



MULTISTATE INCOME/FRANCHISE TAX

California OTA rejects FTB sourcing of nonresident IRC section 751(a) gain

Tax Alert

Overview

On July 24, 2026, the California Office of Tax Appeals (OTA) issued its opinion in [Appeals of J. Burch, J. Carden, and K. Carden](#), OTA Case Nos. 230112266 & 230112267, 2026-OTA-527P (Cal. Off. Tax App. July 24, 2026) (“*Burch*”), holding that the entire amount of a nonresident’s gain from the sale of a partnership interest, including any amount treated as ordinary income for federal income tax purposes pursuant to section 751(a) of the Internal Revenue Code (IRC) (“751(a) ordinary income”), constitutes income from an intangible sourced pursuant to section 17952 of the California Revenue and Taxation Code (CRTC).

In reaching its conclusion, the OTA declined to follow Franchise Tax Board (FTB) [Legal Ruling 2022-02](#) (July 14, 2022) (the “Legal Ruling”), in which the FTB took the position that an individual taxpayer’s 751(a) ordinary income constituted a distributive share of the partnership’s business income that was subject to apportionment pursuant to California Code of Regulations, title 18 (“Regulation”) section 17951-4(d). For more background on the Legal Ruling, see the August 10, 2022 [Tax Alert](#). The OTA instead followed the analysis in *Rawat v. Commissioner*, 108 F.4th 891 (D.C. Cir. 2024), *rev’g* T.C. Memo. 2023-14, and concluded that IRC section 751(a) recharacterizes a portion of the gain from the sale of a partnership interest without treating the transaction as a sale of a partnership’s assets.

This Tax Alert summarizes the opinion. Neither party petitioned for rehearing, and the opinion is final. The OTA has designated the opinion as pending precedential. Members of the public can submit comments to the OTA on the precedential designation through October 28, 2026. The opinion’s precedential status may affect the extent to which the FTB continues to assert the position in the Legal Ruling.

Background

The taxpayers were California nonresident individuals who held membership interests in JCB Investments, LLC (“JCB”), a partnership for federal and California income tax purposes. JCB owned approximately 28 percent of TB LLC, also a partnership, which conducted a unitary business within and without California. In 2012 and 2013, JCB sold portions of its interests in TB LLC.

Under federal income tax law, gain from the sale of a partnership interest constitutes capital gain under IRC section 741, except as otherwise provided in section 751. IRC section 751(a) provides that the amount a selling partner receives that is “attributable to” unrealized receivables and inventory items of the partnership “shall be considered as an amount realized from the sale or exchange of property other than a capital asset.” Under these federal provisions, the portion of JCB’s capital gain that was attributable to its share of TB LLC’s unrealized receivables and

inventory items was recharacterized as ordinary income. JCB's partners reported their respective distributive shares of JCB's capital gain and ordinary income on their federal returns.

On its California return and the K-1s issued to its partners, JCB reported the entire gain as allocable nonbusiness income. On their California nonresident individual returns, the partners did not report any amount of this gain as California source income in accordance with CRTC section 17952, Regulation section 17951-1(b), and Regulation section 17951-4(d)(4). CRTC section 17952 provides that income from intangibles does not constitute California source income unless the intangible has acquired a business situs in California. Regulation section 17951-1(b) provides that a nonresident's California source income includes his or her distributive share of a partnership's California source income. Regulation section 17951-4(d)(4) provides that, in the case of a partnership engaged in a unitary business, trade or profession within and without the state, the nonresident's distributive share of the partnership's nonbusiness income is sourced pursuant to the personal income tax rules, including CRTC section 17952.

The FTB audited JCB's returns. It first determined that JCB's entire gain was business income on the theory that JCB was engaged in a unitary business with TB LLC. After JCB presented evidence to show that it was not unitary with TB LLC and not engaged in a trade or business to begin with, the FTB withdrew the unitary determination.

The FTB then asserted that JCB's 751(a) ordinary income constituted a distributive share of TB LLC's business income from a deemed sale of its unrealized receivables and inventory items. The FTB apportioned JCB's 751(a) ordinary income using TB LLC's California apportionment percentages, which were 13.5581 percent for 2012 and 16.0753 percent for 2013. Having made this determination, the FTB issued notices of proposed assessment to JCB's nonresident partners, asserting they owed tax on their distributive shares of TB LLC's apportionable business income under Regulation section 17951-4(d).

The taxpayers protested. Shortly after the protest hearing, the FTB issued the Legal Ruling, which became the basis for the protest determination in the case. The Legal Ruling asserts that IRC sections 741 and 751(a) treat a sale of a partnership interest as two separate taxable transactions: a sale of the partnership interest by the partner that gives rise to capital gain, and a deemed sale of the IRC section 751 property by the partnership that generates apportionable business income, taxable as distributive share income to the nonresident partner pursuant to Regulation section 17951-4(d).

The OTA agreed with the taxpayers that 751(a) ordinary income was gain from the sale of the partnership interest

The only issue before the OTA was whether JCB's 751(a) ordinary income constituted a distributive share of TB LLC's apportionable business income under the theory set forth in the Legal Ruling. If not, then JCB's gain was allocable (nonbusiness) income and the applicable sourcing rules for the taxpayers' distributive shares of JCB's gain were Regulation sections 17951-1 and 17951-4(d)(4), both of which apply CRTC section 17952. The taxpayers relied on the plain language of IRC section 751(a) and its accompanying regulations, which treat part of the selling partner's gain as income from the sale of other than a capital asset, i.e., ordinary income. (The purpose of this rule was to prevent partners from contributing ordinary income producing property to a partnership and then selling the partnership interest, effectively converting ordinary income into capital gain taxed at a lower rate under federal law. There is no rate differential in California.) The taxpayers contrasted the language of IRC section 751(a) with the plain language of IRC section 751(b) and related regulations, which treat certain distributions as a sale or exchange of property between the partner and the partnership. The taxpayers also pointed to the distributive share rules that expressly reference section 751(b) and omit any reference to section 751(a). They argued that this omission shows

federal law does not treat 751(a) ordinary income as partnership income to be allocated as distributive share income to the selling partner. Accordingly, the taxpayers argued that the entire gain realized by JCB was income from the sale of an intangible. And since JCB was an investment vehicle that was not engaged in a unitary business, trade or profession with TB LLC, (or on its own), the partners' distributive shares of JCB's entire gain were properly sourced pursuant to CRTC section 17952.

The FTB relied on the position articulated in the Legal Ruling, namely that IRC section 751(a) created a "deemed sale" by the partnership and "deemed distribution" to the partner—an argument that allowed the FTB to assert that the 751(a) ordinary income was a distributive share of the partnership's business income that would flow through as California source income to the nonresident partner under Regulation section 17951-4(d).

The OTA disagreed with the FTB, finding that the plain language of the federal statutes did not support the position that IRC section 751(a) provided for a deemed sale of assets by the partnership. Rather, IRC section 751(a) recharacterizes a portion of the selling partner's capital gain as ordinary income. The OTA's construction of IRC section 751 tracks the D.C. Circuit's analysis in *Rawat*. Describing *Rawat*, the OTA stated that IRC section 751(a) "simply converts capital gain into ordinary income," in contrast to IRC section 751(b), which treats certain distributions as a sale or exchange of property.

Accordingly, the OTA held that the taxpayers did not generate California source income from the amounts attributable to IRC section 751(a) property and reversed the FTB's actions in full.

Procedural status and next steps

The OTA posted the opinion as pending precedential on October 5, 2026. Members of the public can submit comments to the OTA on the precedential designation through October 28, 2026. Under Regulation section 30502(e)(1), the OTA updates the designation to precedential or nonprecedential no sooner than 35 days and no later than 60 days after posting, which is between November 9 and December 4, 2026. Under Regulation section 30502(b), a published opinion is precedential in other OTA appeals only if the OTA designates it as precedential. If designated as precedential, it may carry greater weight in future cases and impact whether the FTB chooses to withdraw the legal ruling or not.

Taxpayers considering claims for refund of tax paid on 751(a) ordinary income sourced to California under the Legal Ruling should consider the applicable limitations period. CRTC section 19306 generally requires a claim for refund to be filed by the latest of four years from the date a timely return was filed, four years from the original return due date (determined without regard to extensions), or one year from the date of overpayment. Other provisions may extend or otherwise affect the applicable limitations period depending on the taxpayer's circumstances.

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