

# 'Shock and Awe' Tax Policy

**O**n Feb. 19, 2010, California Assemblyman Juan Arambula, from the 31st District in the Central Valley, introduced Assembly Bill 2640 to eliminate long-standing capital gain and loss nonrecognition provisions from the California Revenue and Taxation Code. These provisions now preclude gain and loss recognition from the exchange of cash or property for stock in a corporation, like-kind real property exchanges, exchanges of property between spouses, condemnation proceedings, exchange of insurance products, and other transactions. Commentators and lobbyists immediately attacked the bill as making California even more business un-friendly than they believe it now is.

Assemblyman Arambula's office views the bill as an icebreaker, the first step in a conversation to re-examine California's tax policy. Assemblyman Arambula believes that many of California's "tax expenditures" – the exclusions, deductions and credits that the Revenue and Taxation Code currently provides taxpayers – may need to be adjusted or even eliminated to comport with current business and fiscal realities. The bill's scope and impact on taxpayers is breathtaking. If the Assemblyman intends AB 2640 to begin the conversation, he certainly has the public's attention.

One blogger cried "[N]ot only will Assemblyman Arambula drive investors and businesses from the [s]tate, he will also trade a short-term benefit for a long-term, permanent cost." Another added, "We fear that this bill, if passed, will signal the death of many California businesses. This would mean lost jobs, lost tax revenues and an increase in the demand for costly state services (such as unemployment expenditures)."

What about this bill inspires such alarmism? How would this bill, if enacted, affect California business?

California tax law largely conforms to federal tax law. The general rule is that when a taxpayer converts property into cash or some other property, the taxpayer recognizes the gain or loss from that transaction. Congress long ago decided that certain property conversions simply continue the old property in new form. Congress concluded that recognition of the gain or loss on these types of conversions should be deferred until an actual "cashing in" occurs.

Sections 1031 through 1043 of the Internal Revenue Code enact this policy. AB 2640 would end the conformity of California tax law with these sections, thereby making each of these conversion transactions immediately taxable under California law.

Some of these transactions form the mainstay of business activity in California. Devastating would be the elimination of Section 1032 conformity. Internal Revenue Code Section 1032 provides that corporations recognize no income when they issue stock in exchange for cash or property. Stock is deemed to have a value equal to the cash or fair market value of the property the corporation receives for its stock. Since the corporation's stock has zero tax basis (that is, the corporation did not pay anything for its own stock), without Section 1032 the corporation would have income subject to California tax equal to the amount it received for its stock.

That is a heavy price for the privilege of raising capital in California. More effectively than almost anything else the Legislature could do, this tax change could indeed drive business activity from the state.

Several of the targeted changes would affect the California real estate industry. Internal Revenue Code Section 1031 provides for the deferral of gain or loss recognition for "like-kind exchanges" of real property until the exchanged-for property is ultimately sold. Investors frequently rely on Section 1031 to acquire new California property. Without its protections, the number of real estate transactions in California



could decline, with consequent impact on local economic activity.

Section 1033 currently provides for the nonrecognition of gain or loss when property is destroyed or taken by eminent domain if the taxpayer reinvests the amount received into replacement property before the conclusion of the next two taxable years. Eliminating California conformity would mean that businesses and homeowners would be taxed on the insurance proceeds they receive for their damaged property and the condemnation awards they receive for their condemned property. That means fewer dollars available for reinvestment, again diminishing California economic activity.

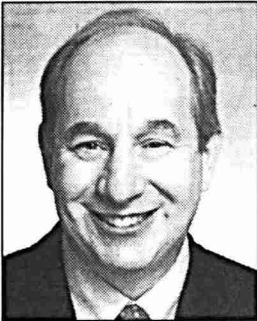
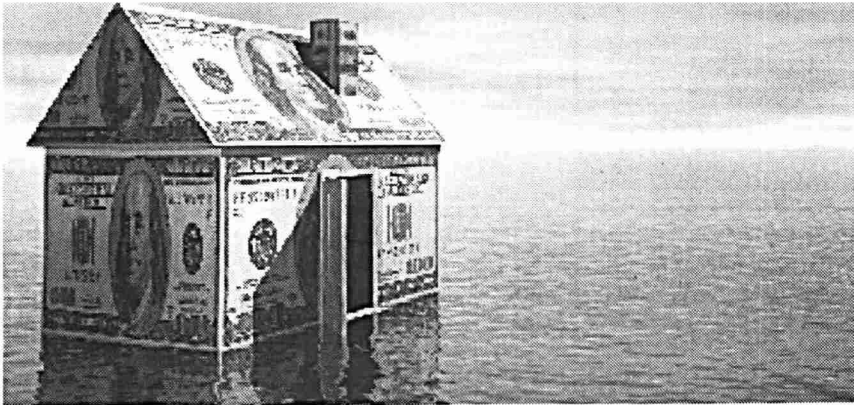
Other proposed changes that might affect the real estate industry involve repeal of conformity with Internal Revenue Code Sections 1038, 1040 and 1041. Section 1038 allows sellers to reacquire real property without gain or loss recognition when a buyer defaults on its purchase money obligation to the seller. Section 1040 affords non-recognition treatment to many estates and trusts that transfer farms and other real property to certain heirs. Section 1041 permits spouses to exchange property freely without recognizing gain or loss and permits former spouses to exchange property without recognition in connection with their divorce.

Some changes may affect individual California taxpayers' investment decisions. Internal Revenue Code Section 1035 provides for nonrecognition of gain or loss when taxpayers exchange certain life insurance policies or annuities for new policies or annuities. Section 1036 permits shareholders to exchange common stock for common stock, and preferred stock for preferred stock, in the same corporation without recognition of gain or loss. Section 1037 permits U.S. government debt holders to surrender those obligations in exchange for the issuance of new obligations without gain or loss recognition. Elimination of California conformity with these provisions would have less dramatic, but still palpable, effect.

The proposed repeal of Internal Revenue Code Section 1042 runs contrary to the established California policy of encouraging employee ownership of the companies they work for. Section 1042 allows companies to sell their stock to employee stock ownership plans (ESOPs) and workers cooperatives under certain circumstances without gain or loss recognition. Fewer companies might choose to create ESOPs for their employees if they faced paying California income tax on the sale of their stock.

Assemblyman Arambula's office believes AB 2640 would require only a majority vote for approval because it is "revenue neutral." The bill contains a sales tax exemption intended to help California's manufacturing industry. It seems, though, at least intuitively, that the amount of new revenue raised by the bill's repeal of conformity with the federal nonrecognition provisions would far exceed the revenue lost from a sales tax exemption. The state marginal income tax rate is higher than the state sales tax rate; and the transactions that would become subject to immediate tax likely exceed in amount the transactions exempted from sales tax. The newly taxable transactions also seem far more central to California's economy.

AB 2640 is currently scheduled for consideration by the Assembly Revenue and Taxation Committee on March 23, but that schedule may change. Assemblyman Arambula's office claims the Assemblyman is not wedded to any particular of these changes. He does want the Committee to consider whether California is incentivizing the right economic behaviors and whether such tax incentives are the right goals for today. Whether AB 2640 survives the Committee bears watching.



**ROBERT A. STEINBERG** is a business and tax attorney who mediates complex business cases through ADR Services, Inc. He can be reached at [bob@bobsteinberg.com](mailto:bob@bobsteinberg.com).