

## CA CCR Ruling: Mortgage Servicing Contracts and Interest Rate Hedging Contracts Do Not Generate “Financial” Income

### Overview

The California Franchise Tax Board (FTB) recently published Chief Counsel Ruling 2018-01 (Ruling) to provide guidance on whether income derived from mortgage servicing contracts and interest rate hedging contracts constitute income from dealings in “money or moneyed capital” within the meaning of California Code of Regulations, Title 18, (CCR) Section 23183.<sup>1</sup> The FTB held that the Taxpayer at issue is not a financial corporation within the meaning of CCR Section 23183 because the Taxpayer derives more than 50 percent of its total gross income from servicing mortgages, which “generates income from a service activity, not from dealing in money or moneyed capital.”<sup>2</sup> The FTB further held that the Taxpayer’s interest rate hedging contracts do not meet the definition of “money or moneyed capital” and, therefore, the gains derived therefrom constitute general, not financial, income.<sup>3</sup>

This tax alert summarizes Ruling 2018-01 and provides some taxpayer considerations.

### Background

The taxpayer in the Ruling is a specialty financial services company that focuses on originating, purchasing, selling, and servicing U.S. residential mortgage loans.<sup>4</sup> The Taxpayer’s predominant business activity, based on gross income generated, has been servicing mortgage loans, rather than originating or purchasing and selling mortgage loans.<sup>5</sup> The Taxpayer also enters into hedging contracts to mitigate the risk created by interest rate fluctuations relating to its mortgage loans held for sale, the value of its mortgage servicing contract revenue, and interest rate lock commitments (which are derivative financial instruments created when the Taxpayer commits to purchase or originate mortgage loans at specified interest rates).<sup>6</sup>

CCR Section 23183(a) defines a financial corporation as a corporation that derives more than 50 percent of its total gross income from dealings in “money or moneyed capital in substantial competition with the business of national banks.”<sup>7</sup> The FTB noted that the listed examples of “money or moneyed capital” in CCR Section 23183(b)(3) fall under two categories: actual legal tender (cash, coin, and currency) and instruments evidencing debt obligations (mortgages, deeds of trust, conditional sales contracts, loans, commercial paper, installment notes, credit cards, and accounts receivable).<sup>8</sup>

### Income from Servicing Mortgage Loans is Non-Financial (General) Income Under CCR Section 23183

In the Ruling, the FTB held that the Taxpayer is not a financial corporation within the meaning of CCR Section 23183 because the Taxpayer derives more than 50 percent of its total gross income from servicing mortgage loans, which do not constitute dealings in “money or moneyed capital.”<sup>9</sup> Citing *Marble Mortgage Co. v. Franchise Tax Board*, the

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<sup>1</sup> FTB Chief Counsel Ruling 2018-01 (Nov. 2, 2018, available [here](#)).

<sup>2</sup> FTB Chief Counsel Ruling, p. 5.

<sup>3</sup> *Id.*

<sup>4</sup> FTB Chief Counsel Ruling, p. 1.

<sup>5</sup> FTB Chief Counsel Ruling, p. 1-2.

<sup>6</sup> FTB Chief Counsel Ruling, p. 2-3.

<sup>7</sup> Cal. Code Regs. tit. 18, §§ 23183(a), (b).

<sup>8</sup> FTB Chief Counsel Ruling, p. 5.

<sup>9</sup> *Id.*

FTB stated that, while originating and selling mortgages constitutes dealings in moneyed capital, the servicing of such loans does not.<sup>10</sup>

### **Gains from Interest Rate Hedging Contracts Constitute Non-Financial (General) Income**

The FTB held that the Taxpayer's interest rate hedging contracts are not "money or moneyed capital" under CCR Section 23183(b)(3) and thus, the gains derived from those contracts constitute general, not financial, income.<sup>11</sup> The FTB explained that the listed examples in CCR Section 23183(b)(3) of "money or moneyed capital" are not meant to be an exhaustive list but all relate to either actual legal tender or instruments evidencing debt obligations.<sup>12</sup> The FTB determined that the Taxpayer's interest rate hedging contracts were not specifically listed in CCR Section 23183(b)(3) and do not share common characteristics with the listed examples of moneyed capital. Therefore, although national banks are permitted to and often do enter into interest rate hedging transactions as part of their ordinary course of business, the Taxpayer's hedging contracts as described in the Ruling do not qualify as actual legal tender or instruments evidencing a debt obligation and thus, the gains derived therefrom constitute general and not financial income.<sup>13</sup>

### **Considerations**

Chief Counsel Rulings are taxpayer-specific rulings that may not be relied upon by other taxpayers. However, they may serve as guidance on how the FTB may evaluate a particular issue or apply an authority. Taxpayers engaged in financial services that may involve servicing mortgage loans or interest rate hedging contracts should consult their tax practitioners to consider whether the FTB's analysis in this Ruling may impact their characterization as a "financial" or "non-financial" corporation under CCR Section 23183 and whether income generated from their activities constitute "financial" or "non-financial" income under the regulation.

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<sup>10</sup> FTB Chief Counsel Ruling, p. 4-5 (citing *Marble Mortgage Co. v. Franchise Tax Board* (1966) 241 Cal.App.2d 26, 39-40).

<sup>11</sup> FTB Chief Counsel Ruling, p. 6.

<sup>12</sup> FTB Chief Counsel Ruling, p. 5-6.

<sup>13</sup> FTB Chief Counsel Ruling, p. 6.

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