STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Legal Division MS A260
PO Box 1720
Rancho Cordova, CA 95741-1720
tel: 213.897.5222 fax: 916.843.2420
ftb.ca.gov

11.02.18

Chief Counsel Ruling 2018 - 01

****
****
****
********** ** **********

RE: Chief Counsel Ruling Request for ****** ********* ********* ****

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

This letter is in response to your Chief Counsel Ruling request dated **** *** **** seeking guidance as to (1) whether a corporation earning more than 50 percent of its gross income from performing services under mortgage servicing contracts is a financial corporation within the meaning of California Code of Regulations, Title 18 ("Regulation"), section 23183; and (2) whether income from hedging contracts designed to mitigate the exposure of mortgage servicing contract revenue and interest rate locking commitment value to interest rate fluctuations is non-financial (or "general") income for purposes of Regulation section 23183.

FACTS

Mortgage Servicing Activity

******** ********* ********* ****[1] ("Taxpayer") is a specialty financial services company with a comprehensive mortgage platform and integrated business focused on originating, purchasing, selling, and servicing U.S. residential mortgage loans. Taxpayer acquires residential mortgage loans before promptly securitizing and selling them to Government Sponsored Entities ("GSEs") or institutional investors. During the brief period of time it owns the loans, Taxpayer recognizes and treats loan origination income, interest income and gain or loss on the sale of the loans as income attributable to dealing in money or moneyed capital in substantial competition with the business of national banks, *i.e.*, financial income. Taxpayer's business model requires it to sell nearly all of its accumulated loans to unrelated third parties. Taxpayer retains the right to service the loans it sells pursuant to a mortgage servicing rights ("MSR") contract it enters into as servicer with the third party owners of the loans at the time of sale.

---

[1] ******** ********* ******** **** **** *** ** ******* ******** ******** ********** **** **** **** ** **** ********** *** ** *** ******* ********* ** **** ****** ******** *** **** ******** ** ******** **** ********* ****. *** ********* *** ** ******* ******** ******** ********* **** *** ** ****** ** ******** ******* ********** **** ** ****** *** **** **** * ** *****.

In addition to entering into MSR agreements with the third party buyers of Taxpayer's loans, Taxpayer also purchases substantial quantities of MSRs directly from other financial institutions and servicers. The servicing fees Taxpayer earns are separately negotiated with the third party owners of the loans and are due and payable irrespective of the rate of interest charged to the borrower on the loan, or whether or not the loan is performing.

Since inception, Taxpayer's predominant business activity, based on gross income generated, has been servicing mortgage loans as opposed to originating or purchasing and selling mortgage loans. Taxpayer's loan servicing segment performs loan administration, collection, and default management activities, including the collection and remittance of loan payments; response to customer inquiries; accounting for principal and interest; holding custodial (impounded) funds for the payment of property taxes and insurance premiums; counseling delinquent mortgagors; and supervising foreclosures and property dispositions.

Interest Rate Hedging Contracts

Taxpayer is exposed to price risk relative to its mortgage loans held for sale as well as to its interest rate lock commitments ("IRLCs"). IRLCs are derivative financial instruments created when Taxpayer commits to purchase or originate a mortgage loan acquired for sale at specified interest rates. During the period beginning when Taxpayer commits to fund or to purchase a mortgage loan to the time the mortgage loan is sold, Taxpayer is exposed to losses if mortgage market interest rates increase, because the fair value of the purchase commitment or prospective mortgage loan decreases. Taxpayer also is exposed to risk relative to the fair value of its MSR contracts.

In order to reduce the loss in value of its mortgage loans held for sale, IRLCs, MSRs, and to ensure a steady revenue stream from its MSR contracts, Taxpayer pursues hedging strategies to manage its exposure to interest rate fluctuations. Taxpayer's hedging activity will vary in scope based on the risks hedged, the level of interest rates, and other changing market conditions. To manage the risk created by interest rate fluctuation, Taxpayer maintains a portfolio of derivative financial instruments such as forward purchase and sales contracts,[2] mortgage-backed securities options[3] and futures,[4] and interest rate futures and

[2] Forwards are financial contracts in which two counterparties agree to exchange a specified amount of a designated product for a specified price on a specified future date or dates. Forwards differ from futures in that their terms are not standardized and they are not traded on organized exchanges. Because they are individually negotiated between counterparties, forwards can be customized to meet the specific needs of the contracting parties.

[3] Options transfer the right but not the obligation to buy or sell an underlying asset, instrument or index on or before the option's exercise date at a specified price (the *strike price*). A call option gives the option purchaser the right but not the obligation to purchase a specific quantity of the underlying asset (from the call option seller) on or before the option's exercise date at the strike price. Conversely, a put option gives the option purchaser the right but not the obligation to sell a specific quantity of the underlying asset (to the put option seller) on or before the option's exercise date at the strike price.

[4] Futures contracts are exchange-traded agreements for delivery of a specified amount and quality of a particular product at a specified price on a specified date. Futures contracts are essentially exchange-traded

swaps.[5] These derivative financial instruments are conditional contracts that function to transfer risks between counter-parties.

ISSUES

1. Is Taxpayer a financial corporation under Regulation section 23183 when it earns more than 50 percent of its total gross income from performing services under MSR contracts?

2. Do Taxpayer's hedging contracts gains constitute financial income under Regulation section 23183 when Taxpayer executes the hedging contracts to mitigate the exposure of its MSR contracts and IRLCs to interest rate fluctuations?

HOLDING

1. Taxpayer is not a financial corporation within the meaning of Regulation section 23183 because Taxpayer derives more than 50 percent of its total gross income from servicing mortgages, not from dealings in money or moneyed capital.

2. Taxpayer's gains from hedging contracts are non-financial income because the hedging contracts are not "money or moneyed capital" as defined in Regulation section 23183(b)(3).

DISCUSSION

I. Income from servicing mortgage loans is non-financial (general) income under Regulation section 23183.

Regulation section 23183(a) defines a financial corporation as a corporation that predominantly deals in money or moneyed capital in substantial competition with the business of national banks. "Predominantly" means that more than 50 percent of a corporation's total gross income is attributable to dealings in money or moneyed capital in substantial competition with the business of national banks (the predominance test).[6] To satisfy the predominance test, more than 50 percent of the corporation's total gross income must be attributable to dealings in money or moneyed capital AND the business activities giving rise to the gross income must be in substantial competition with the business of national banks. Regulation section 23183(b) further provides the following definitions:

---

forward contracts with standardized terms. Futures exchanges establish standardized terms for futures contracts so that buyers and sellers only have to agree on price.

[5] Interest-rate swaps are over-the-counter derivative contracts in which two parties agree to exchange interest cash flows or one or more notional principal amounts at certain times in the future according to an agreed-on formula. The cash flows may be in the same currency or a different currency. The formula defines the cash flows using one or more interest rates and one or more hypothetical principal amounts called *notional principal amounts*.

[6] Regulation section 23183(b)(1).

> (2) 'Deals in' means conducting transactions in the course of a trade or business on its own account, as opposed to brokering the capital of others. A corporation which buys, sells, places or invests its own assets is dealing in moneyed capital.
>
> (3) 'Money or moneyed capital' includes, but is not limited to, coins, cash, currency, mortgages, deeds of trust, conditional sales of contracts, loans, commercial paper, installment notes, credit cards, and accounts receivable.
>
> (4) 'In substantial competition' means that a corporation and national banks both engage in seeking and securing in the same locality capital investments of the same class which are substantial in amount, even though the terms and conditions of the business transactions of the same class are not identical. It does not mean there must be competition as to all phases of the business of national banks, or competition as to all types of loans or all possible borrowers. The activities of a corporation need not be identical to those performed by a national bank in order to constitute substantial competition. It is sufficient if there is competition with some, but not all, phases of the business of national banks, or capital is invested in particular operations or investments like those of national banks.
>
> (5) 'Business of national banks' means the businesses in which national banks are permitted to operate.

The definition of "financial corporation" focuses on competition among financial businesses for investment capital. The danger sought to be averted is that such capital might abandon the national banks for other financial enterprises if the latter were made relatively more profitable by preferential treatment. (See *Marble Mortgage Co. v. Franchise Tax Bd.* (1966) 241 Cal.App.2d 26, 35; *Crown Finance Corp. v. McColgan* (1943) 23 Cal.2d 280.)

Making and selling mortgage loans constitutes dealing in moneyed capital; servicing loans does not. This distinction is made in *Marble Mortgage Co. v. Franchise Tax Board*, *supra*, at 39-40.

> It is undisputed that Marble's activities consisted in dealing in first deeds of trust on real property that were initially acquired in Marble's own name and through the use of funds supplied by Marble. . . . After Marble assigned the first deeds of trust to its various "purchasers," Marble retained a right to share in the interest payments on the loans, collected principal and interest on the loans and took all of the steps necessary to protect the security interest of the loans.
>
> Marble's argument that it made loans only to support its "servicing business" is negated by the fact that the major

> portion of its gross income (51 to 60 percent) came from its activities prior to assignment, while the "servicing fees" accounted for only 34 to 42 percent of its gross income.

Making-selling loans gives rise to income from an activity that deals in moneyed capital. Servicing loans generates income from a service activity, not from dealing in money or moneyed capital. To classify a corporation as a financial corporation, Regulation section 23183 requires that a corporation derive more than 50 percent of its gross income from dealing in money or moneyed capital.

Taxpayer is a non-financial corporation because Taxpayer derives more than 50 percent of its gross income from performing mortgage services that are not attributable to dealings in money or moneyed capital.

II. Taxpayer's gains from interest rate hedging contracts are "general" income because the hedging contracts are not "money or moneyed capital" as defined under Regulation section 23183(b)(3).

To treat the gains from Taxpayer's interest rate hedging contracts as financial income, the hedging activity must meet all of the requirements set forth under Regulation section 23183 of dealing in money or moneyed capital in substantial competition with the business of national banks. Taxpayer represents that, with respect to its interest rate hedging activities, it is in substantial competition with the business of national banks because the provisions of Section 24 (Seventh) of Title 12 of the United States Code[7] permit national banks to engage in the same interest rate hedging activities. While banks are permitted to hedge interest rate risks, Taxpayer's hedging contracts and transactions do not meet the definition of "dealing in money or moneyed capital" mandated by Regulation section 23183.

Regulation section 23183(b)(3) states "money or moneyed capital includes, but is not limited to, coin, cash, currency, mortgages, deeds of trust, conditional sales contracts, loans, commercial paper, installment notes, credit cards, and accounts receivable." According to the rulemaking file prepared at the time of Regulation section 23183's adoption, "the question of what constitutes 'money' or 'moneyed capital' has been addressed by the courts and the Board of Equalization in a variety of situations. However, no comprehensive definition has ever been provided."[8]

The listed examples of money and moneyed capital in Regulation section 23183(b)(3) are not meant to be an exhaustive list. However, they all relate to either actual legal tender (coin, cash, currency) or instruments evidencing debt obligation (mortgages, deeds of trust, conditional sales contracts, loans, commercial paper, installment notes, credit cards, and accounts receivable), since both are integral to the banking business under California case law.[9] Therefore, the drafters of Regulation section 23183 clearly intended for the property

---

[7] 12 U.S.C. § 24 (Seventh) (2015).
[8] California Code of Regulations, Title 18, Section 23183 Rulemaking File, p. RM-24.
[9] *See, e.g.*, *H.A.S. Loan Service, Inc. v McColgan* (1943) 21 Cal.2d 518 [small loans]; *Marble Mortgage*, 241 Cal.App.2d 26 [mortgages]; *Appeals of The Diners' Club, Inc.* (Sept. 1, 1967) 67-SBE-053 [credit card receivables]; *Appeal of Cal-West Business Services, Inc.* (Nov. 6, 1970) 70-SBE-036 [retail/wholesale

in question to be either actual legal tender or an instrument evidencing debt obligation in order to qualify as "money or moneyed capital."

The fundamental rule of construing a regulation is ascertaining the intent of the regulation so as to effectuate its purpose.[10] The words used in an administrative regulation are the primary source for identifying the drafter's intent.[11] Generally, the same rules of construction and interpretation which apply to statutes govern the construction and interpretation of rules and regulations of administrative agencies.[12] The phrase "including, but not limited to" is a term of enlargement and signals the legislature's intent that a statutory provision applies to items not specifically listed in the provision.[13] Although the phrase "including, but not limited to" is a phrase of enlargement, the use of this phrase in a statute does not conclusively demonstrate that the legislature intended a category to be without limit.[14] The items must be similar to those that are specifically listed in the provision. The rule of statutory construction called *ejusdem generis* ("of the same kind or class") instructs that when a statute contains a list or catalogue of items, a court should determine the meaning of each by reference to the others, giving preference to an interpretation that uniformly treats items similar in nature and scope.[15] The class of things is restricted to those things that are similar to, of the same general nature or class, as those that are enumerated specifically.[16]

Interest rate hedging contracts described in this Chief Counsel Ruling are not specifically listed in Regulation section 23183(b)(3), nor do they share the common characteristic with the listed examples of moneyed capital – instruments evidencing a debt obligation. While national banks are permitted to and often do enter into interest rate hedging transactions as part of their ordinary course of business, Taxpayer's gain or loss from these transactions does not constitute financial income for purposes of Regulation section 23183 because the hedging contracts described in this Chief Counsel Ruling do not qualify as either actual legal tender or instruments evidencing a debt obligation. Therefore, Taxpayer's interest rate hedging contracts are not money or moneyed capital as defined by Regulation section 23183(b)(3), and the gains therefrom constitute general, not financial, income.

CONCLUSION

Marble Mortgage establishes a rule of law in California that servicing of loans does not generate "financial" income for purposes of Regulation section 23183. Because Taxpayer earns more than 50 percent of its gross income from performing services under MSR

---

receivables]; *Appeal of First Investment Service* (July 31, 1973) 73-SBE-037 [trust deeds]; *Appeal of Atlas Acceptance Corporation* (July 29, 1980) 81-SBE-078 [conditional sales contracts]; *Appeal of Cashman Investment Corporation* (July 29, 1986) 86-SBE-129 [commercial paper].

[10] *Pacific Gas and Elec. Co. v. Superior Court* (2006) 144 Cal. App. 4th 19, 24.

[11] *In re Espinoza* (2011) 192 Cal. App. 4th 97, 105.

[12] *In Re Player* (2007) 146 Cal. App. 4th 813, 825.

[13] *Oil Workers International Union v. Superior Court of Contra Costa County* (1951) 103 Cal. App. 2d 512, 570; *People v. Western Air Lines, Inc.* (1954) 42 Cal. 2d 621, 639.

[14] *Dyna-Med, Inc. v. Fair Employment & Housing Com.* (1987) 43 Cal. 3d 1379, 1387-1389.

[15] *Kelly v. Methodist Hospital of So. California* (2000) 22 Cal. 4th 1108, 1121.

[16] *Clark v. Superior Court* (2010) 50 Cal. 4th 605, 614.

contracts, Taxpayer is a general, not a financial, corporation within the meaning of Regulation section 23183.

In addition, Taxpayer's gains and losses from interest rate hedging contracts are not items of financial income because they are not attributable to dealing in "money or moneyed capital" as defined in Regulation section 23183(b)(3).

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,

John Su
Tax Counsel IV