Summary of First Interested Parties Meeting Proposed Regulation sections 17951-7 and 25137(e) Sourcing and Apportionment of Tax Deferred Exchanges

I. Administration:

On February 3, 2016 at approximately 9:00 a.m., interested members of the public ("participants") attended an Interested Parties Meeting ("IPM") at the Franchise Tax Board ("FTB") central office in Sacramento, California. Participants attended in person and by telephone. Those physically present were asked to register at the entrance and those on the telephone were asked to fax a business card to Jennifer Johnson for later correspondence. Phone participants introduced themselves. The session was audio recorded for reference, but participants were informed there would be no attribution of comments and no transcript would be made.

IPM Facilitators, Cheryl Akin, Ciro Immordino, and Bruce Langston, listed two documents made available as handouts: (1) the notice of the meeting; and (2) a like kind exchange scenario discussion handout. Participants were told they had until March 3, 2016 to submit written comments.

The purpose of the meeting was to provide participants with an opportunity to discuss and provide comments and input on potential new regulations under California Code of Regulations ("CCR"), title 18, sections 17951-7 and 25137(e), which would provide rules for: (1) the sourcing of deferred gains/losses from Internal Revenue Code ("IRC") section 1031 exchanges by non-resident taxpayers and (2) the apportionment of deferred gains/losses from IRC exchanges by apportioning taxpayers.

II. Summary of Discussion:

The discussion followed 13 different scenarios which were presented in the IPM notice and like kind exchange scenario discussion handout. The purpose of these scenarios is to highlight, for discussion purposes, different issues which can arise regarding the sourcing of California deferred gain/losses from IRC section 1031 exchanges in order to determine the proper treatment of such deferred gains/losses in a possible future regulation. The ordering of the comments in this summary is for ease of reference and thus, readers should not assign any importance to the ordering of comments. The summary includes participant comments received during the IPM and in writing by the close of the IPM comment period.

a. **Scenario 1 – Exchange out of California – Appreciation in Value (Handout pg. 2)**

This scenario involved a taxpayer ("TP") who purchased California property for $5 and thereafter sells the property for $10, deferring the gain by performing an IRC section 1031 exchange. TP exchanges into a property located in State A and later sells this property in a taxable transaction for $20.

There was a discussion nothing that the taxpayers in these scenarios are nonresidents of California. There was general agreement that if the taxpayer was a resident s/he would be taxed on all income or gain regardless of the source of that income or gain.
Multiple commentators agreed that the California gain should be the $5 of California appreciation and not the entire $15 gain on the sale of the State A property.

b. **Scenario 2 – Exchange out of California – Appreciation in Value followed by Depreciation in Value (Handout pg. 3)**

This scenario involved the same facts as in Scenario 1 except that the property located in State A is later sold in a taxable transaction for $8 (instead of $20).

A commentator noted that the primary difference between the first and the second scenarios is that in the first scenario, the California gain is still consistent with the federal gain and taxpayers are simply determining how much of that federal gain is California source, but that in the second scenario, the FTB is potentially arguing for a departure of California law from federal law as the California gain is inconsistent with or in excess of federal gain. The commentator also noted that the FTB may want to explore what the justification would be for finding California source gain of $5 and a State A loss of $2 when there is an overall federal gain on the ultimate sale of $3. This commentator further noted California's conformity to the federal law could potentially be used as statutory justification for limiting the California gain to the federal gain of $3.
Another commentator agreed that the federal gain should place a limit on the California source gain. The commentator noted there was $5 of California appreciation but only $3 federal gain and concluded the California source income should be limited to $3 federal gain.

c. **Scenario 3 – Exchange out of California – Appreciation in Value followed by Loss on Ultimate Sale (Handout pg. 4)**

This scenario involved the same facts as in Scenario 1 except the property located in State A is later sold in a taxable transaction for $4 (instead of $20).

A commentator noted that taxpayers would be very surprised if they had California source income when they ultimately sell the property at a loss for federal purposes and would not be expecting to report California income in such a situation.
There was a discussion regarding whether the $5 of California deferred gain in this scenario is a realized or unrealized gain. The facilitator clarified that the gain was realized when the taxpayer performed the exchange but simply was not recognized at that time and was

instead deferred for tax purposes. The facilitator further noted there are two realization events here: the initial exchange of the California property and the subsequent sale of the State A replacement property but only one recognition event, the sale of the State A replacement property.

There was further discussion regarding the appropriate treatment in this scenario where there is a deferred gain associated with the California property but an overall federal loss on the sale of the property. A commentator suggested that California losses should be limited to the federal loss and that California gain should similarly be limited to the federal gain. Multiple commentators felt that because there is California deferred gain or appreciation but a federal loss, the California source gain on the sale of the State A replacement property in this scenario should be $0.

d. Scenario 4 – Exchange into California – Appreciation in Value (Handout pg. 5)

In this scenario, TP purchased property in State A for $5 and sells the property for $10, deferring the gain by performing an IRC section 1031 exchange. TP exchanges into California property which is later sold in a taxable transaction for $20.

The issue of other state tax credits was raised; however, other state tax credits are outside the scope these regulations which will address sourcing and apportionment only.

Multiple commentators noted that the other state (State A) likely would want a portion of the federal gain to be allocated to their state and that California allocates some of the gain to California in the reverse situation where there is an exchange out of California. A commentator further indicated that it seems the FTB is approaching this by determining the overall final recognized net gain or loss and allocating that net gain or loss based on which property is contributing to the net gain or loss. The commentator noted that in order to be consistent with the prior scenarios, the California gain should be $10, not $15.

An additional commentator suggested that there are two possibilities here: if California is entitled to tax pre-California gain associated with the State A property, then the California source gain is $15. If California is not entitled to tax the pre-California gain, the taxpayer has California source gain of $10.

e. Scenario 5 – Exchange into California – Appreciation in Value followed by Depreciation in Value (Handout pg. 6)

This scenario involved the same facts as in Scenario 4 except that the property located in State A is later sold in a taxable transaction for $8 (instead of $20).

There was a discussion regarding the different possible methodologies that could be used here. First, the taxpayer could be allowed a California source loss of $2 even though there is a federal gain. Second, the taxpayer's California loss could be limited to the federal gain or loss resulting in $0 California source gain or loss in this scenario as there was a $2 loss associated with the California property but a $3 overall federal gain. Third, the $3 federal gain could be treated as California source gain as a California property was ultimately sold.

Commentators and the facilitator generally agreed that there needs to be a unified system that works in completeness. If the taxpayer in this scenario is allowed a California source loss when there is an overall federal gain, then a taxpayer in the converse situation will need to recognize California source gain where there is gain associated with the California property but an overall federal loss.

A commentator suggested that if California is entitled to tax pre-California gain, then California source gain is equal to the federal gain of $3 and if California is not entitled to tax pre-California gain, the California source gain or loss is $0 because there was a decline in value of the California property but an overall federal gain.

f. **Scenario 6 – Exchange into California – Appreciation in Value followed by Loss on Ultimate Sale (Handout pg. 7)**

This scenario involved the same facts as in Scenarios 4 except that the property located in State A is later sold in a taxable transaction for $4 (instead of $20).

A commentator felt the methodology where you lock in the California deferred gain or loss without reference to the federal recognized gain or loss violates California's conformity to IRC section 1031 and suggested the FTB should follow IRC section 1031.

Another commentator noted that all of the $1 federal loss should be California source loss as there was $3 decline in value associated with the California property which should be limited to the federal loss of $1.

g. **Scenario 7 – Multiple Exchanges – Insufficient Deferred Gain (Handout pg. 8)**

In this scenario, TP purchased California property for $5 and sells the property for $10, deferring the gain by performing an IRC section 1031 exchange. TP exchanges into State A property which is later sold for $15 and again defers the gain by performing a second IRC section 1031 exchange. TP exchanges into State B property which is later sold for $20 and again defers the gain by performing a third IRC section 1031 exchange. TP exchanges into State C property which is later sold for $8.

There was a discussion regarding whether it would be appropriate to prorate the $3 recognized gain among the three states that had appreciation associated with property located in those states. Under this method, you have $5 of California gain, but $15 of total appreciation ($5 from California, $5 from State A and $5 from State B). As a result, one third ($5/$15) of the $3 recognized gain would be sourced to California if a proration method were adopted. Some commentators agreed that proration would be appropriate here. Other commentators disagreed and did not think that proration was appropriate in this scenario and felt that because there was California appreciation of $5 but only $3 of federal gain, all of the $3 federal gain should be recognized as California source gain.

There was a discussion regard the difficulties and administrative concerns associated with using a proration method. The facilitator noted the FTB does not currently have information regarding previous or successive IRC section 1031 exchanges performed by taxpayers in other states. As such, if a proration method is adopted the FTB may need to require additional information from taxpayers the California Form 3840. The facilitator noted that there is simplicity in just comparing the California gain or loss to the federal gain or loss and not apportioning or prorating.

h. Scenario 7 – New Fact (Handout pg. 9)

This scenario involved the same facts as Scenario 7 but the State C property is sold for $15 instead of $8.

A commentator suggested that since the federal gain of $10 exceeds the $5 of California appreciation, the California source gain should be the $5 of appreciation associated with the California property.

i. Scenario 8 – Multiple Exchanges – Appreciation followed by Loss on Ultimate Sale (Handout pg. 10)

In this scenario, TP purchased California property for $5 and sells the property for $10, deferring the gain by performing an IRC section 1031 exchange. TP exchanges into State A property which is later sold for $15 and again defers the gain by performing a second IRC section 1031 exchange. TP exchanges into State B property which is later sold for $20 and again defers the gain by performing a third IRC section 1031 exchange. TP exchanges into State C property which is later sold for $4.

Multiple commentators indicated that the California source gain should be $0 because there is a federal loss of $1, but $5 of California appreciation.

j. Scenario 9 – Exchange into and back out of California – California Appreciation followed by Depreciation in Value (Handout pg. 11)

In this scenario, TP purchases property in State A for $5 and sells the property for $10, deferring the gain by performing an IRC section 1031 exchange. TP exchanges into California property which is later sold for $20 and again defers the gain by performing a second IRC section 1031 exchange. TP exchanges into property located in State B which is later sold in a taxable transaction for $10.

There was a discussion regarding whether under a proration method, the overall recognized gain would be prorated among the two states with realized gain or all three states. The facilitator clarified that since there is an overall gain in this scenario, the gain would be allocated between the two states with gain associated with the property in that state and no gain would be allocated to the state where there was a loss associated with the property in that state.

A commentator suggested that instead of the proration method, the entire $5 of recognized gain should be treated as California source gain, as there was $15 of California deferred gain if California can tax pre-California gain and $10 of California deferred gain if California cannot but an overall federal gain of $5.

k. **Scenario 9 – New Fact (Handout pg. 12)**

This scenario involved the same facts as Scenario 9 but the State B property is sold for $15 instead of $10.

A commentator noted that the California source gain should be $5 or $10 depending on treatment of the pre-California gain.

l. **Scenario 10 – Exchange into and back out of California – California Appreciation in Value followed by a Loss on Ultimate Sate (Handout pg. 13)**

In this scenario, TP purchased property in State A for $5 and sells the property for $10, deferring the gain by performing an IRC section 1031 exchange. TP exchanges into California property which is later sold for $20 and again defers the gain by performing a second IRC section 1031 exchange. TP exchanges into a property located in State B which is later sold in a taxable transaction for $4.

There was a discussion about whether the $4 loss should be prorated to all of the states. The facilitator clarified that as with the prior scenarios the loss should be prorated to all states where there was loss associated with holding the property in that state. Because all of the loss was associated with the State B property the entire $1 recognized loss should be allocated to State B. This would be consistent with the other situations where there was a recognized gain which was only prorated to states where there was gain associated with the property in that state.

A commentator suggested that because there is a $1 federal loss but California appreciation of $10, the California source gain or loss should be $0.

m. **Scenario 11 – Exchange into and back out of California – California Depreciation in Value but Gain on Ultimate Sale (Handout pg. 14)**

In this scenario, TP purchased property in State A for $5 and sells the property for $10, deferring the gain by performing an IRC section 1031 exchange. TP exchanges into California property which is later sold for $8 and again defers the gain by performing a second IRC section 1031 exchange. TP exchanges into a property located in State B which is later sold in a taxable transaction for $20.

There was a discussion about whether a taxpayer has to follow the IRC 1031 election for California in a situation such as this where there are multiple exchanges and an overall federal deferred gain but a California deferred loss. The facilitator clarified that IRC section 1031 is mandatory so a taxpayer cannot make an election for California purposes.

A commentator noted and a facilitator agreed that if proration is used in this scenario, none of the gain would be allocated to California as California had a loss associated with the California property. As a result, the ultimate gain would be prorated between the two states that had gains.

Another commentator noted that the California deferred gain is $3 (the $8 sales price on the California property minus the $5 original cost of the State A property) if California is not barred from taxing pre-California gain and $0 if such a bar exists. The commentator indicated that because no federal loss is recognized, no California source loss should be recognized.

n. **Scenario 12 – Exchange into and back out of California – California Depreciation in Value and Loss on Ultimate Sale (Handout pg. 15)**

This scenario involved the same facts as in Scenario 11 except that the property located in State B is later sold in a taxable transaction for $4 (instead of $20).

A commentator felt it would be preferable if California could draft regulations that are similar to the federal law so there would be no California/federal differences.

Another commentator suggested the California deferred gain should be $3 if California is entitled to tax pre-California gain or a $2 deferred loss if California is not entitled to tax pre-California gain. The commentator further indicated that since there is a federal loss of $1, taxpayer has no California source gain if California is entitled to tax the pre-California gain from the State A property and limited to the federal gain of $1 if California is not entitled to tax pre-California gain from the State A property.

o. **Scenario 13 – Apportioning Taxpayers – Is a regulation necessary to clarify which years' apportionment rules and percentages should be applied to deferred gains/losses from IRC section 1031 exchanges? (Handout pg. 16)**

Rather than presenting a fact pattern here, the facilitator asked if a regulation was necessary to clarify which years' apportionment rules and percentages should be applied to deferred gains/losses from IRC section 1031 exchanges: the apportionment rules and factors in the year the exchange is performed or the year the gain or loss is recognized.

There was consensus that a regulation would be helpful, but disagreement as to whether the apportionment factors and rules at the time the exchange was performed or at the time the gain or loss ultimately recognized should be used. One commentator noted that taxpayers already do something similar with Net Operating Losses ("NOLs") and apportioning corporations. The commentator indicated taxpayers have to apply the apportionment percentage in the year the NOL was acquired and that the NOL is then just carried forward and that this would be consistent using the apportionment rules and percentages in the year of the exchange. Other commentators provided the counterview stating that the year of apportionment should be the year the entity is recognizing the gain or loss, not the year of the original transaction. A commentator noted that unlike the earlier scenarios were the exchanges are performed over a relatively short period of time, in a multi-national corporation, some of these exchanges can go on for decades and figuring out what the apportionment factor was in the year the original transaction occurred is not realistic in such a situation. The commentator indicated practical considerations should be the driving force here and recommended that when a taxpayer first recognizes the sale for federal purposes, the taxpayer should recognize the event for California and use that current year's apportionment factor(s). The commentator expressed concern that taxpayers may not have the information necessary to use the historical factors at the time the exchanges were performed. The facilitator noted that there is concern because a taxpayer's California apportionment factor can change significantly over the years. The facilitator acknowledged that a series of IRC section 1031 exchanges can span a significant amount of time, but noted that the FTB has a model for the potential IRC section 1031 regulation in the current FTB treatment of installment sales. The facilitator noted that IRC section 1031 exchanges and installment sales are similar in that both are deferral mechanisms for income the taxpayer would otherwise be required to recognize. In both IRC section 1031 exchanges and installment sales, the taxpayer realized the income but defers reporting of that income or defers the tax on that income. The facilitator suggested that if the installment sale model is used as an alternative, each time there is an exchange you look to the apportionment percentage for that year and attribute the portion of the income or deferred gain from the exchange based on that percentage. The facilitator acknowledge there is an issue with the span of time involved in some series of corporate IRC section 1031 exchanges and noted that the FTB will have to consider this in the regulation.

There was discussion regarding large program exchanges where companies continuously exchange large quantities or fleets of assets with hundreds of thousands of exchanges every year. Multiple commentators indicated that it would be extremely difficult and time consuming to track those exchanges to the year that the gain is realized, especially in an environment where there are multiple ongoing property exchanges. Significant challenges identified by commentators include: (1) the sheer volume of the program and the fact that the deferred gains are rolled over year after year into different replacement properties, (2) multi-property exchange are performed and there can be billions of deferred gain layers, (3) gain may be partially recognized and partially deferred further complicating things, (4) California does not follow MACRS or business depreciation and California gain and federal gain is never the same, and (5) the fact that California located assets are frequently exchanged with other assets from different states, and (6) taxpayers could manipulate their apportionment factor if the sale proceeds are included in the apportionment factor only for recognized gains by programming their matching algorithms to defer the gain from sales in some states and recognize the gain from sales in other states. The commentators indicate that it would be incredibly burdensome to allocate the gain to different states due to the layers of exchanges prior to the sale. Commentators and the facilitator agreed that special rules may needed for large like kind exchange programs.

p. Other Issues (Handout page 17)

The facilitator asked if there were any additional comments or issues for discussion.

A commentator indicated that a state-by-state tracing approach would not be appropriate as: (1) it is discriminatory because it results in different answers if relinquished property and replacement property are both in California rather than separate states and (2) the approach departs from the conformity to federal by ignoring the separate transactions until there is a final divestiture of the business asset.

Another commentator suggested that the regulation should include general rules providing that: (1) the California source gain or loss should not result in recognized gain or loss to a nonresident that would exceed the amount recognized by a California resident, (2) the California source gain or loss should not exceed the federal gain or loss on the disposition of the replacement property, (3) when there is both prior California source gain and out-of-state gain, the recognized gain on the disposition of the replacement property should be allocated to California to the extent of the California source gain and the remainder, if any, should be allocated to the other state(s). The commentator further suggested that the 1031 exchange sourcing regulations should include rules that address: (1) exchanges of single properties for multiple properties, (2) exchanges for land and improvements, (3) the effect of capital expenditures, (4) preserving gain deferral for non-recognition transactions such as those under IRS sections 351, 368, 721, 731, etc., and (5) tax basis increases under IRC section 1014 caused by the death of the taxpayer and IRC section 754 related adjustments for partnerships.

III. Closing

The IPM meeting closed with the facilitator noting that the FTB would accept written comments on the topics discussed at the meeting until March 3, 2016, and that FTB staff intends to consider all comments received on the day of the IPM through the comment deadline. The facilitator indicated that an additional IPM would be scheduled after a draft framework for the regulations is developed. This framework will contain the general rules to be contained in the new regulations. Finally, the facilitator also mentioned that a summary of the IPM would be published online in the future.