OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. BUEHLER (DEC'D) AND D. BUEHLER**	OTA Case No. 21067960

OPINION

Representing the Parties:

For Appellants: Eric M. Anderson, Representative
Michael D. Vigil, Representative

For Respondent: David Hunter, Tax Counsel IV[1]

For Office of Tax Appeals: Andrew Jacobson, Tax Counsel III

E. LAM, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Buehler (appellant-husband) and D. Buehler (collectively, appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $391,032, and applicable interest, for the 2015 tax year.

Appellants waived the right to an oral hearing; therefore, the Office of Tax Appeals (OTA) decides this matter based on the written record.

ISSUE

Whether appellants have shown error in FTB's denial of the other state tax credit (OSTC) for income taxes paid to Massachusetts on the net gain from the sale of a limited liability company (LLC) membership interest.

[1] Veronica I. Long was a representative for the Franchise Tax Board (FTB) in this appeal, but she is no longer employed with FTB. Although she is currently employed with the Office of Tax Appeals (OTA) as an Administrative Law Judge, she has had no involvement with this appeal while at OTA.

FACTUAL FINDINGS

1. EIF Management, LLC (EIF), a Delaware LLC, provided portfolio management services for pooled investment vehicles in the energy sector. EIF was classified as a partnership for federal and California income tax purposes. The record indicates EIF had offices located in California, Massachusetts, and New York.
2. Appellant-husband was one of EIF's three managing members and was actively involved in its management and operations. During the relevant time at issue in this appeal, appellant-husband owned a 23.123 percent membership interest in EIF.[2]
3. On or about October 30, 2014, Ares Holdings L.P. (Ares), a third party, entered into a Membership Interest Purchase Agreement (Purchase Agreement) with EIF and EIM Partners LLC, in its capacity as the representative for EIF's members, to purchase all issued and outstanding LLC membership interests in EIF. The Purchase Agreement indicates appellant-husband was one of the sellers of EIF.
4. Section 2.9(a) of the Purchase Agreement provides, in relevant part, that the sale of the membership interests in EIF is intended to be treated for U.S. federal income tax purposes "from the perspective of each Seller as a sale of a portion of that Seller's Membership Interests for cash in a taxable exchange governed by Section 741 of the [Internal Revenue Code (IRC)] and as a contribution of a portion of that Seller's Membership Interests to the Buyer in exchange for Ares Holdings Units in a non-recognition exchange governed by [IRC] [s]ection 721 . . . ." The Purchase Agreement further provides that "[t]he parties agree that, as a result of the [t]ransaction, EIF shall terminate for U.S. federal income tax purposes under [IRC] [s]ection 708(b)(1)(A) ....."[3]
5. Appellant-husband signed the Purchase Agreement in his capacity as one of EIF's three managing partners.

[2] Since EIF is classified as a partnership for federal and California income tax purposes, this Opinion uses the terms "membership interest" and "partnership interest" interchangeably.

[3] IRC section 741 provides that "[i]n the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in [IRC] section 751 (relating to unrealized receivables and inventory items)." Therefore, under IRC section 741, the partner or member is generally viewed as selling a partnership interest in the partnership, not the underlying assets of the partnership. For personal income tax purposes, California generally conforms to IRC section 741 under R&TC section 17851.

6. On or about January 2, 2015, Ares purchased 100 percent of the outstanding equity interests in EIF. Since appellant-husband sold his membership interest in EIF, appellant-husband recognized a long-term capital gain of $15,192,828 for income tax purposes for the 2015 tax year.
7. Appellants filed a 2015 Massachusetts nonresident tax return.[4] They apportioned 50 percent of the net gain from the sale of appellant-husband's EIF membership interest, or $7,596,414, to Massachusetts.[5]
8. Appellants filed a 2015 California Resident Income Tax Return. On that return, they claimed an OSTC for income taxes paid to Massachusetts of $391,032, which related to the gain on the sale of appellant-husband's membership interest in EIF.
9. FTB issued a Notice of Proposed Assessment (NPA), denying appellants' claimed OSTC of $391,032 and proposed additional tax in the same amount, plus applicable interest.
10. Appellants protested the NPA, but FTB issued a Notice of Action affirming its NPA.
11. This timely appeal followed.

DISCUSSION

Burden of Proof

Tax credits are a matter of legislative grace, and taxpayers bear the burden of proving they are entitled to claimed tax credits. (*Appeals of Swat-Fame, Inc., et al.*, 2020-OTA-046P.) Statutes granting tax credits are to be construed strictly against the taxpayers with any doubts resolved in FTB's favor. (*Ibid*.) Unsupported assertions are not sufficient to satisfy the taxpayers' burden of proof. (*Appeal of Morosky*, 2019-OTA-312P (*Morosky*).) In the absence of credible, competent, and relevant evidence showing error in FTB's determination, FTB's determination must be upheld. (*Ibid*.)

California's Personal Income Tax Law and the OSTC

In accordance with R&TC section 17041(a), the entire income of California residents is subject to taxation by California, regardless of the source. (*Morosky*, *supra*.) If California

[4] Appellants' 2015 Massachusetts nonresident tax return was not provided on appeal.

[5] Appellants assert that they computed this apportioned amount based on EIF's average Massachusetts apportionment percentage for the 2005 through 2014 tax years. To make this determination, it appears they applied Massachusetts law under 830 CMR 62.5A.1(3)(c)(8.2).

residents also earn income in states where they are nonresidents, those nonresident states can (and often do) tax California residents on income sourced to those states under those states' tax laws. Therefore, to avoid double taxation, R&TC section 18001 provides some relief in the form of a credit against the California's resident tax for income taxes imposed by and paid to the nonresident state, provided that certain conditions are met. (See *Christman v. Franchise Tax Bd.* (1976) 64 Cal.App.3d 751, 758 (*Christman*).)

As relevant to this appeal, R&TC section 18001(a)(1) provides that the OSTC shall be allowed only for net income taxes paid to the other state on "income derived from sources within that state." For purposes of that section, "income derived from sources within that state" shall be determined by applying California's nonresident sourcing rules for determining income from sources within California, commencing with R&TC section 17951 et seq., as well as the regulations thereunder. (R&TC, § 18001(c).) Stated differently, in order for a California resident taxpayer to be entitled to the OSTC, income taxes paid to the nonresident state (here, Massachusetts) must be based on income sourced to that nonresident state using *California's* nonresident sourcing rules. (R&TC, § 18001(a)(1), (c).)

There are two relevant nonresident sourcing provisions for purposes of resolving the issue here. R&TC section 17952 provides that nonresident income from intangible personal property is not income from sources within California, unless the property has acquired a business situs in this state. (See also Cal. Code Regs., tit. 18, § 17952.) California Code of Regulations, title 18, (Regulation) section 17951-4(d) provides rules when "a nonresident is a partner in a partnership which carries on a unitary business, trade or profession within and without this state." To determine a nonresident partner's California source income, Regulation section 17951-4(d) essentially requires the nonresident partner's distributive share of a multistate partnership's business income to be apportioned by formula using the partnership's apportionment factors. (See *The 2009 Metropoulos Family Trust, et al. v. Franchise Tax Bd.* (2022) 79 Cal.App.5th 245, 266.)

Appellants contend that they are entitled to the OSTC for income taxes paid to Massachusetts because the gain at issue has a source in Massachusetts using California's nonresident sourcing rules. Specifically, they argue (1) appellant-husband's membership interest in EIF acquired a business situs in Massachusetts under R&TC section 17952, or (2) in the alternative, appellant-husband and EIF constituted a unitary business and therefore the gain

should be considered business income and apportioned to Massachusetts using EIF's apportionment factors under Regulation section 17951-4(d).

FTB counters that appellant-husband's sale of his interest in EIF is the sale of intangible personal property and the resulting gain should be sourced, under California's nonresident sourcing rules, to appellant-husband's California residence under R&TC section 17952. FTB asserts that appellant-husband's membership interest in EIF did not acquire a business situs in Massachusetts. FTB also argues that Regulation section 17951-4(d) does not apply to appellants because the gain in question was derived by appellant-husband himself and is not business income earned by EIF and passed through to appellant-husband as a distributive share. For reasons discussed below, OTA finds in favor of FTB.

Appellant-Husband's Membership Interest in EIF Did Not Acquire a Business Situs in Massachusetts

R&TC section 17952 provides that "income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within [California] unless the property has acquired a business situs in [California] . . . ." Regulation section 17952(c) provides that intangible personal property has a business situs in California if (1) it is employed as capital in California, or (2) the possession and control of the property has been localized in connection with a business, trade, or profession in California so that its substantial use and value attach to and become an asset of the business, trade, or profession in California. Regulation section 17952(c) provides the following 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 [California], the property has a business situs [in California]. Again, if a nonresident maintains a branch office [in California] and a bank account on which the agent in charge of the branch office may draw for the payment of expenses in connection with the activities in [California], the bank account has a business situs [in California].

Regulation section 17952(c) then provides that "[i]f intangible personal property of a nonresident has acquired a business situs [in California], the entire income from the property including gains from the sale thereof, regardless of where the sale is consummated, is income from sources within [California], taxable to the nonresident."

Appellants do not contend, and the evidence in the record does not reveal, that appellant-husband's membership interest was employed as capital in Massachusetts. Therefore, the issue is whether appellants have demonstrated that appellant-husband's membership interest has been localized in connection with a business, trade, or profession in Massachusetts such that its substantial use and value attach to and become an asset of a business, trade, or profession in Massachusetts. (Cal. Code Regs., tit. 18, § 17952(c); see *Appeals of Ames, et al*. (87-SBE-042) 1987 WL 50165 (*Ames*); see also *Appeal of Neuschotz* (68-SBE-017) 1968 WL 1646 (*Neuschotz*).)

In *Ames*, California nonresident taxpayers sold their limited partnership interests in a limited partnership to the general partners, which resulted in the recognition of gain. (*Ames*, *supra*.) The nonresident taxpayers contended 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 [taxpayers'] respective state of domicile" under the doctrine of *mobilia sequuntur personam*, which means moveables follow the law of the person. (*Ibid*.) FTB disagreed, arguing that under R&TC section 17952 and Regulation section 17952, "the operation of the partnership itself ties each [taxpayer's] interest to California as a matter of course and, thus, California becomes the 'business situs' of each limited partner's interest." (*Ibid*.) However, OTA's predecessor, the Board of Equalization (BOE), held in favor of the nonresident taxpayers and concluded that the sale of their limited partnership interest was a sale of intangible property that should not be sourced to California, but rather sourced to their respective state of domicile under the *mobilia* doctrine. (*Ibid*.) BOE reasoned that the gain did not result from partnership operations, but from the limited partners' sale of their partnership interests, which are intangible personal property. (*Ibid*.) Therefore, in BOE's view, the intangible property would only acquire a business situs in California if the taxpayers had "attempt[ed] to employ the wealth represented by their limited partnership interests so as to integrate that interest into the business activities of California," which BOE found did not occur. (*Ibid*.)

In *Neuschotz*, California resident taxpayers owned one-third interests in various parcels of real estate located entirely in New York and some of these parcels were operated in a corporation in which they owned shares. (*Neuschotz*, *supra*.) The corporation was managed by taxpayers' brother who was a New York resident and it maintained a common bank account for business purposes in New York. (*Ibid*.) The taxpayers claimed an OSTC on their California resident tax return for income taxes paid to New York; however, FTB denied the OSTC on the

ground that the stock, from which the taxpayers received income in the form of corporate distributions, did not acquire a business situs in New York. (*Ibid*.) The taxpayers asserted that their shares of stock in the corporation acquired a New York situs because such shares "were integral parts of the entire real estate operation and were simply instrumentalities through which a part of the entire business was conducted" in New York. (*Ibid*.) However, BOE rejected the taxpayers' contention and concluded that their stock itself did not acquire a business situs in New York:

> The concept of business situs involves localization of the intangible property itself in the business situs state as an asset of a business there. In the instant case there is no evidence of localization of [the taxpayers'] stock in New York. The certificates were in the possession of [the taxpayers] in California. The stock was not used in connection with the [taxpayers'] other New York business interests. The fact that [the taxpayers] owned similar interests in New York and that all these interests were managed as one enterprise does not demonstrate localization of the intangible property in that state. Nor does the management of the corporations by a New York resident satisfy this requirement. The intangible shares of stock are the relevant property here, not the corporations and their assets.

(*Ibid*.) Therefore, BOE concluded that the situs of the taxpayers' stock remained in the taxpayers' state of residence (i.e., California) since the intangible property itself (i.e., the stock) was not localized in New York under California's nonresident sourcing rules.

Further, in *Appeal of Withers* (66-SBE-052) 1966 WL 1393 (*Withers*), a California resident taxpayer owned stock in a Minnesota corporation whose principal business was publishing a newspaper in Minnesota. (*Withers*, *supra*.) He also served as a director of the corporation and was employed as its vice president. (*Ibid*.) The taxpayer paid taxes on dividend income from the corporation to Minnesota, which treated the corporation as a partnership for income tax purposes, and claimed an OSTC on his California resident tax return, which FTB denied. (*Ibid*.) The taxpayer contended, in part, that the stock had acquired a business situs in Minnesota due to his employment as vice president and director of the corporation. (*Ibid*.) However, BOE rejected the taxpayer's argument and concluded that:

> [BOE] ha[s] not been referred to any case nor has [BOE's] research disclosed any in which stock has been held to acquire a business situs by virtue of the shareholder's employment by the issuing corporation. While employment is sufficient to connect a stockholder with a corporation's business, it does not follow from this that his stock is localized at the place of the business activity. A

> review of the entire record does not reveal that [the taxpayer's] stock was utilized in the business activity carried on by the [Minnesota corporation].

(*Ibid*.) As a result, BOE found that the dividends were not Minnesota source income under California's nonresident sourcing rules and the OSTC was disallowed.

Appellants assert that because appellant-husband performed services for EIF and actively participated in its daily operations, his membership interest in EIF acquired a business situs in Massachusetts. Appellants contend that appellant-husband spent a substantial amount of time in Massachusetts to operate EIF, as well as to network and maintain relationships. They assert that appellant-husband has personal ties to Massachusetts, where he maintained connections as a Boston College alumnus, he made many significant charitable contributions to the school, and he has a son who lived on the east coast. Appellants further contend that appellant-husband, in his role as one of EIF's three managing members, generated goodwill for EIF by providing investment management services and establishing and implementing partnership policies at its Massachusetts office. Therefore, appellants argue, the combination of these facts inextricably links appellant-husband's membership interest in EIF with EIF's activities in Massachusetts "such that the gain from the sale of his [membership] interest should be partially sourced to [Massachusetts] under California income tax law."

However, appellants have not established that the possession and control of appellant-husband's membership interest in EIF "has been localized in connection with a business, trade, or profession in [Massachusetts] so that its substantial use and value attach to and become an asset of the business, trade or profession in [Massachusetts]." (Cal. Code Regs., tit. 18, § 17952(c).) Appellants assert, without evidence, that appellant-husband's membership interest is somehow inextricably linked with EIF's activities in Massachusetts because he was one of EIF's three managing partners who actively participated in the daily operations of EIF's Massachusetts office and generated goodwill in that state for EIF. Unsupported assertions cannot satisfy a taxpayer's burden of proof. (*Morosky*, *supra*.) There is no evidence to support appellants' assertions that appellant-husband actively participated in EIF's Massachusetts business operations or that he generated goodwill for EIF in Massachusetts.

But even if these assertions were true, nothing in the record reveals that appellant-husband's membership interest *itself* was integrated into the business activities of EIF in Massachusetts. (See *Ames*, *supra*; see also *Neuschotz*, *supra*.) While appellant-husband's services for EIF as one of its three managing partners may connect him with EIF's Massachusetts business

activities, that fact alone does not show that appellant-husband's membership interest was localized in Massachusetts. (See *Withers*, *supra*.) For example, there is no evidence to indicate that appellant-husband's membership interest in EIF was pledged "as security for the payment of indebtedness, taxes, etc., incurred in connection with [EIF's] business in [Massachusetts]," or that appellant-husband's membership interest was used "in connection with [EIF's] activities in [Massachusetts]." (Cal. Code Regs., tit. 18, § 17952(c).) Therefore, appellants have not met their burden to show that appellant-husband's membership interest in EIF acquired a business situs in Massachusetts under R&TC section 17952 and Regulation section 17952(c).

Appellant-Husband and EIF Are Not Unitary and Therefore Regulation Section 17951-4(d) Does Not Apply

Appellants alternatively argue that appellant-husband's active involvement with EIF caused appellant-husband as an individual to become unitary with EIF's business such that his own activities, including the sale of his greater-than-20-percent membership interest in EIF, and the activities of EIF should be combined and apportioned as one business. (See Cal. Code Regs., tit. 18, § 17951-4(d)(6).) It appears that appellants are essentially arguing that appellant-husband's gain from the sale of his membership interest in EIF should be sourced to Massachusetts using California's rules for sourcing a nonresident partner's distributive share of income under Regulation section 17951-4(d). Therefore, appellants appear to contend that the gain should be apportioned (and have a source) in Massachusetts using EIF's apportionment percentage computed under California's nonresident sourcing rules.

Appellants assert that appellant-husband operated a "unitary business" like the taxpayer in *Appeal of Bindley*, 2019-OTA-179P (*Bindley*).[6] They claim that appellant-husband's involvement as one of EIF's three managing members was so inextricably linked with EIF's operations in Massachusetts that such involvement created a single unitary business with EIF. In *Bindley*, OTA found that a nonresident sole proprietor, who wrote screenplays as an independent contractor for unrelated California companies, was carrying on a unitary business within and without California. (*Ibid*.) Therefore, OTA concluded that Regulation 17951-4(c) applied to

[6] A "unitary business" can be defined for purposes of Regulation section 17951-4 as a business, trade, or profession conducted both within and without the state, where the part conducted within the state and the part conducted without the state are not so separate and distinct from and unconnected to each other to be separate businesses, trades or professions. (*Bindley*, *supra*.)

determine the sole proprietor's California source income, which meant California's formula apportionment rules under its version of the Uniform Division of Income for Tax Purposes Act (R&TC, § 25120 et seq.) should be used to make that determination. (*Ibid*.) There was no dispute that the taxpayer was self-employed and reported his sole proprietorship's business income on federal Schedule C. OTA determined that the taxpayer performed a one-service business controlled and managed by him as "one interrelated and interdependent business employing and consuming the same resources." (*Ibid*.) Therefore, since the taxpayer's sole proprietorship engaged in a single unitary business within and without California, OTA concluded his California source income must be determined by applying an apportionment formula. (*Ibid*.)

However, unlike the taxpayer in *Bindley*, appellants have not established that appellant-husband was operating a sole proprietorship or any kind of business activity that could be considered unitary with EIF. The record only supports that appellant-husband directly held his membership interest in EIF. Therefore, OTA finds that appellants have not established that appellant-husband himself was conducting a unitary business with EIF and therefore Regulation section 17951-4(d) is inapplicable to the facts here.[7]

In short, while it may be true that FTB's denial of the OSTC to appellants will result in the income at issue being double taxed, R&TC section 18001 is not "a panacea for all double taxation." (*Christman*, *supra*, 64 Cal.App.3d at p. 758.) "Rather, [R&TC] section 18001 is narrowly drawn, applying only to cases which include the required elements, and the goal of limited protection against double taxation cannot be used to invoke the provision where California law establishes a California situs for the source of the income." (*Ibid*.) Therefore, FTB properly denied appellants' OSTC.

[7] OTA requested additional briefing from the parties to determine whether FTB Legal Ruling 2022-02 applied to the facts of this appeal. Appellants indicated that ruling was inapplicable because EIF did not have unrealized receivables or inventory within the meaning of IRC section 751(a). Therefore, OTA does not address this ruling further.

HOLDING

Appellants have not shown error in FTB's denial of the OSTC for income taxes paid to Massachusetts on the net gain from the sale of an LLC membership interest.

DISPOSITION

FTB's action is sustained.

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Eddy Y.H. Lam
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Eddy Y.H. Lam
Administrative Law Judge

We concur:

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

DocuSigned by:
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Teresa A. Stanley
Administrative Law Judge

Date Issued: 2/28/2023