# Navigating 1031 Rules in California

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# Essential Highlights of 1031 Exchange Rules

- California follows the federal rules for 1031 exchanges laid out in Section 1031 of the Internal Revenue Code. This allows investors to defer capital gains taxes when selling an investment property if the proceeds are reinvested into another "like-kind" property.

- Like the federal rules, in California the properties involved must be held for investment or business purposes. Personal residences do not qualify. Eligible properties include rental homes, commercial buildings, land, etc.

- California imposes a "claw-back" provision for 1031 exchanges where the replacement property is located outside of California. If that out-of-state replacement property is later sold in a taxable sale, California will collect the previously deferred state taxes at that time.

- The standard 1031 exchange timeline of 45 days to identify replacement properties and 180 days to complete the exchange applies in California as well.

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# Essential Highlights of 1031 Exchange Rules

- California has a two-year holding period requirement - the properties involved in a 1031 exchange must be held for at least two years after the exchange or the tax deferral is disallowed.
- California requires filing Form FTB 3840 annually to report any deferred gain from a 1031 exchange until the replacement property is sold or the gain is recognized.
- California imposes a 3.33% state withholding tax on 1031 exchanges involving the sale of a California property, which reduces the cash available for reinvestment

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# 45-Day Identification Rule

- **45-Day Identification Rule:** You have 45 days from the sale of your relinquished property to identify potential replacement properties. This identification must be in writing, signed by the taxpayer, and delivered to a qualified intermediary or another party involved in the exchange.

- **Three-Property Rule:** You can identify up to three properties regardless of their market value.

- **200% Rule:** If you identify more than three properties, their total fair market value must not exceed 200% of the fair market value of the relinquished property.

- **95% Rule:** You can identify any number of properties if you acquire at least 95% of the total value of the identified properties.

- **Specific Identification:** Replacement properties must be clearly identified using a street address, legal description, or Assessor's Parcel Number (APN

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# Claw-Back Provision

- **Out-of-State Replacement:** If you exchange California property for out-of-state property, California will track the deferred state taxes. When the out-of-state property is eventually sold, California will collect the deferred state taxes.

- **Annual Reporting:** You must file an annual information return with the California Franchise Tax Board (FTB) if you exchange California property for non-California property. This reporting continues until the deferred gain is recognized or the property is exchanged again.

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# State Withholding Tax

- **Withholding Rate:** The state requires a withholding of 3.33% of the sales price if the property is sold for over $100,000

- **Exemption:** To be exempt from this withholding, you must submit Form 593-C and certify that the transaction is part of a 1031 exchange. Non-resident sellers must submit Form 593-W to the California Franchise Tax Board

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# Timeline and Holding Period

The timeline and holding period are critical for a valid 1031 exchange:

- **45-Day Identification Period:** You must identify replacement properties within 45 days of selling the relinquished property.
- **180-Day Exchange Period:** The entire exchange must be completed within 180 days of the sale of the relinquished property or by the due date of the taxpayer's tax return, whichever is earlier.
- **Two-Year Holding Period:** While not explicitly stated in the IRS code, it is generally recommended to hold both the relinquished and replacement properties for at least two years to demonstrate the intent to hold for investment purposes

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# Reporting Requirements

- **Form FTB 3840:** You must file Form FTB 3840 annually to report any deferred gain from a 1031 exchange until the replacement property is sold or the gain is recognized.

- **Annual Information Return:** If you exchange California property for non-California property, you must file an annual information return with the FTB, reporting the non-California property

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# In Summary

- While California follows the federal 1031 exchange rules, it has additional state-specific requirements, including the claw-back provision, state withholding tax, and annual reporting obligations.
- Adhering to these rules and timelines is essential to ensure the tax deferral benefits of a 1031 exchange are preserved.
- Consulting with a qualified intermediary and tax advisor familiar with California's specific regulations is **highly recommended** to navigate these complexities successfully

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