



STATE OF CALIFORNIA
FRANCHISE TAX BOARD
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KATHLEEN CONNELL
Chair

DEAN ANDAL
Member

B. TIMOTHY GAGE
Member

July 17, 2000

Chief Counsel Ruling
99-0571

Re: *****

Dear *****,

In your correspondence dated *****, you requested advice concerning the following transaction. *****, who was a resident of Oregon, exchanged real property in Oregon for property in California. At the time of the exchange, he was an Oregon resident. Subsequently, during the same taxable year, the taxpayer became a resident of California. The exchange met the requirements of Internal Revenue Code section 1031, and the taxpayer deferred a gain of ***** for federal purposes. For Oregon purposes, he was required to recognize the gain because the replacement property was located outside Oregon and he terminated Oregon residency.

You asked how the transaction should be reported for California purposes. You presented the following three alternatives for consideration:

1. Follow the federal treatment and defer the gain. This alternative would result in a low depreciable basis for California purposes. You observe, however, that this alternative results in the taxpayer ultimately paying tax to Oregon and to California on the gain from the Oregon property and opine that no tax credit would be available for the year of the exchange because the year would surely be closed to the statute of limitations by the time the California property is sold.
2. Report the gain on the California return and claim a credit for tax paid in Oregon for the year of the exchange. This alternative would result in a higher depreciable basis for California purposes. You question whether this alternative is available considering there may be no possibility of electing out of Internal Revenue Code section 1031 for California purposes.
3. Exclude the gain because the taxpayer was not a resident of California when the exchange occurred nor was the exchanged property located in California. This alternative would result in a higher depreciable basis for California purposes.

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We conclude that the proper treatment of the transaction is to defer the gain for California purposes pursuant to California's conformity to the basis provisions of Internal Revenue Code section 1031. We also conclude that a California tax credit is available in the year the California property is sold for taxes paid to Oregon on the gain from the Oregon property unless Oregon allows a credit.

Revenue and Taxation Code section 18031 conforms to Internal Revenue Code section 1031, which states, in pertinent part:

(d) Basis

If property was acquired on an exchange described in this section, section 1035(a), section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange.

You stated that the transaction met the requirements of Internal Revenue Code section 1031 and that the gain from the Oregon property was deferred for federal purposes. Because California conforms to the federal rule and makes no exception for property acquired by the exchange of out-of-state property, the basis of the California replacement property will not be increased by the gain not recognized under California law.

Revenue and Taxation Code section 18001 provides that California residents shall be allowed a credit for taxes paid to another state on income derived from sources within the other state if the other state does not allow the credit. There is no statutory requirement that the income be taxed by each state during the same taxable year. Revenue and Taxation Code section 18001 only requires that the income taxed by the other state be "taxable under this part."

In this case, the basis rules of Internal Revenue Code section 1031(d) operate to defer the realized gain on the exchanged property until the replacement property is disposed of in a recognized taxable event. When this occurs, the ultimate amount of income that becomes "taxable under this part" consists of two elements, a gain or loss from the replacement property and the deferred gain from the exchanged property. Since Oregon tax was paid on the deferred gain, the income qualifies under the statute.

The source of the deferred gain is the location of the exchanged property. (Cal. Code of Regs., tit. 18, §17951-3.)

Because the governing statute does not require taxes be imposed by two states *in the same year* before the credit is available and the deferred gain has a source in Oregon,

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we conclude that a California tax credit is available in the year the California property is sold unless Oregon allows a credit.

We specifically reject your second alternative. Because you state that the requirements of Internal Revenue Code section 1031 have been satisfied, the taxpayer may not elect to report the Oregon gain for California purposes and receive a stepped-up basis in the replacement property.

The only conceivable statutory basis for excluding the Oregon portion of the gain when the California property is later disposed of is Revenue and Taxation Code section 17554. That section generally provides that income which is recognized after the taxpayer becomes a resident is not taxable if the income accrued when the taxpayer was a nonresident. A recent California appellate court interpreted Revenue and Taxation Code section 17554 to apply only when the code does not prescribe a particular method for reporting the type of income in question. (*Daks v. FTB*, Cal. Tax Rptr. Para 403-036 (June 24, 1999).) Internal Revenue Code section 1031 prescribes a particular method of accounting for like kind exchanges. Accordingly, Revenue and Taxation Code section 17554 does not apply to transactions governed by Internal Revenue Code section 1031.

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes should they occur. This letter is a legal ruling by the Franchise Tax Board Chief Counsel within the meaning of Revenue and Taxation Code section 21012(a)(1). Please attach a copy of this letter and your request to the back of the appropriate return(s) (if any) when filed or any notices or inquiries which might be issued.

Sincerely,

Richard Gould
Tax Counsel