STATE OF CALIFORNIA
Franchise Tax Board

Analysis of Amended Bill

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Subject: Withholding on Outbound Like-Kind Exchanges and Reporting Requirements

Summary

This bill would create an income tax withholding requirement for like-kind exchanges of real property when California property is exchanged for property located outside of California.

Recommendation – No position.

Summary of Amendments

The March 19, 2018, amendments removed all of the bill's provisions, relating to property taxation of certain grapevines and replaced them with the provisions discussed in this analysis.

This is the department's first analysis of the bill.

Reason for the Bill

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

Effective/Operative Date

If enacted in the 2018 legislative session, this bill would be effective January 1, 2019, and specifically operative for like-kind exchanges of specified California real estate exchanged for replacement real property located out-of-state that occur on or after January 1, 2019.

Federal/State Law

Like-Kind Exchanges

In General

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

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

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

Basis of Property Received

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

Character of Qualifying Property

To be qualifying property eligible for nonrecognition of gain or loss in a like-kind exchange, both the property transferred and the replacement property must be held for investment or for productive use in a trade or business.

Federal Qualifying Property

The Tax Cuts and Jobs Act (Act),[3] modified federal law providing for nonrecognition of gain in the case of like-kind exchanges by limiting its application to real property that is not held primarily for sale.[4] In addition, the new special rule applies to foreign real property such that

[1] The federal rules for like-kind exchanges are under Internal Revenue Code (IRC) section 1031, to which California generally conforms under Revenue & Taxation Code (R&TC) sections 18031 and 24941.
[2] Exchange expenses are generally the closing costs paid on the exchange. They include such items as brokerage commissions, attorney fees, and deed preparation fees.
[3] Public Law 115-97, enacted December 22, 2017, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018.
[4] It is intended that real property eligible for like-kind exchange treatment under present law will continue to be eligible for like-kind exchange treatment under the provision. For example, a like-kind exchange of real property includes an exchange of shares in a mutual ditch, reservoir, or irrigation company described in IRC section 501(c)(12)(A) if at the time of the exchange such shares have been recognized by the highest court or statute of the State in which the company is organized as constituting or representing real property or an interest in real property. Similarly, improved real estate and unimproved real estate are generally considered to be property of a like kind. See Treasury Regulation section 1.1031(a)-1(b).

real property within the United States and real property outside of the United States are not property of a like kind. The Act generally applies to like-kind exchanges completed after December 31, 2017. However, an exception is provided for any exchange if the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017, or the property received by the taxpayer in the exchange is received on or before such date.

California Qualifying Property

California conforms to federal law prior to the changes made by the Act, under which land, buildings, machinery, automobiles, and rental houses are examples of property that would generally be qualifying property in a like-kind exchange. Certain types of property are specifically not qualifying property for purposes of a like-kind exchange, including inventory, stocks, bonds, notes, other securities or evidence of indebtedness or interest, interests in a partnership, certificates of trusts or beneficial interest, or choses in action.[5]

Like-Kind Property

To be eligible for nonrecognition of gain or loss, the qualifying property exchanged must be like-kind property. Like-kind properties are properties of the same nature or character, even if they differ in grade or quality. Special rules apply to exchanges of multiple properties and to exchanges of property between related persons.

Identification Requirement

In any exchange where the properties are not exchanged simultaneously, taxpayers must identify the replacement property within 45 days after the date of the transfer of the property given up in the exchange. This period is called the identification period. Any property received during the identification period is considered to have been identified.

Receipt of Replacement Property

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

Qualified Intermediary

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

[5] IRC section 1031(a)(2).

Federal Reporting Requirements

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

California Reporting Requirements

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

Under the general conformity provisions, California law conforms to federal law in effect as of January 1, 2015, with respect to like-kind exchanges, thus taxpayers are allowed to exchange California property for out-of-state property, as long as the exchange meets the federal like-kind exchange requirements. A gain or loss from the exchange of real or tangible personal property located in California is sourced to California at the time the gain or loss is realized, regardless of whether or not the taxpayer that realized the gain is residing in or doing business in California at the time that the gain is recognized.

Under current state law, taxpayers that claim nonrecognition of gain or loss for a like-kind exchange of California property for property located outside of the state are required to file an information return[6] in the taxable year of the exchange and in each subsequent taxable year in which the gain or loss attributable to the exchange remains unrecognized.[7]

For taxpayers that fail to comply with that reporting requirement and fail to file a return to properly report the recognition of the gain or loss attributable to the exchange, the Franchise Tax Board (FTB) may make an estimate of the net income from the exchange using any available information, including the amount of deferred gain or loss reported in the year of the exchange, and may propose to assess the amount of tax, interest, and penalties due in the same manner as assessments that are proposed for the failure to file a return.[8]

<u>California Real Estate Withholding</u>

California requires, with some limited exceptions, the buyer of California real property to calculate withholding using one of the following two methods:

1. Withhold 3⅓ percent of the total sales price, as defined[9], when the buyer is purchasing California real property, or

[6] FTB Form 3840, California Like-Kind Exchanges.
[7] R&TC section 18032(a).
[8] R&TC section 18032(b).
[9] R&TC section 18662(e)(8).

2. Use the Alternative Withholding Calculation Method, also known as the Optional Gain on Sale Election Method, by multiplying the estimated gain by the seller's or transferor's maximum tax rate.

Real estate withholding applies to the following sellers:

- An individual or a trust, or
- A corporation or partnership that has no permanent place of business in California immediately after the sale of the real property.

The exceptions to withholding apply if any of the following conditions are met:

1. The total sales price of the California real property is $100,000 or less.
2. The buyer did not receive written notification of the withholding requirements.[10]
3. A trustee or a beneficiary under a deed of trust is acquiring the property in foreclosure.
4. The seller certifies under penalty of perjury that:

- The property conveyed was the seller's principal residence,
- The property is being exchanged under the like-kind exchange provisions of IRC Section 1031,
- The property was involuntarily converted or sold as defined under IRC Section 1033, or
- The sale results in a loss to the seller.

Withholding is required on each installment sale payment if the sale is structured as an installment sale.

Like-Kind Exchange Withholding

A California withholding exemption is available for a simultaneous or deferred like-kind exchange under IRC Section 1031.

If money or other property (in addition to property that is a part of the like-kind exchange) is received which exceeds $1,500 from the transaction, withholding is generally required. If the exchange does not take place or if the exchange does not qualify for nonrecognition treatment, 3⅓ percent of the sales price is subject to withholding unless the seller elects to use the Alternative Withholding Calculation Method.

[10] In which case, the real estate escrow person (REEP) is responsible for a failure to notify penalty. A REEP is defined as the person (including but not limited to an attorney, escrow company, or intermediary) responsible for closing the transaction or is the person in control of payment. California law requires the REEP to inform the buyer of the withholding requirements.

This Bill

This bill would expand the existing income tax withholding requirement of 3⅓ percent of the sales price, to apply to California real property sales occurring on or after January 1, 2019, where no gain or loss from the sale of the property is recognized under the like-kind exchange provisions[11] for a taxable year, and the property acquired is located outside of California. This withholding would be allowed as a credit against tax in the taxable year in which gain or loss from the exchange is recognized.

Failure to withhold as specified, would be a misdemeanor crime, which upon conviction, would result in a fine not to exceed $1,000 or imprisonment for not more than one year, or both, at the discretion of the court.

This bill would also make a number of technical changes to retain accurate cross-referencing within the R&TC.

The bill states that it is the intent of the Legislature to require tax withholding for properties in which the gain or loss from the property exchange was not recognized for income tax purposes because of IRC section 1031 in order to address the avoidance of income taxes otherwise due and payable to the state when the gain or loss from the property is ultimately recognized.

Implementation Considerations

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

Implementing this bill would require the department to track withholding until California source gain on the original exchange is recognized, if ever, and with no certainty that a state tax liability would be triggered upon recognition. This would require reprogramming to allow the accounting systems to hold payments for application to a future taxable year and to prevent the withheld amount from being inadvertently refunded prior to the taxable year that the deferred California source gain is recognized.

In order to track like-kind exchanges of California property for out-of-state property to correctly match the withholding on an exchange to the transaction that triggers the recognition of a California source gain or loss the department would need to retain documentation beyond existing retention timeframes generating the need for additional storage capacity.

[11] R&TC section 18031 generally conforms to IRC section 1031.

To clearly preserve the existing exemption from withholding for like-kind exchanges of California property within the state, it is recommended that clause (iv) located on page 7, lines 9-11, be amended to specify when the clause will cease to apply to like-kind exchanges of California property for out-of-state property.

Amounts withheld on behalf of a taxpayer subject to the Personal Income Tax Law would be prohibited as a deduction in computing taxable income. The bill lacks a similar prohibition for taxpayers subject to the Corporation Tax Law. If this is contrary to the author's intent this bill should be amended.

This bill would exclude from the existing withholding exemptions all like-kind exchanges of California real property for property located outside of the state. If this is contrary to the author's intent, this bill should be amended.

Legislative History

AB 92 (Assembly Committee on Budget, Chapter 26, Statutes of 2013) provided an annual information reporting requirement for taxpayers that claim nonrecognition of gain or loss for a like-kind exchange when property in California is exchanged for property located outside of California.

AB 3078 (Assembly Revenue and Taxation Committee, Chapter 305, Statutes of 2008), did the following: 1) Subjected non-California partnerships to withholding on California real property sales at a rate of 3⅓ percent of sales proceeds or 9.3 percent of gain, 2) Specified that for S corporations, the entity-level and pass-through withholding rates are combined to determine the alternative withholding rate to be applied to the gain on the sale, 3) Required the buyer to withhold on each installment sale payment if the sale is structured as an installment sale, 4) Clarified that withholding amounts can be collected from the withholding agent if the agent fails to withhold or fails to remit the withheld amounts to the FTB, and provided a clear method for assessment and collection of unremitted withholding.

AB 2962 (Benoit, Chapter 428, Statutes of 2006) allows a seller of California real estate to elect an alternative to the current withholding based on 3⅓ percent of the sales price. The seller is able to choose a withholding amount based on the maximum tax rate for individuals or corporations applicable to the gain on the sale.

Other States' Information

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws lack provisions imposing withholding on like-kind exchanges similar to the withholding this bill would require. The laws of these states were selected due to their similarities to California's economy, business entity types, and tax laws.

Fiscal Impact

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved. As the bill moves through the legislative process, costs will be identified.

Economic Impact

Revenue Estimate

This bill as amended on March 19, 2018, would not change the amount of state income or franchise tax liability due.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

This bill would have no impact on state income or franchise tax revenues. Administratively, there would be income tax withholding of 3⅓ percent on the sales price for out-of-state like-kind exchanges where the gain or loss is not recognized under the like-kind exchange provisions. This exchange would generate a withholding credit, that would be held for the taxpayer until the gain or loss is recognized. At that time, the taxpayer would file a tax return reporting the gain or loss on the sale of the property and the withholding credit would be applied. Because the taxpayer can defer the gain or loss indefinitely, the timing of when the withholding credits would be applied could vary widely.

Legal Impact

This bill would require withholding of tax based on a comparison of activities within California and activities outside the state. This bill could raise constitutional concerns under the Commerce Clause of the United States Constitution because it could appear to improperly favor in-state activity over out-of-state activity.

On August 28, 2012 (*Cutler* v*. Franchise Tax Board* (2012) 208 Cal.App.4th 1247), the Court of Appeal issued a unanimous opinion holding that California's Qualified Small Business Stock (QSBS) statutes were unconstitutional. Specifically, the Court of Appeal held that the QSBS statutes were found to unconstitutionally deny the taxpayer the benefit due to expansion of its activities outside of California.

Support/Opposition

Support: None provided.

Opposition: None provided.

Arguments

Proponents: Some may argue that this bill's like-kind exchange withholding provision would increase compliance in reporting California-source gain that is later recognized on property that was deferred in a like-kind exchange.

Opponents: Some may argue that this bill's like-kind exchange provision would impose an unnecessary and burdensome prepayment of tax at a time when the amount and timing of a tax liability is unknown.

Policy Concerns

Income tax withholding is generally required at the time that cash is received in a taxable transaction. This bill would impose withholding on unrecognized income before cash from the transaction (the like-kind exchange) is received.

Withholding payments required under this bill may never be claimed or claimed many years later due to the ability to defer gain in a like-kind exchange indefinitely, and such payments are not allowed the accrual of interest until after the gain is recognized. This could effectively remove the incentive to utilize the like-kind exchange gain deferral provisions for certain taxpayers.

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