

**CALIFORNIA LAWYERS ASSOCIATION  
TAXATION SECTION  
INCOME AND OTHER TAXES COMMITTEE**

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**CONFORM CALIFORNIA REVENUE & TAXATION SECTION 18031.5  
TO IRC SECTION 1031 ON LIKE KIND EXCHANGES**

This proposal was prepared by Annette Nellen, member of the Income and Other Taxes Committee of the California Lawyers Association's Taxation Section.<sup>1</sup> The author thanks reviewers Mark Mullin and Roger Royse for their helpful comments.<sup>2</sup>

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<sup>1</sup> The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the California Lawyers Association or its Taxation Section.

<sup>2</sup> Although the participants on this project might have clients affected by the rules applicable to the subject matter of this paper, no such participant has been specifically engaged by a client to participate on this project.

## EXECUTIVE SUMMARY

California law should be changed to fully conform to IRC Section 1031 on like kind exchanges. With the Tax Cuts and Jobs Act of 2017 (P.L. 115-97, Dec. 22, 2017), IRC Section 1031 was changed to only apply to real property held for business or investment purposes, effective for exchanges completed after December 31, 2017. Prior to this change, the like kind exchange gain and loss deferral rule also applied to many types of personal property (tangible and intangible) held for business or investment purposes.

California mostly conformed to the TCJA change to Section 1031 but with a notable exception that most individuals and many tax advisers are not aware of. Revenue & Taxation Section 18031.5 was added by AB 91 (Chapter 39, July 1, 2019) to conform to revised Section 1031 for exchanges completed after January 10, 2019.<sup>3</sup> However, the pre-TCJA version of Section 1031, a mandatory provision, continues to apply to individuals who are married filing jointly or using the head-of-household filing status and have under \$500,000 of adjusted gross income (AGI) or if filing single, have under \$250,000 of adjusted gross income for the tax year in which the exchange begins. This exception to conformity results in about 95% of individuals in California needing to consider the application of Section 1031 to an exchange of eligible tangible and intangible personal property held for business or investment purposes, such as digital assets and vehicles used in a sole proprietor's business (likely only a small percentage of these individuals engage in exchanges of personal property eligible for Section 1031 treatment). This non-conformity from federal law for most individuals is not well known and raises challenges in application such as to digital assets held for investment.

For simplification and the reality that the most common type of property to which taxpayers apply Section 1031 is real property, California should conform to the federal version of this rule, effective for transactions in tax years beginning after the change is enacted. This will simplify California tax law by conforming to the federal treatment of recognized gains and losses on exchanges of personal property. In addition, the law is incomplete and sometimes uncertain as to when personal property is like kind to other personal property, particularly for digital assets, so not allowing Section 1031 to apply to such property (as under federal tax law) will simplify tax compliance.

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<sup>3</sup> R&T 24941.5 was also added by AB 91 for corporations and conforms to the TCJA changes to IRC Section 1031 for exchanges completed after January 10, 2019.

Should lawmakers determine that a significant percentage of sole proprietors rely on Section 1031 for exchanges of eligible business assets such as vehicles and equipment, Revenue & Taxation Section 18031.5 can be retained for business assets of eligible sole proprietors (those below the specified AGI levels).

## DISCUSSION

### I. INTRODUCTION

IRC Section 1031 is a longstanding provision that requires individuals and businesses who exchange “like kind” property held for business or investment purposes to defer any realized gain or loss. The realized gain or loss is deferred through basis adjustments to the property received in the exchange. If any cash or non-like kind property is received in the exchange, generally that much of the realized gain is recognized. Certain property such as inventory and other property held primarily for sale, is not eligible for gain or loss deferral. Section 1031 is a mandatory provision if all requirements are met.

The like kind standard is strict for personal property but broader for real property. For example, a business taxpayer’s exchange of a car for a truck, or a copyright on a song for a copyright on a book, is not considered an exchange of like kind properties.<sup>4</sup> In contrast, the exchange of vacant land for a building is considered a like kind exchange.

A significant change was made to Section 1031 by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97, December 22, 2017) (TCJA), to only allow deferral of gain and loss “on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment” (Section 1031(a)(1)). Thus, for federal purposes, beginning for exchanges completed after December 31, 2017, tangible and intangible personal property held for business or investment are no longer eligible for Section 1031 gain or loss deferral.

California mostly conformed to the TCJA change to Section 1031 but with a notable exception. Revenue & Taxation Section 18031.5 was added by AB 91 (Chapter 39, July 1, 2019) to conform to revised Section 1031 for exchanges completed after January 10, 2019.<sup>5</sup> However, the pre-TCJA version of Section 1031 continues to apply to individuals who are married filing jointly or using the head-of-household filing status with adjusted gross income (AGI) under \$500,000 or if filing single, with under \$250,000 of adjusted gross income for the tax year in which the exchange begins.<sup>6</sup>

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<sup>4</sup> Treas. Reg. §1.1031(a)-2.

<sup>5</sup> R&T 24941.5 was also added by AB 91 for corporations and conforms to the TCJA changes to IRC Section 1031 for exchanges completed after January 10, 2019.

<sup>6</sup> Also see FTB, Reporting like-kind exchanges; <https://www.ftb.ca.gov/file/personal/reporting-like-kind-exchanges.html>.

This exception to Section 1031 conformity results in about 95% of individuals in California<sup>7</sup> needing to consider the application of Section 1031 to exchanges of eligible tangible and intangible personal property held for business or investment purposes, such as cryptocurrency<sup>8</sup> and vehicles used in a sole proprietor's business. It also means that federal guidance is no longer needed on the application of Section 1031 to personal property but is still needed in California.

The need for about 95% of individuals to have to continue to apply Section 1031 to exchanges of eligible personal property creates problems for taxpayers, tax professionals, and the Franchise Tax Board (FTB), as explained next. To remedy these problems, California should fully conform to Section 1031 with appropriate transition rules enacted as part of this change.<sup>9</sup>

## II. PROBLEMS OF APPLYING THE PRE-TCJA VERSION OF SECTION 1031 TO SOME CALIFORNIA INDIVIDUALS

Significant challenges and problems exist from California's incomplete conformity to the TCJA changes to Section 1031. These problems are described next.

*Additional Recordkeeping:* Individuals using the married filing jointly or head of household status with AGI below \$500,000 (below \$250,000 for other individuals) in the year an exchange begins must continue to apply Section 1031 to any exchange of tangible and intangible personal property held for business or investment purposes for California purposes although they are not allowed to do so

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<sup>7</sup> IRS statistics were used to estimate how many individuals are below the AGI thresholds to be subject to the pre-TCJA version of Section 1031. Table 1.2, All Returns: Adjusted Gross Income, Deductions, and Tax Items, by Size of Adjusted Gross Income and by Filing Status, Tax Year 2021 (Filing Year 2022), breaks down the number of returns filed by filing status which reported under \$500,000 or AGI or below \$200,000 (it does not break down the number of returns with AGI below \$250,000). Using this data for 2021 returns:

- 92.4% of returns filed using the MFJ filing status had AGI below \$500,000
- 99.4% of returns filed using the Head of Household filing status had AGI below \$500,000
- 96.0% of returns filed using the Single filing status had AIG below \$200,000 (if the data were available for those with AGI below \$250,000, this would be a larger percentage)

See IRS, Individual Income Tax Returns Complete Report 2021, April 2024; <https://www.irs.gov/pub/irs-pdf/p1304.pdf>.

<sup>8</sup> Virtual currency or cryptocurrency is treated as property rather than currency; Notice 2014-21. In this paper, the terms cryptocurrency and digital assets are used. Cryptocurrency is a type of digital asset, as defined at IRC Section 6045(g)(3)(D) and Treas. Reg. 1.6045-1(a)(19).

<sup>9</sup> It appears that all states with an income tax, other than Alabama and California, conform to the federal version of Section 1031 as changed by the TCJA. Arkansas has its own version of Section 1031. Per Ark. Individual Income Tax Regs. 1.25-51-412(a), Exchange of Property for Like Property, "no gain or loss shall be recognized in an exchange of property for like property of a similar value. The property must be held for productive use in a trade or business or held for investment (excluding inventory, stocks, bonds, notes and similar securities).

for federal purposes. Thus, additional recordkeeping is required because federal and California basis on these like kind items of personal property will differ, as well reported gains and losses.

*Information Returns Won't Match for Some Californians:* Some items of personal property exchanged by individuals subject to Section 1031 in California, may be reported on an information report such as Form 1099-B, Proceeds from Broker and Barter Exchange Transactions, or Form 1099-DA, Digital Asset Proceeds From Broker Transactions. Form 1099-DA will first be used for 2025 transactions although brokers are not required to start reporting basis until 2026 transactions (and such reporting of basis is not required by all brokers or for all sales and exchanges of digital assets). When basis is reported on Form 1099-DA, while it may match the recipient's records maintained for federal purposes, it may not match the basis for California purposes due to the individual's digital assets being subject to like kind exchange treatment. In addition, Form 1099-DA will indicate a taxable disposition of digital assets, but the resulting gain or loss will not be reportable in California if the individual and the digital asset is subject to Section 1031 for California purposes. These differences will create recordkeeping challenges, increase the chance of reporting errors, and cause confusion and possible underreporting notices from the FTB.

*Inadvertent Filing Errors by Taxpayers and Inability of the FTB to Detect Them:* Most taxpayers and many tax return preparers are not aware of the non-conformity aspect of Section 1031 in California. This is an area given little attention by taxpayers and return preparers given the oddity of lack of conformity and because it is only for individuals below certain AGI levels and exchanges of personal property are less common than exchanges of real property.

Lack of awareness of Section 1031 non-conformity and the inability to readily determine from review of Form 540 if an individual misreported gains or losses on personal property that is like kind and held for business or investment purposes means that most reporting errors for like kind personal property on Form 540 can easily go undetected by the FTB.

Form 8949, Sales and Other Dispositions of Capital Assets, does not require reporting of details to indicate if a transaction was an exchange rather than a sale and even if a transaction was an exchange, there would be insufficient details to know if the personal property exchanged was like kind. Note that no column on Form 8949 requires separate reporting of sales versus exchanges:

1	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis See the <b>Note</b> below and see <b>Column (e)</b> in the separate instructions.	Adjustment, if any, to gain or loss If you enter an amount in column (g), enter a code in column (f). <b>See the separate instructions.</b>		(h) <b>Gain or (loss)</b> Subtract column (e) from column (d) and combine the result with column (g).
						(f) Code(s) from instructions	(g) Amount of adjustment	

Form 8824, Like-Kind Exchanges, included on a Form 1040 will only report exchanges of real property because Section 1031 only applies to real property for federal tax purposes.

Incomplete conformity to Section 1031 leads to some individuals unwittingly filing incorrect returns for California purposes. For the FTB to detect such errors, they would have to examine returns for individuals below the AGI thresholds who have personal property dispositions reported on Form 8949 (other than stock which is not eligible for like kind exchange treatment). A return showing a good number of cryptocurrency transactions might be a suitable candidate for a Section 1031 examination since many cryptocurrencies can only be acquired using other cryptocurrencies resulting in an exchange. However, the FTB may easily have challenges determining when cryptocurrencies are like kind due to lack of sufficient guidance in this area.

*Lack of Substantial Authority on Return Positions:* Lack of guidance for the most commonly exchanged item of personal property – cryptocurrency, leaves individuals and preparers who *are* aware of California’s Section 1031 nonconformity with challenges of knowing if they are properly applying old Treasury regulations on personal property exchanges correctly to property not specifically covered by these old regulations or other binding guidance from the IRS or FTB. There is no

binding federal<sup>10</sup> or state guidance<sup>11</sup> on when one digital asset is considered like kind to another digital asset. Also, bitcoin and Ethereum likely are the digital assets most often used to acquire other digital assets. Some unique traits of these currencies make it unlikely that they would be considered like kind to most types of digital assets such as because the other cryptocurrency does not allow for smart contracts or is not commonly used to acquire goods and services.

*Lack of Focus on the Area of Non-Conformity in the Guidance Process:* The FTB has an active regulation project open on tax deferred exchanges. This project primarily addresses the exchange of California property for property in another state. This project does not provide guidance on when personal property, such as digital assets, are like kind to other digital assets, an area that became significant with the enactment of AB 91 in July 2019.<sup>12</sup>

*Little Rationale for Incomplete Section 1031 Conformity:* There is no clear reason to treat individuals below specified AGI levels differently from other individuals for Section 1031 purposes when the most commonly exchanged asset is real property rather than personal property. The partial conformity change in July 2019 (AB 91) lacks transparency as to the purpose which also leads many to not be aware of the non-conformity. Also, the most commonly exchanged item of personal property held for investment today are digital assets for which guidance is needed to allow for proper and consistent application of the like kind exchange rule to this type of property.

Perhaps one rationale for allowing many Californians to continue to apply the like kind exchange rule to personal property was to enable sole proprietors with AGI

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<sup>10</sup> IRS CCA 202124008 (June 18, 2021) addresses the question of whether exchanges of Bitcoin for Ether, Bitcoin for Litecoin, and Ether for Litecoin are like kind under Section 1031, finding that they are not. The CCA notes that Bitcoin and Ether, unlike Litecoin, are often used to acquire other cryptocurrencies. The CCA also notes that while Bitcoin and Ether “share similar qualities and uses, they are also fundamentally different from each other because of the difference in overall design, intended use, and actual use.” For example, Bitcoin was designed for a payment network while Ether was also designed for operating smart contracts. This CCA is not binding on the IRS because it was not published in the Internal Revenue Bulletin (see Treas. Reg. 601.601(d)) and is not considered “authority” under Treas. Reg. §1.6662-4(d)(3)(iii). The analysis in the CCA is not complete as it only addresses three types of cryptocurrencies (over 9,000 exist) and it does not list the factors to be considered to know when these intangible assets are considered like kind.

<sup>11</sup> No regulations exist under the R&T provisions on like kind exchanges that were changed or added by AB 91 (Chapter 39, July 1, 2019). Also see James Creech, Annette Nellen, and Roger Royse, “Need for Guidance For California Purposes on the Application of IRC Section 1031 to Virtual Currencies and Other Digital Assets,” *California Tax Lawyer*, Sept 2023; based on paper presented in October 2022 for the California Lawyers Association Taxation Section’s Sacramento Delegation.

<sup>12</sup> See FTB, Active regulation projects; <https://www.ftb.ca.gov/tax-pros/law/regulatory-activity/index.html>. The most recent activity on tax deferred exchanges is dated August 21, 2024.



below the thresholds to apply Section 1031 to exchanges of vehicles or equipment. But why this would be allowed for sole proprietors (individuals) and not other small businesses such as S corporations, is not clear. Also, like kind exchanges of vehicles and equipment are likely not frequently made by individuals, and creating different federal and California gains or losses on these exchanges to be documented and properly reported likely creates more challenges and risk of error than are presented by any tax planning benefits.

### **III. RECOMMENDATIONS TO IMPROVE CALIFORNIA TAX LAW REGARDING LIKE KIND EXCHANGES**

For simplification, greater transparency, and the reality that the most common type of property to which taxpayers apply Section 1031 is real property, California should fully conform to the federal version of this rule, effective for transactions in tax years beginning after the change is enacted.

Should lawmakers determine that a significant percentage of sole proprietors rely on Section 1031 for exchanges of eligible business assets such as vehicles or equipment, Revenue & Taxation Section 18031.5 could be retained, but only for business assets of eligible sole proprietors (those below the specified AGI levels).