STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Legal Branch
PO Box 1720
Rancho Cordova, CA 95741-1720
(916) 845-5316 Fax (916) 845-3648

December 28, 2000

Chief Counsel Ruling
20-0531

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Dear *********,

In your letter dated **********, you questioned whether ********** distributive share of partnership income from **********. constitutes income from qualifying investment securities within the meaning of Revenue and Taxation Code section 17955 such that ********** is not subject to California withholding.

********** is a nonresident partner in **********., a California general partnership. All of ****** assets consist of notes it acquired secured by California real estate. The loans are serviced by another California entity, **********. **. ********** distributive share of ****** income consists of interest from the notes and possibly gain or loss from the disposition or worthlessness of the notes, offset by expenses paid to ******. In our telephone conversation and confirming letter dated **********, you stated that the partnership never owned the real estate which is the security for the loans and does not engage in lending activities, but acquired the notes from third parties. You also indicated that the notes are being held on a long-term basis.[1]

Revenue and Taxation Code section 18662 and the regulations thereunder require persons to withhold tax from payments to nonresidents which constitute income from California sources.

Generally, partnership income has a source where the partnership property is located and where the operations are carried on. (*Appeal of H. F. Ahmanson & Co.*, Cal. St. Bd. of Equal., April 5, 1965; *Appeal of Pick*, Cal. St. Bd. of Equal., June 25, 1985.)

However, in *Appeal of Bass*, 89-SBE-004, the Board of Equalization held that a nonresident's distributive share of income from a California partnership that maintained an office in California, employed individuals in California and owned tangible property in California was not income from California sources because the income was from

[1] In *Appeal of Bass*, *supra*, for example, securities held an average of 5.78 years were considered to be held on a long-term basis.

investments and the activities were related solely to monitoring and servicing the investments.

In addition, Revenue and Taxation Code section 17955 provides that partnership income of a nonresident which constitutes income from qualifying investment securities is not income from California sources even if the partnership has a usual place of business in this state. (Subd. (a)(2).) To qualify under this section, the partnership must be an investment partnership, meaning that at least 90% of its total assets consist of qualifying investment securities and that at least 90% of its gross income consists of interest, dividends, and gains from the sale of qualifying investment securities. (Subds. (c)(1)(A), (B).)

This section does not apply, however, to income derived from investment activity that is interrelated with any trade or business activity in this state separate and distinct from the acts of acquiring, managing and disposing of qualified investment securities. (Subd. (b).)

Income from qualifying investment securities is defined to include interest and gains from qualifying investment securities. Qualifying investment securities includes, among other items, debt securities. (Subd. (c)(3)(A)(ii).) A security is defined broadly to include evidences of obligations to pay money. (*Black's Law Dict.,* Fifth Ed., 1979, p. 1215.)

The notes held by the partnership are debt securities within the meaning of Revenue and Taxation Code section 17955 because the term "securities" is broad enough to include notes secured by real estate. Critical to our determination is that the partnership acquired the notes in question and is holding them on a long-term basis. Based upon your representations, this is not a situation where a commercial lender is making real estate loans on a regular and systematic basis nor a situation where an entity is buying and selling notes as part of an ongoing business activity. The fact that the notes are secured by California real estate is of no importance since the income is produced by the notes, not the real estate. (*Appeal of Bills*, Cal. St. Bd. of Equal., April 5, 1965.)[2] The fact that the partnership was organized in California is likewise not important to this determination.

Whether or not the servicing of the loans by ****** is attributable to **** under agency law, such activity is insufficient under either the *Appeal of Bass, supra*, or Revenue and Taxation Code section 17955 to constitute more than investment activity. The language of section 17955 dealing with place of business in this state contemplates that the partnership may conduct some degree of activity without losing investment partnership status. In addition, subdivision (b) permits a partnership to engage in activities relating to the acquisition, management and disposition of qualified investment securities

[2] If the income were produced by the real estate, the income would have a source in California because the source of such income is where the real estate is located. (Title 18 California Code of Regulations section 17951-3.)

without disturbing the character of the income as that from qualified investment activity. In the *Appeal of Bass, supra,* the partnership maintained an office and employees in California and monitored the investments as well.

Because the notes are the sole assets of the partnership, the partnership qualifies as an investment partnership within the meaning of Revenue and Taxation Code section 17955, and the income therefrom as income from qualifying investment securities.[3] The income also qualifies as investment income within the meaning of the *Appeal of Bass, supra*. Accordingly, no withholding of tax is required.

This ruling is conditioned on the premise that the investment activity of the partnership is not interrelated with any trade or business activity of ********** or an entity in which ********** owns an interest in this state.

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 Chief Counsel within the meaning of Revenue and Taxation Code section 21012(a)(1). Please attach a copy of this letter and your request to the back of the appropriate return(s) (if any) when filed or any notices or inquiries which might be issued.

Very truly yours,

Richard Gould
Senior Tax Counsel

[3] The income from the notes is properly characterized as either interest or gain or loss from the disposition or worthlessness of the notes under the partnership characterization rule of Internal Revenue Code section 702(b), to which California conforms. (Revenue and Taxation Code section 17851.)