

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of:)
J. BURCH,)
J. CARDEN AND)
K. CARDEN)

OTA Case Nos. 230112266 & 230112267

OPINION

Representing the Parties:

For Appellants:

Christopher W. Campbell, Representative
David Han, Representative

For Respondent:

Ellen L. Swain, Attorney
Leah Thyberg, Attorney

For Office of Tax Appeals:

Thomas Marlo, Attorney

K. GAST, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19043.5(b), appellant J. Burch appeals actions by respondent Franchise Tax Board (FTB) proposing to reduce his 2013 tax year net operating loss (NOL) by \$2,535,814, which is comprised of: (1) \$206,532 for the 2013 tax year; and (2) \$2,329,282 carried back from the 2013 tax year to the 2012 tax year. Pursuant to R&TC section 19045, appellants J. Carden and K. Carden appeal an action by FTB proposing additional tax of \$1,507, plus applicable interest, for the 2012 tax year. FTB's actions against appellant Burch and appellants Carden (collectively, appellants) stem from its proposed increases to appellants' taxable incomes related to their net gains from the sales of partnership interests.

Office of Tax Appeals (OTA) Panel Members Kenneth Gast, Huy "Mike" Le, and Hans Famularo held an oral hearing for this matter in Cerritos, California on June 16, 2026. At the conclusion of the hearing, the record was closed, and this matter was submitted for an opinion pursuant to California Code of Regulations, title 18, (Regulation) section 30209(b).

ISSUE

Whether appellants generated California source income from the sales of partnership interests for amounts attributable to unrealized receivables and inventory items under Internal Revenue Code (IRC) section 751(a).

FACTUAL FINDINGS

1. At all relevant times, appellants were California nonresident individuals.
2. Appellants owned direct membership interests in JCB Investments, LLC (JCB), an investment company that was classified as a partnership for federal and California income tax purposes. JCB, in turn, owned a variety of unrelated investments, including approximately 28 percent of the direct membership interests in Tory Burch LLC (Tory Burch). Tory Burch owned a well-known fashion brand, operated retail stores, and engaged in online sales of clothing, accessories, and lifestyle brands. Like JCB, Tory Burch was classified as a partnership for federal and California income tax purposes. Tory Burch conducted a unitary trade or business within and without California.
3. In 2012 and 2013, JCB sold portions of its partnership interests in Tory Burch, and generated a net gain that was (1) partly characterized as capital gain under IRC section 741, and (2) partly characterized as ordinary income under IRC section 751(a) attributable to Tory Burch's unrealized receivables and inventory items (commonly known as "hot assets" and referred to hereafter as "IRC 751(a) property"). On its 2012 and 2013 California partnership tax returns, JCB reported the net gains as nonbusiness income that was not derived from a California source and therefore not taxable to appellants, its nonresident individual partners.
4. As partners of JCB, appellants indirectly realized gain from JCB's sale of its partnership interests in Tory Burch. They reported their respective shares of the gains on their California nonresident tax returns (appellant Burch for 2012 and 2013, and appellants Carden for 2012) as nontaxable, non-California source income under R&TC section 17952.
5. FTB audited appellants' California nonresident tax returns and took the position that their shares of the partnership-interest gains in Tory Burch should be treated as two distinct transactions. According to FTB, portions of the gains are treated as appellants' distributive shares of Tory Burch's apportionable business income resulting from Tory Burch's deemed sale of its IRC 751(a) property, which is sourced to California under Regulation section 17951-4(d) using Tory Burch's apportionment percentages for 2012 and 2013.¹ FTB treated the remainder of the gains as sales of intangible assets (i.e., the partnership interests in Tory Burch), which is not California source income

¹ For the 2012 and 2013 tax years, Tory Burch's California apportionment percentages were 13.5581 percent and 16.0753 percent, respectively.

under R&TC section 17952 because appellants are nondomiciliaries of this state and the partnership interests did not acquire a business situs here.²

6. Based on its determination, FTB increased appellant Burch's taxable income for the 2012 and 2013 tax years (and did the same for appellants Carden's 2012 tax year) to reflect they derived California source income for the portions of their net gains attributable to the deemed sales of Tory Burch's IRC 751(a) property. FTB issued to appellant Burch a Notice of Proposed Assessment (NPA) for the 2012 tax year and a Notice of Proposed Adjusted Carryover Amount for the 2013 tax year that reduced his 2013 tax year NOL by \$206,532 due to the additional income. He protested both notices. FTB affirmed its sourcing position by issuing a Notice of Action (NOA) for each year, but for the 2012 NOA, it allowed appellant Burch to carryback a portion of his 2013 NOL to fully offset the additional taxable income, which resulted in his 2013 NOL being further reduced by \$2,329,282, but no additional tax was due. FTB also issued an NPA for the 2012 tax year to appellants Carden that proposed additional tax of \$1,507, plus applicable interest. They protested the NPA, but FTB affirmed it by issuing an NOA.
7. Appellants timely appealed and OTA consolidated their cases for a decision.

DISCUSSION

I. Burden of Proof

FTB's proposed assessment of additional tax is presumed correct and taxpayers bear the burden of proving it to be incorrect. (*Appeal of Smith*, 2023-OTA-069P (*Smith*).) The burden of proof requires proof by a preponderance of the evidence, which means taxpayers must establish by documentation or other evidence that the circumstances they assert are more likely than not to be correct. (Cal. Code Regs., tit. 18, § 30219(b); *Smith, supra*.) Taxpayers

² The gains at issue arose from JCB's sales of its direct partnership interests in Tory Burch, which presumably flowed through to appellants on a Schedule K-1 as a distributive share of income from JCB. However, the parties agree that under the facts of this appeal, the nonresident sourcing analysis should focus on the sale of a partnership interest in appellants' hands. Thus, R&TC section 17952 (at least to the extent the gain is attributable to IRC section 741) is implicated in this appeal. (Cf. *The 2009 Metropoulos Family Trust, et al. v. Franchise Tax Bd.* (2022) 79 Cal.App.5th 245 [nonresident trust shareholders of a unitary, multistate S corporation must use Regulation section 17951-4, not R&TC section 17952, to source their pro rata shares of intangible business income generated by the S corporation]; *Appeal of Smith*, 2023-OTA-069P [same for nonresident partners]; see also Cal. Code Regs., tit. 18, § 17951-4(d)(4) [R&TC section 17952 is implicated when the source of a nonresident partner's distributive share of items do not constitute business income].)

also bear the burden of establishing both the existence and amount of an NOL that may be utilized in other tax years. (*Appeal of Sadatnejad and Marconet*, 2024-OTA-625P.)

II. General Tax Background

Under the Personal Income Tax Law, California resident individuals are taxed on their entire taxable income regardless of source, while nonresidents, such as appellants, are only taxed on income derived from California sources. (R&TC, §§ 17041(a), (b), & (i)(1)(B), 17951(a); *Smith, supra.*) For purposes of computing the taxable income of a nonresident who has gross income from sources both within and without this state, the income “shall be allocated and apportioned under rules and regulations prescribed by [FTB].” (R&TC, § 17954; *Smith, supra.*) Under this legislative grant of rulemaking authority, FTB promulgated regulations specifying types of income from sources within this state (Regulation section 17951-2), as well as regulations dealing with how to treat intangible personal property (Regulation section 17952) and nonresident income from a business, trade, or profession (Regulation section 17951-4). (*The 2009 Metropoulos Family Trust, et al. v. Franchise Tax Bd.* (2022) 79 Cal.App.5th 245, 266 (*Metropoulos*).)

As relevant here, “Regulation section 17951-4 and R&TC section 17952 provide different nonresident sourcing provisions.” (*Smith, supra.*) “Regulation section 17951-4 contains income sourcing provisions applicable to a nonresident’s business, trade, or profession.” (*Ibid.*) Specifically, Regulation section 17951-4(d) provides rules that when “a nonresident [such as appellants] is a partner in a partnership which carries on a unitary business, trade or profession within and without this state, the source of the partner’s *distributive share* of partnership income derived from sources within this state” is determined according to various rules that follow. (Cal. Code Regs., tit. 18, § 17951-4(d), italics added.) In general, the total apportionable business income of the partnership is apportioned at the partnership level according to the apportionment rules of the Uniform Division of Income for Tax Purposes Act (known as UDITPA, which is found in R&TC section 25120, et seq., and the regulations thereunder). (Cal. Code Regs., tit. 18, § 17951-4(d)(1); *Smith, supra.*) “In contrast, R&TC section 17952 provides that nonresident income from intangible personal property is not income from sources within California unless the property has acquired a business situs in this state.” (*Smith, supra.*; see also Cal. Code Regs., tit. 18, § 17952.)

At issue in this appeal is how to source appellants’ net gains from JCB’s sales of its direct partnership interests in Tory Burch during 2012 and 2013. Appellants assert California cannot tax any of the gain. As support, they rely on R&TC section 17952 and its accompanying regulation, as well as *Appeals of Ames, et al.* (87-SBE-042) 1987 WL 50165, a precedential

decision issued by the Board of Equalization (BOE), OTA's predecessor, to argue that a partnership interest is classified as intangible personal property and its sale by a nonresident cannot be taxed in this state, unless the partnership interest itself acquired a business situs here.³ FTB partially disagrees, contending the portions of the gains attributable to the deemed sales of IRC 751(a) property (unrealized receivables and inventory items) cannot be sourced under R&TC section 17952 because such assets should be treated as if *the partnership* (i.e., Tory Burch) sold them, generating partnership-level gains that flow through (from Tory Burch to JCB and then to appellants) as a distributive share of apportionable business income sourced to California using Tory Burch's apportionment percentages for 2012 and 2013 under Regulation section 17951-4(d)(1).⁴ FTB otherwise agrees the remaining portion of the gains attributable to IRC section 741 cannot be taxed in California under the authorities appellants cite. FTB's position is based in large part on its Legal Ruling 2022-02, issued on July 14, 2022.⁵ For reasons that follow, OTA finds in favor of appellants.

III. Analysis

A. California Conformity to Federal Partnership Tax Principles

California generally conforms to federal partnership tax law under Subchapter K of the IRC, which includes IRC sections 741 and 751. (R&TC, §§ 17851, 17024.5(a)(1)(O) [for the 2012 and 2013 tax years, California conformed to the IRC as of a specified date of January 1, 2009].) When applying the IRC for California personal income tax purposes, federal treasury regulations (final or temporary) are applicable in California to the extent they do not conflict with California tax law or FTB's regulations, if any. (R&TC, § 17024.5(d).) Where, as here, federal and state tax statutes and regulations are identical, or substantially identical, the

³ The nonresident intangible property rule of R&TC section 17952 derives from the common law concept of *mobilia sequuntur personam* (movables follow their owner), which sources the income to the nonresident's state of domicile, and its equally well-settled business situs exception, which, if established, sources the income not to the nonresident's domicile but to where the intangible asset acquired such situs. (*Metropoulos*, 79 Cal.App.5th at pp. 267, 276.)

⁴ Under UDITPA, adopted by California and certain other states and which seeks to establish uniform rules for the attribution of income derived from multiple jurisdictions, a unitary enterprise's (here, Tory Burch's) business income is apportioned among the taxing jurisdictions according to a formula. (*Smith, supra*; see also R&TC, §§ 25120(a) [defining business income], 25128(a) [for tax years before 2013, business income is generally multiplied by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four], 25128.7 [for 2013 and subsequent tax years, business income is generally multiplied by the sales factor].)

⁵ FTB Legal Ruling 2022-02 was issued after the audit (but before protest proceedings concluded) for this appeal. The parties seem to disagree whether the legal ruling was issued in response to the audit of this case, but OTA need not resolve that dispute to decide the legal issue in this appeal.

federal courts' interpretations and effect given to them are highly persuasive, and there is a strong public policy favorable to interpreting state tax statutes that are based upon federal statutes consistent with the interpretations of their federal analogs. (*Appeal of Akhtar*, 2021-OTA-118P.)

Under IRC section 741, when a partner sells a partnership interest, any gain or loss recognized on the sale is generally “considered as gain or loss from the sale or exchange of a capital asset,” which is taxed as capital gain (often at lower, preferential federal tax rates) rather than as ordinary income (often at higher federal tax rates). (*Rawat v. Commissioner* (2024) 108 F.4th 891, 893 (*Rawat*).) IRC section 741, however, includes an express exception and applies “except as otherwise provided in [IRC] section 751 (relating to unrealized receivables and inventory items).” Under IRC section 751(a), when the sale of a partnership interest produces gain “attributable to” either “unrealized receivables of the partnership” or “inventory items of the partnership,” that gain “shall be considered as an amount realized from the sale or exchange of property *other than a capital asset*.”⁶ (*Italics added.*) “That is, gain from the sale of a partnership interest attributable to ‘inventory items’ or ‘unrealized receivables’ is taxable as ordinary income rather than as a capital gain.” (*Rawat*, 108 F.4th 891, 893.)

The crux of the issue is whether for California nonresident sourcing purposes, the sale of a partnership interest must be bifurcated into two distinct transactions: one in which the underlying IRC 751(a) property is treated as sold *by the partnership* immediately before the partner sells its interest, leading to a distributive share of income to the partner; and one in which the remaining intangible partnership interest is sold *by the partner* under IRC section 741. FTB argues that such bifurcation is supported by the relevant federal and California authorities. In contrast, appellants contend the entire partnership gain is treated as a sale of an intangible asset and sourced under R&TC section 17952. Appellants argue that IRC section 751(a) simply affects the character (not the state sourcing) of the gain as either capital or ordinary for purposes of applying preferential tax rates, which are only applicable at the federal level, and the availability of capital losses to only offset capital gains, which is applicable both at the federal level and in California.

⁶ The statutory definitions of “unrealized receivables” and “inventory items” are not at issue and therefore will not be discussed in this Opinion. (See IRC, § 751(c), (d).)

B. District of Columbia (DC) Circuit's Decision in *Rawat* is Highly Persuasive

The substance of FTB's argument was recently made by the IRS and rejected by the U.S. Court of Appeals for the DC Circuit in *Rawat*, which overturned the U.S. Tax Court's decision in *Rawat v. Commissioner*, T.C. Memo. 2023-14. In *Rawat*, the DC Circuit held that a foreign (non-U.S.) individual's gain from the sale of a partnership interest attributable to the partnership's IRC 751(a) property (specifically, inventory) was not U.S.-source income subject to U.S. taxes. (*Rawat*, 108 F.4th 891, 895.) While the parties agreed IRC 751(a) property gain should be taxed as ordinary income, the IRS, like FTB here, argued IRC section 751(a) does more than that—i.e., the IRS asserted the provision “also deems gain on the sale of a partnership interest attributable to inventory to be gain on the sale of inventory, such that it can be taxable as U.S.-source income.” (*Id.* at p. 894, italics in original.)

The DC Circuit in *Rawat* disagreed. It analyzed the “pivotal clause” in IRC section 751(a)—“shall be considered as an amount realized from the sale or exchange of property other than a capital asset”—and concluded, based on IRC section 64's materially identical definition of “ordinary income,” the clause effectively means “ ‘shall be considered as ordinary income.’ ” (*Rawat*, 108 F.4th 891, 895.) Since IRC section 751 interlocked with IRC section 741, which characterizes the gain as capital, the court concluded that IRC section 751 was only meant to change the character of income and not to contrive a separate transaction, contrary to what the IRS advanced (and FTB advances here). (*Id.* at pp. 895-896.) The court also observed that IRC section 751(a)'s legislative history and purpose was to prevent partners from using IRC section 741 to avoid ordinary-income taxes they would otherwise owe by selling their partnership interest to obtain favorable capital gain treatment. (*Id.* at pp. 896-897.)

Critically, the DC Circuit noted that IRC section 751(b), which was not at issue in that case or here, accomplished what the IRS (and here, FTB) says IRC section 751(a) did—i.e., a transaction fitting the description of IRC section 751(b) is not treated as a regular partnership distribution but instead as a sale or exchange of *such property* (i.e., of substantially appreciated inventory or unrealized receivables). (*Rawat*, 108 F.4th 891, 897-898.) But, unlike IRC section 751(b), IRC section 751(a) simply converts capital gain into ordinary income and does not treat the partnership-interest sale as a sale of inventory items or unrealized receivables. (*Ibid.*) Lastly, the IRS's (and here, FTB's) reliance on Treasury Regulation section 1.751-1(a)(2) and (g) was unhelpful, because even if income from IRC 751(a) property must be calculated consistent with a hypothetical sale of such property by the partnership, such calculation is simply one way to determine *the amount* of ordinary income from a partnership-interest sale but does not treat the income as it were in fact a sale of IRC 751(a) property. (*Id.* at p. 899.) “The

short of it is that [IRC section] 751(a) does not of its own force render [IRC 751(a) property] taxable because it does not change the fact that [the taxpayer] sold a partnership interest, not [IRC 751(a) property].” (*Ibid.*) Accordingly, the court rejected the IRS’s contention that IRC section 751(a) treats the partner (or partnership itself) as selling unrealized receivables or inventory items, and therefore no such deemed sale occurs at the partner (or partnership) level and no distributive share of such income flows through from the partnership to its partners.

Although the DC Circuit’s decision in *Rawat* is not binding precedent in California but instead binding for cases appealable from the U.S. Tax Court to the DC Circuit,⁷ OTA nonetheless finds the court’s analysis and reasoning to be highly persuasive. FTB argues *Rawat* was wrongly decided (or least distinguishable) because the court did not properly consider there are two transactions involved in the sale of partnership interest—one, the ownership interest or capital asset under IRC section 741, and two, the IRC 751(a) property. However, as previously noted, *Rawat* engaged in a thorough statutory construction analysis that addressed this contention and rejected it. IRC section 751(a)’s recharacterization of capital gain to ordinary income involving partnership-interest sales has a clear anti-abuse function and IRC section 751(a) does nothing more than that; i.e., as *Rawat* instructs, IRC section 751(a) has no application to U.S. income tax sourcing rules and should not, by extension here, affect California nonresident sourcing rules.

FTB makes much of the fact that Subchapter K of the IRC contains two competing approaches to viewing partnerships: the entity theory, in which the partnership is viewed as a distinct legal entity separate from its partners; and the aggregate theory, in which the partnership is viewed as merely an aggregate of the individual partners who comprise it. (See McKee, et al., *Federal Taxation of Partnerships & Partners* (Thomson Reuters/Tax & Accounting, 5th ed. 2026, ¶ 1.02.) FTB asserts that although California generally treats the sale of a partnership interest by an individual under the entity approach in conformity with IRC section 741, the treatment of IRC 751(a) property is consistent with the aggregate theory because the partnership, and by extension the partner through the conduit principle under IRC section 702(b), is considered to have sold such property. FTB contends the U.S. Tax Court in *Rawat* properly considered the entity-versus-aggregate distinction, but maintains the DC Circuit did not. However, not only did the DC Circuit overturn the U.S. Tax Court’s memorandum

⁷ See *Appeal of Walker* (84-SBE-139) 1984 WL 16217 [the so-called *Golsen* rule from *Golsen v. Commissioner* (1970) 54 T.C. 742, where the U.S. Tax Court is bound by decisions of the federal court of appeals in the circuit where an appeal from the tax court can be filed, is inapplicable in California].

opinion but the DC Circuit placed heavy reliance on the applicable statutes (as opposed to broader partnership concepts) to reach its conclusion, which OTA finds more persuasive.

At the hearing, FTB contended the sourcing issue in *Rawat* is different from the one here. In *Rawat*, FTB asserts the issue was whether the foreign (non-U.S.) taxpayer was deemed to have sold inventory under IRC section 751(a) for U.S. income tax sourcing purposes, but here, FTB asserts the issue is whether appellants' gains attributable to IRC 751(a) property is from partnership operations (as FTB argues) or an intangible asset (as appellants argue). However, FTB attempts to draw a legal distinction where there is none. *Rawat* plainly concluded that IRC section 751(a) does not change the fact that a partnership interest is sold—not inventory. (*Rawat*, 108 F.4th 891, 899.) Stated differently, in *Rawat*, the inventory was owned by the partnership whose interest was sold and thus was an asset derived from partnership operations, but this did not alter the court's pivotal conclusion that only a partnership interest is ultimately sold for IRC section 751(a) (as well as IRC section 741) purposes. (*Id.* at pp. 892, 894.) This necessarily means that when a partnership interest is sold, a partner does not have income from partnership operations and, accordingly, there is neither an actual or deemed sale of IRC 751(a) property at the partner-level nor a distributive share of such gain at the partnership-level that passes through to its partners.⁸

C. BOE's Appeal of Bense and OTA's Smith are Distinguishable

FTB argues its bifurcation approach to partnership-interest sales finds further support in *Appeal of Bense* (79-SBE-055) 1979 WL 4096 (*Bense*), a BOE precedential decision. In that case, the taxpayers sold their interest in a partnership but did not properly recognize ordinary income under former R&TC statutes patterned after IRC 751(a) property. BOE observed the following: the taxpayers' "partnership interest should have been fragmented and treated as two sales: (1) a sale of [the taxpayers'] interest in the partnership's 'unrealized receivables' to the

⁸ Also at hearing, FTB contended that even if there is no deemed sale of IRC 751(a) property by the partnership, the explicit language of IRC section 751(a) (and Treasury Regulation section 1.751-1(a)(2)) still provide for a separate sale and gain that would have been allocated to the partner if the partnership sold all of its property, and therefore such gain is from partnership operations sourced under Regulation section 17951-4(d). But, again, *Rawat* rejected the substance of this argument, concluding the purpose of IRC section 751(a) is to compute the portion of the partnership-interest gain attributable to ordinary income and the rest as capital gain, without altering the fact that the taxpayer sold a partnership interest. (See *Rawat*, 108 F.4th 891, 899 [Treasury Regulation section 1.751-1(a)(2)'s hypothetical calculations are used to determine amount of ordinary income, not recast the partnership-interest sale as actually involving IRC 751(a) property].) FTB similarly argued that Treasury Regulation section 1.741-1(a) supports its bifurcation theory. However, it appears the intent of that provision is simply to compute IRC section 741 capital gain at the partner-level by removing amounts attributable to IRC section 751(a) ordinary income. It does not state or imply the partnership (or partner) itself is selling IRC 751(a) property, which is consistent with *Rawat*.

extent the ‘unrealized receivables’ represented [ordinary income from IRC 751(a) property]; and (2) a sale of the remainder of [the taxpayers’] partnership interest.” (*Bense, supra.*) BOE further observed the IRC 751(a) property consists of “the amounts that the partnership would be required to report as ordinary income *if* the partnership had sold [such property] immediately before a partner sells or exchanges [its] partnership interest.” (*Ibid.*, italics added.)

However, BOE’s observation that partnership-interest sales attributable to IRC 751(a) property should be fragmented and treated as two sales does not mean the partnership itself is deemed to have sold such property or that the taxpayers received a distributive share of ordinary income from the partnership reflecting the partnership’s deemed sale of such property. Indeed, *Rawat* considered similar “fragments of legislative history,” where U.S. Congress stated “the partner is treated as though [it] disposed of [IRC 751(a) property] independently of the rest of [the] partnership interest,” and “in general, the income rights [from IRC 751(a) property] [is] severable from the partnership interest.” (*Rawat*, 108 F.4th 891, 898.) But the court nonetheless concluded such legislative statements “are naturally read to reiterate that [IRC 751(a) property simply leads to ordinary income], rather than to dictate that a partnership-interest sale be deemed an actual sale of [IRC 751(a) property].” (*Ibid.*) In BOE’s own words, the fragmentation simply reflects the anti-abuse “purpose of these [former R&TC] statutes . . . to prevent the conversion of ordinary income into capital gain by the use of the partnership form of doing business.” (*Bense, supra.*) Moreover, *Bense* does not involve nonresident sourcing, presumably because the taxpayers were California residents taxable on their worldwide income. In short, *Rawat* is more recent, direct authority that addresses the issue in this case.

FTB also relies on OTA’s precedential Opinion in *Smith*, but FTB attacked the transaction in that case in a materially different way. *Smith* involved a holding-entity partnership that recognized gain from the sale of its direct partnership interest in an operating partnership, and the gain passed through the holding-entity partnership as a distributive share of income to the ultimate taxpaying-nonresident partner. OTA sustained FTB’s determination, finding the nonresident taxpayer derived California source income. Agreeing with FTB’s legal position, which applied principles from *Metropoulos*, OTA concluded that because the gain was generated at the holding-entity partnership level, Regulation section 17951-4(d), and not R&TC section 17952, was the appropriate sourcing provision to apply. OTA thus determined the holding entity and operating partnership were unitary and the gain constituted apportionable business income to the holding entity that was apportioned at the holding-entity level under Regulation section 17951-4(d), which flowed up to the nonresident taxpayer as a distributive share of California source income.

Here, in contrast to both *Smith* and *Metropoulos*, FTB does not argue JCB and Tory Burch are unitary or the partnership-interest sales constitute apportionable business income at JCB's level that is reported to appellants as distributive shares of income. Rather, largely relying on its Legal Ruling 2022-02, FTB's legal theory is the IRC 751(a) property gains are treated as if Tory Burch sold such assets, resulting in a "deemed distribution" to appellants of California source income based on Tory Burch's apportionment percentages—a treatment that *Rawat* disagreed with. Further, in *Smith*, OTA specifically declined to address such theory. (See *Smith*, *supra*, fn. 14 ["Because OTA sustains FTB's unitary position, it declines to address FTB's alternative position the gain generates business income (and is apportioned) at [the operating partnership's] level under IRC section 751, even in the absence of a unitary relationship," citing FTB Legal Ruling 2022-02]; see also *Appeal of Buehler*, 2023-OTA-215P, fn. 7 [noting FTB's IRC section 751(a) sourcing position from FTB Legal Ruling 2022-02 was not at issue].) Accordingly, *Smith* does not support FTB's position.

D. California's Nonresident Sourcing Laws Do Not Support FTB's Position

How a transaction is characterized for federal income tax purposes, if California conforms, can affect the state sourcing treatment. (See, e.g., *Appeals of Amarr Company and Amarr Company (C SGNF)*, 2022-OTA-041P [IRC section 338(h)(10) election treated as a deemed asset sale by the target corporation, and not a sale of stock by its shareholders, for apportionment purposes]; *Metropoulos*, 79 Cal.App.5th 245, 259 [federal deemed asset sale at S corporation level respected for apportionment purposes, and nonresident shareholders taxed on resulting apportionable business income under UDITPA on their pro rata shares and not under R&TC section 17952];⁹ *Valentino v. Franchise Tax Bd.* (2001) 87 Cal.App.4th 1284, 1294-1295 [federal pass-through treatment of S corporations applies for California nonresident sourcing purposes].) To be sure, and contrary to *Rawat*, if the transactions at issue were characterized as FTB contends, then an analysis applying Regulation section 17951-4(d), including *Metropoulos* and *Smith*, would have been required and the outcome may have changed. However, as *Rawat* shows, the federal characterization of appellants' partnership-

⁹ It is worth noting IRC section 338(a), involving a deemed asset sale by the target corporation, has materially different language from IRC section 751(a). In general, IRC section 338(a)(1) provides that if the purchasing corporation makes an election, the target corporation "shall be treated as having sold all of its assets," even though there was actual sale of stock by its shareholders. In contrast, IRC section 751(a) provides that income attributable to IRC 751(a) property "shall be considered as an amount realized from the sale or exchange of property other than a capital asset." Thus, unlike IRC section 338(a), IRC section 751(a) does not state the selling entity is "treated as having sold" any assets, and the actual partnership-interest sale is respected for federal income tax purposes.

interest sales is entirely treated as just that—a sale of a partnership interest and not a sale by the partnership (or partners) of the partnership’s assets—and the California sourcing analysis must proceed on that legal premise.

This does not mean California cannot otherwise source such income to this state and tax it. California has accomplished this in other similar contexts, regardless of the federal characterization. For example, nonresident income from partnership guaranteed payments is sourced to California “in the same manner as *if* those payments were a distributive share of that partnership.” (R&TC, § 17854, italics added; see also Cal. Code Regs., tit. 18, § 17951-4(d)(3).) And in both the apportionable business income and allocable nonbusiness income contexts, gain or loss from partnership-interest sales are taxed based on the property or apportionment factors of the partnership whose interest was sold. (See Cal. Code Regs., tit. 18, § 25136-2(d)(1)(A)1. [sales factor numerator treatment]; R&TC, § 25120(d) [allocable nonbusiness income treatment].)

Unlike the above examples, neither the R&TC, its accompanying regulations, nor case law provides for the sourcing result FTB seeks. (See generally *Rawat*, 108 F.4th 891, 898 [noting it is a familiar principle of statutory construction that a negative inference may be drawn from the exclusion of language from one statutory provision that is included in other provisions of the same statute].) R&TC section 17952 (including Regulation section 17952) broadly applies to source “income of nonresidents from stocks, bonds, notes, or *other intangible personal property*.” (Italics added.) FTB agrees that partnership-interest sales related to IRC section 741 are sourced under R&TC section 17952, but contends such sales related to IRC 751(a) property are not governed by that provision. However, R&TC section 17952 makes no mention of the bifurcation approach FTB espouses. Similarly, Regulation section 17951-4(d), by its plain terms, is only applicable to a nonresident partner’s “*distributive share* of [unitary] partnership income,” not a nonresident partner’s sale of a partnership interest.¹⁰ (Italics added.) Relying, in part, on R&TC section 17952, BOE and OTA caselaw further provide a nonresident’s gain from the sale of partnership interest is not sourced to California, unless the interest acquires a business situs here. (See *Appeals of Ames*, *supra*; *Appeal of Heller* (97-SBE-014) 1997 WL 768547, fn. 4 [observing that a nonresident’s distributive share of partnership income (or loss) will generally be treated differently from the sale of a partnership interest]; *Appeal of*

¹⁰ In contrast, for example, Idaho Admin. Rule 35.01.01.266(01.) (d.) provides nonresident “gain or loss from the sale of an interest in a publicly traded partnership transacting business in Idaho is Idaho source income to the extent of the gain or loss determined under *Section 751, Internal Revenue Code*, multiplied by the Idaho apportionment factor of the partnership for the year in which the sale occurred.” (Italics added.)

Buehler, supra [applying R&TC section 17952 to an other state tax credit sourcing issue involving a resident taxpayer's sale of a partnership interest].) If FTB wishes to source such sales based on its proposed method, it is free, for example, to approach the Legislature to seek a statutory change.¹¹ (See, e.g., Stats. 1988, ch. 1170, § 2 [Legislature amended R&TC section 25125 to provide specific sourcing rule for corporate nonbusiness income from partnership-interest sales to overturn BOE's decision in *Appeal of Holiday Inns, Inc.* (86-SBE-074) 1986 WL 22707]; see also *Rawat*, 108 F.4th 891, 893 [noting that during the year at issue, no specific sourcing provision governed partnership-interest sales, but since then, the federal Tax Cuts and Jobs Act of 2017 enacted a sourcing rule to govern such sales].)

IV. Conclusion

For all the above reasons, OTA declines to follow FTB Legal Ruling 2022-02.¹² The legal ruling concludes that a nonresident partner's disposition of a partnership interest attributable to IRC 751(a) property is treated as if the partnership had sold such property and allocated it to the partner, which may result in California source income under the appropriate provision, including Regulation section 17951-4(d). But it was issued shortly before both *Rawat* decisions, and OTA finds the DC Circuit's well-reasoned analysis to be highly persuasive and will follow it. Accordingly, OTA concludes that partnership-interest gain attributed to IRC 751(a) property does not change the fact that for California nonresident sourcing purposes, the nonresident sold a partnership interest that must be sourced under R&TC section 17952.¹³

¹¹ FTB's sourcing position is similar to what is known as "investee" apportionment. That method focuses on apportioning income derived by a taxpayer from its investment in an in-state investee (here, Tory Burch) based on the latter's *own* activities within the state (here, Tory Burch's California activities measured by its California apportionment percentages), regardless of whether a unitary relationship exists between the taxpayer and the investee or whether the taxpayer's ownership interest in the investee serves an operational function in the taxpayer's unitary business. (See Hellerstein, Hellerstein, & Appleby, *State Taxation* (Thomson Reuters/Tax & Accounting, 3rd ed. 2026), ¶ 9.11[2][a] [discussing "investee" theory and related cases].) But, as just discussed, California's personal income tax statutes, regulations, and case law do not provide for such method to source gains or losses from partnership-interest sales to this state. (See *VAS Holdings & Invs. LLC v. Commissioner of Revenue* (2022) 489 Mass. 669 [although investee apportionment found to be constitutional, the Massachusetts high court nonetheless invalidated the assessment because the state's statutes imposed tax on gain from partnership-interest sales only when the taxpayer and in-state partnership were unitary].)

¹² In its briefing and at the hearing, FTB did not argue its Legal Ruling 2022-02 is entitled to deference. In fact, FTB acknowledged that OTA could disregard some of the language in the ruling that OTA disagreed with and still find for FTB. Therefore, OTA does not analyze the issue of deference.

¹³ To the extent OTA has not specifically addressed arguments or authorities discussed in the parties' briefing or at the hearing, OTA has considered them and finds them to be moot, meritless, irrelevant, or distinguishable.

HOLDING

Appellants did not generate California source income from the sales of partnership interests for amounts attributable to unrealized receivables and inventory items under IRC section 751(a).

DISPOSITION

FTB's actions are reversed in full.

DocuSigned by:

Kenneth Gast

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Kenneth Gast
Administrative Law Judge

We concur:

DocuSigned by:

Huy "Mike" Le

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Huy "Mike" Le
Administrative Law Judge

Signed by:

Hans Famularo

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Hans Famularo
Administrative Law Judge

Date Issued: 7/24/2026