

## New Jersey court rules on sourcing income from mortgage-related intangibles

### Overview

On March 22, 2016, the Tax Court of New Jersey issued its decision in *Flagstar Bank, FSB v. Dir., Div. of Taxation*, analyzing whether income from certain intangibles in connection with an out-of-state bank's mortgage loan businesses must be situated to New Jersey for state corporation business tax (CBT) apportionment purposes.<sup>1</sup> Notably, income relating to mortgage loans purchased from a third-party was considered integrated with the taxpayer's New Jersey business and thus includable in the receipts factor numerator, even where the taxpayer did not originate the loan and conducted only certain loan purchasing-related activities in New Jersey. Additionally, the court concluded that the sale of mortgage servicing rights does not produce income attributable to the original mortgage intangible, and hence may be sourced outside New Jersey to the extent that such rights are not otherwise attributable to New Jersey.

This Tax Alert outlines the Tax Court's decision in *Flagstar* and discusses related taxpayer considerations.

### Background

Flagstar Bank, FSB (Taxpayer) was a federally chartered stock savings bank headquartered and commercially domiciled in Michigan. The Taxpayer conducted a "retail mortgage lending business" in New Jersey that involved the operation of certain loan centers staffed by the Taxpayer's employees. The loan centers accepted mortgage loan applications from borrowers and submitted the applications to the Taxpayer's headquarters outside of New Jersey for approval, underwriting and funding. The Taxpayer also conducted a "wholesale mortgage operation" in New Jersey that involved the Taxpayer's purchase of mortgage loans originated by third-party independent mortgage brokers and correspondent lenders. The Taxpayer employed account executives in New Jersey to solicit the sale of the mortgage loans to the Taxpayer, and to conduct certain activities to facilitate these sales. The Taxpayer often funded the loans purchased from independent mortgage loan brokers, but the loans purchased from the correspondent lenders were generally originated, closed, and funded by a third-party before being sold to the Taxpayer. The Taxpayer's underwriting and other related activities in connection with the wholesale mortgage operation took place outside of New Jersey.

In connection with its portfolio of mortgage loans, the Taxpayer received mortgage loan origination fees, mortgage loan servicing fees, and proceeds from the sale of mortgage servicing rights. Furthermore, the Taxpayer would eventually sell most of its mortgage loans to certain government sponsored entities (GSE's) in exchange for mortgage-backed securities, which would then be sold by the Taxpayer to broker-dealers.

### Purchased mortgage loans are integrated with the Taxpayer's New Jersey activities

The court considered whether interest income from the Taxpayer's wholesale mortgage operations should be included in the numerator of the receipts factor for CBT purposes, which required an analysis of whether the underlying wholesale mortgage loan intangibles were sufficiently integrated with the Taxpayer's New Jersey activities so as to have taxable situs in New Jersey.<sup>2</sup> Pursuant to N.J. Admin. Code § 18:7-8.12(e), the taxable situs of an intangible is in New Jersey to the extent that the intangible has been integrated with a business carried on in New Jersey.

The court noted that the Taxpayer availed itself of the New Jersey market to conduct its mortgage acquisition business, given that the Taxpayer intentionally entered the New Jersey marketplace not merely to sell retail loans but also to acquire mortgages for its wholesale business.<sup>3</sup> Thus, the court found that the interest income from the acquired wholesale New Jersey mortgage loans was integrated with the Taxpayer's activities in New Jersey, based on the integrated relationship of the wholesale mortgage loans to the Taxpayer's New Jersey activities.<sup>4</sup> In coming to this conclusion, the court pointed out that the Taxpayer employed account executives who were residents of New Jersey and performed substantially all of their duties in New Jersey, including soliciting the sale of loans from local

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<sup>1</sup> *Flagstar Bank, FSB v. Dir., Div. of Taxation*, No. 019335-2010, 2016 N.J. Tax LEXIS 6 (N.J. Tax Ct. Mar. 22, 2016).

<sup>2</sup> *Id.* at \*23-32.

<sup>3</sup> *Id.* at \*30-31.

<sup>4</sup> *Id.* at \*30-31.

brokers and lenders as well as taking steps to facilitate these sales.<sup>5</sup> Moreover, the court pointed out that it did not find much difference between the Taxpayer's retail mortgage lending business activities and its wholesale mortgage operations activities, because, with the exception of taking the original application from the borrower, there was no significant difference in the Taxpayer's undertaken process whether the loan originated in its retail lending offices or through independent mortgage brokers or correspondent lenders.<sup>6</sup> Accordingly, the court concluded that the income from the wholesale mortgage loans was properly situated to New Jersey. In doing so, the court rejected the New Jersey Division of Taxation's assertion that the location of the loan collateral is a controlling factor in the siting of the loan intangible, and instead focused on the relationship between the intangible and the Taxpayer's actual New Jersey activities.<sup>7</sup>

### **Proceeds from sale of mortgage-backed securities considered the proceeds of underlying mortgage loans**

In evaluating the sale of mortgage loans to the GSEs and the subsequent sale of securities to broker dealers, the court deemed the proceeds from the sale of the securities to be proceeds from the sale of the mortgage loans, and thus situated these proceeds to New Jersey.<sup>8</sup> The court found that the sale of the mortgages in exchange for securities and subsequent sale of the securities were so "inextricably intertwined" that they were essentially the same transaction.<sup>9</sup>

### **Origination fee income deemed akin to interest income**

The court found that the origination fees were akin to charges for interest rather than fees for services.<sup>10</sup> Therefore, the court concluded that the origination fees should be sourced like interest income and situated in New Jersey because the mortgage loan intangible is integrated with the Taxpayer's business in New Jersey.<sup>11</sup>

### **Mortgage servicing fee income considered services income, situated to location of work performed**

The court concluded that the mortgage servicing fees were generated based on the underlying services performed, and thus should be sourced to the location where the services were performed.<sup>12</sup> As such, the Taxpayer's mortgage servicing fees were sourced outside New Jersey because it had conducted these servicing activities at its out-of-state offices.<sup>13</sup>

### **Mortgage servicing rights do not accrue upon origination of original mortgage loan**

With regard to sourcing the Taxpayer's income from the sale of mortgage servicing rights to other companies, the court reasoned that the right to service the loan and collect a fee for doing so does not accrue until the sale of the mortgage loan.<sup>14</sup> Because "the mortgage servicing right is at best inchoate at the time a mortgage loan is originated or acquired," the subsequent sale of that right does not produce income attributable to the original intangible mortgage loan.<sup>15</sup> Therefore, because the mortgage servicing right arises later—without connection to the activities conducted with respect to the original intangible mortgage loan—the court concluded that the income from the subsequent sale of mortgage servicing rights to another service provider was not subject to the CBT.

### **Additional holdings: throw-out rule, underpayment penalty, and amnesty penalty**

The court additionally held that New Jersey's CBT sales factor "throw-out rule" did not apply to the matter, and stated that the inquiry is whether the Taxpayer had requisite constitutional contacts with another state to authorize that state to subject the Taxpayer's receipts to tax as evaluated according to New Jersey's nexus standards, including economic presence.<sup>16</sup> Regarding imposition of an underpayment penalty, the court found that there was no reasonable cause for failure to include the income arising from the intangibles that were integrated with the Taxpayer's business in New Jersey.<sup>17</sup> However, the court did find that it was unreasonable to assess New Jersey's amnesty penalty on the Taxpayer, because the final determination was not issued until after the underlying amnesty period had ended.<sup>18</sup>

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<sup>5</sup> *Id.* at \*26-27, 30.

<sup>6</sup> *Id.* at \*26-27.

<sup>7</sup> *Id.* at \*23-32, 34-36.

<sup>8</sup> *Id.* at \*31.

<sup>9</sup> *Id.* at \*31.

<sup>10</sup> *Id.* at \*31-33.

<sup>11</sup> *Id.* at \*31-33.

<sup>12</sup> *Id.* at \*33.

<sup>13</sup> *Id.* at \*33.

<sup>14</sup> *Id.* at \*33-34.

<sup>15</sup> *Id.* at \*33-34.

<sup>16</sup> *Id.* at \*39-40.

<sup>17</sup> *Id.* at \*43.

<sup>18</sup> *Id.* at \*45.

## Considerations

Taxpayers with mortgage loan-related activities in New Jersey may wish to carefully consider their CBT sales factor sourcing decisions regarding third-party originated loans and underlying intangibles. Additionally, the court's ruling in *Flagstar* may potentially present opportunities to reevaluate sourcing decisions made with respect to mortgage servicing income or proceeds from the sale of mortgage servicing rights.

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