

1 HomeAmerican also sells the servicing rights on these mortgages acquired from investors who
2 choose to "outsource" loan collection and management services.¹ These loan-servicing contracts are
3 considered intangible assets under generally accepted accounting principles.

4 Periodically, HomeAmerican bundles servicing contracts from pools of mortgage loans and then
5 sells them to qualified servicing companies. In some instances, HomeAmerican provides and receives
6 revenue from interim collection and management services prior to the transfer of the servicing rights.

7 In 1996 ("Refund Period"), Appellant sourced revenue from Arizona mortgage loan originations
8 and the related interest and interim servicing fees to Arizona. These gross receipts are not at issue. The
9 only items of revenue at issue in this appeal are the gross receipts from HomeAmerican's subsequent
10 disposition of its Arizona mortgage loans and their servicing rights.

11 Corporations are subject to Arizona income tax on income earned from sources within the state.
12 A.R.S. § 43-102(A)(5). Corporations, like Appellant, that have income from sources both within and
13 without the state must allocate and apportion their income. See A.R.S. §§ 43-1131 *et. seq.*

14 Arizona formally adopted its version of the Uniform Division of Income for Tax Purposes Act
15 ("UDITPA") IN 1983. The corresponding rules were promulgated in 1986. With the goal of fair
16 apportionment, UDITPA established the equally-weighted three factor formula as the proper measure for
17 attributing income to a taxing jurisdiction.² The three-factor formula is comprised of a business's property,
18 payroll, and sales. The average of these factors is intended to create a fair reflection of a taxpayer's
19 business activity within the State, and if applied uniformly, results in taxation of no more than and no less
20 than 100 percent of the taxpayer's income. Only the sales factor is at issue here.

21 The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in Arizona
22 during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during
23 the tax period. A.R.S. § 43-1145. "[U]nless the context otherwise requires: . . . "Sales" means all gross
24 receipts of the taxpayer not allocated under this article." A.R.S. § 43-1131(5). Sales other than the sales
25 of tangible personal property are sourced to Arizona if the income producing activity or a greater portion

¹ Mortgage loan servicing refers to the business activities necessary to collect payments from the borrower.

² Arizona adopted a double-weighted sales factor effective September 21, 1991.

1 of it is performed in Arizona based on cost of performance. The term "income producing activity" applies
2 to each separate item of income and means the transactions and activity directly engaged in by the
3 taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains and
4 profits. A.A.C. R15-2-1147.1. The term "cost of performance" is defined as the direct costs determined in
5 a manner consistent with generally accepted accounting principles and in accordance with accepted
6 conditions of practices in the trade or business of the Appellant. A.C.C. R15-2-1147.2.

7 A.R.S. § 43-1148 allows the Arizona Department of Revenue (the "Department") to employ any
8 other method of apportionment to effectuate an equitable allocation and apportionment of the Appellant's
9 income if the apportionment provisions do not fairly represent the extent of Appellant's business activity in
10 Arizona.

11 The Department audited and accepted Appellants' original Arizona corporate income tax return
12 for the Refund Period. Subsequently, Appellant amended the 1996 return to include in the denominator
13 of the sales factor fraction the gross receipts from the sales of mortgage loans and mortgage loan
14 servicing rights. However, Appellant did not source to Arizona (i.e., include in the numerator of the
15 Arizona sales factor) any of its revenue from these sales on the amended return. This methodology
16 increased the denominator of the sales factor by 50%, thereby significantly reducing the sales factor and
17 resulting in a refund request of \$88,800 plus interest. The Department denied the refund request, and
18 Appellant now timely appeals to the Board.

19 DISCUSSION

20 The issue before the Board is whether Appellant may (1) include in the denominator of its Arizona
21 sales factor fraction the dollar value associated with the disposition of mortgages and servicing rights on
22 the secondary mortgage market and (2) exclude from the numerator of its Arizona sales factor fraction all
23 net gains recognized from such disposition.

24 Appellant maintains that the sale of mortgage loans on the secondary market and the sale of
25 mortgage loan servicing rights are distinct "income producing activities" comprising a separate business
conducted by a separate legal entity (HomeAmerican) and performed independent from Appellant's
homebuilding business. Because these activities are engaged in for the "ultimate purpose of obtaining

1 gains and profits," Appellant argues that the gross receipts derived from the sales must be included in the
2 denominator of Appellant's sales factor fraction under the Department's own rule. A.A.C. R15-2-1147.1.

3 The Department argues that the context of a transaction must be considered in determining
4 whether a true "sale" actually occurred. A.R.S. § 43-1131; *Walgreen v. Arizona Dep't of Rev.*, ____ Ariz.
5 ____, 97 P.3d 896 (App. 2004).

6 When Appellant sells a home, the sales price, which includes the principal value of the mortgage,
7 as well as origination fees, etc., is included as gross receipts in the sales factor fraction of the
8 apportionment formula. When Appellant disposes of its mortgages to third parties on the secondary
9 market fifteen to forty-five days later, the resulting *gain* on these transactions constitutes gross receipts to
10 be included in the sales factor denominator. However, the amount of the transaction representing the
11 principal value of the mortgage is merely a return of principal and should not be included in the sales
12 factor a second time, according to the Department. The Board agrees.

13 In this case, including the return of principal in the sales factor denominator does not fairly
14 represent Appellant's business activity in Arizona and defeats the purpose of the apportionment formula.
15 Therefore, the board finds that, on these transactions, the context requires that the term "sales" only
16 includes any gain or profit on the disposition of the mortgages -- not the return of principal.

17 Appellant next argues that the revenue from the subsequent sale of its mortgages and their
18 servicing rights should be excluded from the numerator of the Arizona sales factor fraction because the
19 income producing activities are conducted exclusively in Colorado.

20 Again, Appellant relies on the argument that the sale of mortgage loans and servicing rights are
21 separate and distinct income producing activities. The Board is not persuaded.

22 Appellant is a unitary business. The fact that the sale of its Arizona mortgage loans and servicing
23 rights on the secondary market usually results in no gain suggests that these activities serve to support
24 mortgage originations which in turn supports Appellant's business of selling homes. Merely obtaining
25 funds to conduct business is not a separate income producing activity. *See, Walter E. Heller Western,
Inc. v. Arizona Dep't of Rev.* 161 Ariz. 49, 775 P.2d 1113 (1989).

The return of principal resulting from the sales at issue should be excluded from the numerator
(just as it should be excluded from the denominator). But any gains that are realized on mortgages

1 backed by Arizona properties and any sales originating from sales activities in Arizona (whether or not the
2 sale actually consummated in Arizona) belong in the numerator of the sales factor. *Id.* ("[T]he sales
3 allocation was governed by where the selling activities, i.e., the interaction between the buyer and seller
4 leading to the sale, took place. Those activities involve soliciting and entering into the business
5 transaction rather than consummating it.")

6 Appellant has not provided sufficient evidence supporting their contention that the apportionment
7 formula as applied by the Department unfairly reflects its business activity in Arizona. For the foregoing
8 reasons, the Board finds that Appellant is not entitled to the refund requested.

9 CONCLUSIONS OF LAW

10 1. Appellant may not include in the denominator of its Arizona sales factor fraction the dollar
11 value associated with the disposition of mortgages and servicing rights on the secondary mortgage
12 market. See A.R.S. § 43-1131; see also *Walgreen v. Arizona Dep't of Rev.*, ___ Ariz. ___, 97 P.3d 896
(App. 2004).

13 2. Appellant may not exclude from the numerator of its Arizona sales factor fraction all net gains
14 recognized from the disposition of mortgages and servicing rights on the secondary mortgage market.
15 See A.R.S. § 43-102(A)(5); A.R.S. §§ 43-1131 *et. seq.*; see also, *Walter E. Heller Western, Inc. v.*
16 *Arizona Dep't of Rev.* 161 Ariz. 49, 775 P.2d 1113 (1989).

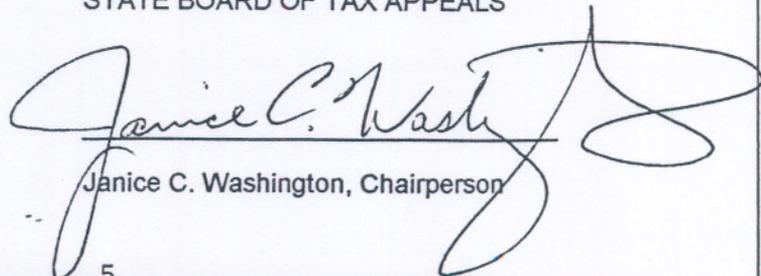
17 ORDER

18 THEREFORE, IT IS HEREBY ORDERED that the appeal is denied, and the final order of the
19 Department is affirmed.

20 This decision becomes final upon the expiration of thirty (30) days from receipt by the taxpayer,
21 unless either the State or taxpayer brings an action in superior court as provided in A.R.S. § 42-1254.

22 DATED this 24th day of May, 2005

23 STATE BOARD OF TAX APPEALS

24 
25 Janice C. Washington, Chairperson

1 JCW: ALW

2 CERTIFIED

3 Copies of the foregoing
Mailed or delivered to:

4 Patrick Derdenger
5 Randal T. Evans
6 Steptoe & Johnson LLP
7 Collier Center
8 201 East Washington Street, Suite 1600
9 Phoenix, Arizona 85004-2382

10 Elizabeth S. Hill
11 Assistant Attorney General
12 Civil Division, Tax Section
13 1275 West Washington Street
14 Phoenix, Arizona 85007

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