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June 4, 2007
Chief Counsel Ruling 2007-2

RE: APPORTIONMENT TREATMENT OF RECEIPTS GENERATED FROM INVESTMENT ACTIVITIES CONDUCTED BY THIRD PARTY INVESTORS

Dear ******:

In your correspondence dated ******, you requested advice concerning the apportionment treatment of receipts generated from investment activities conducted by third party investors, pursuant to written agreement between ******on the one hand, and a third party investor on the other. Your letter enclosed a specimen "Investment Management Agreement" ("the Agreement") as an example of a typical third party investor agreement. Attached to the Agreement was ****** ****** ******"Guidelines for External Fixed Income Investment Managers."

FACTS

******("******") is a Delaware corporation, commercially domiciled in *******, engaged in the business of manufacture and distribution of *******.

****** manages some of its assets internally through its own treasury department, but outsources a substantial amount of its treasury function to third party investors. On behalf of ******, these investors generate interest income from managing and investing in various types of cash equivalents and marketable securities. The contractual investment arrangement between ****** and the third party investors ("Managers") is memorialized by a written agreement, in the form of the Agreement that was attached to your correspondence. Managers act as ******'s agents in managing a portion of ******'s investment portfolio, subject to the terms and conditions set forth in the Agreement and its attachments. For purposes of this Chief Counsel Ruling, it is assumed that the third party investors are neither members of ******'s unitary group, nor employees of members of ******'s unitary group.[1]

[1] Such facts relative to third party investors' membership status in ****** unitary group or status as employees of any member of ****** unitary group are not stated in either your ******letters, nor are such facts implied therein or inferred by the Franchise Tax Board. The statement is made for the purpose of limiting the factual and legal scope of the Chief Counsel Ruling as requested by the taxpayer, and to exclude them from the ambit of FTB Legal Ruling 2006-2, *infra.*

The Agreement recites that (1) ******, through its own employees, manages a substantial investment portfolio, consisting primarily of short-term investments; and (2) ****** wishes to engage Managers as agents to manage a portion of ******'s investment portfolio, and the Managers are willing to accept such engagement, subject to the terms and conditions set forth in the Agreement and its attachments. The Agreement has one attachment, entitled "Guidelines for External Fixed Income Investment Managers" (the "Guidelines"). The Guidelines contain the following sections:

- Cash management objective
- Investment philosophy
- Investment manager objectives
- Liquidity considerations
- Manager performance evaluation
- Restrictions and limitations (on investments, generally, as well as on derivatives)
- Calculation procedures (to determine loss budget, net capital losses, and loss budget utilization)
- Notification and escalation procedures
- Manager relationships
- Other issues

Whereas each of these sections contains certain specific instructions to, or limitations upon the Managers as ******'s investment Managers, the section entitled "Investment Philosophy" states:

> ******
> ******
> ******
> ******
> ******

Upon execution of the Agreement, a Manager becomes authorized to direct the investment and reinvestment of ****** assets (primarily cash and securities), in its discretion, that
****** from time to time has on deposit in a separate ****** account with ******and ******.

In addition to outsourcing investments through contractual agreement with Managers, ****** will continue to manage and invest a portion of its assets internally. ****** employs four internal employees who will continue to handle the management of all investments that are not outsourced. The primary function of these employees is to invest internally managed cash. While these employees are also responsible for oversight of external investment managers, this oversight consists of the monthly review of reports of external investment performance, which generally takes about four hours of the employee's time - approximately 2% of his or her time over the course of a month. The managers do not guide or direct the outside investment managers in their day-to-day investment decisions, nor do they evaluate their performance on a

daily or weekly basis. The only monitoring of outside investment managers is the monthly performance review conducted by the internal employees.

ISSUE

Whether the investment activities of third party investors who manage investments on behalf of ******, pursuant to written agreement, constitute "income producing activity" of ******, within the meaning of Revenue and Taxation Code[2] section 25136, and California Code of Regulations[3] section 25136.

If the activities of the third party investors are not income producing activities that are attributable to ******, should the resulting receipts be excluded from the sales factor?

APPLICABLE LAW

On pages 4-5 of your ****** letter, you correctly cite section 25136 and Regulation 25136 as controlling authority regarding sales of intangible property. Section 25136 provides:

> Sales, other than sales of tangible personal property, are in this state if:
>
> (a) The income-producing activity is performed in this state; or
>
> (b) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

Regulation 25136 provides, in pertinent part:

> (b) Income Producing Activity: Defined. The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. *Such activity does not include transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor.*
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> (c) Costs of Performance: Defined. The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.

(Italics added.)

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[2] All statutory references are to the Revenue and Taxation Code unless otherwise noted.
[3] Specific sections from Title 18, California Code of Regulations are identified by the term "Regulation" and then the section number, e.g., "Regulation 25136."

On pages 5-6 of your letters, you cited section 25137 and particularly Regulation 25137(c)(1)(C) as being pertinent to ******'s circumstances that are the subject of its request for a Chief Counsel's Ruling. Regulation 25137(c)(1)(C) provides:

> (c) Where the income producing activity in respect to business income from intangible personal property can be readily identified, such income is included in the denominator of the sales factor and, if the income producing activity occurs in this state, in the numerator of the sales factor as well. . . .
>
> Where business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, such income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, such dividends and interest shall be excluded from the denominator of the sales factor.

LAW AND ANALYSIS

As indicated in italicized text above from Regulation 25136(b), the threshold question is whether there is any *income producing activity* attributable to ******, from receipts generated by third party investors under contractual agreement with ******. Under Regulation 25136(b), an activity that is performed "on behalf of"[4] the taxpayer does not result in income producing activity attributable to the taxpayer. Therefore, if the third party investors perform investment activities "on behalf of" ****** within the meaning of Regulation 25136(b), then these activities do not constitute income producing activities that will be attributable to ******.

If the activities of the third party managers are excluded by virtue of the "on behalf of" rule, the inquiry then becomes whether there might be other income producing activities performed by the taxpayer, in respect to the ****** employees' oversight of the third party investors' activities. The facts provided in your ****** letters indicate that ****** employees perform no activities of their own that are directed towards generating the receipts in question, but merely provide occasional oversight of the third party investors' activities. Time spent on such oversight activities is therefore *de minimis*, and the activities do not rise to the level of income producing activities contemplated under Regulation 25136(b).

Because there are no identifiable income producing activities that can be used to assign the receipts in question to the numerator of any state, then under Regulation 25137(c)(1)(C) such income "shall be excluded from the denominator of the sales factor."

DETERMINATION

[4] See, FTB Legal Ruling 2006-2 (May 3, 2006)

A third party investor who undertakes investment activity on behalf of ****** pursuant to written agreement, in the form of the Agreement, is not performing an "income producing activity" that can be considered as an income producing activity of ******, within the meaning of Regulation 25136(b).

Because ****** has no other income producing activities related to these receipts, the receipts cannot be readily attributed to any particular income producing activity of ******, the taxpayer. Therefore, under Regulation 25137(c)(1)(C), these receipts shall be excluded from the sales factor.

This ruling does not apply to investment activities of ****** employees, or to the income or receipts resulting from their investment and/or management of funds that ****** does not outsource (as discussed on pages 2-3 of your May 15, 2007 correspondence.)

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the Revenue and Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

Eric R. Brown
Tax Counsel