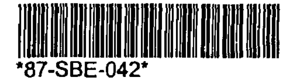

87-SBE-042

BEFORE THE STATE BOARD OF EQUALIZATION

OF TEE STATE OF CALIFORNIA

In the Matter of the Appeals of) AMYAS MD EVELYN P.) AMES, ET AI,.)	) Nos. 81A-561, 81A-566 8 1A-400, 8 1A-567 81A-562, 81A-568 81A-563, 81A-569 81A-564, 81A-570 81A-565, 81A-252-KP

Appearances:

For Appellant: Richard A. Keefe
Attorney at Law

For Respondent: B. (Bill) S. Heir
Counsel

O P I N I O N

These appeals are made pursuant to section 18593[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Amyas and Evelyn P. Ames, et al., against proposed assessments of additional personal income tax in the amounts and for the years as follows:'

1/ Unless otherwise specified, .all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

Appeals of Amyas and Evelyn P. Ames, et al.

Appellants	Years	Proposed Assessments
Amyas and Evelyn P. Ames	1974	$11,539.06
Edward L. and Merle Sleeper	1974	30,834.61
Estate of James R. Carter	1974	26,427.04
Frank Coggins, Jr.	1974	14,376.59*
Gerald R. Curtis	1974	5,344.82
Anne Coggins DeBorde	1974	15,453.60*
Charles H. and Margaret H. Dyson	1974	18,236.51
John S. and Kathe B. Dyson	1974	15,956.48
W. E. and M. C. Grace	1974	33,594.07
Sherlock Hibbs	1974	8,971.77
David M. and Perrin B. Lilly	1974	21,511.32
Abraham Hoffman	1973	26,479.49

*Includes penalty

There are two issues presented by these appeals: (1) whether the appellants' limited partnership interests had a business situs in California so as to subject the gains they realized on the sales of their interests to California taxation: and, (2) whether respondent correctly assessed 'failure to file upon notice and demand" penalties against two of the appellants. Since all of the listed appellants were limited partners in the same partnership and as the identical threshold question of law is present in these appeals, all of the appeals have been consolidated for purposes of opinion. In addition, all of the appellants were nonresidents of California at all times in question.

Prior to the years in question, each appellant purchased an interest in the Bunker Hill Redevelopment Company, a limited partnership formed under Missouri law. The partnership's principal business activity concerned real property located in Los Angeles. The general partners for the partnership were located in California and they filed all of the appropriate partnership documents with the appropriate state agencies, including filing partnership returns with respondent. During the operation of the partnership, no California taxes were due by any of the limited partners since any net rental income received by the partnership was offset by the accelerated depreciation taken against the real property.

The real estate project ran into severe financial difficulties at the end of 1973. In January 1974, the owner of the first trust deed foreclosed on the property. All of the appellants, with the exception of appellants Edward and Merle Sleeper, sold their partnership interests to the general partners just prior to the foreclosure. Each appellant, with the exception of the Sleepers, sold his or her interest for less than he or she originally paid for it. The gains involved in these appeals arise because of the reduction in the bases of appellants' respective partnership interests caused by the allocated partnership losses from the accelerated depreciation taken in the prior years. Mr. and Mrs. Sleeper maintained their ownership in the limited partnership until the partnership was dissolved. The Sleepers realized their gain upon dissolution of the limited partnership.

Upon review of the facts, respondent determined that, despite the fact that each limited partnership interest was an intangible interest, the limited partnership interests in question had developed a "business

situs" in California. Therefore, the interests in issue had become localized to this state, and the eventual sale of those interests lead to recognized gains that were subject to California's taxation. Respondent based the assessments in question upon this theory.

Sometime after 1974, respondent contacted each of the appellants and demanded that each limited partner file a return. Two of the appellants, Frank Coggins, Jr., and Anne Coggins DeBorde, failed to respond to respondent's notice and demand. Consequently, respondent assessed a penalty against those two individuals for the failure to file a return after notice and demand.

Appellants protested, contending that, since the gain that each partner realized was based on the sale of intangible personal property, the source of the gain was in each appellants' respective state of domicile under the doctrine of mobilia sequuntur personam. Further, the two appellants who had failed to file their returns after notice and demand requested that appellant withdraw its penalties as their failure to file was due to reasonable cause. After considering appellants' arguments, respondent affirmed its assessments with respect to both issues and this appeal followed.

Section 17041, subdivision (a), imposed a tax upon the entire taxable income of every nonresident which was derived from sources within this state. Section 17951 defines the gross income of a nonresident to be 'only the gross income from sources within this State." Section 17952 states that:

> Income of nonresident: from stocks, bonds, notes, or other intangible personal property is not income from sources within this State unless the property has acquired a business situs in this State, except that if a nonresident buys or sells such property in this State or places orders with with brokers in this State to buy or sell such property so regularly, systematically, and continuously as to constitute doing business in this State, the profit or gain derived from such activity is income from sources within this State irrespective of the situs of the property.

Respondent's pertinent regulation states that:

> Intangible personal property has a business situs in this State if it is **employed as capital in this State or the possession and control of the property has been localized in connection with a business.** trade or orofessron in this State so that its substantial use and value attach to and become an asset. of the business, trade or profession in this State. For example, if a nonresident pledges stocks, bonds, or other intangible personal property in California as security for the payment of indebtedness, taxes, etc., incurred in connection with a business in this State, the property has a business situs here ....
>
> If intangible personal property of a nonresident has acquired a business situs here, the entire income from the property including gains from the sale thereof, regardless of where the sale is consummated, is income from sources within this State, taxable to the nonresident. (Emphasis added.)

(Cal. Admin. Code, tit. 18, reg. 17952, subd. (c).)

This appeal revolves around the interpretation of the term "business situs" as it is used in section 17952 and respondent's regulation 17952, subdivision (c), supra. On appeal, appellants contend that the intangible did not acquire a business situs in California and that the gain realized was properly allocated to each taxpayer's domicile under the doctrine of mobilia sequuntur personam. In support of their position, appellants' point to the example given in regulation 17952, subdivision (c), wherein a nonresident pledges intangible personal property as security for a debt. Appellants contrast that example with their own situation where their sole contact with California is in the ownership of limited partnership shares of a partnership doing business in California. The rule of the business situs concept is succinctly revealed in the earlier cases.

> [I]ntangible property may acquire a situs for taxation other than at the domicil of the owner if it has become an integral part of some local business. [Citations.] Business situs arises from the act of the owner of the

> intangibles in employing the wealth represented thereby, as an integral portion of the bus'iness activity of the particular place, so that it becomes identified with the economic structure of that place .... (Emphasis added.)

(Holly Sugar Corp. v. Johnson, 18 Cal.2d 218, 223-224 [115 P.2d 8] (1941); see also Appeal of Robert and Patricia Neuschotz, Cal. St. Bd. of Equal., Mar. 25, 1968.)

In applying the above reasoning to the present situation, it is clear that the appellants made no attempt to localize their limited partnership interests to California. Rather than admitting that appellants' actions do not meet the Holly Sugar test, however, respondent attempts to salvage its assessments by redefining the term "business situs."

Respondent argues that the operation of the partnership itself ties each appellant's interest to California as a matter of course and, thus, California becomes the "business situs" of each limited partner's interest. As stated by respondent, the gain on the sale of the limited partnership interests is

> taxable by California because . . . a partner is considered engaged in the business of the partnership; second, that the activities engaged in by appellant, through its partnership, constituted conducting business in California; third, that the distributive shares of the partnership are allocated to the partners pursuant to their partnership interests; and fourth, that the partnership interests, being so integrally involved with the business being conducted, acquire a business situs where the partnership activity occurs.

(Resp. Br. at 4.)

In support of its position, respondent cites Arizona Tractor Company v. Arizona State Tax Commission, 115 Ariz. 602 [566 P.2d 1348] (1977), wherein an Arizona court of appeals found that a limited partner's interest acquired a business situs in a state other than that of the taxpayer's domicile by the very nature of that

interest. The court determined that operating losses suffered by a nonresident partnership were not deductible by a resident limited partner, focusing on the fact that the operating income (or loss) was a result of the partnership's business activities carried on outside the limited partner's home state. Respondent points out that the Arizona case was interpreting a statute and a regulation which have language almost identical to section 17952 and regulation 17952. Therefore, respondent concludes, the Arizona case is persuasive authority that this board should follow.

Rather than bolstering its reasoning, respondent's reliance upon Arizona Tractor points out the basic flaw in respondent's four-step analysis. We have no disagreement with the Arizona Tractor rationale that where an out-of-state partnership has produced an operating loss, an in-state resident may not deduct his distributive share of that loss on his California return (see, e.g., Appeal of Midway Homes, Cal. St. Bd. of Equal., Apr. 9, 1985; Appeal of Bay Alarm Company, Cal. St. Bd. of Equal., June 29, 1982: Appeal of H. F. Ahmanson & Company, Cal. St. Bd. of Equal., Apr. 5, 1965), but that is not the issue presently before us. These appeals are concerned with the gain realized by limited partners through the sale of their ownership interests in a partnership. The gain was not a result of partnership operations, but as a result of the sale of an intangible. (See Appeal of Holiday Inns, Inc., Cal. St. Bd. of Equal., Apr. 9, 1986; see also Appeal of Robert and Patricia Neuschotz, supra.) Therefore, the gains in question would only be taxable in California if we found that the intangible had a business situs in this state under the Holly Sugar rule. As stated above, appellants made no attempt to employ the wealth represented by their limited partnership interests so as to integrate that interest into the business activities of California. (Holly Sugar Corp. v. Johnson, supra.) Consequently, we find that the intangibles did not acquire a business situs in California and that the situs of each appellant's interest was his or her respective domicile under the rule of mobilia sequuntur personam. California, therefore, had no jurisdiction to tax those gains since none of the appellants were California residents.

The same result is reached in the case of Mr. and Mrs. Sleeper. A dissolution of a partnership and a distribution of assets to a partner is considered a sale or exchange of a partnership interest. (Rev. & Tax.

Code, S 17891.) As the distribution involved the sale or exchange of a nonresident's intangible, the gain realized on the sale or exchange is not income from sources within this state under the mobilia rule. (Rev. & Tax. Code, $ 17952.)

As a result of the above determination, we need not consider whether the failure-to-file penalties imposed upon appellants Coggins and DeBorde were due to reasonable cause. As no tax was due from either party at any time, there is no amount of tax upon which a penalty may be assessed. (Rev. & Tax. Code, S 18683.)

For the above-stated reasons, respondent's actions in these matters must be reversed in their entirety.

Appeals of Amyas and Evelyn P. Ames, et al.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the actions of the Franchise Tax Board on the protests of Amyas and Evelyn P. Ames, et al., against proposed assessments of additional personal income tax in the-amounts and for the years, as follows:

Appellants	Years	Proposed Assessments
Amyas and Bvelyn P. Ames	1974	$11,539.06
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Sherlock Hibbs	1974	8,971.77
David M. and Perrin B. Lilly	1974	21,511.32
Abraham Hoffman	1973	26,479.49

*Includes penalty

be and the same are hereby reversed.

Done at Sacramento, California, this 17thday Of June , 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis , Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett , Member

Paul Carpenter , Member

Anne Baker* , Member

*For Gray Davis, per Government Code section 7.9