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07.14.2022

LEGAL RULING – 2022-02

SUBJECT: Appropriate sourcing of Internal Revenue Code ("IRC") section 751(a) gain from the disposition of a nonresident individual's partnership interest to the extent the IRC section 751 property is located in California.

ISSUE

Whether, due to the operation of IRC section 751(a),[1] a nonresident individual partner who disposes of a partnership[2] interest has California-source income attributable to the partnership's unrealized receivables or inventory as if the partnership had sold those assets, to the extent those assets are located in California, as sourced by California Code of Regulations, Title 18, ("Regulation") section 17951-4.

SITUATION 1

Nonresident individual partner A owns a 49% interest in ABC Partnership. ABC's business is carried on wholly within California. ABC's assets include unrealized receivables, appreciated inventory located in California, and depreciation recapture on assets located in California. A sells their partnership interest to an unrelated third party.

SITUATION 2

Assume the same facts as Situation 1, except ABC conducts business within and without California.

LAW AND ANALYSIS

IRC Sections 741 and 751

[1] California Revenue and Taxation Code ("RTC") section 17851 conforms to Subchapter K, which includes sections 701 through 777 of the IRC, with some exceptions, not relevant here. Specifically, RTC section 17851 conforms to IRC section 751 with certain exceptions provided for in RTC sections 17855, 17856, and 17857, relating to certain exemptions from "hot asset" treatment.
[2] "Partnership" as used in this Ruling includes any eligible entity that is treated as a partnership for federal income tax purposes, including, but not limited to, a limited liability company ("LLC") classified as a partnership for tax purposes.

Under federal tax law, taxation of partnerships is governed by Subchapter K of the IRC. Many of the provisions found in Subchapter K derive from two competing approaches to viewing the partnership: the "aggregate approach" and the "entity approach."[3]

The interplay between an entity and an aggregate approach has long been a subject of case law:

> The entity theory holds the nature of a partnership to be such that the partnership is a distinct legal entity separate from its partners. The aggregate theory on the other hand considers the partners of a partnership as not forming a collective whole. Rather the partnership is viewed as merely an aggregate of the individual partners of which it is comprised.
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> A resolution of the dispute concerning whether the entity theory or aggregate theory of partnership should be applied for all purposes has not been reached.[4]

When Subchapter K was enacted in 1954, Congress adopted a hybrid approach where the general rule is an aggregate approach but with important exceptions where an entity approach is applied.[5]

IRC section 741 applies an entity approach to partnerships, and therefore is an exception to the general rule. Under IRC section 741, when a partner sells or exchanges their partnership interest, the partner generally recognizes a capital gain or loss on the sale only to the extent the partnership holds no unrealized receivables or appreciated inventory. To the extent the amount received by the partner is attributed to the partnership's unrealized receivables or appreciated inventory under IRC section 751 ("IRC 751 property"), the partner is required to recognize ordinary income or loss on the portion of the sale attributable to these items.

In conformity with IRC section 741,[6] California generally treats the sale of a partnership interest by an individual under the entity theory, as a sale of intangible personal property, a capital asset, sourced to the state of residence of the seller.[7] If the intangible property has acquired a business situs in California, the gain on the sale of the partnership interest is sourced to California.[8]

However, the treatment of IRC 751 property is consistent with the general application of the aggregate theory to partnerships.[9] IRC section 751 provides that the amount of any money

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[3] For a detailed discussion, see *The Logic of Subchapter K, a Conceptual Guide to the Taxation of Partnerships,* Chapter 1, 5th Edition (2017), Laura Cunningham and Noel Cunningham.
[4] *Unger v. Commissioner*, T.C. Memo 1990-15, 58 T.C.M. (CCH) 1157, T.C.M. (RIA) 90015.
[5] See H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954) for a discussion of the entity versus aggregate approach as applied to IRC section 707.
[6] See RTC section 17851.
[7] *Appeal of Amyas and Evelyn P. Ames, et al.* (June 17, 1987) 87-SBE-042.
[8] RTC section 17952.
[9] H.R. Conf. Rep. No. 2543, *supra,* note 6.

(or the fair market value of any property) received by a selling partner in exchange for all or a part of their interest in the partnership, which is attributable to unrealized receivables or inventory items of the partnership, is considered to be realized from the sale or exchange of property other than a capital asset. The gain to the partner is ordinary gain.[10]

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 the source from which realized by the partnership, or incurred in the same manner incurred by the partnership."

An unrealized receivable is an account receivable of a partnership which has not yet been included in income. There are three categories of unrealized receivables: goods, services, and recapture items. IRC section 751(c) defines the term "unrealized receivables," to include, "to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered."

Unrealized receivables also include a list of partnership assets, which, if sold by the partnership, may result in ordinary income recapture. The most common unrealized receivable recapture item is partnership property subject to depreciation recapture under IRC section 1245.[11]

The operation of IRC section 751, therefore, necessitates that the sale of the partnership interest be treated as two distinct transactions: one in which the intangible partnership interest is sold by the partner, and one in which the underlying IRC 751 property is treated as sold by the partnership immediately before the partner disposes of its interest, leading to a deemed distribution to the partner. The State Board of Equalization ("the Board")[12] recognized this dual sale treatment resulting from the sale of a partnership interest in the *Appeal of Gerald H. and Dorothy A. Bense*.[13] The Board found that the sale of "appellants' partnership interest should have been fragmented and treated as two sales: (1) a sale of appellants' interest in the partnership's 'unrealized receivables' to the extent the 'unrealized receivables' represented 'potential [Revenue and Taxation Code] section 18211 income' or 'potential [Revenue and Taxation Code] section 18212 income'; and (2) a sale of the remainder of appellants' partnership interest."[14]

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[10] 26 Code of Federal Regulations section 1.751-1(a). See RTC section 17851.

[11] RTC section 18151 conforms to Subchapter P of the IRC, composed of sections 1220 through 1260. Specifically RTC section 18165 conforms to IRC section 1245 with certain exceptions.

[12] The Board was the prior appellate body for Franchise Tax Board ("FTB") cases. Today, the Office of Tax Appeals ("OTA") hears appeals of FTB's determinations. Precedential opinions of the Board still hold such value before the OTA. (Cal. Code Regs, tit. 18, section 30504.)

[13] *Appeal of Gerald H. and Dorothy A. Bense* (March 7, 1979) 79-SBE-055.

[14] Today, California conforms to IRC Subchapter K in RTC sections 17851, et seq. RTC sections 18211 and 18212 addressed IRC 751 property in 1979.

Since the operation of IRC section 751 characterizes the transaction separately as a sale of the partnership interest and a sale of the underlying IRC 751 property, the sourcing rules for the sale of an intangible asset will not apply to the sale of the underlying IRC 751 property, as discussed below.

Sourcing the Income from the Disposition of a Partnership Interest

RTC section 17951 provides, for purposes of computing taxable income, nonresidents need include only gross income from sources within this state. Under IRC section 702(b), the income generated by the deemed sale of IRC 751 property will be sourced as distributive share.[15] The regulations under RTC section 17951 specify the rules for determining when an item of income shall be determined to be sourced to California. Specifically, Regulation section 17951-4 provides for the sourcing of income from a trade, business or profession.

RTC section 17952 provides sourcing rules for the sale of intangible assets. In the case of the sale of a partnership interest, RTC section 17952 applies to the sale of the intangible partnership interest, but when the partnership holds IRC 751 property, RTC section 17952 is not sufficient to source the entirety of the sale since the sale is deemed to be bifurcated through the operation of IRC section 751. The deemed sale of the IRC 751 property, which is treated as if having been sold by the partnership immediately before the transaction by the partner (through operation of IRC section 751), is not treated as a sale of intangible property, nor is it treated as an asset sale by the transferor partner. Instead the proceeds attributable to the deemed sale of the IRC 751 property are treated as a pro rata distribution (or distributive share) to the partner of gain or loss items of the partnership.[16] This distribution is, therefore, income from a trade, business or profession to be sourced pursuant to Regulation section 17951-4.

To the extent a nonresident individual's business is wholly within or without California, Regulation section 17951-4(a) would apply to source the income of the business. Regulation section 17951-4(a) provides that the net income from a nonresident's business, trade, or profession carried on wholly within California is California source income. Conversely, none of the net income from a nonresident's business, trade, or profession carried on entirely outside of California is California source income.

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[15] See *Consolidated Appeals of the 2009 Metropoulos Family Trust and the Evan D. Metropoulos 2009 Trust*, (November 7, 2019) 2019–OTA-385P. Although Metropoulos involved an S-corporation, the governing IRC section 1366(b) provides nearly identical language to IRC section 702(b): "The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation." In *Valentino v. Franchise Tax Board* (2001) 87 Cal.App.4th 1284 (Cal. Ct. App. 2001), the court opined, "the conduit rule of Internal Revenue Code section 1366(b) was intended by Congress to be the same as the partnership rule, Internal Revenue Code section 702(b)."
[16] *Consolidated Appeals of the 2009 Metropoulos Family Trust and the Evan D. Metropoulos 2009 Trust*, (November 7, 2019) 2019–OTA-385P. The OTA clarified that Regulation section 17951-4 applies to distributive share income, "Regulation 17951-4(d)(1) provides the general rule that business income is apportioned at the S corporation level, not the shareholder level as appellants essentially argue using R&TC section 17952."

For partnerships conducting business within and without California, Regulation section 17951-4(d) provides:

If a nonresident 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 shall be determined in the manner described below.

> (1) Except as provided, the total business income of the partnership shall be apportioned at the partnership level in accordance with the apportionment rules of the Uniform Division of Income for Tax Purposes Act, Sections 25120 to 25139, Revenue and Taxation Code, and the regulations thereunder.
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> (2) If the partnership and the business activity of the partner are part of one unitary business, then the rules of Title 18, Cal. Code Regs., §25137-1(f) apply and the apportionment of the partnership business income is done at the partner level for the unitary partner or partners. Each partner's distributive share of the partnership business income apportioned to this state is income derived from sources within this state.
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> (3) The source of guaranteed payments received by a nonresident partner from a partnership shall be determined as if the guaranteed payments were a distributive share of partnership business income.
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> (4) The source of a partner's distributive share of items which do not constitute business income shall be determined in accordance with the sourcing rules of Sections 17951 through 17955, Revenue and Taxation Code, and the regulations thereunder, as if the income producing activity were undertaken by the partner in its individual capacity.

In the case of the sale of a partnership interest when the partnership operates wholly within California and holds IRC 751 property, the income attributable to the sale of the IRC 751 property will be sourced to California as the income from the business is treated as California source income pursuant to Regulation section 17951-4(a).

Since the purpose of IRC section 751 gain is the capture of ordinary income of a partnership, the nature of the income attributable to the deemed sale of the IRC 751 property of a partnership operating both within and without California is business income[17] and the gain on the deemed sale of the IRC 751 property will be sourced according to UDITPA (RTC sections 25120 to 25139) pursuant to Regulation section 17951-4(d)(1). Since the proceeds are treated as if the partnership itself sold the IRC 751 property, gain

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[17] RTC section 25120 defines "business income" as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. See also *Hoechst Celanese Corp. v. FTB*, (2001) 25 Cal.4th 508.

should be sourced according to the appropriate rule as if the IRC 751 property itself was sold, not the partnership interest.[18]

Finally, IRC section 751(f) provides special rules for tiered partnerships. When determining whether a partnership is holding IRC 751 property, "the partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner."

HOLDING 1

All gain or loss associated with ABC's IRC 751 property is sourced to California. Regulation section 17951-4(a) provides the net income from a nonresident's business, trade or profession carried on wholly within California is California source income. Therefore, all of A's income attributed to the IRC section 751 gain (or loss) will be sourced to California. A's IRC section 741 gain is considered the sale of intangible property and sourced pursuant to RTC section 17952. Assuming it has not otherwise gained a business situs in California, the IRC section 741 gain would not be sourced to California.

HOLDING 2

The gain or loss associated with ABC's IRC 751 property is sourced to California based upon ABC's California apportionment factors by operation of Regulation section 17951-4(d). Since the gain or loss is calculated as if the partnership had sold the IRC 751 property and distributed it up pro rata to A, the income would be treated as income from a trade, business or profession and sourced according to UDITPA (RTC sections 25120 to 25139). Each item of IRC 751 property, not the partnership interest, must be sourced under the sourcing rule appropriate to that item.

DRAFTING INFORMATION

The principal authors of this legal ruling are Natasha S. Page and Christopher Casselman of the Franchise Tax Board, Legal Division. For further information regarding this ruling, contact Ms. Page or Mr. Casselman at the Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, California 95741-1720.

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[18] In the *Appeal of Amyas and Evelyn P. Ames*, 87-SBE-042, June 17, 1987, the Board held that a partnership interest, which both FTB and the parties agreed was intangible property, did not gain a California business situs merely through the operation of the partnership in California. Therefore, it was sourced pursuant to RTC section 17952, which applied the doctrine of *mobilia sequunter personam*, which sources the proceeds from the sale of intangible property to the state of residence of the owner. However, in that case, there was no issue raised with respect to IRC 751 property; therefore, the Board did not have to address the bifurcation of the interest that had been the subject of the *Appeal of Bense*. So the application of the *Appeal of Ames* is proper only as to the IRC section 741 portion of the gain by the transferor partner and not the sourcing of the IRC section 751 portion of the gain.