



chair John Chiang  
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State of California  
**Franchise Tax Board**

08.17.10

Information Letter 2010-4

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Dear \*\*\*\*\*,

Your letter of February 18, 2009, requesting an Information Letter as to an issue involving the definition of qualified investment securities has been assigned to me for a response.

Your letter requests advice as follows:

1. For purposes of Sections 17955 and 23040.1 [of the California Revenue and Taxation Code], the term "qualifying investment securities" includes credit default swaps, interest rate swaps, interest rate swaptions, cross currency swaps and equity swaps, and other similar financial instruments.
2. The income generated from credit default swaps, interest rate swaps, interest rate swaptions, cross currency swaps and equity swaps, and other similar financial instruments constitutes interest, dividends, or gains within the meaning of Sections 17955 and 23040.1 [of the California Revenue and Taxation Code].

While it is the policy of the Franchise Tax Board to respond to inquiries from taxpayers, the Franchise Tax Board will ordinarily not issue a ruling, or may decline to issue a ruling, because of the hypothetical nature or the highly factual nature of the inquiry, among other reasons. For your convenience, attached you will find a copy of Franchise Tax Board Notice 89-277, in effect at the time of your request, which identifies and discusses the guidelines for ruling requests.

The Franchise Tax Board will not issue a Chief Counsel Ruling when the request includes hypothetical situations. Your inquiry requires the assumption of unknown facts and proposes hypothetical situations. Your statement of facts contains descriptions of a broad range of hypothetical transactions. Your request is also made on behalf of an unidentified taxpayer and involves vague descriptions of the purported securities. Therefore, the Franchise Tax Board is not able to issue a ruling on the questions you presented.

However, in response to your inquiry, the following information may be of assistance to you in helping taxpayers reach a determination of whether certain transactions and/or securities would fall into the definition of "qualified investment securities" under the Revenue and Taxation Code.

California Revenue and Taxation Code section 17955 provides:

(a) For purposes of computing "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of Section 17041, notwithstanding Sections 17951, 17952, and 17953, gross income of a nonresident (as defined in Section 17015) from sources within this state shall not include dividends, interest, or gains and losses from qualifying investment securities if any of the following apply:

(1) In the case of an individual, with respect to the qualifying investment securities, the taxpayer's only contact with this state is through a broker, dealer, or investment adviser located in this state.

(2) In the case of a partner's distributive share of income from qualifying investment securities, the partnership qualifies as an investment partnership, whether or not the partnership has a usual place of business located in this state.

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(b) This section shall not apply to income derived from investment activity that is interrelated with any trade or business activity of the nonresident or an entity in which the nonresident owns an interest in this state, whose primary activities are separate and distinct from the acts of acquiring, managing, or disposing of qualified investment securities, or if those securities were acquired with working capital of a trade or business activity conducted in this state in which the nonresident owns an interest.

(c) For purposes of this section:

(1) "Investment partnership" means a partnership that meets both of the following requirements:

(A) No less than 90 percent of the partnership's cost of its total assets consists of qualifying investment securities, deposits at banks or other financial institutions, and office space and equipment reasonably necessary to carry on its activities as an investment partnership.

(B) No less than 90 percent of its gross income consists of interest, dividends, and gains from the sale or exchange of qualifying investment securities.

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(3) (A) "Qualifying investment securities" include all of the following:

(i) Common stock, including preferred or debt securities convertible into common stock, and preferred stock.

(ii) Bonds, debentures, and other debt securities.

(iii) Foreign and domestic currency deposits or equivalents and securities convertible into foreign securities.

(iv) Mortgage- or asset-backed securities secured by federal, state, or local governmental agencies.

(v) Repurchase agreements and loan participations.

(vi) Foreign currency exchange contracts and forward and futures contracts on foreign currencies.

(vii) Stock and bond index securities and futures contracts, and other similar financial securities and futures contracts on those securities.

(viii) Options for the purchase or sale of any of the securities, currencies, contracts, or financial instruments described in clauses (i) to (vii), inclusive.

(ix) Regulated futures contracts.

(B) "Qualifying investment securities" does not include an interest in a partnership unless that partnership is itself an investment partnership.

The Franchise Tax Board cannot conclude from the statutory language and legislative history that the transactions described in your letter will qualify as "qualified investment securities" under Revenue and Taxation Code sections 17955 and 23040.1. However, to the extent that your questions seek to determine whether derivatives might be included in the definition of "qualified investment securities," the Franchise Tax Board agrees that they might be included. Although, derivatives are not specifically mentioned in section 17955(c)(3)(A), the statutory definition appears to encompass such securities. Clause (vii) of section 17955(c)(3)(A) includes as qualifying investment securities "stock and bond index securities and futures contracts, and other similar financial securities and futures contracts on those securities." The reference to "stock and bond index securities" specifically encompasses derivatives.

However, to determine whether a specific transaction falls within one of the subparagraphs of the section would require a determination of whether or not such transaction is "similar" to the enumerated examples. Certain transactions may align more closely with different subparagraphs.

This letter is only intended to provide you with an overview of the requirements of certain securities to be "qualified investment securities." This letter is being provided for information purposes only and may not be considered "written advice from the Board" within the meaning of Revenue and Taxation Code section 21012.

Very truly yours,

Natasha Sherwood Page  
Tax Counsel III

Enclosure