



09.24.2019

FTB NOTICE - 2019 - 05

SUBJECT: Imposing the Failure to Withhold Penalty Against Qualified Intermediaries Who Actively Participate in Certain Improper Like-Kind Exchange Transactions

PURPOSE: The purpose of this Notice is to inform qualified intermediaries ("QIs") that the Franchise Tax Board ("FTB") will impose failure to withhold penalties against QIs who actively participate in structures where boot¹ or proceeds from an attempted like-kind exchange are converted into an installment note or similar arrangement in which payments are to be paid out over two or more years. These penalties may be imposed beginning with attempted like-kind exchanges in which property is relinquished on or after March 24, 2020.

BACKGROUND:

I. The Transaction

FTB is aware of arrangements in which a taxpayer or QI attempts to convert proceeds from a failed like-kind exchange, or the unreinvested portion of proceeds from a partial like-kind exchange, into an installment payment structure such as an installment note or similar arrangement in which payments are to be paid out over two or more years (the "Transaction"). These arrangements do not allow for a deferral of gain recognition under Internal Revenue Code ("IRC") sections 453 and 1031 since, among other reasons, these sections and the federal doctrine of constructive receipt do not support such a deferral of gain recognition.²

¹ The term boot is generally used to reference non-like-kind property received in an exchange.

² California conforms to IRC section 453 pursuant to Revenue and Taxation Code ("RTC") section 17551 as modified by RTC section 17560 (California Personal Income Tax) and RTC sections 24667 and 24668.1 (California Corporation Tax). California conforms to IRC section 1031 pursuant to RTC sections 18031 and 18031.5 (California Personal Income Tax) and 24941 (California Corporation Tax).

II. General Withholding Requirements for QIs in Real Estate Transactions

Under both RTC section 18662 and California Code of Regulations, title 18 ("18 CCR"), section 18662-3, in the case of any disposition of a California real property interest by a transferor (seller), unless an exemption applies, the transferee (buyer), including for this purpose any intermediary or accommodator in a simultaneous or deferred like-kind exchange, is required to (1) withhold 3 1/3 percent of the sales price of the California real property conveyed, or (2) elect an alternative withholding calculation based on the gain required to be recognized from the sale. (Rev. & Tax. Code § 18662(e)(2)(A), (B) and Cal. Code Regs., tit. 18, § 18662-3(a).)³

Generally, an intermediary or accommodator will not be required to withhold if the intermediary or accommodator, in good faith and based on all the information of which they have knowledge, relies on the transferor's certification that the transfer will qualify as a simultaneous or deferred like-kind exchange within the meaning of IRC section 1031. (Rev. & Tax. Code § 18662(e)(3)(D)(ii); Cal. Code Regs., tit. § 18, 18662-3(d)(3)(A).) However, if the transferor receives proceeds (including excess debt relief) or non-like-kind property from the sale (boot) in excess of \$1,500, the intermediary or accommodator must either withhold at 3 1/3 percent of that amount, or elect an alternative withholding calculation. (Cal. Code Regs., tit. 18, § 18662-3(d)(3)(A)(1)-(2).)

Notwithstanding any transferor's certifications, if an exchange fails, does not occur, or does not meet the IRC section 1031 requirements, the intermediary or accommodator must either withhold at 3 1/3 percent of the sales price, or elect an alternative withholding calculation based on the gain required to be recognized from the sale. (Cal. Code Regs., tit. 18, § 18662-3(d)(3)(A)(3).)

III. Penalty for Failure to Withhold

Unless it is shown that the failure to withhold is due to reasonable cause, RTC section 18668(d) imposes a failure to withhold penalty whenever a person required to withhold fails to withhold any amount in connection with a real estate transaction. (Rev. & Tax. Code § 18668(d).) The failure to withhold penalty is the greater of \$500 or 10 percent of the amount that should have been withheld. (Rev. & Tax. Code § 18668(d).)

³ No withholding is required if the transferor certifies that it a corporation that has either qualified with the California Secretary of State or has a permanent place of business in California, and this includes a limited liability company ("LLC") taxable as a corporation or federal and California income tax purposes. (Cal. Code Regs., tit. 18, § 18662-3(d)(2)(E).) In addition, no withholding is required if the transferor certifies that it is a California partnership or a partnership qualified to do business in California (or an LLC that is classified as a partnership for federal and California income tax purposes) that is not disregarded for federal and California income tax purposes. (Cal. Code Regs., tit. 18, § 18662-3(d)(2)(G).) Moreover, an intermediary or an accommodator is required to withhold, irrespective of whether the real estate escrow person provided a written notice of the requirements to withhold under RTC section 18662(e). (Rev. & Tax. Code § 18662(e)(3)(B) and Cal. Code Regs., tit. 18, § 18662-3(d)(1)(C).)

IV. Application of the Failure to Withhold Penalty to the Transaction

With respect to the Transaction, a QI has a withholding obligation under RTC section 18662 and the regulations promulgated thereunder—specifically, 18 CCR section 18662-3(d)(3)(A)(3)—withholding is required when "the exchange fails, does not occur, or does not meet the IRC section 1031 requirements," and the transaction does not meet any other exemption from withholding. If a QI does not withhold, the QI is subject to a failure to withhold penalty under RTC section 18668(d) equal to the greater of \$500 or 10 percent of the amount that should have been withheld, unless it is shown that the failure to withhold was due to reasonable cause.

These penalties may be imposed beginning with attempted like-kind exchanges which are similar to the Transaction in which property is relinquished on or after March 24, 2020.

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