Financial Institutions Regulation Apportionment & Allocation Issues List For MTC Income and Franchise Tax Uniformity Subcommittee[1]

I. Property factor issues related to solicitation, investigation, negotiation, approval and administration (SINAA).

A. Case-by-Case Review to Determine Substantive Contacts.

1. The language of the regulation suggests that each loan should be reviewed and the preponderance of substantive contacts should be determined under the facts and circumstances of each loan.

2. Is it reasonable to expect either the financial institution or the state auditor to review each loan? Banks and other financial institutions often sell loans shortly after origination and use the origination fee and sale proceeds to make new loans. Thus a single loan will not stay with the financial institution for very long and the volume of loans will be large (churning).

3. Alternatives to loan-by-loan review:

   a. Break down by business line – typically by loan types: Commercial, Consumer, Residential home loans, Credit card receivables, Auto loans, Agricultural loans, etc.

   b. Review loan types on a branch-by-branch basis.

   c. Agree to a representative sampling for each loan type, perhaps by branch or geographic area.

B. Weighting of SINAA elements

1. The regulation is silent as to how to weigh the SINNA elements.

   a. Should the measure be a simple majority (3 out of 5)?

   b. Should specific weighting be designated to each element for each loan: 5% solicitation, 30% investigation, 20% negotiation, 15% approval, and 30% administration?

   c. How is weight for each factor to be determined? Amount of employee time? Amount of cost associated with each activity?

[1] Adapted from work by Larry Allen, Deputy Attorney General, State of Idaho

d. Because the process has become so automated, some banks now use a modified cost of performance test and include the cost of their centralized computer system to weight the factor toward their place of commercial domicile.

2. Alternative: Amend regulation to provide how the yardstick for measuring each of the SINAA elements:
    a. employee time
    b. cost to the financial institution
    c. regular place of business where customer is required to interact with bank
    d. amount of time customer is required to interact with the financial institution and place.

C. Since the interest on loans and credit card receivables in the receipts factor is designed to favor market states, should the SINAA provisions be interpreted to favor money-center states?

1. SINAA provisions are not obvious on their face as favoring market states or money center states.

    a. Alan Friedman in Final Report to the MTC indicated that the property factor of the Recommended Formula was intended to be biased in favor of money-center states (compromise for loan interest and credit card receivables in receipts factor?)

    b. Under the statute, loans are presumed to be located where the taxpayer assigns the loans on its records if the taxpayer: (1) must report the loan to a particular place of business for federal or state regulatory purposes; (2) makes the assignment on its records in consideration of SINAA; and (3) consistently reports the same place of business on its state and local tax returns.

    c. A state may overcome the presumption with a showing (preponderance of evidence) that the SINAA activities occurred at a place of business other than that assigned by the financial institution.

    d. Difficulty: the financial institution is in control of the information regarding the SINAA contacts.

    e. One response: Interview local branch managers and employees to determine how the loan process works.

2. Given the comments of the Hearing Officer, one must assume the presumption favors money-center states; however, were the SINAA elements themselves a compromise?

a. Arguably, solicitation is a market state provision.

b. The hearing process for the rule began in 1990. At that time much of the investigation, at least for consumer loans, auto loans, and home loans probably occurred at a local branch.

c. Negotiations probably also occurred locally.

d. Approval for small loans may have occurred locally but larger loans may have occurred at a regional or national headquarters, tending to favor money-center states.

e. Administration also probably favors money-center states, especially for larger financial institutions.

3. The effect of developing technology and e-commerce.

E-commerce has revolutionized banking since the early and mid-1990's.

a. Auto loans are completed at the car dealership with application, investigation, and approval done by virtue of computer interface.

b. The same can be said of many consumer loans and even home loans. This can be interpreted as placing even more weight toward the money-center states.

4. Alternatives to make provisions clearer:

a. Redraft the property factor portion of the rule to provide that loans and credit card receivables are attributed in the same manner as interest on loans and credit card receivables in the receipts factor.

b. Redraft the property factor portion of the rule to state that loans and credit card receivables are attributed by using income-producing activity test (a Cost of Performance).

E. Factors to consider other than SINAA.

1. The regulation states that in attributing the loans and credit card receivables, a state should consider <u>such</u> activities as SINAA, suggesting that other factors should be considered as well.

2. Several financial institutions use a cost of performance type of analysis which ultimately attributes the loans and credit card receivables to their place of commercial domicile (usually a money-center state).

    a. This carries with it the usual all-or-nothing consequences of the cost approach.
    b. Also entails the usual dispute about what costs should be considered.

3. Alternative: Consider a modified cost of performance/market based test that gives weight to the cost of performance, but also gives weight to the activity in the market state. Apportionment of costs.

F. Credit card receivables are treated in the same manner as loans.

II. Receipts Factor

A. Interest on loans and credit card receipts follow the customer.

B. However, there is a broad range of financial institution fees that are sourced differently, usually under a cost of performance test.

1. Loan Fees
2. Trust & Investment Management Fees
3. Deposit Service Charges
4. Treasury Management Revenue
5. Payment Processing Revenue
6. Credit Cards
7. Insurance Product Revenue
8. Commercial Product Revenue
9. Foreign Drafts
10. Retail Product Revenue
11. Investment Product Fees & Commissions

C. Issues related to receipts factor

1. The cost of performance tends to source the gross receipts to the states where the financial institution has the majority of its payroll and property, thereby under-emphasizing the impact of the customer base on the financial institution's overall profitability.

2. Under the cost of performance test employed by most financial institutions, the financial institutions source these fees to their commercial domicile, usually a money-center state.

3. Same cost of performance issues discussed above: What costs are relevant to the test and should it be an all or nothing result?

4. The scope of the test

    a. Financial institutions often take a broad approach and analyze the income stream for each type of fee.

    b. The MTC has taken the position that each transaction must be analyzed.

5. Alternatives:
    a. Redraft provisions to clarify cost of performance.

    b. Redraft provisions to provide for a different method of sourcing, perhaps a hybrid of cost of performance and market test.

III. Entity Structuring - Selling Loans and Receivables to Related or Controlled Entities.

A. Selling loans to a REMIC, but retaining servicing and income of loans.

1. Loans transferred to a REMIC and REMIC Certificates (a security) issued to financial institution.

2. The certificates are backed by mortgage pools and are more liquid than loans. A financial institution often sells the certificates immediately to improve its capital position. In many cases the financial institution will continue to administer the loan.

3. REMIC is a trust which receives principal and interest on loans. In turn, REMIC pays on certificates it has issued.

4. In some cases, financial institutions have decided not to sell the certificates. In such circumstances the financial institution not only continues to service the loans but also receives the principal and most of the interest on the loans.

B. Issue: the financial institution's business activity has not changed, but now the loans and the interest on the loans are no longer in the apportionment formula.

C. Possible solutions for loans in the property factor:

1. Loan remains assigned to its original place of business. The regulation provides:

(i) **Period for which properly assigned loan remains assigned.** A loan that has been properly assigned to a state shall, absent any change of material fact, remain assigned to said state for the length of the original term of the loan. Thereafter, said loan may be properly assigned to another state if said loan has a preponderance of substantive contact to a regular place of business there.

2. Sub-issues:
   a. What constitutes a material change?

   b. Same issues with respect to SINAA.

D. The definitional issue with the receipts factor

1. The regulation definition of "loan" specifically excludes an interest in REMIC.

2. Because the bank now technically receives income from its interest in the REMIC rather than the loans it administers, the income is not included in the receipts factor as interest on loans.

3. The financial institution then applies a cost of performance or other allowed method to source the income to its commercial domicile.

4. This is in direct contravention to the market-based intent of the regulation, although proper under a plain reading of the definition.

E. Alternatives:

1. Rely on the definition of "loans secured by real property" which does not exclude REMIC interests and encompasses a "loan <u>or other obligation</u>" secured by real property. (Affect on third party holders?)

2. Amend the definition of loan to exclude only REMIC interest held by those that have not transferred the loans to the REMIC.

3. Rely on Alternative Apportionment. Section 1(d) provides that if the Recommended Formula does not accurately reflect the financial institution's business activity, the parties may invoke an alternative apportionment.