broad. This change is necessary to eliminate ambiguity and confine the application of the definition exclusively to transactions that specifically qualify under IRC sections 1031 or 1033.

Third, the term "real or tangible personal property" is replaced with "property." This change reflects the regulation’s narrowed scope, which now applies exclusively to real property. The term "property" used here is consistent with the newly added definition in subsection (b)(4), which defines "property" as "real property." This modification is necessary to ensure that the language used throughout the regulation consistently reflects the intended scope.

Fourth, the term "as incorporated by section 18031 of the Revenue and Taxation Code" is added. This addition is necessary to clarify that the definition is based on California's adopted version of federal tax provisions, rather than from interpretations of the IRC as a standalone federal statute.

Subsection (b)(3): Exchange.

First, the term "real or tangible personal" is removed from the term "real or tangible personal property." This change reflects the regulation's narrowed scope, which now applies exclusively to real property. The term "property" used here is consistent with the newly added definition appearing in subsection (b)(4) as discussed in more detail immediately below. This modification is necessary to ensure that the language used throughout the regulation consistently reflects the intended scope.

Second, the term "as incorporated by section 18031 of the Revenue and Taxation Code" is added. This addition is necessary to clarify that the definition's authority is specifically derived from California's statutorily adopted version of specified federal tax provisions.

Subsection (b)(4): Property.

Subsection (b)(4) does not replace the prior subsection (b)(4) and is a new definition. The new subsection (b)(4) provides a definition for the term "property." Subsections (b)(5) and (b)(6) that follow this definition are renumbered accordingly.

The addition of the definition, "Property means real property," is necessary to limit the scope of the term "property" after SB 711 was enacted. Since SB 711 no longer allows tax deferred like-kind exchanges of personal property as of January 1, 2025, this regulation will only apply to real property exchanges. This definition establishes that all subsequent uses of the term "property" in the regulation refer exclusively to real property, effectively excluding tangible personal property from this regulation's scope.

Subsection (b)(5): Relinquished Property.

The addition of a new definition for 'Property' at subsection (b)(4) necessitates the renumbering of the subsection (b)(4) to subsection (b)(5). This renumbering maintains the organization of the regulatory provisions following the insertion of the new definition.

First, the verb "is" is replaced with "means." This change is made to align with standard regulatory drafting practices, where "means" is typically used to introduce a precise and exclusive definition. Using "means" ensures uniformity and consistency throughout this regulation, enhancing clarity and reducing potential ambiguity.

Second, the term "real or tangible personal" is removed from the term "real or tangible personal property." This change reflects the regulation’s narrowed scope, which now applies exclusively to real property. The term "property" used here is consistent with the newly added definition in subsection (b)(4), which defines property as “real property." This modification is necessary to ensure that the language used throughout the regulation consistently reflects the intended scope.

Third, the phrase "exchanged for replacement property" is replaced with "exchanged for like-kind replacement property." This revision is necessary to improve clarity, precision, and to prevent potential misapplication to transactions that do not qualify under the relevant IRC sections. The added phrase "like-kind" mirrors the language used in section 1031 of the IRC, which generally governs like-kind exchanges.

Fourth, the term "under section 1031 of the Internal Revenue Code or the property that is converted under section 1033 of the Internal Revenue Code, as incorporated by section 18031 of the Revenue and Taxation Code" is added. This addition is necessary to clarify that this definition is based on California’s adopted version of federal tax provisions, specifically referring to Sections 1031 and 1033 of the IRC.

Subsection (b)(6): Replacement Property.

The addition of a new definition for 'Property' at subsection (b)(4) necessitates the renumbering of the subsection (b)(5) to subsection (b)(6). This renumbering maintains the organization of the regulatory provisions following the insertion of the new definition.

First, the term "real or tangible personal property" is replaced with "property." This change reflects the regulation’s narrowed scope, which now applies exclusively to real property. The term "property" used here is consistent with the newly added definition in subsection (b)(4). This modification is necessary to ensure that the language used throughout the regulation consistently reflects the intended scope.

Second, the term "as incorporated by section 18031 of the Revenue and Taxation Code" is added. This addition is necessary to clarify that the definition's authority is specifically derived from California’s statutorily adopted version of specified federal tax provisions.

Subsection (c): Single Exchange.

The title of subsection (c) is changed from “Recognition of Deferred Gain or Loss Upon the Sale of the Replacement Property” to “Single Exchange.” The revised title, "Single Exchange," is necessary to reflect the updated content. The previous title, "Recognition of Deferred Gain or Loss Upon the Sale of the Replacement Property," was vague. In addition, the previous title did not specify the type of transaction it governed, but the following titles both contained "Single Exchange." In order to prevent duplication in subsequent titles and to be concise, the title of subsection (c) was necessarily revised to eliminate potential confusion. The new title, "Single Exchange," specifically indicates that the rules within this subsection pertain exclusively to transactions involving a single exchange of property, which more accurately reflects the content of subsection (c) and improves clarity. The prior version of the regulation provided a sourcing rule in subsection (c) and then separately addressed the "no gain/loss scenario" in subsection (f), effectively creating an exception that modified what was considered income from sources within this State. This structure presented more than one determination of income from sources within this State, which had the potential to cause confusion. The initial sourcing determination in the prior version might imply a taxable event, followed by an exception that negated or altered that sourcing. This could lead to ambiguity and potential for misinterpretation or conflicting applications of the regulation. This new framework is necessary to improve clarity by consolidating all possible gain or loss combinations under a single, unified structure within subsection (c).

Subsection (c)(1): Relinquished Property Located in this State.

First, the subtitle "Single Exchange -" is removed from "Relinquished Property Located in this State". This change eliminates redundancy, as the newly revised title for subsection (c), "Single Exchange," already establishes that this paragraph applies to single exchanges. This modification is necessary to streamline the text and enhances readability and eliminates potential confusion, without losing critical information.

Second, the phrase "upon recognition of gain or loss from the exchange for federal income tax purposes" is replaced with the phrase "when replacement property is sold or otherwise disposed of in a transaction in which gain or loss is recognized for federal income tax purposes." This change is necessary to precisely identify the triggering taxable event. The previous phrasing could potentially be interpreted as including the initial exchange itself. The revised phrasing is necessary to clarify that the taxable event that triggers the application of this paragraph occurs specifically upon the subsequent sale or other disposition of the replacement property, and only when gain or loss is recognized for federal income tax purposes from that subsequent disposition.

Third, the phrase "the gain or loss sourced to this State" is updated to "the gain or loss from sources within this State." This revision maintains consistent terminology and is necessary to eliminate ambiguity regarding the sourcing of income to this State.

Finally, "is the lesser of either of the following:" is revised to "shall be determined under one of the following:" This change adds clarity and is necessary to reflect the new framework for subsection (c) which now addresses the scenarios of gain (federal gain and California gain), loss (federal loss and California loss), and no gain or loss (federal gain and California loss, and federal loss and California gain), rendering the previous language no longer applicable.

Subsection (c)(1)(A): Gain.

The previous language, "The deferred gain or deferred loss," is replaced with new language: "Gain. When there is a gain recognized for federal income tax purposes and a deferred gain on the exchange of the relinquished property, the amount of gain from sources within this State shall be the lesser of the deferred gain and the gain recognized for federal income tax purposes." This new language provides precise computational rules for the calculation of gain from sources within this State.

This change is necessary to reflect the new framework of subsection (c), which establishes a new categorized approach for determining gain or loss from sources within this State. The revised subsection (c)(1)(A) adds clarity by explicitly specifying the rule for when both a federal gain is recognized and there was a deferred gain from the initial exchange of the relinquished property. It provides a clear method for determining the gain from sources within this State in this specific scenario, using the lesser of the two gain amounts.

This new framework is necessary to accurately apply California's sourcing rules and integrates with the new framework covering all gain and loss scenarios under subsection (c)(1) and its related subparagraphs.

Subsection (c)(1)(B): Loss.

The previous language, "The gain or loss recognized for federal income tax purposes," is replaced with new language: "Loss. When there is a loss recognized for federal income tax purposes and a deferred loss on the exchange of the relinquished property, the amount of loss from sources within this State shall be the lesser of the deferred loss and the loss recognized for federal income tax purposes." This new language provides precise computational rules for the calculation of loss from sources within This State.

This change is necessary to reflect the new framework of subsection (c), which establishes a new categorized approach for determining the gain or loss from sources within this State. The revised subsection (c)(1)(B) adds clarity by specifying the rule for when both a federal loss is recognized and there was a deferred loss from the initial exchange of the relinquished property. It provides a clear method for determining the loss from sources within this State in this specific scenario, using the lesser of the two loss amounts.

This new framework is necessary for accurately applying California's sourcing rules and integrates with the new framework covering all gain and loss scenarios under paragraph (1) and its associated subparagraphs.

Subsection (c)(1)(C): No Gain or Loss from Sources within this State.

Subsection (c)(1)(C) is added to read:

> C. No Gain or Loss from Sources within this State. When there is a gain recognized for federal income tax purposes and a deferred loss on the exchange of the relinquished property, there shall be no gain or loss from sources within this State. When there is a loss recognized for federal income tax purposes and a deferred gain on the exchange of the relinquished property, there shall be no gain or loss from sources within this State.

Subsection (c)(1)(C) addresses two specific scenarios that were not explicitly covered in the prior version of subsection (c): (1) when there is a gain recognized for federal income tax purposes but a deferred loss from the initial exchange of the relinquished property, and (2) when there is a loss recognized for federal income tax purposes but a deferred gain from the initial exchange of the relinquished property.

This addition is necessary to improve clarity, more thoroughly cover possible gain and loss permutations, and to eliminate potential gaps in interpretation.

In addition, as noted previously, the prior version of the regulation provided a sourcing rule in subsection (c) and then separately addressed the "no gain or loss scenario" in subsection (f), effectively creating an exception that modified what was considered income from sources within this State. This structure presented potential confusion where the initial sourcing rule might imply a taxable event, followed by an exception that negated or altered that sourcing which led to ambiguity and potential for misinterpretation. The added subsection (c)(1)(C) integrates this rule for determining the gain or loss from sources within this State, which is necessary to avoid more than one sourcing determination.

Subsection (c)(2): Replacement Property Located in this State.

The entire subsection (c)(2) is restructured to improve clarity, separate the calculation of total gain or loss from the sourcing determination, and align with California's sourcing terminology.

First, the subtitle "Single Exchange -" is removed from the phrase "Replacement Property Located in this State". This change is necessary to eliminate redundancy, because "Single Exchange" is already the title of subsection (c), encompassing all its subsections. Removing this subtitle improves clarity and conciseness while maintaining the same substantive meaning.

Second, the phrase "the gain or loss sourced to this State is the lesser of either of the following" is replaced with "the gain or loss for purposes of subsection (c)(2) is calculated pursuant to subsection (c)(2)(A) and the amount attributable to sources within this State is calculated pursuant to subsection (c)(2)(B)." This change is necessary to improve clarity by explicitly separating the calculation of the total gain or loss recognized from the application of California sourcing rules. The revised language is also necessary to signal the overall structural change to subsection (c)(2).

Finally, the phrase "sourced to this State" is changed to "attributable to sources within this State". This change is necessary to maintain consistent terminology with California sourcing rules. This change is necessary to enhance precision, ensure consistent application of sourcing methodology, and eliminates potential ambiguity by using the same terminology used in other sourcing regulations.

Subsection (c)(2)(A): Calculating the Gain or Loss.

The title "Calculating the Gain or Loss” is added. This addition is necessary to add clarity and explicitly indicate that subsection (c)(2)(A) will now pertain specifically to the computation of the recognized gain or loss.

In addition, the phrase “gain or loss on the sale or other disposition of the replacement property shall be the” is added. This addition is necessary to improve clarity by linking the calculation to the sale or other disposition of the property that triggers recognition.

The calculation methodology remains substantively unchanged, but the added title and introductory phrase provide a clearer context for its application within the restructured subsection (c)(2).

Subsection (c)(2)(A)(i)

First, the title is changed from (c)(2)(A)(1) to (c)(2)(A)(i). This revision is necessary to align with standard regulatory numbering conventions, ensuring consistency with the formatting used throughout the revised regulation. This change is necessary to improve the readability of the document.

Second, the phrase “Internal Revenue Code section 1016(a)(1)" is replaced with "section 1016(a)(1) of the Internal Revenue Code." This modification is necessary to ensure consistent terminology throughout this regulation and to improve clarity.

Third, the phrase “as conformed to by California Revenue and Taxation Code section 18031” is changed to "as incorporated by section 18031 of the Revenue and Taxation Code.” This revision is necessary to maintain consistency in terminology throughout the regulation when describing the relationship between federal IRC sections and California law.

Subsection (c)(2)(A)(ii)

First, the title is changed from “(c)(2)(A)(2)” to “(c)(2)(A)(ii).” This revision is necessary to align with standard regulatory numbering conventions, ensuring consistency with the formatting used throughout the revised regulation. This change is necessary to improve the readability of the document.

Second, the phrase “Internal Revenue Code section 1016(a)(1)" is replaced with "section 1016(a)(1) of the Internal Revenue Code." This modification is necessary to ensure consistent terminology throughout this regulation and to improve clarity.

Third, the phrase "as conformed to by California Revenue and Taxation Code section 18031" is changed to “as incorporated by section 18031 of the Revenue and Taxation Code.” This revision is necessary to maintain consistency in terminology throughout the regulation when describing the relationship between federal IRC sections and California law.

Subsection (c)(2)(B): Gain and Loss from Sources within this State.

Subsection (c)(2)(B) is completely restructured as detailed below. The entire prior content of subsection (c)(2)(B) is deleted and replaced with a new framework. A title for this subsection is added to read: “*Gain and Loss from sources within this State*.” This new title is necessary to clarify that this subsection pertains to the determination of gains and losses from sources within this State.

Subsection (c)(2)(B)(i): Gain.

Subsection (c)(2)(B)(i) is added to read:

> Gain. When there is a gain recognized for federal income tax purposes and a gain on the sale or other disposition of the replacement property under subsection (c)(2)(A), the amount of gain from sources within this State shall be the lesser of the gain under subsection (c)(2)(A) and the gain recognized for federal income tax purposes.

This provision clarifies that when both a federal income tax gain is recognized and a gain is calculated on the sale or disposition of replacement property under subsection (c)(2)(A), the amount of gain from sources within this State will be the lesser of the two amounts. This addition is necessary to provide a precise computational rule for sourcing gain in this scenario.

This change is necessary to reflect the new framework of subsection (c), which establishes a new categorized approach for determining gain or loss from sources within this State. The revised Subsection (c)(2)(B)(i) adds clarity by explicitly specifying the rule for when both a federal gain is recognized and a gain on the sale or other disposition of the replacement property. It provides a clear method for determining the gain from sources within this State in this specific scenario, using the lesser of the two gain amounts.

This new framework is necessary for accurately applying California's sourcing rules and integrates with the new framework covering all gain and loss scenarios under subsection (c) and its related paragraphs.

Subsection (c)(2)(B)(ii): Loss.

Subsection (c)(2)(B)(ii) is added to read:

> Loss. When there is a loss recognized for federal income tax purposes and a loss on the sale or other disposition of the replacement property under subsection (c)(2)(A), the amount of loss from sources within this State shall be the lesser of the loss under subsection (c)(2)(A) and the loss recognized for federal income tax purposes.

This provision clarifies that when both a loss is recognized for federal income tax purposes and a loss is calculated on the sale or other disposition of replacement property under subsection (c)(2)(A), the amount of loss from sources within this State will be the lesser of the two amounts. This addition is necessary to provide a precise computational rule for sourcing loss in this scenario.

This change is necessary to reflect the new framework of subsection (c), which establishes a new categorized approach for determining the gain or loss from sources within this State. The revised Subsection (c)(2)(B)(ii) adds clarity by explicitly specifying the rule for when both a federal loss is recognized and a loss on the sale or other disposition of the replacement property. It provides a clear method for determining the loss from sources within this State in this specific scenario, using the lesser of the two loss amounts.

This new framework is necessary for accurately applying California's sourcing rules and integrates with the new framework covering all gain and loss scenarios under subsection (c) and its related paragraphs

Subsection (c)(2)(B)(iii): No Gain or Loss from Sources within this State.

Subsection (c)(2)(B)(iii) is added to read:

> No Gain or Loss from Sources within this State. When there is a gain recognized for federal income tax purposes and a loss on the sale or other disposition of the replacement property under subsection (c)(2)(A), there shall be no gain or loss from sources within this State. When there is a loss recognized for federal income tax purposes and a gain on the sale or other disposition of the replacement property under subsection (c)(2)(A), there shall be no gain or loss from sources within this State.

This provision clarifies that if there is a gain recognized for federal income tax purposes but a loss on the replacement property under subsection (c)(2)(A), or if there is a loss recognized for federal income tax purposes but a gain on the replacement property under subsection (c)(2)(A), there is no gain or loss from sources within this State.

In addition, as noted previously, this new provision is necessary to clarify the sourcing rules that existed in the prior version of the regulation. The prior version provided a general sourcing rule in subsection (c) and then separately addressed the "no gain or loss scenario" in former subsection (f). This former structure created an implicit exception to the main sourcing rule, which potentially modified what was considered income from sources within this State through an exception. This prior structure created the potential for misinterpretation and inconsistent application. Integrating the "no gain or loss" rule directly into the primary sourcing framework under subsection (c)(2)(B)(iii) is necessary to eliminate potential conflicts, ensure a clear and consistent methodology for determining gain or loss from sources within this State, and avoid multiple sourcing determinations.

Subsection (d) Summary of Structural Changes:

Subsection (d) has undergone a comprehensive restructuring. This involved consolidating the former subsections (d)(1) through (d)(4) into two new subsections, (d)(1) and (2), along with their associated subparagraphs and clauses. The contents of the former subsections (d)(1) through (d)(3) are now integrated and restructured within subsection (d)(1) and its associated paragraphs and subparagraphs.

This structural change is necessary to improve the clarity and precision of the regulation's application. The prior regulatory framework presented more than one sourcing determination, where all deferred gain originating from California property was initially treated as income from sources within this State.

The former version indicated that any deferred gain or loss associated with property exchanged in a series of exchanges would be sourced to California if the property was located within California. However, the former subsection (d)(4) then introduced a proration rule that modified this initial sourcing. If the sum of all deferred gains and gains on replacement property exceeded the federally recognized gain, the gain from sources within this State was determined by a ratio comparing California deferred gain to total deferred gain. This resulted in more than one sourcing determination where deferred gain might be initially considered as from sources within this State under the former (d)(1), (d)(2), or (d)(3), only for a potentially smaller portion of it to be ultimately sourced to California under the proration rule of (d)(4).

The newly implemented structure and language resolve this inconsistency by clearly and definitively setting forth the methodology. The revised regulation now determines gain or loss from sources within this State upon a recognition event. It explicitly establishes that the amount of gain or loss attributable to sources within this State is precisely the amount calculated under the specific formulas provided within the language of the regulation. This eliminates the prior ambiguity and ensures a single, consistent determination of gain or loss from sources within this State for series of exchanges.

Subsection (d): Series of Exchanges.

The introductory paragraph for subsection (d) is added to read:

> In a series of exchanges, when replacement property is exchanged, sold, or otherwise disposed of in a transaction in which gain or loss is recognized for federal income tax purposes, including any gain recognized from exchanges not solely like-kind under section 1031(b) of the Internal Revenue Code or any gain recognized from the conversions into money or property not similar or related in service or use to the converted property under section 1033(a)(2) of the Internal Revenue Code, the gains and losses for purposes of subsection (d) are calculated pursuant to subsection (d)(1) and the amount attributable to sources within this State is calculated pursuant to subsection (d)(2).

The added text under subsection (d) is necessary to provide clear introductory context and specific guidance on applying California's sourcing rules to federal gain or loss recognition events within a series of exchanges. This addition is also necessary to define the scope of transactions covered (exchanges, sales, or other dispositions of replacement property where gain or loss is recognized for federal income tax purposes).

Subsection (d)(1): Calculating the Gain or Loss.

The original text defining the gain or loss on the exchange of a first relinquished property and subsequent relinquished or replacement properties is restructured and revised into new subparagraphs (A) and (B) under the newly added heading "Calculating the gain or loss." This restructuring separates the step of calculating the amount of gain or loss from the step of determining the amount attributable to sources within this State.

This change is necessary because the prior structure led to more than one sourcing determination, where an amount was initially considered sourced to California and then later potentially prorated, creating ambiguity and inconsistent application of California sourcing rules. This change solves this issue by creating a separate subsection (d)(1) focused solely on calculating the gain or loss. This provides a foundational amount that is then used in subsection (d)(2) by applying the California sourcing rules. The new heading "Calculating the gain or loss" clarifies the specific focus of this subsection. This new heading is necessary to resolve the lack of clarity by explicitly stating that this subsection provides the methodology for calculating the total gain or loss recognized in a series of exchanges, before the sourcing rules are applied.

Subsection (d)(1)(A): Exchange of First Relinquished Property.

The prior language for the gain or loss for the initial exchange in a series, at subsection (d)(1) stated, "First Relinquished Property. In a series of exchanges, the sourcing of deferred gain or deferred loss on the first relinquished property, located in or outside this State, shall be determined under subsection (c)(1)(A) as if such property were located in this State," and is replaced with new language: "Exchange of First Relinquished Property. The gain or loss on the exchange of the first relinquished property shall be the deferred gain or deferred loss, regardless of location." This change limits this section to the calculation of gain or loss for the first relinquished property within a series.

This change is necessary because the prior text contained more than one sourcing determination where an initial amount under the prior (c)(1)(A) was considered sourced to California and then later potentially prorated, creating ambiguity and inconsistent application of California sourcing rules. The revised language resolves this issue by separating the calculation of the deferred amount from the sourcing determination and separating the first exchange from subsequent exchanges, ensuring an unambiguous application of the California sourcing rules.

This substantially revised language establishes the gain or loss on the first relinquished property as the deferred gain or deferred loss, regardless of location. This provides a clear and unambiguous amount that will be used in subsequent steps of this regulation. The deferred amount is then subject to the specific sourcing rules detailed under the newly restructured (d)(2).

Subsection (d)(1)(B): Exchange, Sale, or Other Disposition of Replacement Property.

The prior language for the gain or loss on subsequent exchange of replacement properties, at subsection (d)(2) stated, "(2) Subsequent Relinquished Properties. In a series of exchanges, the sourcing of deferred gain or deferred loss on subsequent relinquished properties, located in or outside this State, shall be determined under subsection (c)(2)(A) as if such properties were located in this State," and at subsection (d)(3) stated, "(3) Replacement Property. In a series of exchanges, the sourcing of gain or loss on the replacement property, located in or outside this State, shall be determined under subsection (c)(2)(A) as if such property were located in this State," are replaced with new language: "B. Exchange, Sale, or Other Disposition of Replacement Property. The gain or loss on a subsequent exchange of any replacement property or sale or other disposition of replacement property shall be calculated according to subsection (c)(2)(A), regardless of location."

The revised subsection (d)(1)(B) combines the prior subsections (d)(2) and (d)(3) and focuses on the calculation of gain or loss of subsequent exchanges of replacement properties and the final disposition of the replacement property.

First, the revised language specifies that the gain or loss on a subsequent exchange, sale, or other disposition of replacement property shall be calculated according to subsection (c)(2)(A). This ties the calculation method directly to subsection (c)(2)(A), ensuring consistency and accuracy in determining the gain or loss amount. This change is necessary to eliminate ambiguity inherent in the previous separate subsections, which could potentially lead to inconsistent interpretations. By consolidating the rules and directly referencing the foundational calculation method in subsection (c)(2)(A), the regulation ensures uniform application of the sourcing rules for all subsequent transactions.

Second, the phrase "regardless of location" is explicitly included. This clarifies that the calculation method defined in subsection (c)(2)(A) will apply to subsequent transactions in the series, whether the replacement property is located in this State or outside this State. This addition is necessary to improve clarity and ensure consistent application of the calculation method regardless of the property's location.

These changes are necessary because the prior text contributed to a lack of clarity where an initial amount under the prior (c)(2)(A) was considered sourced to this State and then later potentially prorated, creating ambiguity and inconsistent application of this State's sourcing rules. The revised language resolves this issue by separating the calculation of the deferred amount from the sourcing determination, ensuring an unambiguous application of the California sourcing rules upon a recognition event.

Subsection (d)(2): Gains and losses from sources within this State.

The prior subsection (d)(4) reads:

> (4) Proration Rule. After applying subsections (d)(1), (d)(2) and (d)(3), if the sum of all the deferred gain on the relinquished properties in all states, plus the gain on the replacement property, exceeds the gain recognized on the sale or other disposition of the replacement property in the transaction for federal income tax purposes, the gain sourced to this State is determined by multiplying the gain recognized for federal income tax purposes by the ratio of total deferred gain in this State and gain on the replacement property, if located in this State, over all deferred gain and gain on the replacement property.

The prior subsection (d)(4) is replaced with the new restructured paragraph (2) and its associated subparagraphs and clauses.

The newly added title for subsection (d)(2), "Gains and losses from sources within this State," is necessary to define that the purpose of this subsection is to determine the final gains and losses that are considered income from sources within this State. This structural change is necessary to provide clarity and distinguish this section, which focuses on determining gains and losses from sources within this State, from the preceding subsection (d)(1), which focuses on calculating the gain or loss recognized.

This restructuring is also necessary to address a lack of clarity in the prior regulation regarding the methodology for sourcing gains and losses within a series of exchanges. The prior proration rule, while providing a mechanism for sourcing, was embedded in a structure that contained more than one sourcing determination. In that prior structure, an amount might be initially considered sourced to California under the former subsection (d)(1), (d)(2), or (d)(3) and then later potentially prorated, creating ambiguity and inconsistent application of California sourcing rules. This change solves this issue by creating a distinct subsection (d)(2) that focuses solely on the sourcing of the gain or loss. This restructuring separates the step of calculating the amount of gain or loss under subsection (d)(1) from determining the amount attributable to sources within this State under subsection (d)(2). This change is necessary to resolve the previous lack of clarity and uncertainty regarding the proper application of sourcing methodology.

Subsection (d)(2)(A): Gain.

Subsection (d)(2)(A) is added to read:

> A. Gain. When there is gain recognized for federal income tax purposes and the net amount of all gains and losses calculated under subsection (d)(1) for properties located within this State results in a gain, the amount of gain from sources within this State shall be determined as follows."

The addition of this introductory language is necessary to define the specific conditions under which the following sourcing rules for gain apply. This establishes an introduction for applying the subsequent rules in subsections (d)(2)(A)(i) and (d)(2)(A)(ii) and prevents their misapplication to situations involving losses or where no federal gain is recognized.

This change is also necessary to provide one sourcing determination. The former structure's proration rule in the prior draft of the regulation could lead to inconsistent sourcing, as amounts were initially considered sourced to California under the former subsection (d)(1), (d)(2), or (d)(3) and then later potentially prorated. The new version resolves this problem by establishing a clear, two-step method: first, the final gain amount is calculated, and then it is sourced. This approach ensures a consistent and unambiguous determination of income from sources within this State for gains.

Subsection (d)(2)(A)(i)

Subsection (d)(2)(A)(i) is added to read:

> If the gain recognized for federal income tax purposes is greater than or equal to the sum of all gains calculated under

> subsection (d)(1) regardless of location, then the amount of gain from sources within this State shall be equal to the sum of all the gains calculated under subsection (d)(1) for properties located within this State.

This addition starts with a conditional statement of when federally recognized gain is greater than or equal to the sum of all gains, regardless of location, then the gain from sources within this State is determined to be the gains that were calculated under subsection (d)(1) for properties located in this State.

By adding this conditional statement, taxpayers are provided with a clear and concise rule to apply when the condition applies. Additionally, there is only one determination of income from sources within this State, which occurs upon a recognition event, as opposed to a realization event.

This new language is necessary to establish a clear, uniform standard for determining California-source income following a federal recognition event, eliminating the potential inconsistency and confusion in the prior regulatory language.

Subsection (d)(2)(A)(ii)

Subsection (d)(2)(A)(ii) is added to read:

> If the gain recognized for federal income tax purposes is less than the sum of all the gains calculated under subsection (d)(1) regardless of location, then the amount of gain from sources within this State shall be determined by multiplying the gain recognized for federal income tax purposes by the ratio of the sum of all the gains calculated under subsection (d)(1) for properties located within this State over the sum of all the gains calculated under subsection (d)(1) for all properties, regardless of location.

This addition starts with a conditional statement of when federally recognized gain is less than the sum of all gains, regardless of location, then the amount calculated under (d)(1) undergoes an additional calculation to determine the amount of gain from sources within this State.

By adding this conditional statement, taxpayers are provided with a clear and concise rule to apply when the condition applies. Additionally, the overarching concern of more than one sourcing determination, which existed under the prior version of subsection (d)(4), is remedied by sourcing the gain once upon a recognition event, as opposed to a realization event.

This new language is necessary to remedy the problem of having more than one sourcing determination under the prior version of subsection (d)(4) and avoiding confusion to taxpayers. By sourcing the gain once upon a federal recognition event, it provides a single, clear, and efficient methodology for taxpayers and ensures consistent application of the law.

Subsection (d)(2)(B): Loss.

Subsection (d)(2)(B) is added to read:

> B. Loss. When there is a loss recognized for federal income tax purposes and the net amount of all gains and losses calculated under subsection (d)(1) for properties located within this State results in a loss, the amount of the loss from sources within this State shall be determined as follows."

This addition of this introductory language is necessary to define the specific conditions under which the following sourcing rules for loss apply. This establishes an introduction for applying the subsequent rules in subsections (d)(2)(B)(i) and (d)(2)(B)(ii) and prevents their misapplication to situations involving gains or where no federal loss is recognized. Subsection (d)(2)(B) mirrors the structure provided in subsection (d)(2)(A) for sourcing of gains.

This change is also necessary because the former structure's proration rule could lead to inconsistent sourcing, as amounts were initially considered sourced to California and then potentially prorated. The new version provides a definitive calculation method, resolving this problem by integrating the calculation and sourcing. This ensures a consistent and unambiguous determination of income from sources.

Subsection (d)(2)(B)(i)

Subsection (d)(2)(B)(i) is added to read:

> If the loss recognized for federal income tax purposes is greater than or equal to the sum of all losses calculated under subsection (d)(1) regardless of location, then the amount of loss from sources within this State shall be equal to the sum of all the losses calculated under subsection (d)(1) for properties located within this State.

This addition starts with a conditional statement of when federally recognized loss is greater than or equal to the sum of all losses, regardless of location, then the loss from sources within this State is determined to be the loss that was calculated under subsection (d)(1) for properties located in this State.

By adding this conditional statement, taxpayers are provided with a clear and concise rule to apply when the condition applies. Additionally, the overarching concern of more than one sourcing determination, which existed under the prior version of subsection (d)(4), is remedied by sourcing the loss once upon a recognition event, as opposed to a realization event.

This new language is necessary to provide an explicit, unambiguous rule for sourcing losses, which eliminates the confusion and inconsistency in the prior guidance of more than one sourcing determination.

Subsection (d)(2)(B)(ii)

Subsection (d)(2)(B)(ii) is added to read:

> If the loss recognized for federal income tax purposes is less than the sum of all losses calculated under subsection (d)(1) regardless of location, then the amount of loss from sources within this State shall be determined by multiplying the loss recognized for federal income tax purposes by the ratio of the sum of all losses calculated under subsection (d)(1) for properties located within this State over the sum of all losses calculated under subsection (d)(1) for all properties, regardless of location.

This addition starts with a conditional statement of when federal recognized loss is less than the sum of all losses, regardless of location, then amount calculated under (d)(1) undergoes an additional calculation to determine the amount of loss from sources within this State.

By adding this conditional statement, taxpayers are provided with a clear and concise rule to apply when the condition applies. Additionally, the overarching concern of more than one sourcing determination, which existed under the prior version of subsection (d)(4), is remedied by sourcing the loss once upon a recognition event, as opposed to a realization event.

This new language is necessary to provide an explicit, unambiguous rule for sourcing losses, which eliminates the confusion and inconsistency in the prior guidance of more than one sourcing determination.

Subsection (d)(2)(C): No Gain or Loss from Sources within this State.

Subsection (d)(2)(C) is added to read:

> C. No Gain or Loss from Sources within this State. When there is a gain recognized for federal income tax purposes and the net amount of all gains and losses calculated under paragraph (1) for properties located within this State results in a loss, there shall be no gain or loss from sources within this State. When there is a loss recognized for federal income tax purposes and the net amount of all gains and losses calculated under paragraph (1) for properties located within this State results in a gain, there shall be no gain or loss from sources within this State.

This revision provides a more precise conditional statement covering the condition where a gain is recognized for federal income tax purposes but a net loss is calculated under (d)(1) for properties located in this State, or, where a loss is recognized for federal income tax but a net gain is calculated under (d)(1) for properties located in this State.

This revision provides for the last conditional statements, covering the final permutation of possibilities when calculating gain or loss in a series of exchanges. This revision is necessary to address all possible conditions when dealing with a series of exchanges. The revision is more precise and accurately reflects the corresponding edits made in subsection (d).

Additionally, the revised rule prevents the potential for multiple sourcing determinations that existed in the prior version of this regulation. The prior version provided a general sourcing rule for series of exchanges in subsection (d) and then separately addressed the "no gain or loss scenario" in the previously drafted subsection (f). This former structure created an implicit exception to the main sourcing rule, which potentially modified what was considered income from sources within this State through an exception. This prior subsection (f) created the potential for misinterpretation and inconsistent application. Integrating the "no gain or loss" rule directly into the primary sourcing framework under subsection (d)(2)(C) is necessary to eliminate potential conflicts and ensures a clear and consistent methodology for determining the gain or loss from sources within this State.

Subsection (d)(3): Recognition Treatment.

The prior subsection (d)(5) has been renumbered to subsection (d)(3). This renumbering is a consequence of restructuring of the preceding subsections (d)(1) through (d)(4) into the new (d)(1) and (d)(2). This change is also necessary to improve the readability of the document.

The term "deferred gain or deferred loss" is replaced with the term "gain or loss." This change is necessary to align the language of this subsection with the comprehensive restructuring of subsection (d) and clarify the sourcing determination. The term "gain or loss" is broader and more accurate in this context because it encompasses both deferred gains, deferred losses, and any gains or losses arising from the disposition of replacement property.

Subsection (e): Exchanges with Multiple Replacement Properties.

The prior language for subsection (e) reads:

> Multiple Replacement Properties. When relinquished property is exchanged for more than one replacement property, deferred gain and deferred loss associated with the relinquished property shall be allocated pro rata among the multiple replacement properties based on the fair market

> value of like-kind property (or property similar or related in service or use under Internal Revenue Code section 1033) received for the relinquished property.

Subsection (e) is revised to read:

> Exchanges with Multiple Replacement Properties. When property is exchanged for more than one replacement property, any deferred gain or deferred loss under subsection (c)(1) and any gain or loss under subsection (d)(1) associated with the property exchanged shall be divided pro rata among the multiple replacement properties based on the fair market value of the replacement properties.

First, the title is revised from "Multiple Replacement Properties" to "Exchanges with Multiple Replacement Properties." The revised title "Exchanges with Multiple Replacement Properties" more precisely identifies the subject matter as being about exchanges involving multiple replacement properties. This change to the title is necessary to provide a clearer and more accurate description of the content covered in the subsection (e).

Second, in the introductory paragraph of subsection (e), the term "relinquished property" is replaced with the term "property." This modification is necessary because the term "property" encompasses both relinquished property and replacement property within the context of a series of exchanges, improving consistency and conciseness while aligning with the revised scope of the entire regulation, which now focuses solely on real property.

Third, the phrase "deferred gain and deferred loss associated with the relinquished property" is changed to "any deferred gain or deferred loss under subsection (c)(1) and any gain or loss under subsection (d)(1) associated with the property exchanged." This change is necessary to reference and link the subsections within this regulation that define the deferred gain and loss. This reference provides greater precision and improves clarity by linking the pro rata division of deferred gains or losses to subsection (c)(1) that defines deferred gains and losses, and the pro rata division of gains or losses to subsection (d)(1) that defines gains and losses, providing greater precision and clarity by directly referencing the relevant computational rules. This change is necessary to improve clarity, ensure consistent application of the rules, and avoid ambiguity.

Fourth, the term "exchanged" is added so the phrase reads "property exchanged shall be divided pro rata…" This addition is necessary to accurately reflect the nature of the transaction being described, emphasizing that the computation applies to properties involved in an exchange.

Fifth, the term "allocated pro rata" is replaced with the term "divided pro rata." This change is necessary to avoid potential ambiguity. The term "allocation" is often used in a different context within tax regulations (e.g., assigning specific income/expense items for sourcing). The term "divided pro rata" provides a more precise and unambiguous instruction for the proportional division of deferred gains and losses among multiple replacement properties, ensuring consistent interpretation and application of the rule.

The term "like-kind property (or property similar or related in service or use under Internal Revenue Code section 1033) received for the relinquished property" is replaced with the term "the replacement properties" to clarify that the fair market value used for the pro rata division refers specifically to the fair market value of the multiple replacement properties received in the exchange. This change in terminology is necessary to improve clarity and conciseness and removes potential ambiguity regarding the basis for the division. In addition, the reference to IRC section 1033 is removed for redundancy because the definition provided under section (b) already specifies that the terminologies used encompasses section 1033 exchanges.

Sixth, a new sentence is added: "For the purposes of this subsection, the fair market value of each replacement property shall be reduced by the fair market value of any property not of like-kind or property not similar in service or use to the relinquished property used to purchase that replacement property." This addition is necessary to prevent the inaccurate or inconsistent calculation of deferred gains/losses by improving clarity. It provides explicit instructions on how non-like-kind property (such as cash or other non-qualifying property, commonly referred to as 'boot') affects the basis for the fair market value calculation, ensuring the resulting allocation of California-source gain or loss is both accurate and consistently applied across all transactions and taxpayers.

Former subsection (f), No Gain or Loss for California Income Tax Purposes, is Deleted.

The prior subsection (f) of this regulation, which outlined rules for no gain or loss for California income tax purposes regarding situations with federal gain and California loss or federal loss and California gain, has been removed. The content within the former subsection (f) is now addressed and made redundant by the rules established in subsections (c)(1)(C), (c)(2)(B)(iii), and (d)(2)(C).

Integrating these rules into subsections (c) and (d) enhances the clarity and overall structure of the regulation. This approach ensures a more logical flow, aligning the regulations more closely with established California sourcing rules and methodology.

In addition, by embedding these rules within the existing framework of subsections (c) and (d), the regulation avoids creating an "exception to sourcing" issue. This ensures the sourcing principles remain consistent throughout the regulation, promoting a streamlined and uniform application of tax laws.

Subsection (f): Examples.

The deletion of the prior subsection (f) requires a necessary re-lettering of the former section (g) to subsection (f) to maintain internal consistency within the regulation.

Subsection (f)(1): Single Exchange – Relinquished Property Located in this State.

The deletion of the prior subsection (f) necessitates the re-lettering of the prior subsection (g)(1) to subsection (f)(1).

In subsection (f)(1), the sentence, "Taxpayer purchases California property for $50" is revised to "Taxpayer purchases property located in this State for $50." The word "California" is removed, and the phrase "located in this State" is added. These changes aligns with common regulatory drafting practices, where "located in this State" serves as a standard jurisdictional reference. This change is necessary to avoid ambiguity and improve clarity.

Next, the sentence, "Taxpayer sells the California property for $150, deferring gain of $100 ($150-$50), under Internal Revenue Code section 1031" is revised to "Taxpayer exchanges property located in this State for replacement property located in State A with a fair market value of $150, not recognizing gain of $100 ($150-$50) under section 1031 of the Internal Revenue Code."

The phrase "sells the California property for $150," is replaced with "exchanges property located in this State for replacement property in State A with a fair market value of $150." The original phrase "sells the California property for $150" is inconsistent with the terminology used for a section 1031 exchange. The revised wording, "exchanges," accurately reflects the transaction as an exchange and is necessary to improve clarity and eliminate ambiguity.

Additionally, the word "deferring" is replaced with "not recognizing," Section 1031 of the IRC states that "No gain or loss shall be recognized..." and does not use the term "deferring". The phrase "deferring" is replaced with the phrase "not recognizing" is necessary to improve clarity and avoid the potential for confusion. The term "not recognizing gains" is a more accurate and precise term to describe the immediate effect of a section 1031 exchange. Since this regulation does not explicitly define the term "deferring," the phrase "not recognizing" is used to mirror the language of section 1031 of the IRC.

The phrase "Internal Revenue Code section 1031" is replaced with "section 1031 of the Internal Revenue Code." This change is necessary to implement consistent terminology throughout this regulation and align with the preferred citation style for federal tax code sections.

Furthermore, the sentence "Taxpayer sells the State A replacement property for $250 in a transaction in which gain of $200 is recognized for federal income tax purposes" is revised to "Taxpayer sells the replacement property in State A for $250 in a transaction in which gain of $200 ($250-$50) is recognized for federal income tax purposes." From the sentence in the prior paragraph, the term "State A replacement property" is changed to "the replacement property in State A." This change is necessary to improve the grammatical structure and flow of the sentence, making the language clearer and more natural within the context of the example. The parenthetical "($250-$50)" is added to show the calculation. This addition is necessary to enhance clarity, transparency, and readability, and to avoid ambiguity regarding the basis of the calculation used to arrive at the federal recognized gain.

Finally, the sentence, "The California recognized gain is $100, which is the lesser of the $100 California source deferred gain and the $200 gain recognized for federal income tax purposes" is revised to "Pursuant to subsection (c)(1)(A), the gain from sources within this State is $100, which is the lesser of the $100 deferred gain and the $200 gain recognized for federal income tax purposes."

Adding "Pursuant to subsection (c)(1)(A)" provides a direct legal reference for the calculation, necessary to add authority to the example and improving clarity for affected taxpayers who might otherwise be unable to determine the authority for the example's outcome.

The change from "The California recognized" and "California source" to "from sources within this State" is necessary to maintain consistent terminology and eliminate potential ambiguity regarding sourcing methodology.

Subsection (f)(2) – Single Exchange – Replacement Property Located in this State.

The deletion of the prior subsection (f) necessitates the re-lettering of the prior subsection (g)(2) to subsection (f)(2).

First, the sentences, "Taxpayer purchases property in State A for $50 and sells the property for $120, deferring gain of $70 ($120-$50), under Internal Revenue Code section 1031. Taxpayer exchanges into replacement property located in California. The California replacement property costs $120," are revised to "Taxpayer purchases property located in State A for $50. Taxpayer exchanges property located in State A for replacement property in this State with a fair market value of $120, not recognizing gain of $70 ($120-$50) under section 1031 of the Internal Revenue Code."

Additionally, the phrase "sells the property for $120, deferring gain of $70 ($120-$50), under Internal Revenue Code section 1031" is replaced with "exchanges property in State A for replacement property in this State with a fair market value of $120, not recognizing gain of $70 ($120-$50) under section 1031 of the Internal Revenue Code."

The original sentence is therefore split into two distinct new sentences. This change is necessary to improve clarity and avoid combining two separate actions, the purchase of the relinquished property and the subsequent exchange transaction, into a single, potentially confusing statement. Separating these actions into two sentences allows for a clearer presentation and is necessary to improve readability and clarity.

The phrase "and sells" is replaced with "Taxpayer exchanges." This change is necessary to accurately reflect the nature of the transaction as a like-kind exchange under section 1031 of the IRC, rather than a taxable sale. The term "sells" is inconsistent with the legal terminology for a like-kind exchange, which involves an exchange of property and the non-recognition of gain. Using "exchanges" improves clarity and eliminates ambiguity regarding the type of transaction being described.

The term "for" is replaced with "in State A for replacement property in this State with a fair market value of." This change is necessary to specify the location of the relinquished and replacement properties, and to indicate the fair market value of the replacement property. This provides essential context for the example and helps to illustrate the mechanics of a like-kind exchange involving properties in different states. The specification of the fair market value of the replacement property is crucial for the subsequent calculation of deferred gain.

The term "deferring" is replaced with "not recognizing". This change is necessary to improve clarity and to use the legally more precise term to describe the immediate effect of a section 1031 exchange. Section 1031 of the IRC explicitly states that "No gain or loss shall be recognized..." and does not use the term "deferring." The phrase "not recognizing gains" is a more accurate term to describe the immediate effect of a section 1031 exchange. Since this regulation does not explicitly define the term "deferring," the phrase "not recognizing" is used to mirror the language of section 1031 of the IRC.

The phrase "Internal Revenue Code section 1031" is replaced with "section 1031 of the Internal Revenue Code." This change is necessary to implement consistent terminology throughout this regulation and align with the preferred citation style for federal tax code sections.

The sentences, "Taxpayer exchanges into replacement property located in California. The California replacement property costs $120," are deleted. These two sentences are deleted because the information in these two sentences is already incorporated in the revised language of this example. The deletion is necessary to therefore reduce the potential for confusion and for clarity.

Next, the sentence, "Taxpayer sells the California replacement property for $150 in a transaction in which gain of $100 is recognized for federal income tax purposes," is revised to "Taxpayer sells the replacement property located in this State for $150 in a transaction in which gain of $100 ($150-$50) is recognized for federal income tax purposes."

The phrase "California replacement property" is replaced with "replacement property located in this State." This change is necessary to maintain consistency with the jurisdictional terminology used throughout the example and elsewhere in the regulation, which avoids the potential for confusion.

The parenthetical "($150-$50)" is added after "$100." Adding the parenthetical calculation "($150-$50)" clarifies how the $100 gain is computed, improving the clarity and removing any potential ambiguity.

Finally, the sentences, "The California source gain is $30 ($150-$120). The California recognized gain is $30, which is the lesser of the $30 California source gain and the $100 gain for federal income tax purposes" are revised to "Pursuant to subsection (c)(2)(B), the gain from sources within this State is $30, which is the lesser of the $30 gain calculated pursuant to subsection (c)(2)(A) ($150-$120) and the $100 gain for federal income tax purposes."

Adding "Pursuant to subsection (c)(2)(B)" is necessary to improve clarity, because the original text lacked direct reference to the specific subsection of the regulation that dictates the calculation method for California recognized gain. This addition is necessary to improve clarity and to prevent ambiguity and ensures the example has a direct, authoritative link to the regulation text.

The phrase "The California source gain" is changed to "gain from sources within this State." This change is necessary to maintain consistent terminology with California's sourcing rules and eliminate potential ambiguity regarding sourcing methodology.

The phrase "($150-$120). The California recognized gain is $30, which is" is changed to "calculated pursuant to subsection (c)(2)(A) ($150-$120)." This revision now adds references subsection (c)(2)(A) and clarifies how the $30 gain is derived. This change is necessary to improve clarity by specifically referencing subsection (c)(2)(A), which ensures consistency in the application of calculation methods and avoids the potential for misinterpretation of how the $30 gain amount was derived.

Subsection (f)(3) – Series of Exchanges.

The deletion of the prior subsection (f) necessitates the re-lettering of the prior subsection (g)(3) to subsection (f)(3).

The prior language for subsection (f)(3) reads:

> (3) Series of Exchanges. Taxpayer purchases California property for $50. Taxpayer sells the California property for $150, deferring gain of $100 ($150-$50), under Internal

Revenue Code section 1031. Taxpayer exchanges into replacement property located in State A. The replacement property in State A costs $150. Taxpayer sells the replacement property in State A for $300, deferring the State A source gain of $150 ($300-$150) and continuing to defer the $100 of California gain, under Internal Revenue Code section 1031. Taxpayer exchanges into replacement property located in State B. The replacement property in State B costs $300. Taxpayer sells the replacement property in State B for $170 in a transaction in which gain of $120 is recognized for federal income tax purposes.

The proration rule in subsection (d)(4) applies since the total of the California deferred gain and California gain ($100) plus the deferred gain and gain in other states ($150) exceeds the gain recognized for federal income tax purposes ($120). The gain to be recognized for California income tax purposes is $48, which is the gain recognized for federal income tax purposes ($120) multiplied by the ratio of California deferred gain and California gain ($100) over the deferred gain and gain in all states ($250). The loss in State B is not considered.

Subsection (f)(3) is revised to read:

Series of Exchanges. Taxpayer purchases property located in this State for $50. Taxpayer exchanges property located in this State for replacement property in State A with a fair market value of $150, not recognizing gain of $100 ($150-$50) under section 1031 of the Internal Revenue Code. Taxpayer exchanges property located in State A for replacement property located in State B with a fair market value of $300, not recognizing gain of $150 ($300-$150) and continuing to not recognize the gain of $100 under section 1031 of the Internal Revenue Code. Taxpayer sells the replacement property located in State B for $170 in a transaction in which gain of $120 ($170-$50) is recognized for federal income tax purposes.

Pursuant to subsection (d)(1)(A), the gain on the sale of property located in this State is $100 ($150-$50). Pursuant to subsection (d)(1)(B), the gain on the sale of property located in State A is $150 ($300-$150), and the loss on the sale of property located in State B is $130 ($170-$300).

> Pursuant to subsection (d)(2)(A), there is gain recognized for federal income tax purposes ($120) and a net amount of gain on the property located in this State ($100). The gain recognized for federal income tax purposes ($120) is less than the sum of all the gains regardless of location ($250 [$100+$150]) calculated under subsection (d)(1). Therefore, the gain from sources within this State is determined under subsection (d)(2)(A)(ii). The amount of gain from sources within this State is $48, which is determined by multiplying the federal gain ($120) by the ratio of the gain on the property located in this State ($100) over the sum of all gains regardless of location ($250).

In subsection (f)(3), the prior language has been entirely replaced with revised language. Previously, the example was in a narrative format and lacked specific references to the regulatory basis for its calculations. This created ambiguity regarding how the example applied the rules, particularly the proration rule for recognizing gain, which increased the potential for misinterpretation and inconsistent application of the regulation.

The revised language addresses these issues by adopting a new structure, now clearly separating the description of the factual transactions from the detailed application of the revised regulatory provisions. The revised language links each step of the analysis and each calculation to the specific subsections of the revised regulation that govern them, including subsections (d)(1)(B), and (d)(2)(A). These changes are necessary to improve clarity and accuracy, and to ensure the example illustrates the updated methodology for calculating and sourcing gain or loss within a series of like-kind exchanges. Specifically, clearly illustrating the updated methodology and linking it directly to the governing provisions, the revision is necessary to avoid inconsistent application and eliminate the potential for confusion.

Additionally, the revision adopted more precise terminology, such as "exchanges property" instead of "sells the property," and "not recognizing gain" instead of "deferring gain," consistent with the terminology used in other revised subsections in this regulation. These changes are necessary to prevent legal ambiguity regarding the nature of the transaction being described and eliminate the potential for conflict or misunderstanding between the regulatory language and the IRC by maintaining consistency with the terminology used under IRC section 1031.

Subsection (f)(4) – Series of Exchanges – Not Solely Like-Kind.

The deletion of the former subsection (f) necessitates the re-lettering of the prior subsection (g)(4) to subsection (f)(4). The entire subsection (f)(4) is replaced. The substantive rules in subsection (f)(4) remain the same.

The prior language for subsection (f)(4) reads:

> (4) Series of Exchanges – Not solely Like-Kind. Taxpayer purchases California property for $50. Taxpayer sells the California property for $150, deferring gain of $100 ($150-$50), under Internal Revenue Code section 1031. Taxpayer exchanges into replacement property located in State A. The replacement property in State A costs $150. Taxpayer sells the replacement property in State A for $300, deferring the State A source gain of $150 ($300-$150) and continuing to defer the $100 of California gain, under Internal Revenue Code section 1031. Taxpayer exchanges into replacement property located in State B. The replacement property in State B costs $275 and Taxpayer takes out $25 cash. Taxpayer sells the replacement property in State B for $250 in a transaction in which gain of $200 is recognized for federal income tax purposes. The receipt of $25 is recognized immediately upon the exchange of the State A property under Internal Revenue Code 1031. The proration rule in subsection (d)(4) applies since the total of the California deferred gain and California gain ($100) plus the deferred gain and gain in other states already part of the exchange ($150) exceeds the gain recognized for federal income tax purposes ($25). The gain to be recognized for California income tax purposes is $10, which is the gain recognized for federal income tax purposes ($25) multiplied by the ratio of California deferred gain and California gain ($100) over the deferred gain and gain in all states thus far in the exchange ($250). The future exchange or sale in State B is not considered. Under the recognition treatment rule in subsection (d)(5), the $25 recognized is no longer considered deferred gain or deferred loss for purposes of this subsection.

Subsection (f)(4) is revised to read:

> (4) Series of Exchanges – Not Solely Like-Kind. Taxpayer purchases property located in this State for $50. Taxpayer exchanges property located in this State for replacement property located in State A with a fair market value of $150, not recognizing gain of $100 ($150-$50) under section 1031 of the Internal Revenue Code. Taxpayer exchanges property

located in State A for replacement property located in State B with a fair market value of $275 and receives $25 cash, not recognizing gain of $125 ($275-$150) and continuing to not recognize the gain of $100 under section 1031 of the Internal Revenue Code. The receipt of $25 cash is recognized immediately for federal income tax purposes upon the exchange of property in State A under section 1031(b) of the Internal Revenue Code.

Pursuant to subsection (d)(1)(A), the gain on the sale of property located in this State is $100 ($150-$50). Pursuant to subsection (d)(1)(B), the gain on the sale of property located in State A is $150 ($300-$150).

Pursuant to subsection (d)(2)(A) there is a gain recognized for federal income tax purposes ($25) and a net amount of gain on the property located in this State ($100). The gain recognized for federal income tax purposes ($25) is less than the sum of all the gains regardless of location ($250 [$100+$150]) under subsection (d)(1). Therefore, the gain from sources within this State is determined under subsection (d)(2)(A)(ii). The amount of gain from sources within this State is $10, which is determined by multiplying the federal gain ($25) by the ratio of the gain on the property located in this State ($100) over the sum of all gains regardless of location ($250).Pursuant to subsection (d)(3), the $10 of gain recognized in this State is no longer considered gain or loss under subsection (d). The gain on the property within this State is now $90 ($100-$10).

In subsection (f)(4), the prior language has been entirely replaced with revised language. This change is necessary to accurately reflect the revisions made to this regulation in subsection (d), particularly concerning exchanges involving not like-kind property. The prior version of the example was in a narrative format and lacked specific references to the regulatory basis for its calculations. This created ambiguity regarding how the example applied the rules, particularly the proration rule for recognizing gain.

The revised language addresses these issues by adopting a formal structure. The explanation is now segmented, separating the description of the factual transactions from the application of the revised regulatory provisions, including the recognition of not like-kind property under section 1031(b) of the IRC. The revised language links each step of the analysis and each calculation to the specific subsections of the revised regulation that govern them under subsection (d)(1)(A), (d)(1)(B), (d)(2)(A), and (d)(3). These changes are necessary to improve clarity and accuracy, and avoids the potential for confusion by ensuring the example accurately reflects the updated methodology for calculating and sourcing gain, particularly when not like-kind property is received.

Additionally, the revision adopted more precise terminology, such as "exchanges property" instead of "sells the property," and "not recognizing gain" instead of "deferring gain," consistent with the terminology used in other revised subsections in this regulation. These changes are necessary to improve clarity and maintain consistency with the terminology used under IRC section 1031, which eliminates the potential for conflict or misunderstanding between the regulatory language and the IRC.

Subsection (f)(5) – Multiple Replacement Properties.

The deletion of the prior subsection (f) necessitates the re-lettering of the prior subsection (g)(5) to subsection (f)(5). The entire subsection (f)(5) is replaced. The substantive rules in subsection (f)(5) remain the same.

The prior language for subsection (f)(5) reads:

> (5) Multiple Replacement Properties. Taxpayer purchases California property for $210. Taxpayer sells the property for $300, deferring gain of $90 ($300-$210), under Internal Revenue Code section 1031. Taxpayer exchanges into replacement property X located in State A and replacement property Y located in State B. The fair market value of replacement property X and replacement property Y is $200 each. In the exchange transaction, $200 from the relinquished property is used to exchange for replacement property X, and $100 from the relinquished property plus $100 of additional cash is used to exchange for replacement property Y. The California source deferred gain is allocated $60 to replacement property X ($90 x ($200/$300)) and $30 to replacement property Y ($90 x ($100/$300)).

Subsection (f)(5) is revised to read:

> (5) Multiple Replacement Properties. Taxpayer purchases property located in this State for $210. Taxpayer exchanges property located in this State and $100 cash for replacement properties in State X and State Y with a fair market value of $200 each, not recognizing gain of $90 ([$400-$100]-$210) under section 1031 of the Internal Revenue Code. Repla]cement property located in State X is acquired using $200 from the relinquished property. Replacement property located in State Y is acquired using the remaining $100 from the relinquished property and $100 of cash.

> Replacement property located in State Y was acquired using $100 cash. Therefore, under subsection (e), its fair market value ($200) is reduced by the not like-kind property (cash of $100) when dividing the deferred gain from the relinquished property located in this State among the multiple replacement properties. The deferred gain from property located in this State is divided $60 to replacement property located in State X ($90 x ($200/$300)) and $30 to replacement property located in State Y ($90 x ($200-$100]/$300)).

In subsection (f)(5), the prior language has been entirely replaced with revised language. This change is necessary to accurately reflect the revisions made to this regulation under subsection (e), particularly concerning exchanges involving multiple replacement properties and the presence of not like-kind property.

Previously, the example's description of the transaction and the allocation method lacked clarity, particularly regarding how the presence of additional not like-kind property (such as cash or other non-qualifying assets) paid by the taxpayer impacted the division of deferred gain. The explanation now explicitly details the initial acquisition and the exchange transaction, including the addition of cash ("and $100 of cash") by the taxpayer. It then links the division of deferred gain or loss (as defined in (c)(1)) and any recognized gain or loss (as calculated in (d)(1)) to subsection (e) of the regulation, which provides the framework for exchanges involving multiple replacement properties and the specific treatment of not like-kind property. The revised text explicitly states how the fair market value of a replacement property is adjusted when not like-kind property (including but not limited to cash) is used in the acquisition. These changes are necessary to improve clarity, precision, and avoids the potential for confusion by ensuring the example accurately reflects the methodology for dividing the deferred gain when multiple replacement properties are involved and additional not like-kind property is provided by the taxpayer.

Additionally, the revision adopted more precise terminology, such as "exchanges property" instead of "sells the property," and "not recognizing gain" instead of "deferring gain," consistent with the terminology used in other revised subsections in this regulation. These changes are necessary to improve clarity and maintain consistency with the terminology used under IRC section 1031, which eliminates the potential for conflict or misunderstanding between the regulatory language and the IRC.

Subsection (f)(6) – No Gain or Loss from Sources within this State.

The deletion of prior subsection (f) necessitates the re-lettering of the prior subsection (g)(6) to subsection (f)(6). The entire subsection (f)(6) is replaced. The substantive rule regarding the scenario that results in no California gain or loss remains the same, but the explanation and its regulatory basis have been updated.

The title of the example is revised from "No Gain or Loss for California Income Tax Purposes" to "No Gain or Loss from Sources within this State."

The original title was specific to "California Income Tax Purposes." The revised title uses the more formal and general jurisdictional phrase "from Sources within this State" which aligns with the language typically used in California tax regulations to define income subject to its jurisdiction. This revision is necessary to improve consistency with respect to the terminology used within the text of the example itself and the overall regulatory framework.

The prior language for subsection (f)(6) reads:

> (6) No Gain or Loss for California Income Tax Purposes. Taxpayer purchases California property for $250. Taxpayer sells the California property for $320, deferring gain of $70 ($320-$250), under Internal Revenue Code section 1031. Taxpayer exchanges into replacement property located in State A. The State A replacement property costs $320. Taxpayer sells the State A replacement property for $200 in a transaction in which a loss of $50 is recognized for federal income tax purposes. The California recognized gain/loss is $0 because there is a gain for California purposes and a loss for federal income tax purposes.

Subsection (f)(6) is revised to read:

> (6) No Gain or Loss from Sources within this State. Taxpayer purchases property located in this State for $250. Taxpayer exchanges property located in this State for replacement property located in State A with a fair market value of $320, not recognizing gain of $70 ($320-$250) under section 1031 of the Internal Revenue Code. Taxpayer sells property located in State A for $200 in a transaction in which a loss of $50 ($200-$250) is recognized for federal income tax purposes. Pursuant to subsection (c)(1)(C), there is no gain or loss from sources within this State because there is a loss recognized for federal income tax purposes and a deferred gain under subsection (c)(1)(A).

In subsection (f)(6), the prior language has been entirely replaced with revised language. This change is necessary to accurately reflect the revisions made to this regulation under subsections (c)(1)(C), (c)(2)(B)(iii), and (d)(2)(C), which replaced the prior subsection (f) and provide rules addressing scenarios resulting in no gain or loss from sources within this State, and ensures the example remains current with the revisions in other parts of this draft regulation.

Previously, this example's title and explanation for the "no gain or loss" scenario were informal, and the sourcing mechanism for arriving at "zero" was described narratively ("because there is a gain for California purposes and a loss for federal income tax purposes"), lacking a reference to the specific regulatory provision that dictated this outcome.

The explanation now links the outcome to the specific regulatory provision: "Pursuant to subsection (c)(1)(C), there is no gain or loss from sources within this State because there is a loss recognized for federal income tax purposes and a deferred gain under subsection (c)(1)(A)." This change is necessary to provide clear guidance and accurately reflect the revised framework where the conditions leading to no California gain or loss are explicitly defined within subsection (c)(1)(C). This revision is necessary to ensure that the example precisely illustrates the regulation's application and enhances clarity by referencing to the applicable rule, thereby avoiding subjective interpretation or the misapplication of the rules.

Additionally, the revision adopted more precise terminology, such as "exchanges property" instead of "sells the property," and "not recognizing gain" instead of "deferring gain," consistent with the terminology used in other revised subsections in this regulation. These changes are necessary to improve clarity and maintain consistency with the terminology used under IRC section 1031, which eliminates the potential for conflict or misunderstanding between the regulatory language and the IRC.