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This Week in State Tax (TWIST)

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California: Appellate Court Rejects Deferral of Gain on Involuntary Conversion

A California Court of Appeals ruled against a taxpayer in a dispute over nonrecognition of the gain from an involuntary conversion. The taxpayers were awarded $7.5 million in damages for grapevines that were destroyed by chemicals recommended by a crop advisor. They used the proceeds from the lawsuit to purchase approximately 40 acres of citrus trees. On their California individual returns, the taxpayers claimed protection under IRC 1033, which permits nonrecognition of gain when a taxpayer receives compensation for property that was destroyed, stolen, seized, condemned, or otherwise involuntarily converted so long as the compensation takes the form of, or is used to purchase property that is "similar or related in service or use." For individual income tax purposes, California adopts this provision by reference (Rev. & Tax Code § 18031). For corporate income tax purposes, California law is substantially similar rules to IRC 1033 (Rev. & Tax Code § 24943-44). The Franchise Tax Board rejected the taxpayers' nonrecognition claim, and the taxpayers ultimately appealed to Sacramento County Superior Court. The trial court judge dismissed the case, and the taxpayers again appealed.

Before the state Court of Appeals, the only issue was whether citrus orchards were "similar or related in service or use" to the destroyed grapevines. Under federal precedent from the 9th Circuit , the court was required to "look to the taxpayer's relationship to his [or her] old and new investments" and consider all the facts and circumstances. The court determined that the citrus orchards were *not* similar to the grapevines. In reaching this conclusion, the court identified grapevines as "improvements to land", while the citrus orchards included both improvements (the citrus trees) and the land itself. The additional purchase of land resulted in a fundamentally different investment. In particular, the court noted that even if the trees were destroyed, the taxpayers retain value from the investment in the form of potentially productive land; this would not be the case for an investment consisting entirely of grapevines.

While this case directly relates to the nonrecognition provision for the individual income tax, this understanding of the "similar or related in service or use" language is likely relevant for interpreting that same language found in the California corporate income tax code. Contact Candace Axline or Geoff Way with questions about *Skouti v. Franchise Tax Board*.