BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:)
)
J. BURCH) OTA NO. 230112266
J. CARDEN and K. CARDEN,) OTA NO. 230112267
)
Appellants.)
)

CERTIFIED COPY

TRANSCRIPT OF PROCEEDINGS

Cerritos, California

Tuesday, June 16, 2026

Reported by:

SHELBY K. MAASKE
Hearing Reporter

Job No.:
63124 OTA(A)

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TRANSCRIPT OF PROCEEDINGS, taken at 12900 Park Plaza Drive, Suite 300, Cerritos, California, commencing at 9:03 a.m. and concluding at 11:50 a.m. on Tuesday, June 16, 2026, reported by Shelby K. Maaske, Hearing Reporter.

APPEARANCES:

Panel Lead:	ALJ KENNETH GAST
Panel Members:	ALJ HUY "MIKE" LE ALJ HANS FAMULARO
For the Appellant:	CHRISTOPHER CAMPBELL DAVID HAN
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD ELLEN SWAIN LEAH THYBERG

I N D E X

E X H I B I T S

(Appellant's Exhibits 1 through 6 were received into evidence at page 6)

(Department's Exhibits A through E were received into evidence at page 7)

PRESENTATION

Cerritos, California; Tuesday, June 16, 2026

9:03 a.m.

ADMINISTRATIVE LAW JUDGE GAST: On the record. This is the consolidated appeals of Burch and Carden, OTA Case Nos. 230112266 and 230112267. Today is Tuesday, June 16, 2029, and the time is 9:03 a.m. This hearing is being held in Cerritos, California, with the agreement of all the parties.

My name is Kenneth Gast, and I'm the lead administrative law judge for this appeal. With me today are Administrative Law Judges Mike Le and Hans Famularo.

Can the parties please identify yourself by stating your full name, first and last, for the record, beginning with Appellants.

MR. CAMPBELL: Chris Campbell, Deloitte Tax, for Appellants.

MR. HAN: David Han, Deloitte Tax for Appellants.

MS. SWAIN: Good morning. Ellen Swain for the Franchise Tax Board.

MS. THYBERG: Leah Thyberg for the Franchise Tax Board.

ADMINISTRATIVE LAW JUDGE GAST: Thank you. So the sole issue for today's case is whether Appellants generated California source income from the sales of partnership interest that included amounts and charitable to unrealized receivables and inventory items under Internal Revenue Code Section 751(a).

All right. Going to the exhibits. I know we have had some correspondence related to that recently. So with respect to the evidentiary record, Appellants have provided Exhibits 1 through 6. FTB did not object to admissibility of Exhibits 1 through 5.

However, FTB -- and correct me if I'm wrong, Ms. Swain -- did partially object to the admissibility of Exhibit 6, related to an e-mail dated May 24, 2019, from Mr. Campbell to FTB's Mr. Christopher Casselman.

I'm going to overrule that objection and that will come in. Exhibit 6 does contain facts relevant to the background of this case, even though it is solely a legal issue. So, therefore, these exhibits are entered into the record. So Exhibits 1 through 6 are entered into the record. But I note that Exhibit 5 is a tax article, that will be considered only for purposes of legal argument.

(Appellant's Exhibits 1 through 6 were received.)

ADMINISTRATIVE LAW JUDGE GAST: FTB provided Exhibits A through E -- letters A through E. Exhibits E and F were submitted untimely and after the June 4, 2026 deadline of the Minutes and Orders, but they were submitted in response to Appellants' Exhibit 6. I will admit Exhibits E and F as well into evidence since they are FTB declarations from the auditor and protest officer on this case that respond to Appellants' Exhibit 6.

Appellants have not objected to the admissibility of any of these exhibits, and they have also waived their right to provide written questions for the Declarants, under OTA's Regulation 3214(b)(1) and (3).

So all of FTB's exhibits are entered into the record, but I will note as I did with Appellants' exhibits, that Exhibits A through D are various legal authorities and are considered solely for the purposes of legal argument.

(Department's Exhibits A through F were received.)

ADMINISTRATIVE LAW JUDGE GAST: Any questions there? I know I went kind of quickly.

MS. SWAIN: No, Judge. Thank you

ADMINISTRATIVE LAW JUDGE GAST: Okay. All right. With that, I am going to turn it over to Appellants for their presentation. I know you requested 90 minutes, so whenever you are ready, please begin.

MR. CAMPBELL: Thank you, Judge Gast.

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OPENING STATEMENT

MR. CAMPBELL: Okay. As you mentioned, this case involves a legal issue. The facts are not in dispute. The legal issue is, is a selling partner's 751(a), ordinary income, a distributive share of partnership income from a deemed sale by the partnership of Section 751(a) property.

The answer to that question is clearly no. We phrase the issue this way because the FTB's entire determination in this case hinges on its reading of Section 751(a) as providing for a deemed sale of property by the partnership. And according to the FTB, this deemed sale generates income at the partnership level and, therefore, distributive share of partnership income to the selling partners.

The FTB has created a false premise. There is no deemed sale or distributive share here. And I'm going to go slowly because I know -- I will try to help the reporter, but if I go too fast, just let me know.

THE COURT REPORTER: Thank you. I will.

MR. CAMPBELL: On the screen we have Regulation 17951-4(d). This is the starting point for Franchise Tax Board and for refuting the FTB's protest determination, which is also the conclusion in FTB's legal ruling, 2022-02.

This is the regulation the FTB is relying on to treat the non-resident selling partners, Section 751(a), ordinary income, as a distributive share of the underlying partnership's business income.

A selling partner, Section 751(a), ordinary income, however, is not a distributive share of partnership income, as a result, this regulation does not apply. The right answer in this case, and the answer that has governed every sale of a partnership interest prior to the issuance of the FTB's legal ruling for decades, is that the entire gain from the sale of a partnership interest, both the capital gain and the ordinary income, is income from the sale of intangible personal property that indicates that an individual partner is properly sourced pursuant to Section 17952.

The FTB's determination in this case is wrong and must be reversed. The legal ruling is wrong for the same reasons. There's no shortage of instances by the State Board of Equalization, the OTA, and California courts declining to apply or even invalidate FTB's legal rulings and TAMs when they are contrary to established law. That is what needs to happen here.

In order to demonstrate the FTB's position on the law is wrong, we are going to start with some basic concepts of Subchapter K, though we realize that everyone on the panel is a real expert in subject protection. David will do that in a minute. Then we will discuss the plain language of Section 751 and applicable Treasury regulations, and then show that FTB is misreading these provisions.

And at this point, I want to say that the tax terminology is very important. When a tax agency makes a determination against a taxpayer or issues a ruling of general application on a highly-technical legal issue like Subchapter K, as it apples to a common, everyday transaction, sale of a partnership interest in this case, you would expect the agency to use correct tax terminology. That's the point of going through the concepts on the next couple slides.

We will also explain -- you don't have to take our word for any of this. The DC Circuit Court of Appeals rejected all of the arguments that are being made by the FTB for exactly the same reasons that we have been submitting to the FTB since February of 2018, six years before the Rawat case was even decided.

While there's absolutely no doubt that the FTB's determination in this case and legal ruling is wrong as a matter of law, there's also no doubt that the FTB's position regarding Section 751(a) is new and novel and first released to the public on July 14, 2022, 10 years after the tax years in this case. This position was not the law in 2012 and 2013, and certainly cannot apply to Appellants in this case, as Appellants have maintained with the FTB since 2018.

During the audit the proper avenue for the FTB to seek a change in the law would be to approach legislature. The legislature could enact a special sourcing rule for Section 751(a), ordinary income. It did something similar for guaranteed payments in Section 17854.

There are a lot of consequences the FTB has not thought through, and all of those things could be considered in a public rulemaking process, that would be the appropriate forum for considering whether a rule like this should be adopted in the first place.

For all these reasons, the OTA should rule in favor of Appellants. And at this point, I will turn it over to Mr. Han.

MR. HAN: Thank you, Chris.

MR. CAMPBELL: Sorry. To close the opening, so to speak, we have 17951-4(d) on the monitor, because this is the provision the FTB says it's relying on. This provision applies to source distributive share income of a partnership, and we said that the legal ruling creates a false premise because the legal ruling concludes, as we will go through during our presentation, that 751(a), ordinary income, is a distributive share of income from the partnership, which is what we have -- we are taxed on that.

So the point to start with is that everything that we are about to go through is going to show that 751(a), ordinary income, is not a distributive share partnership income. There is no partnership-level income, so this reg can't apply and this reg must apply for the FTB's position to be correct.

MR. HAN: Thank you, Chris.

So we will start with some very basic concepts, taxation of partnership-level income under Subchapter K of Internal Revenue Code.

again, we understand that everyone on the panel may be familiar with the concept of distributive share income, but these basic concepts are critical to this case, and because the FTB's legal ruling and briefs at certain times do not use the correct tax terminology and this caused confusion to the reader or the listener.

So on this slide we have A very simple example. The partnership with two partners, and to line it up with the facts of this case, the partnership would be Tory Burch LLC. Assume it has $100.00 from operations, and this would be partnership-level income.

This partnership would report its income on a

1065 or 565 or 568 for California. In this example, each partner would report its distributive share of the partnership's income. We have 50/50 equal partners in this example, so each partner would report $50.00 of the partnership's income.

The partnership issues K-1s to each partner reflecting this distributive share. And distributive share rules are generally found under Section 702 of the Internal Revenue Code, and the specific items included any partners distributive share are set forth in the 702 regulations. This is important as we will get into when we discuss the Treasury regulations later on.

Moving on to the next slide. Here, we're showing the same partnership, but one of the partners, Partner B, is selling his partnership interest to a new partner for cash. This is a sale or exchange of a partnership interest. The selling partner realizes gain equal to the amount realized plus the partner's justification in the partnership interest.

No income is realized by the partnership when the partner sells his or her interest. Again, lining up with the facts in this case, JCBI sold its interest in Tory Burch LLC. JCBI, the partner, realized gain. There is no income within the partnership with Burch LLC. Here, we are just making the point conceptually that the taxpayer here is the owner of the interest and the tax bill event is the taxpayer sale or exchange of the property, i.e., the partnership interest. There is no taxable events at the partnership level.

Just to sum up the point of these two slides -- again, these are very simple examples. There's partnership-level income and there is partner-level income. When a partner sells a partnership interest, in this case, when JCBI sold its interest to Tory Burch LLC, JCBI realized income; Tory Burch did not.

Indeed, the FTB does not contend that Tory Burch realized or reported any income as a result of JCBI's sale of its interest. This point of fact is one of the fatal flaws in the FTB's position in the case, and in the ruling. And we will come back to it later in our presentation.

We also wanted to point out in the FTB's opening brief on page 7, where they write that the effect of Appellants' argument is that non-residents should not been taxed on non-realized inventory, notwithstanding the fact that California residents would not be entitled to use Section 17952 similarly as backstop or taxed on the same items.

This is an incorrect statement. There is no leakage as the FTB's statement suggests. There is no additional income for California to tax here as a matter of policy. Resident partners pay tax on their entire gain, capital or ordinary, when they sell their partnership interest. Non-residents are taxed as the same as residents in the same amount.

Partnership business income from selling inventory and collecting unrealized receivables would constitute distributive sharing typical with resident and non-resident partners.

Now I will turn it back over the Chris who will discuss the plain language of the statute.

MR. CAMPBELL: Just on the last point that Mr. Han just made. California residents pay tax on their total income, which would include their total gain; non-residents would not pay tax on gain from the sale of an interest other than to their state of domicile. That's what 17952 says, and that rule usually applies across the board in the states.

Partnership income, however, including income generated from selling inventory or collecting non-receivables pass partnership-level income, and as the partnership operates and generates income, that income will be reported and taxed to support the distributive share of each partner's distributive share of that income will be reported. So that's very separate from the taxpayer-level income from selling an interest.

So let's go to the plain language of the federal statute. So on the left of this slide we have 751(a), and on the right side we have the Tax Code 751(b). 751(a) applies when a partner sells a partnership interest, and that's what applies in this case. 751(b) applies when a partner receives a distribution of property for money from the partnership itself.

751(b) involves a transaction between a partner and the partnership. 751(a) is a transaction between a partner and a third party, like on the prior slide. So sticking with 751(a). When a partner sells a partnership interest, in this case, when JCBI sold its interest in Tory Burch LLC, JCBI realized in Measure I the amount realized and its adjusted basis and the interest.

Under Section 741 of the Internal Revenue Code, now shown, the gain is capital gain because the partnership interest is a capital asset. Section 741 says:

"In 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 the capital asset except as

of a capital asset, except as
otherwise provided in Section 751
(relating to unrealized receivables
and inventory items)."

751(a) on the slide says:

"The amount received by the
selling partner in exchange for
unrealized receivables or inventory
of the partnership shall be considered
as an amount realized from the sale
or exchange of property other than the
capital asset."

Not to get ahead of ourselves, but Congress's use of the same phrase "shall be considered as," in Section 741 and Section 751(a) is important to demonstrating that the FTB has misread the statute. The DC Circuit Court of Appeals makes this point very well in Rawat. We will come back to it later.

So what 751(a) does is it recharacterizes a portion of the selling partner's capital gain as ordinary income. The amount of ordinary income is the amount attributable to the partner's interest in the partnership's 751 property.

So why is this the case? Again, when a partnership sells inventory or collects receivables, the income realized by the partnership is ordinary income. And, again, that ordinary income will flow through to the partners as distributive share income when it's received.

In this case, Tory Burch LLC sells inventory and collects on receivables from its customers, Tory Burch realizes income, and this income is passed through to its members, distributive sharing kind of flows through on K-1 to each member.

So what is 751(a) doing? 751(a) -- under these rules, under the partnership Sub K rules, it was possible for partners to contribute ordinary income property to a partnership and then turn around and sell a partnership interest. Under federal law, the sale of the partnership interest generates capital gain, as we've just discussed, so by holding assets that would have generated ordinary income and contribute them to a partnership, I sell my interest, and now I have capital gain and I've just converted what would otherwise be ordinary income to capital gain, which, under federal law, is taxed at a much lower rate.

751(a) was in enacted in 1954 to prevent partners from doing that. So the whole point is, when I sell my interest in the partnership, the portion of that interest, the amount that I receive from my buyer, a portion of that is going to be treated as ordinary income and taxed at a higher rate for federal tax purposes, that was the solution to that specific problem.

The partnership, of course, in that example in this situation is not selling inventory or unrealized receivables, and there's no deemed sale of property at the partnership level. This is simply a mechanism for treating a portion of the selling partner's income as ordinary income to be taxed at that higher rate, as opposed to capital gain.

And, again, the partnership will continue to earn income from operations in the normal course of its business, and that income will be taxed to the partners as it terms.

I'm going to apologize in advance because I know this is repetitive, but we are going to be repetitive. So apologies in advance.

So what happened here? 751(a) applied. JCBI, realizing when it sold interest in Tory Burch in 2012 and 2013, a portion of this capital gain was recharacterized as ordinary income, therefore, JCBI reported both capital gain and ordinary income when it sold these interests.

Okay. So let's go back for a second to FTB's position on this point. FTB's position is that the 751(a), ordinary income -- the ordinary income that JCBI is reporting under the plain language here is distributive share income, a distributive share of Tory Burch LLC's gain from a sale of partnership property.

So here is 751(a), plain language. Let's go back for a second to the first slide. Again, this regulation applies only to Source A Partner's distributive share of income; and Subsection 2, each partner's distributive share of the partnership business income apportioned to the state is income derived from sources within the state.

The FTB's position in the determination in this case, in the legal ruling, is that the 751(a), ordinary income is -- and we have text showing some of the language -- is a pro rata distribution or distributive share to the partner of gain or loss items of the partnership.

Well, again, from the Subchapter K perspective, and just getting the terminology right, there's no distribution. It's a distributive share, first of all -- but there isn't a distributive share at all in this case.

So I'm finding using the language of 751(a), saying that there is a distributive share, it forces this rule to apply because this rule then would operate the source partnership business income from selling inventory receivables as, in part, California source income.

And, again, Tory Burch LLC, every year, selling inventory, collecting unreceivables, and all that income from that inventory receivables that we are talking about here is reported and taxed to the partners, you know, on Schedule K-1s. None of this applies when you sell an interest in the partnership. Okay.

So let's go look at 751(b), which makes this abundantly clear just purely from looking at statutory language and the words enacted by Congress and the legislature.

So Section 751(b) applies when there's a distribution from the partnership to a partner. This is a sale or exchange transaction between the partner and the partnership.

The whole point of lining these two provisions up next to each other is so that we can compare the statutory language. 751(b), and the distribution from the partnership to a partner, such transaction shall, under regs, be considered as a sale or exchange of such property between the distributee and the partnership that's constituted after the distribution.

That's very different than what 751(a) says, which is simply that the selling partner's -- amount of selling partner's income shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

Again, 741 treats the entire amount in general as capital gain; and this provision, 751(a), recharacterizes a portion of that to ordinary income, that's all it does. It only operates at the partner level. There is no partnership-level transaction, and there's no partnership-level income, and there's no distributive share income, period.

751(b) on the other hand, there is. And this will become very clear in the regulations, and this is important because the regulations have specific references to the distributive share rules and for 751(b), there are no such rules in 751(a).

So, again, Congress and Treasury and IRS, completely understand, have very clear rules demonstrating that there's distributive shared income in 751(b) transaction, and there is not in a 751(a) transaction.

So let's move on. Just one more point. So, again, just focused on this slide, the bold language is there to show that Congress and the legislature which incorporated this in California knows exactly how to provide for a deemed sale when it wants to do so. Okay.

MR. HAN: Thank you, Mr. Campbell.

To that point, FTB's position in this case is that 751(a) creates a deemed sale of property by the partnership. The IRS made this exact same argument in Rawat that Section 751(a) provides for a deemed sale of property by the partnership, and the DC Circuit Court of

Appeals emphatically and very thoroughly dissected and rejected the IRS's position based on the plain reading of the statute.

So here we have some excerpts from the Rawat case, and, in effect, the Commission asked us to interpret the clause, shall be considered as an amount realized from the sale or exchange of property other than the capital asset, 751(a) to mean, shall be considered as an amount realized from the sale or exchange of such property.

Congress used exactly that location in the very next provision of the code, Section 751(b)(1), and the court concludes we cannot conclude that Congress intended to convey in 751(a), what is said far more directly in the adjacent provision 751(b).

Plain language of statute is but one of many things that demonstrated that 751(a) does not provide for a deemed sale by the partnership and, therefore, does not generate distributive sharing income to the selling partner. The regulations make it abundantly clear that there is no deemed sale. Again, absent a deemed sale by the partnership, there is no distributive share income to source pursuant to California Regulation 17951-4.

MR. CAMPBELL: Okay. So the next couple of slides are going to be regulatory provisions that are important here. I will stop and say that the determination in this case nor the legal ruling actually cite or -- quote to or cite, other than one cite to the dash (a)(1) reg, any of these provisions.

So as we will see these regs for both under 751(a) and (b), clearly explain what happens when you have either a sale of the partnership interest or a distribution as a 751(b) transaction, those rules really -- again, if they had been looked at or cited by the ruling they -- we wouldn't be here, put it that way.

So the regs under 751(a), start with the one on the screen, dash (1)(a), this regulation generally restates the code section, but just goes on to say that there's an amount that will be considered as an amount of ordinary income but the remainder of the partner's income is capital gain. That's what that last sentence says.

And what's important as we will go through the next couple regs is that this reg omits any reference to Section 702, which is the distributive share section of the Internal Revenue Code. And under 702, in the dash (1) reg under 702, the items of partnership income, gain, loss, or credit must be included in the partner's distributive share are listed with great specificity.

751(a), ordinary income, is not in that list; however, 751(b) income is, because under 751(b), we have distributive share income and under 751(a), we don't. So that's important.

So let's go to the next slide. The second section of the regulation under 751(a) is simply explaining how you compute the amount of ordinary income -- the selling partner's ordinary income. And it says the amount -- the income or loss realized by the partner is the amount of income from 751 property that would have been allocated to the partner if the partnership had sold all of its property in a fully taxable transaction for cash immediately prior to the partner's transfer of the interest.

The fact that the amount of the selling partner's capital gain is considered as ordinary income and computed by reference to a hypothetical sale is not the same as, you know, saying that there's a deemed sale. So as to this computational point -- it is one of the arguments the IRS made in Rawat, DC Circuit said, look, running a calculation based on a hypothetical inventory sale doesn't change the fact that the partner sold the partnership interest, not inventory.

So that's, you know -- again, comparing this to 751(b), which is what we are going to be doing, this is a calculation, not on actual deemed sale.

Okay. And in the third section of the regulation under 751(a), it just tells you how to report the ordinary income. A partner selling or exchanging any part of an interest in a partnership that has any Section 751 property at the time of the sale or exchange must submit with this tax return for the taxable year, a statement setting forth separately the following information: The date of the sale, the amount of the 751(a) ordinary income, and the amount of the 741 capital gain income.

Again, the Treasury regulations require the selling partner report this information because it is the selling partner's income. None of this information is contained on a K-1 because the amount of the partner's ordinary income and capital gain is not a distributive share of partnership income.

So let's compare all of this with, again, what's going on in 751(b) and those regulations because this is the exact same code section and the exact same set of regulations where, on the one hand, you have got an amount considered as ordinary income, and on the 751(b) side, we have statutory language creating a deemed sale and a partnership sale or exchange and partnership income and a distributive share. And that's just critical to point out.

So these are the regs under 751(b). There are two regs because there's two parts, two different transactions that 751(b) covers, but they say the same thing. So on this slide, this applies to a distribution of Section 51 property, the reg -- like the statute says, this transaction shall be treated as a sale or exchange of such properties between the distributee partner and the partnership.

At the time of distribution, the partnership realizes ordinary income or loss on the sale or exchange of Section 751 property. It goes on to say, in computing the partner's distributive shares of such ordinary income or loss, the income or loss shall be allocated only to partners other than the distributee and separately taken into account under Section 702(a)(8).

Again, the regs under 702, specifically require a partner to take into account, quote, his distributive share of the following items -- and there's a long list -- and then it says income gain or loss to the partnership under Section 751(b). There is no reference to 751(a) because, again, there is no distributive share income in a 751(a) situation.

The next slide says the exact same thing, it's the context is distribution of 751 property, it's a distribution of property or money in exchange for the partner 's interest in the partnership's 751 property. Again, that's a sale or exchange, and the same language of the regulation on the prior slide.

Okay. The FTB understands the significance of Section 702 on the 702 regs. 702 is discussed in page 3 the FTB's legal ruling, but the ruling fails to acknowledge any of these regulations and fails to acknowledge that 751(a), ordinary income, is explicitly excluded, let's put it that way, under the distributive share regs.

So, again, I apologize for being repetitive, but all of this is showing that under 751(a), a selling partner does not have -- is not receiving a distributive share of partnership income, and there is no partnership-level income, and again, the entire -- the FTB's premise is that 751(a) provides for a deemed sale and a distributive share of income to the partners, which then allows FTB to apply 751-4(d) doesn't apply here. Let's turn to you.

MR. HAN: Thank you, Mr. Campbell.

So as we just discussed, the FTB's position is that when a partner sells a partnership interest in the 751(a), ordinary income, is a distributive share of the partnership's California business income. So per the FTB, a portion of a non-resident selling partner's gain constitutes California source income, while the remainder of the balance, the capital gain, constitutes income from the sale of an intangible.

So at this point, we will discuss what the law was, is, and continues to be regarding the nature of the income resulting from the sale of a partnership interest in California. There's no question that a partnership interest is intangible personal property. A non-resident's gain from the sale of a partnership interest constitutes income from the sale of intangible personal property.

Along this is two well-settled to warrant further discussion, see Ames, and the case is cited in Footnote 2 of our supplement opening brief. The ruling itself also acknowledges on page 2 that Section 17952 is the statute that applies to sourcing non-resident's income from the sale of a partnership interest.

You can see on this slide the language of Section 17952, which says,

"For purposes of computing taxable income of a non-resident or part-year resident income of non-residents from stocks, bonds, notes or other intangible personal property is not income sources within this state unless the property has acquired a business license in this state."

The non-resident's income from the sale of the partnership interest is the entire amount realized from the sale. Section 17952 operates on the partner's income from the sale and encompasses the entire amount of the selling partner's income regardless of the character of the income for federal income tax purposes.

To put it differently, the fact that the selling partner's income is for federal income tax purposes, a combination of capital gain and ordinary income does not have any effect on the application of 17952. This was, is, and continues to be the law. The partnership interest sales in this case took place in 2012 and 2013.

Appellants correctly reported the entire amount of the gain from the sale of the partnership interest, both capital gain and ordinary income, as income from the sale of an intangible source through the state of domicile.

So to sum it up at this point, applying the law as it exists, 751(a), ordinary income, is not a distributive share partnership income; regulation dash 4(d) does not apply to Appellant's 751(a), ordinary income, because its income is not a distributive share of Tory Burch LLC's income from a deemed sale of a 751 property.

The entire amount -- again, being repetitive -- of Appellants' income is income from intangible personal property source pursuant to 17952. And as mentioned earlier -- as Mr. Campbell mentioned earlier, the partnership will eventually realize income when it does sell 751 property, and this income will be taxed to the partners at that time.

Subchapter K does not create a deemed sale in this property when a partner sells his interest in that partnership. If it did, it would be clear in the rules just like it is clear in Section 751(b).

MR. CAMPBELL: Okay. Thanks, David.

Everything we just presented is based on federal and California statutes and regulations that have been in existence for decades. 751 was enacted in 1954. 17952 is a codification of the Mobilia common law doctrine going back hundreds of years. FTB is fully aware of the history of these laws.

Appellants filed their returns in accordance with these laws as they're required to do. And I will take one more moment to go back to 17952, because it is something I know many of us deal with every day and there's a lot of cases on it. But this section has, as it always has, operates on income of non-residents from intangible personal property.

Again, more than -- too many cases to cite that deal with sales of partnership interest. Sales of partnership interest are sales of intangible personal property. The income realized by a non-resident partner is the income sourced under this section. It does not matter that the income is capital and ordinary for federal income tax purposes, and it never has.

Again, these rules have been around for decades, and until this legal ruling, as you will see later, the FTB has never applied the law this way. You could not file a return the way the FTB is claiming that you should have filed a return. That's another way to look at this. This is super important.

The FTB's guidance, we will see at the end, changed after it issued the legal ruling. But at the time of these transactions, again, going back decades -- we all know the way these laws work -- you could not have filed a return this way -- you still can't.

Okay. So July 14, 2022, around 10 years after the sales in our case, the FTB issued its legal ruling 2022-02. The position taken in the ruling is, the first time, to the best of our knowledge, that FTB publicly took the position that 17952, quote, is not sufficient to source the entirety of the sale, end quote. And that a selling partner's gain from the sale of the partnership interest is, under California law, partially gained from the sale of intangible and partially a distributive share of partnership income. And even saying that is difficult because my income -- from selling is not from distributive share income.

We have key statements from the ruling on the slide, and I will read some of them out loud just because -- to point out that sometimes hearing it is better, that they're completely contrary to what the statute provides.

And so the second one. The deemed sale of the IRC 751 property, which is treated as if having been sold by the partnership immediately before the transaction through the operate of Section 751, is not treated as a sale of intangible or an asset sale by the transferor partner. Again, referring to it as a deemed sale, treated as if having been sold by the partnership.

And the next one continues, the proceeds attributable the deemed sale of the 751 property are treated as a pro rata distribution or distributive share to the partner of gain or loss.

Well, okay, first of all, there's no deemed sale but they're trying to create a deemed sale so that you can have a distributive share of the partnership income. And just again, as a side on the terminology point, there are no proceeds to a deemed sale. There's no distribution of anything. So that's just confusing and just difficult to read.

Okay. The ultimate conclusion of the ruling is the distribution or distributive share really, therefore, is income from a trade, business, or profession to be sourced pursuant to Regulation 17951-4.

As we just witnessed, the FTB has reversed engineered a distributive share of the income where there is none. That's is for this case, and there's no distributive share here and there's no income to source. That answers the question. Okay. So that's the legal ruling.

Just go back for a minute to the determination letter. So this is July 14, 2022. The hearing in this case occurred on April 11, 2022. Three months later, July 19, three days after the -- four days after the hearing, after the legal ruling came out, protest officer sent the Appellants a copy of the ruling essentially as a preliminary determination, saying, hey, look it over. That was our Exhibit 6.

The determination letter was then sent November 4, 2022, and it generally relied on the ruling as authority, but it has a couple other statements that we want to say on the record.

According to the protest officer, Appellants' 751(a), ordinary income, quote, should be treated in the same manner as typical distributive share which consists of business income. Again, there's no law that allows the FTB to, quote, treat the selling partner's gains as the partnership's business income.

And the fact that that determination is phrased as an opinion that taxpayer's gains should be treated in the same manner as distributive share income, really just proves the point. When we read that, I'm not sure there's a determination there; I feel like it's an opinion.

So I think that, you know, in our view is the FTB's opinion that the selling partner's gains should be treated as business income is not a determination to begin with, and certainly is not a lawful basis for supporting the determination against the taxpayers in this case. That is what it says. It's an incredible contention.

The plain language of Section 17952 operates, as it always has, to source the entire amount of a non-resident individual taxpayer's gain or loss from a sale of a partnership interest. We have gone through that, so to be repetitive, it applies to income of non-residents from intangible personal property, the selling partner's income is the entire amount of income regardless of whether the amount is treated as capital and ordinary for federal income tax purposes.

Okay. That plain language is simply incapable of supporting the FTB's new argument, and the fact that the insufficiency has never been identified before by the FTB, the State Board of Equalization, the OTA, any scholarly articles as far as we can tell, not to mention the fact that the FTB's tax returns and instruction do not identify this insufficiency or provide directions for treating a portion of a taxpayer's gain as distributive share income also should ring alarm bells.

No amount of the taxpayer's gains in this case is distributive share income, and the entire amount sourced is pursuant to the plain language of 17952. By the way, there's also no problem to solve here. As we alluded to before, all California source income is being taxed by the rules as they exist.

These rules were perfectly as written, gains realized by selling partners, both ordinary and capital, are taxed to their states of domicile subject to the business exceptions here and there. Income realized by the partnership, the operating income, is a portion taxed as business income when it is realized by the partnership.

The FTB's ruling and the decision in this case actually caused way more problems than they're trying to answer. If the rule were as the FTB says, then there would be many other tax consequences. And one, the language in the 751(a) regs, and the 702 distributive share regs on the federal side also need to provide for the result that they're seeking. But if they were correct that this is what the law is, then there would be consequences on the corporate side too.

There are no -- when a corporation sells a partnership interest or non-unitary partnership interest, you would think that the amount that those rules would then also need to explain how the ordinary income piece is business income, notwithstanding the rest of the corporation's gain on the sale of the interest is, you know, non-business income, but there are not statutes or rules that explain how any of that would work.

Okay. Again, so the proper way to address this problem, if it's a problem at all, would be to take it up with the legislature as we said at the beginning. In the legislative process, all the nuances and effects of creating a new sourcing rule could be considered in a public forum and all the unforeseen things that I can't even contemplate at this point in time could be dealt with with public comments and investigation. That's what the whole legislative process is for, and that's not what happened here.

MR. HAN: So we wanted to go back to the slide showing regulation 4(d). So you can now see it is obviously reverse engineering and there is simply no distributive share income in this case. The FTB's position in the ruling is completely dependent on the existence of a distributive share of partnership income, and we've already covered 751(a) does not provide for a distributive share, so the FTB's position simply fails.

The FTB's main support is the computational provision that Mr. Campbell went over under the Treasury regulations, and the computational provision doesn't create a deemed sale, it simply tells a partner how to compute the ordinary income amount. And as we saw in 751(b) in its regulations, there is a deemed sale and those rules specifically provide distributive share income to the partner.

So just to close the loop on it, there isn't room for interpretation here, and we will see that the DC Circuit Court addressed of all these points in Rawat.

MR. CAMPBELL: Okay. So the good news, Judges, is that you do not have to take our word for any of this. The FTB's arguments in this case are nearly identical to the arguments made by the IRS in the Rawat case. And the DC Circuit, as we said earlier, thoroughly dissected and rejected all these documents.

So David, why don't you go through those slides.

MR. HAN: Yes. So sometimes hearing things are better than just reading it, and just to read a couple excerpts into the record to show how the FTB's arguments mirror the commissioner's in Rawat. In Rawat, the commissioner argued that 751(a) deemed the gain Rawat realized on the sale of partnership interest to be from the sale of that inventory. The Commissioner urges us to read 751(a) critical language shall be considered as an amount realized from the sale or exchange of property other than capital asset, as a reference back to the list above it, inventory and unrealized receivables.

In his judgment, 751(a) should be read to say that inventory gain shall be considered as an amount realized from the sale or exchange of inventory. And the FTB, in its later ruling, wrote similarly the operation of Section 751, therefore, necessitates a sale of a partnership interest be treated as two distinct transactions.

One which the intangible partnership interest is sold by the partner, and one in which 751 property is treated as sold by the partnership leading to the deemed distribution to the partner.

In here we have the DC Circuit Court's conclusion where they right, the pivotal clause is the last one -- shall be considered as the amount realized from the sale or exchange of property other than a capital asset. The court found these mean shall be considered as ordinary income. These words to not mean, as the commissioner argued, the selling partner's 751(a), ordinary income, shall be considered as an amount realized from the sale or exchange of such property, which is what the FTB's argument is here.

In other words, the plane language of the statute answers this question, there is no deemed sale or exchange of property, yet, this is what the FTB's legal ruling says. And, again, we are repetitive, but Rawat's analysis is conclusive and determinative here. Yes, this is a federal case, but the premise that underlies the IRS's arguments in Rawat is the exact same premise used by FTB in this case.

The IRS's position in the international sourcing rules was dependent on 751(a) providing for a deemed sale of partnership property. The FTB's position on the California sourcing rules is entirely dependent on 751(a), providing for a deemed sale of partnership property, that produces distributive share income to be sources under dash 4(d).

MR. CAMPBELL: In other words, so all the arguments we just made, which was all to refute the FTB's position in this case, are the exact same arguments the IRS was making and the exact same analysis as the DC Circuit uses to debunk those argument applies here, it is directly on point. All that matters is the 751(s) premise, and once that's dispensed with, we have no distributive share income to begin with, which is everything that we are saying.

So we are almost done with our opening. Outside of -- the plain language of 751(a) and the regulations and then using Rawat to understand it all, answers that question here and demonstrates that Appellants' position is right, demonstrates that protest determination is wrong, demonstrates the legal ruling is wrong as a matter of law. But there is a few other things that are worth talking about.

The FTB's ruling and determination letter, they don't point to any authority at all that's in existence prior to the ruling for the proposition that under California law the entire amount of a selling partner's gain from the sale of the partnership interest is, you know, sourced in the way that they're saying.

The one case that they cite to is appeal of Bense from 1979, which they think supports the idea that 751(a), ordinary income, is distributive share partnership income or at least that's what they want it to say, and that ordinary income is not sources by 17952, but that is not what Bense says. Bense involved resident taxpayers who sold a partnership interest and realized gain and they reported the entire amount of gain as capital gain and didn't even apply Section 751(a).

Again, these are residents, their taxed on their worldwide income, and in California, the sources of that gains was never an issue, but they reported the entire amount as capital gain. Under California law at that time, taxpayers were allowed to deduct a portion of their capital gain income. So by deducting this entire amount, of gain, they reduced the taxable income down greater than they should have in California.

The taxpayer's events did not treat any of their gain as ordinary income, so their deduction was overstated, so the FTB came in, they said, hey, you didn't apply 751, your capital gain deduction needs to be reduced because a portion of your gain was ordinary income, you own get to deduct the capital gain piece. So there were specific rules that dealt with capital gain and ordinary income back then.

So the discussion of all that events provides no support the FTB's position that 751(a), ordinary income, is distributive share income to begin with, and it only goes to show that FTB and the SBE, and everybody for that matter, understood that, you know, back then what the law is you get a deduction for capital gain but not ordinary income. And, certainly, there's nothing in that decision that supports this distributive share conclusion.

FTB also relies on the determination letter at least, as Wisconsin tax publication, which we addresses in our briefs, but it's worth bringing it up here. That Wisconsin publication tells non-resident partners to treat a portion of their gain that's attributable to partnership inventory actually located in Wisconsin and Wisconsin source income, and it also says that amounts attributable to unrealized receivables aren't taxable in Wisconsin.

The publication doesn't go into an analysis or claim that there's a deemed sale on the distributive share, it's just a publication that's asserting and telling taxpayers, hey -- again, I don't know what the actual law is in Wisconsin, but all that does is say, hey, we want you to treat your amount attributable to your inventory that's actually here as Wisconsin source. That has nothing to do -- it doesn't support anything that California is saying here.

And, again, I'm just going to come back and say stand back -- step back. The FTB's reliance on a clearly inapplicable SBE case from 1979, and a Wisconsin publication, as support for a position that's dramatically changes the law that applies to an everyday transaction is shocking.

As that Exhibit 6 shows, when this position first came about in a response and audit report that began in

2017, nobody started communicating on this with the FTB. We pointed out -- Appellants pointed out that, hey, there's an Illinois ruling from 2011 that directly addresses this issue. Some taxpayer had asked Illinois to rule that the 751(a), ordinary income, should be sourced to Illinois as a portion income.

The Illinois partner rejected that, and the ruling reads a lot like Rawat. The ruling reads a lot like what we have been saying all along. So they rejected the very position. The FTB is aware of that ruling, just like they are of Wisconsin publication events, and, again, they don't mention that.

So all of this has just been brewing for the last, you know -- out of public eye for the past year -- since 2017 or 2018. And, again, relying on a Wisconsin publication in this case to get this dramatic of a result, and change the way 17952 applies after all these years is, again, that is shocking.

So to sum it up -- I think we are summing it up here. Section 751 has been the law since 1954, partnership interests are sold every day. We respectfully submit that the FTB could not, with a straight face, contend that Section 17952 has always applied only to the capital gain realized by a selling partnership and it is not applied ever to a selling partner's ordinary income, that's what the law is and that's what it's always been, so it's not -- and further, that the ordinary income under 751(a) is distributive share income, it's never been the case.

If the FTB were correct that this is and was the law, one would expect the law to be crystal clear. The partnership and personal income tax forms and instructions would explain that a selling partner's distributive share of 751, ordinary income, would need to be reported as California source income.

Surely, the cases involving sales by non-resident's of partnership interest would discuss the, quote, unquote, bifurcation of the selling partner's income between intangible income and the distributive share of the partnership's income. They do not. And you would see, you know, the discussion of the corporate rules versus the person rules because there would be differences, and you don't see that.

Prior to the issuance of legal ruling in 2022-22, the FTB's Residency and Sourcing Manual had one line for decades, sale of a partnership interest is considered a sale of intangibles assets, see Ames. Again, that was what was there when these transactions occurred.

A few months after the legal ruling came out, the final letter was given to us, the manual was updated and now it contains this line, which, on the screen, sale of a partnership interest is considered a sale of a intangible asset, see Ames, and goes on to basically parrot what's in the ruling that 17952 is now all of a sudden insufficient to source the entire amount of he non-resident's income, the ordinary income piece is something to be sourced under distributive share income under dash 4.

So, again, I think all of this goes to show that this is a change in the law. They're seeking to change the law. And if this was a change in the law, there would have been -- certainly in 2012 and 2013 when these transactions took place, this didn't exist for us. And again, this is such a common transaction for anybody else, there is no indication in any authority anywhere, and the authorities are all under the contrary that 17952 did, in fact, source all partners -- there's nothing about this in Ames or Bense or Metropoulos or Smith for that matter, all of which deal with sales of partnerships. There's 50 cases before that.

Okay. So at this point we will conclude and save anything for rebuttal. And, you know, our closing comment is that without a distributive share of income, we have no California source income to source under this reg, and that's where we stand.

ADMINISTRATIVE LAW JUDGE GAST: Thank you very much. What we will do at this time is take a 10-minute break. It's 10:12. We will come back at 10:23, and we will start with Panel questions for Appellants, if any, and then we will move to FTB's presentation. We will go off the record now. Thank you.

(The morning recess was taken.)

ADMINISTRATIVE LAW JUDGE GAST: Back on the record. At this point I would like to turn it over to my co-panelists to see if they have any questions. I'll start with Judge Le.

ADMINISTRATIVE LAW JUDGE LE: Thank you for your presentation. I don't have any questions. Thank you.

ADMINISTRATIVE LAW JUDGE GAST: Judge Famularo?

ADMINISTRATIVE LAW JUDGE FAMULARO: Yes. Thank you for your presentation. It was terrific. I do have a question. So I understood you to say that 751(a) is what controls the question here, it's a matter or statutory instruction, and you said that there's no room for interpretation. However, I do understand what FTB is going to argue is that the Tax Court viewed it differently.

They looked at that exact same clause that you mentioned, the shall be considered as an amount realized from the sale or exchange of property other than a capital asset, and interpreted that same language differently and, in fact, held for the position that FTB is asking us to find for today.

I would like to hear your position regarding the Tax Court's interpretation of the statutory language. As you know, the DC Circuit case is persuasive, and the Tax Court case is also a persuasive opinion for purposes of the OTA. So the DC Circuit Court case would be binding in the DC Circuit on the Tax Court overruled it for purposes of the DC Circuit but not for the rest of the circuits within country.

So, again, in my view, we have two persuasive opinions, and they are both interpreting the same statutory language, they are coming out with two opposite conclusions. I heard all of the arguments you gave for why the DC Circuit statutory construction analysis is correct. I would like your view on why the Tax Court's statutory construction analysis is incorrect.

MR. CAMPBELL: Good question. Thanks, Judge Famularo. I can answer that probably a couple ways. Number one, this is a California tax case. The fundamental issue here is the construction of California statutes. The law that applies here -- and I will get to your question. The law that applies here is 17952. That is the statute codification of the Mobilia rule that we all know applies to the sale of intangible personal property, which includes partnership interest.

So it is putting a hell of a lot of weight -- excuse me -- a heck of a lot of weight on a reinterpretation of that provision after decades, at least since 1954, let's say, to somehow reverse engineer it and an argument that we are not in that statute. How do we get out of 17952, because that is what applies -- when we got this audit report in 2017, we were shocked. I had never seen this before in my life. I've been doing this for 25.

Rawat wasn't even in existence at that time. So these arguments didn't exist. The position didn't exist. 17952 is a California statute that we all know applies and always has applied. That's the starting point.

You then have the whole concept of distributive share income, which is the regulation. The way to get out of 17952 is to say, oh, we have distributive share income. How do we have distributive share income? Well, somebody -- again, there's lots of e-mails, by the way, in the audit file and records of conversations that occurred in this audit about what was going on behind the scenes. It's all there.

But at some point somebody says, oh, well, maybe we can figure out a better way to create something to source under 17951-4. I get it. Just like the Tax Court in the international sourcing provision and the argument here -- I don't want to make it for them. Basically, they're saying, look, this is attributable to 751 property therefore -- one attorney told me once -- seems like there's something that could be sourced; right?

You are advancing that -- but that's a problem that, like, A, needs a solution that would be legislative, but it is also not a problem, because at the end of the day, the partnership is going to pay tax -- the partner is going to pay tax on that income when the partnership realizes it.

In effect, telling the selling partner that they are paying tax on a portion of this income as if the partnership realizes it, the FTB's position, like, the partnership is realizing it, but in reality is, that is going to be realized and taxed to the other partners when it's actually realized, right, and there is no mechanisms in 751(a) as you know of Sub K experience, to shift basis or specially allocate only to the selling partner.

Obviously, 751(b), in the regs there, allocate to the other partners. It's very technical. To get back to your question, the point is, I get it. You have got two competing opinions under federal law dealing with that specific situation.

I will say that the unanimous decision of the DC

Circuit written by the chief judge who was also a Supreme Court nominee and somebody that I worked for for many years at my former firm -- probably the smartest guy I've ever met -- that opinion is so well written and is just so convincing that when I look at the analysis in the Tax Court decision, I'm, like, well, that's clearly the right answer.

And just from a, you know -- playing in the Sub K sandbox for 20 years, I feel like that's a much better position. So from the question of what's binding on the OTA, I get it, you have two competing positions. And I can't sit here and say as a tax professional academic that I know better than anybody else, but what I can say is the DC Circuit case opinion is way more persuasive in my view, and as far as the issue before the OTA is concerned, which is, do we have a distributive share of income?

And this is important. The Tax Court and the DC Circuit we're dealing with the issue, again, international sourcing issue, it was solved legislatively during the pendency of the case. That issue doesn't exist anymore. But nonetheless, the discussion and the statutory construction of 751(a) is important and relevant and is more persuasive in my opinion in the DC Circuit.

Here, again, this issue -- sales of partnership interests are everyday transaction. The law -- the sourcing law that apply to that have to be clear; they always have been. They need to be in a statute. They are in a statute. To, in 2022, come in, 10 years after 2012 for that matter, and say that, oh, here is a potential argument that could be convincing, you know, to treat some of this partner's gain as, you know, distributive share income, and then to say that, you know, we find support in a tax court case that just came out, and all of a sudden we are going to use that -- and the more flimsy stuff like Bense to support a massive change in the law, the application of a statute here, my first comment was this is way too much --

I'm trying to phrase it the right way. Way too little support to begin with to effect such a gargantuan change in the law that actually exists. Like, we can sit here and argue about which opinion is, you know, more well-reasoned, but that doesn't change the fact that we just don't have distributive share income, but if we did, it would have to be damn clear in the statutes, and California law would have to be super clear to say that this is what you have and this is how you source it, but that didn't happen until it is a legal rule. That doesn't exist before then.

Does that make sense?

ADMINISTRATIVE LAW JUDGE FAMULARO: It does. I appreciate that. And I assume that you are getting also to the point of my question again, which was the way that the Tax Court interpreted that phrase. They looked at the word property in particular and said that that could mean more than just a noncapital asset -- it could mean multiple pieces of property.

And they interpreted that to mean that 751(a) was more than just characterization. That it's accorded the FTB's position that there is a deemed sale of inventory or collection of unrealized receivables. And so I don't know if you have any view specifically to address the way that the Tax Court interpreted that phrase?

MR. CAMPBELL: Well, I guess, on that point, all I can say is I don't agree that that's a persuasive reading of a statute. I mean, it's very -- putting aside what the DC Circuit said -- and, again, I would ask everybody to remember, if you were just to go back and look at all of the back-and-forth submissions in this case, they all occurred before Rawat.

So we have lots of good discussion of all these issues prior to any commentary by the Tax Court. But the symmetry and the language between 751 and 751, which is capital versus ordinary considered as, and the whole point of 751(a), which was to prevent, you know, people from forming partnership and selling and getting ordinary income.

I would ask -- I don't know if the Tax Court's interpretation is really consistent with just the fundamental problem that 751(a) was trying to solve, and I feel like that's what the DC Circuit came in and said, look, here's what the problem was, and they solved it, and it is pretty clear that they are just making it ordinary because that is what, otherwise, would have been realized that they sold it, and they even did the computation that way.

I don't know what more there is to say, otherwise I feel like we are reading too much into the words here. Again, as we say. There's not much to interpret, but I would ask in the whole context, we start with not as a -- when I say 751(a) is determinative, I mean the construction is because the reason it is, is you have find distributive share income. So absent that, you know, that's really -- it's a California issue to begin with. Sorry.

ADMINISTRATIVE LAW JUDGE FAMULARO: No. I appreciate that. Thank you. You did answer my question and I appreciate it. So the other thing I just wanted to follow up on was the regulation under 751. So 751-1(a)(2), which deals with the hypothetical sale, the DC Circuit, in its opinion, said that it was a reasonable interpretation the way that the Tax Court looked at the regulation to say that you bifurcate the transaction to two separate transactions, and determine both, first, the 751(a) amount of ordinary income, and then two, the 751 capital gain piece.

So the DC Circuit did not say that the IRS's position was wrong, but said that there were two different ways to look at the regulation. And I know that the way that the FTB is looking at the regulation and the way that the FTB has cited the regulation in their legal ruling stands with the proposition that there are two separate transactions and they're using that as a support for their position that there is a distributive share when the partnership is deemed to sell the partnership property.

The 751 portion of that, which is allocated to the selling partner, would then be treated as ordinary income and it would go beyond just character, but it would be then looked to the sourcing provisions. Obviously in Rawat we are talking about international sourcing provisions; here we're talking about 17951 and 17952 as you said.

And so the sum of my question is this: Specifically looking at that regulation, what is your specific argument as to why that regulation doesn't do what the FTB claims that it does and what the IRS argued that it did in Rawat? And I could clarify the position more it you'd like.

MR. CAMPBELL: And you can put it on the screen. So that regulation says -- again, as we went through in the presentation, 751(a) there's three -- A, B, and C -- regs, and there's the 751(b) regs. The dash 182 regs says: The income or loss realized by a partner, hence, the gain of the partner, is the amount of income or loss from Section 751 property that would have been allocated to the partner to the extent attributable to the interest sold if the partnership had sold all of its property in a fully taxable transaction for cash immediately prior to the partner's transfer of interest of the partnership, and that gain is ordinary and the rest is capital.

So very language specifically, just looking at this in isolation. This is telling you that you don't have income allocated to the partner because if it would have been allocated to the partner but it is not because there is no income to allocate to the partner.

I don't think anybody would say otherwise that there actually is income to allocate to the partner, and there is no income from a deemed sale to allocate to the partner. It is income that would have been allocated if the partnership had sold all of its property knowing that the partnership didn't sell anything and wasn't deemed to sell anything.

So just looking at this regulation, it is enough to see that the plain language doesn't create a sale of property by the partnership, deemed sale of partnership property, a distributive share of income that flows to the partner, it's just recharacterizing the character, as we would say, from ordinary to capital.

But you can't look at the regulation in a vacuum. The regulations and the statute and 751(b) and those regulations and the 702 regulations all work together. I mean, the Sub K regulations are thousands of pages. And 704 allocation -- they all work together. The whole framework of Sub K is I've got partnership-level income, I have distributive-share income.

And when I have distributive-share income, I have provisions in the code that tell me how to specifically separately state or not separately state those items, what the partnership needs to do with respect to all these different types of income and then put it on a K-1 for reporting purposes, and then I take it into account as a partner, and I'm told that because there is a specific rule that tells me to do that.

We all know from experience that when you sell a partnership interest, that's my transaction and that's the partner's transaction, my gain or loss, and this is just telling me to treat some of it as ordinary. If I compare this language to the 751(b) regs or the statutes like we looked at, once you get to the point -- again, not in a vacuum. I can read this and I already know what it says.

But if I look at this in connection with everything else, now it's really clear to me that I have no distributive share income. And so that's my answer. And, again, please come at this -- I would ask everybody to look at this from the standpoint of what is the law -- - what is the law, what has it been, what body of law is out there, cases, statutes, FTB guidance, ruling TAMs, manuals, administrative decisions, articles.

There is no question that in 2012 and 2013 and probably not until 2022 as far as I know with this ruling that there was ever a consideration, at least I have never seen one asserted in this case until the audit of this one, that 751, ordinary income, under California law would be distributive share income to be sourced under this reg.

So that's the bigger picture here. Yes, I get it, and I want to, like, debate what this reg says, but there is a huge thing going on here which is this ruling changes the law completely and that applies to everybody on a daily basis. I see it in my practice. It is that big.

We could not have filed a return that way. I would say if I look at this regulation in 751-182, I could not have looked at that regulation and said, oh, I have distributive share income. I could not have gone to Tory Burch LLC, I have got a distributive share of income to source. Like, it doesn't say that.

Tory Burch would tell me, no you don't, this wasn't a distribution, I have to give you a piece of paper that tells you what your computation is. That's how that works; right? So I'm probably rambling at this point.

I think I'd look at that regulation and it is as clear as day that it's just operating on my income or loss and telling me the amount that is treated as ordinary income is the amount that would have been allocated to me had there been a sale.

And by the way, again, for state law and federal too, when the partnership does sell that property it is going to generate distributive share income to the partners. So, like, FTB doesn't get to tax it twice just because somebody is a non-resident selling an interest and maybe not in the state anymore, that distributive share income when that inventory is sold is going to be taxed to partners who are partners at that time it's realized; right? So I hope that answered it.

ADMINISTRATIVE LAW JUDGE FAMULARO: It did.

MR. CAMPBELL: And more?

ADMINISTRATIVE LAW JUDGE FAMULARO: I appreciate it. No further questions.

ADMINISTRATIVE LAW JUDGE GAST: I have questions, but I will wait on FTB who has been waiting patiently to get their time to present. So whenever you're ready, you have 45 minutes.

OPENING STATEMENT

MS. SWAIN: Thank you, Judge Gast, and thank you the Panel, and thank you so much to Appellant's counsel. As I mentioned, I represent Respondent along with Leah Thyberg. And what I'm hearing so much from the Appellants is frustration. And I think -- I appreciate -- I appreciate it because I think what's really challenging -- and full disclosure, I'm nerd.

What I like about this case is it requires somehow the weaving of these seemingly inconsistent areas of law, and that's what is challenging. Can it feel frustrating sometimes? Can it feel where is the clarity? Where is the right answer? Is it written someplace? I appreciate that. I think those are the same exact questions we are coming with you as well.

And we are coming in, and thee is the conversations that we certainly have when it comes to coming up with positions and it comes to trying to understand the reconciliation. It's not, hi, I'm sourcing a subject matter expert, take my word for it. It is, like, okay, let me here your perspective from partnership law.

And as we know, Subchapter K is its own precise area of law that is really involved. And in Subchapter K, you are not really asked as much to make some of the leaps that we see in the appeal of Smith, that show up in the Appeal of Valentina v. Franchise Tax Board, and to some degree in J.P. Morgan v. Franchise Tax Board, because that's what happens with state sourcing.

So, fundamentally, we have this issue of if you look through a lens of Subchapter K and you look to state sourcing, you will not get the full picture. If you look through sourcing and you don't acknowledge Subchapter K, you will not get the full picture either, so we have to come through this in a methodical way.

I think one of the other things that is interesting is there isn't a great deal of other states grappling with the same things because part of that is we have states that don't have income tax at all. And we have other states, such as Massachusetts, that has a much broader standard. They're much more like the federal standard, and we see that in the Appeal of Buehler where they have this, essentially, like, effectively connected income.

California is unusual and has a position that's really quite favorable to non-residents by saying, you know what, it might be effectively connected, but we are going to say this is an intangible and we are going to send that back to your state of residence.

So what we are really seeing here -- we are seeing a couple things, we are seeing this historic tension that has always been in the sourcing law, which is which state -- where are you doing business, and can we know that you have some business operations? You are creating -- generating income in the state in which you are not a resident to make it California source income. Or should this be an intangible something that is really better suited to you personally following you back to your state of residence? So that's the tension we see in this case.

So what is an interesting is we really don't -- the relationship between 2202 and the assessment in this case are not as intimately intertwined. Respectfully, we see it a little bit differently. Because there's -- if the Panel found certain language within the legal ruling that they disagreed with, it's possible to uphold this assessment and to say we are disregarding some of this language. That's exactly what happened in the Appeal of

Smith and the legal ruling 22001-01 when it came to discussing the issues of control. And that's in one of the footnotes in the Appeal of Smith and it talks about that, and you see this difference.

Because that's a publicly-stated position, that is not what's ultimately at issue in this case. What's ultimately at issue in this case is is this tax assessment proper or not proper? One of the other things Smith shows us, just to point out, this issue does make any appearance in the Appeal of Smith. If you look to -- I think it's Footnote 14, it talks specifically about how Franchise Tax Board in Appeal of Smith, which was a 2023 decision, had -- and it was also a 2012 case -- that it had raised the exact argument as to whether the gain generates business income and is a portion that shows level under IRC Section 751, even in the absence of the unitary relationship.

And the panel went to say it did not need to address this issue -- declined to address this issue because it was sustaining the unitary position in that case. So that is -- this issue has appeared publicly before as seen in this footnote.

But more importantly, in this case, the facts are not in dispute, which is unusual. This is a case about Mr. Burch held a 98 percent membership interest in JCB Investments. JCB held an investment in Tory Burch LLC, the well-known fashion brand. The eponymous designer and executive, Tory Burch, was formerly married to Mr. Burch and he sold most of his 28 percent share in his former wife's brand for $650 million in late 2012.

And as has been mentioned, Tory Burch LLC operates brick-and-mortar retail stores and engages in online sales for clothing, accessories, and lifestyle items including fragrances. It possesses assets of tangible goods and unrealized account receivable related to those goods, and operate within and without California.

The apportioned income to California was approximately 13 and 16 percent respectively for the tax years 2012 and 2013 that are at issue here. And that's interesting, as well as it brings up another point with the emphasis 17951-4(d) that is for unitary partnerships, and that this is a unitary entity. If the entity were not unitary, we would be looking at it potentially under a different provision such as 17951(b), which talks about the income.

But the question here is whether the determination regarding the source income is proper under federal and state law, and the answer to that question is clear, yes, the sourcing is correct, and Appellants carry the burden to prove that the tax assessment is erroneous. And the tax assessment is based on the AVES 2 issued by the auditor in 2017.

So what is really at play here? We do have these two bodies of law, but the case ultimately involves two competing theories of the entity and the aggregate theories of partnership. There is a conflict between these two theories, and with conflict comes tension, and that tension is what's playing out in Subchapter K, and it also plays out in the sourcing of the income in this case.

So how do these two completely theories interact? We have a dynamic between them that, bear with me, operates a little like a sibling rivalry. We have one code section that would have you believe it's an only child, that's 741. It treats a sale or exchange of partnership interest as one thing, sale of a capital assets. This is the entity theory in action.

And here's the exact language where we track this entity theory taken from 741.

"In the case of a sale or exchange of an the interest in partnership, gain or loss shall be recognized to transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital assets."

Now, that sounds like an inviolate rule. The sale of a partnership interest is treated as a capital asset, but that is not all of language of 741, so there's this limit to this seemingly inviolate law that starts with a comma.

That language says, comma, except as otherwise provided in 751. Relating to unrealized receivables or or inventory items. So here is the aggregate theory stepping onto the stage with 751. 751 says actually let's treat the selling partner as if they sold an undivided interest in each and every partnership asset to the buyer.

In practical reality, this aggregate theory functions as a carveout from 741. So 751 says, like any second sibling, you need to share the stage with me. You don't get the final say 741. There's two of us -- 741 and 751 -- we operate like a family. We are siblings with a different point of view, and we need to be considerate, even when this viewpoint creates tension.

And both of these siblings, these theories of entity and aggregate are represented on Form 8308, where the income is captured in black and white, and the partnership includes the amount of income attributable to 751(a) property.

So what exactly is 751(a) property? And I apologize. This will be a little dry. Section 751 property is unrealized receivables and inventory items, an unrealized receivable is an account receivable of a partnership which has not been included in income. And there's three categories of unrealized receivables: Goods, services, and recapture item.

Section 751 defines the term unrealized receivables to include to the extent not previously includable in income under the method of accounting used by the partnership. Any rights, contractual or otherwise, to payment for, one, goods delivered or to be delivered to the extent that the proceeds there from would be treated amounts received from the sale or exchange of the property other than the capital assets; or two, service rendered or to be rendered.

So unrealized receivables also includes a list of partnership assets which, if sold by the partnership, may result in ordinary recapture. The most common unrealized receivable recapture item is partnership property subject to depreciation recapture under Section 1245.

So the operations and the implications of this, the operation of our two sections, our two siblings, 741 and 751, treats the sale as two distinct transactions. One in which the intangible partnership interest is sold by the partner, and one in which the underlying Section 751 property is treated and sold by the partnership immediately before the partner disposes of its interests.

And the classification of the 741 and 751 gain property has implications. The 741 gain is treated as capital gain and taxed in a more favorable federal rate; the 751 gain is taxed at a less favorable ordinary income tax rates to reflect the fact that it's operational income. But those aren't the only consequences.

There are consequences, for example, that the PricewaterhouseCoopers partner experienced in the Appeal of Mingo, this is the Fifth Circuit Court of Appeal decision where the court found that the partner was not eligible to use installment sale treatment for the gain when the commissioner determined a portion of the gain reflected 751 property and needed to be recalculated as ordinary income and not capital gain.

The court held that because the gain from the unrealized receivables was required to report as ordinary income, the installment method could not be used. They are barred from using the installment method because of this. There are state consequences in California. So California is treating 741 and 751 gain as two separate sales in Appeal of Bense, and the Board of Equalization found that the sale of Appellant's partnership interest should have been fragmented and treated as first the sale of an interest in the partnership's unrealized receivables and, second, a sale of the remainder of the partnership interest.

And while I appreciate this was a resident's case, it was the application of 751 that we pull from that. It's the application of 751 and 741 that's pertinent to this case. Sourcing law does draw from residency law at times, and we see that with the Appeal of Buehler and we see that with the Appeal of Christman, because it's the interpretation of sourcing -- excuse me, it's the interpretation of the rules that are applied both to the resident and non-resident when dealing with sourcing and dealing with OTC and applying Bense in this case is appropriate for that exact same groundwork.

So with two separate sales, we have two separate sourcing analyses. The capital asset sale of 741 is treated as an intangible and source to the state of domicile under 17952; and in comes the 751 sale, which is treated as income from a business, trade, or profession, and source d under 17951-4.

And interestingly, we see this treatment foreshadowed in the Appeals of Ames, which is a case we cite to when we are talking about what is an intangible. But as you walk through the law and the legal statement in there, they say -- the cite to one case, they say these appeals are concerned with the gain realized by limited partners through the sale of their ownership interest and partnerships.

The gain was not the result of partnership operations, but as the result of a sale of an intangible. And when you look to the language, you can see that in way the Ames court is leaving open, it is possible that some of this gain could be gain from operational income.

IRC Section 702(b) explains how to characterize items that would constitute a distributive share of partnership income. The character of an item of income or loss included in a partner's distributive share shall be determined as if such item were realized directly from source from which realized by the partnership or incurred in the same manner incurred by the partnership. And that's how we made the leap to characterize 751 to the Regulation 17951-4. This also foreshadows the Appeal of Smith.

And as to the Appellants objections, this takes us right to the heart of their objections to sourcing of the gain. Their argument hinges on the idea that all of the gain has to be inseparable intangible income, and they seek to portray 17952 as this monolith and, essentially, claim that all income received in tandem with the sale of a partnership interest has to be given this treatment.

It is almost the reverse of effectively connected income -- effectively intangible income. And that's not supported by statute or precedent either, nor is it supported by Subchapter K. Because, essentially, what that does is it requires you to treat 741 as an only child. As if 741 is exactly how this should be sourced in California.

This is ignoring the rule that 751 is playing in the sale of partnership game. And it also ignores 702, to look to the income-producing activity and set the character and have it flow through. And this is akin to the leap that was made in the Appeal of Smith where the unitary relationship created business income.

So looking to -- looking for perfect symmetry between the calculation rules in the Treasury regulations and 17951-4, it's a red herring, with all due respect. And it's a red herring because the Court of Appeal told us in Valentino v. FTB that the California legislation action -- the action of California legislature -- I will move on from that sentence -- is the primary consideration.

And here, the California legislature conformed to 741 and 751, which that, obviously, made a law in California. And then we have the Board of Equalization ruling in Appeal of Bense that directs us to use this dual set of treatment. And two sales involves two separate sourcing analyses, an intangible and income firm business trade, or profession, and that tension is the tension we've seen in the California Code since its inception in the early part of the 20th century.

Appellants have introduced the new exhibit, Exhibit 5, into evidence in the prehearing conference. And this article discusses the DC circuit case. With the introduction of this new exhibit, they're refocusing their attention onto the deemed sale of inventory approach that was central to the DC decision in Rawat, and they find that -- the question was whether 751(a) created a deemed sale of inventory, because if there was a deemed sale of inventory, then there would be US sourcing.

But due to dependency on the federal sourcing rules, the stated issue and analysis focused on whether IRC Section 751(a) deems inventory sale as income from the sale of the inventory itself. That's not the issue here.

For California, the question is not whether IRC Section 751 provides for a deemed sale of the 751 property; instead, for California, the question is whether the Appellants' gain, if it's attributable to the partnership 751 property, is the result of partnership operations sourced under 17951-4 or from an intangible, going to 17952.

And this exhibit really places unnecessary weight on the deemed sale approach. If the Panel agrees -- but if the Panel agrees with the article and the DC Circuit's rejection of the deemed sale approach, that conclusion does not impact the result of this case. So here, the DC Circuit's focus in IRC Section 751 language is instructive.

Respondent is not trying to force language into 751. IRS, Section 751(a) explicitly provides that the amount received by a transferor partner in exchange for all or a part of the interest in the partnership that's attributable to unrealized receivables of the partnership or inventory items of the partnership.

Sourcing law provides that answer in Section 17951-4. That regulation specifically sources income from a business, trade, or profession. Income from partnership operations are income from a business, trade, or profession. Well, how do we make that leap? Well, we make it in two ways.

First, we look to this legislative action when using the regulation, that is what Valentino v. Franchise Tax Board tells us. In that case, the Court of Appeal held that the California legislator intended to look directly at the source of the income, not the cite of this document in this case, to determine whether the non-resident shareholder's pro rata share of the income is taxable by California.

The court then found that given hybrid entity approach to both S corporations and partnership, sourcing a pro rata share of a unitary S corporation could be read into 17951-4(d), when the regulation at the time didn't actually have a specific provision and for sourcing a pro rata share of income from unitary S corporation to a shareholder. The regulation was subsequently amends.

This flexibly in sourcing law present in Valentino demonstrates that looking to legislative, effect, carving out 751 as operating income from a capital asset 741 is appropriates. Next, it is appropriate to look to the nature of the entity. In this case, it's the partnership that has competing theories of aggregate and entity as outlined a moment ago.

Finally, Appeal of Ames itself suggests the operational income is separate from the intangible partnership interest when the Board of Equalization wrote the gain was not a result of partnership operations, but the sale of an intangible.

So these are the steps that walk through to get us to the reporting under 17951-4. And a moment on the reporting question. Respectfully, Schedule CA, which is filed with the 540-NR for non-residents and part-year residents has the three columns listed on there where they have their federal AGI, and then they go into the amount that would be taxed for California resident and the amount of source.

And the column that permits the reporting of income, where you would put business income, that is where the 751 gain would be reported and the intangible portion of income would be reported as non-California source income. To the extent that it could be made clearer and more user friendly, we would certainly be open to those comments -- I think those are valid and we would certainly be able to follow up with something along those lines -- but the current reporting is permitting under the Schedule CA.

Because the language explicitly provides that the partnership 751 gain is the amount attributable to the partnership 751 property, which is calculated under the Treasury regulations as the amount attributable to the partnership 751 property that would be allocated to the partner if the partnership sold all of its property for market value. IRC Section 751(a) itself says that this gain is what is attributable partnership operations.

The amount realized for the 751 gain is generally calculated under Treasury Regulation 1.751-1(a)(2) as the amount of income from the partnership 751 property that would have been allocated to the partner if the partnership sold of the its property at fair market value.

This specific Treasury regulation language, if the partnership had sold all of its property is how we know that 751, again, relates to partnership operations. If the partnership treated as selling all of its property in calculating the income realized by the partner, then that income is from partnership operations.

Additionally, the regulation specifies that it is the amount of income from the partnership 751 property that would have been allocated to the partner if the partnership had sold all of its property, and the use in the Treasury regulation of the word allocated shows the 751 gain is the partner share of partnership income from the partnership to the partner, which again, is sourced appropriately under 17951-4(d).

But regardless of whether there is a deemed sale of 751 property itself, this gain -- 751 gain is from partnership operations, treated as though allocated to the partner and, therefore, the income is sourced from California income tax purposes under Regulation 17951-4(d), more appropriately than under 17952.

I'm now going to turn it over for some more partnership-specific answers from Ms. Thyberg.

MS. SWAIN: Thank you. I'm on rebuttal duty. So I have two points. I would first like to address Appellants' arguments on the preferential tax rates and carveout. It is correct to say there is no preferential tax rate in California, so what's the point for us?

Well, California still conforms to IRC Section 741 and IRC Section 751(a) pursuant to IRC Section 851. IRC Section 741 creates a carveout for IRC Section 751. This carveout is even described in Rawat. You can see this carveout in the Treasury Regulation for 741.

Treasury Regulation 1.741-1(a) is really where you see the peel away. It says the amount realized shall be reduced by the amount attributable under Section 751 to unrealized receivables and substantially appreciated inventory items and the adjusted basis of the transferor or partner's interest in the partnership shall be reduced by the portion of such basis attributable to such unrealized receivables and substantially appreciated inventory items.

This is two separate sales; and, therefore, we are looking at two separate gains. IRC Section 741 gain and IRC Section 751 gain. My next point. Next, I would like to address Appellants' argument on the deemed sale approach to generate distributive share income. The Appellants' entire argument today is focused on whether IRC Section 751(a) creates a deemed sale of property.

They argue that the 751 gain is not properly sourced to California because there is no deemed sale of 751 property generating distributive share income. They point to Indu Rawat as support to this.

The DC Circuit in Indu Rawat analyzed whether IRC Section 751(a) created a deemed sale of the inventory itself because if there was a deemed sale of the actual inventory, then there would be US source income.

The focus was on whether IRC Section 751(a) created a sale of the inventory itself for purposes of applying federal sourcing rules. This is not the issue here. For California, the question is not whether 751(a) provides for a deemed sale of the partnership 751 property; instead, for California, the question is whether Appellants' gain from the sale of the partnership interest that is attributable to the partnership's 751 property is the result of partnership operations or from an intangible.

Even if there is no deemed sale generating income, the 751(a) gain itself as a separate sale, separate gain, includes the amount realized attributable to the partnership's 751 property that would have been allocated to the partner if the partnership sold all of its property.

The explicit language of IRC Section 751 and the Treasury regulation shows how the 751(a) gain is from partnership operations and, therefore, properly sourced under CCR Section 17951-4(d). Thank you.

ADMINISTRATIVE LAW JUDGE GAST: Does that conclude your presentation?
MS. SWAIN: Yes. Thank you, Judge.
ADMINISTRATIVE LAW JUDGE GAST: At this point I will turn to my co-panelists for questions.
Judge Le?
ADMINISTRATIVE LAW JUDGE LE: Thank you for your presentation. I don't have any questions.
ADMINISTRATIVE LAW JUDGE GAST: Okay.
And Judge Famularo?
ADMINISTRATIVE LAW JUDGE FAMULARO: Yes. Thank you for your great presentation. I would like to start by flipping the question that I had for Appellants into ask you specifically in statutory interpretation that the DC Circuit took in Rawat and the way that it analyzed the language in 751(a) that it almost mirrors the language in Section 64 that's defines ordinary income.
And as a result it held that the statutory language itself is clear, on its face, that 751 -- 741 and 751 together deal with a characterization of income as either ordinary or capital, but it does not make a leap -- to use the word that you used a few times -- to then allow the commissioner in Rawat to argue that there was a deemed sale of inventory and as a result then you could look at the international sourcing provision that held that if it

was inventory, it was effectively connected income at that time.

Again, the question I have for you, is your position on the DC Circuit's statutory interpretation on the language in 751(a)?

MS. SWAIN: Yes. Thank you, Judge.

MS. THYBERG: Yes, I got that. So Indu Rawat is really interesting to me. I appreciated the analysis, walking through how important IRC Section 751(a) language is, and they really balanced what the IRS was arguing, which was that it created an actual sale.

Especially, I really liked the point of looking at whether we can add language to 751 itself. Is it a sale of the inventory itself, that was what that balance was. Well, the question they were grappling with was to try to and answer a federal sourcing question.

Because if that was actually of inventory itself, then it would be US source income. So it's really difficult for us to look at that analysis and say the same applies, but I appreciate the focus on IRC Section 751 for purposes of applying California sourcing rules.

And the language itself in IRC Section 751(a) provides that this portion of the partner's gain -- related to 751, is the interest in the partnership attributable to unrealized receivables of the partnership or inventory items of the partnership. We don't even have read language into 751 for our California sourcing rules.

To us, that is clearly partnership operational income. And what is even more helpful is the Treasury regulation, which I know you already know it, but I will -- it's very helpful because it talks about, well, how do you calculate that amount realized?

The amount realized is calculated as the amount -- so the interest in the Section 751 property is the amount of income or loss from the Section 751 property -- again, this is all at the partnership level -- that would have been allocated to the partner if the partnership had sold all of its property in a fully taxable transaction for cash in the amount equal to the fair market value, and then more language.

But it is really interesting to me because we can use Indu Rawat as instructions for 751 is important, the language is important, and especially for California sourcing rules.

ADMINISTRATIVE LAW JUDGE FAMULARO: Thank you. No further questions at this time. Thank you.

ADMINISTRATIVE LAW JUDGE GAST: I want to give the taxpayer 30 minutes, so I don't want to run out of time, and afterwards, we will do more questions to Appellants. You will have 30 minutes for your closing statement.

MR. CAMPBELL: Okay. Thank you. I just want to make some comments and responses to the presentation. And let me just come back to you, Judge Famularo, because I had a chance to look at the Tax Court cases.

I think in looking at the Tax Court in your -- when you asked me the question and we are looking at the language, shall be considered as amount realized from the sale or exchange of property, and property may be more broad than assets, et cetera.

It makes sense. I understand that, especially in the context of the federal sourcing rule they were looking at, which is hey, they're just trying to find something that is income derived from inventory property. It's very different than here. The issue is in our case, and I think it is stronger in the analysis, even stronger for us.

This language 751(a) that we are talking about, it doesn't create distributive share of income. Whether it's considered as income attributable to inventory -- and there's way too much -- attributable means attributable, it doesn't mean distributive share. The very simple problem here is that the FTB's position requires the existence of the distributive share of income because that is what's Section 17951-4(d) applies to.

And I don't think we were heard the word distributive share come out of that side of the table in the last 30 minutes. I don't think it was mentioned.

I don't know if I'm in therapy or if I am in class about something about the siblings, but I'm telling you that what we have here, we need a clear rule of law and there always has been a clear rule to source income from sales of partnership interest.

So if we put 17 back up on the screen -- 17951-4(D) is the provision the FTB is saying applies here. So what I would ask the FTB is, is it there contention that since 751(a) has been in the code, that under California law, the selling partner's ordinary income is and always has been treated as a distributive share of the partnership's business income but sourced under 17951-4, and the answer is no.

If it were, certainly they would have authority to explain that. Certainly, they don't. We know that. And, again, Bense is not authority for any of this. Bense just shows that FTB and State Board what 751 is and does, and there's been no mention ever that the fact that you have an amount attributable to the partnership's ordinary income property is all of a sudden a distributive share of, you know, the partnership's ordinary income, it's not.

And that's just important because, you know, they're using the word attributable to make it sound like or that this is income from operations. There's no dispute that income from partnership operations, just like corporate income that business income, subject to source and apportioned to the states.

And, I mean, we have to live by these rules every day, and this is how -- we all know how these rules work. You can't take the selling partner's ordinary income under that statute and magically turn it into a distributive share of actual operating income from the partnership.

And, again, now the FTB is getting double taxed because the FTB is going to get the tax on the business income when the business income is realized and reported by the partnership when it flows through.

Telling the selling partner that they actually have a distributive share of that income when it doesn't exist is, like, how they're getting it from the selling partner and they are going to get it from the partner who files it at the end of the year. Hat's just a fact. So all of this stuff is irreconcilable with the way the rules actually work and the language.

I have a couple other points. We don't need to sit here on behalf Appellants and say that you need to invalidate the ruling, by the way; we just know that the determination in our case is wrong. I think the ruling is invalid for a million reasons. We just know the determination of Appellants is wrong due to a matter of law. It's based on a ruling but the legal reasons for the determination part is wrong. Right. So our position is simply please reverse the FTB's determination there.

Did I answer your question about the Tax Court decision?

ADMINISTRATIVE LAW JUDGE FAMULARO: You did. Thank you.

MR. CAMPBELL: Okay. Another -- another small point. The concept is this discussion that's in the belief that an intangible property of 17952 is a monolith, whatever that means.

Here's the reality: 17952 sources income from intangible property, covers lots of stuff -- royalties and sales, stocks, bonds, and capital gains from sales of partnership interest and all the gain income from a sale of partnership interest. The exception is written right in the rule for 17952. If it's sourced here saying domicile unless it has a business license elsewhere.

The case you mentioned, Christman, that's a business license case. If there is an exception to taxation -- to income from an intangible, it's governed by the business license rule. There's nothing to debate here in the academic world at this point about whether there is

-- you know, 752 is not sufficient to source this or that there is some other sale here. We are not reading into the law of separate sales. We know that we need treat a portion of the selling partner's gain as ordinary income and, you know, that concept, I keep hearing is being used to -- it's a separate sale.

Okay. Fine. It's a separate sale. It's a calculation. But that sale explicitly, whatever it is, calculation or not, it's not generating a distributive share of partnership income. And you have to have a distributive share of partnership income for this case to hold water if you are the FTB.

Again, by the way, Ames doesn't leave anything open because, Ames, in those cases, they're all about business ITIS. Hey, selling partner who is a non-resident, your gain is not California source income. FTB, you're conflating the concept of business operations in the state because the partnership is doing business here with the income of the selling partner who is living outside of California and is selling it realizing the income.

If there's a business ITIS, then you would have some California source income, but you don't in Ames; right? We are not talking about business ITIS rule, we are talking about do we have an actual distributive share of income that the Franchise Tax Board regulation itself, the plain language its regulation applies to. We do not. And they cannot sit there with a straight face and tell me that we do. They haven't said that they do. And they certainly can't say that the law prior to the legal ruling of 2202-02 provides for that, because it doesn't.

We're almost done. I love that we are frustrated. Apparently, we need to go the therapy. We should come in more often. Again, what taxpayer's, or the Appellants in this case, and all taxpayers rely on is clear rules, like, rule of law, especially for common, everyday transactions.

I don't know how many hundreds of thousands of partnerships exist in this world that are taxable here, but my firm probably prepares two million partnership tax returns a quarter, and there are people selling partnership interests everyday, and the rules work -- like, they're in plain sight. I can go look at the 741, 751, and 702 rules and tax returns, and it all works perfectly. And I can come look at the California returns and it all works perfectly.

This is the first time in the history of this issue that it's now come to light, like, hey, we have this ruling. It's very obvious that the FTB started looking at this issue after the 2012 and 2019 tax years. As we saw in Smith, it was raised there. As we saw in the case, it's raised there. And we know, again, from the audit file here that there was a lot of discussion going on where even in the correspondence I'm being told or the Appellants' representative meaning me are being told looking at this and there's task force and everything.

All of that is to say that this is not the law that is being claimed to exist and so clear. No, this is a position that was developed. And if it's a position that's developed, then the proper avenue from that is to put it out in the public eye, get comments, go to the legislature and figure it out.

Again, there are a lot of repercussions that aren't even dealt with on the corporate tax side. I mean, again, the whole concept of taxing the selling partner but then what do you do about the income that is going to be realized attributable to that which now the new partner has. Are you going to do a reverse 754, I don't know, but there are a million, you know, things that would have to be dealt with.

That's all just to complicated and way too much weight to put on the word attributable. All of a sudden because it's attributable to my interest in the partnership's property and considered as not realized from the sale or exchange of public property other than a capital asset, that all of a sudden that's means I actually have a distributive share of income to source under the regulation that they say applies. We don't have that.

Again, happy to have a public discussion and consider sourcing 751, ordinary income, but I think that's certainly something that could be thought of. Again, guaranteed payments by legislation are sourced as distributive share income, not as comp or interest. You could that here if the legislature wanted to enact that. We don't have that law now. I think -- anything else? Any other questions?

ADMINISTRATIVE LAW JUDGE GAST: Well, if that concludes your closing?

MR. CAMPBELL: I think we are done.

ADMINISTRATIVE LAW JUDGE GAST: So I'll ask the Panel one more time. Judge Famularo, sorry. I cut you off there. Do you want to continue with some of the questions you had? We have about 30 minutes left of this hearing so...

ADMINISTRATIVE LAW JUDGE FAMULARO: Yes. So my question for FTB. The way I understood your presentation was that even if the DC Circuit in Rawat was correct, it doesn't alter outcome in this case, and I just wanted to clarify one thing to make sure that I understood it. The way I understand this is DC Circuit's opinion -- DC Circuit, the Tax Court, and the IRS, they all took the position that 741, 751, it characterizes income, it's not a sourcing provision.

And then the IRS took the position that it does something more than that. That there's this deemed sale of inventory which was at issue in Rawat and is the DC Circuit first the Tax Court agreed with the IRS, and the DC Circuit came back and said, no, we don't think that's what the statutory language provides, and your reading of the regulation to support that position could be read one of two ways.

And we are reading it as a calculation of the amount of ordinary income in the amount of capital gain. So the way that I see the Rawat opinion is that it deals with the characterization versus income and then the DC Circuit, it says we don't go beyond that. We are not saying that there's a deemed sale. And so in Rawat, we are looking at the international sourcing provisions; in this case we are looking at the California sourcing provisions.

I see parallels because in that Rawat case before TCJA, there was no specific sourcing provision for the sale of a partnership interest similar to California. So we have 17951, but it's not specific, it deals with, as you both have said, intangible personal property. So I understood your position to be that the DC Circuit opinion could stand alone and stand as correct and you would still have the authority for the position that you are taking that there is a deemed sale of the second transaction, this deemed sale of inventory and/or collection of accounts receivable.

I just wanted to give you an opportunity to clarify that position, and it would be helpful to me if I could understand your possession a little more fully.

MS. SWAIN: I want to start first from -- thank you, Judge. I wanted to start first from what was different in Rawat and those sourcing rules that had a different requirement for finding an inventory sale. We don't that exact requirement in California, and that's one reason where it's not the same question. That's an extremely narrow lens to be looking through.

I think that we brought up the case initially to show this question of bifurcation. And we also -- and because I had alerts on that case, the moment that the DC Circuit decision came in, which I think was a bit of a surprise. When that came in, immediately filed it and brought it to your attention for just that reason, to say, hey, this new case came out, and what we briefed at the time is -- our position is that wasn't the proper reasoning.

But going one step further, I think, especially because it was a very quick briefing clock, we do think that fundamentally you can still go back to language that it isn't -- and I appreciate the question as getting to didn't they describe that reasoning, and we still think you can go back in to the find the language for purposes of California sourcing rule, and I will have Ms. Thyberg talk about that.

MS. THYBERG: Yes. So I'd love to just clarify 751, how we have been looking at 751 today, especially because Appellants are focusing on that deemed sale of property. And as you have raised in the Indu Rawat, the whole focus was on whether there was a deemed sale of inventory, and that's was so important that they did end up creating IRC Section 864(c)(8) to have that deemed sale of the inventory.

But here, again, in California, that's not our question. We are looking at whether this is from partnership operations or from an intangible. And to tease out what we are saying, even if there is no deemed sale generating the distributive share income in that way that has been argued by Appellants, the 751(a) gain all by itself -- all by itself -- that's a whole separate gain that we need to look at sourcing, how do we source this?

Well, this gain includes the amount realized attributable to the partnership's 751 property, and we get to see how it's calculated. It's calculated as the amount that would have been allocated -- allocated feels kind of important, doesn't it? -- allocated to the partner if the partnership sold all of its property.

The explicit language of 751(a) and the Treasury regulations show how really this gain is all coming from partnership operations. And so it was correctly sourced under CCR Section 17951-4(d). I hope that helped clarify.

ADMINISTRATIVE LAW JUDGE FAMULARO: It did, and I appreciate it. Thank you.

ADMINISTRATIVE LAW JUDGE GAST: Okay. I have a few questions for Appellants, but it is really more towards facts because I'm a little confused on some of the facts just from my own background.

So Tory Burch, there were a few sales by JCB, it wasn't just one -- a few in 2012 and 2013; is that correct?

MR. CAMPBELL: Yes. Do you want me to go through the background?

ADMINISTRATIVE LAW JUDGE GAST: No --

MR. CAMPBELL: Sales in 2012 and in 2013.

ADMINISTRATIVE LAW JUDGE GAST: And the NOL we're talking about for Appellant Burch, is the 2013 NOL, so there was additional income attributable to the Appellant through 751(a) for 2013, so that reduced his NOL and reduced the carry back --

MR. CAMPBELL: Sorry. They're all secondary adjustment based on the primary adjustment.

ADMINISTRATIVE LAW JUDGE GAST: I understand. As I need to understand the background for what was adjusted. So it was the 2013 NOL and no other NOL?

MR. CAMPBELL: Not that I'm aware of.

ADMINISTRATIVE LAW JUDGE GAST: And we are also dealing within 751(a), unrealized receivables and inventory items. Not just inventory items; is that correct?

MR. CAMPBELL: Yes.

ADMINISTRATIVE LAW JUDGE GAST: Okay. I just wanted the background there. That's it for my questions. Everything was well briefed. It's laid out there.

So Judge Le, did you have any final questions?

ADMINISTRATIVE LAW JUDGE LE: Just one. Appellants makes the argument that the FTB's position results in double taxation. I was wondering if you could address that point?

MS. SWAIN: I had questions about that question too. I don't see how that is double taxation. I mean, the income -- when the interest is sold, the partner is going to be -- I mean, there's a potential for double taxation for a non-resident between two states. But, for instance, if the non-resident mentioned lived in Massachusetts -- actually, let me change my hypothetical.

If they're living in New Hampshire, which doesn't have a state sales tax, and the business also apportions -- they're pretty minimal apportionment percentage, 12 and 16 percent -- so you imagine that this unitary partnership is doing business throughout the country so there are going to be instances of double taxation, potentially.

If Tory Burch LLC is doing business in Massachusetts, which is highly likely given the Boston market, I would expect that they would potentially have 10 percent income. That state would tax potentially 13 percent of the whole gain.

ADMINISTRATIVE LAW JUDGE LE: If I can interject? Maybe, Appellants, can you restate your position on that taxation points?

MR. CAMPBELL: Yes. Sure. And so this is why it is super important to have a very solid understanding of Sub K rules; it says nothing about state tax. The FTB's position is that the selling partner's amount of ordinary income is distributive share income and taxed as a share of the partnership's business income.

So under this new rule, the selling partner would have a gain from my sale of my interest measured by my amount realized and adjusted basis, and I would normally pay taxes to my state of residence. Now, because of this California rule, I'm going to treat the 751 piece as business income and pay some tax to California based on the apportionment percentage.

So now California is getting -- taxing based on theory of I have got business income to tax. Well, what is that ordinary income business income attributable to? It is attributable to the partnership's income. The partnership was going to realize that income when it collects on the inventory of the receivables in the future.

So I'm telling the selling partner today, hey you have to pay tax on California source income because the partnership itself has some property that is going to generate some California source income going forward, so we are going to take some of that from you right now in a gain. Meanwhile, the partnership is there all along, selling inventory and collecting unreceivables, and all of that income at the end of the year is going to get allocated to the partners at the end of the year and they are going to pay taxes on that income.

So if my selling partner has a 1 percent interest in the partnership and I will treat some of that gain for

California purposes has a share of business income that hasn't yet been generated, but then it is going to get generated and taxed to the other partners, that's where the double tax comes in.

And by the way, these issues exist outside of this, the federal side, that is why there a super detailed rules that on the 751(b) side, make adjustments, like, we are going to allocate the income to the partners other than the distributee partner. We don't do any of that on the 751(a) side because there is no partnership income.

If there were, you would have to make all sorts of adjustments at the partnership level and have provisions to exactly explain how this gets divided up among the partners when you make a change like that for one partner. So the double tax is the operating income going forward. California is going to get that. You don't need to tax the selling partner now as if that were because they will get it.

And my last point, because I want to make a comment to their comment. It all comes down to, at least in their argument, that this is income from partnership operations. So they're trying to side step the distributive share points and say, no, it is just operations. This goes to the Tax Court question, oh, it's income from inventory, we don't need a deemed sale.

Let's just look at it from the flip side. You need actual partnership operating income that generates distributive share income in order for this rule to apply. Whether it's the word attributable -- that just doesn't magically create actual operating income.

And I will say -- my closing remark is the word allocated is important, but guess what? The words would have been allocated is the actual verb, that's way more authoritative than allocated. That's my point. There's no actual operating income here. If there were, it would be taxed as distributive share income. It will be taxed as distributive share income when it actually is realized.

ADMINISTRATIVE LAW JUDGE GAST: Thank you.

Back to you, Ms. Swain.

MS. SWAIN: Thank you, Judge Le. And thank you for that clarification. I was definitely going to take the long ride to the answer to that question. I very much appreciate that. Thank you, Mr. Campbell.

There's two parts of that question. So when the partnership makes the sale -- when I sell my interest, the partner sells their interest, that is the date of that sale, they're no longer receiving distributive share for future sales, so that's the first question.

Will there potential be double taxation between what happens in the residence and what happens in the state of California, yes, that's what the other state tax credit is designed for. So ideally, that person in their state of residence says, you know what, I'm taxed on 100 percent by you, California just taxed the 751 portion of the income from my 13 percent that was apportioned of the sale of the overall gain. I would like another state tax credit for that. That's the device to do that. So that's in the other states' hands. There are a few exceptions when California would also give a desist to a non-resident, but I don't think for purposes of this they really matter.

And then there's a second part which is the step up rules allowed under 704(b) that would step up the basis in the interest, and that's triggered any time of the sales, so in some ways that gain, conceivably, is evaporating.

MS. THYBERG: Sorry. I can take that one. So just because it is really interesting. The 754 election is allowed any time there's a sale of a partnership interest. So in this situation, the partnership could make a 754 election and that would allow it to have the basis step up under IRC Section 743(b), and that prevents the double taxation from the buying partner. Thank you.

ADMINISTRATIVE LAW JUDGE LE: Thank you, both. No further questions.

ADMINISTRATIVE LAW JUDGE GAST: All right. Well, I believe this concludes the hearing, and I want to thank the parties for the presentations. We will meet and decide the case based on the arguments and documents presented. We will issue our written opinion no later than 100 days from today. The case is submitted and the record is now closed. And we will take a brief recess before the next hearing, which is scheduled to begin at approximately 1:00 p.m. Thank you.

(The hearing was concluded at 11:50 a.m.)

HEARING REPORTER'S CERTIFICATE

I, Shelby K. Maaske, Hearing Reporter, in and for the State of California, do hereby certify:

That the foregoing transcript of proceedings was taken before me at the time and place set forth, that the testimony and proceedings were reported stenographically by me and later transcribed by computer-aided transcription under my direction and supervision, that the foregoing is a true record of the testimony and proceedings taken at that time.

I further certify that I am in no way interested in the outcome of said action.

I have hereunto subscribed my name this 9th day of July, 2026.

Shelby Maaske,
Hearing Reporter

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