MULTISTATE TAX COMMISSION

Report of the Hearing Officer Regarding Proposed Amendments to the Formula for the Apportionment and Allocation of Net Income of Financial Institutions
July 2014

I. Procedural Summary

A. Development of the Proposal

Financial institutions are excluded from UDITPA, and thus from Article IV. The Commission began a project to develop a uniform model financial institutions apportionment rule in 1970, just three years after the Commission was created, but that project was eventually abandoned. The Commission then took up the project again in the mid-1980's, and it proceeded very slowly due to the complexity of the issues and serious conceptual disagreements between the state and industry representatives. But, nearly 10 years later, after creating an elaborate system of industry/state workgroups which met regularly in person as well as by telephone, the current rule was adopted in 1994.

This project began in 2007. The work group charged with reexamining the Commission's 1994 model statute in light of the dramatic changes in the financial industry recommended amendments to the subcommittee. These changes in the industry were caused both by deregulation as a result of the repeal of Glass-Steagall, and by technological innovations. Together these changes allow financial institutions to provide a full range of services, such as mortgage loan and credit card application processing, credit approval and account servicing -- in many cases entirely online.

The work group consisted of representatives of MTC member states and of the financial industry.[1] Meeting regularly by teleconference, the work group has worked to update three aspects of the current rule: (1) the definition of a financial institution, (2) the sourcing of financial institutions specific receipts in the sales factor, and (3) the sourcing of financial institutions loans in the property factor.

After initially identifying several issues regarding the application of the property factor to financial institutions,[2] the work group turned its attention to definitional issues and refining the receipts factor. The work group completed its work on definitions and the receipts factor in 2011 and then returned to consideration of the property factor. The work group completed its work on the project in December 2013 and the Uniformity Committee approved the model as drafted by the work group, on December 11, 2013. The Executive Committee approved the model for public hearing on May 8, 2014.

II. Summary of Proposal

A. Definitions

In the current model, the definition of "financial institution" is grounded in the institution that provides financial services, rather than on the nature of the activities in which that institution engages. That definition includes entities (other than an insurance company, real estate broker, or securities dealer) that derive more than 50% of their gross income form activities that a financial institution is authorized to transact. Ultimately, the work group recommended retaining the existing definition of "financial institution" in the current model.

B. The Receipts Factor

The state members of the work group defined their overarching goal for the receipts factor to be that it reflect the market, rather than the production state.

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[1] A list of the members of the work group is attached hereto as an appendix. The Hearing Officer wishes to thank the members of the work group, both state representatives and representatives of industry, for their participation over the extended history of this project.

[2] These issues largely revolved around whether reliance on the SINAA (sourcing, investigation, negotiation, approval and administration) factors for sourcing loans in the property factor is administrable and if not, how they should be modified or replaced.

This is consistent with a more general trend among the states to source receipts from sales of services and intangible property to the market. Industry defined its goals to be: (1) inclusion of a receipt in a state's sales factor numerator such that the sum of all state numerators should not exceed 100% of the denominator, (2) current receipt sourcing should not be changed if doing so would immediately result in double taxation, (3) receipts from services should be sourced in the same manner that such receipts are sourced for non-financial organizations, (4) incidental receipts should NOT be changed to market sourcing, (5) all receipts should be included in the denominator of the receipts factor, (6) sourcing methods should be practical, not overly burdensome and readily available without programming changes, and (7) no revisions should be considered that cannot likely achieve actual adoption in a majority of states, since adoption by only a few states of the approximately 20 that have adopted the current MTC model would create an environment that is less consistent and uniform than exists today.

The work group recommended the following revisions to the receipts factor. Unless otherwise indicated, the citations are to the current model.

1. ATM Fees, §3(k)

This is a new section designed to source ATM receipts to the location of the machines in order to better reflect the market. Industry representatives conceded to this recommendation, notwithstanding that it will likely result in more than 100% of total ATM fees being included in the combined state factor numerators and will also result in immediate double taxation for institutions where the processing activity is located in states that apply a greater cost of performance (COP) sourcing rule. Industry acquiesced because the information on ATM location is readily available and the relative percentages of fees are small.

2. Merchant Discount, §3(j)

The working group recommended that merchant discount receipts be sourced to the location of the merchant, if the financial institution has readily available information as to that location. Otherwise, merchant discount receipts should be sourced based on the ratio used to source interest and fees from credit, debit or other customer card receivables.

3. Receipts From Investment and Trading Assets and Activities, §3(m)

The work group recommended that the rule be clarified to explicitly state that these receipts include income from investment and trading assets as reflected on the financial institution's call report or similar regulatory report or that would be required to be reported on such report if the taxpayer were a regulated financial institution.

4. Receipts From Investment and Trading Assets and Activities on Behalf of Third Party, §3(l)[3]

As is currently the case with receipts from ATM fees, these receipts currently fall under the rule of unspecified service receipts (§3(l)), which are sourced based on the greater cost of performance. The state members of the work group recommended sourcing these receipts under new section 3(m), which would source them as receipts from services that are not otherwise apportioned in accordance with Reg. IV.17 of the Multistate Tax Commission Allocation and Apportionment Regulations.[4] Industry preferred maintaining the existing sourcing rules which would retain COP sourcing. Industry believes the proposed change to market sourcing will result in immediate double taxation, be burdensome and require significant programming. In the alternative, industry would prefer that such receipts be sourced in the same manner as such receipts are sourced for non-financial organizations in order for there to be a level playing field. As a compromise, ultimately the state members proposed two alternative options for the states to consider. The first would source these receipts in accordance with Reg. IV.17. The second option would have the states source these receipts as they currently do. This issue is discussed in greater detail below, as part of the Hearing Officer's response to the financial institutions' written comments.

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[3] These receipts would include, but not necessarily be limited to, receipts from trust accounts.

[4] Currently, Section 17 sources receipts from services and intangibles based on COP. However, the Commission is engaged in revising Section 17 such that these services would be sourced to the market. The model has been submitted to the states under Bylaw 7 and a majority of affected states have indicated they will consider adopting it. The model will be presented to the Commission on July 31, 2014, for final approval and recommendation that the states adopt it. The financial institutions model is written with the assumption that a large number of states will adopt market-based sourcing under Section 17. But it must be noted that Section 17 is currently in a state of transition.

5. Non-Specified Service Receipts, Other Non-Specified Receipts, and Attribution of Certain Receipts to Commercial Domicile, §§3(l), (n) and (o).

Under current section 3(l) receipts from non-specified service receipts are sourced using COP. The state members of the work group recommended sourcing them in accordance with Reg. IV.17 of the MTC Apportionment Regulations and eliminating section 3(l). Industry does not agree and would retain COP sourcing, at least if these receipts fall below a certain percentage of receipts or, alternatively, source these receipts in the same manner as such receipts are sourced for non-financial organizations (i.e., expanding current (n) to include other services). Industry believes that the move to market based sourcing combined with removing loans from the property factor will result in an increase in its apportionment percentages in market states such that industry should not also have to incur the costs of accounting for the receipts of non-specified services if the overall percentage of such receipts is small.

The state members of the work group proposed retaining current sections 3(n) and (o) -- renumbered as 3(o) and (p) – for other receipts and for the attribution of certain receipts to the commercial domicile.

D. The Property Factor

In May 2009, the work group articulated the state member goals regarding the property factor. As stated in a staff memo of May 22, 2009 to the work group, the state members' "intent is not to recreate the 1994 apportionment outcome of sourcing property to particular states. Rather, the intent is to attempt to maintain the 1994 policy of sourcing property to location of loan activity." Participating industry members take the position that this goal can best be achieved by modifying the so-called SINAA factors (solicitation, investigation, negotiation, approval and administration) so as to eliminate solicitation as a factor in locating loans in the property factor and retaining the remaining four factors (INAA).

Originally, the work group explored various options to retain loans in the property factor. After the work group renewed its focus on the property factor in 2011, the issues the work group examined were (1) should the apportionment formula

for financial institutions continue to include a property factor, (2) if so, should loans continue to be included in the property factor in light of current electronic banking practices, (3) and if so, how – and if there is no good way to do so, should – we reconsider including loans, or a property factor at all? [5]

As the work group continued its teleconferences in 2012 and 2013, the state members increasingly raised concerns similar to those associated with sourcing any intangible property, and began to consider that it may not be possible to properly reflect loans in the financial institution's property factor. The state members therefore reconsidered whether the property factor should be eliminated entirely or alternatively, whether loans should be excluded from the property factor. Participating industry members are of the view that the property factor should be retained and that the need for including loans in the property factor for financial institutions is supported by case law. *Crocker Equipment Leasing, Inc. v. Department of Reve*nue*,* 838 P.2d 552 (OR 1992).

At its July 2013 meeting, the MTC Uniformity Committee, Income and Franchise Tax Subcommittee voted to recommend that loans be removed from the property factor.

III. Public Hearing

After more than 30 days' notice to the public and interested parties, a public hearing was held on June 23, 2014 in Washington, DC.[6] Written public comments were submitted by certain Participating Financial Institutions as prepared by Karen Boucher of Deloitte Tax.[7]

A. Summary of Written Comments and Hearing Officer's Response

The numbered, bold headings that follow are taken verbatim from the headings in the financial institutions' written comments. The Hearing Officer's response follows a summary of each numbered item.

1. Maintain Focus on the Goals of Original Model Apportionment Drafters

[5] Loan receipts are of course included in the receipts factor in the current model.
[6] A copy of the Notice of Public Hearing and proposed model regulation is attached hereto as Exhibit A.
[7] A copy of the Participating Financial Institutions written comments is attached hereto as Exhibit B.

The Participating Financial Institutions note that the overall goals of the original MTC model financial institution apportionment regulation were that the resulting model should be:

1) fair in approach,
2) administrable, and
3) adopted and applied consistently in a majority of states.

One may presume that the Commission and its member states would agree that these are appropriate goals of any MTC uniformity project, including this one. But the participating financial institutions' proposed solution to accomplishing these goals is not realistic. They propose that the model should not become effective in any state until at least 50% of the states that currently have similar apportionment provisions adopt the amendments. The state members of the work group responded to industry's concerns about the costs of changing systems to comply with the new regulations by deferring the effective date of the model to tax years that begin on or after January 1, 2016. That date is not carved in stone. Should the Executive Committee wish to further delay the effective date, doing so is certainly feasible. But to indefinitely postpone the effective date based on enactment by 50% of states with similar apportionment provisions will not necessarily further the goal of ultimately achieving uniformity.

2. Any Amendments for the Current Provision Require Safeguards to Not Source More than 100% of Income

The participating financial institutions are fearful that the current draft of the model, if adopted, will result in multiple taxation because some states will source receipts using a market approach while others will source the receipts to their state under a cost of performance (COP) approach. But that same possibility of disuniformity exists now, both because states that source receipts based on cost of performance do not necessarily do so uniformly and because some states currently use a market approach to sourcing receipts. For example, the District of Columbia sources the receipts of financial institutions from sales other than sales of tangible personal property to the jurisdiction where the greater proportion of the income-producing activity is performed than in any other state, based on cost

of performance. DC ST §47-1810.02(g)(3)(B). Kentucky also utilizes cost of performance to source financial institution receipts but does so by means of a formula that focuses exclusively on offices located in Kentucky and elsewhere through which loans or other receipt sources are negotiated. KRS 41.120(10)(b), 103 KAR 16:150, Section 2. On the other hand, Illinois sources financial institution receipts to the market. 35 ILCA 5/304(c)(3). If anything, the adoption of the model would be expected to serve to reduce disuniformity rather than to increase it. More broadly, the overall trend of sourcing receipts from services or intangible property under UDITPA is to source to the market.[8] There appears to be no sound conceptual reason why similar receipts of financial institutions should not be similarly sourced.

3. Incidental Receipts Should NOT be Changed to Market Sourcing

The participating financial institutions note that the costs of determining the market for numerous categories of small receipt streams can be very costly, such that the effort may well not be cost-effective either for the taxpayer or for the states. Therefore, the financial institutions propose a *de minimis* exception to sourcing minimal revenue streams to the market. The proposal is to source any category of incidental receipts listed in renumbered Section 3(m) below some small percentage of total receipts (i.e., less than 1 or 2 percent) using the current methodology or using the same percentage as all other receipts.

This proposal was discussed in the work group. Some state representatives felt that this would establish a precedent for other industries under UDITPA. The Hearing Officer believes that sourcing incidental receipts using the current methodology is not theoretically justified as the result in many jurisdictions would be to retain COP sourcing precisely for the smallest revenue streams. However, sourcing incidental receipts below a defined percentage of total revenue as other receipts are sourced does not do violence to market sourcing principles and may well reduce the costs of administration and compliance both for industry and for the states. The Hearing Officer therefore recommends a de minimis exception for incidental receipts that fall below a threshold of 1% of total receipts. The attached draft includes the Hearing Officer's suggested language.

[8] The following states have adopted market-based sourcing for receipts from services and/or intangible property under UDITPA: Alabama; Arizona; California; Georgia; Illinois; Iowa; Maine; Maryland; Massachusetts: Michigan; Minnesota; Nebraska; Ohio; Oklahoma; Pennsylvania; Utah; Washington; and Wisconsin.

4. The Inverse of Uniformity is to Permit the States to Pick Among Options When the Desire for the Options is not Based on Administrative Cost or Incidental Amounts.

The financial institutions note that proposed Section 3 (m) sets forth two alternative options for sourcing receipts not otherwise apportioned under Section 3.

> Alternative Option A. The numerator of the receipts factor includes receipts from services not otherwise apportioned under this section, which receipts shall be sourced in accordance with Reg. IV.17 of the Multistate Tax Commission Allocation and Apportionment Regulations, as amended.
>
> Alternative Option B. Delete this proposed Section 3 (m).

Should a state opt not to adopt proposed Section 3 (m),[9] sourcing this category of receipts would default to Section 3(o), which provides;

> (o) **All other receipts.** The numerator of the receipts factor includes all other receipts pursuant to the rules set forth in [insert your state's regular situsing rules for the receipts rules for the receipts not covered by this section].

The financial institutions note that to the extent states choose not to adopt Section 3(m), the effect of Section 3(o) will be to increase disuniformity among the states. The financial institutions are not entirely incorrect in their analysis. But the resulting disuniformity is more the result of the fact that this project is occurring at a time when the states are shifting from COP to market-based sourcing than it is due to Option B itself.

At the present time, Section 17 sourcing is still based on COP. But as noted above, proposed model Section 17 will be based on market based sourcing. It may well take some years for the states to adopt proposed Section 17 in general

[9] The Hearing Officer finds the word "delete" not to be entirely accurate in Section 3(m). The Hearing Officer recognizes that the alternatives are drafted as notes to the state draftsperson and that therefore the word is appropriate for that purpose. More broadly, if a State chooses not to adopt alternative option A, that state would not be "deleting" Section 3(m). It would simply not adopt any Section 3(m) at all.

and these financial institution regulations specifically. The intent behind Section 3(m) was to require market based sourcing. In the transitional period in which the states and taxpayers currently find themselves, simply requiring sourcing based on Section 17 would *itself* have produced disuniform results. The option not to include Section 3(m) allows a state to require its own sourcing rule, be it market based or COP, during this transitional period.[10]

5. Bait and Switch?

The financial institutions express their disappointment that the state members of the work group ultimately recommended dropping loans from the property factor, notwithstanding that the group's original goal had been to retain loans in the property factor.

The issue of whether to retain loans in the property factor and, if so, how the SINAA factors could or should be modified took up by far the greatest time and effort in the work group's discussion of revisions to the model. The state representatives ultimately concluded that revising application of the SINAA factors so that some version of those factors would allow for an accurate, predictable and easily administrable method of sourcing loans would likely prove unfeasible. In addition, the state representatives concluded that, in most cases, the location of a financial institution's real and tangible property would reflect the location of economic activity associated with the institution's loans. In July 2013, the Income and Franchise Tax Subcommittee directed the work group to "move forward with the approach of the property factor being real and tangible personal property and eliminating any aspect of SINAA from the property factor." The participating financial institutions continue to maintain that a modified version of SINAA, perhaps eliminating solicitation, is workable and that loans should therefore be retained in the property factor. Nevertheless, after fully considering the feasibility of doing so, the state members of the work group drafted language limiting the property factor to real and tangible property as requested by the Subcommittee. At its December 2013 meeting, the Uniformity Committee approved the new model.

6. Wood Miller's May 8, 2014 Letter (sic) to the MTC Executive Committee

[10] As noted above, even a COP sourcing rule can produce disuniform results, as the states do not use uniform COP sourcing principles.

The Hearing Officer notes that the participating financial institutions question the accuracy of certain statements in Mr. Miller's May 8, 2014 memo to the Executive Committee. At this point, the Hearing Officer doesn't see any value in debating the accuracy of those statements and simply acknowledges the financial institutions' objections. The Hearing Officer has tried to describe the model's provisions as accurately as possible in this report.

7. Effective Date of Revisions

As noted by industry, the proposed effective date for the model is tax years beginning on or after January 1, 2016. See "effective date" note following Section 5 (Payroll Factor) discussion.

<u>Hearing Officer Recommendation</u>

The Hearing Officer recommends that the proposed model regulation be adopted as modified.

Respectfully submitted,

Sheldon H. Laskin
Hearing Officer

Appendix

Work Group Members

State Representatives

Lennie Collins, Chair (NC)
Chris Coffman (WA)
Phil Horwitz (CO)
Deborah Liebman (NY)
Jessica Lesczinski (NY)
Michael Fatale (MA)
Amy Gill (PA)
Marilyn Harbur (OR)
Helen Armstrong (AZ)
Jennifer Hays (KY)
Carl Joseph (until 2012) (CA)
Lee Baerlocher (MT)
Brian Staley (MT)
Gene Walborn (MT)
Matt Peyerl (ND)
Donnita Wald (ND)
Mike Boekhaus (KS)
Phil Skinner (ID)

Public Representatives (organizations are for identification purposes only. This list is not necessarily all inclusive. Not all members of the public identified themselves on conference calls. The Hearing Officer has compiled the list from emails exchanged during the course of the project.)

Dawn Justice (Idaho Bankers Association)
Eric J. Coffill (Morrison Foerster)
Ferdinand Hogroian (Council on State Taxation)
Fran Mordi (American Bankers Association)
Jeff Friedman (Sutherland Asbill & Brennan)
Karen Boucher (Deloitte Tax)
Karen Nakamara (Price Waterhouse Coopers)
Marc Simonetti (Sutherland Asbill & Brennan)

Nancy Lancia (Securities Industry and Financial Markets Association)
Rebecca Paulsen (US Bank)
Todd Lard (Sutherland Asbill & Brennan)
Jeffrey Serether (Ernst & Young)

EXHIBIT A

MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

NOTICE OF PUBLIC HEARING

PROPOSED
DRAFT AMENDMENTS, FORMULA FOR THE APPORTIONMENT AND ALLOCATION OF NET INCOME OF FINANCIAL INSTITUTIONS

MONDAY, JUNE 23, 2014
10:00 A.M. EASTERN
Hall of the States, Room 231
444 North Capitol Street, N.W.
Washington, DC

The proposed model is available at:

http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Events/2013-14_Committee_Meetings/Exhibit%202%20DRAFT%20FI%20Apportionment%20Amendments%20(12-5-2013).pdf

To participate by telephone, dial 888-809-4012 passcode 663672.

Sheldon Laskin, MTC counsel, will serve as hearing officer. Persons making an oral presentation are requested to file written comments in addition to their oral presentation. ***It is requested that written comments be sent to Loretta King no later than Friday, June 13, 2014.*** The comments may be sent by email to lking@mtc.gov , or by U.S. Mail to

Loretta King
Multistate Tax Commission,
444 N. Capitol Street, N.W., Suite 425,
Washington, D.C. 20001-1538

For more information regarding this hearing, please contact Mr. Laskin at (410) 484 – 2790 or at slaskin@mtc.gov.

MULTISTATE TAX COMMISSION

Maximizing the synergies of multi-state tax cooperation

DRAFT AMENDMENTS

Formula for the Apportionment and Allocation of Net Income of Financial Institutions

December 5, 2013

With suggested modification by the Hearing Officer

Section 1. Apportionment and Allocation.

(a) Except as otherwise specifically provided, a financial institution whose business activity is taxable both within and without this state shall allocate and apportion its net income as provided in this [Act]. All items of nonbusiness income (income which is not includable in the apportionable income tax base) shall be allocated pursuant to the provisions of [ ]. A financial institution organized under the laws of a foreign country, the Commonwealth of Puerto Rico, or a territory or possession of the United States whose effectively connected income (as defined under the Federal Internal Revenue Code) is taxable both within this state and within another state, other than the state in which it is organized, shall allocate and apportion its net income as provided in this [Act].

(b) All business income (income which is includable in the apportionable income tax base) shall be apportioned to this state by multiplying such income by the apportionment percentage. The apportionment percentage is determined by adding the taxpayer's receipts factor (as described in Section 3 of this article), property factor (as described in Section 4 of this article), and payroll factor (as described in Section 5 of this article) together and dividing the sum by three. If one of the factors is missing, the two remaining factors are added and the sum is divided by two. If two of the factors are missing, the remaining factor is the apportionment percentage. A factor is missing if both its numerator and denominator are zero, but it is not missing merely because its numerator is zero.

(c) Each factor shall be computed according to the method of accounting (cash or accrual basis) used by the taxpayer for the taxable year.

(d) If the allocation and apportionment provisions of this [Act] do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [State

Tax Administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(1) separate accounting;

(2) the exclusion of any one or more of the factors,

(3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or

(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Section 2. Definitions.

As used in this [Act], unless the context otherwise requires:

(a) "**Billing address**" means the location indicated in the books and records of the taxpayer on the first day of the taxable year (or on such later date in the taxable year when the customer relationship began) as the address where any notice, statement and/or bill relating to a customer's account is mailed.

(b) "**Borrower or credit card holder located in this state**" means:

(1) a borrower, other than a credit card holder, that is engaged in a trade or business which maintains its commercial domicile in this state; or
(2) a borrower that is not engaged in a trade or business or a credit card holder whose billing address is in this state.

(c) "**Card issuer's reimbursement fee**" means the fee a taxpayer receives from a merchant's bank because one of the persons to whom the taxpayer has issued a credit, debit, or similar type of card has charged merchandise or services to the card.

(d) "**Commercial domicile**" means:

(1) the headquarters of the trade or business, that is, the place from which the trade or business is principally managed and directed; or
(2) if a taxpayer is organized under the laws of a foreign country, or of the Commonwealth of Puerto Rico, or any territory or possession of the United States, such taxpayer's commercial domicile shall be deemed for the purposes of this [Act] to be the state of the United States or the District of Columbia from which such taxpayer's trade or business in the United States is principally managed and directed. It shall be presumed, subject to rebuttal, that the location

from which the taxpayer's trade or business is principally managed and directed is the state of the United States or the District of Columbia to which the greatest number of employees are regularly connected or out of which they are working, irrespective of where the services of such employees are performed, as of the last day of the taxable year.

(e) "**Compensation**" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services that are included in such employee's gross income under the Federal Internal Revenue Code. In the case of employees not subject to the Federal Internal Revenue Code, e.g., those employed in foreign countries, the determination of whether such payments would constitute gross income to such employees under the Federal Internal Revenue Code shall be made as though such employees were subject to the Federal Internal Revenue Code.

(f) "**Credit card**" means a card, or other means of providing information, that entitles the holder to charge the cost of purchases, or a cash advance, against a line of credit.

(f) "

(g) **"Debit card"** means a card, or other means of providing information, that enables the holder to charge the cost of purchases, or a cash withdrawal, against the holder's bank account or a remaining balance on the card.

(h) "**Employee**" means, with respect to a particular taxpayer, any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee of that taxpayer.

(i) "**Financial institution**" means: [insert state's definition here][*for a starting point for the development of a definition, see Appendix A*]

(j) "**Gross rents**" means the actual sum of money or other consideration payable for the use or possession of property. "Gross rents" shall include, but not be limited to:

(1) any amount payable for the use or possession of real property or tangible property whether designated as a fixed sum of money or as a percentage of receipts, profits or otherwise,
(2) any amount payable as additional rent or in lieu of rent, such as interest, taxes, insurance, repairs or any other amount required to be paid by the terms of a lease or other arrangement, and
(3) a proportionate part of the cost of any improvement to real property made by or on behalf of the taxpayer which reverts to the owner or lessor upon termination

of a lease or other arrangement. The amount to be included in gross rents is the amount of amortization or depreciation allowed in computing the taxable income base for the taxable year. However, where a building is erected on leased land by or on behalf of the taxpayer, the value of the land is determined by multiplying the gross rent by eight and the value of the building is determined in the same manner as if owned by the taxpayer.

(4) The following are not included in the term "gross rents":

(A) reasonable amounts payable as separate charges for water and electric service furnished by the lessor;

(B) reasonable amounts payable as service charges for janitorial services furnished by the lessor;

(C) reasonable amounts payable for storage, provided such amounts are payable for space not designated and not under the control of the taxpayer; and

(D) that portion of any rental payment which is applicable to the space subleased from the taxpayer and not used by it.

(k) "**Loan**" means any extension of credit resulting from direct negotiations between the taxpayer and its customer, and/or the purchase, in whole or in part, of such extension of credit from another. Loans include participations, syndications, and leases treated as loans for federal income tax purposes. Loans shall not include: futures or forward contracts; options; notional principal contracts such as swaps; credit card receivables, including purchased credit card relationships; non-interest bearing balances due from depository institutions; cash items in the process of collection; federal funds sold; securities purchased under agreements to resell; assets held in a trading account; securities; interests in a REMIC, or other mortgage-backed or asset-backed security; and other similar items.

(l) "**Loan secured by real property"** means that fifty percent or more of the aggregate value of the collateral used to secure a loan or other obligation, when valued at fair market value as of the time the original loan or obligation was incurred, was real property.

(m) "**Merchant discount**" means the fee (or negotiated discount) charged to a merchant by the taxpayer for the privilege of participating in a program whereby a credit, debit, or similar type of card is accepted in payment for merchandise or services sold to the card holder, <u>net of any cardholder charge-back and unreduced by any interchange transaction or issuer reimbursement fee paid to another for charges or purchases made its cardholder</u>.

(n)"**Participation**" means an extension of credit in which an undivided ownership interest is held on a *pro rata* basis in a single loan or pool of loans and related collateral. In a loan participation, the credit originator initially makes the loan and then subsequently resells all or a portion of it to other lenders. The participation may or may not be known to the borrower.

(o) "**Person**" means an individual, estate, trust, partnership, corporation and any other business entity.

(p) "**Principal base of operations**" with respect to transportation property means the place of more or less permanent nature from which said property is regularly directed or controlled. With respect to an employee, the "principal base of operations" means the place of more or less permanent nature from which the employee regularly (1) starts his or her work and to which he or she customarily returns in order to receive instructions from his or her employer or (2) communicates with his or her customers or other persons, or (3) performs any other functions necessary to the exercise of his or her trade or profession at some other point or points.

(q) "**Real property owned**" and "**tangible personal property owned**" mean real and tangible personal property, respectively, (1) on which the taxpayer may claim depreciation for federal income tax purposes, or (2) property to which the taxpayer holds legal title and on which no other person may claim depreciation for federal income tax purposes (or could claim depreciation if subject to federal income tax). Real and tangible personal property do not include coin, currency, or property acquired in lieu of or pursuant to a foreclosure.

(r) "**Regular place of business**" means an office at which the taxpayer carries on its business in a regular and systematic manner and which is continuously maintained, occupied and used by employees of the taxpayer.

(s) "**State**" means a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States or any foreign country.

(t) "**Syndication**" means an extension of credit in which two or more persons fund and each person is at risk only up to a specified percentage of the total extension of credit or up to a specified dollar amount.

(u) "**Taxable**" means either:

(1) that a taxpayer is subject in another state to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, a corporate stock tax (including a bank shares tax), a single business tax, or an earned surplus tax, or

any tax which is imposed upon or measured by gross or net income; or

(2) that another state has jurisdiction to subject the taxpayer to any of such taxes regardless of whether, in fact, the state does or does not.

(v) "**Transportation property**" means vehicles and vessels capable of moving under their own power, such as aircraft, trains, water vessels and motor vehicles, as well as any equipment or containers attached to such property, such as rolling stock, barges, trailers or the like.

Section 3. Receipts Factor.

(a) **General**. The receipts factor is a fraction, the numerator of which is the receipts of the taxpayer in this state during the taxable year and the denominator of which is the receipts of the taxpayer within and without this state during the taxable year. The method of calculating receipts for purposes of the denominator is the same as the method used in determining receipts for purposes of the numerator. The receipts factor shall include only those receipts described herein which constitute business income and are included in the computation of the apportionable income base for the taxable year.

(b) **Receipts from the lease of real property**. The numerator of the receipts factor includes receipts from the lease or rental of real property owned by the taxpayer if the property is located within this state or receipts from the sublease of real property if the property is located within this state.

(c) **Receipts from the lease of tangible personal property**.

(1) Except as described in paragraph (2) of this subsection, the numerator of the receipts factor includes receipts from the lease or rental of tangible personal property owned by the taxpayer if the property is located within this state when it is first placed in service by the lessee.
(2) Receipts from the lease or rental of transportation property owned by the taxpayer are included in the numerator of the receipts factor to the extent that the property is used in this state. The extent an aircraft will be deemed to be used in this state and the amount of receipts that is to be included in the numerator of this state's receipts factor is determined by multiplying all the receipts from the lease or rental of the aircraft by a fraction, the numerator of which is the number of landings of the aircraft in this state and the denominator of which is the total number of landings of the aircraft. If the extent of the use of

any transportation property within this state cannot be determined, then the property will be deemed to be used wholly in the state in which the property has its principal base of operations. A motor vehicle will be deemed to be used wholly in the state in which it is registered.

(d) **Interest, fees and penalties imposed in connection with loans** secured **by real property**.

(1) The numerator of the receipts factor includes interest, fees, and penalties imposed in connection with loans secured by real property if the property is located within this state. If the property is located both within this state and one or more other states, the receipts described in this subsection are included in the numerator of the receipts factor if more than fifty percent of the fair market value of the real property is located within this state. If more than fifty percent of the fair market value of the real property is not located within any one state, then the receipts described in this subsection shall be included in the numerator of the receipts factor if the borrower is located in this state.
(2) The determination of whether the real property securing a loan is located within this state shall be made as of the time the original agreement was made and any and all subsequent substitutions of collateral shall be disregarded.

(e) **Interest, fees, and penalties imposed in connection with loans not secured by real property**. The numerator of the receipts factor includes interest, fees, and penalties imposed in connection with loans not secured by real property if the borrower is located in this state.

(f) **Net gains from the sale of loans**. The numerator of the receipts factor includes net gains from the sale of loans. Net gains from the sale of loans includes income recorded under the coupon stripping rules of Section 1286 of the Internal Revenue Code.

(1) The amount of net gains (but not less than zero) from the sale of loans secured by real property included in the numerator is determined by multiplying such net gains by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (d) of this section and the denominator of which is the total amount of interest and fees or penalties in the nature of interest from loans secured by real property.
(2) The amount of net gains (but not less than zero) from the sale of loans not secured by real property included in the numerator is determined by multiplying such net gains by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (e) of this section and the denominator of which is the total amount of interest and fees or penalties in the nature of interest from loans not secured by real property.

Receipts from fees, interest, and penalties charged to card holders. The numerator of

the receipts factor includes fees, interest and penalties charged to credit, debit or similar card holders, including but not limited to annual fees and overdraft fees, if the billing address of the card holder is in this state.

(h) **Net gains from the sale of credit card receivables**. The numerator of the receipts factor includes net gains (but not less than zero) from the sale of credit card receivables multiplied by a fraction, the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (g) of this section and the denominator of which is the taxpayer's total amount of interest and fees or penalties in the nature of interest from credit card receivables and fees charged to card holders.

(i) **Card issuer's reimbursement fees**. The numerator of the receipts factor includes

(1) all credit card issuer's reimbursement fees multiplied by a fraction, the numerator of which is the amount of fees, interest, and penalties charged to credit card holders included in the numerator of the receipts factor pursuant to subsection (g) of this section and the denominator of which is the taxpayer's total amount of fees, interest, and penalties charged to credit card holders.

(2) all debit card issuer's reimbursement fees multiplied by a fraction, the numerator of which is the amount of fees, interest, and penalties charged to debit card holders included in the numerator of the receipts factor pursuant to subsection (g) of this section and the denominator of which is the taxpayer's total amount of fees, interest, and penalties charged to debit card holders.

(3) all other card issuer's reimbursement fees multiplied by a fraction, the numerator of which is the amount of fees, interest, and penalties charged to all other card holders included in the numerator of the receipts factor pursuant to subsection (g) of this section and the denominator of which is the taxpayer's total amount of fees, interest, and penalties charged to all other card holders

(j) **Receipts from merchant discount**.

If the taxpayer can readily determine the location of the merchant and if the merchant is in this state, the numerator of the receipts factor includes receipts from merchant discount. .

(2) If the taxpayer cannot readily determine the location of the merchant, the numerator of the receipts factor includes such receipts from the merchant discount multiplied by a fraction:

(A) in the case of a merchant discount related to the use of a credit card, the numerator of which is the amount of fees, interest and penalties charged to credit card holders that is included in the numerator of the receipts factor pursuant to subsection (g) of this section and the denominator of which is

the taxpayer's total amount of fees, interest and penalties charged to credit card holders, and

(B) in the case of a merchant discount related to the use of a debit card, the numerator of which is the amount of fees, interest and penalties charged to debit card holders that is included in the numerator of the receipts factor pursuant to subsection (g) of this section, and the denominator of which is the taxpayer's total amount of fees, interest and penalties charged to debit card holders.

(C) in the case of a merchant discount related to the use of all other types of cards, the numerator of which is the amount of fees, interest and penalties charged to all other card holders that is included in the numerator of the receipts factor pursuant to subsection (g) of this section, and the denominator of which is the taxpayer's total amount of fees, interest and penalties charged to all other card holders.

(3) The taxpayer's method for sourcing each receipt from a merchant discount must be consistently applied to such receipt in all states that have adopted sourcing methods substantially similar to subsections (1) and (2) of this section and must be used on all subsequent returns for sourcing receipts from such merchant unless the [State Tax Administrator] permits or requires application of the alternative method.

(k) Receipts from ATM fees. The receipts factor includes all ATM fees that are not forwarded directly to another bank.

(1) The numerator of the receipts factor includes fees charged to a cardholder for the use at an ATM of a card issued by the taxpayer if the cardholder's billing address is in this state.

The numerator of the receipts factor includes fees charged to a cardholder, other than the taxpayer's cardholder, for the use of such card at an ATM owned or rented by the taxpayer, if the ATM is in this state.

(l) **Loan servicing fees**.

(1) (A)The numerator of the receipts factor includes loan servicing fees derived from loans secured by real property multiplied by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (d) of this section and the denominator of which is the total amount of interest and fees or penalties in the nature of interest from loans secured by real property.

(B) The numerator of the receipts factor includes loan servicing fees derived from loans not secured by real property multiplied by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (e) of this section and the denominator of which is the total amount of interest and fees or penalties in the nature of interest from loans not secured by real property.

(2) In circumstances in which the taxpayer receives loan servicing fees for servicing either the secured or the unsecured loans of another, the numerator of the

receipts factor shall include such fees if the borrower is located in this state.

m) **Receipts from services**.

[Note - States should choose one of the following two options for this section:

Alternative Option A. The numerator of the receipts factor includes receipts from services not otherwise apportioned under this section, which receipts shall be sourced in accordance with Reg. IV.17 of the Multistate Tax Commission Allocation and Apportionment Regulations, as amended. In all cases where the sum of the receipts that would otherwise be apportioned pursuant to this Section 3(m) constitutes less than 1% of the taxpayer's total receipts, the taxpayer shall apportion them in the same ratio that it apportions its receipts pursuant to the provisions of Section 3 (a) through (l).

Alternative Option B. Delete this proposed Section 3 (m).]

(n) **Receipts** from **the financial institution's investment assets and activity and trading assets and activity.**

(1) Interest, dividends, net gains (but not less than zero) and other income from investment assets and activities and from trading assets and activities that are reported on the taxpayer's financial statements, call reports, or similar reports shall be included in the receipts factor. Investment assets and activities and trading assets and activities include but are not limited to: investment securities; trading account assets; federal funds; securities purchased and sold under agreements to resell or repurchase; options; futures contracts; forward contracts; notional principal contracts such as swaps; equities; and foreign currency transactions. With respect to the investment and trading assets and activities described in subparagraphs (A) and (B) of this paragraph, the receipts factor shall include the amounts described in such subparagraphs.

(A)The receipts factor shall include the amount by which interest from federal funds sold and securities purchased under resale agreements exceeds interest expense on federal funds purchased and securities sold under repurchase agreements.

(B) The receipts factor shall include the amount by which interest, dividends, gains and other income from trading assets and activities, including but not limited to assets and activities in the matched book, in the arbitrage book, and foreign currency transactions, exceed amounts paid in lieu of interest, amounts paid in lieu of dividends, and losses from such assets and activities.

(2) The numerator of the receipts factor includes interest, dividends, net gains (but not less than zero) and other income from investment assets and activities and from trading assets and activities described in paragraph (1) of this subsection that are attributable to this state.

(A)The amount of interest, dividends, net gains (but not less than zero) and other income from investment assets and activities in the investment account to be attributed to this state and included in the numerator is determined by multiplying all such income from such assets and

activities by a fraction, the numerator of which is the average value of such assets which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the average value of all such assets.

(B) The amount of interest from federal funds sold and purchased and from securities purchased under resale agreements and securities sold under repurchase agreements attributable to this state and included in the numerator is determined by multiplying the amount described in subparagraph (A) of paragraph (1) of this subsection from such funds and such securities by a fraction, the numerator of which is the average value of federal funds sold and securities purchased under agreements to resell which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the average value of all such funds and such securities.

(C) The amount of interest, dividends, gains and other income from trading assets and activities, including but not limited to assets and activities in the matched book, in the arbitrage book and foreign currency transactions (but excluding amounts described in subparagraphs (A) or (B) of this paragraph), attributable to this state and included in the numerator is determined by multiplying the amount described in subparagraph (B) of paragraph (1) of this subsection by a fraction, the numerator of which is the average value of such trading assets which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the average value of all such assets.

(D)For purposes of this paragraph, average value shall be determined using the rules for determining the average value of tangible personal property set forth in subsections (c) and (d) of Section 4.

(3) In lieu of using the method set forth in paragraph (2) of this subsection, the taxpayer may elect, or the [State Tax Administrator] may require in order to fairly represent the business activity of the taxpayer in this state, the use of the method set forth in this paragraph.

(A)The amount of interest, dividends, net gains (but not less than zero) and other income from investment assets and activities in the investment account to be attributed to this state and included in the numerator is determined by multiplying all such income from such assets and activities by a fraction, the numerator of which is the gross income from such assets and activities which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the gross income from all such assets and activities.

(B) The amount of interest from federal funds sold and purchased and from securities purchased under resale agreements and securities sold under repurchase agreements attributable to this state and included in the numerator is determined by multiplying the amount described in subparagraph (A) of paragraph (1) of this subsection from such funds and such securities by a fraction, the numerator of which is the gross

income from such funds and such securities which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the gross income from all such funds and such securities.

(C) The amount of interest, dividends, gains and other income from trading assets and activities, including but not limited to assets and activities in the matched book, in the arbitrage book and foreign currency transactions (but excluding amounts described in subparagraphs (A) or (B) of this paragraph), attributable to this state and included in the numerator is determined by multiplying the amount described in subparagraph (B) of paragraph (1) of this subsection by a fraction, the numerator of which is the gross income from such trading assets and activities which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the gross income from all such assets and activities.

(4) If the taxpayer elects or is required by the [State Tax Administrator] to use the method set forth in paragraph (3) of this subsection, it shall use this method on all subsequent returns unless the taxpayer receives prior permission from the [State Tax Administrator] to use, or the [State Tax Administrator] requires a different method.

(5) The taxpayer shall have the burden of proving that an investment asset or activity or trading asset or activity was properly assigned to a regular place of business outside of this state by demonstrating that the day-to-day decisions regarding the asset or activity occurred at a regular place of business outside this state. Where the day-to-day decisions regarding an investment asset or activity or trading asset or activity occur at more than one regular place of business and one such regular place of business is in this state and one such regular place of business is outside this state, such asset or activity shall be considered to be located at the regular place of business of the taxpayer where the investment or trading policies or guidelines with respect to the asset or activity are established. Unless the taxpayer demonstrates to the contrary, such policies and guidelines shall be presumed to be established at the commercial domicile of the taxpayer.

(o) **All other receipts**. The numerator of the receipts factor includes all other receipts pursuant to the rules set forth in [insert your state's regular situsing rules for the receipts not covered by this section].

(p) **Attribution of certain receipts to commercial domicile**. All receipts which would be assigned under this section to a state in which the taxpayer is not taxable shall be included in the numerator of the receipts factor, if the taxpayer's commercial domicile is in this state.

Section 4. Property Factor.

(a) **General**. The property factor is a fraction, the numerator of which is the average value of real property and tangible personal property rented to the taxpayer that is located or used within this state during the taxable year and the average value of the taxpayer's real and tangible personal property owned that is located or used within this state during the taxable year, , and the denominator of which is the average value of all such property located or used within and without this state during the taxable year.

(b) **Property included**. The property factor shall include only property the income or expenses of which are included (or would have been included if not fully depreciated or expensed, or depreciated or expensed to a nominal amount) in the computation of the apportionable income base for the taxable year.

(c) **Value of property owned by the taxpayer**. The value of real property and tangible personal property owned by the taxpayer is the original cost or other basis of such property for Federal income tax purposes without regard to depletion, depreciation or amortization.

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(d) **Average value of property owned by the taxpayer**. The average value of property owned by the taxpayer is computed on an annual basis by adding the value of the property on the first day of the taxable year and the value on the last day of the taxable year and dividing the sum by two. If averaging on this basis does not properly reflect average value, the [State Tax Administrator] may require averaging on a more frequent basis. The taxpayer may elect to average on a more frequent basis. When averaging on a more frequent basis is required by the [State Tax Administrator] or is elected by the taxpayer, the same method of valuation must be used consistently by the taxpayer with respect to property within and without this state and on all subsequent returns unless the taxpayer receives prior permission from the [State Tax Administrator] or the [State Tax Administrator] requires a different method of determining average value.

(e) **Average value of real property and tangible personal property rented to the taxpayer**.

(1) The average value of real property and tangible personal property that the taxpayer has rented from another and which is not treated as property owned by the taxpayer for Federal income tax purposes, shall be determined annually by multiplying the gross rents payable during the taxable year by eight.
(2) Where the use of the general method described in this subsection results in inaccurate valuations of rented property, any other method which properly

reflects the value may be adopted by the [State Tax Administrator] or by the taxpayer when approved in writing by the [State Tax Administrator]. Once approved, such other method of valuation must be used on all subsequent returns unless the taxpayer receives prior approval from the [State Tax Administrator] or the [State Tax Administrator] requires a different method of valuation.

(f) **Location of real property and tangible personal property owned by or rented to the taxpayer**.

(1) Except as described in paragraph (2) of this subsection, real property and tangible personal property owned by or rented to the taxpayer is considered to be located within this state if it is physically located, situated or used within this state.

(2) Transportation property is included in the numerator of the property factor to the extent that the property is used in this state. The extent an aircraft will be deemed to be used in this state and the amount of value that is to be included in the numerator of this state's property factor is determined by multiplying the average value of the aircraft by a fraction, the numerator of which is the number of landings of the aircraft in this state and the denominator of which is the total number of landings of the aircraft everywhere. If the extent of the use of any transportation property within this state cannot be determined, then the property will be deemed to be used wholly in the state in which the property has its principal base of operations. A motor vehicle will be deemed to be used wholly in the state in which it is registered.

Section 5. Payroll Factor.

(a) **General**. The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the taxable year by the taxpayer for compensation and the denominator of which is the total compensation paid both within and without this state during the taxable year. The payroll factor shall include only that compensation which is included in the computation of the apportionable income tax base for the taxable year.

(b) **Compensation relating to nonbusiness income and independent contractors**. The compensation of any employee for services or activities which are connected with the production of nonbusiness income (income which is not includable in the apportionable income base) and payments made to any independent contractor or any other person not properly classifiable as an employee shall be excluded from both the numerator and denominator of the factor.

(c) **When compensation paid in this state**. Compensation is paid in this state if any one of the following tests, applied consecutively, is met:

(1) The employee's services are performed entirely within this state.
(2) The employee's services are performed both within and without the state, but the service performed without the state is incidental to the employee's service within the state. The term "incidental" means any service which is temporary or transitory in nature, or which is rendered in connection with an isolated transaction.
(3) If the employee's services are performed both within and without this state, the employee's compensation will be attributed to this state:

(A)if the employee's principal base of operations is within this state; or

(B) if there is no principal base of operations in any state in which some part of the services are performed, but the place from which the services are directed or controlled is in this state; or

(C) if the principal base of operations and the place from which the services are directed or controlled are not in any state in which some part of the service is performed but the employee's residence is in this state.

[This Act shall be effective for tax years beginning on and after January 1, 2016]

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Appendix A — Definition of Financial Institution.

The following definition of a financial institution or a variation thereof could be made part of a statutory proposal or could be adopted by regulation if the state legislature has already delegated the authority to do so to the State Tax Administrator or other administrative officer. Again, the following provides a *starting point* for discussion purposes, and the lack of a uniformly adopted definition by all of the states, while affecting competitive balance, is not critical to the main thrust of the apportionment proposal.

"**Financial institution**" means:

(1) Any corporation or other business entity registered under state law as a bank holding company or registered under the Federal Bank Holding Company Act of 1956, as amended, or registered as a savings and loan holding company under the Federal National Housing Act, as amended;

(2) A national bank organized and existing as a national bank association pursuant to the provisions of the National Bank Act, 12 U.S.C. §§21 et seq.;

(3) A savings association or federal savings bank as defined in the Federal Deposit Insurance Act, 12 U.S.C.§ 1813(b)(1);

(4) Any bank or thrift institution incorporated or organized under the laws of any state;

(5) Any corporation organized under the provisions of 12 U.S.C. §§611 to 631.

(6) Any agency or branch of a foreign depository as defined in 12 U.S.C. §3101;

(7) A state credit union the loan assets of which exceed $50,000,000 as of the first day of its taxable year;

(8) A production credit association organized under the Federal Farm Credit Act of 1933, all of whose stock held by the Federal Production Credit Corporation has been retired;

(9) Any corporation whose voting stock is more than fifty percent (50%) owned, directly or indirectly, by any person or business entity described in subsections (1) through (8) above other than an insurance company taxable under [insert applicable state statute] or a company taxable under [insert applicable state statute];

(10) A corporation or other business entity that derives more than fifty percent (50%) of its total gross income for financial accounting purposes from finance leases. For purposes of this subsection, a "finance lease" shall mean any lease transaction which is the functional equivalent of an extension of credit and that transfers substantially all of the benefits and risks incident to the ownership of property. The phrase shall include any "direct financing lease" or

"leverage lease" that meets the criteria of Financial Accounting Standards Board Statement No. 13, "Accounting for Leases" or any other lease that is accounted for as a financing by a lessor under generally accepted accounting principles.

For this classification to apply,

(a) the average of the gross income in the current tax year and immediately preceding two tax years must satisfy the more than fifty percent (50%) requirement; and

(b) gross income from incidental or occasional transactions shall be disregarded;

or

(11) Any other person or business entity, other than [an insurance company taxable under _____], [a real estate broker taxable under _____], [a securities dealer taxable under _____] or [a _____ company taxable under _____],which derives more than fifty percent (50%) of its gross income from activities that a person described in subsections (2) through (8) and (10) above is authorized to transact. For the purpose of this subsection, the computation of gross income shall not include income from non-recurring, extraordinary items.

(12) The [State Tax Administrator] is authorized to exclude any person from the application of subsection (11) upon such person proving, by clear and convincing evidence, that the income-producing activity of such person is not in substantial competition with those persons described in subsections (2) through (8) and (10) above.

EXHIBIT B

Comments from Participating Financial Institutions Regarding Multistate Tax Commission Proposed Amendments to the Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions

When the July 2007 Multistate Tax Commission (MTC) Income/Franchise Tax Uniformity Committee agenda indicated that the committee would be reviewing the Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions ("MTC model industry apportionment provisions"), a group of financial institutions requested that they be allowed to participate in the process -- similar to the manner in which many of them had participated in the development of the original model industry apportionment provisions.

We appreciate the MTC accommodating our request and creating a state-industry working group, with participation being open not only to the requesting institutions, but to the entire industry and the public. Below are our comments on the process, the proposed amendments, and Wood Miller's May 8, 2014 letter to the MTC Executive Committee.

The Process

We valued being at the table during the review of the MTC model industry apportionment provisions. For the record, however, we believe it is important to note that after California FTB representatives discontinued participation, the "working group" qualities deteriorated considerably. Industry could make suggestions and raise issues, but had no vote or meaningful input in decisions that were made. More importantly, many of the participating states exhibited such a high distrust of taxpayers that the majority of our suggestions to make the provisions more administrable were quickly disregarded or rejected without meaningful discussion. There clearly was no give and take – nor could there have been when many of the participating states viewed every industry suggestion as a ploy to deceive the states and cheat them out of revenue. The resulting resistant and at times combative response from the state representatives made the

industry representatives very hesitant to participate, and substantially decreased the collaborative effort of the group that had been working together to draft a solution that was acceptable to all parties. See for example, our January 2011 comments where we ask the states to re-focus on the goals and work with us rather than against us (copy attached).

The Proposed Amendments

Maintain Focus on the Goals of Original Model Apportionment Drafters

The overall goals of the original MTC model financial institution apportionment provision project were that the resulting model be:

1) fair in approach,
2) administrable, and
3) adopted and applied consistently in a majority of states.

We believe that these three facets are critical and thus should remain the goals of any revisions made to the MTC model industry apportionment provisions. While we recognize the states' rights to adopt different apportionment formulas, the overall goal of any revisions to the MTC model industry apportionment provision should be to retain a high level of uniformity. This, ostensibly, was the primary concern of the participating states: that taxpayers could avail themselves of benefits created by variability among states' apportionment methodologies. It strikes us as odd that the represented states are less concerned with uniformity and more concerned with complaining when taxpayers try to comply with the vast array of different laws if their application occasionally works out in some taxpayers' favor.

Currently, there are approximately 20 states that have adopted apportionment provisions similar to the MTC model. We believe that no revisions should be considered that cannot likely achieve actual adoption in a majority of the states. Adoption by only a few of the states would create an environment that is even less consistent and uniform than exists today. Accordingly, the proposed amended model industry apportionment provisions should be modified to require that

the amendments not become effective in any state until at least 50% of the states that currently have similar apportionment provisions adopt the amendments.

Any Amendments to the Current Provisions Require Safeguards to Not Source More than 100% of Income

As noted above, approximately 20 states have adopted provisions similar to the MTC model statute. Proposed revisions to the current apportionment model result in additional streams of income being market sourced and call for the exclusion of loans from the property factor, which also will result in increasing the apportionment percentage for market states. Since these proposed amendments shift a greater percentage to market states and away from production states, it is likely that the market states will adopt the amendments, while the production states will NOT adopt the amendments.

Accordingly, the industry representatives are fearful that the model act, if changed as currently proposed, will result in multiple taxation of certain revenue streams because some states will source the receipts using a market approach, and others will deem the same receipts to be sourced to their state under a cost of performance approach – typically, the larger, money-center states, in which the banks have significant operations. This was the reason for the "compromise" reached in the initial model industry provisions, which recognized both the value of the market and of the operational infrastructure of the bank in generating income for the company. Industry has advocated for some sort of "safe harbor" that could be implemented to prevent this type of double tax situation, and we continue to believe that there should be a mechanism for it.

Incidental Receipts Should NOT be Changed to Market Sourcing

The costs of determining the "market" for numerous small revenue streams and then programing each account to reflect the determined market sourcing can be very costly – both for the taxpayer and for the state. The *de minimus* impact on the overall apportionment factor doesn't justify the cost.

Accordingly, to maintain the "administrable" goal of the model industry apportionment provision, incidental receipts that don't comprise more than some small percentage (1%, 2%, etc.) of total receipts should either be sourced using the current methodology or using the same percentage as all other receipts.

The Inverse of Uniformity is to Permit the States to Pick Among Options When the Desire for the Options is not Based on Administrative Costs or Incidental Amounts

The proposed amendments to the model industry apportionment provisions permit the states to select among two alternative options the manner in which receipts from services are sourced. According to the proposed amendments:

> [Note - States should choose one of the following two options for this section:
>
> > Alternative Option A. The numerator of the receipts factor includes receipts from services not otherwise apportioned under this section, which receipts shall be sourced in accordance with Reg. IV.17 of the Multistate Tax Commission Allocation and Apportionment Regulations, as amended.
> >
> > Alternative Option B. Delete this proposed Section 3 (m).]

The Merriam-Webster dictionary defines "uniformity" as: the quality or state of being the same; the quality or state of being uniform or identical. It is not a uniform rule if each state can pick the alternative that suits it. Except to facilitate ease of administration, a "model" act, predicated on the concept of uniformity, should not have multiple options.

Moreover, during our many working group conference calls, every time industry suggested giving taxpayers an option to make the apportionment provisions more administrable, the states were quick to object to the concept of options because taxpayers might pick the option that is most favorable to them. For the states to give themselves an option to source receipts from services is duplicitous. This option for services is not necessary for administrative purposes, and

the receipts from services are not incidental (e.g., is not less than 2% of the total receipts for most financial organizations.)

Notwithstanding industry opposition, if Options A and B are retained, then it is important to note for the record that Option B above would delete the separate section (m) describing the sourcing of receipts from services, which then would source service receipts according to the "All Other Receipts" category [proposed amended section (o)], which would source receipts from services pursuant to specified other state rules and would NOT source receipts from services to the "Commercial Domicile" category [proposed amended section (p)] under which receipts that are not sourced to other states are thrown back to commercial domicile. The proposed amendments should be modified to clarify how receipts from services are sourced if a state selects Option B.

Bait and Switch?

For the record, we would like to express our disappointment with the participating states' complicity in shifting what had been the working group's property factor goal, after California FTB representatives discontinued their involvement in the working group.

Prior to the December 2012 working group conference call, the MTC Working Group had concluded and reported to the MTC Income/Franchise Tax Uniformity Subcommittee on many occasions that:

> **Property Factor: State and Industry Overarching Goal** – the intent is not to recreate the 1994 apportionment outcome of sourcing property to particular states. Rather, the intent is to attempt to maintain the 1994 policy of sourcing property to the location of loan activity.

Moreover, the property factor issues to be worked on were reported as being:

> <u>Problems to be addressed:</u> Under the current loan location rule, it is not clear whether the SINAA factors are of equal weight or, conversely, whether the large presence of one factor can outweigh the absence of other SINAA factors. As a result, it is unclear, both to tax

administrators and to financial institutions, how the SINAA factors should be applied in individual cases. While industry participants noted that some clarification would be helpful, they did indicate that, with the exception of a couple of states, they are not encountering significant problems with the current SINAA sourcing provision.

In addition, the term "change of material fact" in the loan assignment rule is undefined. A question has arisen as to whether the sale of a loan or pool of loans to another entity within the same controlled group of corporations as the seller constitutes a material change of fact. Both taxpayers and tax administrators would benefit from the inclusion of objective criteria to determine when there has been a material change of fact.

And later the areas to be worked on were summarized as:

STATES' CONCEPTUAL POLICY GOALS FOR FINANCIAL INSTITUTION APPORTIONMENT - FEBRUARY 2, 2009

Property factor: Overarching goal – not trying to recreate the 1994 apportionment outcome (source to particular states), rather trying to recreate the 1994 policy (source to location of loan activity).

A. Location of Loans §4(g) – Clarify sourcing using California's proposal dated 8/25/08.
B. Material Change §4(i) - Clarify "material change" using California's proposal dated 8/25/08

Accordingly, participating industry members were shocked by the December 2012 "fresh look" request by the then participating states, which subsequently resulted in the states deciding to eliminate loans from the property factor.

The original MTC model industry apportionment provisions' mix of market state and greater cost of performance sourcing of the receipts factor and production state sourcing of loans represented a balanced compromise between the market states and the production states. The increased receipts market sourcing and elimination of loans from the property factor included in the proposed amendments to the MTC model industry apportionment provisions changes the balance between market states and production states.

Wood Miller's May 8, 2014 Letter to the MTC Executive Committee

In reading through Wood Miller's May 8, 2014 letter to the MTC Executive Committee regarding "Uniformity Committee Report of Draft Amendments, Formula for the Apportionment and Allocation of Net Income of Financial Institutions", we identified several inaccuracies that warrant mentioning for the record.

Sourcing of Trust Fees

Starting on the bottom of page 4, "D. Receipts from Investment and Trading Assets and Activities on Behalf of 3rd Party (trust accounts)" misrepresents that the states voted on a separate sourcing provision for services related to trust fees. While the working group discussed possible options for sourcing such services, the group concluded that trust fees would not be treated differently than other service receipts. Accordingly, the state representatives, and subsequently the uniformity subcommittee and full committee, did not make a recommendation specific to the sourcing of trust fees.

Sourcing of Service Receipts

Starting on the top of page 6, "E. Non-specific Receipts, Other Non-Specified Receipts, and Attribution of certain receipts to commercial domicile, §§ 3(l), (n) and (o)" misrepresents that:

1. the state representatives, and subsequently the uniformity subcommittee and full committee, recommended that service receipts be sourced in accordance with Reg.IV.17 of the MTC Allocation and Apportionment Regulations, as amended; and

2. the state representatives, and subsequently the uniformity subcommittee and full committee, recommended retaining the current sourcing rule for Section 3(n) (all other receipts).

With respect to the sourcing of service receipts, as reflected in the MTC's draft FI Apportionment Amendments document dated 12/5/13, the states' recommendation was to provide an option for the states to source service receipts based on: 1) Reg.IV.17 of the MTC Allocation and Apportionment Regulations, as amended; or 2) Section 3(n) specified other state rules.

With respect to the sourcing rule for Section 3(n), the working group never discussed making any changes to Section 3(n) and accordingly no recommendation was suggested or voted-on to retain the current sourcing for receipts that fall under Section 3(n).

Effective Date of Revisions

Wood Miller's letter to the MTC Executive Committee does not mention that the state representatives, and subsequently the uniformity subcommittee and full committee, recommended that if the proposed revisions are adopted by the MTC Executive Committee that the revisions not be effective until tax years beginning on or after January 1, 2016. The Hearing Officer's Report should highlight this effective date to inform states that may consider adopting the revisions.

Appendix of Work Group Members

We were surprised by the listing of group members. On the majority of working group calls, there were as many financial institution employees participating as there were state representatives. Yet, an uninformed party would assume from this list that only one bank and about a dozen consultants who likely represented interested industry members participated on the working group calls.

Attachment

January 2011

Comment Regarding December Income Tax Uniformity Subcommittee Report

During the status report of the financial institutions working group project at the December MTC Income & Franchise Tax Uniformity Subcommittee meeting, Shirley Sicilian noted that states that have adopted a receipts factor only formula, now have what they need to move forward in making changes to their statutes/regulations. Industry believes that Shirley Sicilian did not intend to make this statement because while the working group has a draft of the revisions to the receipts factor section, the revised model apportionment provisions have not been through the hearing process. Moreover, the participating industry members would like to remind the states and MTC staff that it does not agree with many of the receipts factor revisions and thus does plan to submit written comments summarizing the issues we raised during the revision process for future consideration before adoption of the revisions.

Let's Step Back and Allow Common Sense to Proceed

- Re-focus on goals
- Work with us – Not against us

Re-focus on Goals

In order to move this project forward on a timely basis, we believe that the working group needs to re-focus on its goals.

Fair, Administrable, and Applied Consistently

As noted throughout this revision project, we believe it is important for the MTC staff and the states to step back and again review the overall goals of the original financial institution apportionment provision project were that the resulting model be:

1) fair in approach,
2) administratable, and
3) adopted and applied consistently in a majority of states.

We believe that <u>all three facets</u> are critical and thus should remain the goals of any revisions made to the model apportionment provision.

As we continue to work through the property factor revisions, we need to be mindful of the administrable goal. In order for the apportionment provisions to be administratable, industry needs to be able to use documents and systems already in place and we should NOT create a

model that will require financials to incur significant unwarranted costs to prove the proper sourcing of loans in the property factor.

In addition, while we recognize the states' rights to adopt different apportionment formulas, the overall goal of any revisions to the MTC model financial organization apportionment provision should be to retain a high level of uniformity. Currently, there are approximately 20 states that have adopted apportionment provisions similar to the MTC model. We believe that no revisions should be considered that cannot likely achieve actual adoption in a majority of the states. Adoption by only a few of the approximately 20 states would create an environment that is less consistent and uniform than exists today. Similarly, allowing state optional provisions within the model also creates an environment that is less consistent and uniform than exists today.

Maintain the Original Sourcing Outcome

As noted in the June 22, 2009 Financial Institutions Apportionment Work Group Report to members of the MTC Income & Franchise Tax Uniformity Subcommittee, with respect to the property factor, the work group recommendations included:

> The Property Factor: State and Industry Members Overarching goal – the intent is not to recreate the 1994 apportionment outcome of sourcing property to particular states. Rather, the intent is to attempt to maintain the 1994 policy of sourcing property to location of loan activity.

Work with us – Not Against Us

Many industry members were upset with the nature and tone of the November working group call. Industry strongly believes that in setting forth its suggested approaches and written comments, we have been mindful of the states' objectives (although we may not agree with them) and try to set forth what we believe are industry-compromised positions in order to move this project forward.[1] In contrast, some of the states and MTC staff appear to have approached industry suggestions as being false and deceptive, and thus, rather than objectively consider industry comments, they automatically suggest overly burdensome approaches to in their minds "fix" the industry suggestions.

We understand that some states may have had what they view as "poor experiences" with a few financials on audits. And on the flip side, some financials have had what they view as "poor experiences" with states on audits. Accordingly, both sides can point to one or more poor experiences with the other side.

[1] For example, when one of the states suggested that the work group review the property factor sourcing method proposed by Minnesota during the development of the initial apportionment provisions, industry did not suggest that the states consider sourcing loans to the "main office of the original lender", because we were mindful that the states would not want to adopt such an approach.

Nevertheless, we should not be working towards developing overly burdensome revisions that will cover those limited exceptions because states have other means of dealing with such situations. Instead, we should be focusing on revisions that fit the majority of situations and can be more easily administered by both the states and industry.

In hindsight, it is possible that some of these issues have arisen because industry members are very familiar with the current MTC model apportionment provisions, as well as the industry and their company's operations, while most states and MTC staff have only marginal understanding of the industry and of the actual application of the MTC apportionment provisions in practice. Assuming this has fostered some of the perceived issues, prior to providing future suggestions industry will attempt to provide what they believe is an overview of the issues and why they believe their suggestion makes sense. This additional education hopefully will bridge the knowledge gap and allow the project to move along in a smoother and timelier pace.

We also are mindful that the element of compromise of the original drafters is woven throughout the foundation of the model as it operates today. The May 1993 Interim Hearing Officer's Report applauds the collective effort of the parties and the clear "compromise" that was reached between the production states and the market-states. Based on the Hearing Officer's report and supporting documents, it is clear that the model apportionment provisions were largely founded on that compromise. To date, industry believes that there has been little compromise from the states and moreover, based on past working group calls if even one state that may or may not even have adopted the current MTC apportionment provisions comments that they don't "think" they like the suggestion (without even expressing a valid reason why they think so), then the discussion has been treated as having been completed and the suggestion is off of the table.

In comparison to the original development of the MTC financial institutions apportionment provision, we note that what the revision work group is missing is a moderator, who would step in when one side isn't listening or unwilling to make compromises. We believe that the states and industry need to do this within their own ranks if we want move this project forward on a timely basis.

Use of Management Reports for Loan Groupings

Being mindful of the goals noted above, industry strongly believes that management reports should be one of the means allowable in selecting loan groupings.

As industry explained, and Carl Joseph confirmed, management reports are what a company's management uses to determine which products to offer, discontinue and make other changes to the operation of the company – these clearly are not reports devised for tax planning purposes. YET, a large portion of the November working group call focused on whether the states could obtain such reports that have been "audited" and other comments related to states' fears that anything industry suggests must be wrong.

We would like to reiterate that the top management of the country's largest financial organizations have much larger issues to focus on than to try to manipulate management reports

in order to shift a couple of percentages of receipts among the states, which essentially would have a minimal impact the earnings of the company. In an effort to overcome the states' paranoia, we have inserted in the draft revisions that the management reports used must reasonably reflect the taxpayer's products/services sold.

We also would like to note that since the adoption of the MTC apportionment provisions, for purposes of sourcing loans, most (if not all) of the financials have been grouping loans based on management reports. Thus, the suggested language in the draft revisions would not change anything that the financials are already doing – thus satisfying the working group's administratable goal. Accordingly, the suggested language was NOT a change in manner in which financials have been sourcing loans and instead was merely an attempt to put in writing the practice that has been used to source loans for more than 10 years. In addition, the current manner in which the financials have been grouping loans has not been a significant audit issue addressed by the states – thus implying that the method that the financials have been using has been working for the states as well as the industry.

Use of Segment Reporting has no Merit

On the November call, the use of segment reporting required under FAS 131was suggested by a state as a possible requirement for the grouping of loans. Anyone who has spent 10 minutes looking at the segment reporting for large companies will see that the suggestion has no merit other than to extent the revision project by focusing the group on red herrings.

Need to Consider Other Approaches Instead of the Cost Determination

As noted on the November working group call, industry believes that based on their operations, the majority of financial institutions have been able to prove the sourcing of its loans without having to undertake a very costly "cost-study".[2] Moreover, with respect to the use of cost of performance for sourcing certain services, the states have continually voiced that the method needs to be changed because determining costs is too difficult to administer. Accordingly, the working group should consider developing an approach to loan-sourcing that does not require all financials to undertake a cost study if their facts would not otherwise require them to do so.

If the working group concludes that there are some situations in which the preparation of a cost study would be warranted, it might be helpful if Carl Joseph could share with the group some of the "cost" approaches that he noted California has permitted financials to use to source loans.

[2] We do acknowledge that some financials had incorrectly sourced their loans on originally filed returns and thus in order to prove their refund claims, they needed to prepare such costly reports. However, the majority of financial institutions have NOT prepared such cost-studies.

The Sourcing of Loans Would be Made Much Easier if the S is taken out of SINAA

As noted in our November 24, 2010 written comments, currently, the institutions that have been participating on the working group believe that there is merit in retaining SINAA with one adjustment – removing solicitation – and thus retaining INAA.

As Shirley observed on an earlier call, since the solicitation efforts end up being sourced in the receipts factor, retaining solicitation as one of the factors to consider in determining the preponderance of contacts in sourcing the loans in the property factor is not appropriate.

Industry members believe that the largest part of the issues the states have with trying to apply SINAA is the solicitation element and if solicitation were removed, the group may be able to develop means of determining the INAA factors that would be much simpler and less time consuming than a cost determination (i.e., Administration would be given to the state where the loans are serviced without having to determine the costs incurred in servicing each of the loan groupings).

Moreover, it is very clear that if the only element that is within a state is solicitation, then it is impossible for the loan to be sourced to that state. Thus, it seems that in most situations taking the S out, would make the sourcing more administratable both for the states and industry. If the states believe that there are limited situations within which S should be taken into consideration in sourcing, then maybe we can craft language that include S only those situations. For example, if the I and N are in one state and AA are in another state, then unless the working group decides it would be appropriate to give one of the INAA factors more weight than the other 3 elements, then maybe solicitation could be used as the tie-breaker.

Now for the Entertaining Portion of our Comments

Most of the industry participants got a good chuckle from a comment made by Carl Joseph's on the November call. Assuming our notes are correct, Carl noted that if the basic operational facts are clear that 80% of costs are outside of the state, then a state wouldn't have reason to do any further work related to the sourcing of loans. However, based on audit experience, industry notes that as silly as it might seem at least one state will not accept such a position on audit and instead demands extensive work on the part of industry before they will even consider conceding that the loans should not be included in their state's numerator.

As noted above, both sides can point to one or more poor audit experiences with the other side.