

*Multistate Tax Commission*



**FINAL REPORT OF HEARING OFFICER REGARDING  
PROPOSED MULTISTATE TAX COMMISSION FORMULA FOR THE  
UNIFORM APPORTIONMENT OF NET INCOME  
FROM FINANCIAL INSTITUTIONS**

**Submitted to the Executive Committee  
of the Multistate Tax Commission**

**by**

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**FINAL REPORT OF HEARING OFFICER REGARDING  
PROPOSED MULTISTATE TAX COMMISSION FORMULA FOR  
THE UNIFORM APPORTIONMENT OF NET INCOME  
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This Final Report concerns recommendations for the states' adoption of a uniform method for the apportionment of net income earned by financial institutions. It is submitted pursuant to Article VII of the Multistate Tax Compact and Bylaw No. 7 of the Multistate Tax Commission. Those provisions require the Hearing Officer to submit to the Commission's Executive Committee a report which contains a synopsis of the hearing proceedings and a detailed recommendation for Commission action. In the case of a public hearing held pursuant to Article VII of the Compact, the final recommendation of the Hearing Officer is to include a draft of the proposed regulation or other uniformity recommendation which is the subject matter of the hearing.

This Final Report is divided into six sections: an introductory part (Section I); the Hearing Officer's recommendations for Commission action concerning the adoption of a proposed uniform method for the apportionment of income earned by financial institutions (Section II); a discussion of the major substantive issues raised by the proposal (Section III); a brief conclusion (Section IV); an Appendix containing additional materials and suggestions for regulations, guidelines, etc. (Section V); and a List of Exhibits (Section VI). The specific language of the apportionment proposal as finally proposed by the Hearing Officer is set forth at Exhibit A: 1 to this Final Report. It should be reviewed together with the additional provisions contained in the Appendix for a complete view of the matter.

The Exhibits to the Final Report have been selected from hundreds of documents that were either submitted during the public hearing process or otherwise available to the Hearing Officer. Clearly, it was not feasible to submit all of the Exhibits, comprising more than 2,000 pages, with this Final Report. The several Exhibits that were selected for attachment to the Report are indicated by the symbol "✱". These attachments were selected in an effort to provide an historical cross-

section of how the proposal developed and their attachment does not imply that any one Exhibit has more importance than any other. However, the Hearing Officer attempted to attach Exhibits that were more policy-oriented, than technical, or those that represented various turning points during this several year effort. It is recommended that all of the Exhibits, attached or not, be maintained by the Commission for reference purposes.

## I.

### **INTRODUCTION AND BACKGROUND TO PROPOSAL**

#### A. *Early Approaches to Special Rules for Apportionment of Income Of Financial Institutions.*

Ancient lore (a period prior to the Hearing Officer's joining the Commission staff) has it that during the 1970's the Commission states initiated the development of uniform rules for the apportionment of income derived by financial institutions. No formal proposal resulted from that effort. In the mid-1980's, another effort was launched to develop a uniform apportionment method and the Commission's Uniformity Committee, acting with no direct input from any financial institution, crafted the initial draft proposal. See Exhibit B1\*. The initial draft was informally circulated to industry representatives, primarily traditional banking institutions, at regional meetings held in Seattle, Chicago, Atlanta and New York. These meetings were well-attended and proved to be, in the main, quite productive give and take sessions.<sup>1</sup> In mid-1989, the Hearing Officer incorporated many of the suggestions put forward at the regional meetings and presented another draft of a

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<sup>1</sup> As could be anticipated, the meeting with the representatives of the New York institutions was "highly spirited" (a polite gloss is used here to describe this initial meeting). In New York, representatives of the industry added to famous quotes such as "Give me liberty or give me death", "Don't shoot until you see the whites of their eyes", and "No taxation without representation", their description of the states' efforts to apportion their companies' income: "The states are nothing but a wild pack of hyenas chasing the defenseless banks through the forest!!!" After this endearing introduction to the subject, the meeting went downhill from there.

proposed apportionment method for consideration by the Uniformity Committee.

This revised draft regulation was referred out of the Uniformity Committee and on May 10, 1990, the Executive Committees called for a public hearing. (Exhibit C1\*). Four public hearing sessions were held - in Washington, D.C. (August 21, 1990), San Francisco, California (August 23, 1990), Chicago, Illinois (December 3, 1990) and Atlanta, Georgia (December 4, 1990) - with respect to the revised draft proposal. No public hearing session was held in New York due to the Hearing Officer's belief at that time that the New York institutions were so hostile to the concept of income apportionment by pure market-states that little constructive input would likely result from such a session.<sup>2</sup> It became readily apparent throughout the public hearing sessions that the industry's strong objection to the nexus standards that were articulated in paragraph IV.18.(i)(B)(5) (Exhibit C1\* of the proposal, even though modified from their original form, were preventing a healthy dialogue with respect to the substantive merits of the apportionment provisions. Even though a very small part of the nexus provision depended upon the validity of an "economic presence", as opposed to the more traditional "physical presence" test, it was most difficult setting the nexus provisions aside and focusing on the apportionment mechanism.<sup>3</sup>

By the Hearing Officer's Interim Report of November 9, 1990, the Executive Committee of the Commission was advised of the progress of the public hearing and the conclusion that the public record that had been developed to that point "[fell] short of providing sufficient data" upon which several issues, including the nexus issue, could turn. By its resolution of November 9, 1990, the Executive Committee agreed to remove the matter from its July, 1991 agenda, at which time it had

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<sup>2</sup> As will be noted later in this report, eventually the representatives of the New York financial institutions determined to support a collective state effort to develop a uniform apportionment rule and, after that point, their cooperation and input were instrumental to the proposal's development.

<sup>3</sup> Compare IV.18.(i)(B)(5)(d) and IV.18.(i)(B)(5)(a)-(c) of Exhibit C1\*.

anticipated taking action on the proposal. See Exhibit C2\*. The proposal development process was being slowed in the interest of studying the matter in more depth than originally contemplated.

During this same period, however, a few states began adopting financial institutions apportionment approaches of their own and those approaches were strongly market-based oriented.<sup>4</sup> The larger financial institutions recoiled from those state efforts, having determined that several of the newly adopted approaches were even more repugnant than the approach being considered by the Commission hearing process. Additionally, each of those states approached the matter somewhat differently from one another and, thus, a lack of uniformity in approach and increased record keeping requirements were beginning to spread. In comparison, the Commission effort began to look more reasonable to the industry than it had before. The Commission's approach, however it turned out, represented a step toward, not away from one of the industry's newly acquired goals - a uniform apportionment method being adopted among the states.

B. *The Current Effort.*

In April of 1991, a meeting co-sponsored by the American Bankers Association and Price Waterhouse called "The Multistate Taxation of Financial Institutions Forum" was held in Chicago, Illinois. There, the American Bankers Association and a coalition of financial institutions referred to as the "Financial Institutions State Tax Coalition" ("FIST"), announced their willingness to cooperate with the Commission's effort to develop uniformity in the area, so long as it was directed at developing an apportionment proposal that was fair in approach, administrable and uniformly adopted by a large number of states. The Commission, joined by the Federation of Tax Administrators, thereafter agreed to try a new approach to the matter, one that might gain more widespread support from both the states and industry. This new process, referred to as

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<sup>4</sup> States such as Indiana, Minnesota, Tennessee and West Virginia, by statute, adopted new jurisdictional standards and apportionment formulae.

"Financial Institutions State/Industry Meetings" ("SIMS"), was to proceed as follows:

- 1. The pending Commission regulation process would be suspended for a time to provide the SIMS group an opportunity to develop a proposal.**
- 2. A group of interested state representatives would meet with the FIST Coalition to chart the course to be taken.**
- 3. A more open and collaborative process involving both state and industry representatives would be pursued in an effort to develop a fair and administrable apportionment proposal.**

The SIMS group, totaling over sixty state and industry representatives, was formed. Tax Commissioner Heidi Heitkamp (North Dakota) represented the participating states as Co-Chair of SIMS, Haskell Edelstein, then of Citicorp/Citibank, represented FIST as the other Co-Chair. The Hearing Officer was given the role of "Convener", with Fred Ferguson, then of Price Waterhouse and later of Arthur Andersen, the role of Alternate Convener. Harley Duncan, Executive Director of the Federation of Tax Administrators monitored the SIMS meetings for the FTA. For a listing of those who participated as members of the SIMS group and the meeting agendas, see Attachment 2 to Exhibit E2\*.

The first of the SIMS meetings was held in San Francisco on July 15-16, 1991. This meeting resulted, among other things, in the states agreeing to sponsor an educational workshop open primarily to state representatives. The workshop was to be designed for the purpose of the state representatives learning about various income-producing activities of financial institutions. The MTC/FTA-sponsored "Financial Institutions Business Workshop" was held in Washington, D.C. on October 8-9, 1991. Representatives of 23 states attended the Workshop, the agenda for which is found at Exhibit G\*.

At the completion of the Workshop, a subcommittee of interested states (including New York City)<sup>5</sup> was formed to develop an approach that the states could support. Since it was clear that the states were not all in agreement as to the emphasis to place on various market and money-center factors, this subcommittee, referred to as the "State Subcommittee on Apportionment of Income from Financial Services"<sup>6</sup> was formed to determine if any one approach could be supported by the states.

The second SIMS meeting was held in New York on April 29-30, 1992 at which time the group discussed specific approaches to the development of an apportionment formula. The major result of this meeting was the creation of a state/industry working group called "State/Industry Financial Working Group" ("S/IFWG") comprised of a subset of the SIMS members that would analyze selected issues, then draft and propose specific statutory/regulatory language for review and possible agreement by the broader SIMS group. Exhibit I2\* sets forth the direction then being pursued by SIMS.

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<sup>5</sup> New York City actively participated as a full member at all levels of the process. For shorthand purposes, New York City, shall be included each time the word "state" appears in this Report.

<sup>6</sup> This Subcommittee was composed of the following persons:

Convener:

Alan Friedman, Multistate Tax Commission

Subcommittee Members:

Michael Boekhaus (Bill Lunka)	MN	Keith Larson	WV
Eric Coffill	CA	John Malach	IL
Anne Dougherty	TN	Jonathan Robin	NYC
Marilyn Kaltenborn	NY	Harley Duncan (monitoring for Mary Jane Egr FTA)	

S/IFWG was broken down into 21 subcommittees to address twenty-one separate drafting sub-issues. Each S/IFWG Subcommittee was comprised of roughly an equal number of members representing state and industry. A description of the S/IFWG process and roster of the S/IFWG Subcommittees is found at Exhibits I1\* and I3\*.

Meanwhile, the states' economic and philosophical differences were yet to be reconciled among themselves. On the one hand, states such as Tennessee and Minnesota had already taken aggressive market-state approaches to apportioning the income of out-of-state financial institutions. On the other, New York State and New York City, being the commercial domicile of a great number of large financial institutions, had traditionally followed apportionment approaches that were skewed heavily toward the money-centers. The newly formed State Subcommittee on Apportionment of Income from Financial Services met on several occasions between January and March of 1992 through teleconference calls, some lasting several hours. On March 9-10, 1992, several State Subcommittee members met in New York to attempt a reconciliation of the differences between the market-state and money-center state approaches. Exhibit H3\* sets forth minutes of this meeting to provide a flavor for the struggle that was occurring among the states. Gridlock (or, more appropriately, "factorlock") had set in. The state representatives were about to toss in their respective towels, when someone suggested consideration of a five-factor apportionment formula - a payroll factor, a property factor (including intangibles), a deposits factor and two receipts factors (one heavily market-state oriented, the other heavily money-center state oriented).<sup>7</sup> While the five-factor approach was later determined to present too much administrative burden, it reflected the state representatives' willingness to explore different approaches to achieve a uniform apportionment formula.

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<sup>7</sup> No one has ever taken credit for suggesting the five-factor apportionment formula for fear of being ridiculed. The Hearing Officer hastens to point out, however, that the five-factor suggestion became the springboard for productive discussions between the money-center and market-state representatives.

Over the next several months, focus was returned to the process of analyzing and drafting the various components of the formula through the S/IFWG team approach, including consideration of a deposits or source of funds factor. Each of the twenty-one teams had an industry co-leader and a state co-leader responsible for the progress of their team. Virtually all of the discussions and development of the definitions and factors were accomplished through teleconferences, with exchange of drafts occurring between calls. Exhibit I5 is a collection of very important documents, but too bulky to attach here. This exhibit, comprising of scores of notes and memoranda, contains the collective final results of the S/IFWG process, reflecting several of the S/IFWG Subcommittee members' thoughts regarding several of the provisions contained in the final proposal. Eventually, the S/IFWG factor-drafting teams agreed on the components of each factor, as well as the sourcing rules that they wished to recommend, and the draft of the factors was completed. The Convener then assembled the various draft parts, filling in the gaps and making sure that consistent language was being used throughout draft.

On November 23-24, 1992, the SIMS group met for the last time in Chicago, Illinois to review the recommendations developed through the S/IFWG process. At that time, a consensus was reached on several areas, one of which was to eliminate a deposits factor from the formula. This conclusion was not unanimously supported; however, the majority of the SIMS group concluded that singling out deposits, as opposed to all sources of funds, such as borrowings and other debt or equity contributions to a financial institution's funding, was not fully or fairly representative of how a financial institution engaged in income-producing activities. The application of a fully developed "source of funds" factor, while theoretically supportable, was thought to be too burdensome from an administrative viewpoint. In addition, since not all financial institutions had deposits, adjustments in the formula were clearly going to be required with regard to those institutions.

The Interim Report of Hearing Officer dated May 10, 1993 (Exhibit E2\*) sets forth the final product of the SIMS consensus process which, in turn, pointed the way for the development of all but a few of the

provisions that are recommended here. Three of the four Appendices to that Interim Report set forth issues over which consensus was either not attempted or was not clearly reached. Those issues were: (1) the definition of a financial institution, (2) the use of book or tax basis reporting, and (3) the application of the concepts of SINAA to the assignment of certain intangibles to the property factor.<sup>8</sup> These issues have been addressed in Section III of this Report.

It is important to underscore here, however, that the attached proposal represents a *new* proposal and not an amended version of that created by the SIMS process. Therefore, any changes from the SIMS version should not represent or consist of any evidence of the Commission's or the drafter's intent with respect to the proposal set forth in Exhibit A: 1.<sup>9</sup>

With the work of the SIMS group concluded, the Hearing Officer resumed the Commission's hearing process. Three additional public sessions were held to provide the public with an opportunity to compare and contrast the then-pending proposal and the new SIMS-produced proposal. The public sessions were held in Los Angeles, California on May 27, 1993, in Washington, D.C. on July 15, 1993, and in New York City on September 30, 1993. The public record was held open for further written comment until December 15, 1993. At that time, the public hearing process was finally concluded.

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<sup>8</sup> The issues regarding the definition of a "financial institution" are set forth more fully at Section III.B.1. of this Final Report.

<sup>9</sup> For example, the Hearing Officer has stricken the following sentence from the pending proposal that had appeared in the SIMS draft: "Real and tangible personal property include land, stocks in goods and real and tangible personal property rented to the taxpayer." Because it is intended that the current proposal be treated as a new, original proposal, totally unrelated to the SIMS version, one should not be permitted argue based solely upon such change to the SIMS version that the intention was to eliminate rented property from the definition of "Real property owned" and "tangible personal property owned" in Section 2(o). That section should be read and interpreted as if that sentence never existed in the first place. In any event, such rented property is included in the property factor by the operation of Section 4(a) of the proposal.

C. *Format of Proposal*

The proposal found at Exhibit A: 1\* has been drafted in the format of a detailed statute.<sup>10</sup> Many states will be required by law or practice to adopt the proposal legislatively, while others may have already delegated sufficient authority to their State Tax Administrators to accomplish the same result by regulation. Again, it is to be emphasized that the proposed language does not act to impose any tax; it operates solely to apportion a tax that is already imposed on the types of financial institutions selected by the legislature for taxation. Irrespective of the mechanism of adoption, it is critical that the measures adopted by the state legislatures and/or State Tax Administrators adhere very strictly to the language suggested in the proposal if the principal goal of uniformity is to be achieved.

II.

**RECOMMENDATIONS OF HEARING OFFICER**

Based upon the public hearing record in this matter, as well as the administrative notice that the Hearing Officer has taken of the process engaged in through the State/Industry Meetings, the Hearing Officer makes the following recommendations:

**A. That the states adopt by statute, regulation, or other formal process, the provisions of the apportionment method set forth in Exhibit A: 1 attached**

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<sup>10</sup> This proposal assumes the imposition of a tax measured by net income. There are a variety of other types of taxes that states may apply to financial institutions that may also be subject to allocation and apportionment by the same or similar mechanism that is suggested here. The states are reminded that it is clear that only the imposition of a non-discriminatory franchise tax will permit the inclusion in the tax base of income from federal government obligations. See Title 31 U.S.C. §3124 and *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983).

to this Final Report, as may be modified by technical fixes prior to its adoption by the Commission.<sup>11</sup>

**B. That each of the states make such adoption effective for the tax years commencing on and after January 1, 1996 on the condition that as of that date the proposed apportionment method set forth in Exhibit A: 1 (or an apportionment method substantially similar to the proposed method) has been adopted by twenty or more states. The determination that another state's apportionment method is the same or substantially similar to that set forth in Exhibit A: 1 should be made effective upon certification of that fact by the State Tax Administrator. Commission staff should provide whatever assistance the adopting states determine necessary for the purpose of analyzing and determining whether an adoption of an apportionment method is the same or substantially similar to the method adopted by the Commission.**

**C. That the Commission staff organize and facilitate an annual meeting by teleconference or otherwise of representatives of the adopting states for the purpose of exchanging information and ideas regarding the implementation and effectiveness of the uniform method.**

**D. That five years after the uniform method has been adopted by the Commission, its staff should survey all of the adopting states and a sample of affected financial institutions to determine what amendments, if any, should be made to the uniform method. The results of such a survey should be referred to the Executive**

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<sup>11</sup> In response to the issuance of the Hearing Officer's Partial and Interim Report dated April 12, 1994, interested parties reviewed the proposal as attached to that Report. It was noted that a limited amount of technical changes may be in order in two areas - (1) the effect certain provisions have regarding non-U.S. financial institutions and (2) the application of the apportionment principles to trading and investment activity under Section 3(m). The Hearing Officer requests permission to receive added direction in these areas and make whatever technical fix might be necessary before the matter is referred to the member states under Bylaw 7. The Hearing Officer has prepared a Resolution to this effect for the Executive Committee's consideration.

**Committee for its consideration and such further action it determines appropriate.**

### **III.**

#### **DISCUSSION OF SPECIFIC ISSUES**

##### **A. Listing of Issues Presented for Discussion.**

The Notice of Hearing set forth six specific issues to be addressed at the public hearing sessions. They were as follows:

- 1. *What is the most appropriate definition of the terms "financial institution" and "business of a financial institution" for the purpose of statutory or regulatory coverage of the different kinds of financial institutions that are in substantial competition with one another?***
- 2. *Should the receipts factor reflect the delivery of a financial institution's services on a destination basis or on a majority of "cost of performance" basis?***
- 3. *How should states treat intangible property in the form of unsecured or secured loans, investments in securities, etc. for income attribution purposes?***
- 4. *With regard to states that apply the unitary business principle and combined reporting, what, if any, approach should the proposal take with regard to such principles.***
- 5. *What, if any, approach should the proposal take with regard to nexus and/or de minimis concepts?***
- 6. *Should a throwback, throwout or another approach be used to address the attribution of receipts that are sourced to states in which the taxpayer is not subject to taxation?***
- 7. *Such other issues and suggestions that state representatives and other members of the taxpaying community may wish to present for consideration.***

Those additional "other issues and suggestions" that arose during the SIMS and public hearing processes which are specifically addressed in this Final Report are as follows:

- a. ***The Use of SINAA Elements for Determining State to which Loan or Credit Card Receivables have a "Preponderance of Substantive Contact"*** - addressed in Section III.B.7.a. of the Final Report and included at Section 4(g), (h) and (i) of the proposal.
- b. ***The Book vs. Tax Accounting Issue*** - addressed in Section III.B.7.b. of the Final Report.
- c. ***Process for Resolving Apportionment Conflicts*** - addressed in Section III.B.7.c. of the Final Report and Section 6 of the proposal.
- d. ***Need for Securing Adoption by a Critical Mass of States*** - addressed in Section III.B.7.d. of the Final Report.

Lastly, it is important to specifically note the written objections that have been raised by the State of South Dakota to the Commission's proceedings. These objections were raised early in the proceedings and have been consistent and lasting. See Exhibits B15\* and J34\*. The proposal that has been recommended goes far in meeting most, but not all of the objections raised by South Dakota. The Hearing Officer has been attentive to the suggestions and objections raised by South Dakota and, short of recommending that the Commission do nothing in this area, the proposal favorably responds to the most of the technical and substantive objections and suggestions that have been set forth to this point.

**B. Discussion of the Issues.**

The following sets forth the conclusions of the Hearing Officer with respect to some of the more important issues.

**1. Definition of "Financial Institution".**

*a. In General.*

The Hearing Officer has concluded that, since the primary purpose of this proposal is to set forth a fair and administrable uniform method for the apportionment of income earned by financial institutions, the definition of the term "financial institutions" is of secondary importance. The proposal recommended here presumes that the state legislature has already made its determination of what businesses should be treated as "financial institutions". As noted further below, the Hearing Officer is not recommending that any type of institution should or should not be made subject to tax. Therefore, the definition that is discussed below is not incorporated in the body of the proposal, but is set out at paragraph A of the Appendix attached to the proposal.

The intended purpose of the definition of a "financial institution" found in Attachment A is to establish a focal point for those wishing to fashion a definition of "financial institution". It is intended to subject to the proposed apportionment method most of the types of persons and business entities that are generally considered as being in the business of lending and otherwise dealing in money capital, such as banks, savings and loans, larger credit unions, finance companies, leasing companies and the like. The "catch-all" provision of Section (11) is provided in order to apply the proposed apportionment method to a majority of those who derive a substantial portion (in excess of 50%) of their gross receipts from interstate business activities that are authorized to be conducted by the more traditional types of financial institutions defined in section (1) through (10). Therefore, for example, where a finance company (whether independent or captive), a leasing company, a mortgage lender, or other nonbank financial institution derives in excess of 50% of its gross receipts

from the lending of money and is taxable in more than one state, the proposed apportionment method would be applicable.

The principle focus of the definition and proposal has been on the institutions that have traditionally been lenders of money and moneyed capital and it was drafted with these institutions in mind. The effort did not involve an analysis of certain types of businesses, such as insurance companies, securities dealers or real estate brokers, even though one could argue that the "catch all" definition of the term "financial institution" under Section (11) could conceivably include such businesses. The Hearing Officer specifically recommends that insurance companies, securities dealers and real estate brokers not be included within the definition of "financial institution" until the state has reviewed the income-producing activities of those businesses and concluded that the proposed method can be applied to such businesses and will result in a fair apportionment of the net income derived from such activities. Specific language has been added to Section (11) detailing such exclusion.

b. *Authority in State Tax Administrator to Exclude  
Certain Persons from Application of Apportionment*

Section (11) of Attachment A sweeps within the definition of "financial institution" to which the proposed apportionment applies, all businesses that derive "more than fifty percent (50%) of [their] total gross income from activities" that traditional banks, savings and loan associations, finance companies, etc., are authorized to conduct. This "catch all" provision is intended to "catch" only those who conduct activities that are in substantial competition with the traditional financial institutions. For this purpose, it is the quality or kind of activity that is at issue, not the quantity.

However, the "catch all" provision is not intended to cover those businesses whose activities are not directly in furtherance of providing financial services, i.e., those related to the lending of money, extending credit, or otherwise dealing in money capital. For an extreme example, assume that a traditional retail bank would be authorized to issue

coupons or premiums to attract customers. A literal reading of Section (11) might suggest to some, therefore, that a grocery store chain that issues coupons or premiums to attract customers is, likewise, a financial institution. Such an unreasonable construction would be literally correct, but not logical, since sellers of food do not compete with financial institutions.

Certainly, there will be much closer questions of coverage that will need resolution. Given the rapidly changing nature of financial institutions, the Hearing Officer recommends that the State Tax Administrator be permitted the discretion to quickly address those questions. Therefore, specific language has been provided at Section (12) delegating authority to the State Tax Administrator to exclude activities from Section (11) that are not in substantial competition with the specifically covered financial institutions' lending, leasing or other dealings in money capital.

c. *The Inclusion of Credit Unions within the Definition of Financial Institution.*

From the outset of the public hearing process, representatives of state credit unions, as well as state credit union supervisors, strongly advanced the position that state credit unions should be excluded from any definition of the term "financial institution". See Exhibits J3, J7, J27, J29\*, J30, J33, J37, J41, J44. On the other hand, representatives of mainline banks strongly suggested otherwise. See Exhibits J36\* and J45. This presented one of the most difficult policy issues raised during the proceedings. Since federally-chartered credit unions are exempt from state franchise and income taxation under the Federal Credit Union Act, 12 U.S.C. 1768, the argument raised is that the imposition of state operational taxes on state-chartered institutions "threatens to alter the very nature of credit unions" and will drive them to abandon their state charters for federal charters. Credit union representatives also suggest that since credit unions have such a small share of the financial services market compared to banks - \$191.3 billion in assets at 1992 year-end

versus \$2,945.3 billion for banks - that their tax exempt status should remain protected.

On the one hand, the Hearing Officer recognizes the non-profit, member-owned, cooperative nature of credit unions and their being designed to serve members possessing a "common bond". On the other hand, the Hearing Officer notes that some credit unions are of such significant asset size and widespread common bond, that they create significant competition in the financial services marketplace. The Hearing Officer attempted, without much success, to obtain an understanding of the appropriate asset-level cut-off, above which it would be reasonable to classify a credit union as "large" enough to be a significant competitor with for-profit financial institutions in a given service or market area. It is the Hearing Officer's conclusion that *should a state legislature determine that state credit unions are taxable*, only those larger credit unions that pose a significant risk of competition to for-profit financial institutions be included within the definition of a taxable financial institution subject to apportionment.

Despite the conclusion that certain credit unions pose substantial competition for deposits and loans in service areas of other financial institutions, *the Hearing Officer is not here recommending that state legislatures should subject any state credit union to taxation*. That is a legislative policy choice that is beyond the purview of this Report. However, *if credit unions do become subject to taxation*, the Hearing Officer recommends that only those state credit unions that have in excess of \$50,000,000 in total loan assets be subject to apportionment. That *de minimis* level of loan assets would include only those credit unions that had approximately two and one-half times the amount of assets as the average credit union currently possesses. See Exhibit J37. Such larger asset-based institutions presumably have a professional staff capable of complying with the tax laws of the few states in which they are conducting business in competition with other covered financial institutions.

Based upon this recommendation, the Hearing Officer has included in the definition of "financial institution" in Attachment A only those state credit unions "the loan assets of which exceed \$50,000,000 as of first day of the tax year." In this manner, the states can ensure that only the larger state credit unions, the ones in effective competition with other financial institutions, are required to apportion for tax purposes. The medium to smaller-sized credit unions would remain free from any administrative burdens associated with tracking and apportioning their payroll, property and receipts factors, even if the state legislature determines to impose an operational tax on all state credit unions.

**2. The Sourcing of Receipts: To Location of Recipient of the Service or to Location of the Majority of Costs of Performance?**

Under traditional application of the Uniform Division of Income for Tax Purposes Act ("UDITPA"), *all* of the receipts received from services provided by a taxpayer in a multistate context are assigned to only one state - to the numerator of the state in which "a greater proportion of the income-producing activity is performed....based on costs of performance." See UDITPA and the MTC Compact, Section 17(b). Because a majority of the costs of performance for services and for trading in intangibles are normally attributed to the activities of taxpayers' employees who are most likely located outside the market state, the receipts factor under UDITPA and the Compact rarely result in any assignment to the numerator of a market state's receipts factor. The Hearing Officer assumes that the assignment of all receipts from services to one jurisdiction was reached by the drafters of UDITPA primarily to simplify the apportionment mechanism for income received from services. While simplicity has its virtue, gain in ease of application may compromise fairness of result. The "all or nothing" approach based upon the location of the majority of costs to perform the services (assuming that location is easily identified) results in virtually no apportionment of receipts or income to the state that provided market demand. This is because, under UDITPA, all of the traditional factors - payroll, property and receipts - will be assigned most

likely to the commercial domicile or headquarters of the taxpayers. Thus, in normal course, both the UDITPA and Compact apportionment provisions will often ignore any contribution of the market place to the income-producing activity of a financial institution. The apportionment method proposed here in Exhibit A: 1, however, affords some recognition of the market state's contribution and adjusts the factor imbalance that would normally occur in the financial institution context.

Both UDITPA and the Compact recognize their limitations with regard to apportionment of income derived from the activities of financial institutions. Article IV.2. of the Compact and UDITPA specifically exclude from their allocation and apportionment provisions the business activities of a "financial organization". Clearly, the drafters of both laws recognized the unique methods by which financial institutions produce income, calling for the adoption of a specialized allocation and apportionment formula that recognizes and addresses the unique character of the services being provided. As long as the specialized formula is "internally" and "externally" consistent, it meets the requirements of the Commerce Clause of the United States Constitution. See *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983). As long as the formula is fair and administrable, it meets the requirements of good state tax policy and common sense. Lastly, as long as the formula is uniformly adopted by a substantial number of states, a taxpayer providing its services on a multijurisdictional basis will be able to more economically comply with the reporting requirements of the states in which it is doing business and reduce the risk of overlapping tax demands on its net income.

The U.S. Supreme Court decision in *Container* instructs us that a state income apportionment method must be both *internally* and *externally* consistent. *Internal consistency* is met where the apportionment formula, "if applied in every jurisdiction,....would result in no more than all of the unitary business' income being taxed." *Container* at 169. An apportionment, to be *externally consistent*, must apply "the factor or factors [that]....actually reflect a reasonable sense of how income is generated." *Id.* The Hearing Officer concludes that the proposed formula meets both the *internal* and *external consistency* tests. At the

same time, the formula reduces much of the compliance burdens associated with recording, sourcing and reporting a great number of additional factors of lesser apportionment impact. There is no compelling reason why either the state of commercial domicile or the state in which most of a financial institution's employees are located should override all of the contributions made by the market state to the income produced. The proposed formula recognizes to a reasonable degree the in-state marketing activities that are conducted, as well as contributions to income that are made by the residents and government infrastructure within the market state.

**3. The Treatment of Intangible Property  
the Apportionment Formula.**

Under the standard application of UDITPA and the Multistate Tax Compact, the apportionment formula excludes from the property factor all values associated with intangible property, such patents, copyrights, trade secrets, as well as accounts and notes receivable, leases, securities and the like. Since UDITPA and the apportionment provisions of the Compact were designed primarily to address the apportionment of income earned by more traditional businesses dealing in manufacturing and mercantile activities, little focus was placed on the more service-oriented businesses. By excluding financial organizations entirely, the drafters of UDITPA and the Compact paid no attention to the apportionment issues associated with businesses that principally dealt in lending and other money-capital risk or investment-oriented activities.

When states attempt to apply UDITPA and Compact provisions to multistate businesses engaged in financial service activities, the traditional rules just do not result in a proper fit or fair apportionment result. The case of *Crocker Equipment Leasing, Inc. v. Department of Revenue*, 838 P.2d 552 (Or. 1992) typifies the effort of the states' use of traditional apportionment tools that were never designed for the task at hand. In *Crocker*, the taxpayer argued that since it was in the leasing business, the value attributed to its leases should be included in the

numerator and denominator of the property factor so as to properly reflect its income-producing activities. The State relied upon an apportionment method identical to the UDITPA/Compact provision that excluded from the property factor any value not associated with owned or rented real and tangible personal property. Since Oregon's approach excluded 98% of the taxpayer's assets that produced its income, the Court determined the remaining factors did not fairly represent the taxpayer's business activities in the state. *Crocker Leasing* clearly demonstrates that the application of the standard UDITPA/Compact apportionment tools to the financial institutions industry does not auger well for producing fair apportionment results.

Section 4(a) of the proposed formula provides for the inclusion of loan and credit card receivables in the property factor. Since the term "loan" includes most leases (see Section 2(j)), this provision adequately deals with the more traditional financial institutions, such as commercial banks, savings and loans, finance companies, leasing companies and the like that engage in retail lending transactions as a regular course. All other types of intangibles, such as securities of all kinds, futures or forward contracts, options, notional principal contracts, assets held in a trading account and the like are to be excluded from the proposed formula's property factor. This recommendation is made in the interest of (i) reducing some of the record keeping burdens and other costs of compliance; and (ii) not further increasing the money-center bias of the property factor without a corresponding increased recognition being given to the possible market state's contributions to the acquisition of those assets.

Even though the recommended approach will exclude intangibles, other than those classified as receivables from loans and credit cards, adjustments may be made to the property factor, as with any other factor, upon a proper showing. It is the intent of the proposal that where a particular financial institution conducts its income-producing activity in such a manner that (i) it relies upon its ownership and use of other types of intangible assets to a substantial degree in its income-producing activity and (ii) the exclusion of such assets from the property factor

would result, when the formula is viewed as a whole, in an unconstitutional attribution of income, a showing may be made for inclusion of such assets under the relief provisions of Section 1(d). Should the income-producing activity of a particular financial institution involve the dealing in other types of intangible property, then either the institution may seek or the State Tax Administrator may require the inclusion of such property in the property factor, if its omission would result in an apportionment factor that unfairly reflects the income-producing activities of the taxpayer in the state. Again, there should only be an adjustment under Section 1(d) where it is shown by the party desiring the adjustment that the exclusion of that particular type of intangible property results, *when the apportionment formula is considered as a whole*, in income being apportioned to the state that is grossly distorted or out of all appropriate proportion to the business transacted in the state. Cf. *Container* at 181.

#### 4. **The Unitary Business Principle and Combination.**

At the outset of the SIMS effort, there were two issues that, albeit extremely important, were not capable of being addressed prior to the adoption of a uniform apportionment methodology. One of these issues was the application to the business of a financial institution of the unitary business principle and related combined reporting concepts. For the purpose of formula development, the Hearing Officer has assumed that all income earned by any part or activity of a financial institution is business income and that all business segments of a financial institution, however organized, were unitary and combinable with all other business segments. Indeed, it is most difficult to imagine it otherwise. However, it is still too early in the game after *Allied Signal, Inc. v. Director, Div. of Taxation*, 112 S.Ct. 2365 (1992), to preclude at least the theoretical possibility that a financial institution may engage in a non-unitary activity that might be viewed as generating non-business income (loss).

It is important to note that the Commission's Uniformity Committee has been laboring hard to develop initial proposals defining the contours of a unitary business, as well as describing those business activities that

create business income. It is recommended that when these uniformity proposals become subject to public discussion, their application to financial institutions be specifically addressed. At that time, both state and industry representatives should be provided an opportunity, once again, to work cooperatively to analyze and make whatever adjustments necessary to render the attached uniform apportionment proposal a better fit with the operations of various segments of the financial institutions industry.

5. **Nexus, Public Law 86-272 and the De Minimis Concepts.**

a. *The Constitutional Nexus Dispute.*

The nexus issue, as it relates to certain activities of financial institutions, was the second issue that could not be effectively addressed prior to reaching a consensus on a uniform apportionment methodology. The 1987 proposal (Exhibit B1\*), in addition to containing provisions asserting taxing nexus upon traditional concepts of "physical presence", also asserted nexus over the out-of-state financial institution where it "engaged in regular solicitation" within the market state by mail, telephone, or other electronic means. "Regular solicitation" was determined to exist if the institution entered into twenty or more depository or creditor/debtor relationships with the state's residents or if it had \$5,000,000 or more in assets attributable to instate sources during the tax period. Subsequently, in the 1989 draft that went to public hearing, "regular solicitation" was presumed to exist if the institution had one hundred debtor/creditor relationships with residents; or had \$10,000,000 in assets and deposits in the state; or had in excess of \$500,000 in receipts sourced to the state during the tax year.

It became apparent as early as 1987 - when the initial Uniformity Committee proposal was circulated to industry representatives - that the state and industry representatives would neither see "eye-to-eye", nor lower their voices, until the original nexus concepts based upon "economic presence" were set to one side. Irrespective of the magnitude of

creditor/debtor or depository relationships that were developed by a financial institution within the state, industry representatives remained adamantly opposed to any concept of nexus that did not depend solely upon the institution's *physical presence* within the market state. The states were equally firm that "economic presence", i.e., the regular solicitation of the market by any means, created constitutional nexus. By mutual consent, this serious impediment to civil discourse was removed by anaesthetizing the nexus dispute for the time being. That issue remains asleep to this moment, despite the threat of the decisions in *Quill Corp. v. North Dakota*, 112 U.S. 1904 (1992) and *Geoffrey Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (1993), cert. denied, 62 U.S.L.W. 3375 (11/29/93) to awaken it.<sup>12</sup>

Recently, the need for including some type of nexus provision has been raised again, this time by the American Financial Services Association. See the Testimony of Donald Adler, Exhibit J38\*. Mr. Adler correctly states that -

"In determining the applicability of any tax to a taxpayer, the first matter of inquiry is nexus .... Once nexus is resolved, the mechanics of the tax are applied to determine the tax base and apportionment to arrive at the tax liability... Consequently, AFSA views that it is absolutely necessary that the MTC fully address the issue of nexus relative to the application of income and franchise (capital-based) taxes applicable to the rendering of financial services....."

The Hearing Officer shares Mr. Adler's view that the first logical step in the application of a particular tax is the determination of what businesses are subjected to the tax. Nexus rules are an important part of this determination, as well as the determination of whether receipts are to

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<sup>12</sup> See also the concurring opinion in *Siegelman v. Chase Manhattan Bank, et al.*, 575 So.2d 1041 (Ala. 1991) in which two Justices of the Alabama Supreme Court saw no problem with the constitutionality of Alabama's assertion of the right to impose its franchise tax on out-of-state credit card issuers arising from income earned from Alabama residents' use of the credit cards.

be thrown back from a market-state to a money-center. The Hearing Officer is a firm supporter of the concept of "economic presence" as a basis for constitutional nexus and believes those nexus standards set forth in IV.18.(i)(B)(5)(d) on Exhibit C1\* would be judicially sustained. The Hearing Officer has elsewhere set out his views on the impact of the *Quill* and *Wrigley* decisions on the requirements of nexus for operational tax purposes. So as not to require the reader of this Final Report to search further, one such discussion (addressing nexus issues in the context of apportioning net income from publishing activities) is applicable here and provided *verbatim* below:<sup>13</sup>

"E. The Effect of the Quill and Wrigley Decisions on the Proposed Publishing Regulation.

During the resumed public hearing, a general discussion was engaged in regarding the potential effect that the cases of *Quill Corp. v. North Dakota*, \_\_\_ U.S. \_\_\_, 112 S.Ct. 1904 (1992) and *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.*, 112 S.Ct. 2447 (1992) might have with respect to the proposed Publishing Regulation. In the *Quill* case, the Supreme Court ruled against the State of North Dakota's action seeking a declaratory judgment that would have applied its use tax collection statute to a direct marketer whose only significant contacts with the state were by mail and common carrier.<sup>14</sup> More specifically, the Supreme Court was called upon to decide whether, under the Commerce Clause and the Due Process Clause of the Fourteenth Amendment, a taxing State may apply its use tax collection statute to a direct marketer that has established minimum contacts, but no physical presence, with the State by purposefully availing itself of carrying on business within

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<sup>13</sup>. Excerpted from "Second Supplemental Report of Hearing Officer Regarding Proposed Adoption of Multistate Tax Commission Regulation IV.18.(j) (Publishing)" dated April 14, 1993. The chief development that has occurred since the writing of this section has only strengthened the Hearing Officer's opinions in this regard. See *Geoffrey*.

<sup>14</sup>. While the Court stated in its discussion of the factual setting that *Quill* also engaged in advertising in national journals and the use of telephone sales, it is unclear what other types of activities might create the "physical presence" sufficient to support the use tax collection duty.

the State. The Court re-affirmed part of its holding in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967) to the extent that the Commerce Clause "substantial nexus" prong established for sales and use tax collection purposes a "bright-line, physical presence" test. Does that same bright line nexus requirement require a publisher to have physical presence within a state before that state can constitutionally require compliance with its income or franchise tax laws?

In the *Wrigley* case, the Supreme Court addressed the type and quantum of activities that may be considered protected "solicitation" under P.L. 86-272. P.L. 86-272 prohibits states from taxing the net income derived from interstate business activities if the only activities within the state consist of the solicitation of orders for the sale of goods, if the orders are sent outside the state for acceptance and are delivered from a point located outside the state. Only activities that are determined to be "solicitations of orders" or "entirely ancillary" to such solicitations were held to fall under the protection of P.L. 86-272. Under these standards, the training and evaluation of sales employees, the company's use of hotels and homes for sales-related meetings, and the like were viewed as being ancillary to solicitation. On the other hand, replacing retailers' stale gum without cost, occasionally using "agency stock checks" to sell gum to retailers and storing of gum for these purposes in the state were held not to be ancillary as these activities served independent business purposes. Assuming that P.L. 86-272 applies to all of the business activities engaged in by publishers, what application does the *Wrigley* case have to the proposed Regulation?

**Conclusions:**

The *Quill* decision prohibits the states, for now, from compelling a direct marketer that does not have physical presence within the market state to collect its use tax. However, the Court's discussion of the issues provides positive support for other positions and efforts that the states may want to take in obtaining personal and tax jurisdiction for income and franchise tax purposes over out-of-state businesses that market their goods and services into the states.

1. *The Due Process Holding.*

The Court, writing through Justice Stevens, unanimously accepted the state's argument that the Due Process Clause was satisfied by Quill's method of marketing through use of catalogs sent into the state by mail and the use of common carrier for delivery of the goods purchased by North Dakota residents. The Court rested this part of its opinion on the due process personal jurisdiction jurisprudence that has evolved since the time of the *National Bellas Hess* decision. In partially overruling *National Bellas Hess* on this ground, the Court stated:

'... In "modern commercial life" it matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: the requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State. Thus, to the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax, we overrule those holdings as superseded by developments in the law of due process.' (112 S.Ct. 1911).

The Court concluded that -

'there is no question that Quill ha[d] purposefully directed its activities at North Dakota residents [through the use of mail and common carrier and]... the magnitude of those contacts are more than sufficient for due process purposes... We therefore agree with the North Dakota Supreme Court's conclusion that the Due Process Clause does not bar enforcement of that State's use tax against Quill.'(112 S.Ct. 1911).

2. *The Commerce Clause Holding.*

The majority Court (Justices Stevens, Rehnquist, Blackmun, O'Connor and Souter) then distinguished between the type and quantity of contacts required for personal jurisdiction under the Due Process Clause ("minimum contacts") and the type and quantity of contacts required to

satisfy the "substantial nexus" requirement under the Commerce Clause test as set forth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The former rests on notions of "notice" and "fair warning"; the latter rests on "structural concerns about the effects of state regulation in a national economy... [and] a means for limiting state burdens on interstate commerce". (Cf., 112 S.Ct. 1913). Thus, the Court holds that even though a taxing state may have those "minimum contacts" with an out-of-state business that satisfy due process concerns, it may still lack "substantial nexus" under the first prong of the *Complete Auto Transit* test.

The Court then addressed whether the facts of this case satisfied the "substantial nexus" requirement of *Complete Auto Transit*. The Court discussed the merits of having a "bright-line" test, as opposed to relying on "contextual balancing inquiries" and concluded for several reasons that a bright line is appropriately drawn with respect to the use tax collection duty. The Court reasoned that (1) it has not intimated a desire to reject all established "bright line" tests; (2) the bright-line rule of *National Bellas Hess* "furthers the ends of the dormant Commerce Clause" and is important in areas of law that are "something of a 'quagmire' and the application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensable power of taxation"; and (3) a "bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment...". (See, 112 S.Ct. 1914-1915).

Based upon the above-stated reasoning, along with the Court's past reliance on the *National Bellas Hess* rule and the fact that the rule "has engendered substantial reliance and has become a part of the basic framework of a sizable industry", the Court concluded that under the judicial doctrine of "*stare decisis*" it was not compelled to reject the bright-line physical presence requirement for use tax collection.

Justice Byron White, the only current member of the Court that was on the *National Bellas Hess Court*, concurred with the majority with respect to its Due Process Clause holding and dissented with respect to the Commerce Clause aspect of the decision by concluding that the Commerce

Clause aspect of *National Bellas Hess* should also be overruled. Justice White succinctly stated his position the "[t]he Court stops short, however, of giving *Bellas Hess* the complete burial it justly deserves." (112 S.Ct. 1917).

After a lengthy analysis of the erroneous reasoning of the majority's clinging to a bright-line physical presence test, Justice White points to what he believes to be the underlying motivating factor in the Court's decision. His beliefs are stated as follows:

The Court hints, but does not state directly, that a basis for its invocation of *stare decisis* is a fear that overturning *Bellas Hess* will lead to the imposition of retroactive liability .... If indeed fears about retroactivity are driving the Court's decision in this case, we would be better served, in my view, to address those concerns directly rather than permit them to infect our formulation of the applicable substantive rule. (112 S.Ct. 1922).

Justice Scalia, writing for Justices Kennedy and Thomas, agreed with the majority's overruling of *National Bellas Hess*' Due Process Clause holding. While agreeing with the majority of the Court that the Commerce Clause holding of *National Bellas Hess* should not be overruled, Justice Scalia would not "revisit the merits of [the Commerce Clause aspect of the *Bellas Hess* opinion], but would adhere to it on the basis of *stare decisis*." (112 S.Ct. 23). Justice Scalia reasoned that in cases where Congress had the power to alter what the Court has ruled and where substantial reliance interests are at stake, the principle of *stare decisis* should control. Additionally, Justice Scalia's concurring opinion lends support in this regard by his stating -

'... I agree with the Court that the Due Process Clause holding of *Bellas Hess* should be overruled. Even before *Bellas Hess*, we had held, correctly I think, that state regulatory jurisdiction could be asserted on the basis of contacts with the State through the United States mail. See *Travelers Health Assn. v. Virginia ex rel. State Corp. Comm'n*, 339 U.S. 643-646-650 (1950)(Blue Sky laws).' (112 S.Ct. 1923).

A curious ending to the opinion suggests that the Court may even entertain revisiting this issue in the future. The Court wrapped up its decision by stating -

"Indeed, even if we were convinced that *Bellas Hess* was inconsistent with our Commerce Clause jurisprudence `this very fact [of Congress' ability to deal with this issue][might] giv[e us] pause and counsel[] withholding our hand, *at least for now*. Congress has the power to protect interstate commerce from intolerable or even undesirable burdens.'" (112 S.Ct. 1916)(emphasis supplied).

Based upon the foregoing, the Hearing Officer concludes that the *Quill* opinion does not require a "bright line" physical presence test with respect to state taxation of income earned in interstate commerce. To the contrary, the opinion does provide additional support for state efforts to assert income and franchise tax jurisdiction over out-of-state businesses who purposefully avail themselves of the state's market through interstate solicitation. The reversal of the Due Process holding of *National Bellas Hess* and the manner by which the Court limited its Commerce Clause holding to sales and use tax collection in the mail order context provide a further support to the states' assertion of taxing jurisdiction in the income and franchise tax areas.

The Court's opinion in *Quill* can readily be read as suggesting that the physical presence test for Commerce Clause jurisprudence in the use tax collection area may not be available to defeat the imposition of other types of taxes, such as income and franchise taxes. The *Quill* majority was clear in its limitation of the bright-line physical presence requirement and that aspect of *National Bellas Hess* to state-imposed duties to collect sales and use taxes. The Court noted -

'...although our Commerce Clause jurisprudence now favors a more flexible balancing analyses, we have never intimated a desire to reject all established "bright-line" tests. Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess*

established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule.

In sum, *although in our cases subsequent to Bellas Hess and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement*, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes. To the contrary, the continuing value of a bright-line rule in this area and the doctrine and principles of *stare decisis* indicate that the *Bellas Hess* rule remains good law. (112 S.Ct. 1914, 1916).' (emphasis added).

To the above-quoted discussion that suggests that no such bright-line currently exists as to any other tax add the Court's admonition that -

'While contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, *Bellas Hess* is not inconsistent with *Complete Auto* and our recent cases.' (112 S.Ct. 1912).

The Hearing Officer further concludes that only direct marketers concerned with use tax collection responsibility may comfortably rely on the bright-line, physical presence test of *National Bellas Hess*. The principles of *stare decisis* that preserve that aspect of the *National Bellas Hess* decision may well be unavailing with respect to corporate net income and franchise taxes. That being said, the Hearing Officer still does not know what "substantial nexus" will mean in the myriad of income and franchise tax factual contexts, as that issue will be fact sensitive on a case-by-case basis. However, one reading of the *Quill* opinion would supports the conclusion that the "economic presence" test or standard - that of a regular or systematic or purposeful availment of the state's market - may be found sufficient, by itself, to satisfy the Commerce Clause's substantial nexus requirement with respect to the corporate income and franchise tax liability.

Both *Quill* and *Wrigley* establish certain limitations and guidelines, however vague, that the taxpaying community

must apply to determine whether certain activities create a taxing nexus. *Quill* applies a "physical presence" standard in the use tax/mail order context only, and suggests that an "economic presence" standard may be Constitutionally sufficient for other taxes. Additionally, the *Quill* decision gave indication that even if a marketer had "physical presence" in a state, such presence does not necessarily create a substantial connection with the state if the property or contacts were of a *de minimis* nature.

The Court in *Wrigley* specifically grafted a *de minimis* principle on to the "solicitation of orders" test under P.L. 86-272. The *Wrigley* Court held that if the business activity under scrutiny exceeded the P.L. 86-272 definition of "solicitation of orders", net income tax jurisdiction would still not be found unless the unprotected activities created a "non-trivial" connection to the taxing state. As with the determination of what activities constitute "substantial nexus" under *Complete Auto* and *Quill*, the determination of what constitutes "solicitation of orders" and a *de minimis* or "non-trivial" connection to the state is a fact sensitive issue to be determined upon the specific facts that exist. The proposed Regulation neither addresses nor defines what nexus or jurisdiction-creating activities are required to be established as a prerequisite for the application of the recommended apportionment method. The Regulation presumes the existence of sufficient in-state connection and activities to satisfy the Due Process and Commerce Clauses, as well as P.L. 86-272, should that statute be found to apply to the publishing activities at issue. Attached Exhibit 9 describes another Commission uniformity effort that is intended to clarify many of the several issues left open by P.L. 86-272 and the *Wrigley* decision. The states and publishing industry representatives are encouraged to participate fully in that effort."

It makes good tax policy sense to set forth a nexus standard agreed to by the competing states (both money-center and market) and to apply that standard to both the market state's assertion of jurisdiction and the money-center or production state's assertion of throwback. The economic presence concept remains to be analyzed by the United States Supreme Court in the context of operational taxes; and the SIMS process has proceeded this far because of an understanding that nexus issues would

be addressed, if at all, at a later date. While that date may soon be upon us, it would not now be appropriate for the Hearing Officer to make any recommendations as to nexus provisions without providing an opportunity to industry representatives to more fully address the issue. Therefore, in deference to this understanding, the Hearing Officer has not made any formal recommendation regarding the nexus standard that should apply to the business activities conducted by financial institutions, even though he remains convinced that "economic presence" nexus provisions are constitutionally supportable.

b. *The Suggestion to Apply P.L. 86-272  
as a Nexus Standard for Financial Institutions*

FIST representatives, as well as the American Financial Service Association, have urged the Hearing Officer to recommend to the states that financial institutions receive the same protections afforded to sellers of tangible personal property under P.L. 86-272, even though the Public Law does not protect service providers. (See Exhibits J5\* and J38\*). With respect to the Hearing Officer's reaction to this suggestion, the following portion of the Hearing Officer's response in his Final Report concerning P.L. 86-272 is also pertinent here:

"Issue 6:

Extending Protection under the Public Law to the Sale  
and Delivery of Services

Submissions received from the Financial Institutions State Tax (FIST) Coalition urge the Commission to treat all industries on a "uniform basis", arguing that "parity in taxation treats all taxpayers equally and does not discriminate against one industry based on a product or service line." On behalf of FIST, Fred Ferguson requests that the Commission -

"...adopt and recommend to its member states, that for the purposes of parity, service companies should be treated similarly to sellers of tangible personal property under P.L.

86-272. The FIST Coalition would be willing to work with the MTC to achieve this end." See Attachment 12.

It is clear that the protection of the Public Law has been limited by Congress to the sale of tangible personal property. The House of Representatives' version of the legislation did not limit the protection to sales of tangible personal property, and sought it to apply to "any business engaged in interstate commerce...". See, H.R. Rep. No. 936, 86th Cong., 1st Sess. 2 (1959). But, the bill as finally passed was the Senate's version (S. 2424), which limited the protection to those engaged in the sale of tangible personal property. As noted in the Willis Committee Report at p. 146:

"[Public Law 86-272] does not apply to activities connected with the sale of services. In such cases, the question of tax liability still turns on the applications of those general constitutional principles which the judicial branch has developed in the absence of congressional action. Moreover, as applied to many factual situations, Public Law 86-272 is itself unclear."

On a purely theoretical level relating to possible economic distortions that may occur in investment decisions caused by differential tax treatment, the Hearing Officer sees some merit in FIST's view that for at least for the purpose of jurisdictional nexus, sellers of services should be treated similarly to sellers of tangible personal property. From the market states' perspective both types of sellers draw, though varying in degree, upon public resources. Both compete with local businesses for a share of sales to the states' residents; and they both rely heavily upon a stable, educated marketplace within the state.

The Hearing Officer supports the general principle that state tax systems should not distort investment choices and, to that extent, shares FIST's goal of achieving tax parity wherever it makes sense to do so. The Hearing Officer departs company with Mr. Ferguson and FIST on how to achieve that goal, as they would carve out yet another huge area of interstate commerce for protection from taxation under vague guidelines. The Hearing Officer believes that one solution lies in the repeal of Public Law 86-272, coupled with voluntary state action in establishing clear and quantifiable *de minimis* standards as to when an out-of-state business

need file returns. Such standards (an example of which is suggested above with reference to Issue 6) would provide more clarity than the vagaries contained in Public Law 86-272; would identify readily those states in which an interstate seller must file returns; and would protect smaller interstate businesses from having to comply with state tax laws when to do so would not be revenue productive.

The law is clear that a sale or delivery of a service is not a protected activity under Public Law 86-272. With regard to the sale or delivery of a service that is in some manner associated with the sale of the tangible personal property, the Hearing Officer concludes that the immunity under the Public Law is also not available to such transactions, unless the service is either ancillary to the original solicitation of the order or otherwise permitted by the signatory states under the Statement. Thus, where the seller of goods also provides such services as installation, warranty repair, and maintenance with respect to the goods sold, whether separately compensated for or not, such activities remove the immunity that otherwise might have been provided under the Public Law.

There are occasions when it may be more difficult to determine whether a service is being provided in the state or not. For example, if printed materials, such as a magazine, are sold and delivered into a market state, do the advertisements that appear in the magazine suggest that a service is being provided to the advertiser? If so, then the sale of the tangible personal property would also consist of the delivery of a service - the distribution by the publisher of the advertisers' messages - to the marketplace. As such, the immunity under the Public Law should not apply to protect the publisher from market state attribution of the receipts from either the magazine sales or the receipts for the advertising services.

For another example, assume that an out-of-state computer software manufacturer solicits the sale of software that it will design specifically for the in-state buyer (not "canned", "off the shelf" software) and delivers the software package from a point outside the state the market state. Here, even though the computer disks are tangible personal property, most states would treat the receipts as being derived from services provided by the development of the

individualized software. As such, the software manufacturer would not be protected under the Public Law.

A further example is found when a seller of goods also delivers those goods in its own trucks. There, while a protected solicitation of tangible personal property may have occurred earlier, the seller has engaged in a separate transaction in the market state - the providing of delivery services. At least where the seller has imposed a charge for private carriage delivery services, the Public Law's "delivery or shipment" protection may not apply. This is because the seller would not be solely engaged in the solicitation of sales of tangible personal property in the state, but could be viewed as providing a business in the state as well. Thus, certain activities conducted by the seller remove the protection under the Public Law, unless all methods of shipment and delivery - by common carrier or by the seller's own trucks - were protected. See the discussion of Issue 3. above.

Recommendation:

In order to provide notice to the business community of the issue regarding the delivery of services, either connected or not with the solicitation and delivery of tangible personal property, the Hearing Officer suggests the following language be added to Section I of the Statement:

**The sale or delivery and the solicitation for the sale or delivery of any type of service that is not either (i) ancillary to solicitation or (ii) otherwise set forth as a protected activity under the Section IV.B. hereof is not protected under Public Law 86-272 or this Statement.**

With regard to the more theoretical issue raised by FIST - the achieving of parity of treatment between sellers of goods and sellers of services - the Hearing Officer concludes few states, if any, will voluntarily rush to raise jurisdictional barriers to their taxation of interstate sellers of services. For the Hearing Officer to suggest here that the states raise such barriers would border on the frivolous and may well undermine the credibility of the remaining recommendations contained in this Final Report.<sup>15</sup>

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15. The Hearing Officer does not wish to imply that FIST's suggestion is frivolous when viewed from its own perspective and is thankful for the opportunity address it. However, the Hearing Officer declines to make any recommendation

The states should continue to protect their right to impose their taxes to the fullest extent permissible under state and federal Constitutions; however, it remains in the best interest of the states to impose their jurisdictional reach in a thoughtful and practical manner. It is one thing for a state to have the right to impose its tax obligations on out-of-state companies, it is another when that imposition can be viewed as an unreasonable and undue burdening of interstate commerce. The states are now working in a post-*Wrigley* environment - one in which state courts and the United States Supreme Court will be interested in construing Public Law 86-272 and fleshing out the definitions of such broad and judgmental concepts as "ancillary", "trivial" and "*de minimis*". Therefore, the Hearing Officer repeats here his recommendation that the states voluntarily review the feasibility of developing a *de minimis* standard in the nature as that suggested in the recommendation to Issue 5 above. By this approach - the taking of a proactive step to create a *de minimis* standard - the states would be better able to demonstrate to taxpayers, the courts and Congress the wisdom and clarity of their tax administration practices."

For the reasons noted above, the Hearing Officer recommends that Public Law 86-272 should be repealed, so that all interstate sellers, whether of services or tangible personal property, can be treated similarly with respect to the imposition of jurisdiction for state income taxation purposes. Should it be determined that a "bright line" be established in order to provide more clear notice to out-of-state sellers of their state tax responsibilities, then it is recommended that Congress empower the states to establish such bright lines through state legislation that specifies their respective *de minimis* levels above which jurisdiction will be asserted. For a discussion of the initial recommendations of the Hearing

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that does not stand a "snow ball's chance" of being widely accepted by State Tax Administrators. Recommending that the states further limit their right to assert taxing jurisdiction over service businesses contributing over one-half the GDP of the United States will only result in the State Tax Administrators making comments about the Hearing Officer, such as, "I told you so, he's crazy, simply crazy"; or "Remember the old saying - 'He who chases red herrings ends up smelling like dead fish'".

Officer concerning approaches to establishing de minimis levels, see the discussion in 5.c below.

c. *The De Minimis Concept.*

Every now and then during the SIMS discussions, while industry representatives would repeat their strong opposition to nexus provisions based upon "economic presence" principles, they would indicate that a *de minimis* provision might be welcome. The *de minimis* concept recently has been raised as a potential bar to a state's assertion of taxing nexus in two contexts. In *Quill*, the United States Supreme Court classified the in-state presence of certain property (a few floppy diskettes) as, possibly, minimal nexus, but not the "substantial nexus" as required by the Commerce Clause in the mail order use tax context. *Quill*, fn. 8. In *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, \_\_\_ U.S. \_\_\_, 112 S.Ct. 2447 (1992), the Supreme Court underscored that a *de minimis* level of unprotected activity or contact of a trivial nature with a state will not be recognized as sufficient reason for withdrawal of the protection afforded out-of-state sellers of tangible personal property under Public Law 86-272.

The Hearing Officer recently had the opportunity to address the identical suggestion in the context of his "Final Report of Hearing Officer Regarding Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272". Here, as in that Report, the Hearing Officer also concluded not to make any formal recommendation to include a *de minimis* provision in the proposed formula; however, the concept carries an appeal that requires its further study. Therefore, the pertinent discussion from that Report is set forth *verbatim* below.

"Issue 5:

De Minimis Level of Gross Receipts, Property, Payroll, or Other Factors

In rejecting Wisconsin's argument that the Public Law does not allow for *de minimis* exceptions, the *Wrigley* Court noted that -

'[Wisconsin's argument] ignores the fact that the venerable maxim *de minimis non curat lex* ("the law cares not for trifles") is part of the established background of legal principles against which all enactments are adopted, and which all enactments (absent contrary indication) are deemed to accept....[citations omitted].... It would be especially unreasonable to abandon normal application of the *de minimis* principle in construing §381, which operates in such stark, all-or-nothing fashion: A company either has complete net income tax immunity or it has none at all, even for its solicitation activities.'

*Wrigley*, 112 U.S. 2457-8.

Would the states be required under the Public Law to afford protection to out-of-state companies that conduct substantial and unprotected activities in the state, but which have such minimal sales that the net income to be apportioned to the market state was trivial or *de minimis*? This issue is discussed below, but the Hearing Officer makes no conclusion as to it based upon the current state of the law.

It is a fact that no state tax administrator has at his or her command sufficient resources to require all who are required under state law to register and file tax returns to do so. Tax administrators do all they can to educate those required to file returns and to enforce their state tax laws as fully and even-handed as their resources permit. But reality requires tax administrators to ration their resources and prioritize their compliance efforts. Few, if any, states have sufficient resources to search out all non-filers whose activities conducted and income earned within their states are minimal.

Should a tax administrator be required to spend a \$1.00 of state funds to collect \$.50 in tax that may be owed the state? Or to spend \$1,000,000 on a certain compliance program that he or she can reasonably anticipate will achieve far less than \$1,000,000 of tax revenue? One valid tax administration rationale for trying to require even those out-of-state companies that earn very little, if any income in the market state, and even those who suffer losses is that when the company has a "good year", some positive tax revenue may result. On the flip side is that too often the tax administrator is compelled to chase "good money after bad", with no net revenue resulting from a compliance program with a very low jurisdictional nexus standard, because doing so provides credibility to other enforcement programs.

From the perspective of the business taxpayer, how frustrating is it to be required to file a tax return in another state, when it costs more in accounting fees and other costs of compliance to file the return than the total tax that is due? Those that do business in an interstate environment, where minimal income (or loss) is at issue, continually face the issue of whether or not to incur filing burdens and comply with the tax laws of other states. Asserting the belief that common sense dictates their action, many businesses will avoid registration in states in which their activities create minimal tax consequences. Should the states apply a de minimis level of income or activity - even beyond that protected by the Public Law - to ensure that government and private resources not be diverted from more productive activity? Is it good state tax policy, as well as in the public's best interest, for government to ensure that small businesses are not burdened by compliance duties where there is negligible, if any, tax revenue at issue?

The Hearing Officer notes that there has not as yet been a United States Supreme Court case in the income apportionment area under either the Due Process or Commerce Clauses of the United States Constitution that prohibits states from imposing a net income or franchise tax measured by net income on any amount of income derived from interstate activities, no matter how small, so long as the four-prong test of *Complete Auto Transit, Inc. v. Brady*, 430

U.S. 274 (1977) is satisfied.<sup>16</sup> If the activities in the taxing state exceed those protected under Public Law 86-272, the business has little legal basis upon which to complain that it is required to comply with the state's general tax laws. But should our inquiry end there? Or, should the states now conduct a more in-depth review, from a joint perspective, of when it is appropriate to place upon interstate business activities the cumulative burdens of multijurisdictional tax compliance?

In *Quill Corp. v. North Dakota*, 112 U.S. 1904 (1992), the United States Supreme Court re-affirmed its long-standing concern regarding the cumulative burdens that are placed upon interstate commerce in the use tax collection context. Of course, this concern was based upon the Court's belief that if it were to allow state and local jurisdictions to require use tax collection on mail order sales, over 6,000 jurisdictions with a myriad of tax exemptions, would be pursuing the vendor for their taxes, and on a monthly filing basis as well. In the context of state corporate franchise and income taxes, however, the number of state and local jurisdictions seeking to apply their income or franchise tax laws to interstate sellers at present is quite small. For now, the burden placed on interstate commerce in the income and franchise tax area, from a registration and filing perspective, should not be considered undue under Commerce Clause standards. But, is there is a growing number of local jurisdictions seeking to impose taxes measured by net income on interstate businesses? If so, the same concerns expressed by the Court in *Quill* - the cumulative burdensome effect of having to comply with a myriad of state and local jurisdictions' tax laws - may come into play in some future case.<sup>17</sup>

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<sup>16</sup> Those four prongs require that the tax (1) be applied to an activity with a substantial nexus to the taxing state; (2) be fairly apportioned; (3) not discriminatory against interstate commerce; and (4) fairly related to the services provided by the state.

<sup>17</sup> It may be argued that since Congress has already set forth its *de minimis* activities requirements in Public Law 86-272 that no additional activities or minimum level of receipts are required under the Commerce Clause with respect to income and franchise taxes measured by net income. Irrespective of this fairly sound legal position, it remains in the state and local jurisdictions' best interest in preserving their tax systems to appear before the Supreme Court with well considered compliance approaches.

It is important to note here that thirty years ago Congress first expressed its concern with the cost-benefit ratio of the states' imposing their income taxes in a manner that produced "small-liability returns". In 1964, the Willis Committee reported as follows:

'It is also inevitable that the State income tax system should introduce additional tendencies to produce returns showing small tax liabilities. State income tax rates are very much lower than the Federal rates. Moreover, for companies paying income taxes in more than one State, the tax of each State is generally imposed on only a portion of the company-wide net income. But if these two factors make a high proportion of small-liability returns at the State level inevitable, they also have another significance. In combination, they will tend to produce some small-liability returns that cannot be justified as essential to sound administration of the revenue laws. In the absence of a jurisdictional limitation, a small company filing large numbers of State income tax returns may find itself making periodic reports to tax collectors in States in which it could never realistically hope to have significant tax liability. One objective of a jurisdictional rule, then, should be to relieve companies from income tax obligations in cases in which their activities in a State are so minimal that they are unlikely ever to be producers of significant amounts of tax.'

Willis Committee Report, p. 488 (emphasis added).

The Supreme Court recently denied review in the case of *Geoffrey Inc. v. South Carolina Tax Commission*, No. (23886 (S.C. July 6, 1993) (slip op.), cert. denied, 62 U.S.L.W. 3375 (11/29/93). In the *Geoffrey* case, South Carolina successfully imposed its franchise tax on earnings derived from license fees earned in South Carolina over an out-of-state corporation that had no physical presence within South Carolina. This issue, left open by the Court in *Quill*, applies to activities and taxes that are not now protected under the Public Law, e.g., business activities relating to the sale and delivery of services and income earned from intangibles. Tax Administrators of both state and local governments may feel more "bullish" than "bearish" in now asserting corporate

income tax jurisdiction in these areas. Therefore, now may be an opportune time for state Tax Administrators to consider the wisdom of establishing *de minimis* activity or gross receipts levels before committing to compliance measures that are either not cost effective or that risk violation of Commerce Clause restrictions.<sup>18</sup>

Even though financial institutions are purely service providers and, therefore, not eligible for protection under P.L. 86-272, the Hearing Officer repeats his recommendation made in his Final Report on Public Law 86-272 that the states study the feasibility of establishing *de minimis* thresholds for the imposition of income tax jurisdiction for sellers of both tangible and intangible property and services. The time will likely come when it would be in the best interests of the states to establish clearly set out nexus or *de minimis* rules, at least on a state-by-state basis. It would be more likely for the states to successfully accomplish this on a voluntarily basis in the near future, than under the duress of either Congressional or judicial making. The Executive Committee currently has before it the Hearing Officer's recommendations regarding changes to its Public Law 86-272 Statement, including a suggestion for a study regarding *de minimis* provisions. Therefore, the following recommendation is repeated here in this context as well:

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18. It is noteworthy that prior to the adoption of S.2524 (later to become P.L. 86-272) that Senator Long proposed an amendment (later rejected) that would have removed the application of the Public Law where, during the taxable year, the business had sales in the state in excess of the lesser of \$1,000,000 or "an amount determined by multiplying the population of such State (according to the last decennial census) by 50 cents." See also, Lee Sheppard, "Geoffrey: The Commerce Clause in the Information Age", State Tax Notes (January 3, 1994), p. 35 wherein the author, in discussing *Quill* and *Geoffrey*, states at p. 36:

"....Systematic exploitation of a state's markets ought to be enough for substantial nexus. If need be, to avoid undue administrative burdens for small merchants, the word 'substantial' could be administratively modified to require a specific dollar volume of business with the state's residents before responsibility for tax would attach."

**"Recommendation:**

The Hearing Officer recommends that the Executive Committee authorize the Uniformity Committee to review the appropriateness and feasibility of establishing "*de minimis*" gross receipts or apportionment factor standards for inclusion in the Phase Two Statement at some future date. Such review should consider various alternatives, including an approach similar to that proposed by the bills introduced in Congress seeking to limit the *National Bellas Hess* case. That approach imposes a use tax collection obligation only when sales during a 1-year period ending as a certain date of the previous calendar year exceeds a minimum level. (See also footnote 11 for another type of "gross receipts" *de minimis* approach that was originally suggested regarding Public Law 86-272).

For still another approach, the Hearing Officer recommends consideration by the Uniformity Committee of the following provision:

**De Minimis Level of Gross Receipts, Federal Taxable Income and In-State Apportionment Factor.**

**Any corporation subject to the personal jurisdiction of this State that is not otherwise protected under Public Law 86-272 or Section IV.B. from being required to pay a corporate income (franchise) tax to this State shall not be required to file a corporate income (franchise) tax return or pay such a tax for any taxable year unless, during such taxable year, the corporation either--**

**(1) had gross receipts from interstate transactions-**

**(A) within the United states exceeding \$\_\_\_\_\_,**

**or**

**(B) within the State exceeding \$\_\_\_\_\_ ; or**

**(2) had a federal taxable income prior to state adjustments exceeding \$\_\_\_\_\_ and an apportionment factor attributable to this State exceeding \_\_\_\_\_%.**

See Attachment 11 for support by California Franchise Tax Board for this type of suggestion."

The Hearing Officer suggests that should the states engage in the recommended study set forth above relating to sellers of tangible personal property, that specific attention should also be addressed to whether the same concepts apply with any force to financial institutions.

#### 6. **The Throwback of Receipts.**

UDITPA and the Compact incorporate the throwback principle in their respective Articles IV.16(b), which provide that the sales of tangible personal property are to be assigned to the numerator of the receipts factor for -

"this State if...the property is shipped from an office, store, warehouse, factory, or other place of storage in this State and (1) the purchaser is the United States Government or (2) the taxpayer is not taxable in the State of the purchaser."

A taxpayer is considered to be "taxable in another State" if -

"(1) in that State he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or

(2) that State has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the State does or does not do so."

(See Article IV.3 of both UDITPA and the Compact).

Under the throwback principle, sellers of tangible personal property will either assign the receipt from a sale to the numerator of the market or destination state's receipts factor; or, if that state does not have jurisdiction due to the operation of P.L 86-272 or the Due Process or Commerce Clauses, the receipt will be assigned generally to the

numerator of the receipts factor of the state from which the goods were shipped. In this manner, *all* of the receipts will be assigned to a state that has a substantial connection to the transaction and the taxpayer. Absent a throwback rule being in force in the "shipped from" state (most often the commercial domicile here), a receipt that is not thrown back will not be assigned anywhere, resulting in a portion of net income being unapportioned to any state and left untaxed.

Three simple examples illustrate this point. Assume that the Haskell Hunting Supply Company manufactures and sells animal traps for catching hyenas that roam through forests ravaging fauna and flora. Haskell has its commercial domicile and manufacturing plant located in State A and has total sales of \$60,000,000 for the tax year, with \$40,000,000 in State A and \$20,000,000 in State B. Assume the company ships all of its hyena traps from State A and earns \$10,000,000 pre-tax net income from its total operation. Assume also that all of Haskell's employees (\$500,000 payroll) and property (\$1,500,000 manufacturing plant and other property) are located only in State A. Should State B have jurisdiction to tax Haskell, the resulting apportionment formulae for the two states are as follows:

EXAMPLE 1.

**State A**

<u>Payroll Factor</u>	<u>Property Factor</u>	<u>Receipts Factor</u>
500,000/500,000	1,500,000/1,500,000	40,000,000/60,000,000
1	1	.6666

$$2.6666/3 = .8888 \text{ factor}$$

.8888 x 10,000,000 net income = \$8,888,888 apportioned to State A.

**State B**

<u>Payroll Factor</u>	<u>Property Factor</u>	<u>Receipts Factor</u>
0/500,000	0/1,500,000	20,000,000/60,000,000

0	0	.3333
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$$.3333/3 = .1111 \text{ factor}$$

.1111 x 10,000,000 net income = \$1,111,111 apportioned to State B.

**EXAMPLE 2.**

Should State B not have jurisdiction to tax Haskell, but State A has adopted the throwback principle, the \$20,000,000 in receipts from sales in State B will be included in State A's receipts numerator resulting in the following apportionment:

**State A**

<u>Payroll Factor</u>	<u>Property Factor</u>	<u>Receipts Factor</u>
500,000/500,000	1,500,000/1,500,000	60,000,000/60,000,000

1	1	1
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$$3/3 = 1.0000$$

1.0000 x 10,000,000 net income = \$10,000,000 apportioned to State A.

**State B**

<u>Payroll Factor</u>	<u>Property Factor</u>	<u>Receipts Factor</u>
0/500,000	0/1,500,000	0/60,000,000

0	0	0
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$$0/3 = .0000 \text{ factor}$$

.0000 x 10,000,000 net income = \$0 apportioned to State B.

### EXAMPLE 3.

If State A did not have a throwback rule to apply and if State B had no jurisdiction to tax Haskell, the \$20,000,000 in State B receipts would not be assigned anywhere and only \$8,888,888 of Haskell's \$10,000,000 in net income would be subject to tax. State B's apportionment would be \$0 as set forth immediately above in Example 2 and State A's apportionment would be calculated as set forth in Example 1. Thus, \$1,111,111 would not be subject to any taxation.

The result of a state's imposition of a throwback rule is to cause the sellers whose shipments originate in that state to assign all of their sales receipts to one state or another. By not imposing a throwback rule, the "shipped from" state permits those sellers located within its borders to create the possibility of "nowhere sales"; thus, some portion of the taxpayer's net income avoids taxation. Of the forty-six state income tax jurisdictions, twenty-eight impose a throwback rule and eighteen do not. (See Raabe and Boucher, 1993 Multistate Corporate Tax Guide, pp. 406-416 (Panel Publishers, Inc.)).

The Hearing Officer does not view the "throwback vs. no throwback" issue as one that, by itself, affects the possibility of duplicative taxation, i.e., the assigning of the identical receipt to two different state tax jurisdictions. The potential for double-counting of the identical receipt is an anathema which a widely adopted uniform approach seeks to avoid. So long as both the shipped from (production) state and the shipped to (market) state abide by the *same apportionment rule* and apply the *same jurisdictional standard*, double-counting will be avoided. If the production state wishes to forego taking into its sales factor numerator those receipts that would be sourced, but for lack of jurisdiction, to the market state, so be it. So long as the market state cannot or does not assert its taxing jurisdiction over the out-of-state business, it remains solely up to the

taxing philosophy of the production state to determine the extent to which those receipts will be included in the production state's numerator.<sup>19</sup>

The throwback rule incorporated under UDITPA/Compact is limited to the throwing back of receipts from the sale of *tangible personal property*. See Article IV.16. Neither law directly provides for a throwback of those receipts from services that are assignable to a market state that does not have jurisdiction to tax the service provider. However, Article IV.17(b) often operates, in effect, as an automatic assignment of receipts from services to the production state. It provides that where the income-producing activity of a service provider is performed in more than one state, *all* of the receipts from such activity are to be assigned to the state in which "*a greater proportion of the income-producing activity is performed....*". Even if the market state in which the income-producing activity is partially performed has taxing nexus over the service provider because its employees are physically present performing services at the customer's location within the market state, not \$1.00 of receipts from such services is assignable to the market state, unless a majority of the costs of performing such services was incurred in the market state. If, as is likely to occur often, the majority of such costs are incurred by the service provider within the state in which its offices and large portion of its employees are located, then 100% of the receipts will likely be assigned there. Therefore, apportionment of income from services under UDITPA/Compact often would result in no market state sharing of any income, since the receipts factor reflection is often 100% production state oriented through the current UDITPA/Compact rules of assignment. One of the issues intended to be addressed by the proposal is the under-attribution to the market states resulting from the application of the standard UDITPA/Compact approach to the sourcing of the receipts factor.

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<sup>19</sup>. The extent to which a state can favor the tax treatment of in-state businesses over out-of-state businesses through tax exemptions and the like will, however, be limited by the Commerce and Equal Protection Clauses to the U.S. Constitution. See, for example, *Westinghouse Elec. Corp. v. Tully*, 459 U.S. 1144 (1983).

For the reasons set forth in Section III.B.2. of this Final Report, the sourcing of the receipts factor that is recommended here has a distinct market-state flavor. Under the proposed apportionment method, the receipts factor remains the only factor of the apportionment formula that can effectively represent the contribution of the pure market-state. As noted earlier, industry representatives raised strong opposition to a nexus threshold different from one based upon the "physical presence" of the financial institution within the market-state. Undoubtedly, over the next several years, some financial institutions are going to resist certain market-state attempts to apply a nexus concept based on "economic presence". While interstate branching will reduce the number of squabbles, they will not disappear until the U.S Supreme Court finally decides the issue of whether *Quill's* limitation in the mail order/use tax context carries over to operational taxes. Those financial institutions that solicit interstate business solely by mail, telephone, computer modem and like facilities apparently will continue to resist efforts by the market-states to apportion any receipts, unless traditional "physical presence" concepts of nexus are satisfied.

Until more definitive nexus standards are developed and accepted, either judicially or otherwise, the Hearing Officer recommends, consistent with the suggestion by the State of South Dakota (Exhibit J34\*), that the money-center states (defined for this purpose as the state of commercial domicile) take assignment of all receipts that are not, *in fact*, included in the numerators of the market states. This assignment to the commercial domicile would occur, even when the market-state had jurisdiction over the taxpayer, *but did not subject the taxpayer to taxation*. For example, even when a market state, such as Nevada, has not enacted any corporate franchise or income tax that applies to the out-of-state financial institution, the receipts that would have been assigned to Nevada would then be assigned to the taxpayer's commercial domicile. This "full" throwback rule is set forth in the Section 2(s) definition of "taxable". Of course, the state of commercial domicile remains free as a matter of its

own taxing policy not to enact any throwback rule, full or otherwise, and to permit the receipt to remain unassigned.<sup>20</sup>

7. **Discussion of Other Issues and Suggestions**

a. ***The Use of SINAA Elements for Determining State to which Loan or Credit Card Receivables have a "Preponderance of Substantive Contact"***

During the SIMS process much discussion was had from the institutions' perspective of the potential for two states assigning the identical loan to their respective property factor numerators, since the phrase "preponderance of substantive contact" contained in Section 4(g)(1)(B) did not give clear guidance. From the states' perspective, the issue of whether a loan is "properly" booked or assigned became an issue. By regulation, New York addresses the proper assignment issue by analyzing the facts of a given loan transaction and determining where the loan was solicited, investigated, negotiated, approved, and administered (the "SINAA" elements). The ultimate issue SINAA elements are used for is to determine if the state to which the loan (or credit card receivable) has been assigned is the state with the "preponderance of substantive contacts". The elements of SINAA are only applied if a question is raised on audit as to whether the loan was improperly assigned by the financial institution.

Representatives of some of the financial institutions complained that SINAA does not fairly solve the issue of loan assignment and adds five more concepts over which to argue. One suggestion was to create a presumption that the state in which the approval and administration were located should be assigned the loan. See I5, letter from Philip M. Plant of

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<sup>20</sup> Currently, important commercial domicile states, such as New York and South Dakota, do not have throwback rules in place for any taxpayers, whether sellers of goods or services. Since New York has already adopted a taxing philosophy that does not include a throwback, the likelihood of its adoption of a throwback for financial institutions would seem low. South Dakota, not having earlier taken a position on throwback, may well consider adopting one.

the Bank of America dated April 30, 1993. While this would add some more certainty, some states believed that this presumption would not lead to a reasonable assignment in many instances, especially after the original term of the loan had expired.

The Hearing Officer believes that the application of SINAA should help to reduce these types of conflicts in more cases than SINAA will cause conflict. However, the weight to be placed on these and, possibly, other relevant factors is not clear. Only experience in applying the SINAA elements will lead to a better understanding of its usefulness. The information presented to the Hearing Officer has been that while vague in its terms, SINAA has been reasonably applied by the State and City of New York thus far, and representatives of institutions there are willing (not necessarily eager) to wait and see how the elements come into play in other states under the proposal. Therefore, the Hearing Officer has recommended the inclusion in Section 4(i) language incorporating the use of SINAA as setting out some measures to determine whether the questioned loans (and credit card receivables) have been properly assigned. Additionally, this is one area that all will benefit from a period of time and trial to determine the appropriateness of the concepts.

**b. *The Book vs. Tax Accounting Issue***

There was no clear agreement among the state representatives to the SIMS process to accept industry's suggestion that the financial institutions be permitted to elect upon which basis to file their returns - either tax or book method of reporting items for factor purposes. Industry representatives suggested that the use of book accounting would be less burdensome in terms of compliance to an apportionment formula. Certain jurisdictions remained insistent on tax basis reporting only, believing that application of normal rules for financial accounting do not work well in this area, with the old "apples and oranges" analogy uttered often. In addition, some state representatives believed that there has been no showing why financial institutions should be treated any differently in reporting than other types of businesses. Other states might permit book basis under certain conditions.

The opposing views on this issue are set out in Exhibit I5, the "S/IFWG Papers", in Jonathan Allen's discussion of S/IFWG Issue 21, as well as minutes to the telephone conference with state representatives on August 11, 1992. It is clear to the Hearing Officer that this is one issue from which little, if any uniformity would be achieved by a Hearing Officer's recommendation. Therefore, the Hearing Officer declines to make one.

**c. Process for Resolving Apportionment Conflicts**

Since the pending proposal does not address nexus standards, it starts with the assumption that constitutional nexus exists in two or more states and that apportionment of income is required. Absent any articulated and accepted nexus standard for the states to currently adopt, what happens when two states assert inclusion of the identical receipt in their respective state's receipts factor numerator because one state misapplied the intent of the rules of assignment? Should the states both claim it and bank on the probability that the amount of over-taxation, albeit grating on the financial institution, will be insignificant as a matter of constitutional law? Is this result appropriate in light of the industry representatives' strong opposition to the articulation of any nexus standard other than one they fully support?

While petard hoisting may be fitting in some settings, it is not here, where state/industry cooperation has fostered substantial communication and a corresponding appreciation of one another's perspectives. Therefore, the Hearing Officer recommends that the states consider a ground somewhere between the state-by-state application of a variety of interpretations of Due Process and Commerce Clause nexus requirements and complete surrender by one side or the other as to whether "physical presence" is the *sine qua non* of nexus. In the absence of any other suggestions, the Hearing Officer recommends that a process be agreed upon by the states that would point the way to resolving those conflicts that arise among states that risk double-counting of the identical item of receipt, property or payroll *where the double-counting results in*

*more than 100% of the denominator of any factor being assigned to the numerators of the states.* The Hearing Officer recommends that the states adopting the proposal agree to certain starting points or points of deference. This agreement would not be set forth by any statutory or regulatory format, but by agreement between the states.

The proposed formula reduces, but does not entirely eliminate, the opportunity for the occasional double-counting of receipts. The assignment rules provided by the proposal will not result in double-counting if all states consistently and correctly apply them. Thus, in the opinion of the Hearing Officer, the formula meets the internal consistency requirements of an apportionment formula under the Commerce Clause.

On rare occasions, however, certain assets, primarily unsecured loans, may fall within the contemplation of more than one state's grasp due to one or the other state's misapplication of the assignment rules. With respect to receipts, the lack of a nexus standard articulated in writing creates the potential for conflict between two states over which state is entitled to the assignment. With respect to asset assignment, such as unsecured loans, the application of the principle of which state has the "preponderance of substantive contact" (Section 4(g)(1)(B)) may be misinterpreted on occasion in a way that causes two or more states to assert their respective claims to the assignment of the intangible loan asset. A state-agreed upon dispute resolution process will work to reduce the risk of double-counting, even though such occasional double-counting would not risk any potential violation of the internal consistency requirement of the Commerce Clause.

The agreement would establish a process by which the states would confer with one another in an attempt to avoid duplicative factor assignments. Where there is actual conflict by reason of the throwback principle, between two states, the states would follow an informal process the taxpayer could request upon a proper showing that quickly and efficiently addresses the issue without the requiring the taxpayer to await conflicting assessments and protesting them both.

When a money-center state asserts the right to a throwback of a receipt and a market state asserts the right to the assignment of the identical receipt or stream of receipts, the initial point of deference should be given to the market-state's laws and determination of whether it has jurisdiction over the taxpayer. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) strongly suggests that the Supreme Court would favor, in principle, some apportionment to the market states, as opposed to 100% allocation to the commercial domicile, in circumstances in which the market state has jurisdiction over the taxpayer. The Court in *Mobil* set forth its philosophy regarding the tension between commercial domicile allocation and apportionment:

"Taxation by apportionment and taxation by allocation to a single situs are theoretically incommensurate, and if the latter method is constitutionally preferred, a tax bases on the former cannot be sustained. See *Standard Oil co. v. Perk*, 342 U.S, 382, 384 (1952). We find no justification, however, for such a preference. Although a fictionalized situs for intangible property sometimes has been invoked to avoid multiple taxation of ownership, *there is nothing talismanic about the concepts of 'business situs' or 'commercial domicile'* that automatically renders those concepts applicable when taxation of income from intangibles is at issue. The Court has observed that the maxim *mobilia sequunter personam*, upon which these fictions of situs are based, "'states a rule without disclosing the reasons for it'. *First Bank Stock Corp. v. Minnesota*, 301 U.S. at 241 (1937). The Court also has recognized that 'the reason for a single place of taxation no longer obtains' when the taxpayer's activities with respect to the intangible property involve relations with more than one jurisdiction. *Curry v. McCandless*, 307 U.S. 357, 367 (1939).

.....

..... Although we do not now presume to pass on the constitutionality of a hypothetical New York tax, we may assume, for present purposes, that the State of commercial domicile has the authority to lay *some* tax on appellant's dividend income as well as on the value of its stock. But there is no reason in theory why that power should be exclusive when the dividends reflect income from a unitary business, part of which is conducted in other States. In that situation, the income bears relation to benefits and privileges

conferred by several States. These are circumstances in which apportionment is ordinarily the accepted method. . . .  
..". (Emphasis added).

Lastly, two or more states may on rare occasion, seek to include in their respective property factor numerators the identical loan, credit card receivable or other intangible asset (where inclusion of such asset is permitted under Section 1(d)) in their respective property factors. On such occasions, the initial point of deference should be given to assigning such asset to a state in which there is a regular place of business of the taxpayer, wherever such place may be, and not on the basis of location of the borrowers or credit card holders. This is in keeping with the sense of the proposal that assignment of intangible assets should remain as is under the current practice - to the state in which the taxpayer maintains a regular place of business and to which the asset has a preponderance of substantive contact, whether at the home office, at a particular branch or subsidiary of the institution, or a loan production office.

The paragraph B of the attached Appendix sets forth some language that the states that adopt this proposal may wish to include in an agreement among themselves in order to address the lack of a brighter line than "a preponderance of substantive contact" found in Section 4(g)(1)(B). Even though such an agreed upon process is not required by law, it should go a long way to address industry's concern regarding the actual over-apportionment of the tax base. It is recommended that the Commission staff be authorized to assist in the development of the suggested agreement.

**d. *Process for Securing Adoption by  
Critical Mass of States***

With the arrival of full-scale branch banking in the near future, many nexus issues will be put to rest and the states will have need of an apportionment tool that will fairly approximate the income being derived within their borders by financial institutions. It is not very difficult to envision that a good number of states will seriously consider this this

proposal, because it has evolved from a collaborative process among representatives of both industry and states with support of the Commission and the Federation of Tax Administrators. The adoption of the proposal by a critical mass of states is most important. Whether the critical mass is actually twenty states as suggested in Section II.B. above, or a number slightly above or below that number, will depend largely upon the timing of adoption by a few of the larger, more market-state oriented jurisdictions. It is noteworthy that the State of Oregon has already adopted an earlier iteration of this proposal. Presumably that state will favorably entertain the suggestion to make the minor amendments necessary to conform its regulation to the version ultimately adopted by the Commission.

It is also difficult to project with any certainty if or when a given state may shift upon its taxpayer base and become more of a market than a money-center state or *vice versa*. Until Citibank located the commercial domicile of its credit card operation in the State of South Dakota, had that state considered itself a "money-center" state? If Manhattan were to lose its luster and allure and no longer retain many of the financial institutions currently domiciled there, could the State of New York eventually be in a circumstance in which a good portion of its financial services are delivered from across the Hudson or electronically from afar?

Because the SIMS process involved substantial discussions and compromises between the money-center and market-state interests, the proposal that evolved is fair to both types of states. Of course, the proposal will be viewed by some to be tipped too much in favor of the money-center states and by others as favoring too much the market-states. Thus, it appears to be within the range where it can be called "fair". With the input received from the industry, certain conventions and presumptions were engaged in that have made the proposal "administrable", without the record keeping burdens earlier complained of concerning the original Commission proposals. The Hearing Officer concludes that two of the three goals of the SIMS process have been met thus far - the development of an apportionment proposal that is both fair and administrable. Presumably, the proposal's fairness and

administrability will form the basis for its acceptance and endurance. It now remains for the states to determine whether the remaining goal - adoption by a critical mass of states - is also fulfilled.

#### **IV. CONCLUSION**

Often during the State/Industry Meetings process, representatives of the financial institutions advanced the position that so long as the apportionment formula selected by the states was fair, uniformly adopted by a substantial number of states, and administrable, the specific provisions of the formula were of less concern. The Hearing Officer is convinced that the uniformity proposal attached as Exhibit A: 1, despite a few fuzzy parts and rough edges, does meet the criteria of being fair and administrable.

The proposed apportionment formula fairly reflects the contributions of both money-center and market-state inputs to the production of income of most financial institutions. Representatives of these two sides labored hard to make the proposal fair to their respective circumstances. The Hearing Officer is confident that, over time, the states and financial institutions will gain the needed experience by continuing to cooperate closely with one another, to clarify the fuzziness and to smooth out the rough edges of the proposal. It is now time to start down the path and leave the forest. A few might see the path suggested here as a "slippery slope"; many others might see it as "the yellow brick road". However viewed, taking the suggested step beats just standing here.

Last, but far from least, is the Hearing Officer's conclusion that the process attempted here was truly remarkable. The SIMS process has provided a lesson in good government, both in effort and in result. Even though certain issues, such as nexus and combination, remain to be addressed and some issues that were addressed may not have been fully nailed down, the process remains remarkable.

The Commission member states could have easily chosen the well-known and comfortable course of its normal rule making process - that of the Commission states and staff developing the uniformity proposal by first talking among themselves, without any industry involvement; and then holding formal public hearings as the sole method of industry input. While good work can be accomplished by the traditional method, there is often the high potential for the proposal to fall short of understanding how a given industry really works; and the proposal likely may not be sensitive enough to the extent of compliance burdens being placed on the industry and its representatives. From the Hearing Officer's prior experience, industry representatives in general, when faced with what appears to them to be a *fait accompli*, often react, almost instinctively, in a resistant, non-constructive mode. Little is communicated and little is gained, with the resulting rule suffering in its inability to work effectively or reasonably.

Some taxpayers and their representatives may take the view that the less the states see or know about the industry at issue, the better. The more enlightened recognize that no matter how little the states see, the taxpayers will still be required to operate, for tax purposes, in the states' darkness. Ill-fitting measures often cause unanticipated, illogical results, pulling both taxpayer and the states into the same darkness and guesswork. Sometimes the refund will issue; sometimes the assessment, with interest and penalties, will be upheld. Too often, the ill-fitting measure will produce little but uncertainty, frustration and the needless waste of time and energy litigating over application and meaning of the tax measure. For whatever reasons the SIMS effort came about, there will be substantially fewer words, phrases and issues over which both states and industry members might stumble in the darkness.

As important as the development of a fair and administrable proposal is, the SIMS and S/IFWG process also provided a healthy break from the type of state/industry dance that has played out during prior uniformity efforts. By sitting at the same worktable and through teaming the talents of those interested and wishing to share, much of the "our

side" versus "their side" mentality dissipated. The good intentions of those sharing the same worktable quickly became apparent, and a more trusting atmosphere developed. This type of effort, whether it results in a widely-accepted uniformity measure or not, was successful because of the process alone. All of those involved know that "good government" was at work. Their efforts should be respected by others now taking the proposal and trying it on to see the fit.<sup>21</sup>

This Final Report of Hearing Officer was submitted on April 28, 1994 and supplemented on September 16, 1994 to reflect the final recommended apportionment formula (Exhibit A: 1) to be distributed to the member states for survey pursuant to Bylaw 7 of the Multistate Tax Commission.



Alan H. Friedman  
Hearing Officer

hofnfnlrpt.ahf 9/16/94

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<sup>21</sup> The Hearing Officer extends to all government and industry representatives who participated, his *heart-felt* thanks and an abiding respect for their professionalism and thoughtful contributions to this effort.

**APPENDIX TO FINAL REPORT  
OF HEARING OFFICER**

V.

**APPENDIX TO FINAL REPORT**

**SUGGESTED ADDITIONAL PROVISIONS FOR  
STATUTORY, REGULATION OR GUIDELINE PURPOSES**

The following represents various suggestions for developing statutory, regulatory or guideline language to supplement or further refine two issues that were mentioned, but not included in the recommended proposal. As such, the following suggestions are intended to be the beginning reference points for further discussion, analysis and statutory, regulation and guideline development.

**A. Definition of Financial Institution.**

The following definition of 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 subsections (2) through (8) and (10) above.**

**B. Process for Addressing Conflicts between States in Apportionment**

As discussed in the Final Report of Hearing Officer (Section III.B.7.a), representatives of financial institutions were concerned that any apportionment proposal adopted by the states should eliminate the possibility that two or more states would include the identical item of any factor in their respective factor numerators. The proposed formula provides a framework for minimizing that possibility. While not perfect, if the proposal and attached regulations are adopted and reasonably applied, the possible double assignment of the identical factor item would

occur, if at all, on very rare occasions when a state misinterprets the formula assignment provision.

On those rare occasions when there still is an opportunity to timely address the issue, i.e., when the states' statutes of limitations permit it, then there should be a process in place that permits the taxpayer an inexpensive way to avoid the double-counting that would result in more than 100% of its income base from being apportioned. To this end, the Hearing Officer recommends that the states that adopt the main proposal set out in this Final Report also enter into an agreement with one another as follows:

**Agreement to Confer to Avoid Over-Taxation.**

**When it appears that this state and one or more other states that have adopted the same or substantially similar provisions to those contained in [this Act] have included or will include the same receipt, property or payroll in their respective factor numerators, at the written request of the taxpayer, this state shall confer with such other state or states to discuss which state should be properly assigned said receipt, property or payroll. Such conference shall identify what law, regulation or written guideline, if any, has been adopted in each state with respect to the issue.**

**(1) In discussing a conflict as to which state is to receive the assignment of any receipt at issue, a preference shall be given to assigning said receipt to the state in which the customer, borrower or other payor of the receipt is located, unless to do so (i) would clearly conflict with any law, regulation, or written guideline of this state; and (ii) would not clearly reflect the income-producing activity of the taxpayer within this state.**

**(2) In discussing a conflict as to which state is to receive the assignment of any property in the form of any loan**

or credit card receivable at issue, a preference shall be given to the state in which a regular place of business of the taxpayer's is located and to which a preponderance of substantive contact between the property and said place of business exists, unless to do so (i) would conflict with any law, regulation, or written guideline of this state and (ii) would not clearly reflect the income-producing activity of the taxpayer within this state.



**LIST OF EXHIBITS TO REPORT  
OF HEARING OFFICER**

**VI.**

**LIST OF EXHIBITS TO FINAL REPORT OF HEARING OFFICER REGARDING  
PROPOSED MULTISTATE TAX COMMISSION  
FORMULA FOR THE UNIFORM APPORTIONMENT OF  
NET INCOME OF FINANCIAL INSTITUTIONS**

The following documents are Exhibits to the "Final Report of Hearing Officer Regarding Proposed Multistate Tax Commission Formula for the Uniform Apportionment of Net Income from Financial Institutions". There are over 2000 pages of Exhibits to this Final Report. The symbol "✱" indicates that the particular Exhibit has also been attached to the Final Report. All of the Exhibits are on file with the Multistate Tax Commission and copies of them may be obtained upon written request.

**EXHIBITS**

**EXHIBIT A: RECOMMENDED APPORTIONMENT FORMULA**

1. Final Recommended Apportionment Formula issued ✱ pursuant to Resolution of the Executive Committee dated March 6, 1994
2. Initial Recommended Apportionment Formula as Attached ✱ to Final Report of Hearing Officer dated April 28, 1994 (superseded by Final Recommended Apportionment Formula (Exhibit A: 1))

**EXHIBIT B: PRE-MAY 10, 1990 PROCEEDINGS**

1. Initial Draft Proposal of Regulation (July 1987) ✱
2. Proposed Revisions to MTC's Draft Regulations from Eugene Mason (First Bank System, Minneapolis, MN) (April 1988)
3. Letter from Haskell Edelstein (Citicorp) (September 19, 1988)

4. Letter from Henry Ruempler  
(American Bankers Association) (October 4, 1988)
5. Letter from Philip M. Plant  
(Bank of America) (October 14, 1988)
6. Letter from Jim A. Peterson  
(Moore Financial Group) (October 17, 1988)
7. Letter from Robert W. Shank  
(Benjamin Franklin Federal Savings  
and Loan Association) (November 2, 1988)
8. Letter from Sheila J. Slaughter (California League of Savings  
Institutions) (November 11, 1988)
9. Letter from Albert A. Wolf  
(Wheeler, Wolf, Peterson, Schmitz,  
McDonald & Johnson) (November 14, 1988)
10. Letter from Richard L. Sprunger  
(California Federal Savings and Loan Association)  
(November 16, 1988)
11. Letter and Minutes from Philip M. Plant  
(Bank of America) (December 30, 1988)
12. Letter from Philip M. Plant w/"Proposed Amendments 1/89"  
(Bank of America) (January 6, 1989)
13. March 1989 Draft Proposal  
w/strikeouts and underlining reflecting Philip Plant's  
recommendations (March 1989) (prepared by MTC)
14. Minutes of April 19, 1989 Meeting - Chicago, IL
15. Letter from James A. Fry\*  
(South Dakota Department of Revenue)  
(May 5, 1989)
16. Letter from J. Daniel Vandermark  
(Norwest Corporation) (May 10, 1989)
17. Minutes of June 22, 1989 Meeting - Atlanta, GA

18. Letter from Sheila J. Slaughter  
(California League of Savings Institutions)  
(July 11, 1989)
19. Letter from Jonathan W. Allen  
(Wachovia Bank & Trust Company (July 11, 1989)
20. Letter from Luc Noiset (ACIR) (August 19, 1989)
21. Memorandum from Alan H. Friedman  
and Paull Mines (MTC) (September 11, 1989)
22. Letter from Marvin C. Umholtz  
(Credit Union National Association, Inc.)  
(November 20, 1989)
23. Letter to various financial institutions  
organizations (November 22, 1989)
24. Letter from Donald Kinley  
(First Commerce Bankshares, Inc.)  
(December 20, 1989)
25. Letter from Robert F. McCammon Jr.  
(CoreStates Financial Corp.) (December 21, 1989)
26. Letter from Daniel N. Leiter  
(The Chase Manhattan Bank, N.A.)  
(December 21, 1989)
27. Letter from Marie Cutillo  
(First Financial Savings Bank) (December 28, 1989)
28. Letter from Stephen R. Cameron  
(First National Bank of Louisville) (December 29, 1989)
29. Letter from Gary S. Austin  
(National City Corporation) (December 29, 1989)
30. Letter from Philip M. Plant  
(Bank of America) (March 27, 1990)

**EXHIBIT C: RESOLUTIONS OF MULTISTATE TAX COMMISSION EXECUTIVE COMMITTEE**

1. Resolution dated May 10, 1990 \*
2. Resolution dated November 9, 1990 \*
3. Resolution dated May 6, 1994

**EXHIBIT D: NOTICES OF PUBLIC HEARINGS AND ATTENDANCE LISTS**

1. Notices of Public Hearing
2. Proposed definition of "finance leasing"
3. Copy of Notice of Public Hearing - ABA Banker's Weekly, Vol. 9, No. 29 (July 24, 1990)
4. Lists of Persons Attending Public Hearing Sessions

**EXHIBIT E: INTERIM REPORTS OF HEARING OFFICER**

1. Interim Report of Hearing Officer (November 9, 1990)
2. Interim Report of Hearing Officer (May 10, 1993) \*
3. Partial and Interim Report of Hearing Officer (April 12, 1994)

**EXHIBIT F: PARTICIPANT LISTS AND AGENDAS:  
STATE/INDUSTRY MEETING GROUP (SIMS)**

1. Statement by Dan R. Bucks, Executive Director, Multistate Tax Commission to State/Industry Meetings
2. State/Industry Meetings (SIMS) Agenda, San Francisco, CA (July 15-16, 1991)

3. State/Industry Meetings (SIMS) Agenda,  
New York, NY (April 29-30, 1992)
4. State/Industry Meetings (SIMS) Agenda,  
Chicago, IL (November 23-24, 1992)

**EXHIBIT G: AGENDA: MTC/FTA FINANCIAL \*  
INSTITUTIONS BUSINESS WORKSHOP**

**EXHIBIT H: WORKING MATERIALS: STATE SUBCOMMITTEE  
ON APPORTIONMENT OF INCOME FROM  
FINANCIAL SERVICES**

1. Agenda for Conference Call (January 24, 1992)
2. Agenda for Conference Call (February 11, 1992)
3. Report of Subcommittee on Apportionment of \*  
Income from Financial Services (Alan Friedman)  
(March 30, 1992) with following attachments:  
  
Attachment 1: Money-center state proposal  
  
Attachment 2: Market-state KISS Compromise  
  
Attachment 3: Chart of proposals  
  
Attachment 4: Minutes of State Subcommittee  
New York Meeting (Alan Friedman)
4. Memorandum re California Discussion Proposal  
(Eric Coffill) (April 24, 1992)
5. Memorandum re Bank Apportionment Formula  
(Michael Boekhaus) (April 29, 1992)

**EXHIBIT I: WORKING MATERIALS: STATE/INDUSTRY  
FINANCIAL WORKING GROUP (S/IFWG)**

1. Memo to S/IFWG members (Alan Friedman) \*  
(May 6, 1992)
2. Memo to S/IFWG members (Alan Friedman) \*  
(May 17, 1992)
3. Memo to S/IFWG members (Alan Friedman) \*  
(May 18, 1992)
4. Memo to S/IFWG members (Alan Friedman)  
(June 4, 1992)
5. Memo to Teams 15-18 (with attachments from other  
Teams) (Alan Friedman) (September 2, 1992) (with later  
generated documents also being incorporated)

**EXHIBIT J: TESTIMONY, DOCUMENTS AND LETTERS  
SUBMITTED DURING PUBLIC HEARING PROCESS**

1. Testimony of Paul Claytor  
(American Bankers Association) (August 21, 1990)
2. Testimony of Fred E. Ferguson  
(Financial Institutions State Tax Coalition (FIST))  
(August 21, 1990)
3. Testimony of Daniel Egan  
(Credit Union National Association and Affiliates)  
(August 21, 1990)
4. Memorandum from Edward N. Delaney  
(Edward N. Delaney & Associates) (August 21, 1990)
5. Testimony of Haskell Edelstein  
(Citicorp/Citibank) (August 21, 1990)

6. Outline of comments by Philip Plant  
(Bank of America) (August 23, 1990)
7. Memorandum from Credit Union National  
Association, Inc. (September 4, 1990)
8. Letter from John R. Engler  
(Security Bank & Trust) (October 3, 1990)
9. Comments by David Danielson  
(Washington Society of CPAs) (November 16, 1990)
10. Testimony of Bruce Baker  
(Dean Witter Financial Services Group)  
(December 3, 1990)
11. Testimony of Ron Schreiner  
(Secretary of Revenue of South Dakota)  
(December 4, 1990)
12. Comments of Tom Neubig  
(FIST) (December 4, 1990)
13. Testimony of Marcia Dieter  
(Washington Bankers Association)  
(December 7, 1990)
14. Letter from Robert F. McCammon Jr.  
(CoreStates) (December 19, 1990)
15. Letter from Fred E. Ferguson (FIST)  
(January 21, 1991)
16. Letter from Philip M. Plant  
(Bank of America) (April 8, 1991)
17. Report by Thomas S. Neubig on "The Economic Effects  
of One State Enacting Destination Source Taxation of  
Financial Institutions" (April 18, 1991)
18. Letter from Haskell Edelstein  
(Citicorp/Citibank) (May 2, 1991)

19. Report of American Bankers Association on "Facts and Issues Concerning State Taxation of Commercial Banks" (1991)
20. Letter from James H. Paige, III (Secretary, West Virginia Department of Taxation and Revenue) (January 15, 1992)
21. Memorandum from Joe Huddleston (Commissioner of Revenue, State of Tennessee) (April 15, 1992)
22. Letter from Douglas L. Whitley (Director, Illinois Department of Revenue) (August 27, 1992)
23. Letter from Haskell Edelstein (Citicorp/Citibank, N.A.) (October 29, 1992)
24. Letter from Anne H. Dougherty (Assistant General Counsel, Revenue Department, State of Tennessee) (April 27, 1993)
25. Comments of the Franchise Tax Board of the State of California re MTC Proposal submitted by Ben Miller, Counsel, Multistate Tax Affairs (June 4, 1993)
26. Letter from Fred E. Ferguson (FIST) (June 11, 1993)
27. Letter from Brenda Jo Seipel (Credit Union National Association, Inc.) (June 11, 1993)
28. Letter from Kim Burse (Secretary, Kentucky Revenue Cabinet) (July 12, 1993)
29. Testimony of Barbara Davis \* (Credit Union National Association) (July 15, 1993)
30. Testimony of Doug Duerr (National Association of State Credit Union Supervisors) (July 15, 1993)

31. Statement by Norma J. Lauder  
(First National Bank of Chicago) "Historical Perspective  
on Multistate Taxation of Financial Institutions"
32. Letter from Fred E. Ferguson (FIST) (July 29, 1993)
33. Letter from Brenda Jo Seipel  
(Credit Union National Association, Inc.)  
(August 11, 1993)
34. Letter from Ron Schreiner \*  
(Secretary of Revenue of South Dakota)  
(September 28, 1993)
35. Letter from John B. Rice (Coopers & Lybrand)  
(September 28, 1993)
36. Testimony of Linda A. Kern \*  
(American Bankers Association)  
(September 30, 1993)
37. Letter from Brenda Jo Seipel  
(Credit Union National Association, Inc.)  
(September 27, 1993)
38. Testimony of Donald N. Adler \*  
(Chairman, American Financial  
Services Association) (September 30, 1993)
39. Statement of Jonathan Robin  
(Assistant Commissioner, New York City  
Department of Finance) (September 30, 1993)
40. Statement of Jeffrey Serether  
(Citibank/Citicorp and FIST)  
(September 30, 1993)
41. Statement of Thomas G. Siciliano  
(Credit Union National Association  
and New York State Credit Union League)  
(September 30, 1993)

42. Letter from John J. Quick  
(Beneficial Management Corporation)  
(October 26, 1993)
43. Letter from Brenda Jo Seipel  
(Credit Union National Association, Inc.)  
(November 1, 1993)
44. Letter from Roy E. Crawford  
(American Bar Association Banking  
and Savings Institutions Committee  
and State and Local Tax Committee)  
(November 3, 1993)
45. Letter from Henry Ruempler  
(American Bankers Association)  
(November 18, 1993)
46. Letter from Fred E. Ferguson (FIST)  
(November 19, 1993)
47. Letter from Ben Miller and Mike Brownell  
(California Franchise Tax Board)  
(December 15, 1993)

**EXHIBIT K:           ARTICLES, PAMPHLETS AND OUTLINES**

1. Advisory Commission on Intergovernmental Relations,  
"Monitoring and Working Group on State Taxation and  
Regulations of Banks" (July 7, 1989) (briefing paper  
and collection of presentations and articles)
2. Advisory Commission on Intergovernmental Relations, "State  
Taxation of Banks: Issues and Options", Report M-168  
(December, 1989)
3. American Bar Association, Committee on Banking and  
Savings Institutions, "Tax Section Recommendation No. 1981-  
3", Tax Lawyer, Vol. 34, No. 3 (Spring 1981) p.861

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**EXHIBIT L: STATUTES AND REGULATIONS**

1. California Bank and Corporation Franchise Tax, Chapter 2, Article 3 and regulatory materials
2. Illinois General Assembly Resolutions (November 30, 1990)
3. Notice of Proposed Rule for Definition of Financial Organization (Draft), Department of Illinois
4. Materials regarding Indiana HB 1625
5. Iowa Administrative Code §§701-59.25-59.29
6. New York Franchise Tax on Banking Corporations, Article 32
7. Oregon Administrative Regulation 150-314.280
8. Letter from James H. Paige III (West Virginia Department of Tax and Revenue) regarding Senate Bill 632

**EXHIBIT M : MISCELLANEOUS**

1. News Articles
2. Tape recordings - Public Hearing Sessions (on file at MTC headquarters)

3. Tape recordings - MTC/FTA Financial Institutions Workshop (on file at MTC headquarters)
4. Memorandum from Alan H. Friedman (MTC) (June 4, 1991) (without attachments)
5. Opinion and selective pleadings: *Siegelman v. Chase Manhattan Bank, et al.*, 575 So.2d 1041 (Ala. 1991)
6. Opinion: *Prulease, Inc. v. Michigan Department of Treasury*, Dkt. No. 91414 (Michigan Tax Tribunal 7/8/92)
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9. Plant, Philip M., Testimony before Oregon Department of Revenue, November 17, 1993
10. Solicitation from Swiss Bank Corporation

**EXHIBIT N: MATERIAL RECEIVED SUBSEQUENT TO SUBMISSION OF FINAL REPORT OF HEARING OFFICER BUT BEFORE BYLAW VII SURVEY**

1. Letter from James W. Wetzler (Commissioner, New York Department of Taxation and Finance) (May 25, 1994)
2. Letter from Phil Plant (Bank of America) (June 29, 1994)
3. Letter from Phil Plant (Bank of America) (July 1, 1994)
4. Letter from Lawrence R. Uhlick (Institute of International Bankers) (August 11, 1994)

**EXHIBIT O: RESULTS OF BYLAW VII SURVEY OF RECOMMENDATION**

**EXHIBIT A**

**RECOMMENDED APPORTIONMENT FORMULA**

**EXHIBIT A: 1**

**Final Recommended Apportionment Formula  
issued pursuant to Resolution of the  
Multistate Tax Commission Executive Committee  
(May 6, 1994)**



## **EXHIBIT A: 1**

### **Final Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions (Issued pursuant to Resolution of the Multistate Tax Commission Executive Committee (May 6, 1994))**

#### 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) "**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.

(d) "**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.

(e) "**Credit card**" means credit, travel or entertainment card.

(f) "**Credit 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 card has charged merchandise or services to the credit card.

(g) "**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.

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

(i) "**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":

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

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

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

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

(j) "**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: properties treated as loans under section 595 of the Federal Internal Revenue Code; 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.

(k) "**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.

(l) "**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 card is accepted in payment for merchandise or services sold to the card holder.

(m) "**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.

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

(o) "**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.

(p) "**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.

(q) "**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.

(r) "**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.

(s) "**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.

(t) "**Taxable**" means either (i) 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 net income; or (ii) 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.

(u) "**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 from loans secured by real property.**

(1) The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from 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 from loans not secured by real property.** The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from 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.

(g) **Receipts from credit card receivables.** The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from credit card receivables and receipts from fees charged to card holders, such as annual 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) **Credit card issuer's reimbursement fees.** The numerator of the receipts factor includes all credit card issuer's reimbursement fees 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.

(j) **Receipts from merchant discount.** The numerator of the receipts factor includes receipts from merchant discount if the

commercial domicile of the merchant is in this state. Such receipts shall be computed net of any cardholder charge backs, but shall not be reduced by any interchange transaction fees or by any issuer's reimbursement fees paid to another for charges made by its card holders.

(k) **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.

(l) **Receipts from services.** The numerator of the receipts factor includes receipts from services not otherwise apportioned under this section if the service is performed in this state. If the service is performed both within and without this state, the numerator of the receipts factor includes receipts from services not otherwise apportioned under this section, if a greater proportion of the income-producing activity is performed in this state based on cost of performance.

**(m) Receipts from investment assets and activities and trading assets and activities.**

(1) Interest, dividends, net gains (but not less than zero) and other income from investment assets and activities and from trading assets and activities 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; future 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) 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) 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) 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 four.

(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) 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) 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.

(n) **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.]

(o) **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, 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 average value of the taxpayer's loans and credit card receivables that are located 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.**

(1) 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.

(2) Loans are valued at their outstanding principal balance, without regard to any reserve for bad debts. If a loan is charged-off in whole or in part for Federal income tax purposes, the portion of the loan charged off is not outstanding. A specifically allocated reserve established pursuant to regulatory or financial accounting guidelines which is treated as charged-off for Federal income tax purposes shall be treated as charged-off for purposes of this section.

(3) Credit card receivables are valued at their outstanding principal balance, without regard to any reserve for bad debts. If a credit

card receivable is charged-off in whole or in part for Federal income tax purposes, the portion of the receivable charged-off is not outstanding.

(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.

**(g) Location of Loans**

(1)(A) A loan is considered to be located within this state if it is properly assigned to a regular place of business of the taxpayer within this state.

(B) A loan is properly assigned to the regular place of business with which it has a preponderance of substantive contacts. A loan assigned by the taxpayer to a regular place of business without the state shall be presumed to have been properly assigned if--

(i) the taxpayer has assigned, in the regular course of its business, such loan on its records to a regular place of business consistent with Federal or state regulatory requirements;

(ii) such assignment on its records is based upon substantive contacts of the loan to such regular place of business; and

(iii) the taxpayer uses said records reflecting assignment of loans for the filing of all state and local tax returns for which an assignment of loans to a regular place of business is required.

(C) The presumption of proper assignment of a loan provided in subsection (1)(B) of this section may be rebutted upon a showing by the [State Tax Administrator], supported by a preponderance of the evidence, that the preponderance of substantive contacts regarding such loan did not occur at the regular place of business to which it was assigned on the taxpayer's records. When such presumption has been rebutted, the loan shall then be located within this state if (i) the taxpayer had a regular place of business within this state at the time the loan was made; and (ii) the taxpayer fails to show, by a preponderance of the evidence, that the preponderance of substantive contacts regarding such loan did not occur within this state.

(2) In the case of a loan which is assigned by the taxpayer to a place without this state which is not a regular place of business, it shall be presumed, subject to rebuttal by the taxpayer on a showing supported by the preponderance of evidence, that the preponderance of substantive

contacts regarding the loan occurred within this state if, at the time the loan was made the taxpayer's commercial domicile, as defined by Section 2(c), was within this state.

(3) To determine the state in which the preponderance of substantive contacts relating to a loan have occurred, the facts and circumstances regarding the loan at issue shall be reviewed on a case-by-case basis and consideration shall be given to such activities as the solicitation, investigation, negotiation, approval and administration of the loan. The terms "solicitation", "investigation", "negotiation", "approval" and "administration" are defined as follows:

(1) *Solicitation.* Solicitation is either active or passive. Active solicitation occurs when an employee of the taxpayer initiates the contact with the customer. Such activity is located at the regular place of business which the taxpayer's employee is regularly connected with or working out of, regardless of where the services of such employee were actually performed. Passive solicitation occurs when the customer initiates the contact with the taxpayer. If the customer's initial contact was not at a regular place of business of the taxpayer, the regular place of business, if any, where the passive solicitation occurred is determined by the facts in each case.

(2) *Investigation.* Investigation is the procedure whereby employees of the taxpayer determine the credit-worthiness of the customer as well as the degree of risk involved in making a particular agreement. Such activity is located at the regular place of business which the taxpayer's employees are regularly connected with or working out of, regardless of where the services of such employees were actually performed.

(3) *Negotiation.* Negotiation is the procedure whereby employees of the taxpayer and its customer determine the terms of the agreement (e.g., the amount, duration, interest rate, frequency of repayment, currency denomination and security required). Such activity is located at the regular place of business which the taxpayer's employees are regularly connected with or working out of, regardless of where the services of such employees were actually performed.

(4) *Approval.* Approval is the procedure whereby employees or the board of directors of the taxpayer make the final determination whether to enter into the agreement. Such activity is located at the regular place of business which the taxpayer's employees are regularly connected with or working out of, regardless of where the services of such employees were actually performed. If the board of directors

makes the final determination, such activity is located at the commercial domicile of the taxpayer.

(5) *Administration.* Administration is the process of managing the account. This process includes bookkeeping, collecting the payments, corresponding with the customer, reporting to management regarding the status of the agreement and proceeding against the borrower or the security interest if the borrower is in default. Such activity is located at the regular place of business which oversees this activity.

(h) **Location of credit card receivables.**

For purposes of determining the location of credit card receivables, credit card receivables shall be treated as loans and shall be subject to the provisions of subsection (g) of this section.

(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.

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**

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.

**EXHIBIT A: 2**

**Initial Recommended Apportionment Formula as Attached  
to Final Report of Hearing Officer dated April 28, 1994  
(superseded by Final Recommended  
Apportionment Formula (Exhibit A: 1))**



**STATUTORY PROPOSAL FOR APPORTIONMENT AND ALLOCATION  
OF NET INCOME OF FINANCIAL INSTITUTIONS  
(SUPERSEDED BY EXHIBIT A: 1)**

Section 1. Apportionment and Allocation.

(a) 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 [     ]. 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.

(b) 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**" shall mean (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; and (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) "**Commercial domicile**" means the headquarters of the trade or business, that is, the place from which the trade or business is principally managed and directed. 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 to be the state which the taxpayer has declared to be its home state pursuant to the provisions of the International

Banking Act of 1978; or, if the taxpayer described in this subdivision has not made such a declaration or is not required to make such a declaration, its commercial domicile for the purposes of this [ACT] shall be deemed to be 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 employee are performed, as of the last day of the taxable year.

(d) "**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.

(e) "**Credit card**" means credit, travel or entertainment card.

(f) "**Credit 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 card has charged merchandise or services to the credit card.

(g) "**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.

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

(i) "**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":

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

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

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

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

(j) "**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: properties treated as loans under section 595 of the Federal Internal Revenue Code; 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.

(k) "**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 card is accepted in payment for merchandise or services sold to the card holder.

(l) "**Participation**" is 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.

(m) "**Person**" shall mean an individual, estate, trust, partnership, corporation and any other business entity.

(n) "**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 "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 the taxpayer, 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.

(o) "**Real property owned**" and "**tangible personal property owned**" means 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.

(p) "**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.

(q) "**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.

(r) "**Syndication**" is 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.

(s) "**Taxable**" means 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, an earned surplus tax, or any other tax which is imposed upon or measured by net income.

(t) **"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 subdivision, 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 from loans secured by real property.**

(1) The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from loans secured by real property if the property is located within this state. If the property is located within this state and one or more other states, the receipts described in this subdivision 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 subdivision shall be included in the numerator of the receipts factor if the borrower is located in this state.

(2) A loan is secured by real property if, at the time the original loan agreement was made, fifty percent or more of the aggregate value of the collateral was real property.

(3) 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 from loans not secured by real property.** The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from 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 subdivision (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 subdivision (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.

(g) **Receipts from credit card receivables.** The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from credit card receivables and receipts from fees charged to card holders, such as annual 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 subdivision (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) **Credit card issuer's reimbursement fees.** The numerator of the receipts factor includes all credit card issuer's reimbursement fees multiplied by a fraction, the numerator of which is the amount included in the numerator of the receipts factor pursuant to subdivision (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.

(j) **Receipts from merchant discount.** The numerator of the receipts factor includes receipts from merchant discount if the commercial domicile of the merchant is in this state. Such receipts shall be computed net of any cardholder charge backs, but shall not be reduced by any interchange transaction fees or by any issuer's reimbursement fees paid to another for charges made by its card holders.

(k) **Loan servicing fees.**

(1) 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 subdivision (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 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 subdivision (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.

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.

(l) **Receipts from services.** The numerator of the receipts factor includes receipts from services not otherwise apportioned under this section if the service is performed in this state. If the service is performed both within and without this state, the numerator of the receipts factor includes receipts from services not otherwise apportioned under this section, if a greater proportion of the income-producing activity is performed in this state based on cost of performance.

(m) **Receipts from investment assets and activities and trading assets and activities.**

(1) Interest, dividends, net gains and other income from investment assets and activities and from trading assets and activities 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; future 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, net 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 interest expense from securities sold not yet purchased and net losses from such assets and activities.

(2) The numerator of the receipts factor includes interest, dividends, net gains and other income from investment assets and activities and from trading assets and activities described in paragraph (1) that are attributable to this state.

(A) The amount of interest, dividends, net gains 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) 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, net 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) 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 subdivisions (c) and (d) of section four.

(3) In lieu of using the method set forth in paragraph (2) of this subdivision, 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 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) 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, net 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) 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 subdivision, 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 the 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.

(n) **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.]

(o) **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, 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 average value of the taxpayer's loans and credit card receivables that are located 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.**

(1) 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.

(2) Loans are valued at their outstanding principal balance, without regard to any reserve for bad debts. If a loan is charged-off in whole or in part for Federal income tax purposes, the portion of the loan charged off is not outstanding. A specifically allocated reserve established pursuant to regulatory or financial accounting guidelines which is treated as charged-off for Federal income tax purposes shall be treated as charged-off for purposes of this section.

(3) Credit card receivables are valued at their outstanding principal balance, without regard to any reserve for bad debts. If a credit

card receivable is charged-off in whole or in part for Federal income tax purposes, the portion of the receivable charged-off is not outstanding.

(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 the 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 leased 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 subdivision 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 subdivision, 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.

**(g) Location of loans.**

(1)(A) A loan is considered to be located within this state if -

(i) it is properly assigned to a regular place of business of the taxpayer within this state; or

(ii) in the case of a taxpayer organized under the laws of the United States or of any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico or any territory or possession of the United States, the loan is assigned to a place which is not a regular place of business of the taxpayer and such taxpayer's commercial domicile is within this state; or

(iii) in the case of a taxpayer organized under the laws of a foreign country, the loan is assigned to a place which is not a regular place of business of the taxpayer and such taxpayer has declared this state to be its home state pursuant to the provisions of the International Banking Act of 1978. If a taxpayer described in this clause has not made such a declaration or is not required to make such a declaration, the loan shall be presumed to be located at the place in the United States to which the greatest number of employees are regularly connected or out of which they are working, irrespective of where the services of such employee are performed, as of the last day of the calendar year.

(B) The state in which a loan has a preponderance of substantive contact with a regular place of business of the taxpayer shall be the state in which a loan is properly assigned.

**(h) Location of credit card receivables.**

For purposes of determining the location of credit card receivables, credit card receivables shall be treated as loans and shall be subject to the provisions of subdivision (g) of this section.

**(i) Elements to Consider in Determining Proper Assignment of Certain Intangible Assets.**

In order to determine the state to which loans or credit card receivables are properly assigned under the "preponderance of substantive contact" test for the purpose of locating said property under Section 4(g)(1)(B) and 4(h), consideration is to be given to such things as: solicitation, investigation, negotiation, approval and administration. The terms "solicitation", "investigation",

"negotiation", "approval" and "administration" are defined as follows:

(1) *Solicitation.* Solicitation is either active or passive. Active solicitation occurs when an employee of the taxpayer initiates the contact with the customer. Such activity is located at the regular place of business which the taxpayer's employee is regularly connected with or working out of, regardless of where the services of such employee were actually performed. Passive solicitation occurs when the customer initiates the contact with the taxpayer. If the customer's initial contact was not at a regular place of business of the taxpayer, the regular place of business, if any, where the passive solicitation occurred is determined by the facts in each case.

(2) *Investigation.* Investigation is the procedure whereby employees of the taxpayer determine the credit-worthiness of the customer as well as the degree of risk involved in making a particular agreement. Such activity is located at the regular place of business which the taxpayer's employees are regularly connected with or working out of, regardless of where the services of such employees were actually performed.

(3) *Negotiation.* Negotiation is the procedure whereby employees of the taxpayer and its customer determine the terms of the agreement (e.g., the amount, duration, interest rate, frequency of repayment, currency denomination and security required). Such activity is located at the regular place of business which the taxpayer's employees are regularly connected with or working out of, regardless of where the services of such employees were actually performed.

(4) *Approval.* Approval is the procedure whereby employees or the board of directors of the taxpayer make the final determination whether to enter into the agreement. Such activity is located at the regular place of business which the taxpayer's employees are regularly connected with or working out of, regardless of where the services of such employees were actually performed. If the board of directors makes the final determination, such activity is located at the commercial domicile of the taxpayer.

(5) *Administration.* Administration is the process of managing the account. This process includes bookkeeping, collecting the payments, corresponding with the customer, reporting to management regarding the status of the agreement and proceeding against the borrower or the security interest if the borrower is in default. Such activity is located at the regular place of business which oversees this activity.

Notwithstanding any provision contained herein to the contrary, the taxpayer shall have the burden to prove, by clear and convincing evidence, that an item of receipt, property or payroll has been properly assigned on its books and records.

(j) **Period for which Properly Assigned Loan Remains Assigned.**

A loan that has been properly assigned to a state shall 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 there.

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 is included in the computation of the apportionable income tax base for the taxable year.

(b) **Compensation relating to Nonbusiness Income**

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:

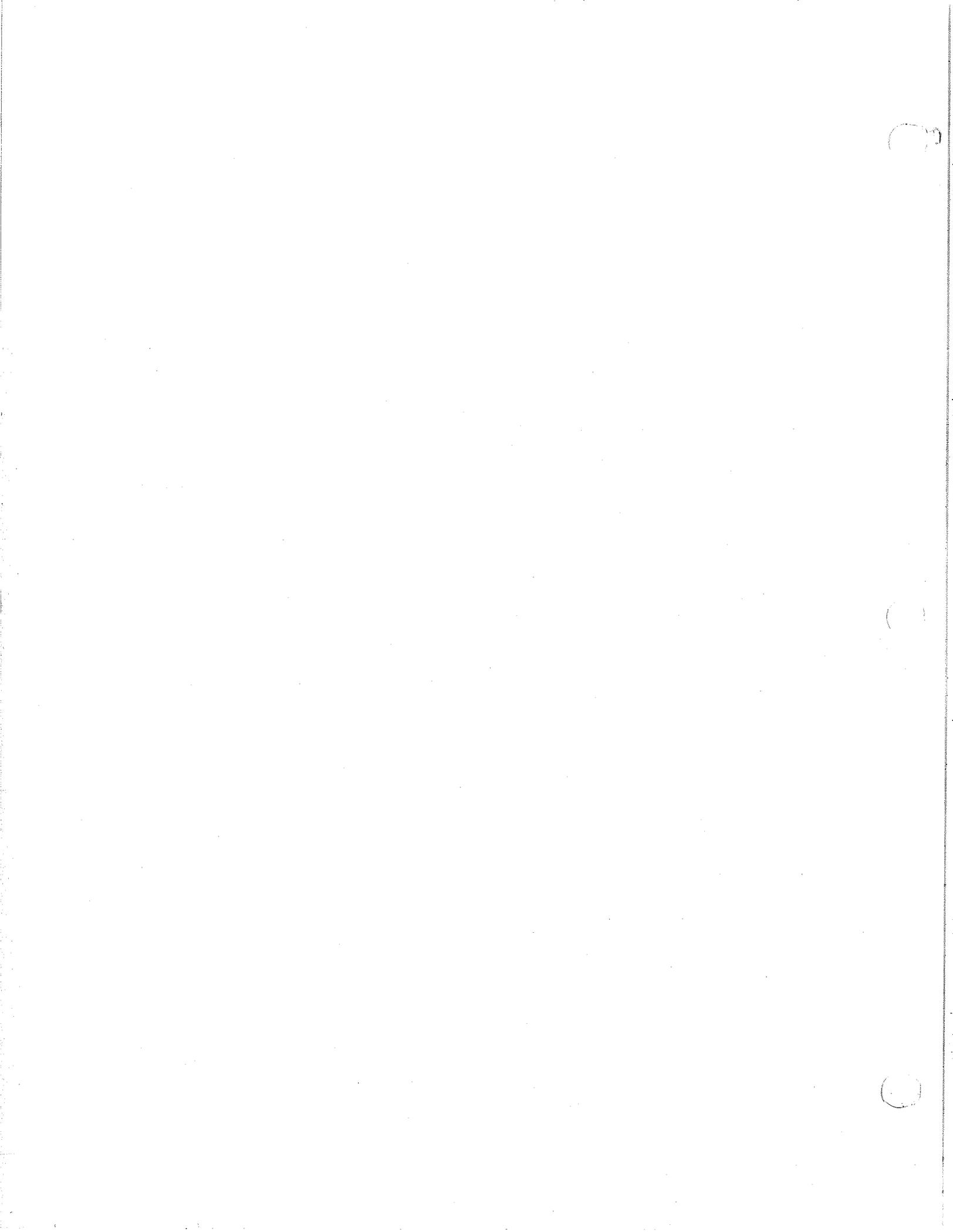
(A) if the employee's principal base of operations is within this state; or

(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 some part of the services are directed or controlled are not in any state in which some of service is performed but the employee's residence is in this state.

**EXHIBIT B: 1**

**Initial Draft Proposal of Regulation  
(July 1987)**



July 1987 Draft Proposal of

**PROPOSED REGULATION FOR THE ATTRIBUTION OF THE INCOME OF  
FINANCIAL INSTITUTIONS**

- (A) **Definitions.** Except as specifically defined herein, all terms used in this regulation shall have the same meaning as such terms have under [here include your State cite to the Multistate Tax Compact or other applicable state law] and the rules and regulations promulgated thereunder.
- (1) "Receipts" for the purpose of the receipts factor, means gross income, including net taxable gain on disposition of assets (including securities, loans, personal and real property and money market transactions) when derived from transactions and activities in the regular course of the taxpayer's trade or business.
  - (2) "Participation Loan" means a loan in which more than one lender is a creditor to a common borrower.
  - (3) "Securities" means United States Treasury securities, obligations of United States Government agencies and corporations, obligations of State and political subdivisions, corporate stock and other corporate securities, participations in securities backed by mortgages held by United States or State government agencies, loan-backed securities and similar investments to the extent that such investments are reflected as assets under generally accepted accounting principles.
  - (4) "Money Market Instruments" mean Federal funds sold and securities purchased under agreements to resell, commercial paper, banker's acceptances, and purchased certificates of deposit and similar instruments to the extent that such instruments are reflected as assets under generally accepted accounting principles.
  - (5) "Property Located in this State"
    - (a) **Tangible Property: General Rule.** -- Except as otherwise provided in this section, tangible and real property which is security for a loan or property subject to a lease, shall be considered to be located in the state in which such property is physically situated.
    - (b) **Moveable tangible property.** -- Tangible personal property which is characteristically moving property, such as motor vehicles, rolling stock,

aircraft, vessels, mobile equipment, and the like shall be considered to be located in a state if:

- (i) the operation of the property is entirely within the state; or
  - (ii) the operation of the property is in two or more states, but the principal base of operations from which the property is sent out is in the state. It shall be presumed, subject to rebuttal, that the location of operation of the property and the principal base of operations from which the property is sent out shall be that duly certified in writing by the lessee or borrower.
- (6) "Exercising a Corporate Franchise or Transacting Business in a State." A financial institution is exercising a corporate franchise or transacting business in this state if:

- (a) it has a place of business in this state;
- (b) it has employees, representatives or independent contractors conducting business activities in its behalf in this state; or,
- (c) it engages in regular solicitation in this state (whether at a place of business, by travelling loan officers or other representatives, by mail, by telephone or other electronic means), and the solicitation results in the creation of a depository or direct debtor/creditor relationship with a resident of this state. For purposes of this regulation, mere processing or transfer through financial intermediaries of checks, credit card receivables, commercial paper and the like does not create a debtor/creditor relationship.

A financial institution is engaged in regular solicitation within this state if it has entered into any of the relationships listed in subsection (c) above with 20 or more residents of this state during any tax period or if it has \$5,000,000 or more of assets attributable to sources within this state at any time during the tax period.

- (7) "Taxpayer" means a financial institution which is subject to taxation in a state because it is exercising its corporate franchise or is transacting business in a corporate or organized capacity in the state and has gross income attributable under this regulation to sources within this state.

- (8) "Subsidiary" means a corporation whose voting stock is more than 50% owned, directly or indirectly, by a financial institution.
- (9) "Holding Company" means any corporation subject to [insert citation of the state law governing the creation of bank holding companies] 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.
- (10) "Regulated Financial Corporation" means an institution the deposits or accounts of which are insured under the Federal Deposit Insurance Act or by the Federal Savings and Loan Insurance Corporation, any institution which is a member of a Federal Home Loan Bank, any other bank or thrift institution incorporated or organized under the laws of the United States, any State or any foreign country which is engaged in the business of receiving deposits or which holds a bank charter, any corporation organized under the provision of 12 U.S.C. sections 611 to 631 (Edge Act Corporations), and any agency of a foreign depository as defined in 12 U.S.C. section 3101.
- (11) "Business of a Financial Institution" includes the following:
- (a) the business that a regulated financial corporation may be authorized to do under state or federal law or the business that its subsidiary is authorized to do by the proper regulatory authorities.
  - (b) the business that any corporation organized under the authority of the United States or organized under the laws of this state or any other state or country does/or has authority to do which is substantially similar to the business which a corporation may be created to do under [insert citations of state's laws governing the creation of banks and trust companies, industrial banks, savings and loan associations, etc.] or any business which a corporation or its subsidiary is authorized to do by said laws.
  - (c) the business that any corporation organized under the authority of the United States or organized under the laws of this state or any other state or country does or has authority to do if such corporation derives more than fifty percent of its gross income from lending activities (including discounting obligations) in substantial competition with the businesses described in subsections (a) and (b) above. For purposes of this subsection, the computation of the gross income of a corporation

shall not include income from nonrecurring, extraordinary items.

- (12) "Financial Institution" includes the following:
- (a) A holding company.
  - (b) Any regulated financial corporation.
  - (c) Any other corporation organized under the laws of the United States or organized under the laws of this state or any other state or country which is carrying on the business of a financial institution.
- (13) "Place of consumption or use of services" means the state in which the benefits of the services are received. If such benefits are received in more than one state, the receipts from those benefits shall be apportioned to this state pro rata according to the portion of the benefits received in this state.
- (14) "Borrower" means the individual or entity who is primarily liable on a debt instrument. If more than one individual or entity is primarily liable on a debt instrument, each such individual or entity shall be considered the borrower to the extent of its interest in the debt instrument. For purposes of this regulation, a partnership shall be treated as a group of individuals.
- (15) "Deposit" means:
- (a) the unpaid balance of money or its equivalent received or held by a financial institution in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to a commercial, checking, savings, time, or thrift account whether or not advance notice is required to withdraw the credited funds, or which is evidenced by its certificate of deposit, thrift certificate, investment certificate, or certificate of indebtedness, or other similar name, or a check or draft drawn against a deposit account and certified by the financial institution, or a letter of credit or a traveler's check on which the financial institution is primarily liable; provided, that, without limiting the generality of the term "money or its equivalent," any such account or instrument must be regarded as evidencing the receipt of the equivalent of money when credited or issued in exchange for checks or drafts or for a promissory note upon which the person obtaining any such credit or instrument is primarily or secondarily liable or for a charge against a deposit

account or in settlement of checks, drafts, or other instruments forwarded to such bank for collection;

- (b) trust funds received or held by such financial institution, whether held in the trust department or held or deposited in any other department of such financial institution;
  - (c) money received or held by a financial institution, or the credit given for money or its equivalent received or held by a financial institution in the usual course of business for a special or specific purpose, regardless of the legal relationship thereby established, including, without being limited to, escrow funds, funds held as security for an obligation due the financial institution or others (including funds held as dealers reserves) or for securities loaned by the bank, funds deposited by a debtor to meet maturing obligations, funds deposited as advance payment on subscriptions to United States Government securities, funds held for distribution or purchase of securities, funds held to meet its acceptances or letters of credit, and withheld taxes; provided that there shall not be included funds which are received by the financial institution for immediate application to the reduction of an indebtedness to the receiving financial institution, or under condition that the receipt thereof immediately reduces or extinguishes such an indebtedness;
  - (d) outstanding drafts (including advice or authorization to charge a financial institution's balance in another such institution), cashier's checks, money orders, or other officer's checks issued in the usual course of business for any purpose, but not including those issued in payment for services, dividends, or purchases or other costs or expenses of the financial institution itself;
  - (e) money or its equivalent held as a credit balance by a financial institution on behalf of its customer if such entity is engaged in soliciting and holding such balances in the regular course of its business.
- (16) "State" means a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or any territory or possession of the United States or any foreign country.
- (17) "Taxable in a State." For the purpose of the receipts factor, a taxpayer is taxable in another state if: (a) in that state, he is subject to a franchise tax measured by net income, a net income tax, a franchise tax for the

privilege of doing business, or a corporate stock tax, or (b) that State has jurisdiction to subject the taxpayer to such a tax regardless of whether, in fact, the State does or does not.

(18) "Resides/Residence/Resident." A person shall be considered to reside or make his or her residence in or be a resident of a state if, in the case of an individual, he/she resides there for more than 100 days of the relevant tax period. For purposes of this regulation, a partnership shall be treated as a group of individuals, each of whom is subject to the above residence rule. A corporation shall be considered a resident of the state in which it has an office or other place of business during the relevant tax period. For purposes of this regulation, a corporation may be a resident of more than one state. An individual or a corporation shall be presumed, subject to rebuttal, to reside at (i.e., be a resident of, make his residence at) the address to which the statement of account is regularly mailed.

(B) **Business Income.** All income (taxable under the laws of this State) which arises from the business of a financial institution shall be deemed derived from transaction in the regular course of the taxpayer's business and subject to apportionment under this regulation. All such income which arises from activities of a financial institution which are not the business of a financial institution as defined in this rule shall be apportioned or allocated in accordance with the rules set forth in [here include your State cite to UDITPA or the Multistate Tax Compact].

(C) **Apportionment of Business Income.**

(1) **General Method.**

(a) If a financial institution is carrying on the business of a financial institution both within and without this state and if, by reason of such business activity, it is taxable in another state, the portion of the net income (or net loss) arising from such business which is derived from sources within this state shall be determined by apportionment in accordance with this regulation.

(b) The tax applicable to financial institutions whose net income (or net loss) is apportionable according to the rules in this section shall be determined by multiplying the tax base by a fraction the numerator of which is the sum of the receipts factor, the

property factor, and the payroll factor as defined in this regulation and the denominator of which is three. If any factor(s) is missing, the remaining factors are added together and the sum is divided by the number of remaining factors. A factor is missing if both its numerator and denominator are zero, but it is not missing merely because its numerator is zero.

- (2) Receipts Factor. In general. -- The receipts factor is a fraction the numerator of which is the receipts of the taxpayer within this state during the tax period and the denominator of which is the total receipts of the taxpayer from all states in which the taxpayer is taxable during such tax period. The numerator of the receipts factor shall include, in addition to items otherwise assignable under [here include your State cite to the Multistate Tax Compact or other applicable state law]:
- (a) Receipts from the lease or rental of real or tangible personal property (including both finance leases and true leases) shall be attributed to this state if the property is located in this state;
  - (b) Interest income and other receipts from assets in the nature of loans which are secured primarily by real estate or tangible personal property shall be attributed to this state if such security property is located in this state;
  - (c) Interest income and other receipts from consumer loans not secured by real or tangible personal property that are made to residents of this state (whether at a place of business, by travelling loan officer, by mail, by telephone or other electronic means) shall be attributed to this state;
  - (d) Interest income and other receipts from commercial loans and installment obligations not secured by real or tangible personal property shall be attributed to this state if and to the extent that the borrower is a resident of this state;
  - (e) Interest income and other receipts from a participating financial institution's portion of participation loans shall be attributed under the rules set forth in subsections (a) through (d);
  - (f) Interest income and other receipts, including service charges from financial institution credit card and travel and entertainment credit card receivables and credit card holders' fees shall be attributed to the state to which such card charges and fees are regularly billed;

- (g) Merchant discount income derived from financial institution credit card holder transactions with a merchant shall be attributed to the state in which the merchant is located. In the case of merchants located within and without this state, only receipts from merchant discounts attributable to sales made from locations within the state shall be attributed to this State. It shall be presumed, subject to rebuttal, that the location of a merchant is the address shown on the invoice submitted by the merchant to the taxpayer.
  - (h) Receipts from the performance of fiduciary and other services are attributed to this state if the services are consumed or used in this state;
  - (i) Receipts from the issuance of travelers checks and money orders shall be attributed to the state in which such checks and money orders are purchased;
  - (j) Receipts from investments of a financial institution in securities of this state, its political subdivisions, agencies and instrumentalities shall be attributed to this state;
  - (k) Receipts from investments of a financial institution in other securities and from money market instruments shall be apportioned to this state based upon the ratio that total deposits from this state, its residents, its political subdivisions, agencies and instrumentalities bear to the total deposits from all states, their residents, their political subdivisions, agencies and instrumentalities. In the case of an unregulated financial institution subject to this regulation, such receipts shall be apportioned to this state based upon the ratio that its gross business income earned from sources within this state bears to gross business income earned from sources within all states. For purposes of this subsection, deposits made by this state, its residents, its political subdivisions, agencies and instrumentalities shall be attributed to this state, whether or not such deposits are accepted or maintained by the taxpayer at locations within this state.
  - (l) All receipts located by this rule in a state without jurisdiction to tax shall be excluded from both the numerator and the denominator of the receipts factor.
- (3) Property Factor. In general. -- The property factor is a fraction the numerator of which is the average value

of the taxpayer's real and tangible personal property owned or rented and used in and intangible property attributed to this state during the tax period and the denominator of which is the average value of all of the taxpayer's real and tangible personal property owned or rented and used in and intangible property attributed to all states during the tax period. For purposes of this regulation, the value of property owned by the taxpayer shall be its federal income tax basis, without diminution for bad debt reserves; the value of property rented by the taxpayer shall be eight times its net annual rental rate. The net annual rental rate for any item of rented property is the annual rate paid by the taxpayer for such property less the aggregate annual subrental rates paid by subtenants of the taxpayer. Intangible personal property shall be included at its tax basis for federal income tax purposes. Goodwill shall not be included in the property factor. The numerator of the property factor shall include, in addition to items otherwise assignable under [here include your State cite to the Multistate Tax Compact or other applicable state law], the following:

- (a) Coin and currency located in this state shall be attributed to this state;
- (b) Lease financing receivables shall be attributed to this state if and to the extent that the property is located within this state;
- (c) Assets in the nature of loans which are secured by real or tangible personal property shall be attributed to this state if and to the extent that the security property is located within this state;
- (d) Assets in the nature of consumer loans and installment obligations which are unsecured or secured by intangible property shall be attributed to this state if the loan was made to a resident of this state;
- (e) Assets in the nature of commercial loan and installment obligations which are unsecured or secured by intangible property shall be attributed to this state if and to the extent that the borrower is a resident of this state;
- (f) Assets in the nature of funds deposited by one financial institution in another financial institution shall be attributed to this state if the depositor is a resident of this state;

- (g) A participating financial institution's portion of a participation loan shall be attributed under the rules set forth in subsections (b) through (e);
- (h) Financial institution credit card and travel and entertainment credit card receivables shall be attributed to this state if such credit card charges and fees are regularly billed to a resident of this state;
- (i) Assets in the nature of securities of this State, its political subdivisions, agencies and instrumentalities shall be attributed to this state;
- (j) Assets in the nature of securities and money market instruments shall be apportioned to this state based upon the ratio that total deposits from this State, its residents, its political subdivisions, agencies and instrumentalities bear to the total deposits from all States, their residents, their political subdivisions, agencies and instrumentalities. In the case of an unregulated financial institution subject to this regulation, such receipts shall be apportioned to this state based upon the ratio that its gross business income earned from sources within all states. For purposes of this subsection, deposits made by this State, its residents, its political subdivisions, agencies and instrumentalities shall be attributed to this state whether or not such deposits are accepted or maintained by the taxpayer at locations within this state.

All property located by this rule in a state without jurisdiction to tax shall be excluded from both the numerator and the denominator.

- (4) Payroll Factor. In general. -- The payroll factor is a fraction the numerator of which is the total amount paid by the taxpayer for compensation during the year and the denominator of which is the total amount of compensation paid in every state.
    - (a) Neither the numerator nor the denominator of the payroll factor shall include wages paid to an employee in a state without jurisdiction to tax.
- (D) **Special Rules.** If the allocation and apportionment provisions of this regulation do not fairly represent the extent of the taxpayer's activity in this state, the taxpayer may petition for or the 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.



**EXHIBIT B:15**

**Letter from James A. Fry  
(South Dakota Department of Revenue)  
(May 5, 1989)**

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May 5, 1989

Alan Friedman  
General Counsel, Multistate Tax Comm.  
444 North Capital Street, NW  
Suite 500  
Washington, DC 20001

RE: Bank Income Allocation Regulations

Dear Alan:

Thank you again for the opportunity to express our views on the proposed allocation of income for financial institutions purposes. We appreciate your openness and your sympathy with our rather difficult position. We also appreciate the willingness of the MTC to consider changes in the proposed regulation or the implementation thereof which might be beneficial to South Dakota.

Aside from the fiscal implications of the regulation, we would like to reiterate our concern regarding the problems which will be created for each state because of the administrative complexity of this regulation. As we stated earlier, we believe that voluntary taxpayer compliance will suffer dramatically. If this regulation is adopted in its present form, taxpayers will be confused or will be unwilling to expend the necessary monies to provide the accounting and record keeping necessary to track the dollars involved. They will adopt a catch-me-if-you-can mentality gambling that their particular firm will not be audited and if it is, the auditors will analyze what records are available, complete a return and bill the taxpayer. The penalty and interest may very well be less than the administrative costs incurred in proper record keeping and reporting. Properly auditing such taxpayers will also be quite difficult and time consuming in that the information available will often be insufficient to allow an auditor to reconstruct the necessary records upon which a sustainable assessment can be made.

This letter would also restate our concern that this regulation sets economic policy rather than tax policy for individual states and is a disincentive to economic development. This regulation would shift the benefits of economic development to states based upon the population size rather than upon any success a state may have in



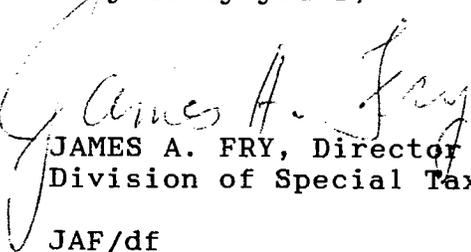
developing its local economic base. We do not feel this is a fair treatment of any state with an advantageous business climate but a small population base.

Finally, it appears to us that the duplication of elements between the receipts factor and the property factor "doubles" the effect of a large population and virtually eliminates any effect the property factor would have in reducing the distortion resulting from population dissimilarities. One example is a credit card transaction where interest income would be included in the receipts factor while the value of the receivable is included in the property factor. In both cases, the value of these elements will be allocated according to relative population size unfairly penalizing small states. We would request that intangible property be removed from the property factor and that only real property and tangible personal property be included when computing that factor. This action would reestablish property as an independent factor and appropriately apply greater weight to the state where the taxpayer enjoys governmental services and transacts its business.

As we discussed the timetable for implementing this regulation, two interesting thoughts developed. First of all, the State of South Dakota would support an approach specifying that a predetermined number of states (twenty states was suggested) must adopt a market approach before implementation of these regulations. Also, a incremental implementation of the regulations may be very appropriate with perhaps the most controversial aspects of income allocation (i. e. credit card transactions) being relegated to the very latter stages of implementation. The phase-in approach would be of considerable benefit to the taxpayer because the immense burden of adapting to this regulation could be spread over a number of years and could be fine tuned during the implementation period. Also, the delay in initiating the credit card income provisions would allow South Dakota an opportunity to determine how it can replace lost revenues.

Again I wish to thank you for the openness you have displayed in listening to our concerns. We trust that discussions will continue. If I can be of service to you in any way, please feel free to contact me.

Very truly yours,

  
JAMES A. FRY, Director  
Division of Special Taxes

JAF/df

**EXHIBIT C: 1**

**MTC Executive Committee Resolution  
(May 10, 1990)**

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*Multistate Tax Commission*



RESOLUTION OF THE EXECUTIVE COMMITTEE OF THE MULTISTATE TAX  
COMMISSION REGARDING THE HOLDING OF A PUBLIC HEARING UPON  
PROPOSED M.T.C. REGULATION ART.IV.18.(i)

**Attribution of Income from the Business of a Financial  
Institution**

WHEREAS, the Multistate Tax Commission (hereafter "Commission") possesses the authority pursuant to Article VII. of the Multistate Tax Compact (hereafter "Compact") to develop and recommend proposals for the purpose of increasing uniformity in the administration of state and local taxes; and

WHEREAS, the Uniformity Committee of the Commission has met on several occasions to study, develop and propose a uniform method for the attribution of net income derived from the business of a financial institution that operates on a multistate basis; and

WHEREAS, the Uniformity Committee has recommended to the Executive Committee that a public hearing be held upon the proposed regulation Art.IV.18.(i) attached hereto; and

WHEREAS, the Executive Committee determines that it is in the interest of state taxpayers and state tax administrators alike that the states determine the most appropriate and administratively feasible method for uniformly applying their tax laws to the multistate business that is carried on by financial institutions; and

WHEREAS, it is in the public interest that a public hearing be held upon said proposed regulation in order to receive public comments thereon.

NOW, THEREFORE, BE IT RESOLVED THAT a public hearing upon said proposed Regulation Art.IV.18(i) be held at a convenient location to the interested public on such date as determined by the Hearing Officer pursuant to the provisions contained in Article VII. of the Compact; and

BE IT FURTHER RESOLVED THAT Alan H. Friedman, General Counsel to the Commission is hereby appointed to act as Hearing Officer for said public hearing; and that he is directed to submit his report

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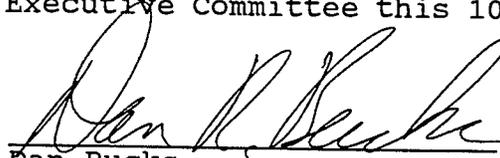
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and recommendations to the Commission within a reasonable period of time following the completion of said public hearing and in advance of the Commission's Annual Meeting to be held in 1991.

Adopted by the Executive Committee this 10th day of May, 1990.

A handwritten signature in cursive script, appearing to read "Dan Bucks", written over a horizontal line.

Dan Bucks  
Executive Director

# Multistate Tax Commission



## MULTISTATE TAX COMMISSION PROPOSED REGULATION ATTRIBUTING INCOME FROM THE BUSINESS OF A FINANCIAL INSTITUTION

### Reg. IV.18.(i). Special Rules: Financial Institutions.

The following special rules are established with respect to the attribution of income derived from the business of a financial institution.

(A) **Application of Regulation.** This regulation shall apply to attribute the income derived from the business of a financial institution to only those states in which the taxpayer either exercises its corporate franchise or transacts business as defined hereunder. Except as may be specifically limited by this regulation, it is the intention of this regulation to subject to taxation all of the income of a financial institution that is within the constitutional power of this state to tax.

(B) **Definitions and General Provisions.** Except as specifically defined herein, all terms used in this regulation shall have the same meaning as such terms have under [here include your State citation to the Multistate Tax Compact or other applicable state law] and the rules and regulations promulgated thereunder.

- (1) "Borrower" means the individual or entity who is primarily liable on a debt instrument. If more than one individual or entity is primarily liable on a debt instrument, each such individual or entity shall be considered the borrower to the extent of its interest in the debt instrument. For purposes of this regulation, a partnership shall be treated as a separate entity.
- (2) "Business of a Financial Institution" includes the business activities, including finance leasing, that:
  - (a) a regulated financial corporation may be authorized to do under state or federal law or the business that its subsidiary is authorized to do by the proper regulatory authorities;
  - (b) any corporation organized under the authority of

the United States or organized under the laws of this state or any other state or country does, or has authority to do, which is substantially similar to the business which a corporation may be created to do under [insert citations of state's laws governing the creation of banks and trust companies, industrial banks, savings and loan associations, credit unions, etc.] or any business which a corporation or its subsidiary is authorized to do by said laws; or

- (c) any corporation organized under the authority of the United States or organized under the laws of this state or any other state or country does or has authority to do if such corporation derives more than fifty percent of its gross income from lending activities (including the discounting of obligations) in substantial competition with the businesses described in subsections (a) and (b) above. For purposes of this subsection, the computation of the gross income of a corporation shall not include income from nonrecurring, extraordinary items.

(3) "Deposit" means:

- (a) the unpaid balance of money or its equivalent received or held by a financial institution in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to a commercial, checking, savings, time, or thrift account whether or not advance notice is required to withdraw the credited funds, or which is evidenced by its certificate of deposit, thrift certificate, investment certificate, or certificate of indebtedness, or other similar name, or a check or draft drawn against a deposit account and certified by the financial institution, or a letter of credit or a traveler's check on which the financial institution is primarily liable; provided, that, without limiting the generality of the term "money or its equivalent," any such account or instrument must be regarded as evidencing the receipt of the equivalent of money when credited or issued in exchange for checks or drafts or for a promissory note upon which the person obtaining any such credit or instrument is primarily or secondarily liable or for a charge against a deposit account or in settlement of checks, drafts, or other instruments forwarded to such bank for collection;

- (b) trust funds received or held by such financial institution, whether held in the trust department or held or deposited in any other department of such financial institution;
  - (c) money received or held by a financial institution, or the credit given for money or its equivalent received or held by a financial institution in the usual course of business for a special or specific purpose, regardless of the legal relationship thereby established, including, without being limited to, escrow funds, funds held as security for an obligation due the financial institution or others (including funds held as dealers reserves) or for securities loaned by the financial institution, funds deposited by a debtor to meet maturing obligations, funds deposited as advance payment on subscriptions to United States Government securities, funds held for distribution or purchase of securities, funds held to meet its acceptances or letters of credit, and withheld taxes; provided that there shall not be included funds which are received by the financial institution for immediate application to the reduction of an indebtedness to the receiving financial institution, or under condition that the receipt thereof immediately reduces or extinguishes such an indebtedness;
  - (d) outstanding drafts (including advice or authorization to charge a financial institution's balance in another such institution), cashier's checks, money orders, or other officer's checks issued in the usual course of business for any purpose, but not including those issued in payment for services, dividends, or purchases or other costs or expenses of the financial institution itself;
  - (e) money or its equivalent held as a credit balance by a financial institution on behalf of its customer if such entity is engaged in soliciting and holding such balances in the regular course of its business.
- (4) "Deposit Related Fees." For purposes of the receipts factor, deposit related fees include all fees associated with the administration of deposit accounts.
- (5) "Exercising a Corporate Franchise or Transacting Business in a State." Except as may be specifically provided for in this regulation, a financial institution is exercising

a corporate franchise or transacting business in this state if it:

- (a) owns, leases or otherwise has an interest in any real or tangible personal property located in this state or maintains an office or other place of business in this state;
- (b) makes any direct loan secured by any real or tangible personal property located in this state;
- (c) has an employee, representative or independent contractor conducting business activities in its behalf in this state; or,
- (d) engages in regular solicitation in this state (whether at a place of business, by travelling loan officer or other representative, by mail, by telephone or other electronic means), and the solicitation results in the creation of a depository or direct debtor/creditor relationship with a resident of this state. For purposes of this subsection, mere processing or transfer through financial intermediaries of checks, credit card receivables, commercial paper and the like does not create a debtor/creditor relationship.

A financial institution is presumed, subject to rebuttal, to be engaged in regular solicitation within this state if, during the tax period, it:

(i) has entered into direct debtor/creditor relationships with one hundred (100) or more residents of this state; or

(ii) has an average during the tax period of ten million dollars (\$10,000,000) or more of assets and deposits attributable to sources within this state; or

(iii) has in excess of five hundred thousand dollars (\$500,000) in receipts attributable to sources within this states.

(e) Notwithstanding any other provision contained in this subsection to the contrary, a financial institution is not considered to be either exercising a corporate franchise or transacting business in this state if its sole and exclusive activities in this state are limited to evaluating, acquiring, maintaining and/or disposing of any of the following property, including any security or collateral relating to such property:

- (i) any participation or syndicated loans;
- (ii) a real estate mortgage investment conduit, a real estate investment trust, or a regulated investment company as those terms are defined by the Internal Revenue Code of 1986, as amended;
- (iii) money market instruments or securities;
- (iv) loan-backed, mortgage-backed, or receivable-backed security representing either: ownership in a pool of promissory notes, mortgages, or receivables or certificates of interest or participation in such notes, mortgages, or receivables, or debt obligations or equity interests which provide for payments in relation to payments or reasonable projections of payments on notes, mortgages, or receivables;
- (v) any interest in a loan or other asset or property attributed to this state under subsection (D)(2)(a) through (h) and in which the payment obligations were solicited and entered into by an independent person not acting on behalf of the taxpayer;
- (vi) any interest in the right to service or collect any income from any loan, asset or other property attributed to this state under subsection (D)(2)(a) through (h) and in which the payment obligations were solicited and entered into by an independent person not acting on behalf of the taxpayer;
- (vii) a funded or unfunded agreement to extend or guarantee credit, whether conditional, mandatory, temporary, standby, secured or otherwise;
- (viii) an interest of a person other than an individual, estate, or trust, in any intangible, real, or tangible personal property acquired in satisfaction, whether in whole or in part, of any asset embodying a payment obligation which is in default, whether secured or unsecured, provided the property is disposed of within a reasonable period of time.; or
- (ix) property or funds held in an escrow or trust account that is maintained in connection with the property described in this subsection (B)(5)(e).

(6) "Finance leasing": [reserved]

- (7) "Financial Institution" includes the following:
- (a) A holding company.
  - (b) Any regulated financial corporation.
  - (c) Any other corporation organized under the laws of the United States or organized under the laws of this state or any other state or country which is carrying on the business of a financial institution.
- (8) "Holding Company" means any corporation subject to [insert citation of the state law governing the creation of bank holding companies] 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.
- (9) "Independent person not acting on behalf of the taxpayer" means, for purposes of subsections (A)(5)(e)(v) and (vi) as follows:
- (a) At the time of the acquisition of the asset, loan or property, the taxpayer must not directly or indirectly own fifteen percent (15%) or more of the outstanding stock or , in the case of a partnership, fifteen percent (15%) or more of the capital or profits interest, of the entity from which the taxpayer originally acquired the asset, loan or property. In determining indirect ownership, the taxpayer is deemed to own all of the stock, capital interest, or profits interest owned by another person if the taxpayer directly owns fifteen percent (15%) or more of the stock, capital interest, or profits interest in that other person. In addition, the taxpayer is deemed to own all stock, capital interest, and profits interest directly owned by any intermediary parties in the transaction, to the extent a fifteen percent (15%) or more chain of ownership of stock, capital interest, or profits interest exists between the taxpayer and any intermediary party;
  - (b) the entity from which the taxpayer acquired the asset, loan or property must regularly sell, assign, or otherwise transfer interest in such assets, loans or property to three (3) or more persons during the full twelve (12) month period immediately preceding the month of acquisition; and
  - (c) the entity from which the taxpayer acquired the

asset, loan or property must not sell, assign or otherwise transfer ninety percent (90%) or more of its exempt assets, loans or property to the taxpayer during the full twelve (12) month period immediately preceding the month of acquisition.

- (10) "Loan Related Fees." For purposes of the receipts factor, loan related fees include all fees associated with the generation and administration of loans, including loan servicing fees.
- (11) "Loan Servicing Fees." For purposes of the receipts factor, loan servicing fees include fees charged by a financial institution that sells, assigns or otherwise transfers loans to a purchasing financial institution in instances in which the transferring financial institution continues to process the loan payments.
- (12) "Money Market Instruments" mean Federal funds sold and securities purchased under agreements to resell, commercial paper, banker's acceptances, and purchased certificates of deposit and similar instruments to the extent that such instruments are reflected as assets under generally accepted accounting principles.
- (13) "Participation Loan" means an arrangement in which a financial institution makes a loan to a borrower and thereafter sells, assigns or otherwise transfers all or a portion of the loan to a purchasing financial institution.
- (14) "Presumption." A presumption subject to rebuttal, as provided in this regulation, shall be rebuttable by clear and convincing proof established by [the party seeking to oppose the application of the presumption.][either the financial institution or [here include title of your State taxing agency]].
- (15) "Property Located in this State".
  - (a) Tangible Property: General Rule. -- Except as otherwise provided in this section, real and tangible personal property which is security for a loan or property subject to a lease shall be considered to be located in the state in which such property is physically situated. It shall be presumed, subject to rebuttal, that the property is physically situated in the same state as the billing address of the borrower or lessee.
  - (b) Moveable tangible property. -- Tangible personal property which is characteristically moving

property, such as motor vehicles, rolling stock, aircraft, vessels, mobile equipment, and the like shall be considered to be located in a state if:

- (i) the operation of the property is entirely within the state; or
- (ii) the operation of the property is in two or more states, but the principal base of operations from which the property is sent out is in the state.

It shall be presumed, subject to rebuttal, that the location of operation of the property and the principal base of operations from which the property is sent out shall be in the same state as the billing address of the borrower or lessee.

- (16) "Receipts" for the purpose of the receipts factor means gross income, including net taxable gain on disposition of assets (including securities, loans, personal and real property and money market transactions) when derived from transactions and activities in the regular course of the taxpayer's trade or business.
- (17) "Regulated Financial Corporation" means any institution the deposits or accounts of which are insured under the Federal Deposit Insurance Act or by the Federal Savings and Loan Insurance Corporation; any institution which is a member of a Federal Home Loan Bank; any other bank or thrift institution incorporated or organized under the laws of the United States or any State which is engaged in the business of receiving deposits or which holds a bank charter, any corporation organized under the provision of 12 U.S.C. 611 to 631 (Edge Act Corporations); any credit union incorporated or organized under the laws of any State; and any agency, branch or subsidiary of a foreign depository as defined in 12 U.S.C. 3101.

It is presumed, subject to rebuttal, that any subsidiary and any holding company of a regulated financial corporation shall be a financial institution for the purpose of this regulation.

- (18) "Resides/Residence/Resident." A person shall be considered to reside or make his or her residence in or be a resident of a state if, in the case of an individual, he/she resides there for 183 or more days of the relevant tax period. For purposes of this regulation, corporations and partnerships shall be treated as residents of their states of commercial

domicile. An individual, a partnership or a corporation shall be presumed, subject to rebuttal, to reside at (i.e., be a resident of, make his residence at) the address to which the statement of account is regularly mailed.

- (19) "Securities" means United States Treasury securities, obligations of United States Government agencies and corporations, obligations of State and their political subdivisions, corporate stock and other corporate securities, participations in securities backed by mortgages held by United States or State government agencies, loan-backed securities and similar investments to the extent that such investments are reflected as assets under generally accepted accounting principles.
- (20) "State" means a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or any territory or possession of the United States or any foreign country.
- (21) "Subsidiary" means a corporation whose voting stock is more than 50% owned, directly or indirectly, by a financial institution.
- (22) "Syndication Loan" means a multi-financial institution loan transaction in which all of the lenders are named as parties to the loan and have privity of contract with the borrower.
- (23) "Taxable" and "Taxable in another State." For the purpose of the receipts factor, a taxpayer is taxable in another state if: (a) in that state, he is subject to a franchise tax measured by net income, a net income tax, a franchise tax for the privilege of doing business, or a corporate stock tax, or (b) that State has jurisdiction to subject the taxpayer to such a tax regardless of whether, in fact, the State does or does not.
- (24) "Taxpayer" means a financial institution which is subject to taxation in a state because it is exercising its corporate franchise or is transacting business in a corporate or organized capacity in the state and has gross income attributable under this regulation to sources within this state.

(C) **Business Income.** All income (taxable under the laws of this State) which arises from the business of a financial institution shall be deemed derived from transactions in the regular course of the taxpayer's business and subject to apportionment under this regulation. All such income which arises

from activities of a financial institution which are not the business of a financial institution as defined in this rule shall be apportioned or allocated in accordance with the rules set forth in [here include your State citation to UDITPA or the Multistate Tax Compact].

(D) **Apportionment of Business Income.**

(1) **General Method.**

(a) If a financial institution is carrying on the business of a financial institution both within and without this state and if, by reason of such business activity, it is taxable in another state, the portion of the net income (or net loss) arising from such business which is derived from sources within this state shall be determined by apportionment in accordance with this regulation.

(b) The tax applicable to financial institutions whose net income (or net loss) is apportionable according to the rules in this section shall be determined by multiplying the tax base by a fraction the numerator of which is the sum of the receipts factor, the property factor, and the payroll factor as defined in this regulation and the denominator of which is three. If any factor(s) is missing, the remaining factors are added together and the sum is divided by the number of remaining factors. A factor is missing if both its numerator and denominator are zero, but it is not missing merely because its numerator is zero.

(2) **Receipts Factor.** In general. -- The receipts factor is a fraction the numerator of which is the receipts of the taxpayer within this state during the tax period and the denominator of which is the total receipts of the taxpayer wherever earned during said tax period. The numerator of the receipts factor shall include, in addition to items otherwise assignable under [here include your State citation to the Multistate Tax Compact or other applicable state law]:

(a) Receipts from the lease or rental of real or tangible personal property (including both finance leases and true leases) if the property is located in this state.

(b) Interest income and other receipts from assets in the nature of loans which are secured primarily by real estate or tangible personal property if such security property is located in this state. In the

event that such security property is located in two or more states, it shall be deemed to be located in the state having the greatest property values.

- (c) Interest income and other receipts from consumer loans not secured by real or tangible personal property that are made to residents of this state (whether at a place of business, by travelling loan officer, by mail, by telephone or other electronic means or otherwise).
- (d) Interest income and other receipts from commercial loans and installment obligations not secured by real or tangible personal property if and to the extent that the borrower or debtor is a resident of this State.
- (e) Interest income and other receipts from a financial institution's portion of loans, including syndication and participation loans, under the rules set forth in subsections (a) through (d) above.
- (f) Interest income and other receipts, including service charges, from financial institution credit card and travel and entertainment credit card receivables and credit card holders' fees to the extent that the borrower or debtor is a resident of this State.
- (g) Merchant discount income derived from financial institution credit card holder transactions with a merchant located in this state. In the case of merchants located within and without this state, only receipts from merchant discounts attributable to sales made from locations within this state shall be attributed to this State. It shall be presumed, subject to rebuttal, that the location of a merchant is the address shown on the invoice submitted by the merchant to the taxpayer.
- (h) Receipts from the performance of services are attributed to this state if:
  - (i) the service receipts are loan related fees, including loan servicing fees, and the borrower resides in this state; except that, at the taxpayer's election, receipts from loan related fees which are either (a) "pooled" or aggregated for collective financial accounting treatment or (b) manually written as non-recurring extraordinary charges to be

processed directly to the general ledger may either be attributed to a state based upon the borrowers' residences or upon the ratio that total interest sourced to that state bears to total interest from all sources;

- (ii) the service receipts are deposit related fees and the depositor resides in this state, except that, at the taxpayer's election, receipts from deposit related fees which are either (a) "pooled" or aggregated for collective financial accounting treatment or (b) manually written as non-recurring extraordinary changes to be processed directly to the general ledger may either be attributed to a state based upon the depositors' residences or upon the ratio that total deposits sourced to that state bear to total deposits from all sources;
  - (iii) the service receipt is a brokerage fee and the account holder is a resident of this state;
  - (iv) the service receipts are fees related to estate or trust services and the decedent for whom the estate relates was a resident of this state immediately before death; or the grantor who either funded or established the trust is a resident of this state; or,
  - (v) the service receipt is associated with the performance of any other service not identified above and the service is performed in this state; or if performed both in and outside this state and a greater proportion of the service is performed in this State than in any other State, as determined on the basis of the cost of performance.
- (i) Receipts from the issuance of travelers checks and money orders if such checks and money orders are purchased in this state.
  - (j) Receipts from investments of a financial institution in securities and from money market instruments, based upon the ratio that total deposits from this state, its residents, its political subdivisions, agencies and instrumentalities bear to the total deposits from all states, their residents, their political subdivisions, agencies and instrumentalities. For purposes of this subsection, deposits made by this

State, its residents, its political subdivisions, agencies and instrumentalities shall be attributed to this state regardless of whether or not such deposits are accepted or maintained by the taxpayer at locations within this state.

In the case of an unregulated financial institution subject to this regulation, such receipts shall be apportioned to this state based upon the ratio that its gross business income earned from sources within this state bears to the gross business income earned within all States.

- (k) All receipts allocated by this rule to a state in which the taxpayer is not taxable shall be attributed pursuant to the laws of the state of the taxpayer's commercial domicile.
- (3) Property Factor. In general. -- The property factor is a fraction the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in, and intangible property attributed to this state during the tax period and the denominator of which is the average value of all of the taxpayer's real and tangible personal property owned or rented and used in, and intangible property attributed to all states during the tax period.

For purposes of this regulation, the value of property owned by the taxpayer shall be its original cost; the value of real or tangible personal property rented by the taxpayer shall be eight times its net annual rental rate. The net annual rental rate for any item of rented property is the annual rate paid by the taxpayer for such property less the aggregate annual subrental rates paid by subtenants of the taxpayer. Goodwill shall not be included in the property factor.

The numerator of the property factor shall include, in addition to items otherwise assignable under [here include your State citation to the Multistate Tax Compact or other applicable state law], the following:

- (a) Coin and currency located in this state.
- (b) Lease financing receivables if and to the extent that the property is located within this state.
- (c) Assets in the nature of loans which are secured by real or tangible personal property if and to the extent that the security property is located within this state. In the event that such security

property is located in two or more states, it shall be deemed to be located in the state having the greatest property values.

- (d) Assets in the nature of consumer loans and installment obligations which are unsecured or secured by intangible property, if the loan was made to a resident of this state.
- (e) Assets in the nature of commercial loans and installment obligations which are unsecured or secured by intangible property, if the borrower is a resident of this state.
- (f) Funds deposited by this state, its agencies, instrumentalities, political subdivisions and residents shall be attributed to this state regardless of whether or not such deposits are accepted or maintained by the taxpayer at locations within this state.
- (g) A financial institution's portion of a participation or syndication loans, under the rules set forth in subsections (b) through (e) above.
- (h) A financial institution's credit card and travel and entertainment credit card receivables to the extent that the borrower or debtor is a resident of this State.
- (i) Assets in the nature of securities and money market instruments, based upon the ratio that total deposits from this State, its agencies, instrumentalities, political subdivisions and residents bear to the total deposits from all States, their residents, their political subdivisions, agencies and instrumentalities.

In the case of an unregulated financial institution subject to this regulation, such assets shall be apportioned to this state based upon the ratio that its gross business income earned from sources within this state bears to the gross business income earned within all States.

All intangible property located by this rule in a state in which the taxpayer is not taxable shall be attributed pursuant to the laws of the state of the taxpayer's commercial domicile.

- (4) Payroll Factor. In general. -- The payroll factor is a fraction the numerator of which is the total amount paid

by the taxpayer for compensation during the year, and the denominator of which is the total amount of compensation paid in every state.

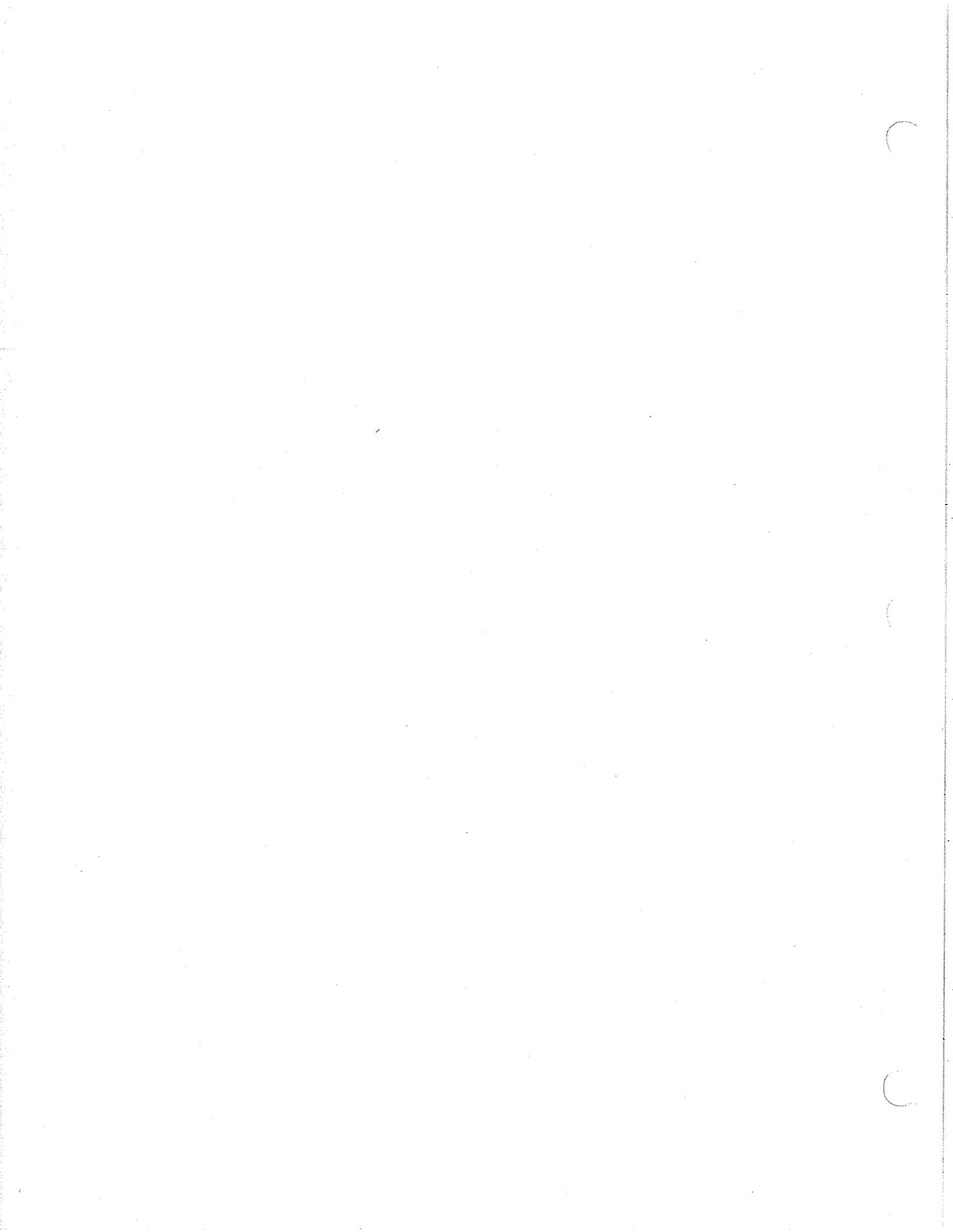
(E) **Special Rules.** If the allocation and apportionment provisions of this regulation do not fairly represent the extent of the taxpayer's activity in this state, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, 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.



**EXHIBIT C: 2**

**MTC Executive Committee Resolution  
(November 9, 1990)**



*Multistate Tax Commission*



RESOLUTION OF THE EXECUTIVE COMMITTEE OF THE MULTISTATE TAX  
COMMISSION ON INTERIM REPORT OF HEARING OFFICER RE PROPOSED M.T.C.  
REGULATION IV.18.(i): ATTRIBUTION OF INCOME  
FROM THE BUSINESS OF A FINANCIAL INSTITUTION

WHEREAS, the Executive Committee has received the Interim Report of Hearing Officer Regarding Adoption of Proposed M.T.C. Regulation IV.18.(i): Attribution of Income from the Business of a Financial Institution dated November 9, 1990; and

WHEREAS, the Executive Committee has reviewed said Interim Report and determines that said Interim Report should be accepted in its entirety; and

WHEREAS, the pending regulatory proposal was originally scheduled for Commission action at its July, 1991 meeting; and

WHEREAS, the importance of the pending regulatory process requires that economic and other data be developed in the public record that is sufficient for the purposes of the Hearing Officer in the making of his recommendations to the Executive Committee herein; and

WHEREAS, the Executive Committee wishes to provide additional time for a thorough and studied consideration of the proposed Regulation and the facts and circumstances relating thereto; and

WHEREAS, the pending case of Ford Motor Credit Company, Inc. v. Florida Department of Revenue, No. 88-1847 will likely be decided by the U.S. Supreme Court within the next several months and that such decision may provide valuable insight into the method by which income derived from intangibles may be attributed.

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NOW, THEREFORE, IT IS HEREBY RESOLVED that the Executive Committee adopts all of the findings, conclusions and recommendations of the Hearing Officer as set forth in his Interim Report dated November 9, 1990.

IT IS FURTHER RESOLVED that the Executive Committee directs the Hearing Officer to keep the Executive Committee apprised of all developments in this matter.

IT IS FURTHER RESOLVED that the Executive Director develop and submit proposals for securing the data referred to in the Hearing Officer's Interim Report.

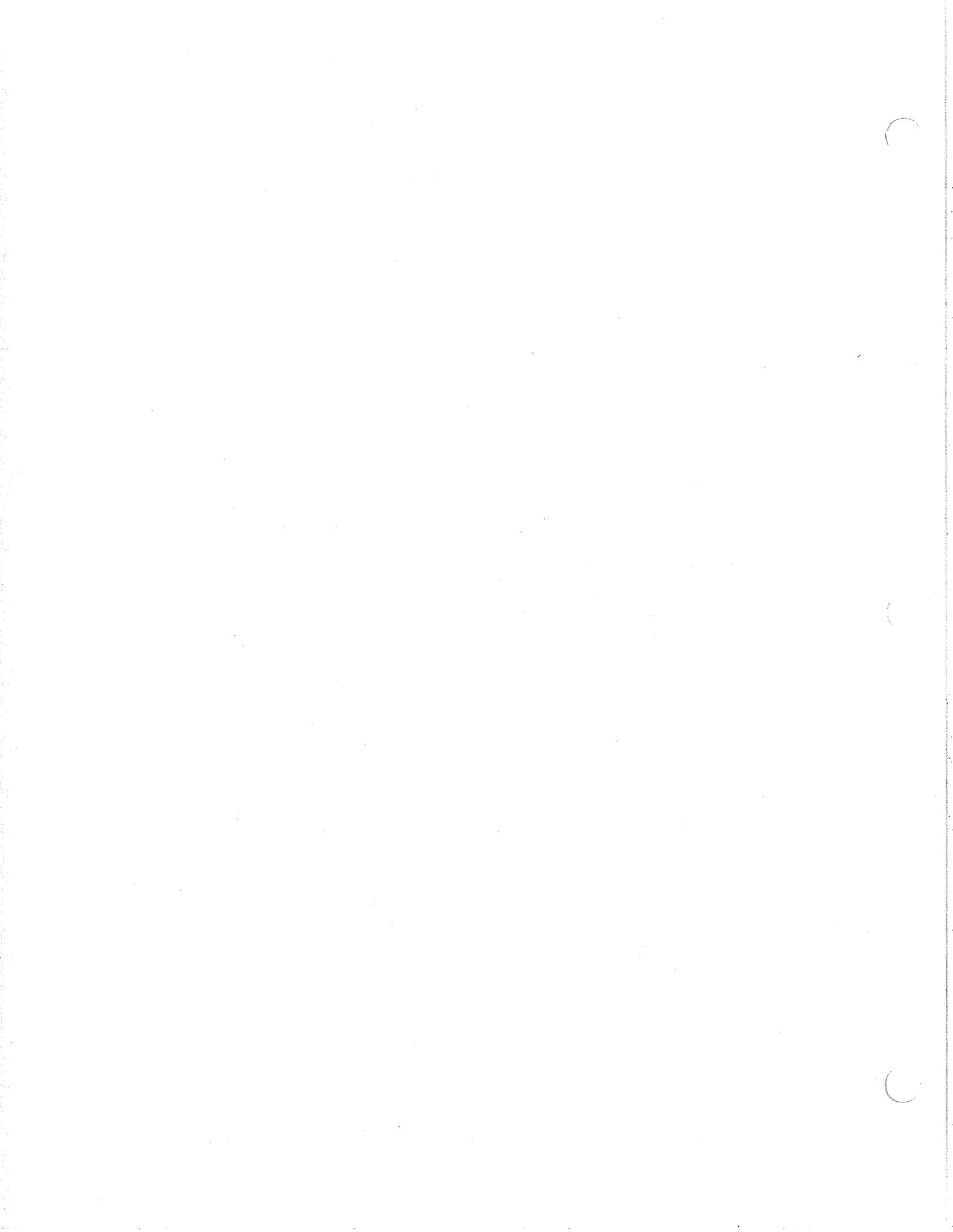
IT IS FURTHER RESOLVED, in the interest of providing sufficient time for the further development of the proposed Regulation, that it not be scheduled for action by the Commission in July of 1991; and that it will be scheduled for action by the Commission after completion of the public hearing process and upon further direction of the Executive Committee.

Adopted by the Executive Committee of the Multistate Tax Commission on this 9th day of November, 1990.

ATTEST:           /s/ Dan R. Bucks            
Dan R. Bucks  
Executive Director

**EXHIBIT E: 2**

**Interim Report of Hearing Officer  
(May 10, 1993)**



# Multistate Tax Commission



## INTERIM REPORT OF HEARING OFFICER REGARDING PROPOSED REGULATION IV.18(i) APPORTIONING THE INCOME OF FINANCIAL INSTITUTIONS

### INTRODUCTION

The following is intended as an interim report to the Executive Committee of the Multistate Tax Commission regarding the current status of the effort to develop a uniform apportionment method for the attribution of income earned by financial institutions.<sup>1</sup> Attachment 1. is a draft proposal of one such method of attribution which will be introduced in the resumed public hearing process for comment and consideration. This proposal is the product of the joint effort of government and industry representatives that was supported by the Commission and the Federation of Tax Administrators (the "MTC/FTA Working Group on Financial Institutions"). As noted below, fairly broad industry input was developed and provided primarily through the coordinated efforts of a coalition of several large financial institutions organized and acting under the acronym of F.I.S.T.<sup>2</sup> A listing of the principal individuals who assisted in this effort is appended as Attachment 2.

The draft formula presented here was developed through the collective efforts of extremely able and experienced persons representing both government and industry interests. It represents the result of a cooperative effort that continues between government and industry, as well as between and within various factions of government as well. On the one hand, representatives of jurisdictions such as New York State, South Dakota and New York City represented a more commercial domicile or "money-center" approach. On the other, representatives of states such as Minnesota, Tennessee, New Hampshire, North Dakota and several others represented

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<sup>1</sup> For a bit of relatively recent history concerning this effort, see "Report of Subcommittee on Apportionment of Income from Financial Institutions" dated March 30, 1991 from Alan H. Friedman, Convener, to Heidi Heitkamp, North Dakota State Tax Commissioner, Chair, MTC/FTA Working Group on Financial Institutions and attachments. This Report can be obtained by contacting the Multistate Tax Commission at 202-624-8699.

<sup>2</sup> F.I.S.T. stands for "Financial Institutions State Taxation" Coalition. While the acronym suggests something other than an extended and open hand, the Coalition, as noted in this Report, did not act in the manner suggested by its moniker.

a substantial revenue loss to the state. Lastly, in this regard, a continuing commitment has been expressed by the F.I.S.T. coalition to work in support the states' legislative and regulatory adoption of the uniform apportionment method, so long as that method is "fair and administrable" and adopted by a significant number of jurisdictions.

### THE EFFORT TO ACHIEVE UNIFORMITY AMONG THE STATES

The basic purpose of this effort - the achievement of a fair, administrable and uniform apportionment methodology - will be greatly undermined should states modify, in any substantial manner, the attribution or factor weighting rules that are suggested by a uniform apportionment method. Unilateral modifications raise the serious risk (theoretically at least) of affected institutions being subject to apportionment and taxation of either more or less than 100% of their net income. While the United States Supreme Court has tolerated a certain amount of over-apportionment of income, neither over-apportionment, nor under-apportionment to any substantial degree should be an acceptable goal for a rational, fair state tax system affecting interstate business enterprises.

Should a sufficient number of states, as well as a few of the more directly affected states, not adopt either the attached suggested approach or some other uniformly supported method, it is likely and understandable for the industry representatives to withdraw their current support of this effort. Should the states fall short of obtaining a fair, uniform and administrable apportionment approach in this most important area, voluntary industry compliance will be seriously impeded; and "business as usual" - division between taxpayer and government, contentiousness and conflict - will likely fill the void left from the emptying of this cooperative effort. All involved in this effort - industry representatives, tax officials and legislators - are requested to keep in focus the cooperative manner by which the following draft statute was created, its weighing of competing interests between government and industry, as well as among the government entities themselves.

### SCOPE OF THE DRAFT STATUTE - THE DEFINITION OF FINANCIAL INSTITUTION; NEXUS; COMBINED REPORTING

The scope of the definition of a financial institution that is provided in Appendix A. to the proposal has been drafted in an effort to include traditional national and state banks, as well as other business entities that substantially deal in money or moneyed capital and compete with banks in the same marketplace. Should a state wish to broaden further or narrow the scope of coverage, it is free to do so without undermining the principal purpose of this uniformity effort. The focus of the current effort is principally on achieving apportionment uniformity, with scope of statute coverage being of secondary importance.

Respectfully submitted on May 10, 1993.

Alan H. Friedman  
Alan H. Friedman  
Hearing Officer *Jm*

ATTACHMENT 1.

**PROPOSED UNIFORM ALLOCATION AND APPORTIONMENT  
METHOD FOR FINANCIAL INSTITUTIONS**

## STATUTORY PROPOSAL FOR APPORTIONMENT AND ALLOCATION OF NET INCOME OF FINANCIAL INSTITUTIONS

### Section 1. Imposition of Franchise Tax.<sup>1</sup>

A franchise tax measured by net income is imposed on every financial institution for the privilege of doing business in this state and for exercising its franchise in a corporate or organized capacity.

### Section 2. Apportionment and Allocation.

(a) A financial institution having income from business activity which 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 [ ]<sup>2</sup>. 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.

(b) The apportionment percentage is determined by adding the taxpayer's receipts factor (as described in section 4 of this article), property factor (as described in section 5 of this article), and payroll factor (as described in section 6 of this

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<sup>1</sup> *This proposal assumes a tax measured by net income. There are a variety of other types of taxes that states may apply to financial institutions. While this proposal suggests a franchise tax that is measured by net income, other types of taxes that apply to financial institutions may be subjected to allocation and apportionment by the same or similar mechanism that is suggested here, and this section, as well as others, will need further modification. A franchise tax is selected here because it is clear that such a statute will not be precluded by federal law from including income earned from federal government obligations in its taxable base.*

<sup>2</sup> *While it is understood that all income derived from currently known activities of a financial institution, whether from deposit, lending and other credit activities or from investment activities dealing with tangible and intangible property, is business income, this sentence allows for the future possibility that some activity may be unrelated to the business activities commonly associated with financial institutions, but still authorized by law. Since this discrete business activity is theoretically possible, the proposed statute will more readily conform on its face to the dictates of the Allied Signal, Inc. v. Director, Div. of Taxation, 112 S.Ct. 2365 (1992).*

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.<sup>3</sup>

(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 3. 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 as the address where any notice, statement and/or bill relating to a customer's account is mailed.

(b) "**Borrower or credit cardholder located in this state**" shall mean (1) a borrower, other than a or credit card holder, that is engaged in a trade or business which maintains its commercial domicile in this state; and (2) a borrower that is not engaged in a trade or business or a credit card holder whose billing address is in this state.

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<sup>3</sup> *Industry representatives have raised a compliance issue based upon the information that is to be used for calculating the factors - either financial book or tax basis. An industry suggested regulation is attached at Appendix A. which will be subject to comment during the public hearing process.*

(c) "**Commercial domicile**" means the headquarters of the trade or business, that is, the place from which the trade or business is principally managed and directed.

(d) "**Compensation**" means wages, salaries, commissions and any other form of remuneration paid to an employee 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.

(e) "**Credit card**" means credit, travel or entertainment card.

(f) "**Credit card issuer's reimbursement fee**" means the receipt a taxpayer receives from a merchant's bank because one of the persons to whom the taxpayer has issued a credit card has charged merchandise or services provided by the merchant to the credit card.

(g) "**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.

(h) "**Financial institution**" means [insert state's definition here].<sup>4</sup>

(i) "**Gross rents**" means the actual sum of money or other consideration payable for the use or possession of property.<sup>5</sup>

(j) "**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.

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<sup>4</sup> No definition of "financial institution" is proposed at this time, leaving the state to define their own coverage. However, the Hearing Officer reserves the option to make a final recommendation regarding coverage at a future time. The definition provided in Appendix B is set forth for comment and consideration in the determination of what types of business organizations and activities may be made subject to the recommended formula.

<sup>5</sup> In the interest of seeking additional uniformity, suggested regulatory language further defining the term "gross rents" is offered at Appendix C.

Loans shall not include: loans representing property acquired in lieu of or pursuant to a foreclosure under section 595 of the Federal Internal Revenue Code; 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 other 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.<sup>6</sup>

(k) **"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 card is accepted in payment for merchandise or services sold to the card holder.

(l) **"Participation"** is 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.

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

(n) **"Real property owned"** and **"tangible personal property owned"** means 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 include land, stocks in goods and real and tangible personal property rented to the taxpayer. Real and tangible personal property do not include coin, currency, or property acquired in lieu of or pursuant to a foreclosure.

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<sup>6</sup> *The term "loan" is intended to have a broad meaning and the list of exclusions from the definition of "loan" is intended to be exclusive. For example, because an interest bearing balance due from another depository is not specifically mentioned in subparagraph (j), the underlying activity for such an account would be considered a loan.*

(o) "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.

(p) "Syndication" is 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.<sup>7</sup>

(q) "Taxable in another state" means that a taxpayer is either:

(1) subject to a franchise tax measured by net income, a net income tax, a franchise tax for the privilege of doing business, or a corporate stock tax in another state; or

(2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not do so.<sup>8</sup>

#### Section 4. 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 are included in the computation of the apportionable income base for the taxable year.

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<sup>7</sup> This definition permits the taxing jurisdiction to look to either the Call Reports, Federal Reserve Form FR Y-9C dealing with Consolidated Financial Statements for Bank Holding Companies, or the financial institution's records to determine the amount of receipts attributable to syndications.

<sup>8</sup> The question of whether financial institutions are subject to a state's taxing jurisdiction will sometime depend upon what standard is to apply to determine the adequacy of nexus under applicable jurisdictional principles. Since financial institutions are service providers, as opposed to sellers of tangible personal property, Public Law 86-272 would not apply to such institutions. However, considerations under the Due Process and Commerce Clauses need be analyzed to determine issues of both taxability and throwback. See Quill v. North Dakota, 112 S.Ct. 1904 (1992).

(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 subdivision, 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 movable tangible personal property owned by the taxpayer, such as aircraft, rolling stock, water vessels, or mobile equipment, are 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 is determined by multiplying 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 movable tangible personal 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 from loans secured by real property.**

(1) The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from loans secured by real property if the property is located within this state. If the property is located within this state and one or more other states, the receipts described in this subdivision 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 subdivision shall be included in the numerator of the receipts factor if the borrower is located in this state.

(2) A loan is secured by real property if fifty percent or more of the principal amount of the loan is secured by real property at the time that the original loan agreement was made.

(3) 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 from loans not secured by real property.** The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from 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, including participations and syndications. 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 subdivision (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 subdivision (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.

(g) **Receipts from credit card receivables.** The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from credit card receivables and receipts from fees charged to card holders, such as annual 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 all 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 subdivision (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) **Credit card issuer's reimbursement fees.** The numerator of the receipts factor includes all credit card issuer's reimbursement fees multiplied by a fraction, the numerator of which is the amount included in the numerator of the receipts factor pursuant to subdivision (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.

(j) **Receipts from merchant discount.** The numerator of the receipts factor includes receipts from merchant discount if the commercial domicile of the merchant is in this state. Such receipts shall be computed net of any cardholder charge backs, but shall not be reduced by any interchange transaction fees or by any issuer's reimbursement fees paid to another for charges made by its card holders.

(k) **Loan servicing fees.**

(1) 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 subdivision (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 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 subdivision (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.

(l) **Receipts from services.** The numerator of the receipts factor includes receipts from services not otherwise apportioned under this section if the service is performed in this state. If the service is performed both within and without this state, the numerator of the receipts factor includes receipts from services not otherwise apportioned under this section, if a greater proportion of the income-producing activity is performed in this state based on cost of performance.

(m) **Receipts from investment assets and activities and trading assets and activities.**

(1) Interest, dividends, net gains and other income from investment assets and activities and from trading assets and activities 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; future 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, net 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 net losses from such assets and activities.

(2) The numerator of the receipts factor includes interest, dividends, net gains and other income from investment assets and activities and from trading assets and activities described in paragraph (1) that are attributable to this state.

(A) The amount of interest, dividends, net gains and other income from investment assets and activities in the investment account to be attributed to this state and included in the numerator of the receipts factor 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 booked for tax purposes at 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 of the receipts factor is determined by multiplying the amount described in subparagraph (A) of paragraph (1) 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 booked for tax purposes at 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, net 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 federal funds sold and purchased, attributable to this state and included in the numerator of the receipts factor is determined by multiplying the amount described in subparagraph (B) of paragraph (1) by a fraction, the numerator of which is the average value of such trading assets which are properly booked for tax purposes at 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 subdivisions (c) and (d) of section five.

(3) In lieu of using the method set forth in paragraph (2) of this subdivision, 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 and other income from investment assets and activities in the investment account to be attributed to this state and included in the numerator of the receipts factor 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 booked for tax purposes at 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 of the receipts factor is determined by multiplying the amount described in subparagraph (A) of paragraph (1) 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 booked for tax purposes at 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, net gains and other income from trading account assets and activities, including but not limited to assets and activities in the matched book, in the arbitrage book and foreign currency transactions, attributable to this state and included in the numerator is determined by multiplying the amount described in subparagraph (B) of paragraph (1) by a fraction, the numerator of which is the gross income from such trading assets and activities which are properly booked for tax purposes at 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 subdivision, it shall use this method on all subsequent returns unless the taxpayer receives prior written permission from the State Tax Administrator, or the State Tax Administrator requires, the use of 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 booked for tax purposes at 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 the 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:

(A) in the case of a taxpayer organized under the laws of the United States or of any state, at the commercial domicile of the taxpayer; or

(B) in the case of a taxpayer organized under the laws of a foreign country, in the state which the taxpayer has declared to be its home state pursuant to the provisions of the International Banking Act of 1978. If a taxpayer described in this clause has not made such a declaration or is not required to make such a declaration, the asset or activity shall be presumed to be located at the taxpayer's place of business in the United State to which the greatest number of employees are regularly connected or out of which they are working, irrespective of where the services of such employee are performed, as of the last day of the taxable year.

(n) **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.]

(o) **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 5. Property Factor

(a) **General.** The property factor is a fraction, the numerator of which is the average value of the taxpayer's real property, tangible personal property, loans and

credit card receivables located and used<sup>9</sup> within this state during the taxable year and the denominator of which is the average value of all such property located and used both 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.**

(1) 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.

(2) Loans are valued at their outstanding principal balance, without regard to any reserve for bad debts. If a loan is charged-off in whole or in part for Federal income tax purposes, the portion of the loan charged off is not outstanding. A specifically allocated reserve established pursuant to regulatory or financial accounting guidelines which is treated as charged-off for Federal income tax purposes shall be treated as charged-off for purposes of this section.

(3) Credit card receivables are valued at their outstanding principal balance, without regard to any reserve for bad debts. If a credit card receivable is charged-off in whole or in part for Federal income tax purposes, the portion of the receivable charged-off is not outstanding.

(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

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<sup>9</sup> While the phrase "located and used" quite applicable with regard to real and tangible personal property, it is much less so with regard to intangibles such as loans and credit card receivables. This provision is not intended to condition the location or assignment of these intangibles on their use in the state. With regard to these intangibles, the location of the intangible will control and their use, for example where the proceeds of a loan are applied or where the interest payment or loan repayment may be made, are neither relevant nor operative.

be used consistently by the taxpayer with respect to property within and without the state and on all subsequent returns unless the taxpayer receives prior written 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 leased 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 subdivision 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 written 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 subdivision, 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) Movable tangible property, such as aircraft, rolling stock, water vessels, or mobile equipment, are 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 movable tangible 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.

**(g) Location of loans.**

(1) (A) A loan is considered to be located within this state if -

(i) it is properly booked for tax purposes at a regular place of business of the taxpayer within this state; or

(ii) in the case of a taxpayer organized under the laws of the United States or of any state, the loan is properly booked for tax purposes at a place which is not a regular place of business of the taxpayer and such taxpayer's commercial domicile is within this state; or

(iii) in the case of a taxpayer organized under the laws of a foreign country, the loan is properly booked for tax purposes at a place which is not a regular place of business of the taxpayer and such taxpayer has declared this state to be its home state pursuant to the provisions of the International Banking Act of 1978. If a taxpayer described in this clause has not made such a declaration or is not required to make such a declaration, the loan shall be presumed to be located at the place in the United States to which the greatest number of employees are regularly connected or out of which they are working, irrespective of where the services of such employee are performed, as of the last day of the calendar year.

(B) The state in which a loan has a preponderance of substantive contact with a regular place of business of the taxpayer shall be the state in which a loan is properly booked.<sup>10</sup>

(h) **Location of credit card receivables.** For purposes of determining the location of credit card receivables, credit card receivables shall be treated as loans and shall be subject to the provisions of subdivision (g) of this section.

**Section 6. 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

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<sup>10</sup> The phrase "preponderance of substantive contact" used in Section 5(g)(1)(B) to locate loans and credit card receivables requires further definition normally left for inclusion in regulations supporting the statute. Regulatory language is suggested at Appendix D.

include only that compensation which is included in the computation of the taxpayer's 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 included 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 or the place from which the services are directed or controlled is not in any state in which some part of the service is performed but the employee's residence is in this state.



## NOTICE OF PUBLIC HEARING

The Multistate Tax Commission will hold three sessions of a public hearing on the following subject:

**The development and adoption of Proposed Multistate Tax Commission Regulation VI.18.(i) dealing with the attribution of income from the business of financial institutions.**

To this end, the Hearing Officer will receive public input in person and in writing from all interested persons addressing the following matters:

1. *What is the most appropriate definition of the terms "financial institution" and "business of a financial institution" for the purpose of statutory or regulatory coverage of the different kinds of financial institutions that are in substantial competition with one another?*
2. *Should the receipts factor reflect the delivery of a financial institution's services on a destination basis or on a majority of "cost of performance" basis?*
3. *How should states treat intangible property in the form of unsecured or secured loans, investments in securities, etc. for income attribution purposes?*
4. *With regard to states that apply the unitary business principle and combined reporting, what, if any, approach should the proposal take with regard to such principles.*
5. *What, if any, approach should the proposal take with regard to nexus and/or de minimis concepts?*
6. *Should a throwback, throwout or another approach be used to address the attribution of receipts that are sourced to states in which the taxpayer is not subject to taxation?*
7. *Such other issues and suggestions that state representatives and other members of the taxpaying community may wish to present for consideration.*

A copy of the most recent draft version of the proposed uniform statute/regulation (MTC Reg.IV.18.(i)) may be obtained on and after May 13, 1993 by writing or calling:

Teresa Moore  
Multistate Tax Commission  
444 North Capitol St., N.W.  
Washington, D.C. 20001  
Phone: (202)-624-8699

The Hearing Officer that has been assigned to this matter is:

Alan H. Friedman, General Counsel  
Multistate Tax Commission  
386 University Avenue  
Los Altos, CA 94022  
Phone: (415)-941-0556

The two public sessions will be held at the locations, dates and times specified as follows:

1. Thursday, May 27, 1993, beginning at 10:00 a.m. at the Ronald Reagan State Office Building, 300 South Spring Street, Los Angeles, California, first floor Auditorium.
2. Thursday, July 15, 1993, beginning at 10:00 a.m. at the Hall of the States, 444 No. Capitol St., N.W., Room 333, Washington, D.C.

A third public session will be held in New York in late summer and supplemental public notice will be made of the date, time and specific location of that session.

The Multistate Tax Commission invites all interested parties to participate in the public sessions of this hearing. Those desiring to make oral presentations to the Hearing Officer must notify him in writing at least two working days prior to the holding of the public session. An attempt will be made to accommodate those who wish to present oral testimony but are unable to travel to the location for the public sessions. Any person desiring to testify by use of telecommunications should make that desire known at the time he/she discloses an interest in making a presentation. Depending upon feasibility, an attempt will then be made to assign specific time slots to those parties requesting the opportunity to testify by telecommunications. Anyone desiring to submit written comment may do so by submitting them to the Hearing Officer at any time prior to the last date for public session or such later date as may be announced for the closing of the public hearing.

ATTACHMENT 3.

**NOTICE OF PUBLIC HEARING**



## INDUSTRY PARTICIPANTS

<u>Name</u>	<u>Company or Association</u>
Henry Ruempler	American Bankers Association
Joanne Ames	American Bankers Association
Philip M. Plant	Bank of America NT & SA
Dan S. Lazar	Bank of New York Company, Inc.
Paul Buchman	Bank of New York Company, Inc.
Marty Linzer	Bankers Trust Co.
Harry Montgomery	Bankers Trust Co.
Robert Godwin	Boatmen's Bancshares Inc.
Joseph L. Taetle	Chase Manhattan Bank, N.A.
Jeffrey M. Serether	Citicorp/Citibank, N.A.
Donald N. Adler	Dean Witter Financial Svcs. Grp. Inc.
Raymond F. Douglas	Dean Witter Financial Svcs. Grp. Inc.
Norma Lauder	First Chicago Corporation
Charles J. Wooding	First Chicago Corporation
Marcia C. Dieter	First Independent Bank
Richard A. Hayes	First Interstate Bancorp
Michael J. Palko	Great Western Financial Corporation
Brad Ellison	Great Western Financial Corporation
Nancy Worman	KeyCorp
Holly Chamberlain	KeyCorp
Allan B. Lubarsky	Morgan Guaranty Trust Co. of NY

Myron Rosenberg

Brent C. Andersen

Haskell Edelstein

John H. Kasser

Terry J. Baker

Jonathan W. Allen

Morgan Guaranty Trust Co. of NY

NationsBank

Price Waterhouse & Co. (formerly  
Citicorp/Citibank, N.A.)

South Holland Trust & Savings Bank  
Group, Inc.

SunTrust Banks, Inc.

Wachovia Corporation

Keith Larson

West Virginia Department of Tax and Revenue

Monitoring for Co-sponsor  
Federation of Tax  
Administrators:

Harley Duncan and  
Mary Jane Egr

Federation of Tax Administrators



ATTACHMENT 2.

STATE/INDUSTRY MEETING GROUP ON FINANCIAL INSTITUTIONS

Convener: Alan Friedman,  
Multistate Tax Commission

Alternate Convener: Fred E. Ferguson  
Karen J. Boucher  
Arthur Andersen

STATE PARTICIPANTS

<u>Name</u>	<u>Agency</u>
Eric Coffill	California Franchise Tax Board
Ed Campion	California Franchise Tax Board
Gerald Goldberg	California Franchise Tax Board
Ben Miller	California Franchise Tax Board
John Libby	Connecticut Department of Revenue Services
Rod Felix	Florida Department of Revenue
John Malach	Illinois Department of Revenue
Barbara Phillips	Indiana Department of Revenue
Mark Beshears	Kansas Department of Revenue
Thomas Sheridan	Kansas Department of Revenue
Virgil J. Brady	Louisiana Department of Revenue
Michael E. Boekhaus	Minnesota Department of Revenue
Bill Lunka	Minnesota Department of Revenue
Stanley R. Arnold	New Hampshire Department of Revenue

Maurice Gilbert	New Hampshire Department of Revenue
Daniel H. Levine	New Jersey Department of Taxation
Marilyn N. Kaltenborn	New York Department of Taxation and Finance
Deborah Liebman	New York Department of Taxation and Finance
Richard Garrison	New York Department of Taxation and Finance
Bill Ryan	New York Department of Taxation and Finance
James W. Wetzler	New York Department of Taxation and Finance
Carol O'Cleireacain	New York City Department of Finance
Michael Hyman	New York City Department of Finance
Jonathan R. Robin	New York City Department of Finance
Jerry Rosenthal	New York City Department of Finance
William Thomas	New York City Department of Finance
Ashley C. Morris	North Carolina Department of Revenue
Heidi Heitkamp	North Dakota Tax Department
Ron Schreiner	South Dakota Department of Revenue
James Fry	South Dakota Department of Revenue
Anne Dougherty	Tennessee Department of Revenue
Wade Anderson	Texas Comptroller of Public Accounts
Steve Zegalo	Washington Department of Revenue

## APPENDIX A.

### **Suggested Regulation - "Basis of information included in apportionment factors".**

At the election of the taxpayer, the information used in the calculation of the apportionment factors as provided in Sections 4 through 6 [of the Act] may be based either upon information contained in the taxpayer's financial books and records (book basis) or in the taxpayer's federal income tax return (tax basis), so long such information used fairly represents the extent of the taxpayer's activities in the state. Once such election is made of either book basis or tax basis, such basis shall be used by the taxpayer for all future years, unless permission is obtained in writing from the State Tax Administrator to use another basis.



## APPENDIX B

Suggested definition of "financial institution" - [The following definition of "financial institution" is offered solely as a guide for those states that wish to follow it. It is to be emphasized that the pending proposal is one that is designed to assign uniformly the net income of a financial institution as that term may be defined by a state.]

### Term: Financial Institution.

"Financial institution includes:

- (a) 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;
- (b) 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.;
- (c) A federal savings and loan association;
- (d) Any bank or thrift institution incorporated or organized under the laws of any state;
- (e) A mutual savings bank incorporated or organized under the laws of the United States or of any state;
- (f) Any corporation organized under the provisions of 12 U.S.C. 611 to 631.
- (g) Any agency or branch of a foreign depository as defined in 12 U.S.C. 3101;
- (h) A credit union;
- (i) 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;
- (j) Any corporation whose voting stock is more than fifty percent (50%) owned, directly or indirectly, by any person or business entity

described in subsections (a) through (i) above other than an insurance company taxable under [insert applicable state statute] or a \_\_\_\_\_ company taxable under [insert applicable state statute];

(k) A corporation or other business entity that derives more than fifty percent (50%) of its total gross income from 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,

(i) 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

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

(l) Any other person or business entity which derives more than fifty percent (50%) of its gross income from activities that a person described in subsections (b) through (i) above is authorized to transact. For the purpose of this subsection, the computation of gross income shall not include income from nonrecurring, extraordinary items.

## APPENDIX C.

### Suggested Regulation - "Gross rents described." (Section 3.(i)).

"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.

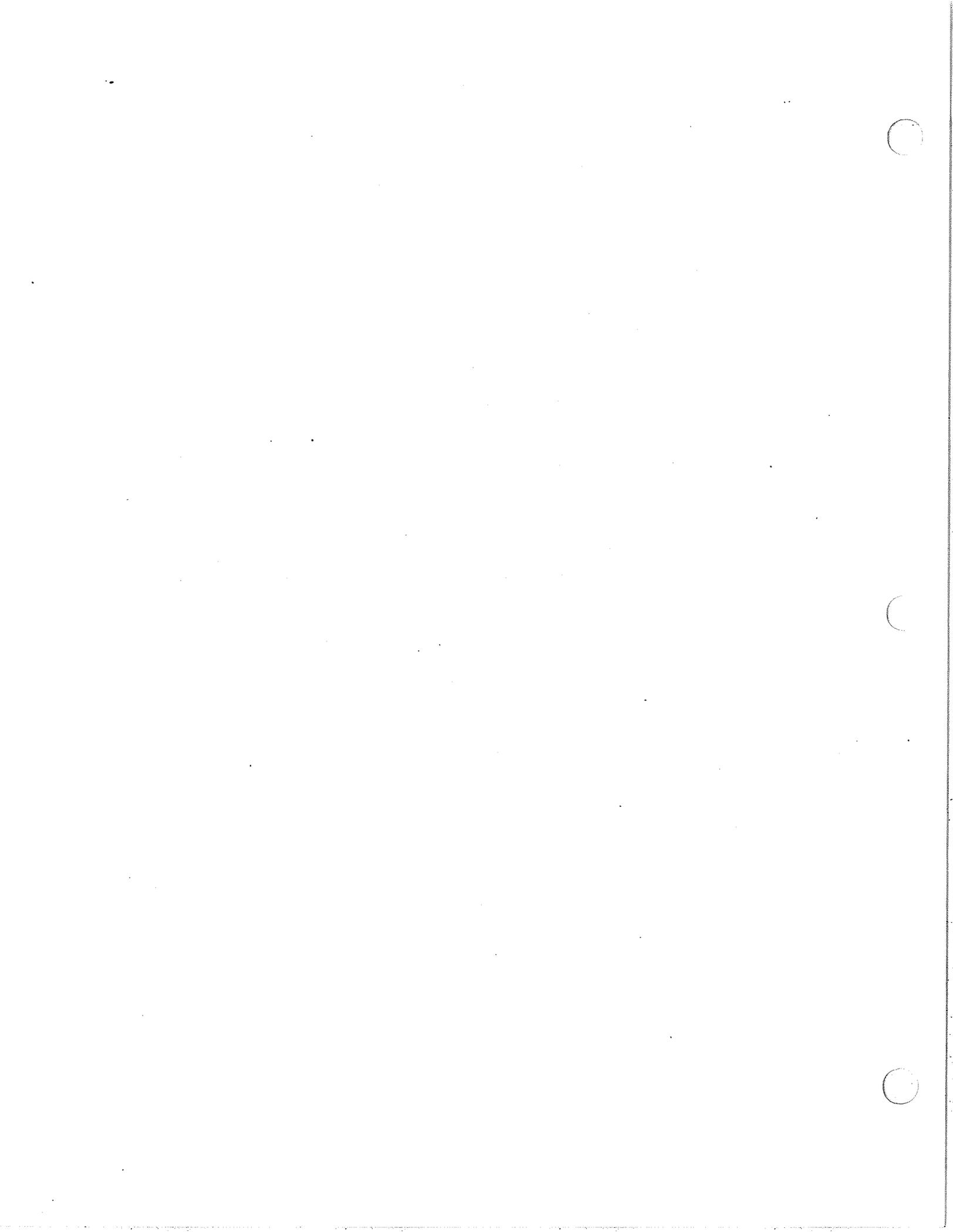
(4) The following are not included in the term "gross rents":

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

(ii) amounts payable as service charges, such as janitorial services, furnished by the lessor;

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

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



## APPENDIX D.

### **Suggested Regulation - "Preponderance of substantive contact for locating certain loans and credit card receivables; presumption." (Section 5(g)(1)(B)).**

(1) In order to determine the state in which loans or credit card receivables are properly booked under the "preponderance of substantive contact" test for the purpose of locating said property under Section 5(g)(1)(B), consideration is to be given to such things as: solicitation, investigation, negotiation, approval and administration. The terms "solicitation", "investigation", "negotiation", "approval" and "administration" are defined as follows.

(A) *Solicitation.* Solicitation is either active or passive. Active solicitation occurs when an employee of the taxpayer initiates the contact with the customer. Such activity is located at the regular place of business which the taxpayer's employee is regularly connected with or working out of, regardless of where the services of such employee were actually performed. Passive solicitation occurs when the customer initiates the contact with the taxpayer. If the customer's initial contact was not at a regular place of business of the taxpayer, the regular place of business, if any, where the passive solicitation occurred is determined by the facts in each case.

(B) *Investigation.* Investigation is the procedure whereby employees of the taxpayer determine the credit-worthiness of the customer as well as the degree of risk involved in making a particular agreement. Such activity is located at the regular place of business which the taxpayer's employees are regularly connected with or working out of, regardless of where the services of such employees were actually performed.

(C) *Negotiation.* Negotiation is the procedure whereby employees of the taxpayer and its customer determine the terms of the agreement (e.g., the amount, duration, interest rate, frequency of repayment, currency denomination and security required). Such activity is located at the regular place of business which the taxpayer's employees are regularly connected with or working out of, regardless of where the services of such employees were actually performed.

(D) *Approval.* Approval is the procedure whereby employees or the board of directors of the taxpayer make the final determination whether to enter into the agreement. Such activity is located at the regular place of business which the taxpayer's employees are regularly connected with or working out of, regardless of where the services of such employees were actually performed. If the board of directors makes the final determination, such activity is located at the commercial domicile of the taxpayer.

(E) *Administration.* Administration is the process of managing the account. This process includes bookkeeping, collecting the payments, corresponding with the customer, reporting to management regarding the status of the agreement and proceeding against the borrower or the security interest if the borrower is in default. Such activity is located at the regular place of business which oversees this activity.

(2) In applying the standards for determining the state to which a loan is to be located, a preponderance of substantive contact shall be presumed, subject to rebuttal, to exist at a taxpayer's regular place of business to which it has been booked, if the loan is approved and administered there.<sup>11</sup>

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<sup>11</sup> *It was urged by some of the industry representatives that a presumption or convention of sorts be adopted to reduce the opportunity for more than one state to assign the same loan or credit card receivable to itself. Since the suggested property factor favors money-center state assignment for intangible property, the suggested preference here is consistent with that approach.*

**EXHIBIT G:**

**AGENDA: MTC/FTA FINANCIAL INSTITUTIONS BUSINESS  
WORKSHOP**

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**FINANCIAL INSTITUTIONS BUSINESS WORKSHOP**  
**CO-SPONSORED BY THE MULTISTATE TAX COMMISSION**  
**AND THE FEDERATION OF TAX ADMINISTRATORS**

**Grand Hyatt Hotel**  
**Washington, DC**

**October 8 -9, 1991**

**AGENDA**

**Tuesday, October 8, 1991**

**8:00 AM - 4:30 PM**

**I. INTRODUCTION TO WORKSHOP**

**II. BANKING BUSINESS BASICS**

***This introductory session builds upon the participant's basic understanding of the banking business.***

**Topics include:**

***The changing definition of banking***

***Financial statements in the banking industry***

***Banking profitability***

**III. RETAIL BANKING**

***This session reviews the business and profitability issues involved in retail banking.***

**Topics include:**

***Consumer lending***

***Direct vs. indirect***

***Secured v. unsecured***

***Real estate***

***Credit card operations***

***Deposit gathering***

***Electronic banking***

***ATMs***

***Point-of-sale (POS) systems***

***LUNCH BREAK (WORKING LUNCH)***

**IV. WHOLESALE BANKING**

***This session addresses the unique services that banks provide to their corporate customers.***

***Topics include:***

***Corporate finance***

***Corporate lending***

***Loan participations***

***Factoring***

***Asset-based financing***

***Leasing***

***Commercial real estate***

***Fee-generating activities***

***Service products***

***Cash management***

***Funds transfer***

***International banking***

***Letters of credit***

***Bankers acceptances***

***Investment banking***

***Commercial paper***

***LBOs and HLTs***

***Securitization***

***Underwriting***

**V. TRUST SERVICES**

*This session treats the various trust and securities processing services provided by banks.*

*Topics include:*

*Agent services*

*Personal services*

*Institutional trusts*

*Asset management*

*Global custody*

**VI. TREASURY FUNCTIONS**

*This session deals with the functions of the internal treasury department of a bank.*

*Topics include:*

*Trading*

*Securities*

*Foreign exchange*

*Asset/liability management*

*U.S. Treasuries*

*Fed funds*

*Repurchase agreements*

**Wednesday, October 9, 1991**

**8:00 AM - 12:30 PM**

**VII. OPERATIONS AND ADMINISTRATION**

***This session addresses the issues on the operational side of a bank in dealing with tax and audit requirements.***

**VIII. INCOME AND ASSET REPORTING**

***This session addresses some of the accounting and regulatory reporting aspects of banking.***

***Topics include:***

***Balance sheet and income statement analysis***

***SEC, GAAP and regulatory requirements***

**IX. STRUCTURE AND REGULATION**

***This session reviews the more significant of the federal regulatory agencies that oversee bank operations, soundness and various reporting requirements.***

***Topics include:***

***Comptroller of the Currency***

***Federal Reserve Board***

***FDIC***

***Securities Exchange Commission***

***Reports filed with the regulators***

***Structure of banks (holding company, subsidiaries and their activities)***

***Risk-based rules regarding capital***

**X. U.S. OPERATIONS OF FOREIGN BANKS**

***This session deals with foreign bank activities in the U.S.***

**LUNCH BREAK (ON YOUR OWN)**

**THE REMAINDER OF THE WORKSHOP SHALL BE LIMITED  
TO GOVERNMENT REPRESENTATIVES ONLY**

**1:30 PM - 5:00 PM**

**XI. CURRENT AND EVOLVING ISSUES**

***This session deals with the issues faced by federal and state  
tax auditors in reviewing bank records.***

**XII. DISCUSSION AND EVALUATION OF INFORMATION**

***The government representatives will evaluate the information  
provided in the Workshop and discuss the next steps to be  
taken in the development of state taxation approaches to  
financial institutions.***

**RECEPTION (5:30 PM - 7:00 PM)**

**WORKSHOP LEADERS**

**Sessions II. through VI.**

**Banking Business Basics, Retail Banking,  
Wholesale Banking, Trust Services, Treasury Functions**

**GREGORY GUNTHER:** *President, Enhanced Communications, Inc. (ECI), a designer and presenter of training courses in the financial institutions industry. ECI has presented various training courses to institutions including American Banker, American Express, Chase Manhattan Bank, Chemical Bank, Dun and Bradstreet, First Interstate, J.P Morgan, Norwest, and Price Waterhouse.*

**Session VII.**

**Operations and Administration**

**SUNIL ANTANI**

**Executive Vice-President, MNC Financial**

**Session VIII.**

**Income and Asset Reporting**

**LARRY ASHMORE**

**First Vice-President, SunTrust Bank**

**Session IX.**

**Structure and Regulation**

**EUGENE W. GREEN:**

**Deputy Chief Accountant  
Office of the Chief Accountant  
Comptroller of the Currency**

**Session X.**

**U.S. Operations of Foreign Banks**

**JOHN L. CARR, ESQ:** *Shaw, Pittman, Potts & Trowbridge and contributing author to International Financial Law and Regulation of Foreign Banks in the United States*

**Session XI.**

**Current and Evolving Audit Issues**

**RICHARD FLEMING:** *Bank Specialist, Internal Revenue Service*

**EDWARD CAMPION:** *Tax Audit Specialist  
California Franchise Tax Board*

**ROLAND SADOWSKY:** *Corporate Tax Auditor III  
New York State Department of Taxation and Finance*

**Session XII.**

**Discussion and Evaluation of Workshop Information**

**HEIDI HEITKAMP:** *Tax Commissioner, State of North Dakota*

**HARLEY DUNCAN:** *Executive Director  
Federation of Tax Administrators*

**MARILYN KALTENBORN:** *Chief of Tax Regulations  
New York Department of Taxation and Finance*

**ERIC COFFILL:** *Senior Staff Counsel, Multistate Tax Affairs  
California Franchise Tax Board*

**ALAN FRIEDMAN:** *General Counsel*

***Multistate Tax Commission***

## ADDITIONAL WORKSHOP RESOURCES

### C. JAMES JUDSON, ESQ.:

*Davis Wright Tremaine, Lawyers; Chairman of the firm's Business Law Group; frequent lecturer and author in areas of federal and state tax issues concerning financial institutions; editor of American Bar Association's State Taxation of Banking Institutions; member and past Chairman of ABA Committee on Banking and Savings Institutions, ABA Tax Section.*

*Mr. Judson has agreed to provide his expert services throughout the entirety of the Workshop. He will provide his comments and respond to your questions as to any of the subjects where it might be necessary to further illustrate or complement the session presentations. Mr. Judson's experience in the financial industry's transactional side permits him to provide the "color" commentary to many of the subjects dealt with in the Workshop.*

### WORKSHOP MATERIALS

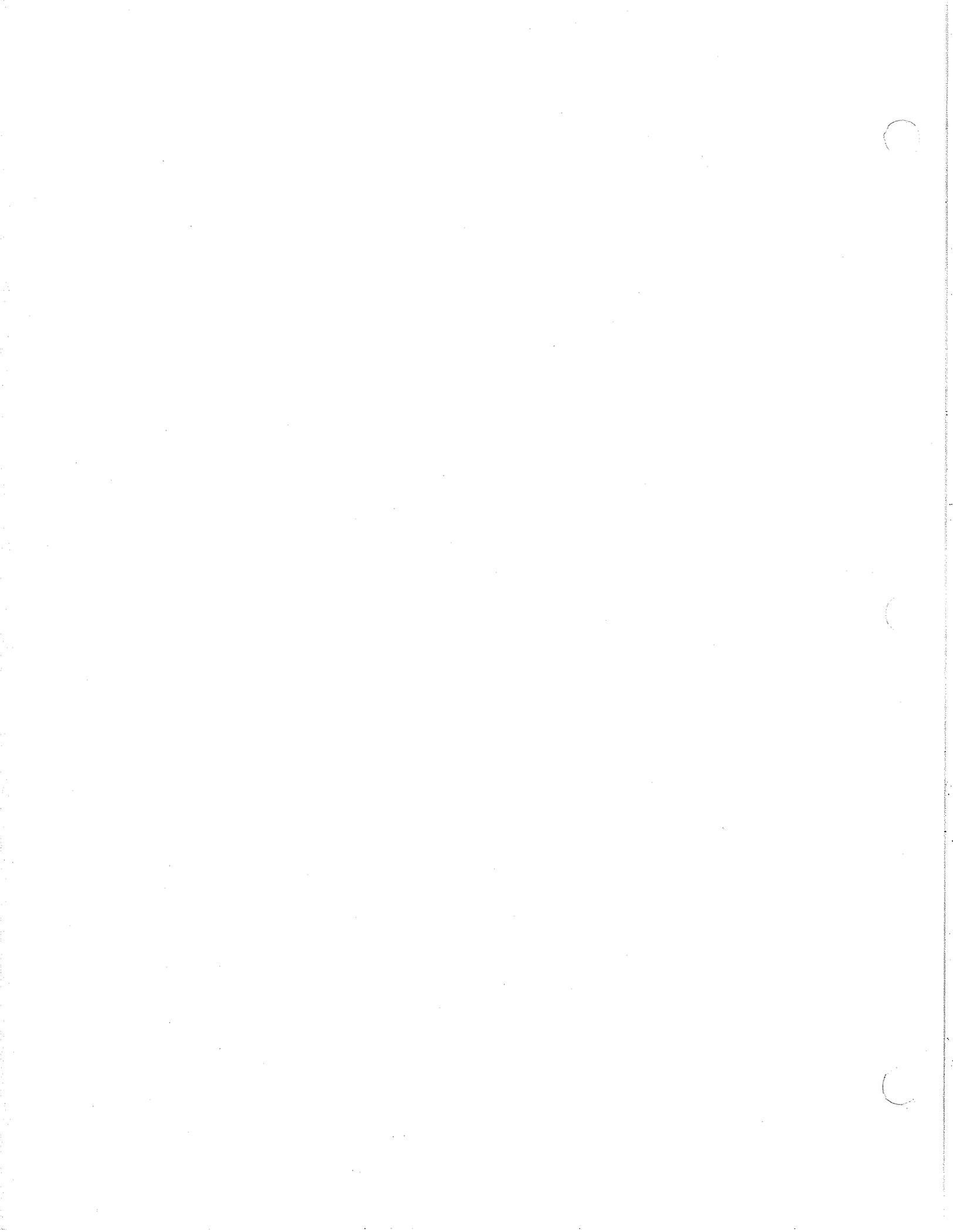
*Reading of the "Banking is Business" manual in advance of the Workshop is strongly recommended for all of the participants. While it may present new information for some and a basic refresher for others, it will provide a common place upon which many of the Workshop sessions will be based. Please note that although some portions of the manual contemplate the doing of workshop-type exercises, time does not permit us to engage in that type of training. You will receive additional written materials when you arrive at the Workshop that will assist you in following the fairly quick-paced presentations that will be presented.*



**EXHIBIT H: 3**

**Report of Subcommittee on Apportionment of Income from  
Financial Services (Alan Friedman)  
(March 30, 1992) with the following attachments:**

- Attachment 1: Money-center state proposal**
- Attachment 2: Market-state KISS Compromise**
- Attachment 3: Chart of proposals**
- Attachment 4: Minutes of State Subcommittee  
New York Meeting**



## PROPOSED FACTORS (OTHER THAN PAYROLL)

## SOURCE OF FUNDS FACTOR

**BORROWINGS** - Rebuttable presumption that all borrowings are attributable to headquarters. This recognizes that some borrowings may be as a result of the creditor dealing with another office of the bank, e.g., an LPO or representative office. The degree of contact with the LPO or other office that will result in a borrowing being attributed there must be developed.

Borrowings do not include anything in the equity section of the balance sheet and in the repo setting are to be net of repo assets. As a result, only net repo liabilities, if any, would be included in the factor.

Fed. funds borrowings and discount window borrowings would be attributable to the headquarters only. No rebuttable presumption because this activity is done by the headquarters as part of managing the bank's assets and liabilities, overall. It is not done by any one branch or as a result of the bank's accessing any particular market.

Study Federal Home Loan Bank Board (or its successor's) advances to S & Ls.

**DEPOSITS - Small Account** - If the account has less than \$X, it is attributable to the address of the depositor. This is not a presumption and may not be rebutted.

**Medium Account** - If the account has between \$X and \$Y, it is attributable to the branch where booked. This is not a presumption

and may not be rebutted. The branch must be a real branch with employees in full time attendance. The employees must have the authority to approve loans, accept loan repayments, disburse funds and conduct one or more other functions of a banking business. This is to eliminate allocation to "shell" branches. If the deposit is booked at a "shell" branch, then it is attributable to the headquarters.

Large Accounts - If the account has over \$Y, it is attributable to the branch which has the most contact with the deposit. The criteria for determining where the most contact has occurred must be developed, but SINAA (see receipts factor for large loans) would be a good place to start.

#### RECEIPTS FACTOR

Credit Cards - Interest - billing address; merchant discount - merchant's address; service fee - billing address.

Leases (non-finance) - Where tangible or real property located.

Small Loans (under \$Z) - If collateralized, where collateral is. If no collateral, application address.

Large Loans (\$Z and over) - Presumed at branch where booked, rebutted by SINAA (solicitation, investigation, negotiation, approval and administration). Note that first 3 elements of SINAA may well occur in a market state.

Syndication Loans (A loan made by several banks in the first instance; that is, several banks are named as lenders in the loan agreement.) - Treat the same as large loans. Any servicing fees earned by the lead bank are situated where the service is performed.

Participation Loans - (A loan that is made by one (or several) banks who then assign some or all of the loan to another bank(s). The new bank(s) receive the same interest payments that the original bank(s) would have received. The assignment can be with or without recourse.) Treat participations as a loan made by the new bank(s) to the original bank(s) and determine the situs of this loan in the same way as large loans are treated. Loan by original bank treated as a large loan. Receipts factor to include only the net interest income retained by the original bank(s). Servicing fees are to be situated to the place where the service is performed.

PASS-THROUGH CERTIFICATES - (Typically many small loans are sold to a corporation or, more likely, a trust, which then sells pass-through certificates which entitle the holders to receive their pro-rata share of principal and interest.) The original bank has sold loans which result in a gain or loss. Should the receipts factor reflect this gain or loss? A bank which buys a pass-through certificate has purchased an investment and the investment and trading income rules apply. Open question on servicing fees, should they follow rules for the direct loan (e.g. credit cards) or should they be situated where service is performed?

INVESTMENT AND TRADING INCOME (Including government bonds) -  
Study IRS ideas on 24 hour global trading (see Tax Notes, 8/27/90,  
p. 1143).

SERVICES - Where performed.

NEW YORK

ACTIVITY	RECEIPT ATTRIBUTED
Credit Cards	Billing Address
Merchant Discount	Merchant Address
Credit Card Service Fee	Billing Address
Leases (non-finance)	Location of Tangible or Real Property
Collateralized Small Loans (<\$Z)	Location of Collateral
Unsecured Small Loans (<\$Z)	Borrower's Address on Application
Large Loans (> or = \$Z)	Branch (Rebuttable-SINAA)
Syndication Loans	Branch (Rebuttable-SINAA)
Syndication Loan Service Fee	Where Service is Performed
Participation Loan-Orig. Bank	Branch (Rebuttable-SINAA); Net Amount
Participation Loan-New Bank	Branch (Rebuttable-SINAA w/Original Bank)
Participation Loan-Service Fee	Where Service is Performed
Pass-Through Certificates - Seller	Reflect Gain or Loss?
Pass-Through Certificates - Purchaser	Investment & Trading Income Rules
Pass-Through Certificates - Service Fee	Where Service is Performed or Investment Rules
Investment & Trading Income	Study?
Other Services	Where Performed

## NEW YORK

ACTIVITY	SOURCE OF FUNDS ATTRIBUTED
Small Deposits (< \$X)	Depositor's Address
Medium Deposits (between \$X and \$Y)	Branch Where Booked (if shell then throwback to headquarters)
Large Deposits (> \$Y)	Branch (SINAA)
Fed Funds	Headquarters
Discount Window	Headquarters
Net Repo Liabilities	Headquarters (Rebuttable)
Other Borrowings	Headquarters (Rebuttable)
Advances to S&Ls	Study?

TO: HEIDI HEITKAMP, NORTH DAKOTA TAX COMMISSIONER  
CHAIR, MTC/FTA WORKING GROUP ON FINANCIAL INSTITUTIONS

FROM: ALAN H. FRIEDMAN, CONVENER,  
SUBCOMMITTEE ON APPORTIONMENT OF INCOME  
FROM FINANCIAL SERVICES

RE: REPORT OF SUBCOMMITTEE ON APPORTIONMENT OF INCOME  
FROM FINANCIAL SERVICES

DATE: MARCH 30, 1992

During the April 17-18, 1991 Banking Conference that was sponsored by the American Bankers Association in Chicago, industry representative stated that they were willing to work with the Multistate Tax Commission in its effort to develop a uniform apportionment method to apply to income derived from activities of financial institutions. Following that meeting, representatives of various states and financial institution industry members met to discuss together the possibility of reaching a uniform method among the states for the apportionment of income from financial institutions. On July 15-16, 1991, approximately 35 state and industry representatives met in San Francisco to discuss the various issues involved in trying to reach some uniform apportionment method short of one being Congressionally mandated.

One result from the initial meeting in San Francisco was the recognition by the state representatives present the additional commitment by the states to seek additional information concerning how financial institutions operated before attempting to address the apportionment issues. To this end, a two-day "Financial Institutions Business Workshop" was organized by the Multistate Tax Commission and the Federation of Tax Administrators for October 8-9, 1991. The Workshop was held in Washington, D.C. at which representatives of 23 states attended.

Immediately following the Workshop, this Subcommittee was formed to carry forward with the effort of developing fair, uniform and administrable apportionment formulae for the financial institutions industry. The membership of the Subcommittee is as follows:

Convener:

Alan Friedman, Multistate Tax Commission

Subcommittee Members:

Michael Boekhaus (Bill Lunka)	MN	Keith Larson	WV
Eric Coffill	CA	John Malach	IL
Anne Dougherty	TN	Jonathan Robin	NYC
Marilyn Kaltenborn	NY	Harley Duncan (monitoring for Mary Jane Egr	FTA)

Due to fiscal problems faced by most of the states, the Subcommittee met principally via telephone conference calls, most of which were of several hours duration. For background purposes, each of the Subcommittee members was provided with the following materials:

1. Paper by Jim Judson entitled "State Taxation of Banks and Other Financial Institutions"
2. Paper submitted Haskell Edelstein of Citicorp entitled "State Taxation of Financial Institutions - A Fresh Approach"
3. Letter dated January 21, 1991 from Fred Ferguson detailing major and minor drafting problems contained in the MTC draft proposal
4. Letter dated April 8, 1991 from Phil Plant of the Bank of America
5. California's definition of a "financial corporation".

Between conferences, various suggested apportionment approaches were circulated among the Subcommittee members.

The first three teleconferences were held on January 24, February 11, and February 27, 1992. Agendas for these meetings are available should any state representative wish to review them. At the outset, the Subcommittee agreed on several points:

- A. Nexus issues were not on table for formal discussion or action at this time, the assumption being that nexus would have to exist before apportionment could be applied.
- B. Uniformity of state tax bases was not to be addressed.
- C. Joint-state administrative possibilities were to be discussed after consensus was reached on an

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- B. Uniformity of state tax bases was not to be addressed.
- C. Joint-state administrative possibilities were to be discussed after consensus was reached on an

apportionment formula.

- D. The initial drafting efforts were to be focussed on traditional banking activities.
- E. Foreign owned banks were to be included in any proposal.
- F. The suggestions put forth by the industry by F.I.S.T. and Haskell Edelstein's "A Fresh Approach" were considered and were to be the subject of further discussion after the states' efforts were concluded.

During these first three teleconferences, the division between the two principal approaches - the money-center and the market approaches - were set forth and discussed. Attachment 1 sets forth the money-center state suggested compromise resolution and Attachment 2 describes one market state suggested compromise resolution. Attachment 3 combines in one document the money-center vs. market outlines of their respective positions. During the February 27th conference call, it became apparent that both the market and money-center state positions were staked out fairly firmly and that the only real possibility for reaching additional consensus required a face-to-face meeting of representatives of the two positions. That meeting was held in New York on March 9-10, 1992.

Attachment 4 sets forth the Minutes of the meeting held in New York on March 8th and 9th and presents the most comprehensive description of the various issues that were addressed by the Subcommittee as a whole. During this meeting, representatives of the differing approaches fully discussed and clarified their respective positions. Both money-center state and market state representatives expressed their desire to reach some sort of uniform approach; but, other than the compromises represented in Attachments 1 and 2, no one at the table was able to move off his or her respective state approach.

Toward the end of the New York meeting, another formula approach emerged for consideration. While no state representative will take credit for the suggestion and no state representative has yet to commit to recommend its adoption, the Subcommittee offers this approach for consideration because it represents one potential for compromise. The suggested approach, more definitively set forth in the Minutes, is for the application of a five-factor apportionment formula. The five factors would consist of: (1) a traditional payroll factor, (2) a property factor that would include intangibles, (3) a receipts factor sourced on a market state basis, (4) a receipts factor sourced on a money-center basis, and (5) a source of funds factor that consisted of deposits only and no other borrowing. No weighing of the factors has been settled upon as yet.

Lastly, the Subcommittee identified several other issues that require addressing once an apportionment formula has been agreed upon. The major issues that the Subcommittee identified in this regard are:

- A. Entities to be included within scope of definition of financial institution.
  - 1. Nonbank banks?
  - 2. Credit Unions?
  - 3. Brokerage houses?
  - 4. Insurance companies?
  - 5. Others?
- B. Weighing of factors once they are identified and agreed upon.
- C. Development of definitions for unique terms.
- D. Unitary/combination/Finnigan issues.
- E. Reduction of record keeping and other administrative burdens on bank and audit staffs.
- F. Possible joint-state administrative mechanisms.

In order to provide the industry with sufficient time to prepare for the April 29-30 meeting, the Subcommittee recommends that this Report be distributed to industry representatives at the same time that it is distributed to the states.

ATTACHMENT 1

ATTACHMENT 2

**MINNESOTA**

Department of Revenue

**Appeals, Legal Services and Criminal Investigations Division**

Phone (612) 296-107

# Memo

**To:** Bank Apportionment Subcommittee  
**From:** Mike Boekhaus  
**Subject:** KISS Compromise  
**Date:** February 24, 1992

This is what I have come to think of as the KISS Compromise, which basically follows my philosophy for tax system management: keep things simple enough so that I can explain it to a legislator from the northlands who has better things to do than worry about theories of taxing banks.

The basic premise of this proposal is the splitting of the attribution of the income from intangible property and the intangible property interest between the market and the money-center. Bill Lunka put together the attached spreadsheet that shows the general outline of the proposal. Please note that this is a draft for discussion purposes only.

The concept is relatively simple and is predicated on the traditional three-factor formula designed for manufacturing/mercantile corporations. In the manufacturing context, the plant/property is attributed to its location. The income derived from the plant is attributed to the location of the customers purchasing the products.

What we are attempting to do with the intangible property is similar. The property interest is attributed to the state where the facility that created the property is located, the money center. The income from that property is assigned to the location of the customers/borrowers, the market state.

There are three basic reasons for advancing this alternative. First of all, it fits within the traditional, judicially approved three-factor formula. This is important not only from a judicial standpoint, but also from the legislatures' views as well. Whatever is settled on has to pass legislative muster before the constitutional test. My experience is that it is much easier to pass variations on a common theme, than it is to offer something completely new and different.

## KISS Compromise

Page Two

Secondly, it attempts to minimize the compliance problems by, in most cases, using information readily available to the banks as attribution rules. Based on the experience of Minnesota's auditors and long discussions with the industry, the banks can administer these attribution rules with minimal effort. From the tax administration standpoint, states won't have to adopt extensive complex regulations to administer. There also won't be the expense inherent in administering a complex new system.

Finally and most importantly, it is a compromise between the market and the money-center approaches that we have seen so far. It recognizes the fact that we all are going to have to give up something or the U.S. Congress may take all of it away, leaving us no flexibility (Remember the Railroads!).

As to the proposal itself, I stress that this is only a work-in-progress for our discussion. I am aware of the need for some refinements to make it work. What I am looking for is some agreement that this is the route we want to follow in putting together a fair (for the states and banks), simple and administrable formula. That should be the first order in our discussion before we spend time picking away at the details.

Now for the details. The spreadsheet is pretty much self-explanatory. We didn't have time to include attribution rules based on the size of the loan, but the concept merits further discussion.

There are three issues that I'd like to highlight. First of all, you will note that investments and securities have been excluded from the property and receipts factors. This is our version of a punt. The current market formulas attribute this property and associated income based on deposits. The theory for the current rule is that deposits are the source of funds for purchasing these instruments. But deposits aren't the sole source of funds available to a bank, as our previous telephone conference made painfully obvious. All of the income, deposits and borrowings of a bank can be used to purchase securities. The complexity of a source of funds rule solely to attribute this income did not seem feasible. The alternative of attributing this income and property to a bank's principal place of business puts everything in the money-center and nothing in the market.

Therefore, the proposal excludes investments and securities on the theory that the other measures of business activity will arrive at a fair approximation of the business activity within a state. That proportion would in turn be a fair approximation of the investments and securities attributable to activity in that state. This is the same result in many states for investments and securities held by manufacturers.

The second issue is income from services. Let me be up front about the fact that Minnesota has committed to attributing services for all corporations based on consumption. This is an issue that goes beyond banking for us. That said, there are two areas of contention about services. The banks and money-centers argue that consumption is difficult and expensive to administer. A good argument that can be ameliorated by a majority of states adopting the concept (which is essentially what occurred when states adopted the destination sales rule for manufacturers). The market/single factor states argue that the alternative of where the services are performed duplicates the payroll and distorts the formula. Also, a good argument. A possible compromise may be to use some rebuttable presumption looking at the location of the customer for whom the services are performed to attribute this income, either by billing address or principal place of business. This would give the income a market orientation, yet ease the administrative burden on the banks. Market states would have to include a payroll factor to reflect business activity occurring in the money-center.

The final issue is the toughest: unsecured commercial loans. This would probably be a good area to use some attribution rules based on the size of the loans. The proposal situates the income based on where the funds are used as a general principal. Here again, we could use a rebuttable presumption to attribute the income and require a higher degree of care in determining where the funds are applied based on the size of the loan. Smaller loans are more numerous and less subject to manipulation. Larger loans present an opportunity for "tax planning." All of the property interest is essentially attributed to the money-center.

Syndication and participation loans are not specifically addressed. The attribution of income and property arising out of syndication and participation loans should be determined by the type of loan that is being syndicated or participated in. The issue for participation and syndication loans is

**KISS Compromise**

**Page Four**

more properly addressed in the nexus context. Does the fact that a bank participates in a loan that attributes income to a state create nexus in that state?

Finally, I just want to tease you with this thought: what about interstate branching? This proposal could allow us to create property attribution rules for when a bank has a branch within the state and when it doesn't. This would address the banks' complaint about taxing them when they can't branch into a state. A bank would be taxed more or less, depending on whether it had a branch in the state. Just a thought.

Talk to you all on Thursday.

Enclosure

**Proposed Financial Institution  
Apportionment Formula**

Activity	Property Attributed	Payroll Attributed	Receipts Attributed
Coin and Currency	Where Physically Located	N/A	Where Physically Located
Goodwill	Excluded from Formula	N/A	Excluded from Formula
Lease	Where Tangible Property Is Located	N/A	Where Tangible Property Is Located
Financing	Where the Main Office of the Original Lender is Located	N/A	Where the Collateral is Physically Located
Loans Collateralized by Tangible Property	Where the Customer Regularly Sends Their Payment	N/A	Where the Customer Resides
Unsecured Consumer & Installment Loans	Where the Customer Regularly Sends Their Payment	N/A	Where the Customer Is Regularly Billed
Credit & Travel	Where the Main Office of the Original Lender is Located	N/A	Where the Funds Are Used
Entertainment Cards	Excluded from Formula	N/A	Excluded from Formula
Unsecured Commercial Loans	N/A	Where Employee is Employed	N/A
Investments & Securities	N/A	N/A	Where the Merchant Is Located
Employees	N/A	N/A	Where the Benefits of The Services Are Consumed
Merchant Discount Income	N/A	N/A	Where the Travelers Check or Money Order was Purchased
Fiduciary and Other Services	N/A	N/A	N/A
Travelers Checks & Money Orders	N/A	N/A	N/A
Tangible Property	Where Property is Sitused	N/A	N/A



PROPOSED FINANCIAL INSTITUTION APPORTIONMENT FORMULA - NYS/NYC

Activity	Source of Funds Attributed	Payroll Attributed	Receipts Attributed
Borrowings (General)	Headquarters 1	N/A	N/A
Borrowings (Repo's)	Headquarters 2	N/A	N/A
Borrowings (Fed. Funds)	Headquarters	N/A	N/A
Borrowings (Discount Window)	Headquarters	N/A	N/A
Borrowings (Fed. Home Loan Bank Board)	?	N/A	N/A
Deposits < \$X	Depositor's Address	N/A	N/A
Deposits \$X - \$Y	Branch Where Booked 3	N/A	N/A
Deposits > \$X	Branch Per SINAA 4	N/A	N/A
Credit Cards (Interest)	N/A	N/A	Billing Address
Credit Cards (Merchant Discount)	N/A	N/A	Merchant's Address
Credit Cards (Service Fee)	N/A	N/A	Billing Address
Leases (non-finance)	N/A	N/A	Location of property
Collateralized Loans < \$X	N/A	N/A	Location of collateral
Uncollateralized Loans < \$X	N/A	N/A	Address of borrower
Commercial Loans > \$X	N/A	N/A	Branch where booked 1
Loans (Syndication)	N/A	N/A	Branch where booked 2
Loans (Participation)	N/A	N/A	Branch where booked 3
Pass-Through Certificates	N/A	N/A	?
Investment/Trading Income 1	N/A	N/A	?
Services	N/A	N/A	Where performed
Employees	N/A	Where employee employed	N/A

**PROPOSED FINANCIAL INSTITUTION APPORTIONMENT FORMULA - MINNESOTA**

<b>Activity</b>	<b>Property Attributed</b>	<b>Payroll Attributed</b>	<b>Receipts Attributed</b>
Coin and currency	Where physically located	N/A	Where physically located
Goodwill	Excluded from formula	N/A	Excluded from formula
Lease financing	Where tangible property located	N/A	Where tangible property located
Loans collateralized by tangible property	Main office of original lender	N/A	Where collateral physically located
Unsecured consumer & installment loans	Where customer sends payment	N/A	Where customer resides
Credit & travel cards	Where customer sends payment	N/A	Where customer billed
Unsecured commercial loans	Main office of original lender	N/A	Where funds used
Investments and securities	Excluded from formula	N/A	Excluded from formula
Employees	N/A	Where employee employed	N/A
Merchant discount income	N/A	N/A	Where merchant located
Fiduciary and other services	N/A	N/A	Where benefits of services consumed
Travelers checks and money orders	N/A	N/A	Where travelers checks or money orders purchased
Tangible property	Where property situated	N/A	N/A

**FOOTNOTES:**

**Property Attributed:**

1. Rebuttable presumption.
2. Net of Repo assets; only net Repo liabilities included.
3. If branch determined to be "shell," then attributed to headquarters.
4. SINAA—Solicitation, Investigation, Negotiation, Approval and Administration.

**Receipts Attributed:**

1. Rebuttable per SINAA.
2. Rebuttable per SINAA; servicing fees earned by lead bank attributed where performed.
3. Treated as loan by new bank(s) to original bank(s); Rebuttable per SINAA; include only net interest income retained by original bank(s); servicing fees attributed where performed.

**Activity:**

1. Includes government bonds

ATTACHMENT 4

MINUTES OF THE SUB-SUBCOMMITTEE ON APPORTIONMENT OF INCOME FROM  
FINANCIAL SERVICES

March 9-10, 1992  
New York City

The Sub-Subcommittee on Apportionment of Income from Financial Services met for the better part of two days on March 9-10, 1992 in the office of the New York City Department of Finance, One Centre Street, New York, NY. Members of the Sub-Subcommittee were:

Marilyn Kaltenborn	New York State Tax Department
Jonathan Robin	New York City Department of Finance
Bill Lunka	Minnesota Department of Revenue

Others present were:

Alan Friedman	Multistate Tax Commission
Richard Garrison	New York State Tax Department
Jerry Rosenthal	New York City Department of Finance
Kathy Barnett	" " "

For the purpose of simplicity, with the exception of a few particular references, these minutes will not identify who made what particular point during the two-day meeting. At other times, the minutes will use the terms "money-centered" or "domicile" state to reflect certain expressions of that bias and the term "market" state to reflect that bias. Some of the suggestions are not attributed to either bias, but evolved from the group dynamic and are owned by neither money-center nor market state representatives.

The meeting opened with Jonathan Robin describing an analysis that had been conducted of several of New York's largest domiciliary and alien (non-U.S.) banks with reference to the size of their New York allocation factors. Robin expressed some surprise at the results in that the selected domiciliary banks (on an aggregated basis) had assigned to New York only 50.57% of their net income. The range on an individual bank basis ran from 30%-60% New York apportionment factor, with the remaining percentage being attributed primarily to the banks' overseas activities. The apportionment percentage attributed to New York by alien banks (based on "effectively connected" income) was 57.73% on an aggregated basis, with approximately 86% attributed to trading and investment activity located in New York. A brief check of foreign

(domestic, non-New York banks) reflected a 2.66% apportionment factor for New York. Robin suggested that these preliminary numbers reflected that the states were laboring under a misconception that New York was sweeping in close to 100% of their domiciliary banks' income into the New York tax base.

Robin and Kaltenborn then briefly described the New York state and City apportionment formula which included:

An 80% payroll factor - for business location and development

A double-weighted receipts factor

A double-weighted deposits factor (using the FDIC definition of deposits)

Both Robin and Kaltenborn remained committed throughout the meeting to including a "Source of Funds" element in the factors. While they believed that all liabilities comprising the sources of a bank's funding of its activities are an important measure of that activity for apportionment purposes, they could envision supporting a formula that just included deposits as an approximate measure of that activity.

Lunka expressed Minnesota's opposition to using a source of funds or deposits factor in place of a property factor. He suggested that he could envision supporting a more traditional looking three-factor formula that reflected assets, payroll and receipts. He added that the receipts factor is the proxy for the market states and intangible assets should be included in the property factor which will act as the proxy for the money-centered states.

Based upon the positions taken, the market and money-centered approaches were stuck at the following bidding with regard to the number and type of the factors:

#### FACTORS

MONEY-CENTER STATE	MARKET STATE
Payroll factor	Payroll factor
Receipts factor	Receipts factor
Property factor (open issue)	Property factor
Source of funds or deposits factor	No source of funds or deposits factor

The Sub-Subcommittee, setting aside its differences as to the number and kind of factors, then worked at developing the factors in terms of the types of items or activities included and their attribution.

**PAYROLL FACTOR**

The Payroll Factor was the least controversial and one which was fully agreed upon by the representatives. Included in this factor would be all employees, including general executive officers with company-wide responsibility (currently excluded from New York's payroll factor) and deferred compensation. This agreement is represented by the following chart:

PAYROLL FACTOR

Activity: Employees		
ITEM ATTRIBUTED	MONEY-CENTER STATE	MARKET STATE
Payroll	Place of employment include officer 's comp. and deferred comp.	Same

**RECEIPTS FACTOR**

There was no disagreement expressed between the money-center and market approaches with regard to the specific items to be included in a receipts factor and such items are noted in the chart below. With regard to the attribution of receipts from these items, the money-center vs. market state differences are based upon differing economic philosophies. Money-centers generally believe that the service activities of a financial institution should be attributed to the place of performance of the services (normally the headquarter state). Market states generally believe that such receipts should be attributed to the location of the borrower of such services, irrespective of where the actual services might be considered to have been performed. Minnesota has thrown in a rather unique twist in that it would attribute income from services based upon the place of consumption of the services and not, necessarily, the state of residence of the borrower.

This basic conflict dominated most of the meeting and created

the "rub" which neither side was willing or able to smooth out when addressing receipts on an item-by-item basis. Although, the money-center approach was willing to flex somewhat on the basis of distinguishing between "retail" and "wholesale" banking activities, the treatment of large loan items became a sticking point. The flexibility that the money-center states might find possible is the attribution of "small" collateralized loans (\$ limit not yet defined) to the location of the collateral (real and tangible personal property). A rebuttable presumption attributing "small" uncollateralized loans to the address of the borrower as stated on the loan application was also suggested by the money-center state. The market state approach would require both "large" and "small" collateralized loans to be attributed to the location of the collateral. Both sides suggested that loans that were collateralized by intangible property be treated as uncollateralized loans are treated.

Despite this difference in approach, some agreement was initially reached regarding the attribution of some receipts in the market state numerator that arise from certain types of loan or other service income. *Credit card interest income* and *merchant discount income* was agreed to be assigned on a credit card holder address and merchant address basis under any scenario. An early concession by the money-center, based upon the "retail/wholesale" dichotomy, was that *credit card service fee income* would also follow the attribution of credit card income (state of card holder). However, this latter money-center state concession was withdrawn when a five-factor (with double receipts) approach, that will be set out later in these minutes, was presented.

*Operating (non-finance) leases* were agreed to be assigned to location of the property (with no presumptions regarding the location of the property, eg., that the property is located at the billing address of the lessee). It was also agreed to treat *finance leases* the same as collateralized loans; but, again, the treatment of said loans remained in flux due to the possible use of the double receipts factor approach discussed below. Should the double receipts factor not be accepted by a sufficient number of states, it is assumed that the money-center "retail/wholesale" approach would result in the "*small*" collateralized loans being attributed to the location of the collateral and the "*large*" collateralized loans being situated to the branch to which they are properly booked.

One possibility suggested would be to attribute any size of loan to the state in which the loan funds are used to acquire property from third parties or improve the collateralized property located in that state. Another suggestion was to attribute to the market and money-center states a certain set percentage of income from loans based upon the bank's and the borrower's contacts regarding the loan, such as the bank's office of original loan application, location of borrower, etc.

Currently, New York presumes the proper attribution of any

loan to be at the branch where the loan was booked. But, on a loan-by-loan analysis of several factors, referred to as "SINAA", New York may re-attribute a loan to another and more appropriate location. SINAA is the acronym for "Solicitation", "Investigation", "Negotiation", "Approval" and "Administration". If a sufficient number of these factors are shown on audit with respect to a given loan to be at another branch (but not an office), the loan may be taken from the place booked by the bank and attributed to a more appropriate location.

*Large uncollateralized loans* fell into the same two camps that collateralized loans fell into. Market state approach would source them to the state of the borrower (commercial domicile of corporations) or place of consumption in MN's case; money-center approach would source them based on the office of the bank which had the most contacts with the loan under SINAA. The group briefly discussed the effect interstate branching would have on, eg., New York's receipts factor which uses SINAA. It was agreed that New York's numerator would decrease, but which states' would have an increase is not known.

*Interest income from syndicated loans* would be attributed the same as the money-center or market state would treat the underlying loan. If collateralized or uncollateralized, the market state approach would be to assign the income to the state of the collateral or borrower; the money-center would either apply the "small" loan approach to a collateralized loan or booking office (subject to a SINAA adjustment). *Loan origination and loan service fees from syndicated loans* would be attributed to the state of the collateral or borrower by the market state and, by the money-center state to the state in which the services were performed.

*Interest and fee income from participation loans* would follow the same choice of attribution patterns followed for the syndicated loans. The market state takes the position that involvement by an out-of-state bank in either a participation or syndication loan will not, by itself, create nexus over the bank. However, if nexus otherwise exists, the income from such loans will be attributed as discussed above. The money-center position is that the second or purchasing bank in a participation loan situation has nothing to do with the original borrower and, therefore, no income attribution to the state of the borrower is supportable. This assumption - that there is an insufficient contact between the borrower and the second bank - needs to be confirmed before this assumption is relied upon. The money-center position is that there is a separate, second, loan where the first bank is borrowing from or selling an interest in a loan asset to the second bank. This transaction is a separate and distinct transaction from the loan by the first bank to the original borrower.

One suggestion with regard to the participation loan interest income is to attribute to the market state of the borrower the gross receipts from the loan, even though the bank collecting the proceeds remits a portion of the proceeds to the second or

participating institution. Not allowing the deduction from gross receipts by the originator of the loan is consistent with the "gross receipts" requirement of UDITPA and should work to prevent the originating bank from exporting all of the interest receipts to out of the market state. With regard to the treatment of the numerator of the receipts factor of the participating bank, the money-center approach would treat the receipts as receipts from a loan to the originating bank using SINAA situsing rules. The market state approach would continue to view this as a loan to the original borrower.

The Sub-Subcommittee wrestled with a very difficult issue of the possible conversion of loan instruments into securities and the big swing in income attribution that depended upon this issue. It should be noted that there is currently an issue whether participation loans sold by banks are "securities", no longer maintaining the characteristics of a loan. See, Banco Espanol de Credito v. Security Pacific National Bank, et al., 763 F.Supp.36 (S.D.N.Y. 1991), currently on appeal to the Second Circuit Court of Appeals, which held loan participations did not lose their classification as loans for SEC disclosure purposes. See also, FFIEC Supervisory Policy Statement, Fed. Reg. Vol. 57, No. 22 (February 3, 1992), possibly permitting the classification of some loan participations as instruments that are required to be assigned to a bank's trading or held for sale accounts, as opposed to its investment account (loan account).

A discussion was held regarding the practice of banks to engage in trading and investment activities that are treated differently for bank regulatory purposes depending upon whether the security or loan is intended to be held as a long term "investment" or short term "trading" or "held for sale" activity. The Sub-Subcommittee referenced the newly adopted Supervisory Policy Statement on Securities Activities for financial institutions adopted by the Federal Financial Institutions Examination Council (Federal Register, Vol. 57, No. 22, February 3, 1992) for a detailed explanation of the different accounting treatment for loans and securities held in a bank's investment account and those held for sale or trading. In this area, New York would treat "pass throughs" (eg., mortgages or bundles of credit card receivables sold to a trust that in turn sells pass through certificates in the trust to investors) as securities, if are held in the bank's trading or held for sale account. Receipts generated by these assets would be attributed by New York to the state in which they were held and managed, and would not attribute these receipts simply on a branch location basis.

A discussion was also had of the "24-Hour Book" in which an institution will trade on a 24 hours basis by passing the Book from its London office to its New York office and then to its Tokyo office. The receipts derived by this taxpayer needs to be apportioned among the activities of its three offices. Today, New York accomplishes this by attributing to its receipts factor that portion of the 24-hour Book receipts based upon the ratio that

trading and investment assets in New York bear to such assets everywhere. One suggestion made was to apportion such receipts by the ratio that the payroll attributable to the 24-hour Book in the state bears to total payroll for such Book everywhere. There was a concern that since we already had a payroll factor this might not be desirable. It was then suggested that the number of traders might be a more appropriate measure of in-state activity. Currently, MN and the MTC regulation proposal would use a deposits factor to apportion the receipts from this activity. An article explaining the 24-Hour Book has been written by a Charles Plambeck in the August 27, 1990 publication of Tax Notes. It was agreed that we needed to study this area more to address the apportionment issues raised by such activities.

With regard to other services, such as trust services, merger and acquisition advisory services, economic forecasting, data processing, transfer agency services, payment of municipal bond interest through banking services, and the like, the same issues exist as to where the services were performed v. where the customer is located or the services consumed issues were raised and left undecided. The group agreed that states should use the same receipts situs rules for these service fees as they use for general business corporations. It is to be noted that, absent any special rule adopted to the contrary, UDITPA would situs such services to the state in which the majority of the cost of performance of the service were incurred. See, UDITPA, Section 17. However, many states are moving away from this all or nothing approach with respect to certain service industries. New York, for example, in the advertising media area, apportions receipts from advertising upon a proportionate audience or readership basis. See, also MTC Regulations IV.18.(h)(Television and Radio Broadcasting and IV.18.(j)(Publishing) to the same effect.

At this point in the discussion a suggestion to break the market state/money-center state impasse was raised. *Two receipts factors were suggested - one accommodating the money-center activities and one accommodating the market state activities.* Thus, a five-factor formula was placed on the table that included a property factor (including tangible and intangible property), a payroll factor, a market state receipts factor, a money-center receipts factor, and a source of funds factor (deposits only). All agreed that this suggestion deserved review by the full Subcommittee. The two receipts factors are set forth in a combined fashion on the following chart:

TWO RECEIPTS FACTORS

Activity	Market State	Money-Center State
Credit cards interest	Billing address	Same
Merchant discount	Merchant address	Same
Credit card fees	Billing address	Where service performed
Leases (non-fin.)	Location of tangible or real property	Same
Collateralized loans-interest*	Location of collateral	Branch booked (rebuttable-SINAA)
Collateralized loans-service fees	Location of collateral	Where service performed
Unsecured loans-interest*	Debtor's address (commercial dom.)	Branch booked (rebuttable-SINAA)
Unsecured loans-service fees	Debtor's address (commercial dom.)	Where service performed
Trading income** (in 24-Hour Book)	Trader's ratio***	Same
Trading income** (not in 24-Hour Book)	Where asset is held, managed, and controlled	Same
Other services	Where service is performed****	Same

- \*Loans** = debt instruments in Investment Account (FFIEC)
- \*\*Trading income** = income from the Trading Account and Held for Sale Account (FFIEC); the 24hr Book included income from only assets reflected by the Trader's Ratio; include at net if distortive.
- \*\*\*Trader's ratio** = U.S. domestics: number of Traders (no Mgrs.) within/everywhere (worldwide)  
 = Alien's: number of Traders (no Mgrs.) within/everywhere (effectively connected)
- \*\*\*\*To be treated the same as services are treated under state's general business corporation approach.**

NOTE: Trading income currently attributed by a Trading Asset ratio in NY and by a Deposits ratio in MN and under proposed MTC reg.

In the newly suggested 5-factor approach, a *property factor* would be included that would have as its primary component intangible property (mainly loan and investment assets). While it was noted that the same situsing conflict exists between the market and money-center states, it was suggested that only one property factor should be used, instead of constructing a market and money-center property factor as was done with respect to the receipts factor. No charting of the property factor is included here as no common situsing rules were agreed to. However, it was understood that the relative weighing of the various factors could be used to reach a consensus among the competing interests.

Lastly, New York presented its "*Source of Funds*" factor which was limited to deposits only, with no other borrowing included, as this was viewed less weighted toward the money-center. This will be especially true if and when interstate branching becomes a reality. The money-center would divide deposits into "small" (under \$100,000) and "large" (\$100,000 and over), with small deposits being sitused to the address of the depositors and large deposits sitused to the branch where properly book (with SINAA to be applied where not properly booked). The market state, while not agreeing to a deposits factor, would source one based upon depositors' addresses irrespective of the size of the deposit. Chart-wise, the deposits factor suggested would be as follows:

DEPOSITS FACTOR

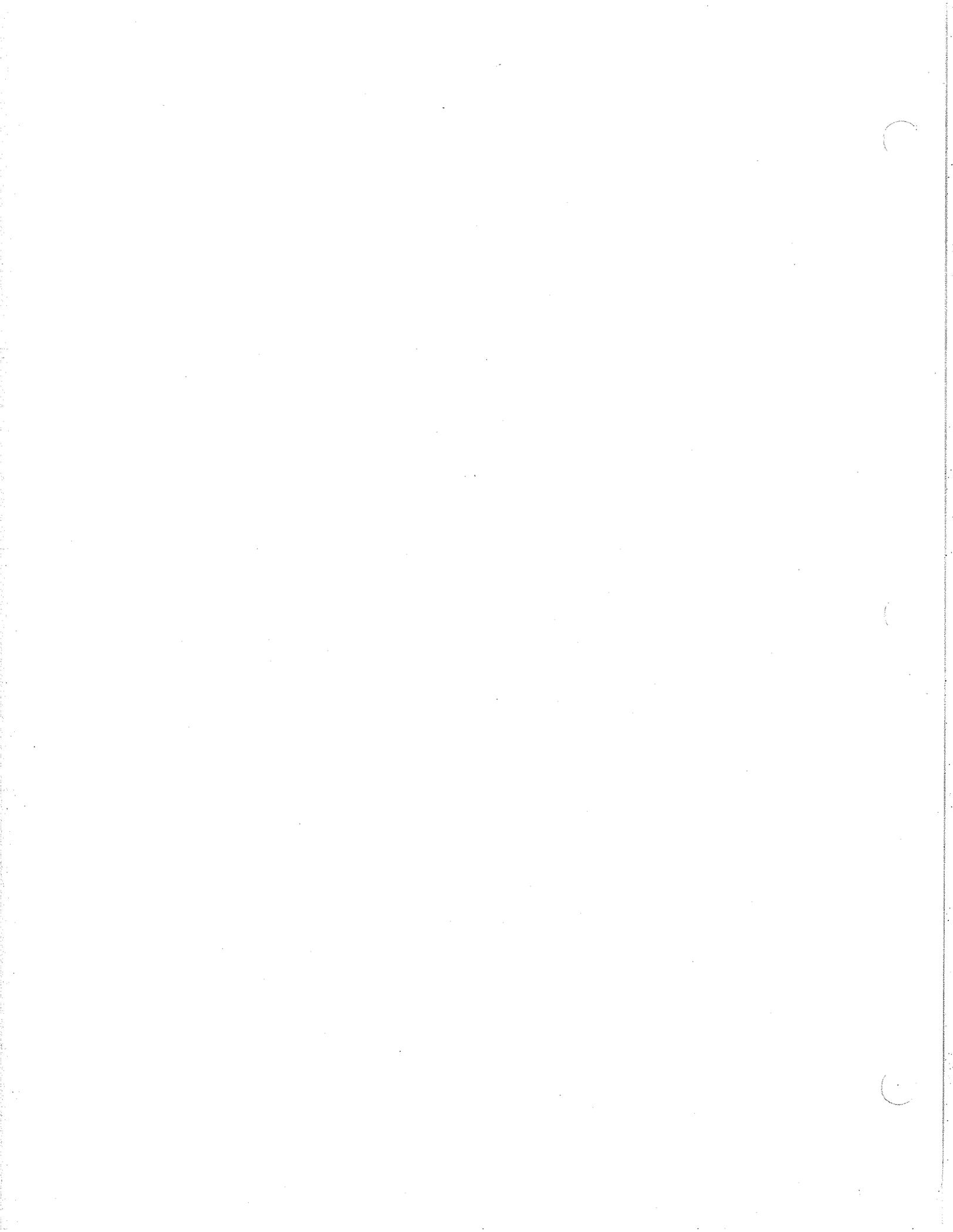
Activity	Market State	Money-Center State
Deposits (less than \$100,000)	Depositor's address	Same
Deposits (more than \$100,000)	Depositor's address	Branch booked (SINAA adjustment available)

The full Subcommittee is requested to review the progress made by the Sub-Subcommittee, think about the remaining areas of disagreement, consider the 5-factor approach or any additional approach that might resolve the conflict between market and money-center states, and arrive at your recommendation. Since the next meeting with the industry is set for April 29-30, 1992, it is requested that the Subcommittee decide upon its recommendations no later than April 3, 1992, so that further direction could be received from the Tax Administrators by April 21st.

In order to accomplish the foregoing, our next teleconference call is set for Thursday, March 26th at 1:30 PM (Eastern). You are invited to join that teleconference by your calling 202-296-3132 at the scheduled time. **Your recommendations will be sought, so please be prepared to make your Subcommittee position known at that time.** I would anticipate our discussion lasting 1 and 1/2 to 2 hours.

**EXHIBIT I: 1**

**Memo to S/IFWG members  
(Alan Friedman)  
(May 6, 1992)**





for this first teleconference call or for any later conference, please call me at 1-800-327-1258 with your suggestions. I will be travelling out of state until the end of next week, but I will pick up messages and respond fairly quickly to your call.

A few suggestions for ground rules for our teleconferences:

1. Until we all can recognize each others' voices, I request that we each identify ourselves at the beginning of each time we contribute to the discussion.<sup>2</sup>

2. If there is a need for input on a roll call basis, we will use the order determined by the convener or on the basis of the order set out above.

3. Each of the above representatives may designate one alternate resource person to participate on the following basis:

a. The alternate will be able to add his or her comments after all of the representatives have addressed the subject. At that point, it can become a free-for-all among representatives and alternates until that particular subject is exhausted and then we again go back to representatives' input first again.

b. If the representative is not available for any particular conference, the alternate should be made available in place of the fallen representative. On those occasions, the alternate shall act in the full capacity of his or her representative.

4. A representative may permit as many persons as he or she wishes to be present listening by speakerphone, so long as none of those persons interrupt the conversation between the representatives or designated alternates. Should any one present who is neither a principal nor an alternate wish to contribute, the representative who has invited that person to be present shall introduce that person and subject of discussion.

5. Should the use of speakerphones or other devices inhibit the free flow of conversation, the convener is free to request that such devices not be used.

6. No conversation shall be recorded unless all representatives are advised of the desire to do so and all representatives agree to allow such recording.

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<sup>2</sup>. For obvious reasons, Edelstein, Taetle, and Kaltenborn are excused from this ground rule from the very start.

7. Finally, the convener, as sort of the captain<sup>3</sup> of the ship we are boarding, shall be responsible for keeping the conferences moving and productive and shall have the prerogative of moving the agenda along as he sees fit, unless and until a successful mutiny occurs.

Lastly, a more serious personal comment. As you may note, this and all other correspondence from me will not bear the MTC or any other letterhead. While this joint state/industry effort may affect what I do as Hearing Officer of the MTC regulation process, this effort is not part of that process. I look upon the role of convener as one who is to facilitate and who should reflect no partiality to any one side or approach. I am not here to represent the interest of the market states; the state members on the Working Group representing that perspective do not need any assistance in that regard.

As convener, I will do my best to facilitate a process that encourages all constructive views to be expressed. But, there will be times when I might sense that diminishing returns have set in during an exchange; then I will push the conversation to other issues. Please forgive me in advance for cutting you off more abruptly than you would wish. If you still have important information left to impart on a particular subject and I have forced the conversation elsewhere, there will be time reserved at the end of the conferences for your lofting up another shot.<sup>4</sup>

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<sup>3</sup>. No, I doubt if my status as "captain of this good ship will permit me to perform marriage ceremonies. But, Fred, our alternate convener may want to give them a try.

<sup>4</sup>. In basketball parlance, this time at the end of a lopsided game is normally referred to as "garbage time"; but I won't use that term in case someone felt that I was disparaging for fear of inhibiting a grand thought. So, let's just refer to that time at the end of our agenda as "Tea Time".

STATE/INDUSTRY FINANCIAL WORKING GROUP

Teleconference Agenda  
March 11, 1992

**I. Introductions of Representatives.**

The representatives shall briefly introduce themselves in the alphabetical order set out in the memorandum above and describe his or her area of emphasis and/or expertise.

**II. Fixing of Working Group Goal(s) and Timing for Achievement Thereof.**

- A. Convener will present the Working Group with his conception of the general goal(s) of the Working Group for discussion, possible revision, and acceptance by the Group.
- B. Working Group will discuss and agree upon specific research or drafting activities necessary to achieve agreed upon goals.
- C. Working Group will discuss and agree on a time line for completion of activities.

**III. Assignment of Specific Activities.**

Each representative will select five research or drafting activities that he or she would feel most suited to tackle. This selection shall be made on the enclosed form that will be completed by you and faxed to me after or May 11th teleconference. It is anticipated that 3 or 4 representatives will be assigned, primarily on the basis of stated preference, to each activity as a team, with at least one state person and one industry person being included on each team. Unless other notions prevail, each team will select a chairperson and work together between teleconferences of the Working Group as a whole (via fax and their own teleconferencing) to complete their research or drafting activities. The convener and alternate convener shall confer and seek to obtain the services of any one or more representatives that are necessary to complete the activities in a timely manner.

Both convener and alternate convener will maintain contact with team Chairs in order to keep up on progress toward the time line goals and to determine whether sufficient progress has been had to confirm the next scheduled teleconference session of the Working Group as a whole. The convener and alternate convener shall be on the distribution list for all of the teams, but shall not share the work product thereof with anyone until all efforts of the team are completed. At that point, the work product of that team shall be shared among all representatives in preparation for the next teleconference session of the Working Group. The work product of all of the teams will be shared with the Working Group

as a whole in order discuss the appropriate approach to achieving a formula that will be most widely adopted by the states and interested cities.

In the end, however, it must be representatives of government, whether at the table or not, who are the final decision-makers of what, if any, apportionment formula is to be recommended for adoption in their jurisdictions. Even though this is a unique joint effort between government and industry representatives, no government representative can cede his or her public responsibility to any member of the private sector.

As may be supplemented by the research and drafting activities that may be agreed upon in II.B. above, the following research and drafting activities appear required to meet any formula requirements:

1. Definition of: Financial institution (nonbank banks, thrifts, credit unions, foreign based financial institutions, brokerages, insurance companies; others; the business of a financial institution
2. Definition of: Syndication, participation, securitization, pass-through certificates
3. Definition of: Finance lease, true or operating lease
4. Definition of: Merchant discount
5. Definition of: Investment and trading
6. Definition of: Commercial domicile, branch, billing address
7. Definition of: Deposits
8. Definition of: Holding company, subsidiary, affiliate
9. Definition of: Regulated financial corporation
10. Definition of: Resides/resident/residence
11. Definition of: Taxable in a state
12. Definition of: Receipts (net or gross issues)
13. Definition of: Money market instruments
14. Definition of: Securities
15. Drafting of Payroll Factor

16. Drafting of a Property Factor that includes  
intangibles

17. Drafting of a Property Factor that includes  
deposits

18. Drafting of Receipts Factor

19. Research re record keeping burdens

20. Other:

21. Other:

22. Other:

23: Other:

24: Other:

25: Other:

26: Other:

27: Other:

28: Other:

29: Other:

30: Other:

IV. Tea Time.

V. Critique of Teleconference Process and Suggestions for  
Improvement.

VI. Set Date for Next Working Group Conference Call.

RESPONSE FORM FOR SELECTION OF RESEARCH OR DRAFTING TEAMS

(Please complete and fax to: Alan Friedman, fax # 202-624-8810  
(Attention: Teresa) on or before May 13, 1992.)

Please state by the numbers specified on the fax to you dated May 6, 1992 from Alan Friedman, the five research and drafting activities that you would prefer to work on. You may state your selections in order of your preference from most preferred being stated first and so on.

1. The five numbered activities that I prefer working on are:

[ ] [ ] [ ] [ ] [ ] .

2. I would also agree to work on the following activities:

[ ] [ ] [ ] [ ] [ ] .

3. Upon further thought after our teleconference of May 11, 1992, I think that the Working Group should also work on the following research and drafting activities:

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4. Additional Comments:

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Submitted by: \_\_\_\_\_

## STATE/INDUSTRY FINANCIAL WORKING GROUP

State Participants

<u>State</u>	<u>Name</u>	<u>Address</u>	<u>Phone #</u>	<u>Fax #</u>
CA	Eric Coffill	Multistate Tax Affairs Bureau Legal Division Franchise Tax Board P.O. Box 1468 Sacramento, CA 95812-1468	916/369-3323	916/369-3648
FL	Rod Felix	State of Florida Department of Revenue Building I, Taxworld Tallahassee, FL 32308	904/922-4111	904/922-6054
IL	John Malach	Illinois Department of Illinois 100 W. Randolph Suite 7-500 Chicago, IL 60601	312/814-3004	312/814-1402
MN	Michael E. Boekhaus	Minnesota Department of Revenue Mail Station 2220 10 River Park Plaza St. Paul, MN 55146-1022	612/296-1022	612/296-8229

State Participants (cont'd)

Page 2

<u>State</u>	<u>Name</u>	<u>Address</u>	<u>Phone #</u>	<u>Fax #</u>
NH	Stanley R. Arnold	New Hampshire Department of Revenue Administration 61 S. Spring Street Concord, NH 03301	603/271-2191	603/271-6121
NY	Marilyn N. Kaltenborn	Department of Taxation and Finance Building 9, Room 104 W.A. Harriman Campus Albany, NY 12227	518/457-1153	518/485-7196
NY City	Jonathan R. Robin	New York City Department of Finance 345 Adams Street Brooklyn, NY 11201	718/403-4537	718/493-4092
TN	Ann Dougherty	Tennessee Department of Revenue 1240 Andrew Jackson Bldg.-500 Deader Nashville, TN 37242	615/741-2348	615/741-0682
<b>Monitoring for Co-sponsor Federation of Tax Administrators:</b>				
	Harley Duncan and Mary Jane Egr	Federation of Tax Administrators 444 North Capitol Street, NW Suite 348 Washington, DC 20001	202/624-5890	292/624-7888

## STATE/INDUSTRY FINANCIAL WORKING GROUP

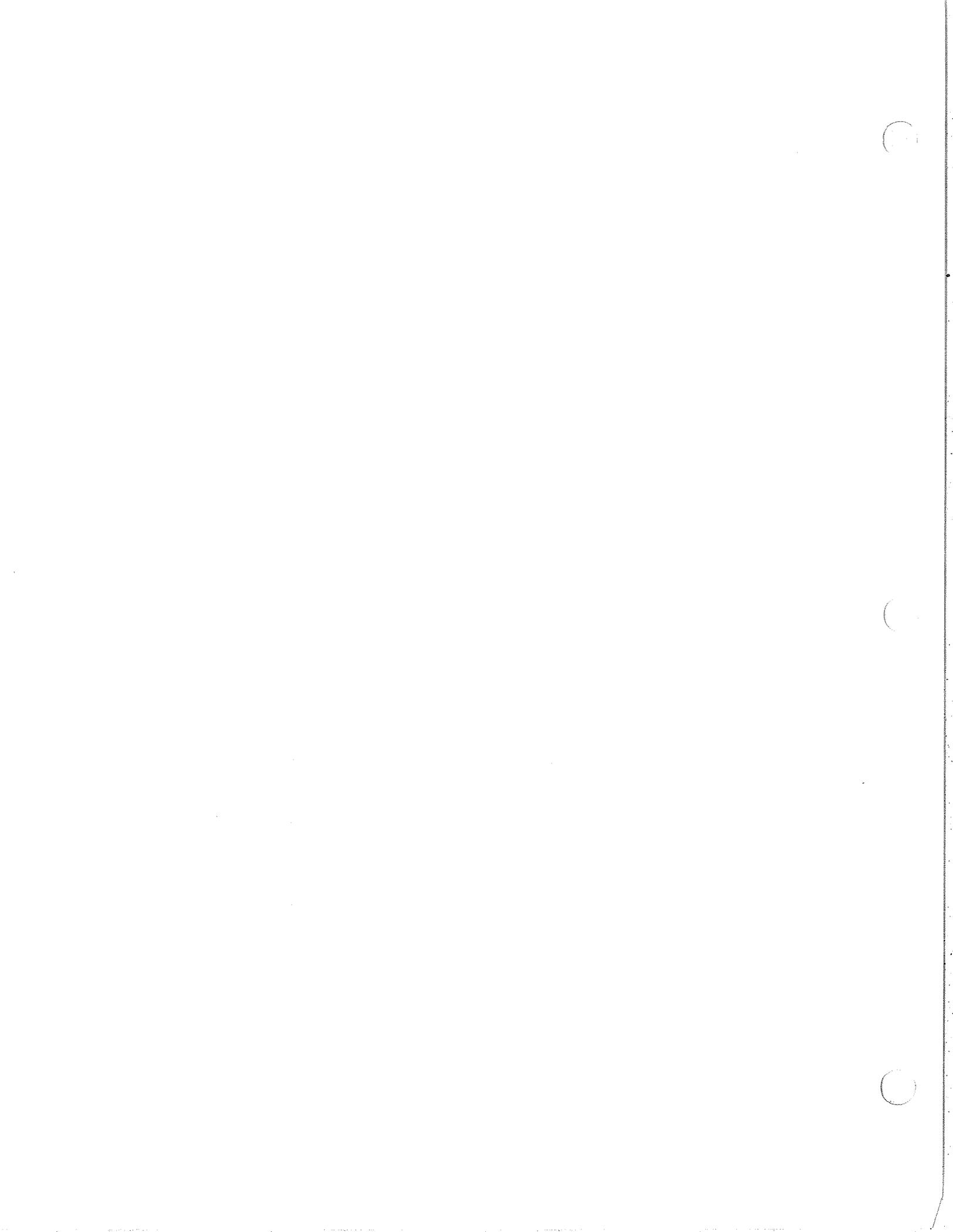
Industry Participants

<u>State</u>	<u>Name</u>	<u>Address</u>	<u>Phone #</u>	<u>Fax #</u>
CA	Philip M. Plant	Bank of America NT & SA Bank of America Center 799 Market Street, 6th Floor San Francisco, CA 94103	415/622-2877	415/624-0709
NC	Jonathan W. Allen	Wachovia Corporation 301 North Church Street P.O. Box 3099, MC 31038 Winston-Salem, NC 27150	919/770-5556	919-770-5369
NY	Joseph L. Taefle	Chase Manhattan Bank, N.A. (The) 33 Maiden Lane, 20th Floor New York, NY 10081	212/968-3544	212/968-3684
ABA	Terry J. Baker	SunTrust Banks, Inc. P.O. Box 4418, CC633 Atlanta, GA 30302	404/588-8715	404/588-8783
FIST	Haskell Edelstein	Citicorp/Citibank, N.A. 399 Park Avenue 2nd Floor - Zone 3 New York, NY 10043	212/559-2738	212/559-5138

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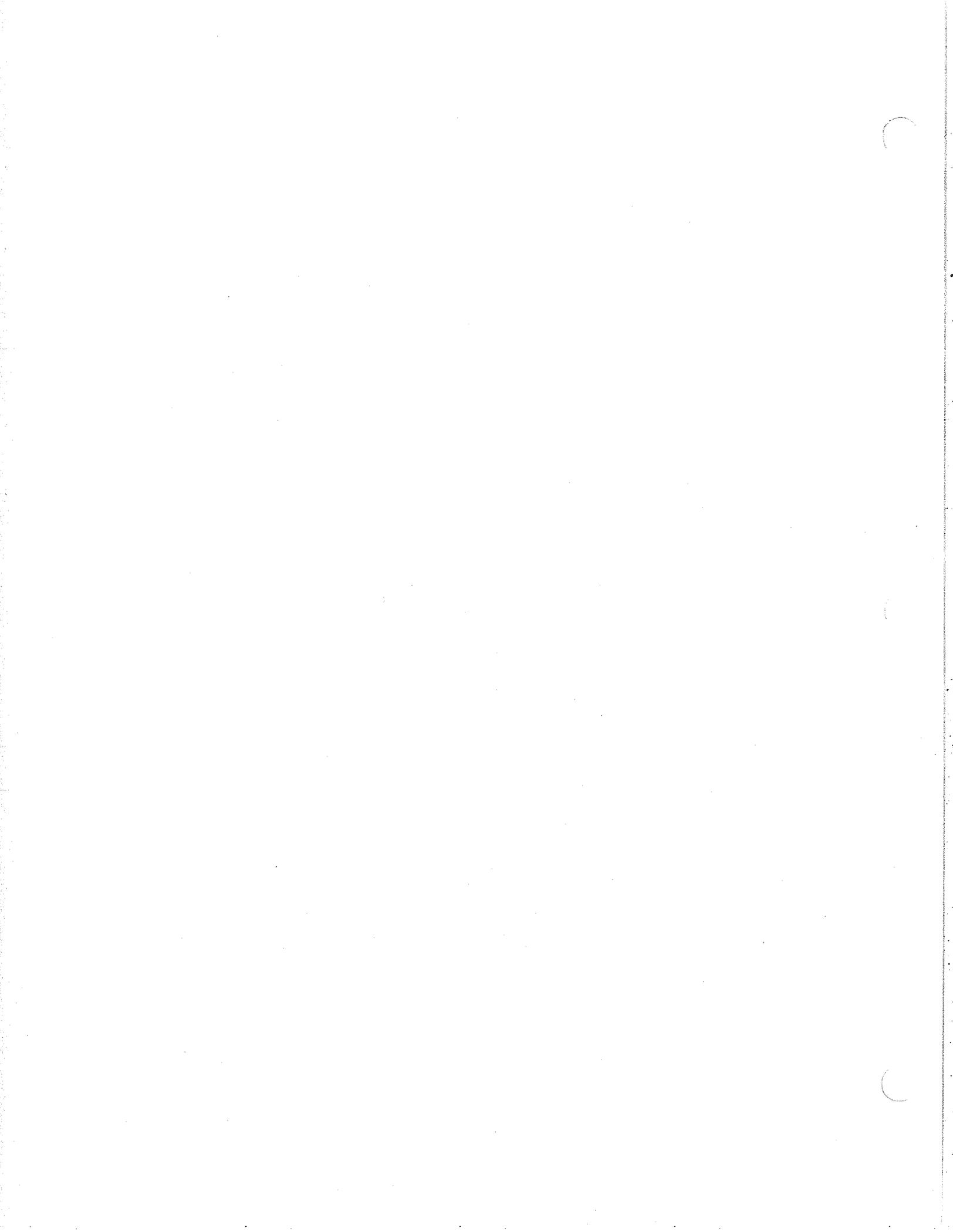
Industry Participants (cont'd)

<u>State</u>	<u>Name</u>	<u>Address</u>	<u>Phone #</u>	<u>Fax #</u>
Non-Banking Fin. Inst.	Donald N. Adler	Dean Witter Financial Services Group, Inc. 2500 Lake Cook Road Riverwoods, IL 60015	708/405-1429	708/405-1122
U.S. Savings League	Michael J. Palko	Great Western Financial Corporation Great Western Savings 8484 Wilshire Boulevard Beverly Hill, CA 90211	213/852-3349	213/852-3799
<b>Convener:</b>	Alan Friedman, Multistate Tax Commission 386 University Avenue Los Altos, CA 94022 Telephone (415) 941-0556; Fax (415) 941-0557			
<b>Alternate Convener:</b>	Fred E. Ferguson Price Waterhouse 1801 K Street, NW, Suite 700 Washington, DC 20006 Telephone (202) 296-0800; Fax (202) 296-6062			



**EXHIBIT I: 2**

**Memo to S/IFWG members  
(Alan Friedman)  
(May 18, 1992)**



**STATE/INDUSTRY FINANCIAL WORKING GROUP**

TO: S/IFWG MEMBERS:

	<u>Telepone #</u>	<u>Fax #</u>
(1) Eric Coffill	916/369-3323	916/369-3648
(2) Rod Felix	904/922-4111	904/922-6054
(3) John Malach	312/814-3004	312/814-1402
(4) Michael E. Boekhaus	612/296-1022	612/296-8229
(5) Stanley R. Arnold	603/271-2191	603/271-6121
(6) Marilyn N. Kaltenborn	518/457-1153	518/485-7196
(7) Jonathan R. Robin	718/403-4537	718/403-4092
(8) Anne Dougherty	615/741-2348	615/741-0682
(9) H. Duncan/Mary J. Egr	202/624-5890	202/624-7888
(10) Bob Heller	206/753/1971	206/586-7603
(11) Philip M. Plant	415/622-2877	415/624-0709
(12) Jonathan W. Allen	919/770-5556	919-770-5369
(13) Joseph L. Taetle	212/968-3544	212/968-3684
(14) Terry J. Baker	404/588-8715	404/588-8783
(15) Haskell Edelstein	212/559-2738	212/559-5138
(16) Donald N. Adler	708/405-1429	708/405-1122
(17) Michael J. Palko	818/775-7305	818/349-1467
(18) Brent Andersen	704/386-1872	704/386-1551

FROM: ALAN H. FRIEDMAN AND FRED FERGUSON

RE: DRAFTING TEAM ASSIGNMENTS

DATE: May 18, 1992

**A BIT ABOUT THE ISSUE ASSIGNMENT AND DRAFTING PROCESS**

Please note the number that appears above to the left of your name. You have been assigned by that number to the Drafting Teams dealing with the issues set out below. Your particular number will be found following a statement of the drafting issue.

Please note also the letters "A" and "B" that appear next to two of the persons' assigned numbers for each Drafting Team. These letters designate the co-leaders for each group and the contact persons for Fred and me. The co-leaders should contact one another upon receipt of this memorandum and coordinate the conference calling and specifics of their team's approach to drafting their issue.

The co-leaders are also responsible for making sure that Fred and I are copied in on drafts of issues and are provided with prior notice of telephone conference calls among the team members so that we can sit in if time permits. In this way, Fred and I can best keep up with the progress of each team and prepare for the next teleconference of the entire S/IFWG group. In other

words, Fred and I should be treated as members of each of your teams - be included on your individual mailing and calling lists - and generally be afforded opportunity for as full inclusion as we can handle.

#### **DRAFTING ISSUES AND TEAM ASSIGNMENTS**

After reviewing the survey returns from the S/IFWG members, the following issues and the team assignments have been established:

ISSUE 1. Definition of: Financial institution (nonbank banks, thrifts, credit unions, foreign based financial institutions, brokerages\*, insurance companies\*; others; the business of a financial institution (\*indicates areas to be addressed after other types of financials) (combined with 8 and 9)

TEAM 1. 2,4,9(A),10,11,16,17(B)

ISSUE 2. Definition of: Syndication, participation, securitization, pass-through certificates

TEAM 2. 1(A),3,6,13,14,16(B)

ISSUE 3. Definition of: Finance lease, true or operating lease (combined with 4)

TEAM 3. 7(A),10,11,13(B)

ISSUE 4. Definition of: Merchant discount (combined with 3)

TEAM SAME TEAM AS 3

ISSUE 5. Definition of: Investment and trading

TEAM 5. 1(A),3,6,13(B),15,16

ISSUE 6. Definition of: Commercial domicile, branch, billing address

TEAM 6. 7,8(A),9,15,18(B)

ISSUE 7. Definition of: Deposits (combined with 17)

TEAM 7. 4(A),6,7,14,15(B),17,18

ISSUE 8. Definition of: Holding company, subsidiary, affiliate  
**combined with 1)**

TEAM SAME AS TEAM 1

ISSUE 9. Definition of: Regulated financial corporation  
**(combined with 1)**

TEAM SAME AS TEAM 1

ISSUE 10. Definition of: Resides/resident/residence

TEAM 10. 5(A),9,11(B),15

ISSUE 11. Definition of: Taxable in a state (for throwback)

TEAM 11. 2(A),5,9,12(B),18

ISSUE 12. Definition of: Receipts (net or gross issues)

TEAM 12. 1,2,4,8(A),11,17(B)

ISSUE 13. Definition of: Money market instruments **(combined with  
14)**

TEAM 13. 3(A),6,10,13,18(B)

ISSUE 14. Definition of: Securities **(combined with 13)**

TEAM SAME AS TEAM 13

ISSUE 15. Drafting of Payroll Factor

TEAM 15. 3(A),5,12,14(B)

ISSUE 16. Drafting of a Property Factor that includes  
intangibles

TEAM 16. 1,2,4,6(A),8,12,13,14,16(B),17

ISSUE 17. Drafting of a Factor that includes deposits **(combined  
with 7)**

TEAM SAME AS TEAM 7

ISSUE 18. Drafting of Receipts Factor

TEAM 18. 1,3,4(A),5,7,8,12,13,16,17(B)

ISSUE 19. Research re record keeping burdens

TEAM 19. 3,9(A),12,14(B)

ISSUE 20. Combination/consolidated reporting issues

TEAM 20. 1(A),5,6,7,11,13,15(B),18

ISSUE 21. Book vs. tax basis reporting

TEAM 21. 3,7,8(A),12(B),17

Fred and I have tried to assign you to the issues that you preferred in the summary the best we could given the number of team members we believed necessary for an issue. Only a few of you will find that you are assigned to an issue for which you did not volunteer and all of you will find that you have been assigned to several, but not necessarily all of the issues for which you did volunteer.

Should you be terribly disappointed that you were not assigned to one or more of the issues you volunteered for or were assigned to a team that you do not want to volunteer for, please give me a call AT 1-800-327-1258 to discuss possible change in assignment. However, it will be in the best interest of the process, as a whole, for you to remain a team member of the all teams originally assigned for which you did volunteer, even though you may be added to another team at your request. Given the need to keep the teams to a manageable size and appropriate mix, I cannot guarantee that your desire to volunteer elsewhere can be accommodated.

**STATE/INDUSTRY FINANCIAL WORKING GROUP**

**TO S/IFWG MEMBERS:**

Philip M. Plant  
Jonathan W. Allen  
Joseph L. Taetle  
Terry J. Baker  
Haskell Edelstein  
Donald N. Adler  
Michael J. Palko  
Brent Andersen

**DELIVERED BY FAX**

Eric Coffill  
Rod Felix  
John Malach  
Michael E. Boekhaus  
Stanley R. Arnold  
Marilyn N. Kaltenborn  
Jonathan R. Robin  
Anne Dougherty  
Bob Heller

**FROM: ALAN FRIEDMAN**

**RE: S/IFWG SUBCOMMITTEE ASSIGNMENTS AND JULY 23, 1992**

**DATE: JUNE 4, 1992**

I am faxing to advise you of the following:

1. The states' victory in the Quill case does not change the states' commitment to pursuing this cooperative effort.
2. Based upon current workload and vacation scheduling, a couple of changes in Co-Leader assignments have been made. They are as follows:
  - a. Joe Taetle has agreed to co-lead the Receipts Factor subcommittee (Issue 18) with Michael Boekhaus. Membership on the subcommittee remains the same.
  - b. Haskell Edelstein has agreed to co-lead the Investment and Trading subcommittee (Issue 5) with Eric Coffill. Membership on the subcommittee remains the same.
  - c. Ed Champion, Eric Coffill's alternate, has agreed to co-lead Definition of Syndication Participation, etc. subcommittee (Issue 2). The membership on the

subcommittee otherwise remains the same.

- d. Marilyn Kaltenborn has become a member of the Receipts Factor Subcommittee (Issue 18) and Jonathan Robin has become a member of the Property Factor Subcommittee (Issue 16). The membership on these subcommittees otherwise remains the same.
  - e. The Combination/Consolidation Subcommittee (Issue 20) should not begin its work until after the apportionment formula has been developed. Co-leaders and membership on the subcommittee remains the same.
3. I have received the same suggestion from several state representatives, as well as Fred on behalf of industry representatives - that our July 23, 1992 goal for meeting as a whole is unrealistic. The feeling expressed was that given the work that needed to be done before that time and the impact of various summer vacation and meeting schedules, that that date put too much pressure on the effort.

I agree that it would be best not to have all of you working under an unrealistic time frame or one that places a premium on getting the task done at the risk of a loss of quality. Therefore, the meeting set for July 23, 1992 is to be reset at a future date that Fred and I will clear with the participants. However, it is important that the subcommittee effort begin as soon as possible and bear down on the end of summer or no later than early fall as the time for completion of the drafting efforts. Fred and I will do our best to assist your groups' efforts to come to closure by that time period by prodding in a warm and supportive fashion.<sup>1</sup>

4. Lastly, after discussions with several state representatives and Fred, it has been agreed that more order should be put into place than that earlier suggested by me in my "empowering" mode. Since the factor drafters must rely heavily upon the work product of those drafting the definitions and a couple of other areas - Issues 1 through 14, 19 and 21 - that there is a logical and helpful sequence for these efforts. That

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<sup>1</sup>. Should "warm and supporting" not work, we are committed to other measures, the horrors of which cannot be adequately described in writing. However, this writer has been known to threaten recalcitrants with the application of the famous Orvis Duck Plucker device used to pull the feathers off of ducks and geese for the purpose of down pillow and comforter manufacturing.

sequence is for Issues 1 through 14, 19 and 21 be addressed and substantially, if not completely completed, before the factors are to be drafted.

Once the so-called "definitional" issues are completed, Issue Subcommittees 15 through 18 will become operational. At that time, the state/city members of those subcommittees will first labor among themselves to iron out their differences as to the basic approach(es) that would provide uniformity and then prepare the initial draft of the approach(es). From time-to-time, the state/city participants may have the need to get input from industry representatives and they will request such assistance through the industry co-leaders assigned to the factor subcommittees.

Once the state/city representatives have prepared the initial draft of the respective factors, the industry representatives on the respective factor subcommittees will have at the draft for purposes of discussion, suggesting additions, deletions and other changes during the factor subcommittee conferences. It is believed that this process will maximize the potential for reaching a uniform proposal that will have the widest governmental support - the primary goal of our efforts.

The suggested timetable for these efforts is now as follows:

- a. Each of Subcommittees 1 through 14, 19 and 21 should have met by teleconference call by June 22nd to begin their work if not already begun.
- b. The written work product of each those subcommittees should be completed by no later than August 15th and shared with all remaining participants. The co-leaders of these subcommittees shall be available to consult with the factor-drafting subcommittees as a resource.
- c. The written work product of all of the subcommittees should consist of:
  - (i) A draft of the subcommittee's recommended definition. Should there be a split with regard to the recommendation, all recommendations should be reported out of the subcommittee.
  - (ii) A brief written outline or minutes describing the major points of consideration that were addressed and decided or left undecided by the subcommittee.

(iii) Copies of the written materials relied upon or, if too much paper is involved, a reference by title to the materials.

- d. Upon completion of the work of Subcommittees 1 through 14, 19 and 21 no later than August 15th, the initial drafts of the factors (Subcommittees 15 through 18) should be completed approximately 6 weeks thereafter or no later than October 1st and delivered to all other participants. It is anticipated that the order in which the factor subcommittee would be preparing their initial drafts is for the Receipts Factor to be developed first, with the Property Factor, if there is one to be proposed, to be dealt with next.
5. For those of you that do not have other teleconferencing systems that are adequate to co-lead your subcommittee's discussions, you may use Access, the Washington, D.C. service that we used for our first conference. You may set up the teleconference by contacting Torsten at 1-800-777-1826. Access will need the names and addresses of your subcommittee members for purpose of spreading the billing out.

I suggest that we all share and be equally billed for the set-up charges for the calls that we are on and, of course, pay our own long distance charges. That was the billing system we used for our May 11th call. Torsten can guide you, as co-leader, through the process; but remember, the system requires each participant to call in. For no extra charge you can ask the operator assisting you to corral by calling those that might have spaced out calling in.

If any of you have any strong feelings about the suggested process set forth above, please contact either Fred or me. Unless we hear from you to the contrary with other suggestions, the foregoing will be relied upon as the schedule. In any event, Fred and I will be in touch with you all in your capacities as subcommittee leaders over the next several weeks. Please feel free to go forward and multiply be productive as you deem best, given the new time line goals.

**EXHIBIT I: 3**

**Memo to S/IFWG members  
(Alan Friedman) (May 17, 1992)**



**STATE/INDUSTRY FINANCIAL WORKING GROUP**

**TO: S/IFWG MEMBERS:**

**GOVERNMENT REPRESENTATIVES:**

CA	Eric Coffill
FL	Rod Felix
IL	John Malach
MN	Michael E. Boekhaus
NH	Stanley R. Arnold
NY	Marilyn N. Kaltenborn
NY City	Jonathan R. Robin
TN	Anne Dougherty
WA	Robert Heller
FTA	Harley Duncan/Mary Jane Egr

**INDUSTRY REPRESENTATIVES:**

CA	Philip M. Plant
NC	Jonathan W. Allen
NY	Joseph L. Taetle
ABA	Terry J. Baker
TX/FL	Brent Anderson
FIST	Haskell Edelstein
Non-Banking Fin. Inst.	Donald N. Adler
U.S. Savings League	Michael J. Palko
Alternate Convener	Fred Ferguson

**FROM: Alan H. Friedman, Convener**

**RE: Recap of April 29-30, 1992 New York Meeting**

**DATE: May 17, 1992**

The following is a short outline version of the high points from our New York discussion as captured by me on the flip chart paper. I will not engage in much narrative given that Phil Plant and Doug Lindholm have prepared detailed notes of that meeting that are to be distributed to the S/IFWG members contemporaneously with this memorandum. To the extent that there may be some conflict between the two documents, neither will control the other, because we have agreed that the "empowered" subcommittees are to control their substantive agendas at this point. Therefore, the following represents solely my understanding of some of the major points of discussion and should not be viewed as dispositive in any manner.

From our New York discussions, the consensus of those present was formed around drafting efforts of at least two factors - payroll and receipts. The inclusion of a third factor - property or deposits or some combination thereof - was to be drafted and discussed as possible inclusion in a formula. The potential factors and their elements were the following:

1. PAYROLL FACTOR

This factor is to include all employees, including foreign employees, but exclude deferred compensation. Forms 1120, W-2s and 940's would be looked to for this information. Unless good reason exists for deviating from UDITPA rules in this area, those rules will apply.

2. PROPERTY FACTOR

Both owned and leased tangible property is to be included in the draft of the property factor; and UDITPA rules apply. With respect to intangible property, valuation issues are to be addressed, as well as attribution on either a booking or debtor address basis. Additionally, the issues of (1) duplication of intangible factor element between property and receipts factors; and treatment of such off-balance sheet items as securitized loans will be addressed.

3. SOURCE OF FUNDS FACTOR

It was the consensus at the NY meeting that if there were to be a source of funds factor that it would be limited to deposits and no other borrowings. Based upon our discussion today, the Deposits Factor subcommittee has license to recommend anything it determines appropriate and to distinguish between types of financial institutions in the development of this factor.

Some of our discussion centered around:

- a. Whether all deposits would be attributed to the address of the depositor or whether only small deposits (eg. under \$100,000) would be attributed to the depositor's address with larger deposits being attributed to where maintained or on some other basis.
- b. There was an "aggregation" issue to address, as well as a border bank situation.
- c. One suggestion was to create language that would substitute a property or some other factor for a deposits factor where deposits were less than \_\_\_\_\_% of total liabilities.

- d. As with all formulas, a Section 18 adjustment will be available should the factors not produce a fair apportionment result.

4. RECEIPTS FACTOR

The receipts factor is to include, receipts from credit card operations, with interest and fees sourced to billing address of credit card holder. The consensus that I understood here was that merchant discount was to be included and attributed to merchant billing address; but a suggestion of attribution to commercial domicile of primary merchant remained for discussion as well.

Syndicated and participated loans, as well as pass-through certificates for CMOs and securitized investment vehicles were to be included, but the issue remained as to valuation at gross of net.

Leases were to be included and attributed as are loans -either to the location of the property or on the same basis as secured loans are attributed.

Secured loans were to be either attributed to the location of the property or to the location of the majority of the property or to either the billing address of the debtor or to the commercial domicile of the debtor. A large loan/small loan distinction of \$10,000,000 was also discussed as a possible demarcation of treatment on a wholesale or retail banking business attribution basis, with small loans being attributed to the debtor's billing or commercial domicile address basis.

Unsecured loans also included the possible distinction between large and small loans, with small loans being attributed to the debtor's billing or commercial domicile address. Concerns were expressed that definitive rules were needed in this area. Additionally, treatment of loans to a parent company needed attention.

It was suggested that all fees for services, including trust services and merger and acquisition advice, were to be included in the factor and should be treated as all other business services are treated under UDITPA.

Trading and Investment interest and gains and other receipts were to be included (even California indicated that they should be included after hearing some of the discussion). These receipts are to be reflected on a net, as opposed to a gross, basis; and the double-

counting issue regarding the property factor is to be addressed.

Additionally, I understood the consensus to be that the Working Group would address throwback rules, transition rules, and the administrative vehicle for implementation of the proposal, such as an interstate compact.

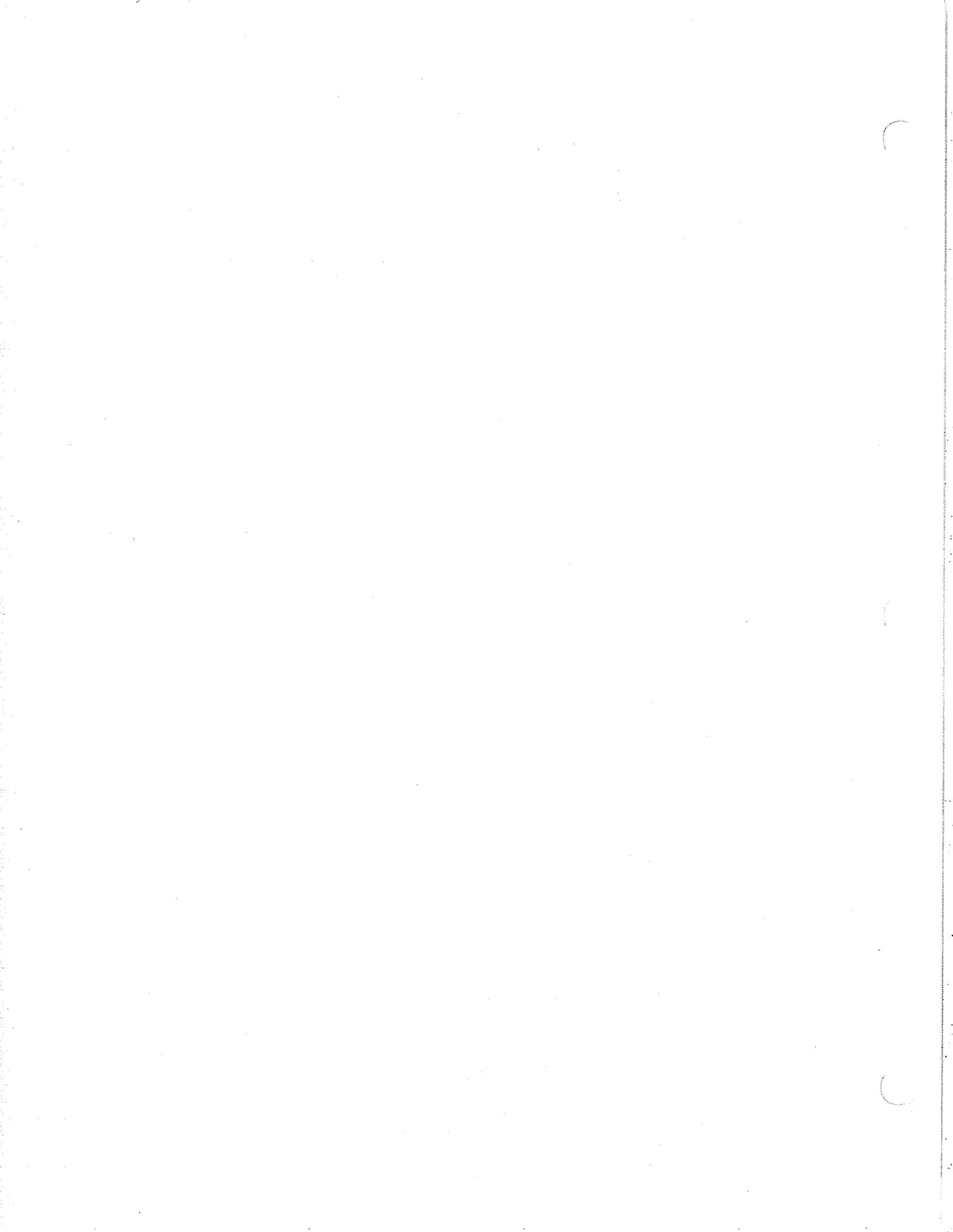
Lastly, the industry representatives maintained that in order for this effort to attain its objective successfully from their perspective, the number of states adopting a uniform proposal would have to be at least 26, with 8 being from a list of 20 specified states. These requirements are set forth as conditions 1 and 2 on page 11 of the document entitled "A Fresh Approach" dated July 5, 1991. The industry representatives also agreed that it no longer would insist that its condition number 3 on page 12 of that document - that certain specified states must ratify (or adopt) the uniform proposal. I understood from the New York meeting that if the effort were "successful", that is, if an acceptable uniform apportionment proposal is developed that the industry would not only expend effort to support the final proposal before state legislature, but would not seek Congressional legislation.

Should anyone wish to offer suggested amendments, corrections or other changes to the foregoing, please do not hesitate to provide such in writing to me. I will be glad to have your view of the meeting incorporated, with attribution, in these notes.

Lastly, please note the two additions to S/IFWG - Bob Heller from the State of Washington and Brent Anderson. Brent was originally to be with us, but due to a bit of confusion was left at the gate. The addition of Bob Heller will permit Washington to get more closely involved with this effort and will provide us with additional drafting talent.

**EXHIBIT J: 29**

**TESTIMONY OF BARBARA DAVIS  
(Credit Union National Association)  
(July 15, 1993)**



**STATEMENT BY**  
**BARBARA DAVIS**  
**BEFORE THE MULTISTATE TAX COMMISSION**  
**ON BEHALF OF THE**  
**CREDIT UNION NATIONAL ASSOCIATION, INC.**

**July 15, 1993**

**STATEMENT BY**  
**BARBARA DAVIS**  
**BEFORE THE MULTISTATE TAX COMMISSION**  
**ON BEHALF OF THE**  
**CREDIT UNION NATIONAL ASSOCIATION, INC.**  
**July 15, 1993**

Thank you for the opportunity to appear before you this morning. I am Barbara Davis, chief executive officer of Houston Municipal Employees Credit Union in Houston, Texas. It is a pleasure for me to represent the Credit Union National Association (CUNA) and its affiliated organizations and discuss the Multistate Tax Commission's proposed tax policy for financial institutions.

CUNA is the only trade association in the nation representing exclusively the interests of the nation's 13,400 state and federal credit unions and the 65 million American consumers who are the member-owners of their credit unions. CUNA is a confederation of 52 credit union leagues, located in each state, the District of Columbia, and Puerto Rico.

The Commission's proposal would require that financial institutions with income from taxable business activities "allocate and apportion" net income based on the provisions and formulas set forth in the proposed statute.

Our testimony today is in response to the Commission's request for comments on the recommended definition of business organizations and activities which may be subject to the apportionment formulas.

We are extremely concerned that the Commission's proposed definition would include credit unions. If adopted on a nationwide scale, each of the 5,485 state-chartered credit unions would be adversely affected by the proposal. Federal credit unions would, however, be exempt from the statute by virtue of the exemption accorded them by federal law (12 U.S.C. 1768).

CUNA urges the Commission to exempt credit unions from its proposal. Including not-for-profit, consumer-owned credit unions in the proposal would mean they would be taxed in the same manner as for-profit, shareholder-held corporations. This would be unfair to the taxpayers in our states who own their credit unions. Such a policy would unfortunately treat credit unions like for-profit financial institutions even though credit unions are by statute, philosophy, and operating practice distinctly different types of institutions. I would like to explain this important point in more detail.

Credit unions are non-profit, member-owned cooperative financial institutions. Their structure is based on the simple idea that people can pool their money together and make loans to each other. Only members may vote, serve on the committees and boards, and participate in the credit union's thrift and credit programs.

These unique financial institutions return to their owner-members every penny of income earned in excess of operating expenses and transfers to reserves. Earnings received by credit union members are already subject to taxes at the federal level and in the state where the member resides. Imposing yet another level of taxation on credit union members' own income would be extremely burdensome and unfair.

It is important to fully consider the many unique characteristics that clearly distinguish credit unions from for-profit financial institutions. Unfortunately, many people do not fully understand the uniqueness of credit unions. For example:

■ Credit unions are financial cooperatives that are owned and democratically controlled by their members. Members -- the owners of credit unions -- join together with each other, in a cooperative form and structure, to encourage savings by offering a good return, to use collective monies to make loans to members at competitively low interest rates, and to provide other financial services.

Each member has one vote, regardless of the number of dollars (shares) on deposit at the credit union. If at any time, credit union members feel that the institution is not being operated in their best interest, they can--and do--elect new directors. Through this process they totally influence policy making, service offerings, and to a great extent, the day-to-day operation of the credit union.

No other financial institution operates this way.

■ Credit union membership is limited to persons within a field of membership -- general employment, association or geographic in nature. Membership is limited by a common bond, as specified in the credit union charter.

No other financial institution operates this way.

■ As volunteers, credit union members serve their fellow members in the true spirit of volunteerism. These volunteers are willing to be involved and devote substantial amounts of their time without pay because they are committed; they really believe in what the credit union is doing.

No other financial institution operates this way.

■ Credit unions have never operated for the purpose of making a profit. Our motto, "Not for profit, not for charity, but for service," captures the essence of the credit union movement. Credit unions return to their owners (members) every penny of income earned in excess of operating expenses and reserves.

No other financial institutions operate this way.

Credit unions were created as an alternative to for-profit financial institutions. The statutory framework of credit unions has not changed. Credit unions have remained true to their principles. They are cooperative institutions that operate "not for profit, not for charity, but for service."

Any attempt at treating credit unions the same as for-profit financial institutions, as suggested by the Commission's proposed language, would be detrimental to the credit unions and their members. Not only would it cost our credit unions in terms of tax dollars, but perhaps even more costly would be the administrative burdens this proposal would create.

And states themselves could experience unexpected consequences. It has long been known that a dual chartering system -- the choice between a federal and state charter -- has provided healthy competition between federal and state governments to appropriately control and respond to regional, geographic and economic situations.

Adoption of this proposal by state legislatures would provide a strong incentive to state-chartered credit unions to convert to federal charters which, as noted earlier, are exempt from such taxes. If this were to happen, the state would lose its control over existing state chartered credit unions, and also lose the revenues it now receives from these credit unions.

The evidence already exists. There is currently a franchise tax policy awaiting enforcement that would impose a new, 7% tax on state-chartered credit unions. Of the 250 state-chartered credit unions in California, 70 have already requested conversion to federal charter. The California Credit Union League has reported that unless the tax provision is amended, the state could lose up to \$10 million a year in revenues and destroy California's dual chartering system.

Other states that require additional taxes from our state chartered credit unions would well encounter a similar migration. By driving state credit unions to change charters, the Commission's proposal would weaken the dual chartering system which is already teetering out of balance and a cause for concern to state governments and state-chartered institutions. Ironically, then, the states that desire such a tax could find themselves worse off because of it.

In conclusion, CUNA strongly urges the Multistate Tax Commission to exempt credit unions from the statutory proposal in recognition of their numerous unique characteristics that clearly distinguish them from for-profit financial institutions.

Including credit unions in the proposed definition of financial institutions would seriously undermine the non-profit credit union alternative to the for-profit sector. In the long run, the 65 million citizens who are members of America's credit unions would be the losers.

Thank you.

**EXHIBIT J: 34**

**Letter from Ron Schreiner  
(Secretary of Revenue of South Dakota)  
(September 28, 1993)**





DEPARTMENT OF REVENUE

September 28, 1993

Alan H. Friedman, Hearing Officer  
Multistate Tax Commission  
386 University Ave  
Los Altos CA 94022

RE: PROPOSED MULTISTATE TAX COMM. REGULATION VI.18.(i)

Dear Mr. Friedman:

This letter is intended as public input from the South Dakota Department of Revenue regarding the above referenced proposed regulation. Our continuing opposition to the concept and general approach of the regulation in regard to the allocation of credit card interest and merchant fees to the domicile of the card holder/merchant is well established! We see no reason to repeat it here. Our comments will thus be confined to certain of the issues enumerated in your Notice of Public Hearing in the desire that should this regulation be adopted over our objections, it will contain some protection for states such as South Dakota.

Item 1. In addition to including banks chartered either Federally or by the states, savings banks, finance companies, mortgage banks etc., the definition should be sufficiently broad to cover entities which operate in direct competition to or provide substantially similar services as banks. The definition set forth at Appendix B appears sufficiently comprehensive though there may be some concern over the arbitrary nature of a 50% of income test as it applies to 'leasing' companies.

Item 2. South Dakota has testified in favor of a "cost of performance" or source state approach on several preceding occasions and will stand on our record in regard to this issue.

Item 3. Our position would be that such intangible property should be allocated to the state where it is properly booked.

**GREAT FACES. GREAT PLACES.**

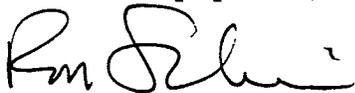
This property constitutes assets of the taxpayer and is owned, managed by and has most other substantive contact with that state. See Item 7 for our position on the treatment of certain intangibles for purposes of the property factor.

Item 6. The inclusion of a throwback provision is strongly encouraged. This is an appropriate response to our earlier contention that the concept of the rule promotes 'nowhere income' and allows the clever taxpayer to escape assessment because of confusion over the allocation formula or through suspect accounting methods. ((However, We would prefer the definition of 'taxable in another state' at section 3 (g) be amended to exclude subdivision (2) so that income would be thrown back to the domiciliary state if the other state did not in fact tax these receipts.)) This would most effectively eliminate nowhere income. ((Jurisdictional questions arising from this narrow definition would be easier to resolve than the confusion that results from having to make educated guesses under (2) or the temptation to exclude the receipts altogether.))

Item 7. We would urge the Commission to delay adoption or implementation of the regulation until such time as a predetermined number of states (20 has been seriously discussed) have individually adopted a market state approach to income allocation. If the number is set at a realistic level, this trigger mechanism would insure that critical mass is present before plunging both the states and industry into the throes of change and contention.

We would support the Commission in its adoption of a property factor which allocates loans and credit card receivables to the state in which they are properly booked. This straight forward method of allocation promotes simplicity, and certainty. Further, it eliminates the duplication of elements between the receipts factor and the property factor which occurs when income from loans and credit card receivables are sourced to the residence of the borrower under the receipts factor and it reestablishes the property factor as an independent factor.

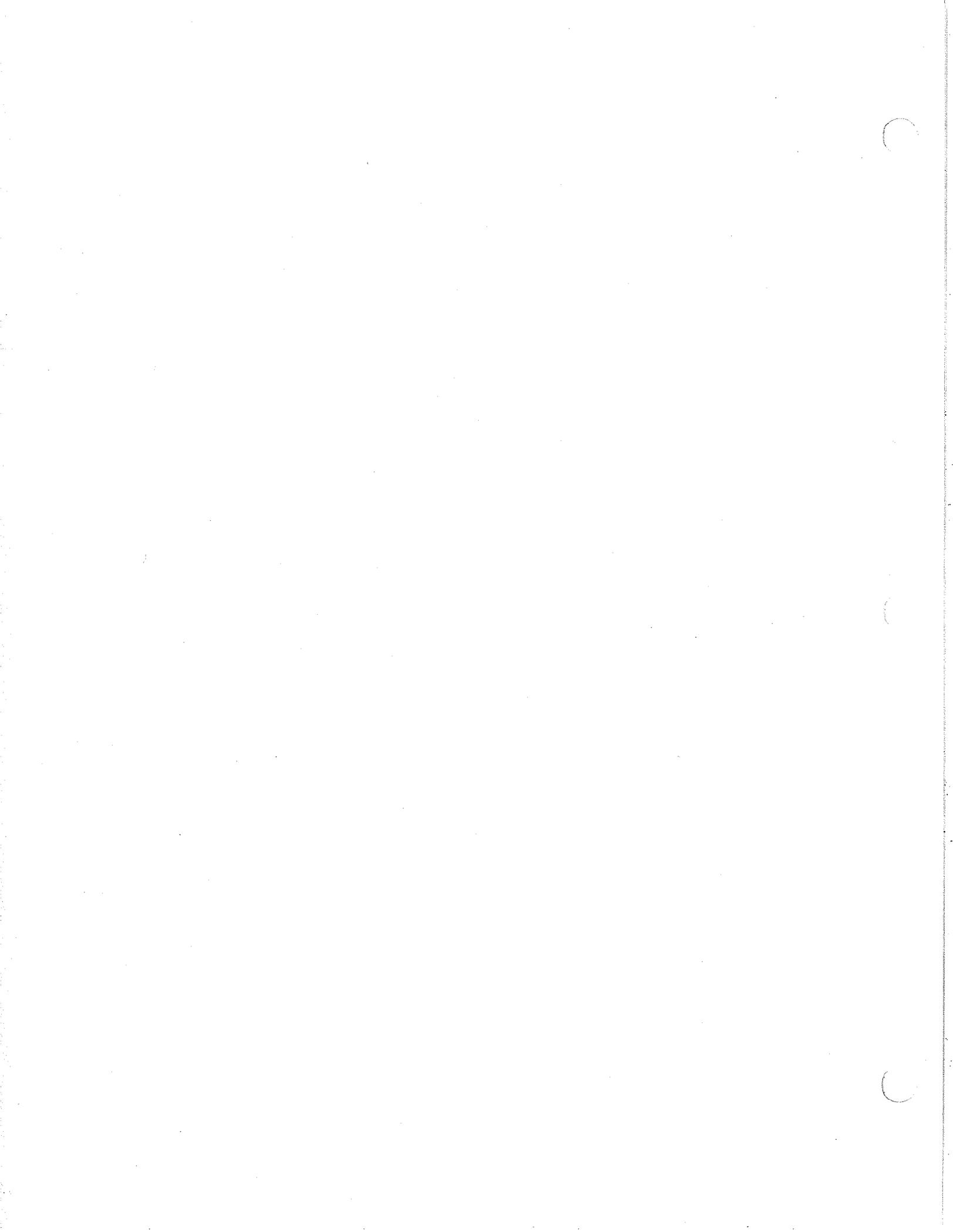
Sincerely yours,



Ron Schreiner  
SECRETARY OF REVENUE

**EXHIBIT J: 36**

**Testimony of Linda A. Kern  
(American Bankers Association)  
(September 30, 1993)**



Statement of  
LYNDA A. KERN  
on behalf of the  
AMERICAN BANKERS ASSOCIATION  
concerning the  
MULTISTATE TAX COMMISSION'S  
Proposed Regulation Apportioning the Income  
of Financial Institutions

September 30, 1993

On behalf of the American Bankers Association (ABA), I am pleased to appear at this hearing to present the ABA's views on the proposed regulation apportioning the income of financial institutions, as contained in the Hearing Officer's Interim Report of May 10, 1993. My name is Lynda A. Kern, Vice President-Taxation, AmSouth Bank NA, Birmingham Alabama, and Chairperson of the ABA Taxation Committee. The ABA is the national trade and professional association for America's commercial banks. ABA members include banks of all sizes and types -- community banks, regional banks, and money center institutions. The assets of ABA member banks are approximately ninety percent of the industry total.

The ABA testimony on this subject in 1990 reflected the strong concerns of the banking industry that the primary effect of the MTC project was to facilitate market state taxation of banks, even where the state law forbids out-of-state banks from having a physical location in the market state. Even today we still do not have a court decision on the constitutional law issue of whether the states can apply an income tax on out-of-state banks based solely on the location of the customer, or in other words based solely on economic presence. That legal issue cannot be resolved at this hearing, so my testimony today will focus on other issues.

The circumstances under which banks do business outside of their home states are changing, albeit at an uneven pace. Federal laws adopted many years ago effectively restrict nationwide banking.<sup>1</sup> In the last decade, the principal development has been interstate acquisitions of banks under initiatives in several states which authorize regional reciprocal

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<sup>1</sup> The McFadden Act (12 U.S.C. 36) restricts interstate branching by national banks to those states which authorize branching by state banks. The Douglas Amendment (12 U.S.C. 1843(d)) prohibits a bank holding company from acquiring a bank in another state unless expressly authorized by state law. There is an exception (12 U.S.C. 1823(f)), enacted in 1982, which permits acquisitions of failing institutions.

bank acquisitions, upheld by the Supreme Court. My own bank holding company has acquired financial institutions in Tennessee, Florida and Georgia. Thus, AmSouth, like many other banks, already pays taxes in states outside its home state, albeit through subsidiary banks in those states.

Banks and holding companies have also long served customers in states where they have no physical location, based on customer choice. Both depositors and borrowers have always been free to patronize banks in other states, conducting business by mail or travelling to the bank. Often bank customers move outside their bank's market area, but wish to retain their relationship with the bank. While credit card operations were initially franchised to serve market areas, the growth of nationwide credit card operations is now the most common form of bank lending across state lines. If the market state approach for taxation, adopted in Minnesota and elsewhere, is upheld, banks will file more state returns in new states, pay more state income tax, and potentially double state tax on some income.

Several factors have come together to create enormous pressure for more uniformity in state taxation of financial institutions. These developments include the change of the state laws restricting out-of-state acquisitions, a shift to taxation based on customer location, and needs to enhance revenues in many states.

### Need for Uniformity

The complexity faced by banks in the state tax area is increasing. In some states, the tax law predates the current banking environment. Many of the states have different types of taxes, and even in states where a franchise tax is the norm, there are differing tax bases (both concerning income taxed and deductions permitted), and different sourcing rules for attribution of income. Moreover, some states have throwback rules, and some permit consolidated reporting, whereas others do not. Consolidated reporting is sometimes permitted for commercial banks because the restrictions under Federal and state law of permissible activities for banks forces holding companies to pursue business opportunities through a variety of different corporate entities, some of which are subsidiaries of the bank and some of the holding company only.

The MTC proposal is the result of a dialogue between state tax officials and bankers who are experts in state taxation of financial institutions. ABA believes that the proposal is a useful model for uniform state taxation of financial institutions. We would note, however, that it is not necessary to require that a state enact a franchise tax measured by net income, if a state sought to achieve a similar level of uniformity by employing the approach of the MTC in the context of a different state tax. Frankly, we don't think the MTC proposal

should be read to require states to adopt a franchise tax in addition to their existing tax or that they should have to switch to the franchise tax approach. In general, the proposed three factor formula and the attribution of income rules reflect a reasonable balance between the headquarters states and the market states. The difficulty will be in holding that balance together and not having individual states pick and choose among factors, or double weight factors in their favor to the disadvantage of financial institutions.

As different states have wrestled with state taxation of banks in recent years, it is our observation that the states will benefit from the MTC's study of financial institutions and the effort to resolve competing considerations. Frankly, it is very difficult for state legislatures to address a complex subject such as the taxation of financial institutions during the hectic schedule of a legislative session. We believe that the MTC's proposal is a more thoughtful approach than can be expected from a pressure packed drafting session in any state legislature. Certainly the states that have already adopted a market state approach have had to consider revision of their statutes.

The most important feature of the MTC proposal is that it establishes rules for the taxation of out-of-state banks which either have no physical presence in the state or which are located in the state, but headquartered elsewhere. In effect this means that it is adaptable to future changes in the laws affecting where banks are permitted to locate. It should be understood that the uniformity of state tax laws could result in a shifting of current tax revenues among the states.

### Interstate Branching

The balance of tax base between market states and headquarters states will be especially important in an interstate branching environment. In 1991, both houses of Congress passed versions of interstate branching, only to have the issue dropped in conference. Those bills have been reintroduced in this Congress,<sup>2</sup> hearings have been held in the House Subcommittee on Financial Institutions<sup>3</sup> and the Clinton Administration is expected to endorse some form of interstate legislation in the near future.

In an interstate branching environment, a multibank holding company which owns banks in several states will likely be able to designate a headquarters state and then convert its banks outside

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<sup>2</sup> Among the bills introduced are H.R. 2235 (Rep. Vento) and S. 810 (Sen. Ford).

<sup>3</sup> Hearings were held September 28 and 29. Hearings are also scheduled in the Senate Banking Committee on October 5, 1993.

of that state to branches. Congress made it clear in the debate in 1991 that it wants to be sure that the states will still be able to tax the branches of those out-of-state institutions.<sup>4</sup> Indeed, banks want to remain good corporate citizens and pay their fair share of state taxes. If interstate banking legislation is passed by Congress, some states may have to redesign their state tax statutes to reach in-state branches of banks headquartered in other states and thereby preserve their tax base. The MTC proposal is a good model for accomplishing that redesign.

#### Definition of Financial Institution

The ABA believes that the definition of the term "financial institution" be drafted to cover the different kinds of financial institutions that are in substantial competition with one another. The clear movement at the Federal level is toward functional regulation and functional taxation of competing financial institutions. The most recent example is the enactment of Internal Revenue Code Section 475 which applies mark to market taxation to "dealers" in "securities" with both terms broadly defined. The provision is not limited by the type of charter of the taxpayer.

At the August 1990 MTC hearing, as well as the July 15, 1993 hearing, the credit union industry asked for exemption, relying on their cooperative status and the current exemption from federal taxation. Tax exemption is not necessary for cooperative entities, as is exemplified by mutual thrift institutions which lost their federal exemption in 1951. Moreover, the federal exemption for credit unions, which was also enacted in 1951, was based on a very different set of facts than exists today.

Credit unions are now a \$200+ billion industry providing diversified financial services to a wide array of customers who are no longer connected by a traditional common bond. Credit unions no longer function in a "cooperative" manner based on the shared deposits and loans of their members, but rely on a deposit insurance fund enacted in 1970. Moreover, they offer many new products and are managed by professional managers and employees. State chartered credit unions are subject to state income tax, so there is no reason why the MTC should exempt these institutions from the proposed regulation.

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<sup>4</sup> See Section 309 of H.R. 6 as reported by the House Banking Committee in 1991 and Section 302 of S. 543 as reported by the Senate Banking Committee in 1991. While the debate focussed on the ability of the states to apply a franchise tax on income from federal obligations, it seems likely that the same policy arguments will apply.

## Nexus Threshold

While I stated at the outset that the nexus issue involves a yet-to-be-decided constitutional law question, there are other aspects to the issue. The MTC should consider advocating a threshold provision in order to improve the prospects for enactment of the proposed regulations in a critical mass of states.

First, it should be clear from the MTC's inquiry into this subject that there is a minimum level of taxation of financial institutions below which it is in neither the states' interest nor the taxpayers' interest in going to the expense of a full tax return filing and audit.

Consider a bank with \$10 million in assets in the state, an average return on assets of 1%, and a state tax rate of 6%. An analysis of the cost to the taxpayer of preparing a valid return and the cost to the state of auditing that return diminishes the value of the \$6000 tax due to virtually nothing. This case gets even more difficult when the legal nexus might be based on the movement of tangible personal property such as a leased automobile that is registered in a new state.

Second, smaller financial institutions, which would be hit most severely by the compliance costs involved, will be very vocal in their opposition to any state legislation that doesn't include a threshold rule. They know that the action in their state legislatures will be watched in neighboring states. If there is no threshold provision in their state, there probably won't be one in the next state that would protect them.

There may be an alternative that finesses the undecided legal question and simplifies the process for all parties involved. A threshold could be established based on relatively easily determined data such as total assets in the state based on customer zip codes. Any bank with less than a minimum dollar amount or minimum percentage of assets could merely file a letter with the state revenue authority together with a minimum fee acknowledging presence without establishing legal nexus. No audit would be needed, and the state would know that the taxpayer has some presence in the states.

## Conclusion

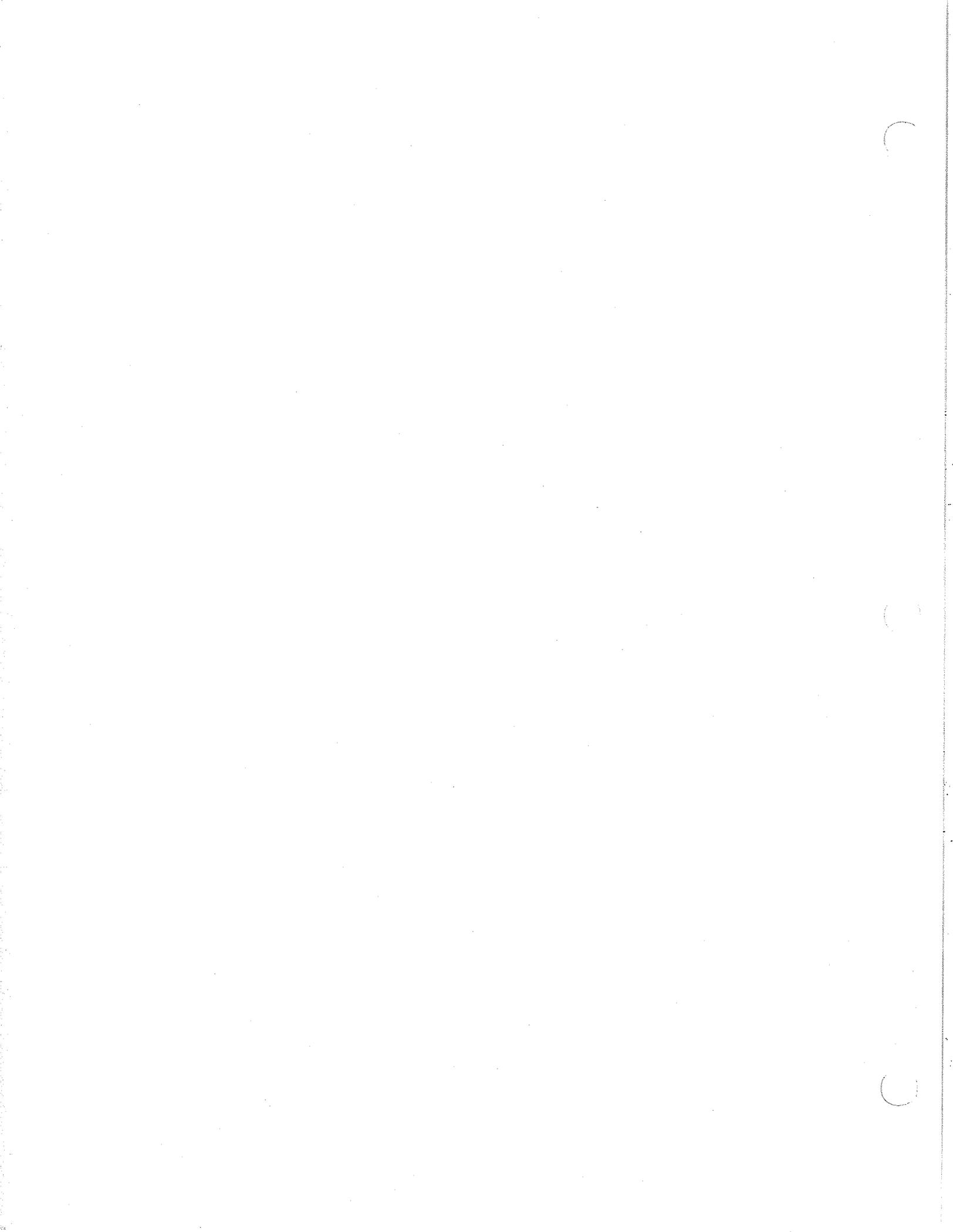
The ABA appreciates the time and hard work of the MTC and the efforts of those in the banking industry in developing a more uniform approach to state taxation of institutions. It is clear that uniformity is an important long term goal. If we are going to really reach that goal the proposal should be complete -- that is, the MTC should specifically endorse a threshold rule that allows banks, especially the smaller institutions, to avoid having to compute a de minimis liability and to reduce the administrative burden on both the state revenue department and

the taxpayer.

Finally, the ABA defers to the state bankers associations on matters of state legislation. The state associations have extensive knowledge of their state law and expertise about banking in each state, underscoring the benefits of such an ABA policy. While we believe the MTC proposed regulations are a constructive approach if it is amended to include a threshold provision, our comments should neither be construed as an ABA endorsement of any specific state legislation nor an indication of the views of the state bankers associations.

**EXHIBIT J: 38**

**Testimony of Donald N. Adler  
(Chairman, American Financial Services Association)  
(September 30, 1993)**





American Financial Services Association

October 22, 1993

Mr. Alan H. Friedman  
General Counsel  
Multistate Tax Commission  
444 North Capitol Street, N.W.  
Suite 425  
Washington, D.C. 20001

Dear Alan:

I am writing in response to the Notice of Public Hearing relating to Public Law (P.L.) 86-272, copy enclosed, on behalf of the American Financial Services Association (AFSA).

The Notice of Public Hearing requests in question 7, comments related to "such other issues and suggestions that state representatives and other members of the taxpaying community may wish to present for consideration."

AFSA believes that the nexus standard for taxability of financial institutions and organizations as well as other types of service enterprises should be the same as for sellers of tangible personal property under federal law P.L. 86-272. AFSA's reasoning in support of this position was more fully described in the testimony which I delivered at the MTC public hearing which you conducted in New York City on September 30, 1993 related to the Proposed Multistate Tax Commission Regulation IV. 18 (i) dealing with the Attribution of Income From the Business of a Financial Institution, a finalized copy of which is enclosed.

Please call me (708/405-1429) if you should have questions regarding the above or require further information.

Best regards,

A handwritten signature in cursive script, reading "Donald N. Adler", is written over the typed name.

Donald N. Adler  
Chairman, AFSA Multistate Tax Task Force

Enclosures

1373kz

American Financial Services Association

Testimony on Proposed Multistate Tax Commission  
Regulation IV.18.(i) Dealing with the Attribution of Income  
From the Business of a Financial Institution

September 30, 1993

Good morning. My name is Donald N. Adler and I am Director, Tax for the Credit Services segment of Dean Witter, Discover & Co.

Today, I am testifying on behalf of the American Financial Services Association (AFSA). I am presently serving as Chairman of AFSA's Multistate Tax Task Force. AFSA is the nation's largest trade association representing non-bank providers of consumer financial services. Organized in 1916, AFSA represents 367 companies engaged in extending over \$200 billion of consumer credit throughout the United States. These companies range from independently-owned consumer finance offices to the nation's largest financial services, retail, and automobile companies. Consumer finance companies hold over \$150 billion of consumer credit outstanding and \$67 billion in second mortgage credit, representing one quarter of all consumer credit outstanding in the United States. AFSA member companies are vitally concerned with the state and local income taxes applicable to their operations. Accordingly, the proposed apportionment regulation and its potential impact is of great interest to these firms.

AFSA appreciates the opportunity to present its views, and would like to commend the Multistate Tax Commission (the "MTC") for undertaking the project of addressing state taxation of financial institutions. This matter has many facets and presents numerous difficult issues.

My comments today fall into three categories: background and status of the project; general comments; and specific comments with respect to the statutory proposal for apportionment and allocation of net income of financial institutions (the "Proposal").

I. Background and Status of the Project

A. Background

The efforts to develop an acceptable alternative to an earlier MTC model regulation draft (most recently issued in May, 1990) on the taxation of financial institutions began in mid - 1991 with a joint meeting of representatives of various states, the Multistate Tax Commission, the Federation of Tax Administrators, and the financial services industry, principally members of the Financial Institutions State Taxation Coalition (F.I.S.T.), held July 15 - 16, 1991 in San Francisco. The objective of the group, which became known as the State/Industry Financial Working Group (S/IFWG), was to seek an acceptable uniform set of rules for states' taxation of multistate financial institutions.

The attached article (Exhibit I) by Mr. Haskell Edelstein, an industry participant in S/IFWG, provides a good background on this issue. On page 70 of this article, requirements for a workable and equitable system for taxing financial institutions are proposed, namely (in summary):

1. Fair and equitable to all states;
2. Prevent double-taxation;
3. Simple to understand and apply;

4. Easy compliance and auditing; and
5. Rules determined by nature of the business or product rather than the character of the institution doing the business.

The article then goes on (Pg. 71) to describe the critical elements in a "Proposal For a Fresh Approach" which was put forth by Mr. Edelstein as a member of F.I.S.T. (see also Exhibit II attached) at the July 15 - 16, 1991 meeting in San Francisco referred to above, as follows (in summary):

1. Uniform adoption procedures to avoid multiple taxation;
2. Minimal compliance costs;
3. Determinable nexus;
4. Reasonable information requirements; and
5. Averaging of apportionment formula elements.

Based upon these above-noted points, what was proposed was that the changes needed to develop a workable and equitable system for the taxation of financial institutions would have to address:

- o Nexus;
- o Apportionment Procedures;
- o Uniform adoption procedures;
- o Uniform application of the rules to taxpayers based upon the nature of their business (i.e., need for a

definition of a financial institution/organization);  
and, as an overall consideration,

- o Administrability and simplicity.

The S/IFWG held another meeting in late April, 1992 in New York. From that meeting numerous drafting teams were formed which included state and industry representatives to address various issues and topics. As a side note, I was a participant on several of these teams. A subsequent meeting was held in Chicago in November, 1992 to review progress. The statutory proposal for apportionment and allocation which is the subject of this hearing was the end product of this process.

While the proposal is a significant achievement, I would point out that it addresses only one of the four key components for a tax system for financial institutions. The other key components which were identified at the onset of the formation of the S/IFWG are not addressed, namely; nexus, uniform adoption procedures, and uniformity of application (definition of a financial institution/organization).

Due to the significance of these items, as noted below in my general comments, AFSA believes that these elements must be addressed and included in any truly uniform system for the taxation of financial organizations. Consequently, we would urge that the MTC fully address these issues before it releases any uniform rules.

B. Status of the Project

An interim Hearing Officer report dated May 10, 1993 accompanied the release of the Proposal. In it, the Hearing Officer has noted that the Proposal is the joint effort of industry and state representatives. While recognizing this as the case, I would also point out that the portion of the financial services industry participating in the S/IFWG was relatively small in light of the broad scope and size of the industry.

Large segments of the financial services industry, which are potentially impacted, for example mortgage banking, leasing, and non-bank financial organizations, have either not been heard from or have participated to only a limited degree. Given the potential, and unknown, application of the Proposal, AFSA believes this to be a significant point and that to suggest that the Proposal has "industry" support appears to overstate the case.

II. General Comments

AFSA's comments here relate to the broad-based issues identified above with respect to the development of a uniform state taxation system for financial institutions and the salient features of the Proposal.

A. Nexus

1. Observations

As the Interim Report of Hearing Officer Regarding Proposed Regulation IV.18 (i) Apportioning the Income of Financial Institutions (Hearing Officer's Report) indicates on page 4, the MTC

Proposal does not address the issue of nexus, and "... assumes that Constitutional nexus exists in the state for apportionment purposes." The Hearing Officer makes reference to the U.S. Supreme Court's decision in Quill v. North Dakota (112 S. Ct. 1904 (1992)), refers to his expressed views on this matter, and goes on to state that "... the Quill decision supports the notion that 'physical presence' of the taxpayer is not required for a finding of constitutional nexus in the area of operational taxes, such as the taxation of net income, that is derived from the rendering of financial services."

The development of the MTC Proposal commenced in mid-1991 at a point prior to the rendering of the Quill decision. The perspective of the S/IFWG was that the nexus issue was not resolvable by the group at that time, in light of the fact that the Quill case had not yet been decided. Consequently, the issue of apportionment rules was taken up first.

In determining the applicability of any tax to a taxpayer, the first matter of inquiry is nexus - i.e., is the taxpayer subject to the tax by virtue of its activities in a particular jurisdiction or is it not? Once nexus is resolved, the mechanics of the tax are applied to determine the tax base and apportionment to arrive at the tax liability.

Given this logical ordering, nexus is the threshold issue relative to the application of income and franchise taxes to financial institutions and organizations. Consequently, AFSA views that it is absolutely necessary that

the MTC fully address the issue of nexus relative to the application of income and franchise (capital-based) taxes applicable to the rendering of financial services. The benefit of bright-line tests and settled expectations relative to taxability were clearly pointed out in the Quill decision. AFSA believes that there should be certainty as to when a financial services provider is taxable in a state and when it is not.

## 2. Recommendation

AFSA believes that the nexus standard for taxability of financial institutions and organizations as well as other types of service enterprises should be the same as for sellers of tangible personal property under federal law P.L. 86-272, which limits the ability of states to impose income taxes on interstate business.

AFSA believes that such an approach would generally equate to taxability of financial services providers based upon physical presence in a jurisdiction, an approach that would provide for a bright-line nexus standard.

P.L. 86-272 was enacted in 1959 as a temporary legislative solution. At that point in time, mercantile and manufacturing firms were by far conducting the largest share of interstate business. Services, and financial services in particular, were delivered on a local market basis. Obviously, the nature of the United States economy has changed substantially in the last thirty-four years. A nexus rule which puts

providers of good and services on the same basis is in order. AFSA suggests financial services providers should be protected from income and franchise (capital-based) taxation when activities are limited to solicitation and reasonable ancillary activities. This approach would avoid difficulties faced by certain taxpayers currently where states with dual-basis tax systems (income and/or capital) afford P.L. 86-272 protection for the income tax element, but deny it for the capital-based tax element, an illogical and unfair approach. Under these circumstances, the same activities of a taxpayer are subject to one type of tax (capital-based) but not the other (income-based), and can be subject to tax in one year but not the next. Clearly these types of situations do not promote uniformity or administrability.

Many AFSA members render financial services to customers through interstate commerce with no physical presence in the customer's state of residence. Obviously, the MTC proposal is of vital interest, and AFSA members want fair, workable, and consistent rules relative to nexus and believe that it is incumbent upon the MTC to address this issue as part of any set of uniform rules for the taxation of financial institutions in order to preclude unfair and unconstitutional double taxation. This is an opportune juncture for the MTC to address the issue of nexus and avoid unnecessary years of audit controversies and litigation.

B. Definition of Financial Institution

1. Observations

As presented, the Proposal does not define the term "Financial Institution". Rather, it is contemplated that a state which would adopt the Proposal would insert its own definition. A suggested definition is included in Appendix B to the Proposal.

Since the Proposal is intended to render a uniform allocation and apportionment method for financial institutions, the lack of a definition hollows the proposal and raises vital issues as to just which financial organizations the Proposal is intended to cover and how the Proposal can be uniform for various adopting states if they are left to their own means to develop and implement a definition of entities which constitute financial institutions.

AFSA is also concerned that by not specifically addressing this issue, adopting states may use the suggested definition of the term financial institution contained in the Proposal as a means for modifying existing definitions of the term or related terms, such as financial organization, which serve as the basis of combined and unitary groupings of entities. For example, the Proposal suggested definition includes finance lease companies. Several AFSA members have leasing subsidiaries which currently file combined returns with various entities which may or may not fall within the Proposal's suggested Financial Institution definition. The end result could be that long standing combined return groupings are adversely modified.

2. Recommendation

AFSA strongly recommends that the Proposal be modified to include a definition of financial institution. It is logical to define which firms the apportionment rules are to apply to as part of the allocation and apportionment Proposal. The definition should also address which organizations are not intended to be covered - e.g., securities broker-dealers, investment managers and distributors of mutual funds.

The suggested definition included in Appendix B focuses primarily on regulated institutions, such as banks and savings and loans, and contains a catch-all in section (1) for "Any other person or business entity which derives more than fifty percent (50%) of its gross income from activities that a person described in subsections (b) through (i) is authorized to transact". Since regulated banks are authorized to conduct a wide variety of activities, this approach could result in the unintended characterization of entities as financial institutions. Also, the Proposal's approach would be difficult to apply since its definition of a financial institution requires reference to non-tax bank regulatory rules.

AFSA believes that the focus should be on those firms whose predominant business is the making, acquiring, selling, or servicing of loans or extensions of credit. Indeed, most of the specific apportionment rules contained in the Proposal relate to those types of activities. An approach such as that used by Indiana in its Financial Institutions Tax law which contains a provision for an 80% of gross income test would

appear to be workable. The key point is that the end result of the definition should be that the same rules apply to those firms with a substantial involvement in business activities with customers related to the activities noted above - i.e., making, acquiring, selling, or servicing of loans or extensions of credit, as noted above.

C. Uniform Adoption Procedures

1. Observations

The Proposal does not address how it is to be adopted by states in order to avoid double taxation, whereby "market" states are taxing the the income of a financial institution based upon customer location via adoption of the Proposal, and the state of commercial domicile of the financial institution is taxing all of its income. Consequently, AFSA has great concerns that its members will be unfairly disadvantaged by inconsistent taxing procedures among states. The fiscal realities of today's economy leave many states with fiscal shortfalls. Due to the appeal of the potential revenue source resulting from the adoption of the Proposal by "market" states, it is unlikely that the issue of double taxation will be addressed, unfairly disadvantaging financial organizations.

2. Recommendation

AFSA believes that an adoption mechanism, such as that explained on pg. 11 of Exhibit II under "Adoption and Implementation", which assures a high level of uniformity of adoption and consistency among states is a vital element in any

uniform system for the income taxation of financial institutions. This mechanism should also address uniformity of weighting of apportionment factors, since this is also a critical element in consistency, as the interim report of the Hearing Officer (p. 3) points out.

D. Basis for Apportionment Factor Information

1. Observation

The compliance burden which the Proposal will generate will be substantial, since the information needed to comply does not currently exist in many financial institutions' systems.

2. Recommendation

Given the substantial changes which will be required, AFSA strongly urges that the book/tax option contained in Appendix A to the Proposal be made a part of the Proposal. Incorporation of this rule would greatly aid financial organizations that would be affected by the Proposal, if adopted, and improve administrability.

In summary, three of the above general issues are those which were identified at the outset of the S/IFWG deliberations as being key elements to a uniform system for the taxation of financial institutions. As was noted above, AFSA believes that these issues must be addressed if a fair and administrable system is to be developed. While AFSA recognizes that the apportionment Proposal is a significant accomplishment, it addresses only one of the four key elements. AFSA has significant concerns that states will view the

Proposal as all that is needed to tax financial institutions and organizations, and that the other key elements will not be addressed, with the end result of unfair double taxation, lack of administrability, and substantial litigation.

III. Specific Comments

- A. Sec. 1 - This section should be deleted as it imposes a tax. Since the purpose of the Proposal is to establish an apportionment and allocation mechanism, this section is not needed.
- B. Sec. 3 (e) - Consideration should be given to adding "charge card" to the definition of "credit card".
- C. Sec. 3 (f) - Re: Definition of "credit card issuer's reimbursement fee" - suggest striking the words "provided by the merchant" near the end of the sentence.
- D. Sec. 3 (j) - Re: Definition of "Loan" - while the term loan specifically excludes credit card receivables, the later term is not defined. It should include all amounts charged to customer credit card accounts from whatever source, including purchases of good and services, cash advances, fees, etc.
- E. Sec. 3 (q) - Need to add a definition for the term "state" which includes states, possessions and territories of the United States, the District of Columbia, Puerto Rico, and foreign countries.
- F. Secs. 4 (j), (k), and (l) - All of these receipts relate to services performed, and AFSA believes

that the preferable basis to apportion these receipts is cost of performance - that is, the receipts should be sourced to the location where the majority of the costs are incurred to produce the service.

AFSA is aware that there was a bias to source receipts to the "market" state as a compromise proposition since the payroll and property factors source to the "home" state. However, we believe that this approach produces illogical results and, when viewed in the broader context of sourcing the service revenues of all types of taxpayers, could produce very distortive results.

An example of this is the provision of Sec. 4(k). Under this provision, loan servicing fees derived from loans secured by real property are sourced to a state or states based upon the interest, fees and penalties earned by the financial institution on loans secured by real property located in the state or states. That is, the sourcing of receipts on mortgage loans held in portfolio or held in inventory for sale governs the sourcing of loan servicing fees. This sourcing rule represents a radical departure from current concepts which govern apportionment of receipts generally, and in effect constitutes third-party sourcing.

Mortgage loan servicing fees are paid by the owner of the loans to the servicer financial organization. These fees may be paid out of the gross interest income which accrues to the owner of the loans, but they are nonetheless paid by the owner of the loans. The Proposal's sourcing rule is designed to attempt to source these receipts to

the location of the mortgagors on serviced loans (a third party to the loan servicing transaction) through a surrogate approach. That is, the sourcing rule uses the location of interest received on real property -secured loans owned by the institution to source servicing fees received. This rule is illogical in that there may be absolutely no relationship between the location of mortgagors on loans owned by the financial institution and the location of mortgagors on serviced loans.

AFSA members have substantial involvement in the mortgage banking industry and are vitally concerned about this rule in the Proposal. Many mortgage banking firms have small loan origination functions which operate in limited geographic areas (e.g., one or two states). However, such firms may service substantial loan portfolios which were originated by other firms in other geographic areas. The effect of applying the Proposal's rule would be that all of the servicing fee receipts would be sourced to the one or two states in which the firm's own origination function operates, rather than to the state where the loan servicing function is being performed on the firm's much more significant serviced loan portfolio, which is not owned by the financial organization. AFSA believes that this rule could give rise to significant distortions, and that a better approach is to source such receipts to the location where the service is performed.

In closing today, I would like to express my appreciation for the opportunity to make AFSA's views known with respect to the vital issue of state taxation of financial institutions and organizations. Much work has been done on

this matter through the efforts of both state and financial industry representatives. However, AFSA firmly believes that there are several key components to a truly uniform state taxation system for financial institutions and organizations which remain to be addressed. Without resolution of these issues, a uniform system will not be possible, resulting in unfair and unconstitutional double taxation of financial organizations. AFSA would like to extend an offer to work with the MTC and others to address these issues.

# How Should the Income of Banks With Multistate Operations Be Allocated?

The "market state" approach, which several states have adopted and others are considering, will produce distorted results. The author argues for a uniform system accepted by all states that generally taxes income where services are performed but also recognizes market states' demands.

By Haskell Edelstein

**I**n 1986, after many years of quiescence, the states began to rethink approaches to the taxation of banks having multistate business. With the development of a proposal by the Multistate Tax Commission (MTC) and its almost immediate adoption by Minnesota, a new era began. Although the MTC has not yet completed work on its draft proposals, several other states have proceeded to adopt various new approaches to taxing banks, focusing particularly on those without physical presence, but having customers in the state. (See Pickhardt, "Determining Nexus for Banks in Market States," 2 JMT 10 (Mar/Apr 1992).)

The new approach, in general, seeks to extend income-based taxes

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HASKELL EDELSTEIN is Senior Vice President and General Tax Counsel of Citicorp in New York. This article is based on material presented to a group of banks brought together under the aegis of the Multistate Tax Commission, the Federation of Tax Administrators, the American Bankers Association, and Financial Institutions State Taxation (FIST) Coalition in an ongoing process of seeking an acceptable uniform set of rules for the states' taxation of multistate financial institutions.

to banks when their only connection with the state is having customers located in the state, as borrowers, credit card holders, or users of the banks' services. That is known as the "market state" approach, and it may be distinguished from the "headquarters state" or "money center state" approach, which views banks as being subject to tax based on income only where they have a physical presence and where they perform their activities.

In general, the dispute focuses on which states may tax a transaction when the customer and the location at which the service is rendered are different. In the case of banks, since money is an intangible, a related issue is: Exactly what service is being rendered? In view of most states' need to raise revenue, banks are merely the first target of such legislation. Legislation aimed at other service-based industries, such as travel agencies and law and accounting firms, will likely follow.

At least as applied to financial institutions, these new approaches have focused on two critical elements:

*Nexus*—extending the taxing juris-

isdiction of a state from one based on physical presence to one based on the location of a minimum number of customers or dollar amount of loans to customers located in the state.

*Sourcing of interest income*—changing the sourcing of interest received on a loan from the place where the loan is made and administered to the location of the borrower.

In addition to these changes, a few states have adopted a new apportionment formula based on a single receipts factor, and one state (Indiana) now taxes banks domiciled in that state on their entire U.S. income, with a credit for taxes paid by the bank on that income to other states. (See Stroble, "Indiana Amends Financial Institutions Tax," 1 JMT 39 (Mar/Apr 1991).)

The focus on the location of borrowers, the sourcing of interest income, and the reliance on receipts in the apportionment of income necessitate a clear understanding of the nature of lending in reaching proper conclusions as to how a bank earns interest income and

where that income is earned. In other words, why is a lender entitled to interest at all?

### RISKS INCURRED BY BANKS

The key element of the bank's role as "financial intermediary" (between borrowers and suppliers of funds) is that of *taking risks*. Interest rates charged by banks on commercial loans are usually determined by the creditworthiness of the borrower. The best, most creditworthy borrowers pay only base or "prime" rate, while those less creditworthy pay higher rates. But that *credit risk* is only one of many risks a bank undertakes in making a loan.

A litany of other risks incurred by banks encompasses the following:

1. Credit risk—the risk that the loan will not be repaid.
2. Interest rate risk—the risk that the cost of funds over the term of the loan will exceed the interest charged to the borrower.
3. Liquidity risk—the risk that the bank will not be able to obtain or retain the funds necessary to lend to the borrowers or to repay liabilities, including deposits.
4. Event risk—the risk of sudden political, military, or natural events that prevent the bank from carrying out the lending and repayment functions.
5. Foreign exchange risk—the risk that when funds are lent or obtained in different currencies, the other currencies used in the transaction may not be available or may fluctuate in value.
6. Sovereign (country) risk—e.g., the risk of expropriation or political or governmental action that interdicts the bank's relationships with its customers.
7. Operational risk—the risk of errors, omissions, and other operational failures.

Most important, these items are primarily *future oriented*, situation specific, and unique to each bank and time.

The focus on risk-taking as the primary reason why and how banks earn interest revenue points up a number of critical elements.

A loan continues for a period of time into the future. The risks do not *begin* until the loan is made, and continue for as long as the loan is outstanding. That must be distinguished from a sale of goods, where the transaction is generally completed once the goods are delivered. Risk-taking is based on, and the sole result of, judgments derived from all available relevant information. The judgment process, like the risks themselves, is continuous over the time the loan is outstanding. This judgmental process is done by *people*.

Compensation for risks usually does not coincide with the occurrence of the risk, if and when it should actually happen. For example, compensation for credit risk (if and to the extent actually paid) invariably will be received *before* a borrower fails to pay back a loan.

This analysis points to a number of conclusions regarding the principles that ought to apply for tax purposes. First and foremost, taking risks involves primarily exercising judgment, making decisions, and carrying out conclusions based on the analysis of the facts on which the judgments are determined. That is, and can only be, done by *people*. Thus, interest earned for taking risks is earned by people, and where they perform their functions is where that income is earned. In the case of risks, that is where the risks are managed.

Second, the income earned by accepting and taking risks needs to be sourced at the same place where the risks will impact if they should happen. Among the major implications for taxing the financial services enterprise is the problem of losses. If the lender is earning or entitled to

interest as compensation for taking risks, the principal one being risk of credit loss, it follows that the tax effect of the loss should be the same as that of the interest income previously taxed. For example, assume a state taxes an out-of-state bank on the basis of a single-factor receipts formula and the bank, aside from its business in its home state, makes a single \$25 million loan to a customer in that state, for a five-year term. For the first three years, the borrower pays the interest due (no principal payments being required until the end of the term), which is taxed by the state. In the fourth year, the borrower develops severe financial difficulties and ceases to pay interest. The bank determines at the beginning of the fifth year that it can and will collect none of the principal of the loan, and charges off the loan as a bad debt. In the fifth year, the bank has no receipts attributable to the state. Therefore, the state has had the benefit of taxing the bank's compensation for taking the credit risk, but has avoided having to give any tax benefit for the loss actually suffered. That result mirrors the situation in the bank's headquarters state if it has adopted the same apportionment rules: it would tax none of the revenue, but would suffer the full impact of the bank's bad debt charge-off.

Such a result is clearly wrong. Although the existence of the erroneous result should be obvious, the reasons why are not so evident. One reason is simply that the absence of a deduction for additions to loan loss reserves, which results from following the concepts used in determining Federal taxable income, guarantees a mismatching of income and expense. Even the use of loan loss reserves for tax purposes, however, does not solve the problem, since the bulk of the actual loss will occur and be deducted *after* the loan goes bad and interest income has ceased. A receipts factor simply does not, and probably can-

not, give proper recognition to the reasons why a bank receives interest income in return for or as *compensation for taking risk*. It is thus important that the interest income and the effect of risks be reflected in the same taxing jurisdiction, whenever those elements occur.

There is a further circumstance that illustrates the problems generated by the use of a receipts factor in apportioning the interest income of a bank. Many loans are made at

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*Income from services should be taxed where the services are performed.*

floating interest rates—the rate of interest is tied or related to an independent market rate of interest (e.g., U.S. Treasury interest rates, LIBOR—London interbank offered rate, prime rates) and, accordingly, the rate of interest payable changes at regular intervals during the term of the loan. To the extent that the element upon which the interest rate is based reflects the cost of the funds the bank obtains to make the loan, the “spread” (i.e., the difference between the interest received and the interest paid by the bank) remains constant over the term of the loan. In an apportionment formula using only gross receipts, however, shifts in apportionment of income will occur because (1) fixed rate loans will continue to generate the same gross income while (2) gross receipts from floating rate loans go up and down, yet (3) net income (the spread) from the floating rate loans will remain unchanged. Thus, a state’s share of income apportioned on the basis of gross receipts can increase or decrease even though no changes occur either in the manner in which the lending is carried out or in the net income from such activity.

These considerations suggest that although the receipts factor in an apportionment formula is appropriate in the case of a business selling tangible property, the nature of the lending business is such that receipts will be both misleading and distortive, since changes in receipts can occur for reasons unrelated to either the level of income being earned or the way in which the business is conducted. The importance of this conclusion derives from understanding a major purpose of an apportionment formula—to fairly determine the portion of a business’s income that may be attributed to a particular state. One element clearly is where income is earned. In the case of financial services, however, the use of receipts often produces distorted results under those principles.

The changes in state approaches to the taxation of banks, noted above, come at a time when the financial services industry itself is undergoing significant changes. New financial products are being developed and used, new competition is arising both from financial institutions that are not banks and from banks owned by companies in other types of business, and the existing geographic barriers that presently prevent banks from operating by way of branches across state boundaries are being reconsidered.

#### **EQUITABLE SYSTEM REQUIREMENTS**

Given these changes in both the financial services business and the tax rules, it is imperative to develop a workable and equitable system for taxing financial, and other service-related, institutions to achieve a tax regime that:

1. Is fair and equitable to all states.
2. Prevents two or more states from asserting the right to tax the same income.
3. Is simple to understand and apply.

4. Makes compliance and auditing easy to achieve without undue expense to either the taxpayer or the tax collector.
5. Contains rules that are determined by the nature of the business or product rather than by the character of the institution doing the business.

To measure the practicality and theoretical justification of a particular approach to taxing financial institutions, a conceptual framework is essential as a measurement tool. To develop that tool, the nature of lending money must be examined. The lending of money can be characterized in several different ways:

1. It can be viewed as a *service* business in which the lender receives interest income from the borrower for taking risks and managing those risks. The work of analyzing the data and making the decision to undertake the risks involved in a loan, as well as the ongoing evaluation and decisions required during the term of a loan, constitutes the rendering of a service to the borrower for which the lender is compensated through the payment of interest.
2. A lender holding a *portfolio* of loans is acting in the nature of an *investor* holding a portfolio of bonds. Under this characterization, lending is equivalent to investment management, in that the bank determines first to make the loan investment, and simultaneously or from time to time thereafter determines how and whether to alter the investment portfolio through sales of portions by way of participations, syndications, or securitization.
3. A bank or other financial institution acts as a *financial intermediary* by obtaining and pooling available funds (obtained through deposits or borrowing) for the purpose of investing

those funds in loans. The lender gathers funds and lends them for a "commission" equivalent to the net spread between the cost of funds and the interest paid by the borrower. The financial intermediary also takes risks, and is also compensated by the net interest spread. This is, in essence, providing a service to *both* the sources and users of the funds.

4. A bank or other financial institution acts as the lessee of money because the lending of money for interest is the equivalent of renting a car to the user-lessee.

Several points need to be noted in viewing each of the foregoing characterizations of lending money:

1. The *service* element is paramount in items 1, 3, and 4.
2. The customer-borrower is of relatively little importance in item 2, in the sense that any benefit to the borrower is incidental to the creation and management of a portfolio for the benefit of the financial institution itself. Indeed, changes in the loan portfolio will usually change the risks involved, so that the compensation will change depending on the ebb and flow of such risks.
3. Items 2 and 3 may also be treated as the activity of investment banking—the lender may not take a position in the loan itself, and is thus essentially rendering the *service* of arranging for sources of and access to funds.
4. Item 4 suggests the strongest linkage to the location of the customer as an important element in determining where income is derived, *i.e.*, the "location" of the funds "rented" is the basis on which the lender's income is earned.

The foregoing discussion deals only with the activity of lending

money, and the role of the financial institution in that process. In addition, financial services involve other activities in the nature of services that may involve taking or accepting risks (either credit or other kinds of risks) without lending money or otherwise creating assets (receivables), or creating assets without credit risks. Some activities involve purely service activities that do not involve either external risks, *i.e.*, risks due to conditions beyond the control of the financial institution, or the creation of assets on the books of the financial institution.

Such activities generally have little element of customer relationship or "contact" with any state other than that of the location of the operations or activities providing the service, although that does not suggest that more substantial contacts with the location of the customer cannot be formulated.

In general, several conclusions can be made from the use of this conceptual framework:

1. Most formulations of the business of lending money tend to suggest that it is heavily service-oriented, thus focusing activity on the location where the service is performed. Since this result would be unfavorable to market states, strict adherence to those formulations may not achieve the required results.
2. The business of lending should be viewed and treated separately from all other services provided by financial institutions, such as by applying different sourcing rules for receipts or different weighting of factors in the apportionment formula.
3. Rendering a service without creating an asset, *i.e.*, an intangible in the form of a loan or receivable, should be treated the same as any other service for tax purposes—such as travel agent, lawyer, doctor, advertising agency, etc.

The various ways of characterizing the lending business, as well as the other functions of the financial services business, strongly lean in the direction of service. If the applicable principle for taxing the income of a service business is that income is to be taxed where it is earned, income from services should be taxed where the service is performed. Financial services also have two unique characteristics:

1. There is an undertaking and management of risk, which includes, but is not limited to, credit risk that the customer will fail to repay its loan.
2. Some activities only incidentally involve providing services to a customer—*e.g.*, trading in securities, currencies, etc.

Giving recognition to those special elements is appropriate, so that the location of the customer is of more significance in the case of credit risk, while the income resulting from the performance of trading activities should be taxed where those activities occur.

#### PROPOSAL FOR A FRESH APPROACH

In formulating the following proposal, certain elements were considered critical:

1. The rules need to be adopted uniformly by all states, to avoid conflicting rules that can result in multiple taxation of the same income by two or more states.
2. Compliance costs and audit issues need to be minimized. All rules should be bright-line tests. No rebuttable presumptions should be included, other than an overall authority to modify the rules to prevent evasion or substantial avoidance of tax in egregious cases. A standard form of return should apply to each state with respect to at least (a) net income (Federal tax-

able income); (b) apportionment formula calculations; and (c) nexus determinations.

3. Nexus must be readily determinable *prior to* the beginning of a taxable year, based on *point-in-time* data.
4. Information needed to comply with the tax rules should be limited to data collected by the taxpayer in the normal course of its business.
5. Apportionment formula elements should be determined by averaging the quarterly amounts during the taxable year.

These considerations suggest a proposal regarding nexus and sourcing of receipts in the case of banks, other financial institutions, and service-related businesses that could achieve results acceptable to all states. This consideration is the most important, because the application of inconsistent rules by various states can result in a financial institution being taxed on more than 100% of its income by all states in the aggregate. That circumstance must be avoided, as it is unfair to taxpayers who would be taxed on the same income by two or more states. For example, if a bank in State A performed all of its activities there, and had no office elsewhere, State A could claim the right to tax 100% of the bank's income. If State B, where some of the bank's customers were located, claimed the right to tax 20% of the bank's income on the basis of the bank's receipts being sourced by the location of its customers, the bank would, in effect, be taxed on 120% of its income. Thus, the following proposal is intended to be uniformly applicable to avoid such multiple taxation, as well as for practicability in compliance and administration.

### Factors Considered

Nexus for a taxable year should be determined on the basis of data

available before the end of the preceding taxable year, and it should consider the following:

1. A physical presence (a branch or other office) in the state.
2. A minimum number of credit card customers located in the state.
3. A minimum number of other borrowers located in the state.
4. A minimum dollar amount of loans to borrowers in the state.

The location of the borrower should be determined on the basis of the mailing address for bills, as shown on the lender's records. Due to the distinction in numbers of customers and volumes in the case of the credit card business, a separate test is appropriate, since credit cards are frequently issued by banks exclusively in that business. Finally, if and when interstate branching by banks is permitted by Federal law, no nexus should exist as to any state if a bank is not permitted by the laws of that state to operate a branch in that state.

Apportionment of income should be determined on the basis of a three-factor formula:

- Payroll—double weighted.
- Property—limited to tangible property and loans, and receivables in the nature of loans.
- Deposits and borrowings (including all stock except common and perpetual preferred stock).

In viewing this proposal, several items should be noted with respect to the reasons for certain aspects of the proposal:

1. The payroll factor, double weighted, gives proper recognition to the *services* aspect of the business.
2. The property factor is easier to deal with than the receipts factor, but serves the same function of representing the cus-

tomers location element. Since loans are the principal property that generates income, and tangible property is a proper element in determining location of activities, both types should be included in the property factor.

3. The deposits-borrowing factor represents the other side of the financial intermediary function of the business (*i.e.*, the funds-gathering function as opposed to the funds-investment lending function). Since deposits are only one source of funding for loans, and are not available to financial service businesses that are not banks, other sources of funds must be taken into account. Since these other funds cannot be traced to their sources (*e.g.*, the holders of marketable securities are usually not easily determinable), these sources must necessarily be attributed to the borrower's headquarters location.
4. The traditional-receipts factor is not included for several reasons; the same result and element is reflected in the intangible property factor with regard to loans, and receipts are more difficult to locate and involve fairly complex recordkeeping. In addition, when receipts from loans reflect floating interest rates, they distort the formula because an increase in receipts really reflects the costs of funds supplied, which is not a function related to the borrower.
5. Sources of funds other than deposits cannot practically be traced, so such other sources are best located where they are gathered and managed.
6. Limiting the intangible property factor to loans and receivables in the nature of loans takes into account that other types of intangibles do not relate to a specific customer (*e.g.*, trading assets). Thus, loans should encompass all intangi-

bles involving both the creation of a receivable and the presence of a credit risk. Loans should thus include all leasing when the financial institution is the lessor, regardless of the Federal income tax treatment (but only for apportionment purposes).

7. All income, except sales of businesses (including bank branches) and real estate used for business operations, should be business income. The types of income that constitute non-business income in the case of mercantile and manufacturing corporations clearly constitute income from the ordinary business conducted by financial services corporations.
8. *Deposits* should generally be defined as money paid to the financial institution that is subject to a liability to repay on demand or at a specific time, with or without interest, and the use of which until then is unrestricted in the hands of the recipient and is not represented by a marketable instrument (except money orders and travelers checks).
9. Nexus should not exist in any case in which the corporation is not permitted, under state law, from conducting business through a branch (in the case of a depository institution) or office located in the state.
10. If the state includes Subpart F income in U.S. taxable income as the tax base, the controlled foreign corporation should be treated as if it were a branch of its U.S. parent, and therefore its payroll, property, and sources of funding (from third parties) should be included in the apportionment formula.
11. In the case of sourcing loans under the intangible property factor of the apportionment formula, all loans should be sourced by billing address. For loans acquired by the holder by

way of syndications or participations, the billing address should be that of the borrower, even when the loan is administered by another financial institution as agent. This approach is consistent with the "economic presence" theory that a lender has a presence in a state based on where the borrower is located, regardless of how the loan was acquired. On the other hand, it is inconsistent with the economic reality that the lender-taxpayer is merely investing in a portfolio-type investment under the second scenario of the framework, discussed above.

### CONCLUSION

The foregoing proposal seeks to give due consideration to a number of elements, including the nature of the financial services business, the role of both customers and performance of services, and the need for simplicity and certainty of rules. Although there may be more precise measurements (such as the gross profitability of each type of financial product), these considerations would only substantially increase complexity and reduce the precision of data, without necessarily improving the quality of the results. The proposal seeks to avoid all distinctions among types of financial services and products except credit cards and pure lending activities. It is hoped that this can form the basis for a workable system, acceptable to all states while consistent with the nature of the financial services business. ■

# State Taxation of Financial Institutions

## A Fresh Approach

### I. INTRODUCTION

After many years of quietude, states began to rethink the approaches to taxation of banks and other financial institutions beginning in 1986. With the presentation of a proposal by the Multistate Tax Commission, and its almost immediate adoption by Minnesota, a new era commenced. Although the Multistate Tax Commission has not as yet completed work on its draft proposals, a few other states have proceeded to adopt various new approaches to taxing banks, focusing primarily on banks and other financial institutions without physical presence in the state.

The new approach in general seeks to extend income-based taxes to banks whose only connection with the state is having customers located in the state, as borrowers, credit cardholders or users of the banks' services. That is called the "market state" approach, which is distinguished from the "headquarters state" approach which in general views banks as being subject to tax based on income only where they have a physical presence and where they perform their activities.

The new approach has focused on two especially critical tax elements:

- Nexus - Rules for determining when a state will assert jurisdiction to tax an out-of-state bank.
- a. Traditional rule requires physical presence of an office, branch or the presence of employees, agents or independent contractors.
  - b. The new rule merely requires the bank to have a minimum number of customers or amount of loans to customers located in the state.

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- Sourcing - Rules for determining the numerators of the apportionment factor elements of receipts and intangible property (loans).
- a. Traditional rules source receipts and loans where the loans are granted and administered.
  - b. The new rule would source both receipts and loans on the basis of where the customer or borrower is located.

In addition, variants on the new approach include:

1. Using only a single factor receipts apportionment formula.
2. Taxing banks domiciled (headquartered) in the state on their entire U.S. income, with a credit for taxes paid to other states; taxing non-domiciled banks on their income apportioned to the state.

These changes in approach to state taxation of banks come at a time when the financial services industry itself is undergoing significant changes. New financial products are being developed and utilized, new competition is arising both from financial institutions which are not banks and banks owned by companies in other types of business, and the existing geographic barriers which presently prevent banks from operating by way of branches across state boundaries are being reconsidered.

Given these changes in both the financial services business and the tax rules, it is imperative to develop a workable and equitable system for taxing financial institutions in order to achieve a tax regime which:

Is fair and equitable to all states;

Prevents two or more states from asserting the right to tax the same income;

Is simple to understand and apply;

Makes compliance and auditing easy to achieve without undue expense to either taxpayer or tax collector; and

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Contains rules that are determined by the nature of the business or product rather than the character of the institution doing the business.

## II. THE NEED FOR A CONCEPTUAL FRAMEWORK

In order to measure the practicality and theoretical justification of a particular approach to taxing financial institutions, a conceptual framework is essential as a measurement tool. In order to develop that tool, the nature of lending money must be examined.

The lending of money can be characterized in several different ways:

1. As a service business - the lender receives interest income from the borrower for taking risks and managing those risks. The work of analyzing the data and making the decision to undertake the risks involved in a loan, as well as the ongoing evaluation and decisions required during the term of a loan, constitute the rendering of a service to the borrower for which the lender is compensated through the payment of interest. See Attachment A.
2. A lender holding a portfolio of loans is acting in the nature of an investor holding an investment in a portfolio of bonds. Under this characterization, lending is equivalent to investment management in that the bank determines first to make the loan investment, and simultaneously or from time to time thereafter determining how and whether to alter the investment portfolio through sales of portions by way of participations, syndications or securitization.
3. A bank or other financial institution acts as a financial intermediary by obtaining and pooling available funds (obtained through deposits or borrowing) for the purpose of investing those funds in loans. The lender gathers funds and on-lends them for a "commission" equivalent to the net spread between the cost of funds and the interest paid by the borrower. Of course, the financial intermediary also takes risks, as described in 1, above, which is also compensated by the net interest spread. This is in essence the providing of a service to both the sources and users of the funds.

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4. A bank or other financial institution acts as the lessee of money - the loan of money for interest is the equivalent of renting a car to the user-  
lessor.

Several points need to be noted in viewing each of the foregoing characterizations of lending money:

1. The service element is paramount in cases 1, 3, and 4.
2. The customer-borrower is of relatively little importance in case 2, in the sense that any benefit to the borrower is incidental to the creation and management of a portfolio for the benefit of the financial institution itself. Indeed, changes in the loan portfolio will usually change the risks involved, so that the compensation will change depending on the ebb and flow of such risks.
3. Cases 2 and 3 may also be treated and viewed as the activity of investment banking - the lender may not take a position in the loan itself, and is thus essentially rendering the service of arranging for sources of and access to funds.
4. Case 4 suggests the strongest linkage to the location of the customer as an important element in determining where income is derived - *i.e.*, the "location" of the funds "rented" is the basis on which the lender's income is earned.

The foregoing discussion deals only with the activity of lending money, and the role of the financial institution in that process. In addition, financial services involve other activities in the nature of services which may involve taking or accepting risks (either credit or other kinds of risks) without lending money or otherwise creating assets (receivables), or creating assets without credit risks. Some activities involve purely service activities not involving either external risks (*i.e.*, risks due to conditions beyond the control of the financial institution) or the creation of assets on the books of the financial institution. Such activities generally have little element of customer relationship or "contact" with any state other than that of the location of the operations or activities providing the service, although that does not suggest that more substantial contacts with the location of the customer cannot be formulated.

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In general, several conclusions can be seen from the use of a conceptual framework:

1. Most formulations of the business of lending money tend to suggest that it is heavily service oriented, thus focusing activity on the location where the service is performed. Since the result would be entirely unfavorable to market states, strict adherence to those formulations may not achieve the needed conclusions.
2. The business of lending should be viewed and treated separately from all other services provided by financial institutions, such as applying different sourcing rules for receipts or different weighing of factors in the apportionment formula.
3. Rendering a service without creating an asset (*i.e.*, an intangible in the form of a loan or receivable) should be treated the same as any other service for tax purposes -- such as travel agent, lawyer, doctor, advertising agency, etc.

### III. A MODEST PROPOSAL FOR A FRESH APPROACH

The various ways of characterizing the lending business, as well as the other functions of the financial services business, strongly lean in the direction of service. If the applicable principle of taxing the income of a service business is that income is to be taxed where it is earned, then income from services should be taxed where the service is performed. However, financial services also have two unique characteristics:

1. The undertaking and management of risk, which includes, but is not limited to, credit risk that the customer will fail to repay its loan.
2. Some activities only incidentally involve the providing of services to a customer - *e.g.*, trading in securities, currencies, etc.

Giving recognition to those special elements is appropriate, so that the location of the customer is of more significance in the case of credit risk, while the income resulting from the performance of trading activities should be taxed were those activities occur.

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In formulating the following proposal, certain elements were considered critical:

1. Minimize compliance costs and audit issues --
  - a. All rules should be bright-line tests - no rebuttable presumptions should be included, other than an overall authority to modify the rules to prevent evasion or substantial avoidance of tax in egregious cases.
  - b. A standard form of return should apply to each and every state with respect to at least:
    - i. Net income (Federal taxable income)
    - ii. Apportionment formula calculations
    - iii. Nexus determinations
2. Nexus (jurisdiction to tax) must be readily determinable prior to the beginning of a taxable year, based on a point-in-time data.
3. Information needed to comply with the tax rules should be limited to data collected by the taxpayer in the normal course of its business.
4. Apportionment formula elements should be determined by averaging the quarterly amounts during the taxable year.

### THE PROPOSAL

#### NEXUS

1. Determine on the basis of data as of the end of the third quarter of the preceding taxable year, *i.e.*, calendar year 1992 nexus determined as of September 30, 1991.

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2. Any one of the following will create nexus:
  - a. Physical presence by virtue of a branch office or full-time employees of the taxpayer in the state with an aggregate annual salary rate of at least \$250,000.
  - b. Credit card customers in the state - the greater of (i) more than 5,000 cardholders or (ii) 2% of the total cardholders of the card issuer.
  - c. Other borrowers in the state -- more than 100 (if a borrower is also a credit cardholder, that borrower will be included in each category).
  - d. Loan assets in the state -- more than \$50MM of loans outstanding on the financial records (*i.e.*, excluding written-off loans).
3. Nexus is determined on an individual corporation basis.

**COMMENTS:**

The nexus rules simply provide *de minimis* standards.

The test in the case of credit cards is intended to eliminate both smaller banks and small segments of large credit card operations, since the revenue affects would be minimal.

Location of loans and location of borrowers would be based on the same criterion -- the mailing address for bills shown on the lender's records.

**APPORTIONMENT:**

1. Formula -- Three factors:
  - a. Payroll - average annual salary and other compensation as shown on W-2 forms - double-weighted.

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- b. Property - tangible and intangible (but limited to loans and receivables in the nature of loans).
- c. Deposits and borrowings (including all stock except common and perpetual preferred).

**COMMENTS:**

The payroll factor, double-weighted, gives proper recognition to the services aspect of the business.

The property factor is easier to deal with than the receipts factor, but serves the same function of representing the customer location element.

The deposits/borrowing factor represents the other side of financial intermediary functions of the business (*i.e.*, the funds gathering function opposite the funds investment lending function). Since deposits are only one course of funding for loans, and are not available to financial service businesses which are not banks, other sources of funds must be taken into account. Since such other funds cannot be traced to their sources (*e.g.*, the holders of marketable securities are usually not easily determinable), such sources must necessarily be attributed to the headquarters location of the borrower.

The traditional receipts factor has not been included for several reasons - the same result and element is reflected in the intangible property factor with regard to loans, and receipts are more difficult to locate and involve fairly complex recordkeeping. In addition, where receipts from loans reflect floating interest rates, they will distort the formula because an increase in receipts really reflects the costs of funds supplied, which is not a function related to the borrower.

**2. Sourcing Rules**

- a. Payroll - by location of employee's office or where employee is managed in the case of no office.
- b. Property - tangible by physical location; intangibles (loans and receivables) by billing address.

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- c. Deposits - by statement mailing address.
- d. Other sources of funds - by location of headquarters.

**COMMENTS:**

Sources of funds other than deposits cannot practically be traced.

Limiting the intangible property factor to loans and receivables in the nature of loans takes into account that other types of intangibles do not relate to a specific customer (e.g. trading assets). Thus loans should encompass all intangibles involving both the creation of a receivable and the presence of a credit risk. Loans should thus include all leasing where the financial institution is the lessor, regardless of the Federal income tax treatment (but only for apportionment purposes).

**OPERATIONAL RULES:**

1. The throwback rule should apply to income apportioned to a state having no taxable nexus.
2. Every state should allow a loss carryback of at least 5 years.
3. Sourcing of bad debt losses.

In order to overcome the problem identified in Attachment A, taxable income should be apportioned without including bad debts in the calculation of taxable income. Bad debt losses should then be directly allocated to each state and deducted from the pre-bad debt loss taxable income apportioned to the state. These computations should be made without regard to whether or not there is nexus with a state. However, if in the year a bad debt loss is allocable to a state which does not have nexus, the net loss attributable to the state should be thrown back only if there was also no nexus with that state for the preceding five years (the loss carryback period). If there was nexus during any of those carryback years, then a net loss for the current year should be allowed as a carryback to the extent of the net taxable income attributed to the

state in the carryback years. Any excess should then be subject to the throwback rule in the current year.

4. All income, except sales of businesses (including bank branches) and real estate used for business operations, should be business income. The types of income which constitute non-business income in the case of mercantile and manufacturing corporations clearly constitute income from the ordinary business conducted by financial services corporations.
5. Deposits should be generally defined as money paid to the financial institution which is subject to a liability to repay on demand or at a specific time, with or without interest and whose use until then is unrestricted in the hands of the recipient and is not represented by a marketable instrument (except money orders and travelers checks).
6. Unitary - Combination Rules
  - a. Nexus should be determined separately for each corporation.
  - b. Unitary (water's-edge) combination returns should include the parent holding company.
  - c. Intercompany transactions should be eliminated for both nexus and allocation purposes, as well as from taxable income.
7. Nexus should not exist in any case where the corporation is not permitted, under the laws of the state, to conduct business through a branch (in the case of a depository institution) or office located in the state.
8. If the state includes Subpart F income in the tax base, then the controlled foreign corporation should be treated as if it were a branch of its U.S. parent, and therefore its payroll, property and sources of funding (from third parties) should be included in the apportionment formula.

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9. In the case of sourcing loans under the intangible property factor of the apportionment formula, all loans are sourced by billing address. In the case of loans acquired by the holder by way of syndications, participations, or other purchases, the billing address should be that of the borrower, even where the loan is administered by another financial institution as agent.

**COMMENT:**

This approach is consistent with the economic presence theory that a lender has a presence in a state based on where the borrower is located, regardless of how the loan was acquired. On the other hand, it is inconsistent with the economic reality that the lender-taxpayer is merely investing in a portfolio type investment pursuant to the second scenario of the Conceptual Framework described earlier.

**ADOPTION AND IMPLEMENTATION:**

A major requirement for this, or indeed any, system of state taxation based on income is uniformity of the rules for both nexus and apportionment of income. In order to attain that objective, uniform adoption by the states is imperative. That uniformity can and should be achieved in a manner consistent with the Multistate Tax Compact, which has the same goal in the area of corporate income taxation. The following points, utilizing the "Financial Institutions Tax Compact," should be essential conditions for adoption, ratification and implementation of the final proposal, and for smooth transition into the new tax rules. The Compact will become effective only upon completion of these steps.

1. The Financial Institution Tax Compact must be ratified by a majority of the states (at least 26 states).
2. Eight of the following states must ratify the Financial Institution Tax Compact: *(20 to be listed)*

California	Illinois	Ohio
Colorado	Maryland	Oregon
Connecticut	Massachusetts	Pennsylvania
Delaware	Michigan	South Dakota

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Florida  
Georgia  
Illinois

New Jersey  
New York  
North Carolina

Texas  
Virginia

3. The Financial Institution Tax Compact must be ratified by all of the following states:

Indiana  
Iowa  
Minnesota

Tennessee  
West Virginia

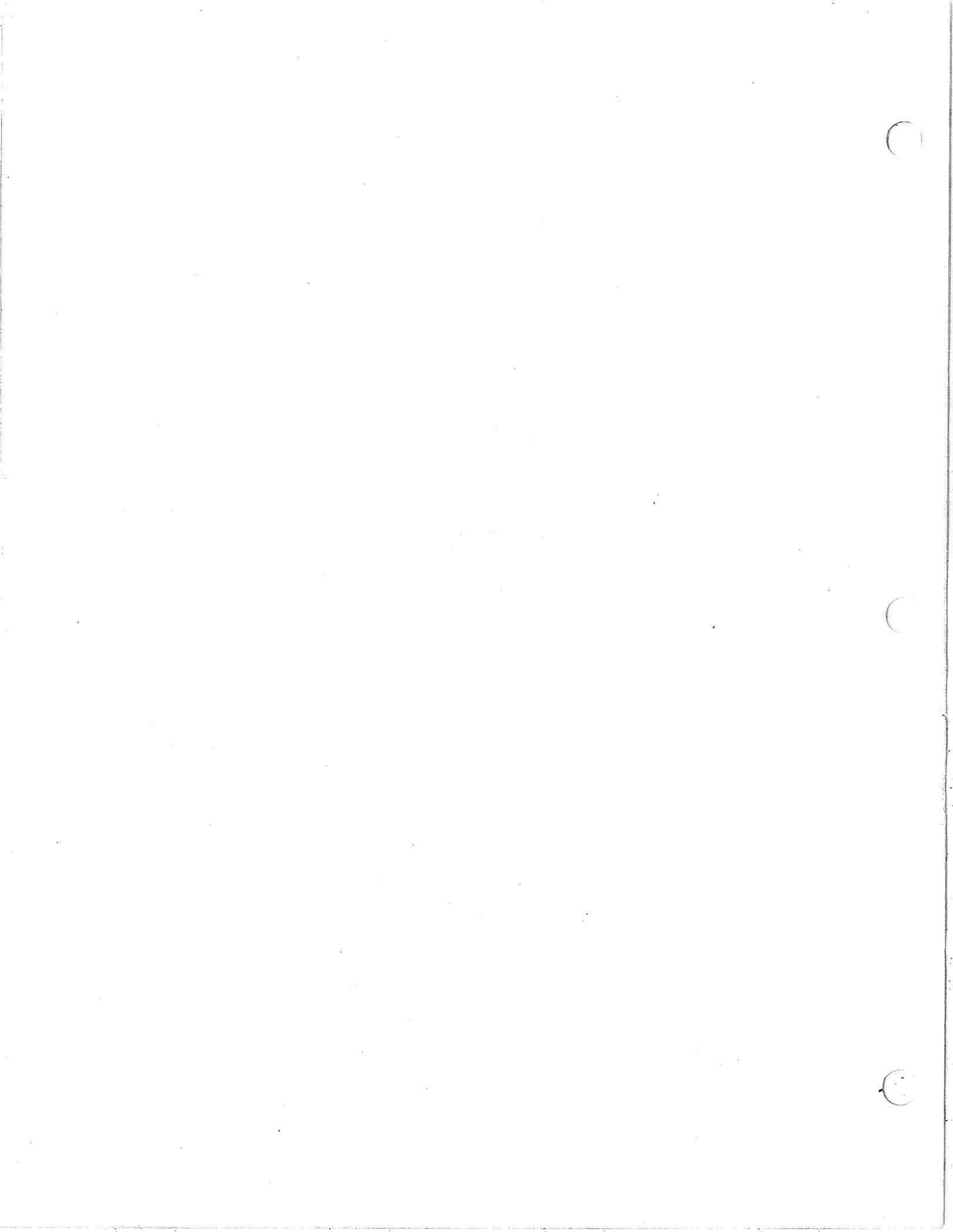
4. The Financial Institution Tax Compact will take effect in all of the member states, provided that conditions 1, 2 and 3 are met, on January 1, 1998.
5. All member states agree that if and when the Compact takes effect, they will collectively petition Congress to enact Federal legislation ratifying the Compact and making it applicable to all states. This will avoid class warfare among states which (1) may apply lower nexus standards and different apportionment ratios to attract revenue and (2) may apply higher nexus standards and more liberal apportionment to attract business.

#### IV. CONCLUSION

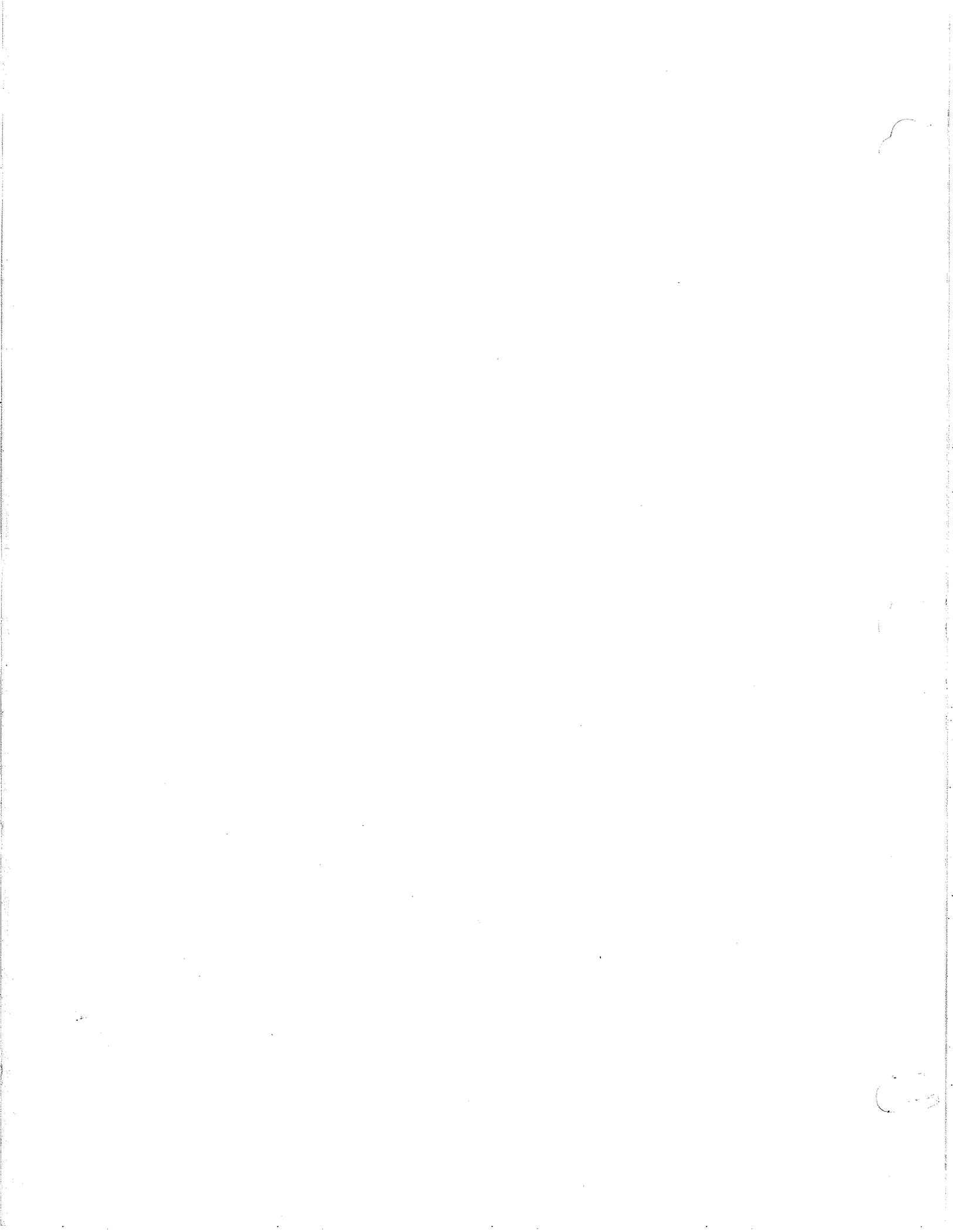
The foregoing proposal seeks to give due consideration to a number of elements, including the nature of the financial services business, the role of both customers and performance of services, and the need for simplicity and certainty of rules. While there may be more precise measurements (such as the gross profitability of each type of financial product), such considerations would only substantially increase complexity and reduce the precision of data, without necessarily improving the quality of the results. Only in the area of bad debt losses has a special exception been made to allocate such losses to avoid an undesirable shift of tax effect among states. In all other respects, the proposal seeks to avoid all distinctions among types of financial services and products except credit cards and pure lending activities.

Hopefully, this can form the basis for a workable system, acceptable to all states while consistent with the nature of the financial services business.

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**RESOLUTION OF MULTISTATE TAX COMMISSION  
(NOVEMBER 17, 1994)  
ADOPTING FINAL VERSION OF PROPOSAL FOR UNIFORM  
APPORTIONMENT OF INCOME EARNED FROM THE BUSINESS OF A  
FINANCIAL INSTITUTION AND FINAL VERSION**





**RESOLUTION ADOPTING PROPOSED UNIFORM METHOD FOR  
ALLOCATION AND APPORTIONMENT OF NET INCOME  
FROM FINANCIAL INSTITUTIONS**

WHEREAS, a proposal for the uniform allocation and apportionment of net income earned by financial institutions has been developed through several years of Multistate Tax Commission committee efforts, as well as through six public hearing sessions and countless other meetings involving comment received from affected industry members; and

WHEREAS, as required by Article VII of the Multistate Tax Compact, the Hearing Officer for such public process, Alan H. Friedman, has submitted his Final Report of Hearing Officer Regarding Proposed Multistate Tax Commission Formula for the Uniform Apportionment of Net Income from Financial Institutions dated April 28, 1994 and his Supplement to such Final Report dated September 16, 1994; and

WHEREAS, said Reports have attached thereto Exhibit A:1 reflecting said Hearing Officer's final recommended allocation and apportionment formula to be applied to financial institutions coming within the state's taxing jurisdiction; and

WHEREAS, pursuant to a survey conducted pursuant to Multistate Tax Commission Bylaw 7 reflects that a majority of the interested member states of the Commission would consider the proposed allocation and apportionment formula for adoption in their respective states should the Multistate Tax Commission adopt such uniformity recommendation; and

WHEREAS, the proposed formula consists of an allocation and apportionment approach that is fair and administrable and that strikes a reasonable balance in income attribution methodology between the interests of states that view themselves as "market" states and those that view themselves as "money-center" states; and

WHEREAS, the Commission specifically notes that there has been no Hearing Officer recommendation with respect to issues such as the appropriate nexus standard to be applied by the states regarding operational taxes for financial institutions. Nor has there been any recommendation regarding the use of combined reporting for related

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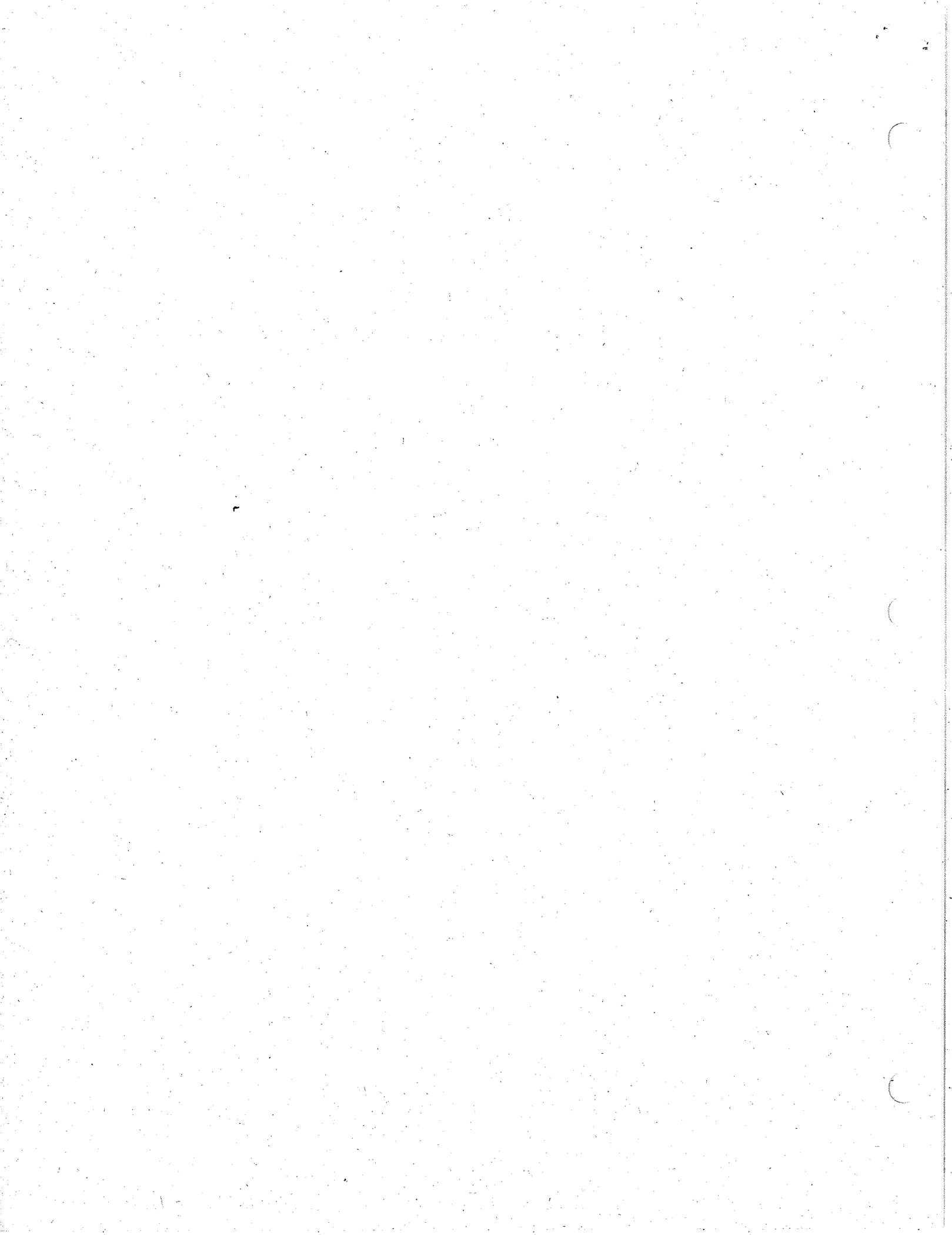
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financial institutions. The reservation of these two important issues was made necessary in order for the hearing process to proceed to recommendations regarding the apportionment formula; and

WHEREAS, the Commission concludes that the discussion of nexus appearing in the Final Report of Hearing Officer did not constitute either a formal or informal recommendation regarding the nexus issue, but that such discussion was made necessary in order for the Hearing Officer to respond to public comments submitted by industry representatives with respect to that issue, as he was required to do under Article VII of the Multistate Tax Compact hearing process; and

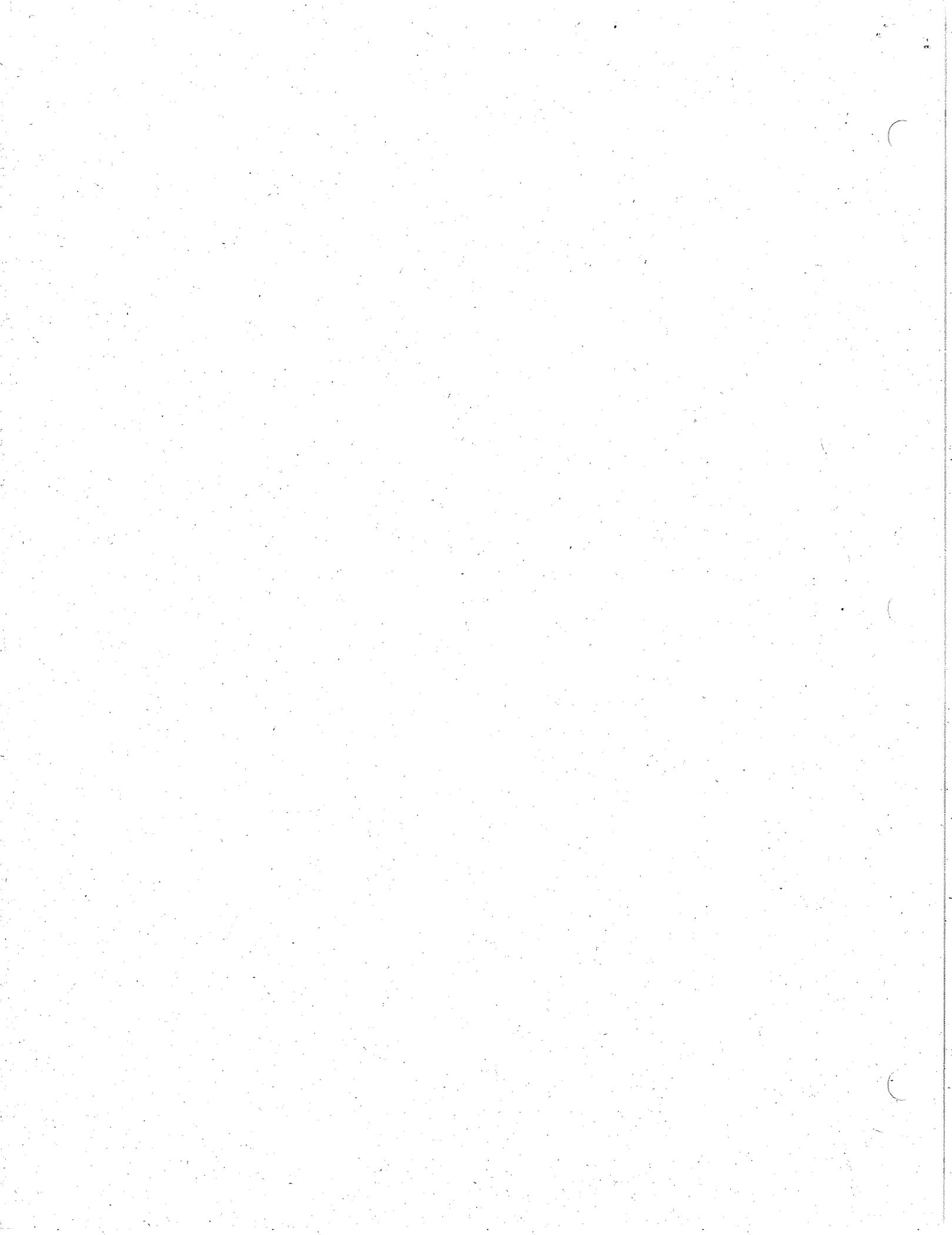
WHEREAS, other efforts of the Commission are currently under way that seek to (1) uniformly define nexus for operational tax purposes for all similarly situated taxpayers, and (2) establish uniform standards for determining the scope of a unitary business.; and

WHEREAS, the Commission makes no specific finding or conclusion with respect to the issues of nexus and combined reporting at this time concerning the measurement or taxation of net income from financial institutions.

NOW, THEREFORE, the Multistate Tax Commission hereby adopts the attached Formula for the Allocation and Apportionment of Net Income from Financial Institutions and recommends that all interested states adopt said formula through their respective statutory, regulatory or other appropriate processes.

IT IS FURTHER RESOLVED that should a sufficient number of representatives of affected financial institutions wish to participate in a joint state/industry effort to address issues not specifically included in the uniform formula hereby adopted, such as nexus standards, the appropriate methods of combined reporting or other issue of common interest to several states, the staff of the Multistate Tax Commission is authorized to discuss said issues with industry representatives and to keep the Executive and Uniformity Committees of the Commission apprised of any such discussions.

IT IS FURTHER RESOLVED that the staff of the Multistate Tax Commission should organize and facilitate an annual meeting by teleconference or otherwise of representatives of states adopting said



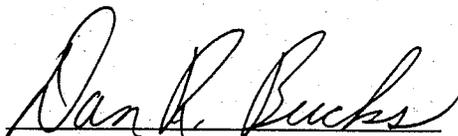
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uniform formula for the purpose of exchanging information and ideas regarding the implementation and effectiveness of the formula; and

IT IS FURTHER RESOLVED that on or before five years from this date that the staff should survey the adopting states and a sample of affected financial institutions to determine what amendments, if any, should be made to the uniform formula and refer the results of such survey to the Executive and Uniformity Committees of the Commission for their consideration and such further action they determine appropriate.

Adopted this 17th day of November, 1994 by the Multistate Tax Commission.

Attest:



Dan R. Bucks  
Executive Director and Secretary

