A PROPOSED CALIFORNIA TAX INCREASE:

"TAX DEFERRAL WOULD BE ELIMINATED FOR SOME REAL ESTATE INVESTORS"

California's massive budget shortfall has generated a variety of legislative proposals intended to raise tax revenue to close the gap. One area that has received attention in the State Legislature is the income tax deferral available to California taxpayers who complete tax deferred exchanges under Internal Revenue Code Section 1031. Section 1031 (a federal tax rule) has been around in one form or another since 1921. That section permits a taxpayer to sell appreciated investment property and to defer the resulting capital gains tax if the taxpayer acquires like-kind replacement property with the requirements of Section 1031. California's income tax laws have generally conformed to the federal law with respect to tax deferred exchanges such that a California taxpayer may defer both federal and state income taxes by completing a properly structured exchange. Of course, the deferral permitted under Section 1031 comes at a cost to the State budget and has become a target for some in the Legislature.

The first proposed legislative salvo was included in Assembly Bill 2640 which would have ended the longstanding conformity between California's tax laws and Section 1031. If enacted as originally proposed, California taxpayers who engaged in a 1031 exchange would have to recognize and pay California income tax on gain realized on the sale of the relinquished property. Fortunately, that language was eliminated from AB 2640 in March of this year following an aggressive lobbying campaign by the California Apartment Association and other groups concerned about its potential effect on California's real estate market. Six weeks later, however, Senate Bill 1316 (SB 1316) was amended to include language that would deny state income tax deferral for California taxpayers who exchange California real estate for investment property located outside of California. If this bill is enacted as proposed, the limitation on deferral would apply retroactively to all exchanges initiated after January 1, 2010. Deferral of state income tax would continue for exchanges of property located within California.

The elimination of deferral as proposed in Senate Bill 1316 presents a threat the health of California's real estate market. California has experienced the worst effects of the real estate down turn and some economists believe that we are not yet out of the woods. By limiting the opportunity for tax deferral, SB 1316 would render California real estate less attractive than real estate in other states that continue to conform to Section 1031. Given the current state of California's real estate market, any change in the tax laws that would reduce the desirability of California real estate would seem particularly ill advised. Moreover, if property values fall, other revenue streams available to the State, such as property taxes, would also be reduced. This new proposed tax change is aimed squarely at businesses and real estate investors who are already stressed and who would be the catalyst for California's exit from the worst budget crisis in the state's history.

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