

NOTE: This handout is intended only for purposes of facilitating the discussion at the second interested parties meeting – it provides examples from the first interested parties meeting with proposed solutions, and outlines topics FTB staff will be referring to during our discussion.

## **APPROACH TO REGULATIONS**

### **SOURCING AND APPORTIONMENT OF TAX DEFERRED EXCHANGES**

#### **PROPOSED ADOPTION OF CALIFORNIA CODE OF REGULATIONS, TITLE 18, (CCR) SECTION 17951-7 and PROPOSED AMENDMENT TO CCR SECTION 25137, ADDING NEW SUBSECTION (e)**

The focus of this Interested Parties Meeting (IPM) will be on the proposed adoption of title 18, California Code of Regulation, (CCR) section 17951-7, California's rule for sourcing gains and losses realized and deferred upon the voluntary or involuntary disposition of real or tangible personal property located in this State in an exchange that qualifies for deferral under section 1031 or 1033 of the Internal Revenue Code (IRC), as conformed to by Revenue and Taxation Code section 18031. This proposed regulation will only apply to nonresidents of California. In addition this IPM will also focus on evaluating a possible amendment to CCR section 25137, adding subsection (e), for 1031 Exchanges in an apportioning taxpayer context. This will be the second IPM for the proposed regulatory actions. The first IPM was held on February 3, 2016.

Available to the public for this second IPM are the following two documents: the Second IPM Notice, and handout outlining the structure of the proposed regulation and several examples illustrating how the new regulation may operate. These examples may be seen in a graphic format in the handout provided for the first IPM, available online at: <https://www.ftb.ca.gov/tax-pros/law/regulatory-activity/index.html>

## **APPROACH TO REGULATIONS**

- 1) Exchanges of California Properties for Out-of-State Properties
  - a. The gain or loss realized when a taxpayer relinquishes California property will retain its California source when the California property is exchanged for replacement property in another state.
  - b. When gain or loss is ultimately recognized from the exchange, the California recognized gain or loss will be the lesser of the federal recognized gain or loss, or the California realized gain or loss.
  - c. A federal recognized loss with a California realized gain will result in no gain or loss for California purposes. A federal recognized gain with a California realized loss will result in no gain or loss for California purposes.

**Example 1:** Exchange of appreciated California relinquished property for out-of-state replacement property followed by a sale or other disposition of the appreciated replacement property in a transaction where gain is recognized for federal income tax purposes.

Taxpayer purchased California property for \$5 and sells the property for \$10, deferring the gain with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in State A. The out-of-state replacement property cost \$10. The out-of-state replacement property is later sold for \$20 in a transaction in which gain is recognized for federal income tax purposes. The California recognized gain is \$5.

**Example 2:** Exchange of California appreciated relinquished property for out-of-state replacement property followed by a sale or other disposition of the depreciated replacement property in a transaction where gain is recognized for federal income tax purposes.

Taxpayer purchased California property for \$5 and sells the property for \$10, deferring the gain with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in State A. The out-of-state replacement property cost \$10. The depreciated out-of-state replacement property is later sold for \$8 in a transaction in which gain is recognized for federal income tax purposes. The California recognized gain is \$3, the lesser of the amount realized on the sale of the California property or the amount recognized for federal purposes.

**Example 3:** Exchange of appreciated California relinquished property for out-of-state replacement property followed by a sale or other disposition of the depreciated out-of-state replacement property in a transaction where loss is recognized for federal income tax purposes.

Taxpayer purchased California property for \$5 and sells the property for \$10, deferring the gain with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in State A. The out-of-state replacement property cost \$10. The depreciated out-of-state replacement property is later sold for \$4 in a transaction in which a loss is recognized for federal income tax purposes. The California recognized gain/loss is \$0. A federal recognized loss and a California realized gain will result in no gain or loss for California purposes.

2) Exchanges of Out-of-State Properties for California Properties

- a. The out-of-state property will receive a basis equal to its cost basis (rather than a carryover basis) when it is exchanged for a California property.
- b. When gain or loss is ultimately recognized from the exchange, the California recognized gain or loss will be the lesser of the federal recognized gain or loss, or the California realized gain or loss.
- c. A federal recognized loss with a California realized gain will result in no gain or loss for California purposes. A federal recognized gain with a California realized loss will result in no gain or loss for California purposes.

**Example 4:** Exchange of appreciated out-of-state relinquished property for California replacement property followed by a sale or other disposition of the appreciated California replacement property in a transaction where gain is recognized for federal income tax purposes.

Taxpayer purchased property in State A for \$5 and sells the property for \$10, deferring the gain with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in California. The California replacement property cost \$10. The appreciated California replacement property is later sold for \$20 in a transaction in which gain is recognized for federal income tax purposes. The California recognized gain is \$10, the lesser of the amount realized on the sale of the California property or the amount recognized for federal purposes.

**Example 5:** Exchange of appreciated out-of-state relinquished property for California replacement property followed by a sale or other disposition of the depreciated California replacement property in a transaction where gain is recognized for federal income tax purposes.

Taxpayer purchased property in State A for \$5 and sells the property for \$10, deferring the gain with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in California. The California replacement property cost \$10. The depreciated California replacement property is later sold for \$8 in a transaction in which gain is recognized for federal income tax purposes. The California recognized gain/loss is \$0.

**Example 6:** Exchange of appreciated out-of-state relinquished property for California replacement property followed by a sale or other disposition of the depreciated California replacement property in a transaction where loss is recognized for federal income tax purposes.

Taxpayer purchased property in State A for \$5 and sells the property for \$10, deferring the gain with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in California. The California replacement property cost \$10. The depreciated California replacement property is later sold for \$4 in a transaction in which loss is recognized for federal income tax purposes. The California recognized loss is \$1, capped at the federal recognized loss.

### 3) Examples of Multiple/ Serial Exchanges

- a. The recognized gain or loss for California recognition purposes will be tied to the recognized gain or loss for federal recognition purposes. This may reduce the need for tracking for practitioners in transactions with multiple exchanges.
- b. In cases where the recognized gain is less than the total realized gain in California plus other states, the federal recognized gain will be prorated between California and the other states with realized gain, provided that the taxpayer was taxed by the other state(s). There will be a presumption that the taxpayer was not taxed by another state on realized gain, unless the taxpayer provides a copy of the completed other state tax return(s) and evidence of payment of the tax to the state(s).
- c. A federal recognized loss with a California realized gain will result in no gain or loss for California purposes. A federal recognized gain with a California realized loss will result in no gain or loss for California purposes.

**Example 7:** Series of Consecutive Exchanges where original property was a California property and only one California property is involved; Gain recognized for federal purposes exceeds California realized gain.

Taxpayer purchased California property for \$5 and sells the property for \$10, deferring the gain with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in State A. The out-of-state replacement property in State A cost \$10. The out-of-state replacement property in State A is later sold for \$15, deferring the gain again with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in State B. The out-of-state replacement property in State B cost \$15. The out-of-state replacement property in State B is later sold for \$20, deferring the gain again with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in State C. The out-of-state replacement property in State C cost \$20. Taxpayer later sells the out-of-state replacement property in State C for \$15 in a transaction in which gain is recognized for federal income tax purposes.

The proration rules may apply since the total of California's and other states' gain is \$15 but only \$10 of federal gain is recognized. Assuming each of the other states taxed the gain and the taxpayer provides proof of taxation and payment of the taxes, the recognized gain for California would be \$3.33 ( $5/15 \times \$10$ ).

**Example 8:** Series of Consecutive Exchanges where original property was a California property and only one California property is involved; Loss recognized for federal purposes but California realized gain.

Taxpayer purchased California property for \$5 and sells the property for \$10, deferring the gain with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in State A. The out-of-state replacement property in State A cost \$10. The out-of-state replacement property in State A is later sold for \$15, deferring the gain again with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in State B. The out-of-state replacement property in State B cost \$15. The out-of-state replacement property in State B is later sold for \$20, deferring the gain again with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in State C. The out-of-state replacement property in State C cost \$20. Taxpayer later sells the out-of-state replacement property in State C for \$4 in a transaction in which a loss is recognized for federal income tax purposes. The California recognized gain is \$0.

**Example 9:** Series of Consecutive Exchanges where original property was an out-of-state property exchanged for a California property and only one California property is involved; California realized gain exceeds gain recognized for federal purposes.

Taxpayer purchased a property located in State A for \$5 and sells the out-of-state property for \$10, deferring the gain with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in California. The replacement property in California cost \$10. The California replacement property is later sold for \$20, deferring the gain again with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in State B. The out-of-state replacement property in State B cost \$20. Taxpayer later sells the out-of-state replacement property in State B for \$10 in a transaction in which gain is recognized for federal income tax

purposes. The California recognized gain is \$5, the lesser of the amount realized on the sale of the California property or the amount recognized for federal purposes.

The proration rules may apply since the total of California's and other states' gain is \$15 but only \$5 of federal gain is recognized. Assuming the other states taxed the gain and the taxpayer provides proof of taxation and payment of that tax, the recognized gain for California would be \$3.33 ( $10/15 \times \$5$ ).

**Example 10:** Series of Consecutive Exchanges where original property was an out-of-state property exchanged for a California property and only one California property is involved; California realized loss but gain recognized for federal purposes.

Taxpayer purchased a property located in State A for \$5 and sells the out-of-state property for \$10, deferring the gain with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in California. The replacement property in California cost \$10. The California replacement property is later sold for \$8, deferring the gain again with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in State B. The out-of-state replacement property in State B cost \$8. Taxpayer later sells the out-of-state replacement property in State B for \$20 in a transaction in which gain is recognized for federal income tax purposes. The California recognized gain/loss is \$0.

**Example 11:** Series of Consecutive Exchanges where original property was an out-of-state property exchanged for a California property and only one California property is involved; California realized loss and loss recognized for federal purposes.

Taxpayer purchased a property located in State A for \$5 and sells the out-of-state property for \$15, deferring the gain with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in California. The replacement property in California cost \$15. The California replacement property is later sold for \$8, deferring the gain again with an IRC section 1031 exchange. Taxpayer exchanges into replacement property located in State B. The out-of-state replacement property in State B cost \$8. Taxpayer later sells the out-of-state replacement property in State B for \$4 in a transaction in which gain is recognized for federal income tax purposes. The California recognized loss is \$1, the lesser of the amount realized on the sale of the California property or the amount recognized for federal purposes.

4) 1031 Exchanges in an Apportioning Taxpayer Context

- a. The general rule is that apportioning taxpayers report deferred gain from an IRC 1031 exchange recognition event using the apportionment factors for the year of the sale, not the apportionment factors for the year the income is reported.
- b. However, proposed CCR section 25137(e) would allow for an election to use apportionment factors for the year the income is reported, but the election could not be revoked for 5 years.