March 3, 2016

Cheryl Akin
Legal Division (MS-A260)
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Re: Comments on Sourcing and Apportionment of Gains/Losses from IRC Sec. 1031 Exchanges

Dear Ms. Akin:

We write this letter on behalf of three separate trade associations, whose members include companies with like-kind exchange ("LKE") programs. This letter includes comments concerning potential regulations under California Code of Regulations ("CCR"), Title 18, secs. 17951-7 and 25137(e) addressing (1) the sourcing of gains/losses from Internal Revenue Code ("IRC") section 1031 exchanges, and (2) which year's apportionment factor(s) should be applied to such gains/losses for apportioning taxpayers. We appreciate the opportunity to provide comments to the Franchise Tax Board ("FTB") concerning these potential regulations and the issues discussed at the Interested Parties Meeting on this issue held on February 3, 2016. Our members are concerned about the administrative burdens that proposed regulations would impose.

Background on Proposed Regulation Project

The FTB requested public input on potential regulations under California Code of Regulations ("CCR"), Title 18, Secs. 17951-7 and 25137(e) that would address: (1) the sourcing of gains/losses from IRC Sec. 1031 exchanges; and (2) which year's apportionment factor(s) should be applied to such gains/losses for apportioning taxpayers.

The FTB noted the need for guidance in light of new reporting requirements for taxpayers executing IRC Sec. 1031 exchanges of real or tangible personal property located in California for real or tangible property located outside of California. As a result of these reporting requirements, some taxpayers have requested clarification of the California source of gain or loss, especially in the case of multiple exchanges.

The FTB held an Interested Parties Meeting ("IPM") on February 3, 2016, to discuss this potential regulation project and elicit public comment. As part of the IPM materials, the FTB provided a handout with examples. The handout predominately addressed issues involving individual taxpayers who may be exchanging in-state property for out-of-state property and vice versa. Two questions were posed regarding apportioning taxpayers: (1) Should the FTB develop a regulation addressing which year's apportionment factor(s) should be applied to the deferred gain/loss from an IRC Sec. 1031 exchange when such deferred gain/loss is ultimately recognized; and, (2) What should be the scope of the regulation.

Burden of Historical Apportionment or Tracing of California Gain/Loss for Certain Corporate Taxpayers

LKE programs have been implemented by many types of companies including captive finance companies, leasing companies, banks, equipment and rental car companies and equipment dealers. These LKE programs are streamlined to systematically meet the LKE tax requirements while minimizing interruption to the taxpayer's normal course of business. The underlying asset is typically leased anywhere from one year to several years. Upon lease expiration these assets are purchased by the lessee, sold to a third party, purchased by the dealer or sold at auction. The proceeds from the sale of the leased asset are used to acquire new leases that the taxpayer is originating. As such, the lessor has exchanged the sold asset for the new asset through meeting the requirements of an LKE program.

The LKE programs described above can involve significant asset volume and require complex tax calculations for depreciation along with specific proprietary systems to track and report deferred gain/loss, recognized gain/loss, basis and depreciation for tax compliance purposes. A typical exchange portfolio may include more than one million assets and there can be hundreds of thousands of exchanges in a given year.

Based on the IPM materials, the FTB is considering whether to require corporate taxpayers to use the historical apportionment formula from the earlier year of the exchange to apportion gain from the eventual sale of the replacement asset. This would require tracing back through numerous layers of exchanges, covering a decade of time or more, to determine the years in which each of the exchanges took place, the amount of deferred income related to each of those exchanges, and whether the original exchange was of a California asset to begin with, in order to apply a historical California apportionment factor to the recognized gain. The process of tracing particular assets to determine application of the historical apportionment would be extremely difficult and burdensome, particularly considering the size of some portfolios and the number of exchanges. Additionally, these programs typically match two relinquished assets to one replacement asset. The matching depends on the proceeds from the relinquished asset and the cost of the replacement asset. Other scenarios can include two relinquished assets matched to two replacements or one relinquished asset matched with two replacements. The matching depends on the relative cost difference between the sales proceeds of the relinquished/sold asset and the cost of the replacement/new asset.

Also, any attempt to trace gain related to year of origin as well as identify specific California-located assets, either for apportionment or information reporting purposes, is further complicated by the fact that within the LKE programs assets are exchanged with other assets from different states. For example, when two assets are relinquished in exchange for a replacement asset, these relinquished assets can be from different states, and these multi-asset exchanges can take place several times before an asset is ultimately sold in a taxable disposition. It would be incredibly burdensome to allocate the gain to the different states due to the layers of exchanges prior to the sale. Due to the scale of many of these LKE programs, the scenario of a California asset exchanged for a non-California asset is just as likely as the reverse scenario in which a non-California asset is exchanged for a California asset. Thus, an extraordinary compliance effort may be required for transactions that may end up essentially offsetting each other.

Recommendations for Application to Corporate Taxpayers

In the IPM materials, the FTB asked, "What should the scope of the regulation be?" Given the size and complexities of these LKE programs, we request that the regulation project be limited to Personal Income Tax and not applied to corporate taxpayers. Under existing rules, these corporate taxpayers would

continue to use the apportionment factor in the year of the sale to apportion all of the business gain/loss in that year. Proceeds from recognized gains should be sourced in the year of sale to the state in which the property sold was located. This approach is sensible and the only practical way of sourcing recognized gain in the context of LKE programs.

Requiring the application of historical apportionment which itself requires tracing of the gain/loss through multiple exchanges spanning decades of time is simply not administratively feasible for corporate taxpayers with LKE programs. Further, the volume and complexity of the transactions would make it extremely difficult for the FTB to audit taxpayers' compliance with a historical apportionment rule. Historical apportionment is an unworkable solution from the standpoint of both taxpayer compliance and tax administration.

We note that the FTB has previously acknowledged that historical apportionment requirements may be overly burdensome for corporate taxpayers. For example, the historical apportionment rules for installment sales do not apply to dealers. (Legal Ruling 413, Jan. 15, 1979). We strongly urge the FTB to follow similar reasoning and allow corporate taxpayers to use existing rules to apportion gain and loss from the eventual sales of these exchanged assets.

Alternatively, if the FTB is compelled to apply the regulations to corporations in some capacity, we would request that the application be limited to real estate transactions where required tracing may be much simpler and easier. The sheer volume of the personal property transactions within many LKE programs would create significant compliance burdens for the affected taxpayers.

We respectfully request that you give our position on this matter due consideration. If you have further questions, please do not hesitate to contact us.

Respectfully,

Danielle Fagre Arlowe
Senior Vice President, State Government Affairs
American Financial Services Association
919 Eighteenth Street, NW, Suite 300
Washington, DC 20006
Phone: (952) 922-6500
dfagre@afsamail.org

Dennis Brown
Vice President, State Government Relations
Equipment Leasing and Finance Association
1825 K Street NW, Suite 900
Washington, DC 20006
Phone: (202) 238-3411
dbrown@elfaonline.org

Randall McCathren
Managing Director
Association of Consumer Vehicle Lessors
702 Clearview Drive, Suite B
Nashville, TN 37205
Phone: (615) 383-1930
rmccathren@blcassociates.com