

## California FTB Ruling 2018-01: Lipstick on a Piggy Bank and Financial

by Ted Tourian



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In this article, the author discusses California's FTB Chief Counsel Ruling 2018-01, which provides that mortgage servicing revenue earned from a contract is general rather than financial income, and argues the rules of statutory construction were applied inconsistently, raising more questions than it answered.

The California Franchise Tax Board released Chief Counsel Ruling 2018-01 on November 2, 2018, which provides that mortgage servicing revenue earned from a mortgage servicing rights contract is general rather than financial income for the purpose of whether a taxpayer is a financial under California Code of Regulations, title 18, section 23138.<sup>1</sup> The ruling finds that 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 reg. section 23183(b)(3).

<sup>1</sup>Unless otherwise specified, section references are to the California Revenue and Taxation Code, and reg. section references are to the applicable California regulations promulgated thereunder.

The following argues CCR 2018-01 raises more questions than it answers by either ignoring principles of statutory construction or applying them too rigidly. The analysis provides a factual background of how third-party mortgage servicers interact with the rest of the mortgage market and the related interest rate hedging. The analysis then provides descriptions of reg. section 23183 and CCR 2018-01. The analysis argues that CCR 2018-01's strict use of the predominance test ignored whether such income was attributable to activities that would have made it financial income, rendering one of the examples in the regulation meaningless; CCR 2018-01 created a situation in which banks and financials are treated differently than savings and loan associations, contravening the legislative intent of section 25128; and CCR 2018-01's strict utilization of *ejusdem generis* in defining moneyed capital under reg. section 23183(b)(3) could have unintended consequences pertaining to classifying hybrid financial instruments like bitcoin.

### Factual Background

Third-party mortgage service providers are one facet of the mortgage industry. They serve an important role between borrowers, mortgage brokers, loan originators, and both government and nongovernmental investors. The following is an overview of how each of these players interact.

Borrowers obtain loans from mortgage brokers and generally pay off loans to the lender or servicer. Mortgage brokers act as intermediaries between borrowers and lenders — they do not originate loans. Mortgage brokers are middlemen between home

purchasers or homeowners and lenders.<sup>2</sup> Brokers take loan applications, check credit and income, and handle much of the underwriting and processing, without funding the actual loan.<sup>3</sup>

Loan originators (or lenders) are financial institutions providing borrowers loans.<sup>4</sup> Loan originators make money through fees charged to originate a mortgage, and the difference between the interest rate given to a borrower and the premium a secondary market will pay for that interest rate.<sup>5</sup> After a lender originates a loan, the lender may retain ownership of the loan in its portfolio or sell it. The payment received for the loan replenishes the lender's coffers and enables the lender to make more loans.<sup>6</sup> When lenders hold their loans in a portfolio and wait for borrowers to make payments, there is less capital available to make new loans.<sup>7</sup>

Servicers collect loan payments from borrowers and for remitting payments to the issuer for distribution to the investors. Servicers are typically compensated with fees based on the volume of loans serviced. Servicers are responsible for handling delinquent loans and foreclosures.<sup>8</sup>

Mortgage investors purchase mortgages from originators. In most cases, these investors are government entities or government-sponsored enterprises (GSEs) that purchase loans, so lenders are able to continue selling new home loans by replenishing reserves. GSEs are generally institutions like Fannie Mae and Freddie Mac. They are financial corporations created by Congress and are generally privately owned. GSEs expand the secondary mortgage market by securitizing mortgage loans in the form of mortgage-backed securities, allowing

loan originators to reinvest their assets into more lending and in effect increasing the number of lenders in the mortgage market by reducing the reliance on locally based savings and loan associations.<sup>9</sup> Private investors typically include investment banks, pension funds, life insurance companies, state housing agencies, large financial institutions, or foreign investors.<sup>10</sup>

In 2010 three banks (Wells Fargo, Bank of America, and Chase) originated 56 percent of all mortgages.<sup>11</sup> Since 2010 the number of mortgages originated by nonbanks has increased, and nonbanks now originate most mortgage loans.<sup>12</sup> Through the first half of 2019, GSEs purchased 38.6 percent of all newly issued mortgages, and private securitization companies purchased only 2.1 percent of all loans. Portfolio loans — mortgages held by banks — represent a 40.2 percent share of first-lien originations in the first half of 2019. Finally, the Federal Housing Administration and U.S. Department of Veterans Affairs loans accounted for 18.7 percent.<sup>13</sup>

Further, companies originating and selling mortgage loans are generally subject to mortgage servicing rights (MSR) and pipeline risks. MSR-related risk occurs when a borrower pays back a loan quicker, causing MSR-related revenue to fall. MSR-related risk is greatest when interest rates fall, because falling rates make it more likely borrowers will refinance loans to take advantage of cheaper financing.<sup>14</sup> Pipeline risk generally occurs with “interest rate lock commitments,” and happens when a lender commits to fund a loan at an interest rate and interest rates change by the time the loan is finalized. Borrowers typically lock in an interest rate on their home mortgage loan several weeks before closing a mortgage. A loan during this period is “in the pipeline.” When mortgage rates fall, borrowers may find that the rate they locked in is higher than the prevailing rates at the time

<sup>2</sup> National Consumer Law Center, *Mortgage Lending* (2019), Chapter 1.4.2.

<sup>3</sup> Julia Kagan, “Mortgage Originator,” *Investopedia* (Mar. 11, 2020).

<sup>4</sup> Chung-Jui Wang and Stan Uryasev, “Best Execution in Mortgage Secondary Markets,” Department of Industrial and Systems Engineering, University of Florida (Mar. 14, 2005).

<sup>5</sup> *Supra* note 3.

<sup>6</sup> The Balance, Secondary Mortgage Market Economic Impact (updated May 16, 2020).

<sup>7</sup> *Supra* note 2 at 1.4.12.

<sup>8</sup> Universal Banking Securitization of Loan User Guide, Oracle FLEXCUBE Universal Banking Release 12.4.0.0.0 (2017), Chapter 2.

<sup>9</sup> Ramon P. DeGennaro, “Government Sponsored Entities: Fannie Mae and Freddie Mac,” 14 *J. of Structured Fin.* 18-22 (2008).

<sup>10</sup> Genworth, Secondary Market Basic Review (Jan. 2018).

<sup>11</sup> Mortgage Daily press release, “3 Biggest Lenders Close over Half of U.S. Mortgages” (Feb. 15, 2011).

<sup>12</sup> Urban Institute, “Housing Finance at a Glance: A Monthly Chartbook, November 2019” (Nov. 27, 2019).

<sup>13</sup> *Id.*

<sup>14</sup> *S. Ferry LP, No. 2 v. Killinger*, 542 F.3d 776, 780 (9th Cir. 2008).

of closing. Conversely, when rates rise, borrowers may lock in rates below market by closing, leaving the lender to fund a below-market rate loan.<sup>15</sup>

To manage MSR-related and pipeline risk, lenders hedge expected MSR and mortgage-origination revenues with securities and derivative instruments. When rates rise, lenders face greater pipeline risk because market rates are more likely to exceed the locked-in rates at the time mortgage deals close. However, MSR revenues provide some protection from pipeline risk, because borrowers are less likely to refinance and prepay their mortgages when the rates that would apply to their refinancing loans are higher than the rates they pay on their existing mortgage. Accordingly, lenders receive more stable MSR-related revenues when lenders suffer increased pipeline risk. This natural hedge, in theory, allows lenders to have a steadier revenue stream despite interest rate volatility.<sup>16</sup>

### Banking and Financial Corporations

California imposes a franchise tax on general corporations under section 23151, banks under section 23181, and financials under 23183. The statutory tax rate established for banks and financial corporations is the sum of the tax rate on general corporations under section 23151 plus 2 percent.<sup>17</sup>

The distinction for taxing general corporations differently than banks and financials is that California Constitution Article XIII, section 27 provides that the tax banks and financials are subject to are “measured by their net income and shall be in lieu of all other taxes and license fees.”<sup>18</sup> Because the franchise tax on banks and financials are in lieu of other taxes,

banks and financial corporations are taxed at a higher rate under section 23186.<sup>19</sup>

### Definition of a Financial Corporation

Section 23183 does not define a financial corporation. However, reg. section 23183 defines a financial corporation as a corporation that “predominately deals in money or moneyed capital in substantial competition with the business of national banks.”

The term “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).<sup>20</sup> Prior jurisprudence has not always used the predominance test,<sup>21</sup> and cases like *Appeal of Ponticopoulos Inc.*<sup>22</sup> have looked at which portion of the business income and expenses were attributed to financial activity in determining if a taxpayer was a financial institution.

The term “deals in” is defined as “conducting transactions in the course of a trade or business on its own account as opposed to brokering the capital of others.”<sup>23</sup> This distinction is important to demonstrate whether income is generated from moneyed capital or service income.<sup>24</sup>

Money or moneyed capital includes coin, cash, currency, mortgages, deeds of trust, conditional sales contracts, loans, commercial paper, installment notes, credit cards, and accounts receivable.<sup>25</sup>

<sup>19</sup> California Franchise Tax Board, title 18, California Code of Regulations, section 23183, Office of Administrative Law Matter Number 91-0201-01 S, Exhibit A “Background Material — The Definition of a ‘Financial Corporation’ under Revenue and Taxation Code section 23183,” at 2 (1991), provides: “The reason that a higher rate is imposed upon financial corporations (and banks) 1/ is that it is, by statute, in lieu of all other taxes and licenses, state, county and municipal, 2/ upon the banks and financial corporations, except taxes” under section 23182.

<sup>20</sup> Reg. section 23183(b)(1).

<sup>21</sup> FTB, *supra* note 20, at 13-14.

<sup>22</sup> Cal. St. Bd. of Equal. (Sept. 1, 1966).

<sup>23</sup> Reg. section 23183(b)(2).

<sup>24</sup> FTB, *supra* note 20, at 15, provides: In this latter instance, the corporation cannot be classified as a financial corporation because it is not dealing in money or moneyed capital on its own account (and quite possibly is not dealing in capital on anyone’s account, but is actually dealing in services).

<sup>25</sup> Reg. section 23183(b)(3).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> Section 23186.

<sup>18</sup> FTB Legal Ruling 94-2 provides section 23183 was amended to ensure parity between banks and financial corporations: “The amendment to Revenue and Taxation Code Section 23183 contained in this Act reaffirms the Legislature’s longstanding purpose of insuring competitive parity between banks and financial corporations by subjecting both types of institutions to an equivalent tax burden.”

“In substantial competition” means that a financial corporation is competing for the same type of capital investments for which national banks compete. The definition further allows for atomization along different segments.<sup>26</sup>

“Business of national banks” means “businesses in which national banks are permitted to operate.”<sup>27</sup> The regulation file recognized that a precise definition would be elusive as the banking sector is continuously evolving.<sup>28</sup>

The regulation file provides that *Marble Mortgage Co. v. Franchise Tax Board* was pivotal in defining a financial corporation. In *Marble*, the court was asked to determine whether Marble Mortgage Company was a financial corporation for tax purposes.

Marble was engaged in the business of initiating loans secured by first trust deeds on real property with the intention of assigning them to various institutional investors, a business commonly referred to as “mortgage bankers” or “loan correspondents.” The court of appeal ruled that Marble dealt in moneyed capital when it earned its income from fees for making and servicing construction loans, its “point” charges for making federally insured loans, and all of its pre-assignment earnings, were charges for lending moneyed capital rather than rendering a mere service to its institutional purchasers.<sup>29</sup> The court further determined the term “financial corporation” needs to deal with moneyed capital because that is the type of business national banks deal with, as opposed to other commodities.<sup>30</sup>

### Description of FTB CCR 2018-01

The taxpayer is a specialty financial services company that earns income by originating,

purchasing, selling, and servicing residential mortgage loans. The taxpayer asserts its business model requires it to sell nearly all its accumulated loans to unrelated third parties. The taxpayer also purchases substantial quantities of MSRMs directly from other financial institutions and servicers. The taxpayer manages interest rate risks by maintaining a portfolio of derivative financial instruments such as forward purchase and sales contracts, mortgage-backed securities options and futures, and interest rate futures and swaps.

The FTB held that the taxpayer was not a financial corporation because more than 50 percent of its total gross income was derived from servicing mortgage loans. The FTB reasoned that although originating and selling mortgages would qualify as dealings in money or moneyed capital, it adhered strictly to the 50 percent predominance test under reg. section 23183(b)(2). The FTB did not discuss whether it attributed any income from MSRMs the taxpayer earned from loans it originated or held at one point as income “attributable to dealings in money or moneyed capital.”

The FTB also ruled income from interest rate hedging contracts do not qualify as financial income because hedging contracts are not money or moneyed capital, because these types of contracts do not “qualify as either actual legal tender or instruments evidencing a debt obligation.”

### Do or Do Not, There Is No Attribution

A statute’s meaning requires a contextual analysis, and that the provisions relating to the same subject matter must be harmonized to the extent possible.<sup>31</sup> Further, every word and clause of a statute must be given effect so that no part or provision will be useless or meaningless, and none of its language rendered surplusage.<sup>32</sup>

CCR 2018-01 departs from both the regulations and the FTB’s prior guidance pertaining to what constitutes a financial corporation. CCR 2018-01 strictly relies on the 50

<sup>26</sup> Reg. section 23183(b)(4).

<sup>27</sup> Reg. section 23183(b)(5).

<sup>28</sup> FTB, *supra* note 20, at 19, provides: “This concept is an elusive one to define with any degree of precision because of the ever-changing scope of activities which national banks are permitted to engage in by statute, federal regulatory authorities and the courts. For instance, 12 U.S.C. S 24 sets forth the powers of national banks as permitted by federal statutory law”.

<sup>29</sup> *Marble Mortg. Co. v. Franchise Tax Bd.*, 241 Cal. App. 2d 26, 41, (Ct. App. 1966).

<sup>30</sup> *Id.* at 34-35.

<sup>31</sup> *Lungren v. Deukmejian*, 45 Cal. 3d 727, 735 (1988).

<sup>32</sup> *Briggs v. Eden Council for Hope & Opportunity*, 19 Cal. 4th 1106, 1118 (1999).

percent portion of the predominance test under reg. section 23183(b)(1). Its reasoning relies on *Marble* for the proposition that “servicing loans generates income from a service activity, not from dealing in money or moneyed capital.” CCR 2018-01 neglects the term “attribution” in its analysis of how servicing fees were generated by the taxpayer initially originating such loans<sup>33</sup> for purposes of analyzing the definition of predominantly under reg. section 23183(b)(1), thus creating incongruous results with the rest of the regulation.

Reg. section 23183(b)(4), Example 3,<sup>34</sup> provides a similar example to CCR 2018-01, while illustrating what the phrase “in substantial competition” means. The example provides that a taxpayer, Corporation F, was a financial corporation that lent money in real estate transactions like national banks. Corporation F then sold *all* the loans it generated to institutional investors, while retaining the rights to service those loans. What is unknown about this example is the ratio Corporation F earned between originating and servicing loans.

Based on CCR 2018-01’s logic, one must read into reg. section 23183(b)(4), Example 3, that the majority of the income Corporation F earned was from originating loans, and that there should not be any attribution accorded between originating and servicing for Corporation F to be considered a financial corporation.

Further, FTB Chief Counsel Ruling No. 2000-0236, October 11, 2000, provides an almost identical situation to CCR 2018-01. CCR 2000-0236 describes a situation in which a financial corporation sought to separate the loan

origination, acquisition, and sale business from the loan servicing business. The loan servicing business would be placed in a limited partnership.

The FTB held that the LP would not be considered a financial corporation under section 23183, when — in its analysis — the FTB focused on the following relevant facts: “The limited partnership will not originate, invest in, hold, or acquire mortgage loans,” in addition to the LP not meeting the 50 percent income threshold. However, CCR 2018-01 only focused on the 50 percent income threshold, ignoring that the 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.*” (Emphasis added.)

Both CCRs 2000-0236 and 2018-01 relied on *Marble*’s 50 percent threshold.<sup>35</sup> However, when CCR 2000-0236 tried to address all the facts pertinent to properly address what income is attributable to financial income, CCR 2018-01 did not, leaving a question mark about the future applicability of reg. section 23183(b)(4), Example 3.

### A Butterfly Effect: From Attribution to Apportionment

The fundamental rule of statutory construction is that statutes should be read with legislative intent in mind to effectuate the purpose of the law. Statutes should be construed with reference to the whole system of law to create harmony between different code sections.<sup>36</sup> The lack of attribution in determining

<sup>33</sup> CCR 2018-01 provides: “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.”

<sup>34</sup> Reg. section 23183(b)(4), Example 3, provides:  
EXAMPLE: Corporation F makes loans which are secured by first mortgages or first deeds of trust on real estate. The loans made by F are government insured FHA or VA loans, or conventional or uninsured loans. A substantial number of such loans are similar to real estate loans made by national banks. All loans made are intended for subsequent sale to institutional investors, usually within six months from the time they are originally made. After the loans are sold, F services them by collecting installments and providing other services, such as making certain that the underlying properties are kept insured and that taxes upon them are paid. F services only those loans made by it. F is a financial corporation.

<sup>35</sup> Both CCRs 2000-0236 and 2018-01 cite *Marble*, which provides: 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 majority of its gross income (51 to 60 percent) coming from its activities before assignment, while the servicing fees accounted for only 34 to 42 percent of its gross income. *Marble*, 241 Cal. App. 2d at 39-40.

<sup>36</sup> *Citrus Belt Savings & Loan Association v. California Franchise Tax Bd.*, 218 Cal. App. 2d 584, 588 (Ct. App. 1963).

what financial income is under CCR 2018-01 pertaining to servicing fees from loans that a taxpayer originated cascades to the apportionment rules under section 25128, and countermands section 25128(b)'s legislative intent of treating banking and financial businesses equal to S&Ls for apportionment purposes.<sup>37</sup>

Section 25128.7 provides that taxpayers must apportion business income using only the sales factor, unless a taxpayer falls under section 25128(b). Section 25128(b) requires taxpayers deriving more than 50 percent of their gross business receipts from one or more qualified business activities apportion business income by an equally weighted, three-factor formula, comprising of the property, payroll, and sales factors. Section 25128(c) provides that qualified business activities mean agricultural business, extractive business, savings and loan, or a banking or financial business.

Savings and loan activity means any activities performed by S&Ls or savings banks that have been chartered by federal or state law.<sup>38</sup> Banking or financial business activity means activities attributable to dealings in money or moneyed capital in substantial competition with the business of national banks.<sup>39</sup> It is reasonable to assume that "banking or financial business activity" has the same meaning under section 23183 when "banking or financial business activity" was not defined under section 25128.<sup>40</sup>

All members of a unitary group that have more than 50 percent of its receipts attributable to qualified activities must use the equally weighted three-factor formula. Conversely, all members of a unitary group are required to use only the sales factor if the entire group has less

<sup>37</sup> *California Federal Savings & Loan Association v. City of Los Angeles*, 54 Cal. 3d 1, 18-19 (1991).

<sup>38</sup> Section 25128(d)(4).

<sup>39</sup> Section 25128(d)(5).

<sup>40</sup> Eric J. Coffill, "California FTB Considers Revisions to Combination Regulations for Mixed Financial and Non-Financial Reporting Groups," *J. Multistate Tax'n* 16, at \*10 (July 25, 2015) ("When FTB wrote its regulations for section 25128, it provided detailed rules with respect to the meaning of 'extractive business activity' and 'agricultural business activity,' but provided no rules with respect to the meaning of 'banking or financial business activity.' However, the similarities between that language and the language in FTB's section 23183 regulation defining a 'financial corporation' reasonably suggest that regulatory definition should suffice for purposes of section 25128.").

than 50 percent of its receipts attributable to qualified activities.<sup>41</sup>

CCR 2018-01 creates a disconnect on how to treat servicing income as a qualified activity for purposes of determining banking and financial activity receipts and savings and loan activity receipts, which could have two almost identical businesses using completely different apportionment formulas.

Consider the following example (as illustrated in Table 1) with two sets of unitary groups: a) Group A, consisting of ABC Corp. and XYZ Mortgage Corp.; and b) Group B consisting of DEF Corp. and S&L Savings and Loans Association, with identical receipts. However, the difference between Group A and Group B is that Group A has XYZ Mortgage Corp., which is similar to the taxpayer in CCR 2018-01, and Group B has S&L Savings and Loans Association. Assuming CCR 2018-01's ruling holds regarding Group A, receipts from servicing loans would be general-activity receipts. Regarding Group B, receipts from servicing loans would be S&L activity.

This example demonstrates how the same activity can create different apportionment rules for mortgage companies and savings and loans associations. S&Ls are like commercial banks. However, S&Ls have unique legal restrictions as to how their assets can be used: They may only lend up to 20 percent of their assets in commercial loans and must lend at least 65 percent of their assets as mortgages.<sup>42</sup> For most of the last century, S&Ls dominated home mortgage lending, originating loans on homes in their own communities, and holding the loans in their own portfolios until repayment.<sup>43</sup> However, even S&Ls sell mortgages they originate on the secondary market, while maintaining the right to service loans they originate.<sup>44</sup>

<sup>41</sup> Reg. section 25128(c).

<sup>42</sup> Bankrate, Glossary, Savings and Loan Association.

<sup>43</sup> Michael H. Schill, "Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets," 64 *So. Cal. L. Rev.* 1261, 1263-1265 (1991).

<sup>44</sup> Dick Broom, "Savings and Loan Now Selling Some Mortgages," *MD Islander* (Feb. 2, 2019).

Table 1.							
Entity	Gross Receipts	Financial Activity	General Activity	Entity	Gross Receipts	Savings and Loan Activity	General Activity
ABC Corp. (General)	Gross Receipts Sales		\$1,000	DEF Corp. (General)	Gross Receipts Sales		\$1,000
	Gross Receipts (sale of equipment)		\$1,000		Gross Receipts (sale of equipment)		\$1,000
XYZ Mortgage Co.	Interest Income (lending activity)	\$1,000		S&L Savings and Loans Association	Interest Income (lending activity)	\$1,000	
	Escrow Fee Income		\$50		Escrow Fee Income		\$50
	Gross Receipt (sale of loans)	\$1,000			Gross Receipt (sale of loans)	\$1,000	
	Gross Receipt (sale of equipment)		\$1,000		Gross Receipt (sale of equipment)		\$1,000
	Gross Receipt (servicing loans)		\$2,000		Gross Receipt (servicing loans)	\$2,000	
<b>Total Gross Business Receipt percentage</b>		<b>28%</b>	<b>72%</b>	<b>Total Gross Business Receipt percentage</b>		<b>57%</b>	<b>43%</b>

The rhetorical question that needs to be asked is why should similar taxpayers be treated differently?<sup>45</sup> They shouldn't. Section 25128's legislative history reasoned there was no real distinction between S&Ls and banking and financial companies to warrant different apportionment schemes between two segments in the same industry.<sup>46</sup>

### Right Results, Wrong Reasons, and Reasonable Renditions

CCR 2018-01 used the principle of *ejusdem generis* and determined that gains from interest rate hedging contracts are general income, not financial income. CCR 2018-01 provided that interest rate hedging contracts are not moneyed capital under reg. section 23183(b)(3), even when the underlying assets making up the hedging contracts are moneyed capital. By relying on the a strict construction of what constitutes moneyed capital rather than the nature of the activity, CCR 2018-01 might provide insight on whether bitcoin is moneyed capital, and the potential unintended consequences if bitcoin is not moneyed capital throughout the rest of the code.

*Ejusdem generis* provides that when general words follow an enumeration of persons or things, by words of a particular and specific meaning, such general words are not to be construed in their widest extent, but are to be held as applying only to persons or things of the same general kind or class as those specifically mentioned. Reg. section 23183(b)(3) provides that

<sup>45</sup> Assembly Committee on Revenue and Taxation, Committee Analysis of S.B. 1880, 1993-1994 Regular Session, at 3-4 (Jun. 20, 1994) (Subject: Requires certain financial corporations to apportion income based on an equally weighted three factor formula). This analysis states:

This bill requires savings and loans to apportion their income based on an equally-weighted three factor formula. However, banks would continue to use a double-weighted sales factor calculation. Again, while it can be argued that sourcing income for financial corporations tends to be different than other industries, should distinctions in the standard apportionment formula be made within the same basic industry? What is sufficiently different about savings and loan and bank operations which would justify making a distinction between these industry segments for apportionment purposes?

<sup>46</sup> *Id.*

money or moneyed capital includes coin, cash, currency, mortgages, deeds of trust, conditional sales contracts, loans, commercial paper, installment notes, credit cards, and accounts receivable. Although the regulatory file provides that there is no clear definition pertaining to moneyed capital,<sup>47</sup> the list is meant to evince a form of debt instrument.<sup>48</sup>

CCR 2018-01 limited the meaning of moneyed capital by focusing on the strict contours of the listed examples under reg. section 23183(b)(3). The taxpayer in CCR 2018-01 maintained a portfolio of derivative financial instruments. Derivatives are contracts whose value is based on an agreed-upon underlying financial asset (like a security) or set of assets (like an index). Common underlying instruments include bonds, commodities, currencies, interest rates, market indexes, and stocks.<sup>49</sup> In essence, trading derivative financial instruments is one layer removed from trading underlying instruments that are moneyed capital for purposes of reg. section 23183(b)(3), such as treasury bills.<sup>50</sup>

Further, the gain from these derivative assets is financial income for national banks.<sup>51</sup>

Whether income from derivative instruments would be income from dealing in money or moneyed capital in substantial competition with the business of national banks by analyzing the full scope of reg. section 23183 and its economic realities, rather than a narrow focus of defining moneyed capital, is beyond the scope of this article.

What is interesting is how FTB could treat bitcoin and other cryptocurrencies under reg. section 23183(b)(3) when bitcoin has shared, but not identical, characteristics of financial instruments that are moneyed capital under reg. section 23183(b)(3).

Bitcoin is a decentralized form of digital cash, powered through a combination of peer-to-peer technology and software-driven cryptography, creating a currency backed by code rather than items of physical value, like gold or silver, or fiat currency like the U.S. dollar or Japanese yen.<sup>52</sup> Bitcoin transactions are tracked using blockchain technology, which is basically an electronic ledger. Bitcoin's value is determined by open-market bidding on bitcoin exchanges, like other exchanges.<sup>53</sup> A total of 18.5 million of the available 21 million bitcoins have been mined.<sup>54</sup> The fixed supply of bitcoin means banks are kept in check and not allowed to issue more.<sup>55</sup>

The 21 million bitcoin cap and blockchain technology provide an impediment to any country's fiscal sovereignty, especially pertaining to fractional reserve banking and money supply. Fiscal policy tools, such as

<sup>47</sup> FTB, *supra* note 20, at 16-17, provides:

Another requirement for a financial corporation under the proposed regulation is that it must deal in "money or moneyed capital." 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. The terms include, among other items, coin, cash and currency; loans, mortgages and deeds of trust (e.g., *H.A.S. Loan Service Inc. v. McColgan*, *supra*, 21 Cal. 2d 518; *Marble Mortgage Co. v. Franchise Tax Board*, *supra*, 241 Cal. App. 2d 26; *Appeal of First Investment Service Co.*, *supra*); conditional sales contracts and commercial paper (e.g., *Appeal of Atlas Acceptance*, *supra*; *Appeal of Cashman Investment Corporation*, *supra*); credit cards (e.g., *Appeals of The Diners' Club Inc.*, *supra*); and accounts receivable (e.g., *Appeal of Cal-West Business Services Inc.*, Cal. St. Bd. of Equal., Nov. 6, 1970, CCH Cal. Tax Reports P 204-429). Subsection (b)(3) of the proposed regulation provides that "money or moneyed capital" includes, but is not limited to, these specific items.

<sup>48</sup> FTB Bank and Financial Handbook Section 0110, "Financial Corporations (R&TC Section 23183)."

<sup>49</sup> James Chen, "Derivative," *Investopedia* (Jun 25, 2019).

<sup>50</sup> FTB Bank and Financial Handbook, section 0120.8, "Broker-Dealers" provides:

Under 12 CFR Section 1.3, the OCC permits national banks to underwrite, deal in, purchase and sell certain types of investment securities. The OCC's definition of "investment securities" refers to debt securities not equity securities. These debt securities include, but are not limited to: These debt securities are considered "moneyed capital" as defined in CCR Section 23183(b)(3).

<sup>51</sup> CCR 2018-01 provides: "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 Reg. 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."

<sup>52</sup> Kevin Voigt, "What Is Bitcoin, and How Does It Work?" NerdWallet (June 18, 2019).

<sup>53</sup> Nathaniel Peppercott, "What Is Bitcoin, and How Does It Work?" *New York Times*, Oct. 1, 2017.

<sup>54</sup> Adam Hayes, "What Happens to Bitcoin After All 21 Million Are Mined?" *Investopedia* (May 10, 2020).

<sup>55</sup> *Id.*

money supply, rely on debt lending to create more money through the money multiplier.<sup>56</sup> The money multiplier is a mathematical representation of money created based on the amount of reserves banks are required to hold.<sup>57</sup> For example, a bank with a 10 percent reserve requirement will increase money supply by an additional \$90,000 in the economy when it receives a \$10,000 deposit.<sup>58</sup>

The 21 million bitcoin cap limits the amount of bitcoin that can be circulated, whether through a fractional reserve banking system or otherwise.<sup>59</sup> Further, blockchain greatly reduces the need for traditional banks, as bitcoin is based on code, eliminating the need for banks to carry deposits.<sup>60</sup>

Based on these fiscal policy concerns, the federal government, through the IRS, took the position that virtual currencies are property rather than valid U.S. or foreign currency.<sup>61</sup> The IRS provides individuals who transact, pay, or trade cryptocurrency are responsible for reporting capital gains made during transactions or trades with cryptocurrencies. Likewise, payments for services with virtual currencies are liable to the same U.S. tax law as payments made with property. However, despite these policy concerns, the IRS still took the position that bitcoin and other virtual currencies can act as substitutes for real currency because they can be digitally traded between users and can be purchased for, or

exchanged into, U.S. dollars, euros, and other real or virtual currencies.<sup>62</sup>

As such, would gains realized from bitcoin be recognized in the same manner as foreign currencies, as required under reg. section 25106.5-10(b)(3)(A)2, even if bitcoin were not treated as moneyed capital? Further, states like Wyoming treat bitcoin as currency.<sup>63</sup> Ohio was at one point accepting tax payments in bitcoin, pending review by Ohio's attorney general on whether the processing service met Ohio's competitive selection process requirements.<sup>64</sup> If bitcoin is treated as a commodity rather than legal tender under reg. section 23183(b)(3), would hedging bitcoin be precluded as a treasury function under reg. section 25137(c)(1)(D)1?<sup>65</sup>

In the end, a legislative response will mostly likely solve the above questions if CCR 2018-01 is any indication of how strictly the FTB will adhere to *ejusdem generis*, given that the FTB relied on what was explicitly written rather than economic realities.

In the recent case of *Robert Half*, the OTA determined that the term "sales" for purposes of the sales factor includes foreign excise taxes assessed on services, such as a value added tax, as part of the full amount received on sales of services by the taxpayers. The issue of whether bitcoin should be included in the sales factor was briefly discussed when bitcoin was not specifically listed under reg. section 25134(a)(1)(C). FTB multistate staff stated that they would like to hear from the Office of Tax

<sup>56</sup> FTB Bank and Financial Handbook, Section 0101, "Historical Background."

<sup>57</sup> Study.com, Money Multiplier: Definition & Formula, Chapter 11, Lesson 11 (July 16, 2015)

<sup>58</sup> FTB Bank and Financial Handbook, Section 0101, "Historical Background," provides:

The money multiplier works in the following way, assuming that a bank must keep 10 percent reserves. The initial depositor still has \$10,000 with the bank and can come at any time and get their money. At the same time, the bank lends \$9,000 to other borrowers. The other borrowers spend that money on houses, cars, factories, and machinery, etc. The sellers who receive that money in exchange for their goods or services will deposit their revenue in banks. The other banks turn around and lend another 90 percent of that \$9,000, in a constant iteration, totaling an additional \$90,000 (\$9,000/0.1).

<sup>59</sup> Larry D. Wall, "Fractional Reserve Cryptocurrency Banks," *Notes from the Vault*, Federal Reserve Bank of Atlanta (Apr. 2019).

<sup>60</sup> Wall, "Blockchain Challenges and Governance," *Notes from the Vault*, Federal Reserve Bank of Atlanta (July 2018).

<sup>61</sup> IRS Notice 2014-21, 2014-16 IRB 938 (Mar. 25, 2014).

<sup>62</sup> *Id.*

<sup>63</sup> Miranda Karanfili, "Wyoming Passes Bill to Recognize Cryptocurrencies as Money," *CoinTelegraph* (Feb. 1, 2019).

<sup>64</sup> Matthew Beedham, "Ohio Businesses Can No Longer Use Bitcoin to Pay Taxes – But Will They Care?" *TheNextWeb* (Oct. 3, 2019).

<sup>65</sup> Reg. section 25137(c)(1)(D)1 provides in part: "A treasury function includes the use of futures contracts and options contracts to hedge foreign currency fluctuations. A treasury function does not include a taxpayer's trading function that engages in futures and option transactions for the purpose of hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer."

Appeals — or presumably anyone — as to whether bitcoin should be included as a receipt for purposes of the sales factor.<sup>66</sup>

### Conclusion

Although chief counsel rulings are applicable only to the underlying taxpayers, they are a valuable vehicle of compliance and outlining departmental views. CCR 2018-01 serves as a warning for drafting rulings that do not consider potential cascading ramifications, such as countermanding legislative intent, or interpreting regulations — in a dogmatic manner — that are unable to address current economic realities. ■

<sup>66</sup>The oral arguments in *In the Matter of the Franchise and Income Tax Appeals Hearing of Robert Half International Inc. and Subsidiaries*, 18011756 (June 25, 2019) (Tr. at 47:6-25.), included the following exchange:

ALJ Angeja: Okay. The other question, they mentioned the cryptocurrency. I thought that was interesting that nobody addressed it after that. I don't know if it was just illustrative but 25134(a)(1)(C) doesn't mention cryptocurrency, bitcoin, so if that were the gross receipts from a sale of service, would that not be included either?

Mr. Swieso: I can't respond to that because I don't — you're talking like bitcoin, is bitcoin a service or a product?

Angeja: It's consideration for the payment of service that's not listed in 25134(a)(1)(C).

Ms. Williams: No. We have not — we're addressing that issue. We are investigating that issue, so it's a little before our time.

Angeja: All right.

Swieso: If you know the answer, I'd love to hear it. I mean, it's a very — it's a burgeoning issue.

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