Louis A. Ambrose
Tax Counsel IV
Board of Equalization, Appeals Division
450 N Street, MIC:85
P.O. Box 942879
Sacramento, CA 95814
Tel: (916) 445-5580
Fax: (916) 324-2618

Attorney for the Appeals Division

BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of: **MICHAEL J. BILLS AND** **MARY E. BILLS**	**HEARING SUMMARY** **PERSONAL INCOME TAX APPEAL** Case Nos. 610028 and 782397

Deficiency

Years	Additional Tax
2005	$553,799.00
2006	$784,599.00
2007	$931,712.00
2008	$981,802.00
2009	$525,369.00

Representing the Parties:

For Appellants:	Jeffrey M. Vesely, Pillsbury Winthrop Shaw Pittman LLP Annie H. Huang, Pillsbury Winthrop Shaw Pittman LLP
For Franchise Tax Board:	Brian C. Miller, Tax Counsel III

QUESTIONS: (1) Whether appellants have established error in respondent Franchise Tax Board's determination that appellants were domiciled in and residents of California through April 23, 2005 and therefore taxable on income from all sources until that date.

(2) Whether appellants have shown that payments received by them, upon appellant-

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husband’s withdrawal from a partnership for tax years 2005 through 2009, was not California-source income.

HEARING SUMMARY

SECTION 40 APPEAL

This appeal involves an amount in controversy that is $500,000 or more and thus is covered by Revenue and Taxation Code (R&TC) section 40. Please see Staff Comments below for details.

Procedural Background

Appellants filed joint California resident returns for tax years 2001 through 2004 and California Non-Resident returns for tax years 2005 through 2009, claiming that they established residency in Washington State on January 10, 2005. Appellants received income in tax years 2005 through 2009 from payments in the liquidation of appellant-husband’s partnership interest in Brandes Investment Partners, LP (Brandes) which they excluded from income on their California returns for those tax years. (Appellants’ Opening Brief (App. Op. Br.), p. 7.)

Respondent examined appellants’ 2005 to 2007 returns and determined that appellants were California residents through April 23, 2005 and that the payments from Brandes in 2005 through 2007 were California source income. Respondent issued a Notice of Proposed Assessment (NPA) for each of those years and appellants filed timely protests. After a protest hearing, respondent affirmed the NPAs and issued a Notice of Action (NOA) for each of those years. Appellants filed timely appeals of those NOAs and, subsequent to filing those appeals, respondent examined appellants’ returns for tax years 2008 and 2009 and determined that payments from Brandes for those years were also California source income and issued NPAs for 2008 and 2009. Appellants filed timely protests of those NPAs but requested that respondent close the protests and issue NOAs so that they could consolidate the appeal of those years with the appeals of tax years 2005, 2006, and 2007. At appellants’ request, this Board consolidated those appeals in this matter before the Board. (Respondent’s Opening Brief (Resp. Op. Br., p.1.)

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Factual Background

Appellants are married and lived in Wisconsin until 1997 when appellant-husband moved to California to accept a managing partner position with Brandes. Appellant-husband did not enter into a written employment agreement with Brandes and he was an “at will” employee. Appellant-husband opened a bank account in California on April 1, 1997, and resided in an apartment. In February of 1998, appellants purchased a condominium in which appellant-husband appears to have resided until June of 1998. Appellants currently own the condominium. Appellants purchased a 3,938 square foot home in Rancho Santa Fe (RSF home) for $1,285,000 in June of 1998 which was used as appellants’ primary residence. Appellants claimed the homeowner’s exemption on this property for all of the years at issue.[1] Appellant-wife moved to California in the middle of 1998. (Resp. Op. Br., pp. 2-3, App. Op. Br., Exh. B., pp. 2-3.)

In November of 2004, prior to appellant-husband’s retirement from Brandes, appellants purchased a 5,635 square foot home on a 9.36 acre parcel located in Friday Harbor on the San Juan Islands in Washington State (FH home) for $2,800,000. The home was completely furnished at the time of purchase. The escrow on the house closed on December 1, 2004 and appellants stayed at the FH Home from January 10, 2005 through January 16, 2005. During that time, appellants registered to vote and registered three automobiles in Washington although those vehicles were not moved to Washington during January of 2005. In addition, appellant-husband obtained a Washington State driver’s license using the FH Home as his residence address and appellants received home furnishings, mostly art work, at the FH home. At some time later in 2005, appellants registered four other automobiles, including a 2004 Toyota Prius (which were originally registered in California), in Washington State. Appellants drove the 2004 Prius to the FH Home from California in April 2005 and June 2005 but the other vehicles remained in California. (Resp. Op. Br., pp. 5-7, App. Op. Br., Exh. A, pp.5-6.)

On January 16, 2005, appellants drove back to California and stayed at the RSF Home

[1] Appellants assert that they contacted the San Diego County Assessor’s Office to report that the RSF Home was not eligible for the homeowner’s exemption in 2005 and subsequent years and reimbursed the county for the exemption amounts plus interest, as stated below.

until they left for a series of trips beginning on February 3, 2005 until April 23, 2005. During the period after their return from the FH Home through April 23, 2005, appellants stayed at the RSF Home at all times that they were not travelling, for a total of 64 days. On April 23, 2005, appellants left the RSF Home and drove to the FH Home but, upon arrival, discovered a significant problem with the home's well which required repairs. Although the well problem did not render the home uninhabitable, appellants returned to the RSF Home and resided there until the repairs were completed. In June of 2005, when the repairs were completed, appellants left the RSF Home and travelled to the FH home. (Resp. Op. Br., pp. 7-8, App. Op. Br., p. 6.)

Question (1): Whether appellants have established error in respondent's determination that appellants were domiciled in and residents of California through April 23, 2005 and therefore taxable on income from all sources until that date.

<u>Contentions</u>

<u>Appellants' Contentions</u>

Appellants maintain that they changed their domicile from California to Washington on January 11, 2005 and that their visits to California after that date were for temporary and transitory purposes. Appellants recite the definition of domicile set forth in California Code of Regulations, title 18, section (Regulation) 17014, subdivision (c), and state that an individual is domiciled in the place where he or she intends to remain permanently or indefinitely without any fixed or certain purpose to return to a former place of abode, citing *Estate of Phillips* (1969) 269 Cal.App.2d 656, 659. Appellants assert that they knew before they moved to California that they would not reside there permanently and would move elsewhere when appellant-husband retired from Brandes. Appellants also assert that they intended to reside at the FH Home indefinitely and their visits to California were for temporary and transitory purposes. (App. Op. Br., p. 10.)

As evidence of their intent to establish Washington domicile and residency on January 11, 2005, appellants state that:

- They moved into the FH home on January 10, 2005, and hired a caretaker while they were on vacation and "made arrangements with local businesses to perform further home improvements."

- They stayed at the FH home through January 16, 2005, and while there received household and personal items from California and New York, shopped locally to set up their household, and purchased Northwest Native Art items at the Arctic Raven Gallery.
- They registered their automobiles in Washington and appellant-husband obtained a Washington State driver's license.
- Appellants registered to vote in Washington in January of 2005 and have voted there since that time.
- Appellants opened an account at the Friday Harbor branch of Wells Fargo Bank and they saw local doctors and dentists.
- Over the years, they have acquired a Northwest Native Art collection valued at $1.3 million.[2]
- Appellants have used the RSF Home only as a vacation home since January 10, 2005 and they also own an apartment in New York City that they use as a vacation home. Appellants have spent a majority of their time at the FH Home and approximately 2 to 3 months a year each in the New York City apartment and the RSF home.
- Appellants paid $2.8 million for an almost 6,000 square foot house in Washington State and they still reside there.

(App. Op. Br., pp. 10-11, Exh. A, Appellants' Declarations.)

With respect to services provided for the Friday Harbor house, appellants provide the following three declarations under penalty of perjury, each dated September 7, 2011:

- From Dina Melic, stating that she has known appellants since December 2004, has provided caretaker services for the Bailer Hill Road home from early 2005 to the present and that she provides monthly cleaning services.
- From Peter Kilpatrick, owner of Ravenhill Construction, stating that he has known appellants since January 2005 and has provided remodeling and construction services for their home since 2005 to the present.
- From Jason Suhl, owner of Green Man, Inc., stating that he has known appellants since January

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[2] Appellants provide a declaration from the owner of Arctic Raven Gallery in Friday Harbor stating that they made their first purchase in December 2004 and made many purchases from 2005 to 2007. (App. Op. Br., Exh. A.)

2004 and he completed "an extensive landscape and irrigation project" at the Bailer Hill Road home which commenced in February 2005 and was completed in August 2005.

(App. Op. Br., Exh. A, Declarations.)

Appellants recite the definition of "temporary or transitory purposes" set forth in Regulation 17014, subdivision (b), which provides that a determination of such purpose "will depend to a large extent upon the facts and circumstances of each particular case." Appellants assert that respondent's Residency and Sourcing Technical Manual advises auditors to consider "each particular taxpayer's facts and circumstances." Appellants contend that respondent has failed to follow its own guidance in its determination that appellants remained domiciled in and residents of California after January 10, 2005. (App. Op. Br., Exh. E, pp. 10-12.)

<u>Respondent's Contentions</u>

Respondent asserts that its assessment determination is presumed correct and appellants bear the burden of proving a change in domicile. Moreover, if there is any doubt as to whether there was a change in domicile after the presentation of the facts and circumstances, respondent asserts that a finding of no change in domicile is required. Respondent recites the definition of resident, pursuant to R&TC section 17014, subdivision (a), and states that under this definition an individual may be a resident of California although he or she is domiciled elsewhere and vice versa. Respondent asserts that the question is whether an appellant's purpose in entering or leaving is temporary or transitory in character which is a determination that must be based on objective facts, rather than the individual's subjective intent. In support of that proposition, respondent cites the *Appeals of Nathan H. and Julia M. Juran* (68-SBE-004), decided on January 8, 1968 (Resp. Op. Br., p. 12.)

Respondent contends that an individual who is domiciled in California and leaves the state remains domiciled here as long as there is a definite intention of returning to California, regardless of the length of the absence or the reason that she or she is absent from California. Respondent further contends that a change of domicile requires that an individual actually move to a new residence and intend to remain there permanently or indefinitely and, in determining whether the individual had such an intent, his or her acts and declarations will be considered. When an individual is domiciled in California, it is presumed that he or she remains domiciled here until it is clearly shown that domicile has changed. Respondent asserts that this Board considers the extent to which an individual establishes contacts elsewhere but that, until an individual abandons his or her "old location", he or she remains domiciled in and a resident of that location until actually moving to the "new location". Respondent cites *Noble v. Franchise Tax Board* (2004) 118 Cal.App. 4th 560, in which the court held that "a resident's intent to move unsupported by physical acts is not the determinative factor" for purposes of domicile or residency and "[p]hysical presence in the state has been 'a factor of greater significance than the mental intent or outward formalities of ties to another state." Respondent contends that this test defines a class of individuals who should contribute to the support of the state because they receive substantial benefits and protection from its laws and government. (Resp. Op. Br., pp. 12-13.)

Respondent asserts that appellants established domicile in California in 1998 as the evidence shows that they did not intend to return to Wisconsin. Likewise, respondent asserts that appellants must establish by their actions "a clear intent to abandon California as the state of domicile" on January 10, 2005. Respondent adds that merely "[h]aving an intent to move does not change one's domicile" and contends that appellants had not taken sufficient steps prior to April 23, 2005 to change their domicile or residency to Washington State. As support for its contention, respondent notes that appellants visited the FH Home for only 6 days during the period from January 11, 2005 through April 23, 2005, and "started to outfit it for occupancy" but planned to return to California, depart for several trips from California and return to the RSF Home between those trips. Respondent contends that appellants left California with the intent not to return on April 23, 2005 and thus were domiciled in California until that date. (Resp. Op. Br., pp. 17-18.)

In view of the fact that appellants were domiciled in California, respondent asserts that the residency determination turns on whether appellants were outside of California during the period from January 11, 2005 through April 23, 2005 for other than a temporary or transitory purpose. Respondent describes the trips taken by appellants during that period and states that appellant-husband did not testify that either he or his wife spent any time at the FH Home between January 16, 2005 and April 23, 2005. On that basis, respondent concludes that appellants took vacations and started the process to move but did not take any action that would show that they were outside of California for other than temporary or transitory purposes. (Resp. Op. Br., pp. 18-19.)

Respondent contends that an examination of the factors articulated by this Board in the *Appeal of Stephen D. Bragg* (2003-SBE-002), decided on May 23, 2003, demonstrates that appellants were California residents until April 23, 2005. Respondent notes that "it is important to separate the factors that are merely formal and those that actually show residence." Respondent cites as an example of a "formalistic connection" with Washington the fact that appellants registered many of their automobiles in Washington without bringing them into that state. Respondent adds that some of them were not moved until April 23, 2005, and one of them remained in California for use by appellants' daughter. Finally, respondent notes that three other cars were first registered in California after purchase and later registered in Washington but it is unknown whether they are located at the FH Home or the RSF Home. (Resp. Op. Br., p. 19.)

Respondent also states that appellants registered to vote in Washington "but only swore that before the next election they were going to vote in, they would reside in Washington State for at least 30 days." Respondent contends that this condition indicates that Washington allows people to register to vote "based on a promise that may or may not be realized." Respondent concludes that appellants' voter registration in January of 2005 should not be recognized as a factor of residency because it was, at that time, "simply a possibility of a connection" and, thus, their California voter registration establishes a connection with this state at that time. Respondent further contends that appellant-husband's Washington State driver's license showed only "a formalistic tie to that claimed new residence" because he only used it in Washington for 6 days during January of 2005 and not as if he were an actual resident of Washington as of January 11, 2005. (Resp. Op. Br., pp. 19-20.)

Respondent notes that only appellants occupied the RSF Home for the majority of the time prior to 2005 and that home was fully furnished and occupied by appellants and their daughter after January of 2005 and in 2006 and 2007. Respondent also notes that appellants claimed the homeowner's exemption on the RSF Home during the years in issue. Respondent states that appellants also owned a condominium in San Diego which was never rented or listed for sale. Respondent further asserts that appellants state in their opening brief that the RSF Home and FH Home are used by appellants as their residence during different parts of each year. Respondent asserts that, while the FH Home purchased in 2004 cost more than twice the price of the RSF Home purchased in 1998, it is likely that the RSF Home had substantially appreciated in value by 2004 and that it appears that appellants occupy the RSF Home during the winter months and that it is permanently occupied by their daughter. Respondent contends that this factor weighs in favor of a finding of California residency because appellants were connected to California by their daughter's occupancy of the RSF Home "on and off from 2005 to 2007 and then permanently in 2007." (Resp. Op. Br., pp. 20-21.)

Respondent states that, in late 2004 or early 2005, appellants changed the mailing address for the statements from their financial institutions to the FH Home but did not change account numbers or open any new accounts in Washington. However, respondent notes that appellant-husband stated that, prior to April of 2005, appellants had their credit card and brokerage statements and other bills forwarded from the FH Home to the RSF home. Because appellants arranged to have their mail automatically forwarded from the FH Home to the RSF Home prior to April of 2005, respondent contends that the change of mailing address does not indicate a connection with Washington State. Respondent further asserts that the pre-planned forwarding of mail to the RSF Home shows that appellants did not consider the FH Home to be their primary residence. Thus, respondent contends that this factor favors a finding of California residency. (Resp. Op. Br., p. 21.)

Respondent notes that appellants continued to obtain medical services in California in 2005 and that, although they hired a Washington State attorney to prepare an estate plan during the years in issue, they did not procure any other medical or professional services in Washington during that period. Respondent further notes that appellants used a California-based certified public accountancy firm to prepare their 2005, 2006, 2007, and 2009 federal and state tax returns. Respondent contends that this factor indicates a connection with California favoring a finding of California residency until at least April 23, 2005. Finally, respondent asserts that appellants had no business connections in Washington whereas appellant-husband's partnership agreement provided that, if the partnership was sold during the period he was liquidating his interest, he would receive a proportionate share of the sales price. Thus, respondent contends that appellant-husband had an investment interest in California until 2009. (Resp. Op. Br., pp. 21-22.)

Appellants' Reply Brief and Supplemental Brief

Appellants contend that respondent concedes that they established domicile in

Washington as of April 23, 2005 but that respondent relies on “a significant amount of facts” after that date. Appellants state that, before appellant-husband moved to California in 1997, they would leave the state upon his retirement from Brandes and by 2003 they were ready to move from California. In late 2003, appellant-husband began discussions with the other partners concerning his retirement on December 31, 2004, and appellants started considering where they wanted to reside permanently after his retirement. Appellants purchased the FH Home in November of 2004 and closed escrow on December 1, 2004. (App. Reply Br., pp. 2-3.)

Appellants assert that they did not move any furniture in January of 2005 because FH Home had furnishings that were integral to the design of the house. Appellants state that they made numerous arrangements in November and December of 2004, including setting up accounts with Orcas Power & Light Cooperative and San Juan Propane and they hired a caretaker for their property. They also hired contractors to work on the property and, after the close of escrow, they purchased personal items at a cost of $161,260 for the FH home. Appellants also state that, on January 6 and 7 of 2005, they sent their “personal items” from the RSF Home to the FH Home and, on January 15 and 18 of 2005, they purchased pieces of art from a gallery in Friday Harbor. Appellants state that respondent does not dispute the foregoing facts. (App. Reply Br., p. 3.)

Appellants contend that respondent “chooses to focus on so-called ‘facts’ which have no relevance” to their residency. As an example, appellants state that respondent noted that no furniture was moved to or purchased for the FH Home but did not indicate what appellants required to occupy the home. Appellants also assert that respondent’s statement that there is no evidence that appellants traveled to Friday Harbor to sign the new deed is irrelevant because, as respondent acknowledges, appellants do not claim they moved in 2004. As another example, appellants contend that respondent notes that appellants’ daughter resided at the RSF Home during the summer of 2005 and stayed there more permanently in 2007. Appellants contend that the fact that their daughter stayed at the RSF Home after April 23, 2005, has no bearing on the residency issue and respondent does not explain the relevance of these facts. (App. Reply Br., p. 4.)

Appellants contend that respondent “either ignored or misstated the facts or focused on irrelevant facts post-April 23, 2005” and cite the following:

- The RSF home was never listed for sale or rental.
- Appellants continued to spend time at the RSF Home in 2005, 2006, and 2007. In addition, many credit card charges during 2005 were made by appellants' daughter and son who were authorized users on the credit card account.
- Appellants stayed at the RSF Home while the FH Home well was being repaired. The home was not habitable without the well.
- Appellants claimed the homeowner's exemption for the RSF Home for 2005, 2006 and 2007 but appellants later corrected the error and paid the proper amount of property tax for those years.
- Appellants' tax returns for 2005, 2006, 2007, and 2009 were prepared by a California CPA firm.
- Appellants obtained medical services in California during 2005 through 2009 and respondent incorrectly asserts that appellants did not obtain medical or professional services in Washington.
- Appellants' condominium in New York City was never listed for sale or lease.

(App. Reply Br., p. 5.)

Appellants dispute respondent's conclusion that appellants' voter and vehicle registration in Washington, appellant-husband's Washington driver's license, and opening of a checking account in Washington does not support appellants' claim that they established Washington residency on January 11, 2015. In response, appellants contend that their voter registration was an acknowledgement of Washington residency, appellant-husband was required to relinquish his California license, appellants' insurance company required that their vehicles be registered in their state of residence, and the Wells Fargo Bank of California is separate from the Washington Wells Fargo Bank, so they were required to open a new checking account. (App. Reply Br., p. 6.)

Appellants also assert that they "embarked on several well-deserved vacations" after appellant-husband's retirement and their move to Washington during which they "prepared their new home for immediate occupancy." Appellants state that, when they returned, they packed up some remaining personal items and drove to Washington. Appellants contend that they established Washington domicile in January of 2005 because they demonstrated their intention to remain there either permanently or indefinitely without any fixed or certain purpose to return to California. Thus, according to appellants, the question is whether they were in California for temporary or transitory purposes after January 11, 2005. Appellants contend that they were in California after that date for "a brief rest or vacation" which is a temporary or transitory purpose. (App. Reply Br., pp. 6-7.)

Appellants assert that respondent's analysis of the factors from the *Appeal of Bragg, supra*, is not useful because of the length of time – three and a half months – over which the parties disagree. Appellants assert that a more helpful analysis is set forth in the *Appeal of Odis L. Dobbs and Lois N. Dobbs* (87-SBE-044), decided on June 17, 1987, in which the taxpayers who were residents of Colorado, purchased a house in California in November of 1979 but did not move in until May 1, 1980. Appellants state that the taxpayers were in California in May when their belongings arrived but did not unpack many of the boxes because they planned to spend the summer on their yacht. From May through August 1980, appellants spent time on their yacht and in Mexico and returned to Colorado on a regular basis and continued to maintain bank accounts and conduct most banking activities in Colorado. Taxpayer-husband also received medical care and executed a codicil to his will in Colorado in July of 1980. Despite those connections with Colorado, appellants state that this Board found that appellants were California residents as of May 1, 1980. Similar to the taxpayers in that appeal, appellants assert that they moved to Washington on January 10, 2005, set up their new home, travelled for the following three months, and briefly stopped in California between trips. (App. Reply Br., pp. 7-8.)

In a supplemental brief, appellants argue that respondent seems to suggest that an individual who moves from California is not allowed to visit the state and is not allowed to travel outside of the state in which he or she has established residency. Appellants assert that appellant-husband worked at "a hectic, high-paced, intensively stressful job" so it is understandable that appellants would want to vacation soon after his retirement. Appellants add that it is fortunate that they could afford to keep their home in California even though they spent $2.8 million on a new 5,635 square foot home in Washington and California law does not prohibit nonresidents from owning property in California. (App. Supp. Br., p. 8.)

Appellants also assert that respondent seems to argue that they did not pack their clothes and other personal items and, thus, they did not move to Washington in January of 2005. Appellants

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contend that this statement is not true and that, upon the close of escrow, they purchased personal items and sent other personal items from the RSF home. Appellants also contend that respondent's argument does not make sense given that respondent concedes that appellants moved to Washington on April 23, 2005. Finally, appellants assert that respondent's argument that the *Appeal of Dobbs, supra*, supports respondent's position mischaracterizes the facts of that appeal. Appellants further assert that, in that appeal, respondent argued that the taxpayers failed to prove they did not move to California on May 1, 1980, and here the facts are similar in that appellants were not in Washington during most of the disputed period. According to appellants, respondent is taking inconsistent positions.

Appellants argue that it is important to emphasize that respondent does not dispute any of the facts presented by appellants. Appellants summarize the facts presented above and conclude that they provided substantial evidence to support the establishment of domicile and residency in Washington on January 11, 2005, and the fact that their subsequent visits to California were for temporary or transitory purposes. (App. Supp. Br., pp. 9-10.)

Respondent's Reply Brief

Respondent states that appellants argue that nothing that occurred after April 23, 2005, is relevant to the domicile and residency determination. Respondent asserts that appellants took the actions described above but failed to pack their clothes and other personal items as would anyone who was going to live in a new residence. Respondent further asserts that, between January 16 and April 23, 2005, appellants lived at the RSF Home and took trips outside California but not to the FH home. Respondent notes that all of these trips originated in California and appellants returned to the RSF Home after each of them. Respondent argues that under appellants' theory any California resident could purchase a new residence in a state without an income tax, register to vote there, register vehicles there, obtain a driver's license in the new state and then return to live in California as did appellants but claim that residency had changed. (Resp. Reply Br., pp. 9-10.)

Respondent distinguishes the *Appeal of Dobbs*, *supra*, and state that in that appeal respondent only argued that the primary basis for respondent's determination that the taxpayers were residents of California beginning April 1, 1980, was their reporting on their part-year resident return that they entered California on that date and the absence of any convincing evidence demonstrating that statement was erroneous. Respondent asserts that it has not made such an argument in this appeal as detailed in the opening brief. Furthermore, respondent states that, in the *Appeal of Dobbs*, this Board noted that the taxpayers packed up their household goods and furnishings and closed their Colorado home on April 22nd, whereas appellants did not pack household goods or furnishings and did not close up the RSF home. (Resp. Reply Br., p. 10.)

Respondent argues that a factual similarity exists based on this Board's finding in the *Appeal of Dobbs* that the taxpayers purchased the California home in 1979 but there was no evidence to suggest that they intended to make it their permanent home before May 1, 1980. Respondent contends that, in this appeal, at the time of purchase the FH Home "apparently required a good deal of repairs" and the plans made by appellants and "sometimes large gaps between the planned trips" demonstrate that appellants did not intend to make the FH Home their permanent home in January of 2005. While appellants visited the FH home, met with contractors, and took the actions described above, they did not stay there but instead returned to California and the RSF Home for 64 days of the period from January 16th to April 23rd, 2015 and only spent 6 days at the FH Home prior to April 23, 2005. Respondent concludes that such does not demonstrate an intention to make it their permanent residence or change of domicile prior to that date. (Resp. Reply Br., pp. 10-11.)

Respondent further argues that this Board has continued to refine the importance of the factors used in the *Appeal of Dobbs* and the *Appeal of Bragg* and has recognized that "certain ministerial actions" such as vehicle registration, voter registration, or obtaining a driver's license, "carry far less weight in today's mobile society" than they did when those appeals were decided. Respondent also contends that the holding in *Whittell v. Franchise Tax Board* (1964) 231 Cal.App.2d 278 (*Whittell*) "has maintained its vitality" in that physical presence has "greater significance than the mental intent or outward formalities of ties to another state." In this regard, respondent notes that appellants spent about 10 percent of the time between January 10th and April 23rd at the FH Home and the remaining 90 percent of the time at the RSF Home or traveling to and from that home. Finally, respondent notes that in the *Appeal of Dobbs*, this Board held that an intention "to return to one's former place of abode defeats the acquisition of a new domicile." Respondent asserts that appellants intended to return to the RSF Home after January 16, 2015, take some trips, and subsequently leave for the FH Home on April 23, 2005, which alone supports the conclusion that appellants did not change domicile until April 23, 2005. (Resp. Reply Br., pp. 10-11.)

Applicable Law

Burden of Proof

It is well established that a presumption of correctness attends respondent's determinations of fact and that an appellant has the burden of proving such determinations erroneous. This presumption is a rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary. (*Appeal of George H. and Sky Williams, et al.*, 82-SBE-018, Jan. 5, 1982.) Furthermore, respondent's determinations of residency are presumptively correct. (*Appeal of Joe and Gloria Morgan*, 85-SBE-078, Jul. 30, 1985.)

Taxation of Residents

R&TC section 17041, subdivision (a)(1), provides, in pertinent part, that a tax shall be imposed for each taxable year upon the entire taxable income of every resident of California who is not a part-year resident. R&TC section 17014, subdivision (a), provides that the term "resident" includes: (1) every individual who is in California for other than a temporary or transitory purpose; and (2) every individual domiciled in California who is outside California for a temporary or transitory purpose. Thus, an individual domiciled in California remains a resident until he or she leaves for other than a temporary or transitory purpose. (Cal. Code Regs., tit. 18, § 17014; see also Rev. & Tax. Code, § 17014.)

Domicile Determination

The term "domicile" refers to one's permanent home, the place to which he or she intends to return after an absence. (*Appeal of Anthony V. and Beverly Zupanovich*, *supra* (citing *Whittell v. Franchise Tax Board* (1964) 231 Cal.App.2d 278, 284).) An individual can have but one domicile at any one time. (Cal. Code Regs., tit. 18, section 17014, subd. (c).) To change a domicile, a taxpayer must move to a new residence and intend to remain there permanently or indefinitely. (*Appeal of Stephen D. Bragg*, *supra*; Cal. Code Regs., tit. 18, § 17014, subd. (c).) The party asserting a change in domicile bears the burden of proving such change. (*Appeal of Terance and Brenda Harrison*, 85-SBE-059, June 25, 1985.) If there is doubt on the question of domicile after the presentation of the facts and circumstances, the domicile must be found to have not changed. (*Appeal of Stephen D. Bragg*, *supra*.) Regulation 17014, subdivision (d)(1), states that the type and amount of proof required to show domicile cannot be specified by general regulation, but will depend largely on the circumstances of each particular case. In the case of individuals who claim to be nonresidents by virtue of being outside of the state for other than temporary or transitory purposes, affidavits of friends and business associates as to the reasons for being outside of the state should be submitted.

Residency Determination

If a taxpayer is domiciled in California, the facts must be examined to determine whether the taxpayer is outside of the state for a temporary or transitory purpose, such that the taxpayer should continue to be treated as a California resident. (*Whittell v. Franchise Tax Board*, *supra*.) Regulation section 17014, subdivision (b), discusses the term "temporary or transitory purpose," as used in R&TC section 17014 with regard to residency, in the following manner:

> It can be stated generally, however, that if an individual is simply passing through this State on his way to another state or country, or is here for a brief rest or vacation, or to complete a particular transaction, or perform a particular contract, or fulfill a particular engagement, which will require his presence in this State for but a short period, he is in this State for temporary or transitory purposes, and will not be a resident by virtue of his presence here.
>
> If, however, an individual is in this State . . . for business purposes which will require a long or indefinite period to accomplish, or is employed in a position that may last permanently or indefinitely . . . he is in the State for other than temporary or transitory purposes, and accordingly, is a resident taxable upon his entire net income . . .

Regulation section 17014, subdivision (b), also states that the underlying theory of R&TC sections 17014 to 17016 is that the state with which a person has the closest connection during the taxable year is the state of his residency. Thus, the contacts a taxpayer maintains in California and other states are important factors to be considered in determining California residency. (*Appeal of Anthony V. and Beverly Zupanovich*, *supra*.) Although the actual or potential duration of the taxpayer's presence in, or absence from, California is very significant in determining his residency, it is also important in each case to examine the connections with California and compare them with those he maintains in other places. (*Appeal of Anthony V. and Beverly Zupanovich*, *supra*.)

In *Bragg*, the Board listed nonexclusive factors to aid in determining with which state an individual has the closest connection. The Board in *Bragg* noted that these nonexclusive factors ". . . serve merely as a guide in our determination of residency," and ". . . [t]he weight given to any particular factor depends upon the totality of the circumstances" unique to each taxpayer for each tax year. The *Bragg* factors can be organized into three categories for a more detailed discussion, as provided below. As will be seen below, many factors overlap one another.

Registrations and Filings

This group of factors is representative of the taxpayer's compliance with state legal requirements which is usually a change of status effected by an application for or cancellation of such status with a government agency. The factors in this category include:

- Homeowner's property tax exemption claim;
- State of residence reported on federal and state tax returns and address listed on such returns;
- Automobile registration;
- State driver's license; and
- State of voter registration and voting history.

Personal and Professional Associations

The factors in this group indicate day-to-day contacts in both the taxpayer's occupational life as well as personal life. These factors show where the taxpayer engaged in occupational endeavors and maintained personal relationships and community involvement. These factors include:

- Where the taxpayer's children attend school;
- The location of the taxpayer's bank and savings accounts;
- Where the taxpayer maintains memberships in social, religious, and professional organizations;
- Where the taxpayer obtains professional services, such as doctors, dentists, accountants, and attorneys;
- Where the taxpayer is employed;
- Where the taxpayer maintains or owns business interests;
- The state wherein the taxpayer holds a professional license or licenses; and
- The state wherein the taxpayer owns investment real property.

Physical Presence and Property

This group includes the factors showing where the taxpayer was physically located during the time in question, and where his or her tangible and real property were located. Many of the factors in this group attempt to pinpoint the taxpayer's location, and therefore may be redundant or used to corroborate the taxpayer's location. These factors include:

- The location of all of the taxpayer's residential real property, and the approximate sizes and values of each of the residences (i.e., indicating the nature of the use of the property) including whether the taxpayer sold or rented any residential property around the time of the alleged residency change;
- Where the taxpayer's spouse and children reside;
- Origination point of taxpayer's telephone calls;
- The number of days the taxpayer spends in California versus the number of days the taxpayer spends in other states, and the general purpose of such days (i.e., vacation, business, etc.); and
- Origination point of the taxpayer's checking account transactions and credit card transaction.

Appeal of Odis L. Dobbs (Dec'd) and Lois N. Dobbs

In *Dobbs*, the taxpayers were Colorado residents who purchased an uncompleted home in California in September of 1979 and hired contractors to finish the construction and install furnishings and landscaping so that the house would be ready for their occupancy in 1980. In early 1980, the taxpayers' yacht was in California for repairs. In February of 1980, the taxpayers went on a cruise, they departed from California, and returned to their home in Colorado. In April 1980, the taxpayers wound up most of their business affairs in Colorado and appellant-husband executed a will. The taxpayers left Colorado in late April and were at the California home on May 1, 1980, to direct the movers and unpack some of their boxes and, on that date, they purchased some furnishings for appellant-husband's home office.

From May through August 1980, the taxpayers travelled while their home was being finished and returned to Colorado on a regular basis. They also continued to maintain bank accounts in Colorado and conducted the majority of their banking activities there. Taxpayer-husband continued to receive periodic medical examinations and executed a codicil to his will in Colorado in July of 1980. The taxpayers also visited California that summer to check on the progress of their home and taxpayer-wife obtained a California driver's license in June 1980, registered one of their automobiles, and stored another vehicle there. In July 1980, the taxpayers opened a checking account in a California bank and sold their Colorado home. In August or September 1980, the taxpayers moved into the California house.

The taxpayers took the position that they abandoned their Colorado domicile and established California domicile on May 1, 1980, rather than April 1, 1980 as respondent had determined. The Board ruled in favor of the taxpayers based on the following findings:

- The taxpayers packed up their household goods and furnishings and closed their Colorado home on April 22 and moved them to the California house on May 1.
- On May 1, taxpayer-husband purchased furniture and supplies for his new home office.
- The taxpayers had a history of yacht repair work done in California so that the maintenance of the taxpayers' yacht in California in early 1980 was not inconsistent with a Colorado domicile.
- Even though they departed from California in February 1980 for a Mexican cruise, the taxpayers returned to their home in Colorado and, in April 1980, they wound up personal and business affairs there.
- There was no evidence to suggest that they intended to make California their permanent home prior to May 1.

STAFF COMMENTS

An important issue is whether appellants established domicile in Washington State on January 10, 2005 when they drove to FH Home or on April 23, 2005 when they returned to the FH Home from California. Appellants assert that they moved into their FH Home in January of 2005 and that visits to California after that date were only for temporary or transitory purposes. Appellants state that they left the furnishings in the RSF Home because the FH Home was already furnished in a style compatible with the architecture of the house. Appellants also state that they changed the address for their credit card and brokerage statements but that those statements were forwarded from the FH Home to the RSF Home after January of 2005. At the hearing, appellants should explain why they continued to receive credit card and bank statements at the RSF Home if they did not reside there.

Appellants cite the *Appeal of Dobbs* for support and focus on the activities and location of the taxpayers between May and August of 1980 as relevant to the Board's domicile determination. As described above, in the *Dobbs* appeal, the Board considered only facts and circumstances of the period between November of 1979 and May 1, 1980 during which period the Dobbs visited California, brought their yacht into the state, and departed for a cruise. At the hearing, appellants should be prepared to discuss whether the Dobbs' presence and activities in Colorado for the period between November of 1979 and May 1, 1980 in the *Appeal of Dobbs* is distinguishable from appellants' presence and activities in California for the period between January 16 and April 23, 2005. If the Board determines that appellants did not establish domicile in Washington State before April 23, 2005, and retained California domicile to that date, the board should then determine whether appellants were absent from California during the period from January 1, 2005 through April 23, 2005, for temporary or transitory purposes. If the Board finds that appellants were absent from California for other than temporary or transitory purposes for all or a portion of that period then appellants would be considered nonresidents during such period for the purpose of determining whether the March 2005 payment was taxable on the basis of appellants' residency.

The Appeals Division notes that, if the Board determines that appellants established residency in Washington State on April 23, 2005, the March 2005 payment would be taxable based on appellants' California residency status. However, if the Board determines that appellants established domicile and residency in Washington State on January 10, 2005, then the taxability of the March 2005 and all subsequent payments will be determined based on whether those payments were California-source income as discussed in issue 2 below.

Question (2) Whether appellants have shown that payments received by them, upon appellant-husband's withdrawal from a partnership for tax years 2005 through 2009, was not California-source income.

<u>Factual Background</u>

In 2003, appellant-husband discussed his retirement and resignation from Brandes with the other partners and it was decided that he would retire and resign at the end of 2004. On December 22, 2004, appellant-husband tendered his written resignation and retirement effective December 31, 2004. After his retirement, appellant-husband received Partnership Interest payments from Brandes from 2005 through 2009[3], which the amended and restated partnership agreement (Partnership Agreement) executed in 2002 provided would be treated as IRC section 736(b) payments

[3] Appellant-husband also received Executive Compensation Plan payments during that period but those payments are not in issue.

to be made pursuant to a formula under Article XIII, section 13.3 of the Partnership Agreement. Under that formula, the amount of each payment for each year was dependent upon Brandes' earnings from the prior year. According to the testimony of Brandes' Director of Finance, Gary Iwamura, due to the prescribed formula for calculating appellant-husband's payments after his withdrawal from Brandes, no appraisal was performed for the valuation of the firm as of December 31, 2004. (Resp. Op. Br., pp. 10-11; App. Op. Br., Exh. A "Declaration of Gary Iwamura".)

<u>Contentions</u>

<u>Appellants' Contentions</u>

Appellants state that appellant-husband submitted his notice of withdrawal as a limited partner from Brandes effective December 31, 2004 and, in accordance with the partnership agreement, he was entitled to receive payments over a five-year period as a withdrawing partner. Appellants further state that appellant-husband received his first payment of $7,553,083 on March 15, 2005 and received subsequent payments in the amounts of $7,774,548, $9,205,847, $9,697,337 and $5,138,423 for the years 2006 through 2009, respectively. Appellants state that they reported these payments on their California returns as income from sources outside of California. Appellants also note that, during the years in issue, appellant-husband received additional payments in the amount of approximately $150,000 per year from Brandes pursuant to a Partnership Participation Rights Agreement (PPRA) which was essentially a deferred compensation plan for senior level executives. Appellants state that they paid California tax on the entire amount of those payments and they are not at issue in this appeal. (App. Op. Br., p. 7.)

Appellants state that the five annual payments for the withdrawal from Brandes were calculated according to a two-part formula as stated in the Partnership Agreement. According to appellants, the first part was equal to his tax basis capital account and the second part was a measure of the value of the vested units owned by the withdrawing partner for the year immediately preceding the payment. Appellants state that "Units" represented the percentage equity interest a limited partner had in the partnership and typically each time a limited partner was admitted a new "Class" of units was created. For that reason, an individual who had been a limited partner in Brandes for several years "might have Units in several Classes" and each Class had a floor amount determined by the equity value of Brandes at the time the Class was created. The value of the Units in each Class was calculated every year as a multiple of Brandes' earnings determined in accordance with Generally Accepted Accounting Principles (GAAP), which fluctuated every year. (App. Op. Br., p. 8.)

Appellants explain that if, in any given year, the GAAP earnings did not exceed the floor amount of any particular Class, the value of the Units in that Class would be zero. Furthermore, a payment due to a withdrawing partner was calculated based on the prior year's Unit value and, if that prior year's Unit value was zero, then the withdrawing partner would receive no payment for the Units he owned. If the payments were made over a five-year period and the withdrawing partner did not receive any payment in year 1, he would not receive any payment to make up for year 1 in subsequent years and, at the start of year 2, his equity interest in Brandes would be 80 percent of his original pre-withdrawal interest. In addition, because the value of the Units was calculated every year, the total of the payments the withdrawing limited partner might receive was not fixed or known at the time of the withdrawal and would not be known until Brandes filed its tax returns in either September or October of each year. Finally, appellants state that Brandes treated the amounts paid as payments under IRC section 736(b) in accordance with the Partnership Agreement and Brandes did not deduct those payments as expenses on its returns. (App. Op. Br., pp. 8-9; Exh. A "Declaration of Michael J. Bills" and "Declaration of Gary Iwamura".)

Appellants argue that, based on the formula, the amount of each annual payment was not fixed or known, and it was possible that a withdrawing limited partner could receive no payment attributable to the second part of the formula in any year. Appellants also note that section 13.4 of the Partnership Agreement required that the annual payments made to a withdrawing partner be treated as payments under IRC section 736(b) and Brandes did not deduct those payments for income tax purposes. Appellants assert that payments made under section 13.4 were determined by a methodology for valuing Brandes' partnership assets based on partnership earnings on certain assets owned at the time of separation of the withdrawing partner. Appellants maintain that this method of using earnings is similar to the common technique of using earnings to value a business and, therefore, the payments were not a distributive share of partnership earnings and not California-source income. (App. Op. Br., pp. 12-13.)

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Appellants state that there is a "crucial distinction" between a liquidation of a partnership interest under IRC section 736, a transaction between the partnership and withdrawing partner, and a sale of a partnership interest under IRC section 741, a transaction between a third party or other partners and the selling partner, and in this case the evidence shows that appellant-husband withdrew from Brandes. Because he withdrew under IRC section 736(b), appellants assert that appellant-husband was considered to be a partner for tax purposes until he completely liquidated his interest in 2009 and he did not dispose of his partnership interest on January 1, 2005. (App. Op. Br., pp. 13-14.)

Appellants state that, under R&TC section 17952, the income of nonresidents from intangible personal property is not income from sources in California but is sourced to the state of the individual, unless the intangible personal property has acquired business situs in California. Appellants further state that Regulation 17952, subdivision (c), provides that intangible personal property has business situs in California only if the property is employed as capital in this state or the possession and control of the property has been localized in connection with a business conducted by a nonresident in this state. As an example by which such property could acquire business situs, appellants state that a nonresident might pledge the intangible property as security for a debt incurred in connection with business conducted by the nonresident in California. Appellants contend that appellant-husband was not a resident of California when he received the liquidation payments, he did not conduct business in California from 2005 to 2009, and he did not pledge his partnership interest as security for the payment of any expenses related to business in California. Thus, appellants conclude that none of the payments was California source income. (App. Op. Br., p. 14.)

Appellants assert that, under California law, there is a two-step process for making a sourcing determination: first, subchapter K of the Internal Revenue Code and the California conforming provisions determine the character of appellant-husband's income and then the sourcing rules of R&TC section 17951 and following sections are applied. Appellants cite *Valentino v. Franchise Tax Board* (*Valentino*) (2001) 87 Cal.App. 4th 1284, in which the court applied partnership taxation law to nonresident shareholders of an S corporation that conducted business in California. The court held that the source of a shareholder's pro rata share of S corporation income is first characterized by reference to corporate-income-producing activities under Internal Revenue Code section 1366(b), and then as characterized is sourced to locations according to the rule that applies to that type of income.

Valentino v. Franchise Tax Board, supra, at pp. 1295-1296.[4]

Appellants also cite the *Appeal of Ventura Communications, Inc.*, SBE Nos. 141641 and 140415, decided on February 5, 2003,[5] in which "this Board elaborated on the two-step sourcing process in the context of a nonresident shareholder of an S corporation and a limited partnership interest." In that appeal, the Board held that applying the two-step sourcing process described in *Valentino* resulted in the characterization of gain from the sale of the appellant's partnership interest at the S corporation level as income from the sale of intangible personal property which, pursuant to IRC section 1366(b), passed through to the shareholder characterized in the same manner. The Board further held that the second step of the process involved applying the proper sourcing rule to the income from intangible personal property. (App. Op. Br., pp. 15-16.)

Appellants contend that the same two-step sourcing process must be applied here and, as noted above, the income to appellant-husband was in liquidation of his partnership interest as a retiring partner under IRC section 736(b). As in *Valentino* and *Venture Communications*, the second step involves the application of the sourcing rules under R&TC section 17952 under which "the key is the date when [appellant-husband] realized any income related to his retirement/withdrawal from Brandes." Appellants cite Legal Ruling 2003-1 which states that "the allocation of income between a part-year resident's period of residency and period of non-residency must be made in a manner that reflects the actual date of realization." Appellants contend that appellant-husband is a cash basis taxpayer and did not realize any income with respect to the withdrawal until he received the first two payments in March 2005 and at that time he was a non-resident of California. Therefore, appellants conclude that none of the payments in issue was California-source income. (App. Op. Br., pp. 16-17.)

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[4] In their opening brief, appellants assert that the emphasis (i.e., the italics) in this quotation was placed on IRC section 1366(b) by the Court of Appeal. Staff notes that, based on a review of the electronic version of *Valentino*, no italics were used by the court in that particular sentence.

[5] This document is a summary decision of the Board and is not intended to set precedent. (Rule for Tax Appeals 5511, subsection (z).)

Respondent's Contentions

Respondent states that the parties agree that appellant-husband was liquidating (rather than selling his partnership interest) according to the formula set forth in the revised partnership agreement. According to the declaration of Gary Iwamura, respondent asserts that the liquidation payments depended on the profit or loss of the firm and, despite the terms "equity value", "points", and "Units" used in the formula, it was very clear that Brandes' profits determined the amount of the liquidation payments which were income to appellants. Respondent takes issue with appellants' characterization that "[t]he inclusion of the Brandes' earnings in the formula can be analogized to using a multiple of earnings when valuing a business and is a common valuation technique." Respondent contends that the determination of appellants' liquidation payments was solely dependent on the income of the partnership which meets the definition of "[p]ayments made in liquidation of the interest of a retiring partner" which shall be considered "as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership" pursuant to IRC section 736(a)(1). Because the payments were dependent on Brandes' income for each year that appellant-husband received a payment, respondent concludes that the payments are California-source income and were properly taxable to appellants. (Resp. Op. Br., pp. 22-23.)

Despite appellants' characterization as IRC section 736(b) payments, respondent contends that the substance over form doctrine controls citing *Microsoft v. Franchise Tax Bd.* (2006) 39 Cal.4th 750. Respondent also cites *Milhous v. Franchise Tax Bd.* (2005) 131 Cal.App. 4th 1260, 1269 in which the court held that property had a business situs in California "if the possession and control of the property has been localized in connection with a business, trade or profession in this State so that its substantial use and value attach to and become an asset of the business, trade or profession in this State." Respondent asserts that the Brandes partnership interest had "been localized" because it was used by Brandes as an "asset" to make money and, thus, the interest has California business situs producing California-source income. (Resp. Op. Br., pp. 23-24.)

Respondent asserts that the *Appeal of Venture Communications, Inc.*, Case ID Nos. 141641 and 140415, decided February 5, 2003 and *Valentino v. Franchise Tax Board* (2001) 87 Cal.App.4th 1284, cited by appellants, are distinguishable because each case involved sales of shares of a subchapter S corporation. Moreover, respondent states that in the *Appeal of Venture Communications*, the income received by the shareholder was realized after the S corporation sold a partnership interest and, more importantly, the Revenue and Taxation Code sections cited were applicable to the proper tax treatment of a shareholder's income and not to the income of the appellant Venture Communications. In that appeal, respondent asserts that the Board decided a question involving two levels of intangible property sales, as opposed to a single level transaction as relevant to this appeal and in *Valentino*. (Resp. Op. Br., p. 24.)

Respondent also contends that *Valentino*, which involved the sale of an S corporation's stock by a non-resident in which the court applied partnership law, supports its position because the court held that the taxpayers were required to report gain from the sale of stock as California source income. Respondent maintains that *Valentino* is consistent with respondent's determination because the *Valentino* court held that such income is properly treated "as if received directly in the state wherein the S corporation or partnership is doing business by the source from which it was received." (Resp. Op. Br., pp. 24-25.)0

Appellants' Reply and Supplemental Briefs

Appellants explain the formula for calculating the five annual payments from Brandes to appellant-husband and state that "'Units' essentially represented the percentage equity interest a limited partner had in the partnership" as the "value of the Units was a multiple of Brandes' earnings". Appellants assert that the value of the Units fluctuated every year because the earnings of Brandes fluctuated every year. Appellants state that the annual payments were reported as income under IRC section 736(b) pursuant to that section and the regulations thereunder. Appellants assert that IRC section 736(b) is intended "to permit the participants themselves to determine whether the retiring partner or the remaining partners would bear the tax burden for payments in liquidation of a retiring partner's interest." Appellants quote a portion of IRC section 736 (b) which provides that payments "in exchange for the interest of such partner in partnership property" shall be considered as "a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a)." Appellants also quote a portion of Treasury Regulation section 1.736-1(b)(1) which provides that "[g]enerally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct." Appellants contend that including Brandes' earnings in the payment formula is analogous to using a multiple of earnings which is a common valuation technique for a business recognized by the IRS. (App. Reply Br., pp. 10-11.)

Appellants state that Revenue Ruling 59-60 discussed general approaches, methods, and factors for valuing interests of closely held corporations for gift and estate tax purposes which was expanded by Revenue Ruling 68-609 to include valuation of corporate stock for income and other tax purposes and to apply to valuation of business interests such as partnerships and intangible assets for all tax purposes. Appellants note that Revenue Ruling 59-60 list eight factors including "the earning capacity of the company" and add that the importance of this factor is emphasized in Internal Revenue Manual (IRM) 4.48.4, which provides guidelines relating to issues involving business valuations and other types of valuations. (App. Reply Br., p. 11.)

Appellants dispute respondent's contention that the payments were "solely dependent on the income of the partnership" and argue that respondent misstates the facts and misapplies IRC section 736(a)(1). Appellants contend that respondent relies on the language of IRC section 736(a)(1) for payments made in liquidation of a retiring or deceased partner's interest while ignoring the reference to subdivision (b) which is a specific exception to subsection (a)(1). Appellants contend that, if the payments are made in exchange for a withdrawing or retiring partner's interest in the partnership property, the fact that they are calculated based in part on the GAAP earnings of the partnership is irrelevant. Appellants point to example 2 of Treasury Regulation section 1.736-1(b)(7) which posits the retirement of partner A in accordance with the partnership agreement whereby the partner's share of liabilities in the amount of $1,000 is assumed. Also, under the agreement, the value of partner A's interest is IRC section 736(b) property is $12,000, which is one-third of the value of the partnership property valued at $36,000. The agreement provides for payments based on a percentage of annual partnership income to A for three years. The example concludes that all payments received by A up to $12,000 shall be treated under IRC section 736(b) as payments for A's interest in partnership property. Similarly, appellants contend, the five annual payments to appellant-husband were for his interest in the partnership's property and were not a distributive share of the partnership's net income and those payments did not exceed the value of his interest in the partnership property. (App. Reply Br., pp. 12-

13.)

Appellants state that it is unclear what respondent means when it argues that the substance over form doctrine controls here because, according to appellants, appellant-husband was paid for his interest in the partnership property as provided by IRC section 736(b) which is the substance of these transactions. Furthermore, appellants disagree with respondent's contention that the payments did not satisfy IRC section 736(b). Appellants argue that, as long as the amounts did not exceed the value of appellant-husband's interest in the partnership property, the payments are treated as IRC section 736(b) payments. Consistent with that treatment, appellants note that Brandes did not take deductions for those payments. (App. Reply Br., pp. 12-13.)

Appellants state that section 12.1 of the Partnership Agreement provides that a partner's "aggregate rights to participate in the value and increases in value of the Partnership's business and assets is determined by his 'Equity Interest', which is distinct from his interest in Net Profits and Net Loss and related distributions represented by his Percentage Interest." Appellants further state that section 12.1 provides that a partner's "Equity Interest" is represented by his aggregate Units while section 5.1(b) provides that "a partner's 'Percentage Interest' is a fraction, the number of which is the Points held by such partner, and the denominator of which is the sum of the Points held by all partners." Appellants contend that the Partnership Agreement is "explicit" in providing that the "Equity Interest" used to calculate the annual amounts due a limited partner after withdrawal is distinct from his "Percentage Interest" as an active partner. (App. Reply Br., p. 14 and exh. A "Declaration of Gary Iwamura.)

With respect to respondent's argument that the payments were California-source income because the partnership property had a business situs in California, appellants contend that appellant-husband was not an active partner in Brandes after December 31, 2004. Appellants further contend that pursuant to Regulation 17952, subdivision (c), intangible personal property has a business situs in California only "if it is employed as capital in [California] or the possession and control of the property has been localized in connection with a business . . . in [California] so that its substantial use and value attach to and become an asset of the business . . . in [California]." Appellants assert that appellant-husband "did not pledge the rights to the withdrawal payments for any California-related trade or business nor did he pledge any ‘capital’” and for that reason, the withdrawal payments did not have California situs. (App. Reply Br., pp. 14-15.)

In a supplemental brief, appellants contend that respondent argues that appellant-husband “disposed” of his partnership interest in Brandes upon retirement and, thus, Regulation 17952 is applicable to determine sourcing of the income. Appellants further contend that in their reply brief respondent does not explain how its interpretation of “disposition” is different than a “sale” and does not cite any authority to support the view that a “disposition” includes “liquidation” of a retiring partner’s interest under IRC section 736. In addition, appellants contend that respondent does not address appellants’ point that, under California law, the taxation of income under IRC section 736(b) received by a non-resident requires a two-step process. Rather, according to appellants, respondent argues that two cases involving application of IRC section 1001 are dispositive when the issue is whether the payments were IRC section 736(b) income. (App. Supp. Br., p. 3.)

Appellants repeat their argument that respondent ignores the specific exception set forth in subsection (a)(1) of IRC section 736 which provides that, under these facts, subsection (b) is applicable. Appellants contend that the evidence is uncontroverted that the payments were for appellant-husband’s interest in partnership property and were not a distributive share of Brandes’ net income and that those amounts did not exceed the value of his interest in the partnership property. In addition, appellants contend that respondent has presented no evidence to contradict the two declarations of Gary Iwamura. (App. Supp. Br., p. 4.)

Appellants contend that respondent’s briefing includes the following errors:

- Respondent misstates the fact that appellant-husband did not recover his basis in the partnership property as payments were made. Appellant-husband fully recovered his basis in the partnership of $2,060,327 after the 2005 payments which is consistent with respondent’s Partnership Technical Manual and reflected by the proposed assessment for 2005.
- Respondent incorrectly asserts that under section 13.6 of the Partnership Agreement if the payment for Units is limited in any given year then the payments are added to the following year subject to the limitation of the total amount to be paid to the withdrawing partner. This is directly contradicted by Mr. Iwamura’s declaration in which he states that if the unit value for

the current year is zero, there is no provision for make up for that year in a later year.

- Respondent erroneously argues that payments could not be made until Brandes completed its tax return for the prior year. Mr. Iwamura did not state that payments could not be made, but rather that the amount of the annual payment was “not known” until the returns were filed. The payment made in March 2005 was an estimate because Brandes did not yet know the actual amount to be paid.
- Respondent asserts that Brandes should have sought an independent appraisal of value for the partnership property but there is no legal requirement for an appraisal and Treasury Regulation section 1.736-1(b)(1) provides that the partners’ valuation of a partnership interest in an arm’s-length agreement is generally regarded as correct. The provision in the Partnership Agreement that the payments are to be treated as IRC section 736(b) income “is the epitome of an arm’s-length agreement.”
- Despite respondent’s assertion that Brandes’s method of determining the payment amounts was inconsistent with the proper valuation of a business, the multiple of earnings approach is a common technique recognized by the IRS in Revenue Ruling 68-609 and Treasury Regulation section 1.736-1(b)(7).
- Respondent incorrectly argues that appellant-husband was an active partner for tax purposes in a California partnership under Treasury Regulation section 1.736-1(a)(1)(ii) until he received the last payment in 2009 and, therefore, the payments are California-source income. Appellant-husband was considered a partner for tax purposes under subchapter K only and not an active partner after he withdrew December 31, 2004.
- Appellant-husband did not pledge the rights to the withdrawal payments for any California-related trade or business nor did he pledge any capital and, therefore, no California business situs may be attached to those payments.

(App. Supp. Br., pp. 4-7.)

Respondent’s Reply Brief

Respondent states that appellants argue that this issue is controlled by R&TC section 17952 and the regulations thereunder. Respondent notes that Regulation 17952, subdivision (d), provide that "[t]he source of gains and losses from the sale or other disposition of intangible personal property is determined at the time of the disposition of that property." Respondent also notes that the regulation provides that "a California nonresident who sells intangible personal property would be taxed by California on gain as it is recognized upon receipt of future installment payments in the intangible personal property had a business situs in California at the time of the sale." Respondent asserts that appellant-husband disposed of his entire interest in Brandes on December 31, 2004, after turning in a letter of intention to retire and a vote of the remaining partners approving the retirement effective December 31, 2004. Respondent contends that the foregoing events met the terms of the Partnership Agreement under which he would receive annual payments starting in 2005 and ending in 2009. Thus, respondent contends that appellant-husband disposed of intangible personal property at that time including any interest in Brandes' interest in Brandes LLC. (Resp. Reply Br., pp. 1-2.)

Respondent cites *Cottage Savings Ass'n. v. Commissioner* (1991) 499 U.S. 554, 566, and argues that, consistent with the holding in that case, appellant-husband liquidated his interest in Brandes in 2004 through a disposition of intangible property and realized the income at that time. Specifically, respondent argues that, upon retirement, appellant-husband was entitled to receive cash for his partnership interest which included a percentage interest in the partnership's property. Respondent further argues that the right to receive income upon liquidation does not constitute active participation in Brandes and, as a withdrawing partner, he retained only the right to collect some of the partnership's earnings under Article XIII of the Partnership Agreement. Respondent asserts that, under *Cottage Savings Assn.*, appellant-husband had legally distinct entitlements as of December 31, 2004, but was only required to report the income in the year of recognition. (Resp. Reply Br., pp. 2-3.)

Respondent also cites *Ball v. Commissioner*, T.C. Memo. 2013-39 in which the U.S. Tax Court reviewed the differences between the realization of gain, the recognition of gain, and when recognition is deferred. There, the court held that any gain from the sale or disposition of property must first be realized and, once a realization event has occurred, the amount of realized gain must be calculated in accordance with IRC section 1001. The court notes that IRC section 1001(c) provides in part that once an amount is calculated "the entire amount of the realized gain is recognized unless a Code section provides for nonrecognition treatment." Respondent argues that appellant-husband had a complete and fixed right to receive his proportionate share of the gain of Brandes prior to December 31, 2004, and after that date he retained that right but surrendered other rights as an active limited partner. As such, respondent contends that the payments meet the *Cottage Savings Assn.* definition of realization and the *Ball* court's refinement and reconciliation of the recognition and realization. (Resp. Reply Br., pp. 3-4.)

Respondent states that the *Ball* court noted that "[n]onrecognition transactions generally preserve unrecognized gain by assigning a 'substituted' or 'carryover' basis to the acquired property." Respondent asserts that, after appellant-husband retired from Brandes, he retained the same basis in the partnership he held prior to retirement until the payments commenced and "he had the same rights to the accession of wealth" by Brandes. Respondent also states that the *Ball* court observed that "nonrecognition transactions" may be viewed as the postponement of the taxation of appreciation of property value and deduction of value declines until the taxpayer sells or otherwise disposes of the property. Respondent asserts that the fact that appellants did not know the payment amounts on December 31, 2004 is not relevant to the determination of when they realized the income and that recognition events occurred when those amounts were determined. (Resp. Reply Br., p. 5.)

Respondent quotes a portion of *Ball* in which the court identified several Internal Revenue Code sections and a Treasury Regulation section that provide for nonrecognition treatment of "certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial." Because the differences are more formal than substantial in that "the new property is substantially a continuation of the old investment still unliquidated", the court explained that gain or loss is not recognized at the time of the exchange because those differences are not "deemed controlling". Applying this holding to the facts presented, respondent contends that "[t]he difference between appellant-husband's right to receive increases in Brandes LP value before and after December 31, 2004 was 'more formal than substantial'". On that basis, respondent concludes that it is irrelevant whether the payments were characterized as income under either subsection (a) or subsection (b) of IRC section 736 because appellant-husband held "an unliquidated interest in the partnership's property" both before and after his retirement which was "substantially a continuation of his old investment still unliquidated." Respondent further contends that appellants' residency at the time they received the payments is irrelevant because all income, including gain from partnerships, received by California residents is taxable by this state. Respondent states that, under R&TC section 17952, a non-resident who receives payments from a disposition of property made while he or she is a California resident is taxable by California on that income. Respondent asserts that appellant-husband was domiciled in and a resident of California on December 31, 2004, and therefore the subsequent move to Washington has no effect on the sourcing of the payments to California. (Resp. Reply Br., pp. 5-6.)

Respondent further contends that, pursuant to R&TC sections 17951 and 17952 and Regulations 17951-4 and 17952, subdivision (c), the capital gain from the distribution by Brandes to appellants from 2005 through 2009 is taxable by California. Respondent argues that, according the appellants' reply brief, appellant-husband held an interest in Brandes' property from 2005 to 2009 and the property held by Brandes was a 99 percent interest in Brandes LLC. As a result, respondent asserts that appellant-husband had a personal property interest in Brandes LLC from 2005 to 2009 through his partnership interest in Brandes which is the personal property interest that he was "allegedly liquidating" over five years. Respondent states that Brandes LLC was a financial services firm during that period and its net income flowed up to Brandes. Because appellant-husband remained an active partner in Brandes for tax purposes pursuant to Treasury Regulation section 1.736-1(a)(1)(ii) until he received the last payment in 2009, respondent maintains that, pursuant to R&TC section 17951 and Regulation 17951-4, the distributions are from a partnership with situs in California and, therefore, are California source income. In addition, respondent contends that appellant-husband held an interest in Brandes LLC, which constituted appellant-husband's intangible personal property, and Brandes LLC was situated in California when he retired from Brandes (rather than selling his partnership interest). As a result, respondent asserts that appellant-husband placed his property into California where "the possession and control of the property [was] localized in connection with a business, trade or profession in this State so that its substantial use and value attach[ed] to and [became] an asset of the business" which was Brandes LLC with a situs in California. (Resp. Reply Br., pp. 6-7.)

Respondent refers to the Supplemental Declaration of Gary Iwamura attached to appellants' reply brief which states that appellant-husband received payments for "partnership property". Respondent states that appellants' reply brief focuses on the liquidation of the partnership property but asserts that neither appellants' opening brief nor Gary Iwamura's first declaration mentioned partnership property. In addition, respondent asserts that, although IRC section 736(b) was cited and referenced in the Partnership Agreement, appellants have not presented any contemporaneous evidence that the calculations required under IRC section 736(b) were performed. Respondent contends that appellants pivoted to this position because they recognized that the argument made in their opening brief "was unsustainable and unsupported by law." (Resp. Reply Br., p. 7.)

Respondent further contends that the example Gary Iwamura presents in the supplemental declaration contradicts the example in his first declaration. In the first declaration, he cites an example in which a withdrawing partner might not receive a payment in the five-year withdrawal period if the partnership realizes no income. However, if the payments were actually in exchange for "partnership property" as appellants contend, respondent suggests this characterization is inconsistent with Mr. Iwamura's implication that appellant-husband might not recover his basis in the property. To further undercut Mr. Iwamura's statement, respondent cites section 13.3(a) of the Partnership Agreement which provides that each year of the withdrawal period, 20 percent of the withdrawing partner's basis is required to be included in his payment. Furthermore, respondent contends that section 13.6 directly contradicts both declarations because it provides that, if payments for "units" are limited in any way, those amounts are added to the following year's payment subject to the limitation of the total amount to be paid.

Respondent finds another discrepancy in a statement from Mr. Iwamura's first declaration (but not the supplemental declaration) that payments could not be disbursed until Brandes completed its tax return for the prior year by pointing out that appellant-husband received two payments in March of 2005 and another in October of 2005. Finally, respondent argues that appellants fail to provide an accounting of the value of the partnership property. Rather than obtaining an independent appraisal for the value of Brandes, respondent states that Mr. Iwamura simply used Brandes' federal tax return to determine the income from the previous year which, respondent contends, is inconsistent with the proper valuation of a business. Respondent also argues that appellants' assertion that Brandes' earnings was only one factor used to determine the amount of the payments is refuted by the definition of "Equity Value" in the Partnership Agreement which is based on prior year's income. (Resp. Reply Br., pp. 8-9.)

Applicable Law

Partnership Distributions Upon Retirement of a Partner

IRC section 736 provides in relevant part

> (a) Payments considered as distributive share or guaranteed payment. Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—
>
> (1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or
> (2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.
>
> (b) Payments for interest in partnership.
> (1) General rule. Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations prescribed by the Secretary, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).

Payments made in liquidation of a retiring partner's interest may represent several items, including the fair market value of the partner's interest in all the assets of the partnership, and the partner's interest in any partnership unrealized receivables. (Treas. Reg. § 1.736-1(a)(2).) When any such payments are made, they must be allocated between payments for a partner's interest in partnership property and all other payments. (Int.Rev. Code, § 736(a) and (b); Treas. Reg. § 1.736-1(a)(3).) Amounts paid for a partner's interest in partnership assets are treated in the same manner as a distribution in complete liquidation, and the partnership is allowed no deduction for such payments. (Treas. Reg. §§ 1.736-1(a)(2) & 1.736-1(b)(2).) Generally, the value of a partner's interest in partnership property determined by the partners in an arm's-length agreement will be regarded as correct. (Treas. Reg. § 1.736-1(b)(1).)

If an amount is not paid for a partner's interest in partnership assets, it will be treated as a guaranteed payment or a distributive share of partnership income. Guaranteed payments are ordinary income to the recipient. A payment that constitutes a distributive share of partnership income has the same character in the hands of the distributee as they had in the hands of the partnership. Thus, to the extent that a distributive share includes a share of capital gains or exempt income, the distributee, in turn, would have capital gain or exempt income. (Treas. Reg. § 1.736-1(a)(6).)

A partner is considered to have retired when he ceases to be a partner under local law. For tax purposes, however, a retired partner or the successor of a deceased partner is treated as a partner until his interest in the partnership has been completely liquidated. (Treas. Reg. § 1.736-1(a)(6).)

For purposes of computing the taxable income of a nonresident or part-year resident as defined by R&TC section 17041, subdivision (i)(1), R&TC section 17951, subdivision (a) provides that "in the case of nonresident taxpayers the gross income includes only the gross income from sources within this state." Regulation 17951-4, subdivision (a) provides, in part, that if "the nonresident's business, trade or profession is conducted wholly within the state, the entire net income therefrom is derived from sources within this state."

R&TC section 17952 provides that "income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this state unless the property has acquired a business situs in this state . . .".[6] With respect to business situs, subdivision (c) of Regulation 17952 provides that:

> [i]ntangible personal property has a business situs in this State if it is employed as capital in this State or the possession and control of the property has been localized in connection with a business, trade or profession in this State so that its substantial use and value attach to and become an asset of the business, trade or profession in this State. For example, if a nonresident pledges stocks, bonds or other intangible personal property in California as security for the payment of indebtedness, taxes, etc., incurred in connection with a business in this State, the property has a business situs here.
>
> . . .
>
> If intangible personal property of a nonresident has acquired a business situs here, the entire income from the property including gains from the sale thereof, regardless of where the sale is consummated, is income from sources within this State, taxable to the nonresident.

Valentino v. Franchise Tax Board (2001) 87 Cal. App. 4th 1284

The taxpayers were a married couple who resided in Florida and owned stock in a

[6] Regulation 17952, subdivision (b) is to the same effect.

Delaware subchapter S corporation which conducted business in California. For the years in issue, the corporation's income was from California sources and respondent determined that the taxpayers' pro rata share of the S corporation's income was taxable by California. The taxpayers argued that under R&TC section 17952 and the doctrine of *mobilia sequuntur personam* nonresidents of California were not required to pay tax on income derived from stock of a foreign S corporation doing business in California, unless the intangible property itself, i.e., the stock, acquired a business situs in California. The taxpayers also relied on two cases involving C corporations for the proposition "that the source of the income to the shareholder is the corporate stock and that the source of the income from the stock is the state where the owner resides under the *mobilia* doctrine unless it acquires a business situs elsewhere." The court of appeal distinguished those cases on the basis that they involved the source of dividends received, not a pro rata share of S corporation income, and in taxable years before California adopted S corporation rules. Rather, the court concluded that the California Legislature intended the source of S corporation pass-through income be determined by reference to corporate income producing activities which in that case was California. The court described the sourcing as a two-step process in which "the source of a shareholder's pro rata share of S corporation income is first characterized by reference to corporate-income-producing activities under [IRC] section 1366(b), and then as characterized is sourced to locations according to the rule that applies to that type of income." (*Id.* at 1296.)

<u>Appeal of Venture Communications, Inc.</u>

This Board applied the two-step "sourcing" process for S corporation income passed through to a shareholder as described in *Valentino*, by first characterizing the income generated by the sale of the S corporation's limited partnership interest at the S corporation level. The limited partnership operated a cable television franchise in West Covina, California. The Board found that the income received by the S corporation on the sale of the limited partnership interest was income from the sale of intangible personal property. Thus, pursuant to IRC section 1366(b), the income passed through the S corporation to the shareholder was also characterized as income from the sale of intangible personal property.

In the second step, this Board applied the sourcing rule to the income from the intangible personal property. Following the *Valentino* court, the Board held that R&TC section 17952, as a provision of the Personal Income Tax Law, was applicable to the nonresident individual shareholder and that the shareholder's share of S corporation income itself derived from the sale of intangible personal property. Thus, this Board concluded that, pursuant to R&TC section 17952, the nonresident shareholder was not required to report and pay tax on his pro rata share of the S corporation's income from the sale of its limited partnership interest.

In the *Appeals of Amyas and Evelyn P. Ames*, *et al.*, (87-SBE-042), decided on June 17, 1987, respondent argued that the operation of a partnership in California created a business situs for each partner's interest in California and thus, the gain on the sale of those interests was taxable by California. However, the Board disagreed and held that the gain was not the result of partnership operations, but rather the result of the sale of intangible property and, therefore, the gains would be sourced to California only if the intangible property had a business situs in the state. Because the taxpayers in that appeal did not integrate those partnership interests into business activities in California, the gain was sourced to the taxpayers' states of residence.

In the *Appeal of John Manter* (99-SBE-008), decided on December 9, 1999, the taxpayer was a resident of Connecticut who was a shareholder in an S corporation organized in Delaware that had significant business activity in California. The Board held that respondent properly sourced the shareholder's distributive share of the earnings to California, where the S corporation did business. The Board found support for its determination based on "the longstanding treatment of partnerships in this state for tax purposes." The Board observed that partnerships, like S corporations, are "pass-through" entities and partnership interests are intangible property, just as are shares of an S corporation. Despite there being no explicit exemption for partnership interests as intangible property under R&TC section 17952, the Board noted that Regulation 17951-1, promulgated by respondent, provides that pass-through partnership income received by a non-resident is subject to California tax where the source of the partnership's income is in this state.

Realization and Recognition of Gain

IRC section 1001(a) provides that "[t]he gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.” Treasury Regulation section 1.1001-1(a) provides that “gain or loss realized from the conversion of property into cash, or from the exchange of property for other property *differing materially either in kind or in extent*, is treated as income or as loss sustained.” (italics added).

In *Cottage Savings Ass'n*, a state-chartered mutual savings association experienced financial trouble when a dramatic increase in interest rates forced it to pay more to account and certificate holders than it earned on low-interest fixed term mortgage loans. The net worth requirements established by the Federal Home Loan Bank Board ("FHLBB") prevented Cottage Savings from liquidating its mortgage loan investments which would have allowed it to recognize losses for tax purposes and to claim income tax refunds. Recognizing those restrictions placed on savings institutions, the FHLBB issued a directive that relieved an institution of its obligation to report losses incurred by the sale of mortgage loans, subject to specified requirements. Relying on those guidelines, in 1980, Cottage Savings sold 90 percent participation interests in 252 mortgage loans to four other savings and loan associations while simultaneously purchasing 90 percent participation interests in 305 similar mortgage loans from those four savings and loans. These transactions met the criteria established by the directive and, therefore, were not reported to the FHLBB as losses affecting net worth. Cottage Savings then claimed deductions for the losses sustained on these sales on its 1980 federal income tax return. The IRS disallowed the losses, arguing that the transaction did not result in a realized loss because the mortgage loans exchanged were not “materially different.”

The Supreme Court held that, while the Internal Revenue Code places no “materially different” limitation on the concept of realization, the history of IRC section 1001 and the interpretive regulation indicated that the language of the regulation was entitled to judicial deference. The Court also relied on a line of reorganization cases, for the proposition that a taxpayer realizes gain or loss only if the properties exchanged are “materially” or “essentially” different. The Court concluded that the principles of realization previously developed in these cases are now incorporated in the realization requirement as codified in IRC section 1001(a), and that the regulatory interpretation of this statutory language in a manner consistent with the holdings in these cases must therefore be reasonable.

In determining whether the properties were "materially different" the Court focused on whether the legal entitlements that accompanied the exchanged mortgages were different in kind or extent. The Court held that the mortgage loans received by Cottage Savings provided it with legal entitlements different from those enjoyed prior to the exchange because the loans received were made to different obligors and were secured by different parcels of property. Concluding that the loans exchanged were thus "materially different" because of differences in these legal entitlements, the Court permitted a deduction for the resulting realized loss.

In *Ball v. Commissioner*, the U.S. Tax Court reviewed the differences between the realization of gain, the recognition of gain, and the deferral of recognition. There, the court held that any gain from the sale or disposition of property must first be realized and, once a realization event has occurred, the amount of realized gain must be calculated in accordance with IRC section 1001. Once an amount is calculated, the court held that "the entire amount of the realized gain is recognized unless a Code section provides for nonrecognition treatment" and noted several of the Internal Revenue Code sections that provide for nonrecognition treatment. The court observed that those sections described differences between the properties exchanged which are "more formal than substantial" such that the "differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange." The court further noted that the underlying assumption for such treatment is that "the new property is substantially a continuation of the old investment still unliquidated." Finally, the *Ball* court noted that "[n]onrecognition transactions generally preserve unrecognized gain by assigning a 'substituted' or 'carryover' basis to the acquired property" so that "nonrecognition transactions" may be viewed as the postponement of the taxation of the appreciation of property value and the deduction of value declines until the taxpayer sells or otherwise disposes of the property.

STAFF COMMENTS

Here, respondent contends (and appellants seem to agree) that if the payments are characterized as a distributive share of Brandes' income under IRC section 736(a) then the payments would be sourced to California as income derived from business activity in California. IRC section 736(a) states that, except as provided in IRC section 736(b), payments shall be considered a distributive share of partnership income if the amount of the payment is determined with regard to the income of the partnership. IRC section 736(b), and the regulations thereunder, provide that if a payment is made in exchange for a partner's interest in partnership property, it will be treated as a distribution by the partnership and not as a distributive share of income or a guaranteed payment under subsection (a).

Appellants argue that the payments were not a distributive share of income but rather liquidating distributions from the partnership following appellant-husband's retirement from Brandes under IRC section 736(b). If the payments are characterized as income under IRC section 736(b), appellants argue that R&TC section 17952 is controlling such that the income from the partnership interest during the period that appellants were Washington State residents was not from sources in California. Respondent disputes that the payments were liquidating distributions under IRC section 736(b) and further argues that, even if the payments were liquidating distributions under IRC section 736(b), the payments would be taxable by California on the alternative grounds that the partnership interest acquired a business situs in California or that appellants obtained the right to the payments while still a California resident.

Respondent argues the payments must be treated as a distributive share of income under IRC section 736 because the amount of each payment for appellant-husband's "Units" is solely based on Brandes' earnings or income from the prior year. Respondent should be prepared to discuss IRC section 736(b), which provides an exception to the general rule that payments determined by reference to partnership income constitute a distributive share of income. The exception provided by IRC section 736(b) applies where payments are made in liquidation of the interest of a retiring partner. Respondent should address whether the payments here were made in the liquidation of appellant's interest in partnership assets such that the payments constitute distributions under IRC section 736(b).

Appellants dispute respondent's analysis and contend that using a multiple of earnings to determine the value of appellant-husband's percentage equity interest is a common business valuation technique. At the hearing, appellants should be prepared to explain the valuation methodology, including how the multiple was determined. Respondent should be prepared to address whether using an earnings approach to value a partnership interest necessarily prevents a payment from constituting a liquidating distribution and requires it to be treated as distributive share of partnership income.

Respondent also argues that appellant-husband "disposed" of his partnership interest in

Brandes upon retirement on December 31, 2004, and, therefore, realized the entire amount of the distribution on that date when appellants were residents of California but that the recognition of those payments for tax purposes was deferred until the payments were received. In support of this argument, respondent cites *Ball* in which the court referenced the Internal Revenue Code and Treasury Regulation "nonrecognition treatment" provisions that are applicable to "certain specific exchanges of property" which respondent asserts are similar to the effect of appellant-husband's retirement whereby his right to the distribution of his partnership interest was "substantially a continuation of his old investment still unliquidated." At the hearing, respondent should be prepared to present any legal authority for applying this theory of nonrecognition treatment to a liquidation of a partnership interest.

Respondent acknowledges that appellant-husband remained a partner for tax purposes pursuant to Treasury Regulation section 1.736-1(a)(6) until he received the final payment in 2009, and, for that reason, maintains that pursuant to R&TC section 17951 and Regulation 17951-4 the distributions are from a partnership with situs in California and, therefore, are California source income. Respondent also contends that, after he retired, appellant-husband held intangible personal property in the form of an interest in Brandes LLC situated in California and, under Regulation 17952, subdivision (c), appellants' intangible personal property had business situs in California. At the hearing, respondent should be prepared to reconcile its position that appellants disposed of their partnership interest and realized gain upon appellant-husband's retirement on December 31, 2004 with their position that appellant-husband remained a partner for tax purposes and, as a result, held intangible personal property with a California business situs. Respondent should also be prepared to discuss the *Appeals of Amyas and Evelyn P. Ames, et al.*, *supra*, which discusses when a partnership interest acquires a business situs in California.

Additional Evidence

If either party has additional evidence that the party wants the Board to consider, then pursuant to California Code of Regulations, title 18, section 5523.6, that party should provide such evidence to the Board Proceedings Division at least 14 days prior to the oral hearing.[7]

[7] Evidence exhibits should be sent to: Khaaliq A. Abd'Allah, Associate Governmental Program Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC: 80, Sacramento, California, 94279-0080.

Section 40

As noted above, this matter is subject to R&TC section 40. Therefore, within 120 days from the date the Board's vote to decide the appeal becomes final, a written opinion (i.e., Summary Decision or Formal Opinion) must be published on the Board's website. (Cal. Code Regs., tit. 18, § 5552, subds. (b), (f).) The Board's vote to decide the appeal will become final 30 days following the date of the Board's vote, except when a petition for rehearing is filed within that period.[8] (Cal. Code Regs., tit. 18, § 5460, subd. (a).)

Following the conclusion of this hearing, if the Board votes to decide the appeal, but does not specify whether a Summary Decision or a Formal Opinion should be prepared, staff will expeditiously prepare a nonprecedential Summary Decision and submit it to the Board for consideration at a subsequent meeting. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(2).) Unless the Board directs otherwise, the proposed Summary Decision would not be confidential pending its consideration by the Board (Cal. Code Regs., tit. 18 § 5551, subd. (b)(5)); accordingly, it would be posted on the Public Agenda Notice for the meeting at which the Board will consider and vote on the Summary Decision.

A taxpayer may request that the Board hold in abeyance its vote to decide the appeal so the taxpayer may review the Board's written opinion prior to the expiration of the 30-day period for the filing of a petition for rehearing. If the vote is held in abeyance, the proposed Summary Decision will be confidential until it is adopted by the Board. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(5).) Any request that the Board's vote be held in abeyance should be made in writing to the Board Proceedings Division prior to the hearing or as part of oral argument at the hearing. Any such request would then be considered by the Board during its deliberations on the appeal.

[8] If a petition for rehearing is filed, the Board's decision will not become final, and no written opinion under Section 40 will be considered until after the petition for rehearing is resolved.