

Mai Tran
Tax Counsel III
Board of Equalization, Appeals Division
450 N Street, MIC: 85
P.O. Box 942879
Sacramento, CA 95814
Tel: (916) 324-8244
Fax: (916) 324-2618

Attorney for the Appeals Division

BOARD OF EQUALIZATION
STATE OF CALIFORNIA

In the Matter of the Appeal of:

HEARING SUMMARY
PERSONAL INCOME TAX APPEAL
Case No. 785086

JOHN NAFEH AND
URSULA G. BURGER NAFEH¹

	<u>Year</u>	<u>Proposed</u>
	2007	<u>Assessment</u>
		\$58,481

Representing the Parties:

For Appellants: David B. Porter, Esq.
For Franchise Tax Board: Judy F. Hirano, Tax Counsel III

QUESTION: Whether appellants have shown that their corporation was a “qualified trade or business” under Revenue and Taxation Code (R&TC) section 18152.5, subdivision (e)(3).

HEARING SUMMARY

Background

Appellants acquired stock in HedgeStreet, Inc. (HedgeStreet) at its original issuance in

¹ Appellants list an address in San Mateo County, California.

1 2001. HedgeStreet was an internet-based market exchange where customers could speculate on, or
2 hedge against, price movements in various commodities. In 2007, appellants sold their HedgeStreet
3 stock and excluded gain in the amount of \$678,969 on their California income tax return, on the basis
4 of the qualified small business stock (QSBS) provisions of Internal Revenue Code (IRC) section 1202,
5 as adopted and modified by R&TC section 18152.5.² (Appeal Letter (AL), p. 2.)

6 During audit, the Franchise Tax Board (FTB or respondent) determined that appellants
7 could not exclude the gain of \$678,969 because HedgeStreet was not a qualified trade or business under
8 the provisions of R&TC section 18152.5, subdivision (e)(3). Based on the foregoing, the FTB issued a
9 Notice of Proposed Assessment (NPA) dated April 26, 2011. The NPA proposed additional tax of
10 \$58,481.00, plus accrued interest. Following protest proceedings, the FTB affirmed the NPA in a
11 Notice of Action (NOA) dated October 29, 2013. Appellants then filed this timely appeal. (FTB
12 opening brief (FTB OB), Ex.'s G and J.)

13 Key Statutory Provision

14 R&TC section 18152.5, subdivision (e)(3), provides as follows:

15 . . . the term "qualified trade or business" means any trade or business other than any of
16 the following:

17 (A) Any trade or business involving the performance of services in the fields of health,
18 law, engineering, architecture, accounting, actuarial science, performing arts, consulting,
19 athletics, financial services, brokerage services, or any trade or business where the
20 principal asset of the trade or business is the reputation or skill of one or more of its
21 employees.

(B) Any banking, insurance, financing, leasing, investing, or
similar business.

...

22 The parties discuss R&TC section 18152.5, subdivision (e)(3), and its federal counterpart, IRC section
23 1202(e)(3), interchangeably.

24 Contentions

25 Appellants' Appeal Letter

26 Appellants focus on the language in IRC section 1202(e)(3)(A) which excludes any
27

28 ² Appellants later filed an amended California tax return that is not relevant to the issues on appeal.

1 business where “the principal asset . . . is the reputation or skill of one or more of its employees.”

2 Appellants contend that HedgeStreet was an exchange, like NASDAQ or the New York
3 Stock Exchange, and was also a clearing house that guaranteed the performance of futures contracts
4 traded on the exchange. Appellants assert that the “reputation or skill” of its employees was not
5 relevant to its business. Appellants therefore contend that HedgeStreet is not excluded from being a
6 qualified trade or business under IRC section 1202(e)(3)(A) because its principal asset was not the
7 reputation or skill of its employees. Instead, appellants assert that HedgeStreet’s principal assets were
8 its systems used to match buyers and sellers, and its regulatory licenses. (AL, pp. 3-5.)

9 With regard to IRC section 1202(e)(3)(B), which excludes “[a]ny banking, insurance,
10 financing, leasing, investing, or similar business” from the definition of a qualified trade or business,
11 appellants contend that HedgeStreet was not a “banking, insurance, financing, leasing, investing, or
12 similar business,” as, unlike HedgeStreet, those entities generate profits by putting capital at risk.
13 Appellants contend that HedgeStreet’s profitability depended on market participants buying and selling
14 the products it offered — which were future contracts listed on HedgeStreet’s exchange — for which
15 HedgeStreet received an exchange fee for each transaction. Therefore, appellants assert, HedgeStreet’s
16 profitability was driven solely by the volume of contracts traded multiplied by the pre-contract
17 transaction fees, less HedgeStreet’s cost of maintaining its technology, and it was more like an internet
18 company selling a product (which appellants compare to eBay), than it was like a bank, a financing
19 company, an investing company, etc. Appellants note that HedgeStreet guaranteed the performance of
20 the futures contracts traded on its exchange by (i) collecting the maximum possible loss value from the
21 seller of the futures contract, (ii) holding that value until the expiration of the contract, and (iii) then
22 paying the purchaser of the contract if the purchaser’s contract was ultimately in a gain position. (AL,
23 pp. 5-6.)

24 Appellants note that the FTB’s position letter dated August 8, 2013, makes reference to
25 HedgeStreet’s current operations, which are being conducted by an entity named NADEX. Appellants
26 assert that the FTB’s position letter incorrectly focuses on the current operations of NADEX, which
27 appellants assert are different from the prior operations of HedgeStreet. In this respect, appellants
28 assert that (i) HedgeStreet was sold to IG Group in December of 2007 and it subsequently changed its

1 name to NADEX, and (ii) after the sale, HedgeStreet became a different business, with a different
2 business strategy and different shareholders and employees. Accordingly, appellants contend that the
3 FTB's focus on the current operations of NADEX is improper. Furthermore, appellants contend that
4 the FTB's position letter relies upon information about NADEX/HedgeStreet taken from Wikipedia,
5 and appellants assert that Wikipedia is a questionable source of information. (AL, p. 6.)

6 Appellants assert that HedgeStreet's receipt of exchange fees does not prohibit
7 HedgeStreet from being a qualified trade or business, as there is no reference in IRC section
8 1202(e)(3)(A) or (B) to the receipt of exchange fees. In support of their arguments, appellants provide
9 a copy of a document titled Commodity Futures Trading Commission Release No. 4894-04 (dated
10 February 20, 2004), which states, in part, that "HedgeStreet intends to provide its members with fully
11 electronic, non-intermediated trading over the internet in cash-settled, European-style binary options on
12 various proprietary and non-proprietary indices." (Emphasis in original.) Appellants also provide a
13 copy of the March/April 2004 issue of Futures Industry Magazine, which describes HedgeStreet's
14 business, in part, as follows: "According to documents filed with the CFTC, trading will not be
15 intermediated. Instead, customers who register as members of the exchange will interact directly with
16 the trading facility." (AL, p. 6, Ex. B.)

17 In addition, appellants provide a declaration, dated November 25, 2013, from
18 Gregory J. Robbins, Esq., former outside legal counsel for HedgeStreet. Mr. Robbins describes himself
19 as an expert in commodities laws. He reiterates appellants' description of HedgeStreet as a futures
20 exchange, as well as a futures clearing house. In addition, Mr. Robbins provides his opinion that IRC
21 section 1202(e)(3)(A) is directed at professional service and entertainment firms that are involved in
22 "the performance of services" and that have as their principal asset "the reputation or skill of 1 or more
23 of [their] employees." He asserts that HedgeStreet, as an exchange, provides a "financial marketplace."
24 He contends this is very different from a financial service firm or a brokerage service firm because such
25 firms derive their revenues from the provision of investment advice and therefore have as their
26 principal asset the reputation or skill of one or more of their employees. In contrast, he asserts,
27 HedgeStreet's principal assets are its systems used to match buyers and sellers, and its regulatory
28 licenses, which allow it to operate. (AL, Ex. C, pp. 1-2.)

1 Mr. Robbins further asserts that HedgeStreet is not covered by IRC section
2 1202(e)(3)(B), which excludes “banking, insurance, financing, leasing, investing, or similar
3 business[es].” He states that HedgeStreet does not have a banking or insurance license, and states that
4 it is not engaged in banking or insurance activities such as accepting deposits or issuing insurance
5 policies. Mr. Robbins states that HedgeStreet does not provide financing for any business and does not
6 make investments for itself or others. On this basis, Mr. Robins contends that HedgeStreet is not a
7 banking, insurance, financing, leasing, or investing business. He reiterates appellants’ argument that
8 HedgeStreet is not similar to such businesses because, unlike such businesses, it does not put capital at
9 risk. With regard to the fact that HedgeStreet earned exchange fees, Mr. Robbins observes that there is
10 no reference to exchange fees in IRC section 1202(e)(3)(A) or (B) and further argues that the “clear
11 intent of [IRC] section 1202(e)(3)(A) is not to apply to businesses that generate fees or commissions,
12 but instead to apply to professional service or entertainment businesses, which rely on their employees
13 as their primary asset.” (AL, pp. 2-4.)

14 Respondent’s Opening Brief

15 The FTB asserts that California’s statutory scheme for the exclusion of gain from the
16 sale of qualified small business stock (e.g., R&TC section 18152.5) is virtually identical to the federal
17 statutory scheme (e.g., IRC section 1202). It states that it has been unable to find any federal or
18 California authority interpreting the particular statutory provision at issue. The FTB contends that a
19 statutory provision must be given a “reasonable and common sense interpretation consistent with the
20 apparent purpose and intent of the lawmakers,” citing *Honey Springs Homeowners Assn. v. Board of*
21 *Supervisors* (1984) 157 Cal.App.3d 1122, 1136. In addition, the FTB contends that exclusions from
22 income must be narrowly construed, citing *Commissioner v. Schleier* (1995) 515 U.S. 323, 328. (ROB,
23 pp. 9-13.)

24 The FTB argues that, under R&TC section 18152.5, subdivision (e)(3)(A), HedgeStreet
25 is excluded from being a qualified trade or business because it provided brokerage services. The FTB
26 notes that HedgeStreet offered electronic trading of futures contracts on the internet and because there
27 was no human broker acting as an intermediary, the prospective buyers and sellers simply interacted
28 directly with the HedgeStreet’s electronic trading facility. The FTB contends that HedgeStreet acted as

1 a broker in bringing buyers and sellers together, and thus, its “exchange fees” were the equivalent of
2 trading commissions. (ROB, pp. 14-16.)

3 The FTB also argues that, under R&TC section 18152.5, subdivision (e)(3)(A),
4 HedgeStreet is excluded from the definition of a qualified trade or business because it provides
5 financial services. The FTB contends that the following factors show that HedgeStreet was providing
6 financial services: (i) it held members’ funds and paid interest on such funds if a member’s account
7 had a balance of \$1,000 or more; (ii) it maintained trading accounts for members; and (iii) it adjusted
8 the members’ trading accounts to take into account exchange fees, settlement fees, and payouts. (ROB,
9 p. 17.)

10 The FTB notes that R&TC section 18152.5, subdivision (e)(3)(B), excludes “[a]ny
11 banking, insurance, financing, leasing, investing, or similar business” from the definition of a qualified
12 trade or business. (Emphasis supplied.) The FTB contends that HedgeStreet was an investing (or
13 similar) business and, thus, is excluded from being a qualified trade or business. The FTB asserts that
14 the term “investing business” is a broad concept — much broader than the definition of an investment
15 company, which appellants describe as an organization that manages a portfolio of assets. The FTB
16 states that appellants apparently are asserting that the term “investing business” means an “investment
17 company.” The FTB rejects such an interpretation. It argues that because an “investment company”
18 already is prohibited from being an “eligible corporation” for purposes of the QSBS exclusion under
19 R&TC section 18152.5, subdivision (e)(4), the term “investing business” could not mean an
20 “investment company,” as such an interpretation would be redundant—and would render either the
21 term “investment company” or the term “investing business” as mere surplusage. (ROB, pp. 17-22.)

22 Alternatively, the FTB argues that, even if HedgeStreet was not an “investing business,”
23 it was in a “similar business” and, thus, is excluded from being a qualified trade or business for that
24 reason. Specifically, the FTB asserts that the Legislature’s intent was that businesses involved with
25 investments should not be able to take advantage of the QSBS provisions, as evidenced by the fact that:
26 (i) an investment company is prohibited from being an “eligible corporation” for purposes of the QSBS
27 exclusion under R&TC section 18152.5, subdivision (e)(4); and (ii) an investing business is excluded
28 from being a qualified trade or business under R&TC section 18152.5, subdivision (e)(3)(B). The FTB

1 contends that HedgeStreet is a business involved with investments and, in fact, is regulated by the
2 Commodities Futures Trading Commission. Based on the foregoing factors, the FTB asserts that
3 HedgeStreet should be excluded from being a qualified trade or business as a “similar business.”
4 (ROB, pp 19-20.)

5 Next, the FTB notes that on various corporate tax returns from 2002 through 2007,
6 HedgeStreet either listed its business activity as “Internet Market,” listed its product or service as
7 “Hedging Instruments,” and/or listed its principal business activity code (as well as the principal
8 activity codes of various subsidiaries) as 523210, which under the North American Industry
9 Classification System indicated “Securities and Commodity Exchanges.” The FTB asserts that codes
10 listed on HedgeStreet’s corporate tax returns indicate that HedgeStreet was an investing (or similar)
11 business and, thus, is excluded from being a qualified trade or business. (FTB OB, pp. 21-23.)

12 The FTB also objects to the declaration of Mr. Robbins on the following grounds:
13 (1) the FTB asserts that even though Mr. Robbins claims he is an expert in commodities laws, the issue
14 at hand deals with the interpretation of tax law (not commodities laws); (2) the interpretations of the tax
15 statute(s) at issue involve questions of law, and California prohibits an expert opinion on an issue of
16 law, citing *Summers v. A.L. Gilbert Co.* (1999) 69 Cal.App.4th 1155, 1178; and (3) Mr. Robbins’
17 declaration, to a large extent, merely repeats the contentions made by appellants on appeal. (ROB,
18 pp. 21-24.)

19 Appellants’ Reply Brief

20 Appellants reiterate that R&TC section 18152.5, subdivision (e)(3), excludes the
21 following trades or businesses from the definition of a qualified trade or business:

22 (A) Any trade or business involving the performance of services in the fields of health, law,
23 engineering, architecture, accounting, actuarial science, performing arts, consulting,
24 athletics, financial services, brokerage services, or any trade or business where the
25 principal asset of the trade or business is the reputation or skill of one or more of its
employees.

26 (B) Any banking, insurance, financing, leasing, investing, or similar business

27 In relation to the FTB’s argument that HedgeStreet essentially performed brokerage
28 services by bringing buyers and sellers together, appellants argue that the FTB’s argument is directly in

1 conflict with the language of R&TC section 18152.5, subdivision (e)(3)(A). Specifically, appellants
2 contend that the exclusion of a business from being a qualified trade or business, as set forth in R&TC
3 section 18152.5, subdivision (e)(3)(A), is limited to businesses involved in the performance of
4 professional services that rely on the reputation or skill of its employees. Appellants reiterate that
5 HedgeStreet was not a professional service firm that relied on the skill or reputation of its employees,
6 like law firms or similar businesses. Appellants reiterate that HedgeStreet was a financial marketplace,
7 which did not rely on the reputation or skill of its employees to perform services or generate profits.
8 (ARB, pp. 1-2.)

9 Next, appellants dispute the FTB's determination that HedgeStreet was providing
10 financial services. As noted above, the FTB contends that the following factors show that HedgeStreet
11 was providing financial services: (i) it held members funds and paid interest on such funds if a
12 member's account had a balance of \$1,000 or more; (ii) it maintained trading accounts for members;
13 and (iii) it adjusted the members trading accounts to take into account exchange fees, settlement fees,
14 and payouts. In response, appellants contend that the crediting of interest to deposits is a common
15 practice in a wide number of business transactions that do not rise to the level of being labeled
16 "financial services." Specifically, appellants assert that landlord might credit interest on deposits but,
17 by doing so, the landlord is not providing financial services, per se. In addition, appellants note that
18 HedgeStreet did not have a bank or insurance license, and thus, it could not accept banking or insurance
19 deposits or make investments for itself or others. (ARB, p. 2.)

20 Appellants contend that Hedgestreet was not an investing business or similar business,
21 citing R&TC section 18152.5, subdivision (c)(2)(B), which provides:

22 (B)(i) Notwithstanding subdivision (e), a corporation shall be treated as meeting the active
23 business requirements of subdivision (e) for any period during which the corporation
24 qualifies as a specialized small business investment company.

25 (ii) For purposes of clause (i), the term "specialized small business investment company"
26 means any eligible corporation (as defined in paragraph (4) of the subdivision (e))
27 that is licensed to operate under Section 301(d) of the Small Business Investment Act
28 of 1958 (as in effect on May 13, 1993). (Emphasis supplied.)

Appellants note that the FTB contends that, because an "investment company" already is prohibited
from being an "eligible corporation" for purposes of the QSBS exclusion under R&TC section 18152.5,

1 subdivision (e)(4), the term “investing business” could not mean an “investment company,” as such an
2 interpretation would be redundant — and would render either the term “investment company” or the
3 term “investing business” as mere surplusage. In response, appellants contend that the FTB’s statutory
4 analysis is “convoluted” and is not supported by the plain meaning of the QSBS laws. In this respect,
5 appellants reiterate that HedgeStreet did not earn a profit by putting capital at risk, as might have been
6 the case if HedgeStreet managed a portfolio of assets. Instead, appellants reiterate that HedgeStreet
7 simply received fees. (*Id.*) Appellants also reiterate that receipt of exchange fees does not prohibit
8 HedgeStreet from being a qualified trade or business, as there is no reference in R&TC section
9 18152.5, subdivision (e)(3)(A) or (B), to the receipt of exchange fees. In addition, appellants reiterate
10 that HedgeStreet was more like an internet company selling a product (which appellants compare to
11 eBay), than it was like a bank, a financing company, an investing company, etc. (ARB, p. 3.)

12 Next, as indicated above, the FTB notes that on various corporate tax returns from 2002
13 through 2007, HedgeStreet either listed its business activity as “Internet Market,” listed its product or
14 service as “Hedging Instruments,” and/or listed its principal business activity code (as well as the
15 principal activity codes of various subsidiaries) as 52210, which indicates “Securities and Commodity
16 Exchanges.” In response, appellants argue that the term “Internet Market” has no relationship to
17 personal or financial services. Also, appellants assert that the FTB essentially is arguing that anything
18 related to the finance and economic sector of our country supports a conclusion that the company is an
19 investing business or something similar, and such an interpretation is too broad, as it would mean that
20 the New York Stock Exchange is an investing business or something similar. (ARB, pp. 3-4.)

21 With regard to the declaration from Mr. Robbins, appellants contend that Mr. Robbins is
22 not providing an opinion on tax law — appellants assert that Mr. Robbins merely is describing what
23 HedgeStreet did as a business. Appellants reiterate that Mr. Robbins is an expert on commodities laws,
24 with an emphasis on futures exchanges and clearing houses. Appellants contend that the issue at hand
25 is not a case of statutory interpretation. Instead, appellants assert that the situation involves a factual
26 interpretation. Appellants assert that Mr. Robbins is qualified to provide the evidence put forth because
27 he worked with HedgeStreet. In addition, appellants assert that an opinion need only be helpful, rather
28 than necessary, citing *People v. McAlpin* (1991) 53 Cal.3d 1289. Appellants contend that there is no

1 valid basis to exclude Mr. Robbins' declaration and to do so would be an abuse of discretion. (ARB,
2 pp. 4-6.)

3 The FTB's Reply Brief

4 The FTB maintains that, as HedgeStreet performed brokerage services, HedgeStreet is
5 excluded from being a qualified trade or business. The FTB reiterates that R&TC section 18152.5,
6 subdivision (e)(3)(A), excludes the following trades or businesses from the definition of a qualified
7 trade or business:

8 Any trade or business involving the performance of services in the fields of health, law,
9 engineering, architecture, accounting, actuarial science, performing arts, consulting,
10 athletics, financial services, brokerage services, or any trade or business where the
11 principal asset of the trade or business is the reputation or skill of one or more of its
12 employees.

13 The FTB asserts that R&TC section 18152.5, subdivision (e)(3)(A), does not state that
14 the "performance of services" must be in relation to professional services. Rather, the FTB contends
15 that the statute provides that the services can include, among other things, performing arts and athletics,
16 which are not professional services. The FTB also contends that the statute's reference to "reputation
17 or skill" does not apply to all of the services listed therein. Rather, the FTB asserts that the phrase "any
18 trade or business where the principal asset of the trade or business is the reputation or skill of one or
19 more of its employees," sets forth a category of trade or business separate and independent from the
20 previously enumerated categories. In any event, the FTB asserts that the operation of HedgeStreet's
21 online futures exchange required the skill of one or more employees to develop, maintain, and modify
22 the system. (RRB, pp. 4-6.)

23 The FTB reiterates that HedgeStreet performed financial services because: (i) it held
24 members funds and paid interest on such funds if a member's account had a balance of \$1,000 or more;
25 (ii) it maintained trading accounts for members; and (iii) it adjusted the members trading accounts to
26 take into account exchange fees, settlement fees, and payouts. Based on the foregoing, the FTB
27 reiterates that HedgeStreet was performing financial services and, thus, is excluded from being a
28 qualified trade or business. As to appellants' assertion that HedgeStreet could not have performed
financial services because (i) it did not have a banking or insurance license, and (ii) it could not accept

1 deposits or make investments for itself or others, the FTB contends that it is not asserting that
2 HedgeStreet was a bank or insurance business. Instead, the FTB contends that the issue on appeal is
3 whether for purposes of the QSBS exclusion, HedgeStreet performed brokerage and financial services.
4 The FTB reiterates that the three factors set forth above show that HedgeStreet performed financial
5 services. (RRB, p. 7.)

6 The FTB contends that, contrary to appellant's assertion, HedgeStreet was not a
7 specialized small business investment company. As noted above, appellants' reply brief cites R&TC
8 section 18152.5, subdivision (c)(2)(B), which makes reference to a "specialized small business
9 investment company." R&TC section 18152.5, subdivision (c)(2)(B), provides:

10
11 (B)(i) Notwithstanding subdivision (e), a corporation shall be treated as meeting the active
12 business requirements of subdivision (e) for any period during which the corporation
13 qualifies as a specialized small business investment company.

14 (ii) For purposes of clause (i), the term "specialized small business investment company"
15 means any eligible corporation (as defined in paragraph (4) of the subdivision (e))
16 that is licensed to operate under Section 301(d) of the Small Business Investment Act
17 of 1958 (as in effect on May 13, 1993). (Emphasis supplied.)

18 The FTB asserts that because section 301(d) of the Small Business Investment Act of
19 1958 was repealed in 1996, which was before HedgeStreet was formed in 2000, HedgeStreet could not
20 have been licensed under that provision and thus would not qualify for the QSBS exclusion under
21 section 18152.5, subdivision (c)(2)(B). Moreover, the FTB asserts that the operative effect of R&TC
22 section 18152.5, subdivision (c)(2)(B), is unclear after repeal of the underlying statute. (RRB, p. 8.)

23 The FTB reiterates that HedgeStreet was an investing (or similar) business and, thus, is
24 excluded from being a qualified trade or business. The FTB also reiterates that the term "investing
25 business" must include companies that engage in a business whose revenue-generating objective is to
26 enable other people to make investments. With regard to appellants' reference to eBay, the FTB asserts
27 that because eBay is not an online futures or securities exchange, HedgeStreet was different than eBay.
28 In any event, the FTB asserts that the issue at hand is whether HedgeStreet was a qualified trade or
business (which the FTB reiterates, in a general manner, it was not). (RRB, pp. 9-10.)

The FTB also clarifies that it does not object to the portions of Mr. Robbins' declaration

1 based upon his personal knowledge. Instead, the FTB asserts that it objects to (1) his interpretation of
2 statutory provisions, (2) his arguments (taken almost verbatim from appellants' opening brief)
3 supporting appellants' position with respect to the statutory provisions, and (3) his legal conclusion that
4 "[b]ased on the facts and reasons stated above, HedgeStreet is not similar to the business listed in
5 Section 1202(e)(3)(A) or (B)." The FTB further states that (i) the issue at hand deals with the
6 interpretation of tax law, (ii) there is no evidence in the appeal record that Mr. Robbins has particular
7 expertise with respect to tax law, (iii) California prohibits an expert opinion on an issue of law, citing
8 *Summers v. A.L. Gilbert Co., supra*, and (iv) to a large extent, Mr. Robbins' declaration merely repeats
9 the contentions made by appellants on appeal. (RRB, pp. 10-15.)

10 Appellants' Supplemental Brief

11 Appellants contend that the FTB is trying to interpret R&TC section 18152.5,
12 subdivision (e)(3)(A) in such a manner that the phrase "where the principal asset of the trade or business
13 is the reputation or skill of one or more of its employees" is not connected to the terms "financial
14 services" and "brokerage services." Appellants contend that to adopt such an interpretation "would
15 turn the statute on its head." (ASB, p. 2.)

16 Next, appellants reiterate that HedgeStreet was not a professional service firm that relied
17 on the skill or reputation of its employees. Instead, appellants reiterate that HedgeStreet was a financial
18 marketplace, which did not rely on the reputation or skill of its employees to perform services or
19 generate profits. In addition, appellants assert that HedgeStreet did not provide investment advice or
20 invest capital. Furthermore, appellants assert that there are numerous differences between a securities
21 broker and HedgeStreet's business. First, appellants assert that brokers have a duty of best execution,
22 in that they are obligated to send a customer's trade to the exchange where it will get the best price.
23 Second, appellants assert that exchanges have members and do not owe fiduciary duties to those
24 members, whereas brokers have customers to whom they owe fiduciary duties. Third, appellants assert
25 that brokers must comply with net capital requirements under Rule 15c-3 of the Securities Exchange
26 Act of 1934, but exchanges do not have those requirements. Fourth, appellants assert that brokers are
27 regulated by the Financial Institution Regulatory Authority (FINRA) on the securities side and
28 National Futures Association (NFA) on the futures side; but exchanges are not regulated as such. Fifth,

1 appellants contend that brokers have their balance sheets at risk for customer trading activity, but
2 exchanges do not. Based on the foregoing factors, appellants assert that it is clear that R&TC section
3 18152.5, subdivision (e)(3)(A), is concerned with the use of human expertise and talent (i.e., the skill or
4 reputation of employees). (ASB, pp. 3-4.)

5 Appellants note that R&TC section 18152.5, subdivision (e)(3)(B), excludes “[a]ny
6 banking, insurance, financing, leasing, investing, or similar business” from the definition of a qualified
7 trade or business. Appellants reiterate that HedgeStreet was simply an exchange/clearing house and its
8 profitability did not depend on putting capital at risk. In addition, appellants contend that unlike
9 investment companies, HedgeStreet did not manage third-party assets. Appellants further reiterate that
10 Mr. Robbins is not providing an opinion on tax law—appellants assert that Mr. Robbins is merely
11 describing what HedgeStreet did as a business. Appellants also reiterate that Mr. Robbins is an expert
12 on commodities laws, with an emphasis on futures exchanges and clearing houses. Appellants contend
13 that an expert witness may testify about practices and usage of a trade, citing *Spitzer v. Stichman*
14 (2d Cir. 1960) 278 F.2d 402, 409; *United States v. Cohen* (2nd Cir. 1975) 518 F.2d 727, 737. In
15 addition, appellants assert that in a tax case, an expert witness is permitted to state his/her summary
16 conclusions about the meaning of the taxpayer’s transactions, citing *United States v. Barnette*
17 (11th Cir. 1986) 800 F.2d 1558, cert. den. (1987) 107 S. Ct. 1578. (ASB, pp. 4-6.)

18 FTB’s Additional Brief

19 In response to the Appeals Division’s request for additional information, respondent
20 submitted an additional brief discussing the discrepancies between IRC section 1202(e)(3)(A) and
21 R&TC section 18152.5, subdivision (e)(3)(A). The FTB emphasizes that the issue in this appeal is
22 based on R&TC section 18152.5, subdivision (e)(3)(A), and not its federal counterpart. The FTB
23 reiterates that IRC section 1202, relating to the 50 percent exclusion of gain from the sale of certain
24 small business stock, does not apply in California, citing R&TC section 18152.5, subdivision (a).
25 Rather, the FTB contends that the IRC references to the exclusion allowed under IRC section 1202 are
26 modified to refer to the exclusion allowed under R&TC section 18152.5, citing R&TC section 18152.5,
27 subdivision (b). (RAB, pp. 1-3.)

28 However, the FTB acknowledges that, as with R&TC section 18152.5, subdivision

1 (e)(3)(A), IRC section 1202(e)(3)(A) does not include the word “other” in the second clause. The FTB
2 notes that the United States Statutes at Large provide legal evidence of the federal laws, citing 1 U.S.C.
3 § 112 and *Washington-Dulles Transportation, Ltd. v. Metropolitan Washington Airports Authority*
4 (4th Cir 2001) 263 F.3d 371, 378-379. The FTB contends that the language of the Statutes at Large is
5 legal evidence that the second clause does not contain the word “other”. The FTB contends that
6 Public Law 103-66, Title XIII, section 13113(a), enacted on August 10, 1993, added a new section
7 which was codified as IRC section 1202. The FTB notes that the second clause of this new section
8 stated “or any trade or business where the principal asset of such trade or business is the reputation or
9 skill of 1 or more of its employees, . . .”, citing 107 Stat. 425. The FTB notes that IRC section 1202 was
10 amended several times, but subsection (e)(3)(A) was never amended since its enactment. The FTB
11 argues that the United States Code published by the United States Government Printing Office
12 (USGPO) is prima facie evidence of the laws of the United States in federal and state courts (1 U.S.C.
13 § 204(a)) and notes that the 2006 edition of the United States Code in effect during the 2007 year at
14 issue, the second clause of IRC section 1202(e)(3)(A) does not contain the word “other”. (RAB, pp. 3-
15 4, Exs. AA, BB & DD.)

16 The FTB notes that the Board has not questioned the fact that R&TC section 18152.5,
17 subdivision (e)(3)(A), does not contain the word “other” in the second clause. However, the FTB
18 points out that the 1993 Statutes of California, chapter 881, section 12, which added R&TC section
19 18152.5, do not contain the word “other” in the second clause of R&TC section 18152.5, subdivision
20 (e)(3)(A). The FTB also notes that, although R&TC section 18152.5 has been amended several times,
21 subdivision (e)(3)(A) has not been amended. (RAB, p. 4, Ex. EE.)

22 With respect to whether there is any explanation for the discrepancy in the wording of
23 IRC section 1202(e)(3)(A), the FTB states that it does not know of any explanation other than the
24 Statutes at Large and the United States Code published by the USGPO, statues and codes printed by
25 commercial publishers are not authoritative and are subject to error. The FTB notes that the Westlaw
26 online version of IRC section 1202(e)(3)(A) does not contain the word “other,” unlike the printed
27 Complete Internal Revenue Code referenced by the Appeals Division staff, even though both are
28 published by Thomson Reuters. The FTB notes, with regard to the House Report No. 103-111 of the

1 Committee on the Budget, which contained the word “other”, the report was superseded by the House
2 Conference Report No. 103-213, which does not contain the word “other.” According to the
3 explanatory statement of the Conference Committee in the House Conference Report, the U.S. Senate
4 amended the House bill (H.R. 2264) by striking the entirety of the House bill after the enacting clause
5 and inserting substitute text. The House Conference Report discusses the differences between the
6 House bill, the Senate amendment, and the substitute language agreed to by the Conference Committee.
7 The FTB notes that the substitute language adopted by the Conference Committee and enacted into law
8 does not contain the word “other” in the second clause of IRC section 1202(e)(3)(A). (RAB, pp. 4-5,
9 Exs. AA & FF; ROB, Ex. M.)

10 As to the proper interpretation of IRC section 1202(e)(3)(A) and R&TC section 18152.5,
11 subdivision (e)(3)(A), the FTB contends that the plain language of the statute controls, citing
12 *Dyna-Med-Inc. v. Fair Employment and Housing Commission* (1987) 43 Cal.3d 1379, 1386-1387. The
13 FTB reiterates that neither R&TC section 18152.5, subdivision (e)(3)(A), nor IRC section
14 1202(e)(3)(A) requires that the performance of the types of services enumerated in the first clause rely
15 on the reputation or skill of employees since, otherwise, the second clause, “any trade or business
16 where the principal asset of the trade of business is the reputation or skill of one or more of its
17 employees,” would have the word “other” after the word “any.” (RAB, p. 6.)

18 The FTB notes that the language of IRC section 1202(e)(3)(A) set forth in the IRS
19 Private Letter Ruling (PLR) 201436001 (May 22, 2014) contains the word “other.” As such, the FTB
20 argues that it is incorrect based on the authoritative language set forth in the United States Statutes at
21 Large. The FTB further argues that the delineation of the law in the PLR is erroneous to the extent it
22 requires that the principal asset be the reputation or sill of one or more employees for the performance
23 of services in the enumerated categories of subsection (e)(3)(A) to be prohibited. The FTB argues that
24 little or no weight should be given to the discussion in the PLR based on incorrect language. The FTB
25 contends that incorrect legal advice from an IRS employee does not have the force of law and cannot
26 bind the Commissioner, respondent, or the Board, citing *Schwalbach v. Commissioner* (1998)
27 111 T.C. 215, 228, and other authorities. The FTB contends that the statutes, regulations, and judicial
28 decisions govern a taxpayer’s tax liability, citing *Richmond v. Commissioner, supra*. The FTB

1 contends that the PLR may not be cited as precedent in accordance with IRC section 6110(k)(3), citing
2 *Abdel-Fattah v. Commissioner* (2010) 134 T.C. 190, 202. Nevertheless, the FTB agrees with the
3 statement in the PLR that IRC section 1202(e)(3)(A) “excludes various service industries and specified
4 non-service industries.” The FTB notes that the IRS determined that, while the company’s activities
5 were in the pharmaceutical industry, which is “a component of the health industry,” rather than
6 performing services in the health industry, the company used specific manufacturing and intellectual
7 property assets in carrying out its operations. The FTB contends that the IRS focused on the
8 company’s role in the drug manufacturing processed, as opposed to simply providing services in the
9 pharmaceutical industry. (RAB, pp. 6-7.)

10 With regard to *Owen v. Commissioner*, T.C. Memo. 2012-21 (*Owen*), the FTB notes that
11 this case dealt with IRC section 1045, which provides for the deferral of gain on the sale of QSBS held
12 by a taxpayer for more than six months where he purchase replacement QSBS within a 60-day period.
13 Pursuant to IRC section 1045(b)(1), QSBS for purposes of IRC section 1045 has the same meaning as
14 QSBS pursuant to IRC section 1202. The FTB notes that the Tax Court determined that the stock sold
15 by the taxpayer in *Owen* was QSBS under IRC section 1045 as the principal asset of the corporation
16 was not the skill of the husband, as the IRS asserted, but rather the training and organizational structure,
17 using independent contractors to sell the policies that earned the premiums. The FTB points out that
18 the Tax Court did not address the fact that the corporation sold prepaid legal service policies, but did
19 not itself provide prohibited legal services under IRC section 1202(e)(3)(A). The FTB notes that the
20 Tax Court’s discussion of the definition of IRC section 1202(e)(3)(A) did not contain the word “other”
21 in the second clause, but the Tax Court’s determination regarding a qualified trade or business did not
22 hinge on the lack or inclusion of the word “other.” The FTB notes that, although the sold stock was
23 QSBS, the Tax Court held that the taxpayer did not qualify for nonrecognition of gain from the sale
24 because the purchased stock did not satisfy the active business requirements. The FTB contends that
25 the nonrecognition of gain provided in IRC section 1045 does not apply for California purposes as
26 R&TC section 18038.5 provides separate rules for California purposes. The FTB further contends that
27 the present appeal involves the exclusion, not deferral, of gain from the sale of QSBS under R&TC
28 section 18152.5 and, thus, R&TC section 18038.5 is inapplicable. As for the second clause of R&TC

1 section 18152.5, subdivision (e)(3)(A), “or any trade or business where the principal asset of the trade
2 or business is the reputation or skill of one or more of its employees,” the FTB reiterates that
3 HedgeStreet was not a qualified trade or business due to its being a trade or business performing
4 services in the fields of brokerage services and financial services. As such, the FTB maintains that
5 appellants are not entitled to the 50 percent exclusion of gain from the sale of their HedgeStreet stock in
6 2007. (RAB, pp. 7-10.)

7 Appellants’ Additional Brief

8 Appellants state that the that the definition of “qualified trade or business” provided in
9 IRC section 1202(e)(3) is any trade or business other than “(A) any trade or business involving the
10 performance of services in the fields of health, law, . . . financial services, brokerage services, or any
11 other trade or business the principal asset of which is the reputation or skill of one or more employees.”
12 Appellants state that R&TC section 18152.5, subdivision (e)(3)(A), has the same definition, but omits
13 the word “other” in the definition. Appellant contends that this language including the word “other” is
14 found in the Internal Revenue Code published by Thomson Reuters, the House of Representatives
15 Ways and Means Committee Markup of Administrations Revenue Proposals, Joint Committee on
16 Taxation, JCX 1-93 (May 4, 1993), the Fiscal Year 1994 Budget Reconciliation Recommendations of
17 the Committee on Ways and Means as submitted to the Committee on the Budget pursuant to
18 H. Con. Res. 64 (May 18, 1993), the House Report of the Committee on the Budget to accompany
19 H.R. 2264, Report No. 103-11, 1993-3 C.B. 163 (July 1993), and IRS PLR 201436001 (May 22, 2014).
20 Appellants acknowledge that *Owen, supra*, and the Statutes at Large, cited by the FTB, do not contain
21 the word “other.” Appellants state that it does not know why there are these discrepancies in the
22 wording of the federal statute. Appellants surmise that the omission of the word “other” was a clerical
23 error or clerical correction. (AAB, pp. 1-2.)

24 Nevertheless, appellants contend that the difference of the wording in the statute does
25 not affect the meaning of the statute. Appellants point to the original legislative intent of the federal
26 statute provided in the House Report No. 103-11. Appellants contend that it is unreasonable for the
27 FTB to argue that it is necessary to have the word “other” in the statute in order to interpret the list of
28 businesses as principally involving the reputation or skill or one or more of its employees. Appellants

1 note that the businesses listed are: health, law, engineering, architecture, accounting, actuarial science,
2 performing arts, consulting, athletics, financial services and brokerage services. Appellants contend
3 that these businesses all involve the personal skill and reputation of the individuals in performing the
4 services. (AAB, pp. 2-3.)

5 Appellants contend the PLR is significant in that it shows the IRS's general
6 interpretation of "qualified trade or business" under IRC section 1202(e)(3). Appellants contend that
7 the "plain language of the statute might have been read more broadly to exclude clinical testing and
8 drug research as activities equivalent to the performance of services in the health industry." Appellants
9 contend that the PLR's narrower interpretation of the exclusions in the statute provides companies with
10 a more favorable outlook as to their QSBS eligibility. Appellants contend that the PLR does not
11 directly address the meaning of the "reputation or skill" language in IRC section(e)(3)(A). Appellants
12 state that the FTB would argue that the language should be interpreted to encompass all start-up
13 companies with few hard assets on their books because those companies rely heavily on key employees
14 to establish and maintain business value. Appellants argue that HedgeStreet is similar to the
15 pharmaceutical company at issue in the PLR in that it received revenue from third parties and not from
16 being in the field of financial or brokerage services. Appellants contend that the PLR explains that the
17 "reputation or skill" provision is designed to exclude consulting firms, law firms, and financial asset
18 management firms and the intent of IRC section 1202(e)(3) is to exclude businesses whose primary
19 value generator is services. (AAB, pp. 4-5.)

20 Appellants further point to *Owen, supra*, as a failed attempt by the IRS to disqualify a
21 corporation from QSBS eligibility due to the importance of the founder's skills to the business.
22 Appellants note that the Owen case involved a company that created and sold insurance-related
23 financial products, whose founder was a seasoned insurance salesman. The founder sought QSBS
24 status and a rollover of his stock in a personal holding company, which sold prepaid legal service
25 policies. Appellants note that, while the IRS argued that the company did not qualify because of the
26 "reputation or skill" language in IRC section 1202(e)(3) because the founder's skills was one of the
27 company's principal assets, the Tax Court disagreed. Appellants note that the Tax Court reasoned that,
28 while the founder's skill did contribute to the success of the company, it was not an asset of the

1 company. Appellants note that the Tax Court found that the principal asset of the company was the
2 training and organizational structure which consisted of independent contractors who sold policies that
3 earned premiums. Appellants further note that the founder worked as one of the independent
4 contractors. Appellants also note that, even though the company also provided estate planning services,
5 the Tax Court held that the corporation qualified as a QSBS because it earned money from selling legal
6 service policies and the taxpayer did not personally participate in the selling of the legal services or
7 estate planning services. Appellants argue that, “[g]iven the Owen case and the rationale of the PLR, it
8 is reasonable for a start-up that is not engaged in one of the specifically excluded businesses to
9 conclude that it is a QSBS company even though it relies heavily on the skill and expertise of its
10 employees, particularly where their efforts are necessary in order to develop valuable intangible assets
11 that ultimately represent the value of the company.” Appellants contend that, similar to Owen, while
12 appellants “may have been instrumental in developing the algorithms and software used in the
13 automated internet clearinghouse,” HedgeStreet received its revenue from third-parties who bought and
14 sold its products and appellants did not perform selling services in their personal capacity. (AAB,
15 pp. 4-5.)

16 With regard to whether there is any authority limiting the application of R&TC section
17 18152.5, subdivision (e)(3)(B), to situations where capital is placed at risk, appellants contend that the
18 plain wording of the statute limits the application to a banking, financing, investing, insurance and
19 similar businesses. Appellants contend that the word “similar” means “the same or having something
20 in common.” Appellants contend that all of these businesses put capital at risk and notes that the
21 statute does not state that non-qualified businesses are those involved in financial transactions.
22 Appellants argue that it would not be reasonable to interpret the statute broadly when the legislature
23 defined non-qualified businesses specifically. Appellants further argue that the IRS and the Tax Court
24 have interpreted the statute specifically in the PLR and *Owen, supra*. Appellants further contend that it
25 is not reasonable to conclude that R&TC section 18152.5, subdivision (e)(3)(B), should include all
26 financial businesses that are primarily focused on financial transactions, rather than be limited to
27 financial businesses that extend capital for risk. Appellants contend that, if it was interpreted to include
28 financial businesses that are primarily focused on financial transactions, then entities such as credit card

1 companies, western union and similar cash wiring facilities, and exchanges, and clearinghouses would
2 be included. Appellants argue that none of these entities are specifically listed in the provision and “it
3 is beyond comprehension why FTB cannot see the difference between an exchange and these
4 businesses.” (AAB, pp. 5-6.)

5 Appellants also contend that it is not clear how a leasing business has anything to do
6 with financial transactions. Appellants point to the “recent bank stress tests to understand that there
7 isn’t a regulator in the work who thinks a bank is primarily focused on financial transactions – instead a
8 bank is concerned with putting capital at risk in order to make a profit.” Appellants assert that “the fact
9 that the bank processes transactions for its depositors in order to keep their deposits to place at risk is
10 merely incidental.” Appellants contend that the same analysis applies to the other businesses listed in
11 R&TC section 18152.5, subdivision (e)(3)(B). Appellants contend that, while these businesses have
12 some involvement in financial transactions, the real way they generate revenue is through placing
13 capital at risk. (AAB, p. 6.)

14 Applicable Law

15 Burden of Proof

16 Income tax deductions and exclusions are a matter of legislative grace, and a taxpayer
17 who claims a deduction or exclusion has the burden of proving by competent evidence that he or she is
18 entitled to that deduction/exclusion. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435;
19 *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.)³

20 QSBS Exclusion

21 R&TC section 18152.5 excluded from an individual’s gross income 50 percent of the
22 gain from the sale of QSBS held for more than five years. To be treated as QSBS under the statute, the
23 underlying corporation was required to satisfy the active business requirement test for substantially all
24 of the shareholder’s five-year holding period. (Rev. & Tax. Code, § 18152.5, subd. (c)(2)(A).) The
25 active business requirement test required that 80 percent (by value) of the assets and 80 percent of the
26 payroll of the underlying corporation are attributable to the active conduct of one or more qualified
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28 ³ Board of Equalization cases are generally available for viewing on the Board’s website (www.boe.ca.gov).

1 trades or businesses in California. (Rev. & Tax. Code, § 18152.5, subds. (e)(1)(A) and (e)(9).) The
2 constitutionality of this requirement was brought before the courts, and the California Courts of Appeal
3 determined that this requirement was unconstitutional. The FTB thereafter issued FTB Notice 2012-03,
4 in which it stated that, for tax years prior to 2008, the QSBS treatment would be allowed for taxpayers
5 who met the requirements of the statute other than the unconstitutional California property and payroll
6 requirements. However, appellants must show that HedgeStreet met the remaining requirements of the
7 statute, including the qualified trade or business requirement. R&TC section 18152.5, subdivision
8 (e)(3),⁴ defines a qualified trade or business as follows:

9 For purposes of this subdivision, the term “qualified trade or business” means any trade or
10 business other than any of the following:

11 (A) Any trade or business involving the performance of services in the fields of health, law,
12 engineering, architecture, accounting, actuarial science, performing arts, consulting,
13 athletics, financial services, brokerage services, or any trade or business where the
14 principal asset of the trade or business is the reputation or skill of one or more of its
15 employees.

16 (B) Any banking, insurance, financing, leasing, investing, or similar business.

17 (C) Any farming business (including the business of raising or harvesting trees).

18 (D) Any business involving the production or extraction of products of a character with
19 respect to which a deduction is allowed under section 613 or 613A of the Internal
20 Revenue Code.

21 (E) Any business of operating a hotel, motel, restaurant or similar business.

22 The California statutory scheme for the exclusion of gain from the sale of QSBS is
23 virtually identical to the federal statutory scheme. IRC section 1202(e)(3)(A) and (B) provide the same
24 exceptions from being a qualified trade or business.

25 In *Owen v. Commissioner, supra*, the Tax Court considered whether a certain business
26 should be treated as a qualified trade or business for purposes of nonrecognition of gain when a
27 taxpayer sells QSBS pursuant to IRC section 1045 which references the definition of QSBS pursuant to

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⁴ The federal counterpart language is set forth in IRC section 1202(e)(3).

1 IRC section 1202.⁵ The business at issue created and sold insurance-related financial products, whose
2 founder (and taxpayer) was a seasoned insurance salesman. The taxpayer sought QSBS status and a
3 rollover of his stock in a personal holding company, which sold prepaid legal service policies and estate
4 planning services. The taxpayer worked as one of the independent contractors selling the insurance
5 policies, but did not participate in the estate planning services. The Tax Court determined that the
6 stock was QSBS under IRC section 1045 as the principal asset of the corporation was not the skill of
7 taxpayer, but rather the training and organizational structure, using independent contractors to sell the
8 policies that earned the premiums. The Tax Court however determined that the purchased stock did not
9 satisfy the active business requirements and therefore, the taxpayer did not qualify for nonrecognition
10 of gain.

11 In PLR 201436001 (May 22, 2014), the IRS opined on whether a company that provided
12 products and services primarily in connection with the pharmaceutical industry and whose business
13 activities included research, development, manufacture and commercialization of experimental drugs
14 for its clients was a qualified trade or business for purposes of IRC section 1202.⁶ The company in
15 question also assisted clients in developing successful drug manufacturing processes. The IRS stated
16 that IRC section 1202(e)(3) “excludes various service industries and specified non-service industries.”
17 The IRS determined that, while the company’s activities were in the pharmaceutical industry, which is
18 “a component of the health industry,” the company was not in the business of offering service in the
19 form of individual expertise. The IRS noted that, instead of providing services, the company used
20 specific manufacturing and intellectual property assets in carrying out its operations. The IRS focused
21 on the company’s role in the drug manufacturing processed, as opposed to simply providing services in
22 the pharmaceutical industry. The PLR is not precedential. (Int. Rev. Code, § 6110(k)(3).)

23 Statutory Construction

24 Exclusions from income must be narrowly construed. (*Commissioner v. Schleier, supra*,
25 515 U.S. 323, 328 (superseded on other grounds); *United States v. Centennial Sav. Bank FSB* (1991)
26

27 ⁵ The *Owen* decision does not contain the word “other” in its citation to IRC section 1202(e)(3)(A).

28 ⁶ The PLR contains the word “other” in its citation to IRC section 1202(e)(3)(A).

1 499 U.S. 573, 583; *Commissioner v. Jacobson* (1949) 336 U.S. 28, 49.) In construing a statute, a court
2 must ascertain the intent of the Legislature so as to effectuate the purpose of the law. To determine
3 legislative intent, the first step is to look to the words of the statute. (*Ordlock v. Franchise Tax Bd.*
4 (2006) 38 Cal.4th 897, 909 – 910 (*Ordlock*); *Lennane v. Franchise Tax Bd.* (1994) 9 Cal.4th 263, 268
5 (*Lennane*); *Lungren v. Deukmejian* (1988) 45 Cal.3d 727, 737 (*Lungren*)). The words of the statute are
6 given their ordinary meaning but are considered in the context of the relevant statutory scheme.
7 (*Ordlock, supra*, 38 Cal.4th at pp. 909 – 910 [citing *Lungren, supra*, at p. 735].) “If the statutory
8 language is clear and unambiguous, then we need go no further.” (*Hoechst Celanese Corp. v.*
9 *Franchise Tax Bd.* (2001) 25 Cal.4th 508, 557 [citing *Lungren, supra*, at p. 735]; see also *Lennane,*
10 *supra*, 9 Cal.4th at p. 268.) In determining a statute’s meaning, “courts should, if possible, accord
11 meaning to every word and phrase in a statute so as to better effectuate the Legislature’s intent.”
12 (*Ste. Marie v. Riverside County Regional Park & Open-Space District* (2009) 46 Cal.4th 282, 289
13 (citations omitted).)

14 When the language of a statute “is susceptible of more than one reasonable
15 interpretation,” the California courts consider “a variety of extrinsic aids, including the ostensible
16 objects to be achieved, the evils to be remedied, the legislative history, public policy, contemporaneous
17 administrative construction, and the statutory scheme of which the statute is a part.” (*Eel River*
18 *Disposal & Resource Recovery, Inc. v. County of Humboldt* (2013) 221 Cal.App.4th 209, 227 (citations
19 omitted).) The California courts should “select the construction that comports most closely with the
20 apparent intent of the Legislature, with a view toward promoting rather than defeating the general
21 purpose of the statute, and avoid an interpretation that would lead to absurd consequences.” (*Id.*
22 (citations omitted).)

23 STAFF COMMENTS

24 R&TC section 18152.5 provides that taxpayers that invest in certain businesses are
25 eligible to exclude 50 percent of the gain from the sale of QSBS. To be eligible for the exclusion,
26 among other requirements, the business must be a “qualified trade or business.” As noted above, the
27 statute provides as follows:

28 . . . the term "qualified trade or business" means any trade or business other than any of

1 the following:

2 (A) Any trade or business involving the performance of services in the fields of health,
3 law, engineering, architecture, accounting, actuarial science, performing arts, consulting,
4 athletics, financial services, brokerage services, or any trade or business where the
5 principal asset of the trade or business is the reputation or skill of one or more of its
6 employees.

(B) Any banking, insurance, financing, leasing, investing, or
similar business.

...

7 The terms “financial services,” “brokerage services,” and “investing, or similar
8 business” are not defined in R&TC section 18152.5. At the hearing, the parties should be prepared to
9 discuss further the activities conducted by HedgeStreet and whether those activities constitute a
10 business involving a brokerage or financial service, a business where the principal asset is the
11 reputation or skill of employees, or a “banking, insurance, financing, leasing, investing, or similar
12 business.” With regard to the exclusion of “investing, or similar business” provided by R&TC section
13 18152.5, subdivision (e)(3)(B), the parties should be prepared to discuss appellants’ contention that this
14 provision is limited to businesses that extend capital for risk.

15 The parties should be prepared to discuss *Owen, supra*, T.C. Memo 2012-21. Although
16 the decision deals with IRC section 1045, which is not at issue in this appeal, it analyzes the definition
17 of qualified trade or business pursuant to IRC section 1202(e)(3)(A), the federal counterpart to R&TC
18 section 18152.5(e)(3)(A). Although not precedential, the parties should also be prepared to discuss
19 whether the analysis in PLR 201436001 may be instructive in analyzing the present appeal or
20 suggesting how the IRS applies this provision.

21 With regard to the discrepancy found in the printed version and online version of IRC
22 section 1202(e)(3)(A), it appears that the parties agree that the discrepancy is not controlling. It
23 appears that the relevant inquiry is whether HedgeStreet is a qualified trade or business pursuant to
24 R&TC section 18152.5.

25 Additional Evidence

26 If a party has any further evidence that the party wants the Board to consider, then
27 pursuant to California Code of Regulations, title 18, section 5523.6, that party should provide such

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1 evidence to the Board Proceedings Division at least 14 days prior to the oral hearing.⁷

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28 ⁷ Evidence exhibits should be sent to: Khaaliq A. Abd’Allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC: 80, Sacramento, California, 94279-0080.