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MULTISTATE INCOME/FRANCHISE TAX

California ruling on sourcing of IRC section 751 gain from the sale of a partnership interest

Tax Alert

Overview

On July 14, 2022, the California Franchise Tax Board ("FTB") issued Legal Ruling 2022-02 providing guidance on the sourcing of gain from the sale of a partnership interest by a nonresident individual where the underlying partnership has Internal Revenue Code ("IRC") section 751 assets.

This Tax Alert summarizes some of the relevant provisions of Legal Ruling 2022-02.

Sale of partnership interest should be analyzed as two distinct transactions for purposes of sourcing the gain/loss to California

In Legal Ruling 2022-02, the FTB takes the position that the operation of IRC section 751 requires the sale of a partnership interest to be treated as two distinct transactions:

- Proceeds from the sale of a partnership interest that are attributable to IRC section 751 assets are apportioned to California using the partnership's California apportionment factor.
    - FTB's interpretation of IRC section751 creates a deemed sale of the IRC section 751 assets by the partnership followed by a deemed distribution to the selling partner.
    - FTB states that IRC section 751 gain is treated as distributive share under IRC section 702(b).
    - FTB concludes *"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. This distribution is, therefore, income from a trade, business or profession to be sourced pursuant to Regulation section 17951-4".*

    - In other words, according to the FTB the IRC section 751 gain is apportioned to California based on the partnership's California apportionment factor.

- IRC section 741 gain or loss, proceeds from the sale of the partnership interest not attributable to IRC section 751 assets, are treated as the sale of an intangible asset.

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