The California Claw Back Withholding Requirements: What Every 1031 Exchange Investor Should Know!

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When you own California real estate and decide to sell, the state has an extremely long memory. Even if you complete a 1031 exchange and move your investment to property located in another state, California still expects you to pay tax on the deferred gain when you eventually sell in the future. This withholding requirement has been nick-named the California Claw-Back, and it surprises many investors.

This article explains what the California Claw Back is, how it affects real estate investors who sell California real property and exchange into out-of-state real estate, and how the California Franchise Tax Board (FTB) Form 3840 keeps you compliant. You will also learn how a properly structured 1031 exchange defers the taxable gain, what responsibilities fall on you and your advisors, and the steps that protect you from costly penalties.

What Is the California Claw Back?

The California Claw back is the state's way of preserving its right to collect tax on deferred gain on the sale of California real property, even after that gain has been deferred through a 1031 exchange into property located outside of California.

Here is the core idea. When you sell California real estate and reinvest in replacement property located in another state through a 1031 tax-deferred exchange, you defer your federal and, in most cases, California tax on the taxable gain, including capital gain and depreciation recapture taxes. California allows the tax deferral, but the state does not forget or forgive the California-source taxable gain. When you later sell that out-of-state replacement property in a fully taxable transaction (i.e., not sold through another exchange), California "claws back" the deferred gain and taxes it as California-source income.

In short, the taxable gain that originated in the state of California remains taxable to California, no matter where your replacement property ends up being located. However, as long as you continue to structure tax-deferred exchange transactions and defer the payment of your capital gain and depreciation recapture taxes into the future, California will receive nothing. If you exchange and hold your properties until you pass, your heirs will generally receive a step-up in cost basis upon your death, owe no taxes, and California will get zero.

Quick example: You sell an apartment building in Los Angeles, California and complete a 1031 exchange into a replacement property located in Houston, Texas. Texas has no state income tax. Years later, you sell the Houston, Texas property without exchanging again. California will tax the original gain that was deferred from the sale of the Los Angeles property.

The takeaway: tax deferral is not tax forgiveness, tax avoidance or tax-free. California-source income follows your investment until a taxable sale triggers recognition of your gain, or you pass away and your heirs receive a step-up in cost basis.

How Does the Claw Back Apply to Out-of-State Property Owners

The clawback applies to any taxpayer, whether they are a California resident or a nonresident, who:

- Sells California real property;
- Defers their taxable gain through a 1031 tax-deferred exchange; and
- Acquires replacement property located outside the state of California.

Residents and nonresidents alike are often caught off guard by this claw back rule. You may live in Arizona, Texas, Nevada, or Florida, complete an exchange into property in your home state, and assume California has no further claim. California takes the position that it does. California asserts that the deferred gain remains California-source income because it originated from California real estate (at least until someone decides to challenge the rule as unconstitutional, and win the argument with the California FTB).

The Role of the California FTB Form 3840

The state of California enforces the claw-back provision through a required annual reporting requirement to the . FTB. CA FTB Form 3840, California Like-Kind Exchanges, is the tracking tool that keeps your deferred California-source gain on the state's radar. Taxpayers are required to file FTB Form 3840 each year after they have completed their like-kind exchange.

When You Must File California Form 3840

You must file the California FTB Form Number 3840 for the tax year in which you complete a 1031 exchange of California real property into one or more out-of-state replacement properties. After that initial filing, you must continue filing Form 3840 every year until one of the following happens:

- You sell or dispose of the replacement property in a taxable transaction and report the deferred gain to the California Franchise Tax Board;
- You complete another like-kind exchange and report the new replacement property on a fresh California FTB Form 3840; or
- You pass away and leave the property to your heirs.

Why Annual Filing Matters

The annual California FTB filing requirement is not optional. The filing tells California where your deferred gain lives and confirms you have not yet triggered recognition of the taxable gain. Skipping a filing in a year can cause real problems.

If you fail to file Form 3840, the FTB may estimate the tax due and issue a Notice of Proposed Assessment. That means California can move to collect the deferred gain before you ever sell the replacement property. Staying current with Form 3840 protects you from premature assessments and penalties.

Here's what to do next: Mark the annual Form 3840 filing on your calendar and your CPA's calendar every year until the deferred gain is finally recognized, deferred again, or passed on upon your death.

How a Properly Structured 1031 Exchange Defers Avoids the Claw Back

A 1031 exchange defers the payment of capital gain and depreciation recapture taxes on the sale of rental, investment or business-use real estate. When structured correctly, it defers both your federal and the California-source gain subject to the Claw Back.

The deferral continues indefinitely as long as you keep exchanging. Each subsequent like-kind exchange rolls the deferred gain forward. Many investors use this strategy across decades, deferring recognition until a future taxable sale, or until a step-up in basis occurs through estate planning (i.e., death of the taxpayer).

To qualify for deferral, your exchange must meet the core requirements of Section 1031:

- Qualified use property: Both the relinquished and replacement properties must be held as qualified use properties, meaning held for rental, investment or productive use in a trade or business.
- Like-kind property: The relinquished property and the replacement properties must be of like kind to each other, meaning real estate exchanged for other real property.
- 45-day identification: You must identify one or more potential replacement properties within 45 calendar days of selling your relinquished property. The exchange deadlines can't be extended for any reason.
- 180-day completion: You must acquire one or more replacement properties within 180 calendar days of the sale of your relinquished property.
- Qualified intermediary: You should use a best practices and regulated qualified intermediary to hold the exchange proceeds. You cannot take actual or constructive receipt of the funds.
- Equal or greater value: To fully defer your gain, reinvest all net proceeds and acquire property of equal or greater value and debt.

When these requirements are satisfied, California honors the deferral. The claw-back simply preserves the state's right to tax the gain later, while Form 3840 keeps the record open.

Responsibilities of the Exchanger and Their Advisors

A successful exchange and ongoing California Claw Back compliance depends on a coordinated team, including the investors' professional advisors. Each party has a defined and crucial role.

The Investor (Exchanger)

- Engage a qualified intermediary before closing on the sale of the relinquished property.
- Meet the strict 45-day and 180-day deadlines.
- File FTB Form 3840 every year until the deferred gain is recognized or until death.
- Keep accurate records of the original California gain and all subsequent exchanges.

CPAs and Tax Advisors

- Prepare and file Form 3840 annually with the exchangor's California return.
- Track the deferred California-source gain across multiple exchanges.
- Advise on the tax consequences of a future taxable sale that triggers the Claw Back.

Attorneys and Financial Planners

- Coordinate exchange documentation and contract language.
- Integrate the deferred gain into estate and succession planning, where a step-up in basis may affect the outcome.
- Discussion using a Delaware Statutory Trust (DST) as part of your identified replacement property ID notice.

The Qualified Intermediary

- Prepare the exchange documents and structure the transaction for compliance.
- Receive, hold, and safeguard the exchange proceeds through a qualified trust account.
- Work alongside your CPA, attorney, and financial planner to support a successful, compliant exchange.

The lesson here: Claw Back compliance is a long-term commitment that outlasts the closing table. Build your advisory team early and keep them coordinated.

Common Mistakes to Avoid

- Assuming California is "done" after the exchange has been wrapped up. California is not done. The deferred gain remains California-source income.
- Forgetting the annual Form 3840 filing. Missing a year invites a Notice of Proposed Assessment.

- Believing an out-of-state, no-tax state escapes the claw back. It does not avoid the claw-back provisions. Exchanging into Texas, Nevada, or Florida does not erase the California gain.
- Taking receipt of exchange proceeds. This disqualifies the entire exchange. Always use a best practice and regulated qualified intermediary.
- Missing the 45-day or 180-day deadlines. These are firm due dates. There are no extensions for missing them.

Why Work With Exeter 1031 Exchange Services, LLC

Navigating the California Claw Back requires a qualified intermediary with deep technical knowledge and a commitment to safeguarding your funds. Exeter 1031 Exchange Services, LLC (Exeter1031™) is one of the safest and most secure qualified intermediaries in the industry today, and one of the few that operates with genuine regulatory oversight.

Exeter1031™ chose to undergo a rigorous, multi-year regulatory review to approval process to obtain its own trust company charter. The result was Exeter Trust Company, which is licensed, regulated, and audited by the Wyoming Division of Banking. Your 1031 exchange funds are deposited, held, and safeguarded in separate, segregated, dual-signature, restricted qualified trust accounts, and protected by substantial fidelity bond, errors and omissions, cyber and wire fraud insurance coverage, and regulatory required minimum equity capital reserves.

Just as important, Exeter delivers consultative guidance. Our experienced exchange specialists will work directly with you and your CPA, attorney, and financial planner to structure a compliant exchange and to keep your California Claw Back obligations, including Form 3840, on track year after year.

Conclusion

The California Claw Back ensures that gain originating from California real estate stays taxable to California, even after a 1031 exchange into out-of-state property. The state tracks that deferred gain through annual FTB Form 3840 filings, and it expects compliance until a taxable sale finally triggers recognition.

A properly structured 1031 exchange lets you defer that gain legitimately, often for decades, while you build and reposition your real estate portfolio. The key is meeting every deadline, filing Form 3840 each year, and working with advisors who understand the rules.

Your next step: Contact the experienced exchange specialists at Exeter1031™ before you sell your California property. We will help you structure a compliant exchange and protect and safeguard your 1031 funds every step of the way.

Frequently Asked Questions

Does the California Claw Back apply even if I move to another state?

Yes. The claw back applies to residents and nonresidents alike. If the gain originated from California real estate, it remains California-source income regardless of where you live.

How long must I file FTB Form 3840?

You must file Form 3840 every year after your exchange until you recognize the deferred gain in a taxable sale or report new replacement property through another like-kind exchange or pass the property to your heirs after your death.

Can I avoid the claw back by exchanging into a no-income-tax state?

No. Exchanging into tax-free states such as Texas, Tennessee, Nevada, or Florida defers the gain, but California still claws back the original California-source gain when you sell in a taxable transaction.

What happens if I forget to file Form 3840?

The California Franchise Tax Board may issue a Notice of Proposed Assessment and estimate the tax due, potentially collecting the deferred gain before you sell the replacement property.

Can I defer the California gain indefinitely?

Yes, as long as you keep completing qualifying 1031 exchanges and file Form 3840 each year. Many investors defer recognition for decades through successive exchanges.