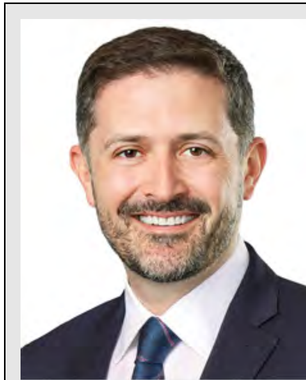
California's Taxation of Sales of Flow-Through Interests

by Christopher T. Lutz



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In this installment of Internally Consistent, Lutz advises taxpayers to be wary of the California Franchise Tax Board's aggressive and seemingly inconsistent treatment of flow-through entities for state tax purposes.

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Partners of flow-through entities regularly navigate a variety of issues regarding how they treat flow-through distributions for state tax purposes. Rules vary state by state or, in many instances, states fail to provide much guidance. Taxpayers must know whether a business or nonbusiness income determination should be made at the partner or partnership level. They also must know whether the income from the flow-through should be apportioned on an aggregate or entity basis. And as a practical matter, they need to know how these filings should be done. Further complicating things, rules vary substantially based on whether the partner is a corporate partner or an individual. These challenges are perhaps most apparent in the context of partners' complete dispositions of their interests in flow-through entities, as these rules can also vary compared with rules for ordinary distributions.

California recently made this analysis more difficult with the Franchise Tax Board's seemingly inconsistent treatment of its own statutes and regulations regarding dispositions of interests in flow-through entities for individuals and corporations. Far from providing clear guidance, recent cases and rulings in the context of both resident and nonresident individuals have appeared results-oriented. While there is a dearth of recent case law regarding corporate partners' dispositions of partnership interests, the state's rules — and the FTB's recent activity in this area — suggest that may not be the case for long.

California's Taxation of Individual Partners' Liquidations

Metropoulos and Income Earned by Nonresident Trust S Corporation Shareholders

Most notably, in *Metropoulos*,[1] the California Court of Appeal upheld the FTB's denial of a refund claim in which the taxpayer contended it should not owe tax on the liquidation of its S corporation interests because that S corporation had not obtained a business situs in California. The nonresident trust shareholders in the S corporation were subject to California's personal income tax on the gain from the liquidation. Consequently, the taxpayer pointed to Cal. Code Regs. tit. 18, section 17952, which provides the personal income tax sourcing rules for nonresident individuals. That statute provides:

> income of nonresidents from intangible personal property such as shares of stock . . . is taxable as income from sources within this State only if the property has a situs for taxation in this State.

Because this rule for individuals is generally understood to have derived "from the common

[1] *Consolidated Appeals of the 2009 Metropoulos Family Trust v. California Franchise Tax Board*, 79 Cal. App. 5th 245 (2022).

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law concept of *mobilia sequuntur personam* (movables follow their owner),"[2] the fact that the nonresidents lacked a situs in California resulted in no income tax being sourced to California.

Despite the language in section 17952, the FTB pointed to its own regulation, Cal. Code Regs. tit. 18, section 17951-4(d), to support its proposition that the gain should have been apportioned at the S corporation level. That regulation states that "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 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." The FTB contended — and the appellate court agreed — that the distinction in that case was whether the shareholder and S corporation were engaged in a unitary business and that the gain at issue generated business income. Because there was no dispute in that case as to unity, the gain was apportioned using the apportionment rules under the state corporate income tax rather than rules governing sourcing income for nonresident individuals.

Smith and Income Earned by Nonresident Members of an LLC

Notwithstanding the statute, it's possible to contend that reasonable minds can differ on the *Metropoulos* case. The FTB's intention to pursue gains on sales of flow-through entities, however, shows little sign of stopping at *Metropoulos*. In December 2022 the Office of Tax Appeals (OTA) again sided with the FTB in *Smith*.[3] In that case, a nonresident member of a limited liability company (Holdco) earned a gain on Holdco's sale of a 50.5 percent membership interest in another LLC. Relying on section 17951-4, the OTA determined that because Holdco and the LLC were engaged in a unitary relationship, the nonresident member was required to apportion the gain to California using the LLC's apportionment attributes. Although the OTA recognized that "*Metropoulos* dealt with unitary S corporations and their nonresident shareholders," it found the reasoning in that case "equally applicable to unitary partnerships and their nonresident partners." While it was the personal income tax at issue and not the corporate income tax, the apportionment rules for corporations nonetheless governed.

Buehler and Income Earned by Resident Members of an LLC

Most recently, in another taxpayer loss, the OTA actually determined that a taxpayer's sale of its LLC membership interest should have been sourced according to the rules for the personal income tax in section 17952 and that the gain on the sale of the membership interest should have been sourced to the taxpayer's domicile in California. In *Buehler*,[4] the taxpayers were California residents who had a membership interest in an LLC. The taxpayer also performed services for the LLC, at least some of which were done in Massachusetts.

When the taxpayer sold its membership interest, it sought to apportion the gain on the sale in a manner consistent with the FTB's approach in *Metropoulos* and *Smith*, using the LLC's apportionment factor. This resulted in approximately 50 percent of the gain being sourced to Massachusetts. Here, the OTA concluded that a California resident was not entitled to a credit for taxes paid to Massachusetts. Because the California resident directly sold his membership interest, the taxpayer's membership interest itself had never obtained a business situs outside California. Thus, although the nonresidents in *Metropoulos* and *Smith* were required to source a portion of the gain on their liquidations to California using the tax attributes of the underlying entity, the

[2] *Id.* at 267.

[3] *In the Matter of the Appeal of L. Smith*, OTA Case No. 20036033 (2022).

[4] *In the Matter of the Appeal of J. Buehler and D. Buehler*, OTA Case No. 21067960 (2023).

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California residents in *Buehler* were not permitted to source a portion of the gain outside California and were not entitled to a credit for taxes actually paid to Massachusetts.[5]

The OTA was similarly dismissive of the *Buehler* taxpayer's alternative argument that the gain constituted business income, so the sourcing rules under section 17951-4 applied even if the California residents directly sold their interest. Despite the plain language in *Metropoulos* that the court's conclusion "would not change even if the income could be characterized as from intangible goodwill within the meaning of section 17952, because we agree the goodwill acquired a business situs here," the OTA did not allow the California residents to receive a credit for any amount of tax paid to other jurisdictions on the basis that some portion of the gain should have been sourced outside California.

Reconciling California's Case Law and Rulings

These cases together reflect California's unusual approach to elevate form over substance in the context of income tax related to liquidations, leading to inconsistent results. To the extent that an individual partner directly sells its partnership interest in a business operating in many states, California appears to require the gain to be sourced entirely to the state of the taxpayer's domicile. However, if a flow-through entity instead sells a membership interest or the assets of another flow-through entity, the income that flows up to the same individual member must be sourced at the entity level. Whether it is merely by coincidence that these seemingly inconsistent interpretations resulted in the FTB prevailing in each case remains to be seen.

California's Taxation of Corporate Partners' Liquidations[6]

When a Gain Generates Business Income

Even when the taxpayer is a corporation, California law is not consistently applied. Although untested, California has in some instances determined that assets sold that are not unitary under the functional test may still generate business income under the transactional test. That is, a company engaged in one industry — say, retail — could generate business income on the sale of a passive interest in an entity that was never involved in the retail business, could not be treated as unitary under the functional test, and was never included on the California combined return. If the retailer had purchased and sold other passive interests over the years, California has suggested that the transactional test could be satisfied because the retailer also buys and sells passive interests in unrelated entities. This novel theory has not been tested in any California court.

Rules for Sourcing Gains Vary

How California apportions gains also varies, even when the gain constitutes business income. For instance, when the sale of intangible property is the sale of stock in a corporation or the sale of an ownership interest in a passthrough entity, or when the gross receipts from intangible property are dividends or goodwill, the apportionment method will differ depending on whether 50 percent or more of the assets of the entity sold consist of real and/or tangible property versus intangible property. If the entity's assets sold are primarily real and/or tangible property, the gain should be apportioned by averaging the payroll and property factors of the corporation or passthrough entity. If the assets are primarily intangible property, the gain is apportioned using the sales factor of the entity.[7]

Although the regulation defines intangible property, the FTB has not provided any guidance as to how this calculation is to be accomplished or what books and records are required to prove the

[5]Note that even in this instance, IRC section 751(a) assets such as accounts receivable or inventory, under FTB Legal Ruling 2022-02, would be sourced using the apportionment rules for that item. Thus, if those assets had been part of the member's sale of the LLC interest, the sourcing rules under regulation 17951-4 would apply to those items. The OTA in this case requested additional briefing on this topic but determined that the LLC did not have any unrealized receivables or inventory within the meaning of section 751(a). Thus, the general rule under IRC section 741 applied, which provides that the "member is generally viewed as selling a partnership interest in the partnership, not the underlying assets of the partnership." The OTA addressed these issues in footnotes 3 and 7 of the decision.

[6]Or also, as discussed earlier, how California will source some individual partner shareholder income under regulation 17951-4.

[7]Cal. Code Regs. tit. 18, section 25136-2(d)(a)(1)(a)-(b).

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calculation. While the general rule is that the property and payroll of the entity sold should dictate how gain is apportioned, the FTB has shown signs that it intends to take an expansive view of what assets constitute intangible property for purposes of this 50 percent test, potentially rendering the exception the rule.[8] It is not clear that California will calculate this 50 percent test using the commonly understood distinction between intangible holding companies and operating companies.

Conclusion (and Don't Forget About Distortion)

Taxpayers should remain wary of the FTB's aggressive stances on this front. From using the transactional test to determine that income from the sale of an otherwise nonunitary entity constitutes business income, to using corporate apportionment rules for nonresident individuals in circumstances outside of *Metropoulos*, many of the FTB's interpretations have not been tested in court. And even if the FTB's uneven interpretation of California law is correct, the risk of a grossly distorted result remains high, as the FTB is largely attempting to tax substantial gains without allowing the gains — let alone the gross receipts from a given sale — to be included in the apportionment factor. While we await a Michigan Supreme Court decision on *Vectren*,[9] I would not be surprised to see similar challenges in California. ■

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[8] Incidentally, the same challenges arise in the context of allocable nonbusiness income. Capital gains from the sale of intangible personal property are generally allocated to the state of the taxpayer's commercial domicile. Cal. Rev. & Tax. Code section 25125(c). However, if the gain is on the sale of a partnership interest, the same 50 percent test is used to determine whether to allocate based on the location of the property or based on the partnership's sales factor. Cal. Rev. & Tax. Code section 25125(d).

[9] *Vectren Infrastructure Services Corp. v. Department of Treasury*, Dkt. No. 163742 (Mich. 2023). *Vectren*, argued on April 5, presents the question whether the state's exclusion of a substantial gain on the sale of all the taxpayer's S corporation shares from its Michigan sales factor was proper.

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