State of California
Franchise Tax Board
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Interested Parties Meeting
1031 Exchange Sourcing Regulations

To attend this meeting, please RSVP by January 29, 2016 by contacting Jennifer Johnson at (916) 845-5042 or Email: jennifer.johnson@ftb.ca.gov.

To participate in this meeting by telephone, please dial: (877) 923-3149. Enter the participant pass code 2233420, followed by the # sign.

When
Wednesday, February 3, 2016
9:00 a.m.

Where
Franchise Tax Board
Golden State Room B, North Lobby
9646 Butterfield Way
Sacramento, CA 95827

Topic
Under Revenue and Taxation Code ("RTC") section 17041(a)(1), California residents are taxed on their entire income as if they had been residents of California for the entire taxable year and for all prior years. In contrast, nonresidents of California are only taxed on gross income from sources within California. (RTC section 17951.) Apportioning taxpayers (i.e. those doing business both within and without California) must allocate and apportion their income according to the provisions of the Uniform Division of Income for Tax Purposes Act ("UDIPTA"). (RTC sections 25120-25139, inclusive, and the regulations thereunder.)

On June 27, 2013, the California Legislature enacted Assembly Bill ("AB") 92. (Stats. 2013, Ch. 26.) Under AB 92, taxpayers who perform Internal Revenue Code ("IRC") section 1031 exchanges of real or tangible personal property located in California for real or tangible personal property located outside of California are required to file an annual information return with the Franchise Tax Board ("FTB") for each year in which the gain or loss from that exchange has not been recognized. (See RTC sections 18032 and 24953.) As a result of this reporting requirement, FTB has received requests for clarification of the determination of California source gain or loss in IRC section 1031 exchanges, especially in the context of multiple exchanges.

Under RTC section 17954, the FTB is specifically authorized to issue regulations for allocating and apportioning gross income from sources within and without California for the purposes of computing taxable income of nonresidents and part-year residents under paragraph (1) of subdivision (i) of section 17041. The FTB also has the authority in Part 11 to require alternative apportionment formulas where the standard allocation and apportionment provisions of UDIPTA do not fairly represent the extent of the taxpayer's business activity in this state. (RTC section 25137.)

Purpose

To elicit public input on potential regulations under California Code of Regulations ("CCR"), title 18, sections 17951-7 and 25137(e), that would address: (1) the sourcing of gains/losses from IRC section 1031 exchanges; and (2) which year's apportionment factor(s) should be applied to such gains/losses for apportioning taxpayers. The focus of this interested parties meeting will be to discuss these items in the context of the following scenarios:

Exchanges Out of California

1. **Exchange out of California followed by sale of out-of-state property (appreciation in value)**

   Taxpayer ("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 property located in State A which is later sold in a taxable transaction for $20.

   Question:

   - How much of the $15 federal gain ($20 sales price minus $5 basis) is California source gain?

2. **Exchange out of California followed by sale of out-of-state property (appreciation followed by depreciation in value)**

   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 property located in State A which is later sold in a taxable transaction for $8.

   Questions:

   - How much of the $3 federal gain ($8 sales price minus $5 basis) is California source gain?
   - Does TP have California source gain in excess of the federal gain reported in the year the State A property is sold?

3. **Exchange out of California followed by sale of out-of-state property (appreciation followed by loss on the ultimate sale of the property)**

   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 property located in State A which is later sold in taxable transaction for $4.

   Questions:

- How much of the $1 federal loss ($4 sale price minus $5 basis) is California source loss?
- Does TP have California source gain in the year the State A property is sold even though a federal loss is reported?

Exchanges into California

4. **Exchange into California followed by sale of California property (appreciation in value)**

   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.

   Question:

   - How much of the $15 federal gain ($20 sales price minus $5 basis) is California source gain?

5. **Exchange into California followed by sale of California property (appreciation followed by depreciation in value)**

   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 $8.

   Questions:

   - How much of the $3 federal gain ($8 sales price minus $5 basis) is California source gain?
   - Does TP have California source loss even though TP is reporting a federal gain in the year the California replacement property is sold?

6. **Exchange into California followed by sale of California property (appreciation followed by loss on ultimate sale)**

   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 $4.

   Questions:

   - How much of the $1 federal loss ($4 sale price minus $5 basis) is California source loss?
   - Does TP have California source loss in excess of the federal loss reported in year the California replacement property is sold?

Exchanges out of California – Multiple Exchanges

7. **Exchange out – Multiple exchanges (insufficient deferred gain)**

   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.

   Questions:

   - How much of the $3 federal gain ($8 sales price minus $5 basis) is California source gain?
   - Does TP have California source gain in excess of the federal gain reported in the year the State C property is sold?

   <u>NEW FACT</u>*:* The State C property is sold for $15 instead of $8.

   - How much of the $10 federal gain ($15 sales price minus $5 basis) is California source gain?

8. **Exchange out – Multiple exchanges (loss on ultimate sale)**

   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.

   Questions:

   - How much of the $1 federal loss ($4 sales price minus $5 basis) is California source loss?
   - Does TP have California source gain in the year the State C property is sold even though a federal loss is reported?

Exchanges into and back out of California

9. **Exchange into and back out of California (appreciation, followed by more appreciation, followed by depreciation in value)**

   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 a property located in State B which is later sold in a taxable transaction for $10.

Questions:

- How much of the $5 federal gain ($10 sales price minus $5 basis) is California source gain?
- Does TP have California source gain in excess of the federal gain reported in the year the State B property is sold?

<u>NEW FACT</u>*:* The State B property is sold for $15 instead of $10.

- How much of the $10 federal gain ($15 sales price minus $5 basis) is California source gain?

10. **Exchange into and back out of California (appreciation, followed by more appreciation, followed by loss on the ultimate sale of the property)**

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.

Questions:

- How much of the $1 federal loss ($4 sales price minus $5 basis) is California source loss?
- Does TP have California source gain in the year the State B property is sold even though a federal loss is reported?

11. **Exchange into and back out of California (appreciation, followed by depreciation, followed by appreciation in value)**

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.

Questions:

- How much of the $15 federal gain ($20 sales price minus $5 basis) is California source gain?
- Does TP have California source loss in the year the State B property is sold even though TP reported a federal gain on the sale?

12. **Exchange into and back out of California (appreciation, followed by depreciation, followed by loss on the ultimate sale of the property)**

TP purchased property in State A for $5 and sells the property for $15, 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 $4.

Questions:

- How much of the $1 federal loss ($4 sales price minus $5 basis) is California source loss?
- Does TP have California source loss in excess of the federal loss reported in the year the State B property is sold?

13. **Apportioning Taxpayers**

Questions:

- Should the FTB develop a regulation addressing which year's apportionment factor(s) should be applied to the deferred gain/loss from an IRC section 1031 exchange when such deferred gain/loss is ultimately recognized?
- What should the scope of this regulation be?

14. **Other Potential Issues**

Are there any other potential issues with the sourcing of deferred gains/losses from IRC section 1031 exchanges of California property that should be considered?

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Visitors Parking Map
***This facility is architecturally accessible to persons with physical disabilities.**

COST IMPACTS OF PROPOSED RULEMAKING
The department encourages submission of information from interested parties during the pre-APA process in order to assess the economic impact of a proposed rulemaking action on businesses (including small businesses), employees, jobs or occupations, competitiveness of California businesses, reporting requirements, or individuals.