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State tax considerations for Internal Revenue Code section 1031 like-kind exchanges

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Many taxpayers have taken advantage of the like-kind exchange rules under Internal Revenue Code (IRC) section 1031 to defer income tax on the gain realized from the sale of qualified property. If the rules are followed, income tax on any gain realized is deferred until a subsequent sale of the property. As a consequence of the gain deferral, the taxpayer generally gets a "carryover" basis in the property acquired.

For federal income tax purposes, there is no requirement that the newly acquired property be located in the same state as the property relinquished (the newly acquired property, however, cannot be located in a foreign country, unless the disposing property is also located in a foreign country). In fact, one of the reasons a taxpayer may wish to engage in a section 1031 exchange is to diversify holdings among different geographic regions of the country on a tax-deferred basis. Although no difference exists for federal income tax purposes between an interstate exchange and an intrastate exchange, there can be a significant difference for state income tax purposes.

Many states either use federal taxable income as the starting point for computing state taxable income or have adopted the IRC as of a particular date to compute their state income tax. In either case, absent a law modifying the computation of federal taxable income, these states have either implicitly or explicitly adopted the deferral provisions of section 1031.

A number of states, however, either (1) do not use federal taxable income as the starting point for computing state taxable income, (2) have not adopted the IRC for purposes of computing state taxable income, or (3) have added specific provisions relating to the location of replacement property. Taxpayers planning a section 1031 involving property in one of these states must consider the state income tax consequences of the exchange in their planning.

In general, states that depart from the federal like-kind exchange rules generally do so by either (1) disallowing the gain deferral, (2) requiring in-state reinvestment, or (3) clawback. The first two of these taxing methods impose an immediate state income tax on the otherwise unrecognized gain. States that use a clawback method for taxing the deferred gain generally allow deferral of the gain until the property is ultimately sold in a taxable transaction, regardless of where the taxpayer resides at the time of the sale resulting in the gain recognition.

Pennsylvania is a state that has not adopted the IRC, and it does not use federal taxable income as its starting point for computing state taxable income. It currently does not have a state income tax provision similar to IRC section 1031 (while there is consideration in the 2013-14 state budget to put in the provision, currently it does not exist). That means that any real property sold in Pennsylvania as part of a section 1031 exchange will be subject to state income tax at the current individual rate of 3.07%. As a result, a taxpayer engaging in an interstate exchange of Pennsylvania property who purchases replacement property in a state that fully recognizes section 1031 will likely have a lower carryover basis in the newly acquired property, potentially causing double state taxation when the replacement property is eventually sold in a taxable transaction.

For example, assume a New York resident sells a building in Pennsylvania for $2 million with an adjusted basis of $400,000 as part of a section 1031 exchange and that a replacement property is purchased in New York for $2 million. No federal or New York income tax will be due, and the replacement property will have a basis of $400,000 for federal and New York income tax purposes. For Pennsylvania purposes, an income tax of $59,200 ($1.6 million X 3.07%) will be due. Since New York recognizes section 1031, the gain from the sale of the original property will be subject to double taxation (i.e., once by Pennsylvania and once by New York) when the replacement property is ultimately sold in a fully taxable transaction.

California has enacted a new clawback provision beginning in 2014. When a California property is sold as part of a section 1031 exchange and the replacement property is out of state, California now requires that the taxpayer report the previously deferred gain when that out of state replacement property is sold in a taxable transaction. The tax will be due regardless of whether the taxpayer is residing or doing business in California at the time the gain is recognized.

California taxpayers will be required to file an information return with the franchise tax board (FTB) for the year of sale and for each subsequent year when the gain is not recognized. If the form is not filed, the FTB may estimate the net income tax due on the exchange from any information available and assess tax, interest and penalties.

States that currently either use federal taxable income as the starting point for computing state taxable income or have adopted the IRC as of a particular date to compute their state income tax are looking at limiting the deferral on like-kind exchanges for properties acquired out of their states as they face mounting budget deficits. As a result, taxpayers should make sure they consider the state income tax effects when planning an interstate exchange of property under IRC section 1031.

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