

California OTA--Nonresident's partnership-interest 'hot asset' gain not California-source

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In brief

What happened?

The California Office of Tax Appeals (OTA) recently published its July 24, 2026 opinion in *Appeals of J. Burch, J. Carden, and K. Carden (2026-OTA-527P)*, currently designated pending precedential. The OTA held that Internal Revenue Code (IRC) Section 751(a) did not convert a sale of a partnership interest into a deemed sale of underlying assets and that the disputed ordinary gain was not California-source income to the nonresident taxpayers.

Why is it relevant?

The OTA declined to follow Franchise Tax Board (FTB) Legal Ruling 2022-02, which would have sourced the Section 751(a) gain using the underlying partnership's California apportionment. The decision distinguishes a nonresident's gain on the sale of a partnership interest from a partner's distributive share of partnership business income. The Section 751(a) ordinary-income treatment does not, by itself, determine which California sourcing rule applies.

Actions to consider

Nonresident individuals who reported California-source gain attributable to Section 751(a) on a sale of a partnership interest may wish to evaluate whether the decision supports refund claims for open years,

considering the facts and transaction structure. Taxpayers also should monitor the opinion's precedential status, the FTB's response, and any legislative developments.

In detail

Background

The taxpayers were California nonresident individuals with interests in JCB Investments, LLC (JCB), an investment company classified as a partnership that held a variety of unrelated investments. One was an approximately 28% interest in Tory Burch LLC (Tory Burch), a partnership conducting a unitary business within and outside California. JCB sold portions of that interest in 2012 and 2013, recognizing capital gain under IRC Section 741 and ordinary income under Section 751(a) attributable to unrealized receivables and inventory ('hot assets').

JCB reported both components as nonbusiness income not derived from California sources, and its nonresident partners reported their shares as non-California-source income under California Revenue and Taxation Code (R&TC) Section 17952. That provision generally excludes a nonresident's income from intangible property, including a partnership interest, from California-source income, subject to statutory exceptions such as a California business situs.

The FTB did not dispute the Section 741 treatment but challenged the Section 751(a) component. In a position later reflected in FTB Legal Ruling 2022-02, the FTB treated the hot-asset gain as a deemed sale by Tory Burch that flowed through as apportionable business income under California Code of Regulations (CCR) Section 17951-4(d). The taxpayers maintained that Section 751(a) altered only the character of gain on the partnership-interest sale.

Federal and California framework

California generally conforms to IRC Sections 741 and 751. Section 741 treats gain or loss on a partnership-interest sale as capital, except as provided by Section 751(a), which treats amounts attributable to unrealized receivables or inventory as ordinary income. The question in this case was whether that change in character also changed the transaction for California sourcing purposes.

Two California sourcing provisions frame the dispute. R&TC Section 17952 generally addresses nonresident income from intangible property. CCR Section 17951-4(d), by contrast, governs a nonresident partner's distributive share of business income from a partnership carrying on a unitary business inside and outside California, with apportionment at the partnership level. These provisions address different categories of income.

OTA's decision

The OTA relied heavily on *Rawat v. Commissioner*, 108 F.4th 891 (D.C. Cir. 2024), which held that Section 751(a) changes the character of gain without treating a partnership-interest sale as a sale of the underlying assets. The hypothetical asset-sale calculation under Treasury Reg. 1.751-1(a)(2) measures the ordinary-income portion of gain; it does not create a separate asset sale or a distributive share of the underlying partnership's income.

Following *Rawat*, the OTA concluded that the gain remained attributable to the disposition of a partnership interest and was sourced under R&TC Section 17952 in the circumstances presented. The OTA contrasted Section 751(a) with federal provisions expressly deeming asset sales, such as the

Section 338(h)(10) election addressed in *Appeals of Amarr* (2022-OTA-041P), and declined to follow FTB Legal Ruling 2022-02.

Relationship to other California cases

Although JCB was the seller, the parties agreed that, under the facts of the appeal, the sourcing analysis should focus on a sale of a partnership interest in the taxpayers' hands. Unlike in *Appeal of Smith* and *Metropoulos*, the FTB did not assert that JCB and Tory Burch were unitary or that the gain was apportionable business income at JCB's level. The OTA therefore addressed the FTB's deemed-sale theory for the Section 751(a) portion; the Section 741 capital-gain portion was not disputed.

Observation: *Burch* addresses the sourcing of partnership-interest gain reported by nonresident individuals under California's Personal Income Tax Law. Separate rules apply to corporate taxpayers disposing of partnership interests, including provisions that consider the underlying partnership's tangible property or sales. Those rules were not at issue in *Burch*.

Let's talk

For questions about the decision and its possible implications for California nonresident filings, contact:

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