State of California
Franchise Tax Board

Legal Division MS A390
PO Box 2229
Sacramento, CA 95812-2229

03.25.10

CHIEF COUNSEL RULING 2010-1

Subject: Request for Chief Counsel Ruling that Certain Investments are "Qualifying Investment Securities" Within the Meaning of Sections 17955(c)(3)(A) and 23040.1(d)(4)(A) of the California Revenue and Taxation Code.

Dear ************,

This is in response to your request for a ruling that certain investments are "qualifying investment securities" within the meaning of sections 17955(c)(3)(A) and 23040.1(d)(4)(a) of the California Revenue and Taxation Code.

Your request relates to ************************************** (the "Onshore Fund") which conducts its affairs with the intention of being an "investment partnership" that holds only "qualifying investment securities." If it is concluded that the Onshore Fund is an "investment partnership," its U.S. investors who are not residents of California will not receive California-source income from the Onshore Fund and they therefore will not be subject to California income tax or reporting requirements on such income.

FACTS

The Onshore Fund's Operations

The Onshore Fund is a private investment vehicle. Investors in the Onshore Fund ("Investors") purchase classes of LLC interests, including a Base Class and one or more Overlay Classes.

The Onshore Fund is part of a "master-feeder" investment fund structure that is common in international investment management. In such a structure, the master fund makes the direct investments and holds the securities portfolio. A feeder fund invests all of its investable assets in the master fund. This structure allows different kinds of investors to invest through various types of feeder funds in a single, commingled asset pool held by the master fund. For example, U.S. persons typically make international investments through entities that are treated as partnerships for federal income tax purposes, such as the Onshore Fund. Non-U.S. persons and certain tax-exempt investors are more likely to invest through a feeder fund that is treated as a corporation for federal income tax purposes.

The Onshore Fund is a feeder fund. The Onshore Fund seeks to achieve its investment objective by investing all or substantially all of its assets in ******************* *************** (the "Master Fund"), an exempted limited duration company organized under the laws of the Cayman Islands. The Master Fund's registered office in the Cayman Islands is *** *********************. The Master Fund has filed an election with the Internal Revenue Service on Form 8832 to be treated as a partnership for federal income tax purposes and conducts its affairs so that it is not a publicly traded partnership.

The investment advisor for both the Onshore Fund and the Master Fund is ****** **, located at ****************** *********************. ***** is one of the largest investment management firms in the world and manages assets for investors in the United States and many other countries.

The Onshore Fund has many U.S. Investors who are not residents of California. These California-nonresident Investors include individuals and corporations. Both the Onshore Fund and the Master Fund conduct their affairs with the intention of being "investment partnerships" that hold only "qualifying investment securities" as those terms are defined in sections 17955(c)(I), 17955(c)(3)(A), 23040.1(d)(3) and 23040.1(d)(4)(A) of the California Revenue and Taxation Code. By conducting their affairs in this manner, the Onshore Fund can offer interests to California-nonresident investors without exposing them to California income tax, and thus can purportedly remain competitive with passive investment vehicles offered by other investment management firms located outside California.

<u>The Proposed Investments</u>

Overlay investment strategies offer Investors the opportunity to gain greater diversification through exposure to different asset classes. To give Investors exposure to returns on commodities, the Master Fund proposes to invest in an asset class of commodity-linked derivative securities, including swaps, structured notes, options, futures, and forwards (collectively referred to herein as "commodity-linked derivative securities"). Investors will be able to choose an overlay interest in the Onshore Fund that tracks the Master Fund's investments in commodity-linked derivative securities.

The value of a commodity-linked derivative security is generally based on the price movement of a physical commodity, a commodity index, a commodity futures contract, or another economic variable that is based on the value of commodities or the commodities markets. The commodity-linked derivative securities in which the Master Fund proposes to invest provide the Master Fund with a means to track and match the return on one or more commodities or commodity indexes without the risk of having to take physical delivery of a commodity.

(a) Swaps. Swaps are often the most economical way for the Master Fund to gain exposure to returns on commodities. Swap agreements are a form of notional principal contract. They are two-party contracts entered into primarily by institutional investors for periods ranging from a few weeks to more than one year. In a standard "swap" transaction, two parties agree to exchange the returns (or differentials in the rates of return) earned on particular predetermined investments, sometimes with an adjustment for an interest factor. The gross returns to be exchanged or "swapped" between the parties are normally calculated with respect to a notional amount, i.e., the return on or increase in value of a particular dollar amount invested at a particular interest rate or in a commodity or basket of commodities representing a particular index. For example, if the Master Fund enters into a commodity index swap, it would normally receive from the counterparty the price appreciation of a commodity index, applied to a specified notional amount over a specified period, in exchange for paying the counterparty an agreed-upon consideration (typically based on either a fixed or floating interest rate) plus any depreciation in that same commodity index.

The Master Fund's proposed commodity swaps could be linked to the performance of any one or more of the following commodity indexes or commodities:

(i) Broad-based indexes such as (i) the Dow Jones AIG Commodity Index Total Return Index; (ii) the Dow Jones AIG-Commodity Index Excess Return Index; (iii) the S&P Goldman Sachs Commodity Index; or (iv) the S&P Goldman Sachs Total Return Index;

(ii) A subindex of one of the above broad-based indexes; for example, the Dow Jones AIG Indexes have several subindexes, including those for Energy, Precious Metals, Industrial Metals, Livestock, and Grains;

(iii) Individual commodities included in any of the broad-based indexes or subindexes; or

(iv) Other combinations or baskets of commodities included in any of the broad-based indexes or subindexes.

(b) Structured Notes. A structured note, also known as a commodity index linked note, has a return that is normally based on the performance of any one or more of the same commodity indexes or commodities described above on which the return of a swap could be based. If the Master Fund purchases a structured note, upon its redemption the issuer would pay the Master Fund a redemption price based on the principal amount being redeemed multiplied by a factor representing the performance of the reference commodity index or commodity over the period from the date of issuance to the date of redemption, less fees. The redemption amount can take into account an interest rate if such a rate has been included in calculating a total return index. As the holder of the structured note, the Master Fund would generally have the right to direct the issuer at any time to redeem the note before maturity. The issuer is also required to redeem a structured note automatically if a defined triggering event occurs, such as a decline in the closing price of the reference index by a specified percentage.

(c) Options, Futures and Forwards. Other derivative securities that the Master Fund proposes to use to gain exposure to the commodities markets are options, futures and forwards. The terms of these types of derivative securities are less complex and will be in the same widely accepted form used throughout the securities markets.

RULING REQUESTED

The Onshore Fund requests a ruling that the commodity-linked derivative securities described above are "qualified investment securities" within the meaning of sections 17955(c)(3)(A) and 23040.1(d)(4)(a) of the California Revenue and Taxation Code.

HOLDING

The proposed investments in commodity-linked derivative securities are "qualified investment securities."

DISCUSSION

California Revenue and Taxation Code section 17955 provides[1]:

> (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.

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[1] Revenue and Taxation Code section 23040.1 uses the same language as Revenue and Taxation Code section 17955 to define both "qualified investment securities" and "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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> ***
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> (3) (A) "Qualifying investment securities" include all of the following:
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> (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.
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> (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.

Although commodity-linked 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, and the reference to "other similar financial securities" encompasses commodity-linked derivatives.

"Stock and bond index securities" can only be derivative securities. An index security is not a stand-alone security; its value derives from the price movement of the stocks and bonds included in the index. Stock and bond index securities could be options, futures, forwards, swaps or structured notes, but in every case an "index security" is a derivative with a return derived from the particular index used as a reference. After specifically enumerating "stock and bond index securities" as one type of qualifying investment security, clause (vii) continues with the following inclusive reference: "and other similar financial securities." Commodity index securities are similar to "stock and bond index securities." They operate in a similar manner and have a similar function and purpose of providing investors with the opportunity to participate in the movement of a financial index. The broad reference to "other similar financial securities" therefore seemingly includes commodity index securities as "qualifying investment securities."

In summary, all of the proposed investments in commodity-linked derivative securities fall within clause (vii). Derivative securities as a type of investment are specifically contemplated by the reference in clause (vii) to "stock and bond index securities." Commodity index securities, which by definition include such derivatives as swaps, structured notes, options, futures and forwards, are included by the statutory reference in clause (vii) to "other similar financial securities." Derivative securities on individual commodities are likewise included by the statutory reference in clause (vii) to "other similar financial securities." Thus, clause (vii) provides authority for the requested interpretation.

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,

Natasha Sherwood Page
Tax Counsel III