

EXHIBIT H

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

EXHIBIT H: 1

**Agenda for Conference Call
(January 24, 1992)**

SUBCOMMITTEE ON APPORTIONMENT
OF INCOME FROM FINANCIAL SERVICES

Agenda for Conference Call
January 24, 1992
1:30 PM (Eastern)

Convener:

Alan Friedman, Multistate Tax Commission

Subcommittee Members:

Michael Boekhaus (Bill Lunka)	MN
Eric Coffill	CA
Anne Dougherty	TN
Marilyn Kaltenborn	NY
Keith Larson	WV
Jonathon Robin	NYC
Mary Jane Egr	(Monitoring for Fed. of Tax Admin.)

AGENDA

- I. STATEMENT OF BACKGROUND, PURPOSE AND PROCESS¹ FOR TELEPHONE CONFERENCE
- II. STATEMENT BY EACH SUBCOMMITTEE MEMBER DESCRIBING HIS OR HER STATE/CITY'S CURRENT APPROACH TO TAXATION OF FINANCIALS AND ASSESSMENT OF POTENTIAL FOR MODIFICATION

¹. In order to expedite discussion, at least in the initial stage of the telephone conference, Subcommittee members are requested to respond to the topics seriatim in the order as listed above. Or, if Subcommittee members prefer, the order of response could be based upon any other criteria, eg., age (each permitted to subtract up to 10 years from actual age), beauty ("eyes of the beholder" standard to apply), assets (financial statement required), or difference between actual number of dependents versus number declared on 1040. After a few rounds, we will get used to the sound of each other's voice and telephone conference protocol will likely be pushed aside by anarchy.

III. DISCUSSION OF POSSIBLE SUBCOMMITTEE GOALS TO BE ACHIEVED

- A. Uniformity in apportionment method
- B. Uniformity in tax base to be apportioned
- C. Joint administrative possibilities
- D. Suggestions for other goals

IV. DISCUSSION OF BASIC SUBSTANTIVE ISSUES TO BE DECIDED

- A. Discussion of Haskell Edelstein's "A Fresh Approach" (enclosed)
- B. Scope of definition of financial institution
 - 1. Nonbank banks - excess of 50% of income from lending activities?
 - 1. Credit Unions?
 - 2. Brokerage houses?
 - 3. Insurance companies?
 - 4. Foreign based financial institutions?
 - 5. Others?
- C. Nexus
 - 1. Articulation of nexus in statute or rule?
 - 2. Nexus thresholds?
 - 3. Inclusion or exclusion of participation or syndication loans for nexus purposes?
 - 4. Other nexus issues?
- D. Apportionment methodology
 - 1. Number of factors?
 - a. Single receipts factor vs. traditional three factors?
 - b. Four factors - property (tangible and intangible), payroll, receipts and deposits?
 - c. Other suggestions?

2. Receipts factor
 - a. Market state?
 - b. Commercial domicile?
 - c. Cross between market and domicile?
 - d. Other attribution suggestions?
 - e. Suggestions regarding recordkeeping burden?
 - f. Finnigan principle?
 - g. Weight of factor?
 - h. Other receipts factor issues?
3. Property factor
 - a. Inclusion of intangibles in property factor? Crocker Equipment Leasing, Inc. v. Department of Revenue, Or. Tax Court (3/12/91)
 - b. Elimination of property factor entirely?
 - c. Valuation of intangibles for factor purposes?
 - d. Other property factor issues?
4. Payroll factor
 - a. Any issues?
5. Proper treatment of deposits?

V. DISCUSSION OF PROCESS BY WHICH TO ACHIEVE STATED GOALS

- A. Establish time line to accomplish goals
- B. Establish Subcommittee member assignments
- C. Review positives and negatives regarding telephone conference mechanism and decide whether to use it for any future set of discussions

VI. SET DATE FOR NEXT TELEPHONE CONFERENCE OR MEETING

VII. SCHEDULE SURGERY FOR REMOVING TELEPHONE FROM EAR

EXHIBIT H: 2

**Agenda for Conference Call
(February 11, 1992)**

**SUBCOMMITTEE ON APPORTIONMENT
OF INCOME FROM FINANCIAL SERVICES**

**Agenda for Conference Call
February 11, 1992
1:30 PM (Eastern)**

Convener:

Alan Friedman, Multistate Tax Commission

Subcommittee Members:

Michael Boekhaus (Bill Lunka)	MN
Eric Coffill	CA
Anne Dougherty	TN
Marilyn Kaltenborn	NY
Keith Larson	WV
Jonathon Robin	NYC
Mary Jane Egr	(Monitoring for Fed. of Tax Admin.)

AGENDA

- I. BRIEF REVIEW OF SUBCOMMITTEE'S CURRENT FOCUS AND DIRECTION**
 - A. Nexus issues not on table for formal discussion or action at this time.**
 - B. Uniformity in tax bases not to be addressed.**
 - C. Joint administrative possibilities to be discussed after consensus reached on apportionment formula.**
 - D. Initial drafting effort to be focussed on traditional banking activities.**
 - E. Foreign owned banks to be included in proposal.**
 - F. Haskell Edelstein's "A Fresh Approach" considered and taken off the table for now.**
 - G. Other suggestions.**

II. DISCUSSION OF NEW YORK DRAFT OF APPORTIONMENT FACTORS

- A. Receipts Factor.
- B. Source of Funds Factor.

III. DISCUSSION OF OTHER FACTORS TO BE INCLUDED.

- A. Traditional property.
- B. Traditional payroll.

IV. DISCUSSION OF WEIGHT TO BE ATTRIBUTED TO FACTORS.

V. DISCUSSION OF SOURCING RULE APPROACHES.

VI. DISCUSSION OF PROCESS.

A. Possible Subcommittee member assignments.

1. Draft language for core franchise tax bank statute.
2. Definitions to be included in regulation.
3. Consideration of intangibles in apportionment formula. Crocker Equipment Leasing, Inc. v. Department of Revenue, Or. Tax Court (3/12/91)
4. A focus on reduction of recordkeeping and other administrative burdens on bank and audit staff.
5. Valuation issues, e.g., intangibles.
6. Unitary/combination/Finnigan issues.

B. Projected completion date.

- C. Need and ability for members to have in-person meeting prior to completion of final draft to be reviewed and acted upon.

VI. SET DATE FOR NEXT TELEPHONE CONFERENCE OR MEETING.

EXHIBIT H: 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**

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**

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

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.

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

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?

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

ATTACHMENT 2

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.

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

ATTACHMENT 3

PROPOSED FINANCIAL INSTITUTION APPORTIONMENT FORMULA - MINNESOTA

<u>Activity</u>	<u>Property Attributed</u>	<u>Payroll Attributed</u>	<u>Receipts Attributed</u>
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

ATTACHMENT 4

(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 "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

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

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.

EXHIBIT H: 4

**Memorandum re California Discussion Proposal
(Eric Coffill) (April 24, 1992)**



P.O. Box 1468
Sacramento, CA 95812-1468
Interagency Mail Code P-5

Telephone: (916) 369-3323
ATSS: 468-3323
FAX: (916) 369-3648

MEMORANDUM

TO: Alan Friedman, MTC
Marilyn Kaltenborn, New York
Mike Boekhaus, Minnesota
John Malach, Illinois

DATE: April 24, 1992

FILE:
410:EJC:caldraft.1

FROM: Eric J. Coffill

BY FAX THIS DATE

SUBJECT: California Bank/Financial Apportionment Proposal

Attached is a proposal we have written over the last several days. It is a discussion proposal only, and we wanted you to have it in advance of the New York meeting. It is not confidential, and you may share it with anyone you wish (Marilyn: be sure to give it to NYC). The California banks will be providing it to the FIST coalition.

If anyone has questions (or reactions they wish to share), call me at (916) 369-3323. Otherwise, see you in New York.

Eric J. Coffill

Senior Tax Counsel
Multistate Tax Law Bureau

Encl.

cc: Gerald H. Goldberg
Ed Campion

California Discussion Proposal

Apportionment formula would consist of equally-weighted three factors of payroll, deposits, and receipts. Payroll assigned under traditional UDITPA rules to where the services are performed. Deposits and Receipts are assigned as follows:

<u>Activity</u>	<u>Deposits</u>	<u>Receipts</u>
Coin & currency	N/A	N/A
Goodwill	N/A	N/A
Operat. lease	N/A	Where prop. located
Credit card recpts	N/A	Where holder resides/ corp. com. domicile, ¹ provided TP taxable there. If not ² , throwback to TP's com. dom.
Merc. disc. inc.	N/A	Where merchant located, provided TP taxable there. If not, throwback to TP's com. dom.
Fiduc/other servs.	N/A	Where services

¹ "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed. (CRTC 25120(b).)

² A taxpayer asserting that it is taxable in a state must provide substantiation of its claim of taxability as follows:

•By showing that returns have been filed and taxes due have been paid (other than minimum taxes), or

•By providing incontrovertible evidence of taxability in that state.

All loans	N/A	performed
		Com. dom (or residence) of borrower, which is presumed to be where billed. If TP not taxable there, throwback to where booked (subj. to SINAA)
Investments & securities	Excluded	Excluded
Trav. chks, money orders	N/A	Where purchased
Deposits		
\$100k or less	Depositor's Address	N/A
over \$100k	Book per SINAA	N/A
Syndicat/partic. loans	N/A	?

EJC 4/22 proposal

EXHIBIT H: 5

**Memorandum re Bank Apportionment Formula
(Michael Boekhaus) (April 29, 1992)**

Memo

To: Industry and State Representatives
From: Mike Boekhaus, Director 
Subject: Bank Apportionment Formula
Date: April 29, 1992

Minnesota opposes the five-factor formula. The formula contains an unneeded degree of complexity and fails to address the real issues that should be the focus of our debate. Therefore, we offer an alternative for consideration at the meeting with industry representatives in New York next week.

The states have been confronting the issue of bank taxation for a number of years. The debate has taken an unfortunate turn. The focus is not so much on what is the proper measure of tax, but rather on which states win and which states lose.

The states have been divided into two camps: market states vs. money-center states. We must recognize that a state may be both a market and a money-center. If technologies and banking business practices continue to evolve at their current rates, the lines of distinction between markets and money-centers will become so blurred as to be indistinguishable.

We, the states, must stop thinking in terms of market and money-center and instead frame the debate in terms of the desirable characteristics for any apportionment formula. Those characteristics should be fairness and understandability.

- Fairness.** The formula must be fair, not just to the taxpayer, but also to the state in which the taxpayer is doing business. Fairness for the taxpayer means that the formula should be a fair approximation of the taxpayer's business activity within the state, in comparison to the taxpayer's business activity everywhere. The formula should reflect the state's services that allow and facilitate the bank's business activity within the state.

Fairness for the state means that the activity apportioned to the state reflects the services and benefits provided by the state in relation to the services and benefits provided by all of the other states in which the taxpayer transacts business. It should reflect the state services that support the social, economic, and political infrastructure that:

- provides the bank with customers;
- provides employees and a physical location;
- facilitates the existence of financial markets;
- facilitates the existence of businesses that support the bank's business (i.e., telecommunications);
- provides police and fire protection for property (office buildings and security interests) and individuals (customers and employees);
- provides laws for contracts and rights in tangible and intangible property; and
- provides courts to protect those contracts and rights.

•**Understandability.** The formula must be understandable. While fairness should be the number one goal, total accuracy is not necessary nor practical. The formula must be as simple as possible given the relative complexity presented by this industry. Simplicity would serve two basic purposes: ease of compliance for taxpayers; and, efficiency in administration for the states.

Measured by these standards, the five-factor formula advanced by New York state and city representative should not be the model for state taxation. It should fail simply due to its inherent complexity.

Therefore, Minnesota proposes a compromise encompassing these standards. In recognition that states provide a wide range of services that benefit both the market and money-center/headquarters, the apportionment formula should reflect both.

Services that support a bank's market should be reflected by the receipts factor because receipts are directly related to the existence of customers and marketplace.

Services that support and protect a bank's physical plant and employees should be reflected in a separate factor. This is a significant change from previous proposals. Tangible property has always been grouped with the intangible property. This had the effect of significantly reducing the percentage of business attributable to tangible property due to the large amounts of intangible property included in the property factor. If one assumes that there is a relationship between the services a state provides and the amount of business activity within that state, then tangible property should be more than an insignificant part of the formula. Tangible property and payroll are grouped together because the services a state provides to protect people and property are similar.

Services that support and facilitate the existence of a financial market (money-center) should be reflected in an intangible property factor. (There may be some room to consider a "source of funds" factor

within this factor. Some states have already implicitly recognized this by using deposits to apportion securities.)

The concept is relatively simple and 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 I am proposing to do with the intangible property is similar. The property interest is attributed to the state where the branch that created the property is located. The income from that property is assigned to the location of the customers/borrowers.

There are three basic reasons for advancing this alternative. First of all, it is simple. This is important not only from an administrative and cost of compliance viewpoint, but also from the legislative view as well. Whatever is settled on has to pass legislative muster. It is much easier to pass variations on a common theme, than it is to offer something completely new and different.

Secondly, it is understandable and, in most cases, uses information readily available to the banks as attribution rules. From the tax administration standpoint, states will not have to adopt extensive complex regulations to administer the tax. Also, states and taxpayers will not have the expense of administering a complicated new system.

Finally, and most importantly, it recognizes the services provided by the market and the money-center.

This is only a work-in-progress for discussion. I am aware of the need for some refinements to make it work. What I am looking for is 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 of our discussion before we spend time picking away at the details.

Attached is a spreadsheet that shows the basic attribution rules we propose. This is not a detailed regulation, but rather for discussion.

I have left open the issue of the weight to be assigned to each of the factors, although my personal preference is an equal weighting between market and money-center factors. That weighting would serve all states as the financial markets continue to evolve.

Proposed Financial Institution Apportionment Formula

Activity	Receipts	Tangible Property/Payroll	Intangible Property
Coin and currency	N/A	N/A	Where physically located
Goodwill	Excluded from formula	N/A	Excluded from formula
Lease financing	Where tangible property is located	N/A	Where tangible property is located
Loans collateralized by tangible property	Where the collateral is physically located	N/A	Where branch or main office of original lender is located
Unsecured consumer and installment loans	Where the customer resides	N/A	Where the customer regularly sends their payment
Credit and travel entertainment cards	Where the customer is regularly billed	N/A	Where the customer regularly sends their payment
Unsecured commercial loans	Where the funds are used	N/A	Where branch or main office of original lender is located
Investments and securities	Excluded	N/A	Deposits (source of funds?)
Employees	N/A	Where employed	N/A
Tangible property	N/A	Where located	N/A
Merchant discount income	Where the merchant is located	N/A	N/A
Fiduciary and other services	Same as services are attributed for other corporations	N/A	N/A
Travelers checks and money orders	Where purchased	N/A	N/A

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

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

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?

ATTACHMENT 2

MINNESOTA

Department of Revenue

Appeals, Legal Services and Criminal Investigations Division

Phone (612) 296-101

Memo

To: Bank Apportionment Subcommittee
From: Mike Bockhaus
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.

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

ATTACHMENT 3

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

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 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 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 situsing 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

**WORKING MATERIAL: STATE/INDUSTRY FINANCIAL WORKING
GROUP (S/IFWG)**

EXHIBIT I: 1

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

*** S/IFWG ALERT ***

TO: Donald N. Adler Anne Dougherty Marilyn N. Kaltenborn
Jonathan W. Allen Harley Duncan John Malach
Stanley R. Arnold Haskell Edelstein Michael J. Palko
Terry J. Baker Rod Felix Philip M. Plant
Michael Boekhaus Fred Ferguson Jonathan R. Robin
Eric Coffill Joseph L. Taetle

FROM: ALAN H. FRIEDMAN, CONVENER

RE: INITIAL CONFERENCE CALL SET FOR MONDAY, MAY 11, 1992

DATE: MAY 6, 1992

Please set your watches and calendars for 11:00 AM (eastern) on Monday, May 11, 1992 for our first teleconference call for the "State/Industry Financial Working Group (S/IFWG)".¹ The system that we use, Access, is based in D.C. and operates by YOU CALLING IN TO 202-296-3132 at the appointed time. Each participant's organization will be separately billed for its equally-weighted portion of the set-up fee and long distance charges incurred. I would guess that the first conference should take about one hour, unless some of the substantive drafting was accomplished during this past week. Due to the shortness of time before our Monday conference, I am asking those who have some draft to share to fax it to all of the representatives. In the future, time permitting, my secretary, Teresa, will do the faxing centrally from our office in D.C.

I am enclosing a list of the representatives and their addresses, telephone and fax numbers, as well as a brief agenda for this first call. Should any of you have additional agenda items

¹. This is the name of our joint effort until someone comes up with a better name and an appropriate acronym. Since the acronym "FIST" is taken already, how about mixing in an offsetting metaphor, like the "Velvet Glove"? Thus, we can hide the harsh, cruel clenched fist of the industry that is ready to strike inside the soft, caring cover offered by the states here. Or, maybe the mixing of an acronym with a metaphor is too much like mixing apples and oranges or deposits and loans (oops, I think a simile or two just crept in).

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.²
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.

². 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 captain³ 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.⁴

3. 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.

4. 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:

4. Additional Comments:

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

Page 2

State Participants (cont'd)

<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. Kaltborn	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
Monitoring for Co-sponsor Federation of Tax Administrators:				
	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. Taetle	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

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 Winter 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

Convener: Alan Friedman,
Multistate Tax Commission
386 University Avenue
Los Altos, CA 94022
Telephone (415) 941-0556; Fax (415) 941-0557

Alternate Convener: 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 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 Alternate Convener	Michael J. Palko 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 I: 3

**Memo to S/IFWG members (Alan Friedman)
(May 18, 1992)**

STATE/INDUSTRY FINANCIAL WORKING GROUP

TO: S/IFWG MEMBERS:

	<u>Telephone #</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-/70-5369
(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.

EXHIBIT I: 4

**Memo to S/IFWG members (Alan Friedman)
(June 4, 1992)**

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 Campion, 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.¹

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

¹. 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: 5

**Memo to Teams 15-18 (with attachments from other Teams)
(Alan Friedman) (September 2, 1992) (with later
generated documents also being incorporated)**

TO: SUBCOMMITTEE MEMBERS OF:

TEAM 15 (PAYROLL)
TEAM 16 (PROPERTY FACTOR THAT INCLUDES INTANGIBLES)
TEAM 17/7 (FACTOR THAT INCLUDES DEPOSITS)
TEAM 18 (RECEIPTS)

ERIC COFFILL/ED CAMPION (TEAMS 16 AND 18)
ROD FELIX (TEAM 16)
MICHAEL BOEKHAUS (TEAMS 17/7 AND 18)
STANLEY ARNOLD/MAURICE GILBERT (TEAMS 15 AND 18)
MARILYN KALTENBORN (TEAMS 16 AND 18)
JONATHAN ROBIN (TEAMS 16 AND 18)
ANNE DOUGHERTY (TEAMS 16 AND 18)
JONATHAN ALLEN (TEAMS 15 AND 16)
JOE TAETLE (TEAMS 16 AND 18)
PHIL PLANT (TEAMS 16 AND 17/7)
TERRY BAKER (TEAMS 15, 16 AND 17/7)
DONALD ADLER (TEAMS 16 AND 18)
MICHAEL PALKO (TEAMS 16, 17/7 AND 18)
BRENT ANDERSEN (TEAM 17/7)
HASKELL EDELSTEIN (TEAM 17/7)

CC: HARLEY DUNCAN/MARY JANE EGR
STEVEN ZEGALO
DAN R. BUCKS
FRED FERGUSON

FROM: ALAN H. FRIEDMAN (CONVENER)

DATE: SEPTEMBER 2, 1992

I am enclosing a copy for each of you of the materials that have been thus far produced by the various Subcommittee Teams. As you can see, the collaborative effort was most successful and productive. Each of you are now invited to provide your written critique, comments and suggestions to the respective Team Co-leaders concerning any of the suggested language.

I want to thank all of you for your attention to this most important effort and the professionalism you all have brought to it. I think that what we have set out to do -- the fashioning of an apportionment formula that is both fair and administrable -- is within our grasp. While the most sensitive discussions still lay ahead, I am optimistic that the mutual respect and openness of communication that has been developed among us will carry our remaining effort.

It is now time for the factor-drafters to begin their efforts. As you recall from our last full Subcommittee teleconference, we are aiming toward having all of the alternative factors drafted by no later than October 15th. We have scheduled the meeting for the

full S/I Meeting (SIM) to review the S/IFWG Team work for Monday and Tuesday, *November 23-24* in Chicago. Please make your own hotel and air reservations on the assumption that we will begin the joint session at 10:00 AM on Monday, with caucus rooms available beginning at 8:00 AM.

Also, based upon our last teleconference, the consensus of the group was that the Receipts Factor (TEAM 18) alternative(s) should be focussed on first and then the Property (TEAM 16) and Deposits (TEAM 17/7) factors finalized thereafter. You will note that an early draft of a Deposits and a Source of Funds Factor has already been submitted for initial discussion by TEAM 17/7.

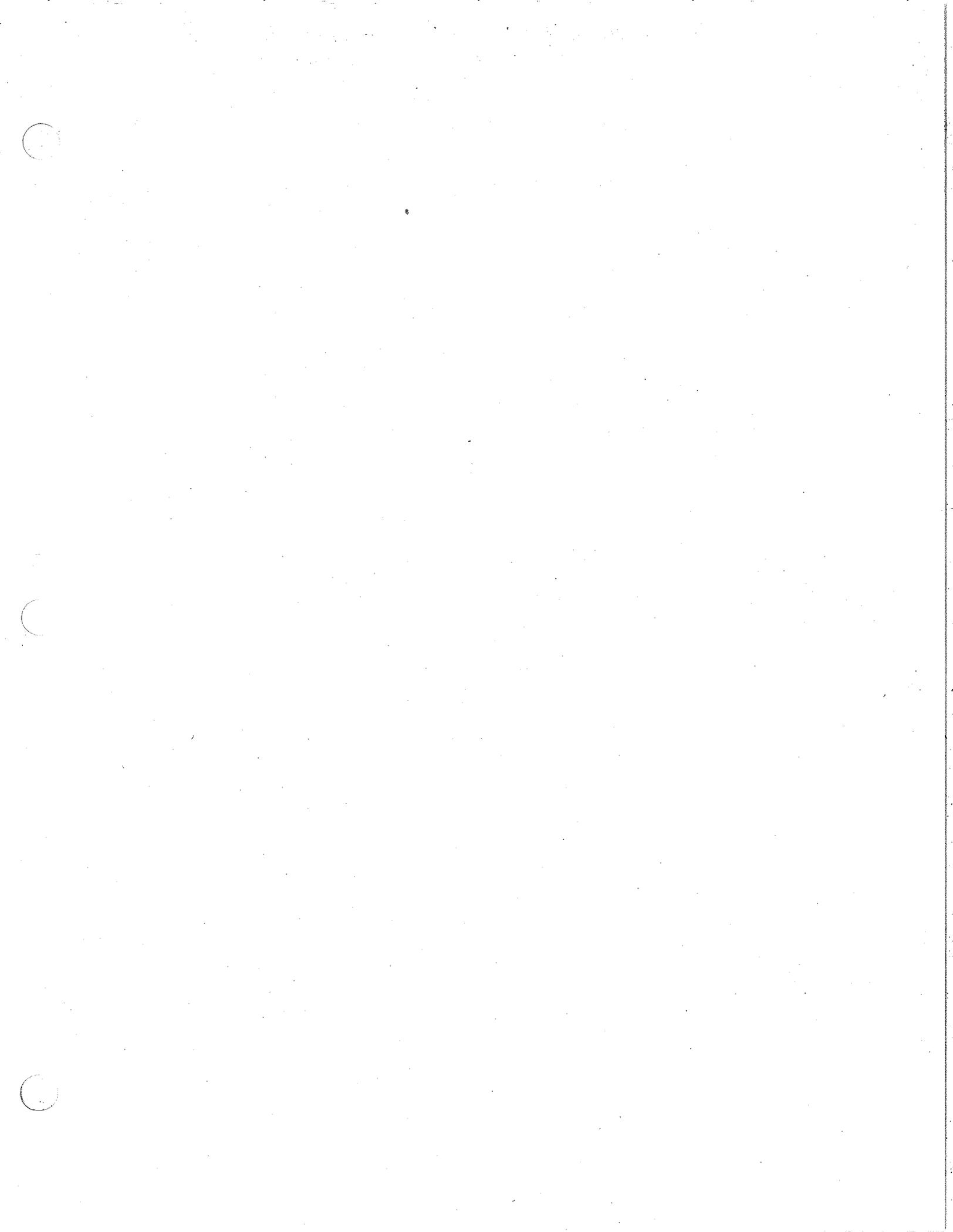
In order for everyone to contribute as fully as they wish in this effort, I am requesting that the Co-leaders of TEAMS 15, 16, 17, and 18 notify all other interested Subcommittee members who request prior notification of the times for each conference call, so that they may listen in on your teams' efforts in these critical areas. In any event, Fred and I should be given prior notice and an opportunity to be present on all future telephone conferences of TEAMS 15 through 18. So, Terry, Mike, Joe, Marilyn, Don and Haskell - please give us such notice at the same time and in the same manner that you provide notice to your respective team members. And, lastly in this regard, that in response to my invitation of August 25th, Phil Plant has volunteered to join TEAM 16; so Marilyn and Don should now place Phil on their Team roster.

Lastly, while as convener I am to remain neutral in this process, I cannot restrain myself from sharing with the factor-drafting subcommittee members important research that I have made on a few of the necessary definitions.¹ They are as follows:

1. "Branch office or branch bank" - an imperialist outpost in a legal hinterland established to plunder the local environs for the benefit of the home office.
2. "Capital gains tax" - accrual and unusual form of capital punishment.
3. "Churning" - with reference to sales of securities, a sin of commission.
4. "De minimis" - Latin abbreviation for "De minimis non curat lex" or "The law does not care about small things". This doctrine precludes medical malpractice claims being brought by accountants and lawyers alleging brain damage.

¹. In order to confirm your suspicions that I could not be so witty all by myself and to assure the states that I have not spent my time writing comedy, I confess that I relied completely on *White's Law Dictionary* for the suggested definitions.

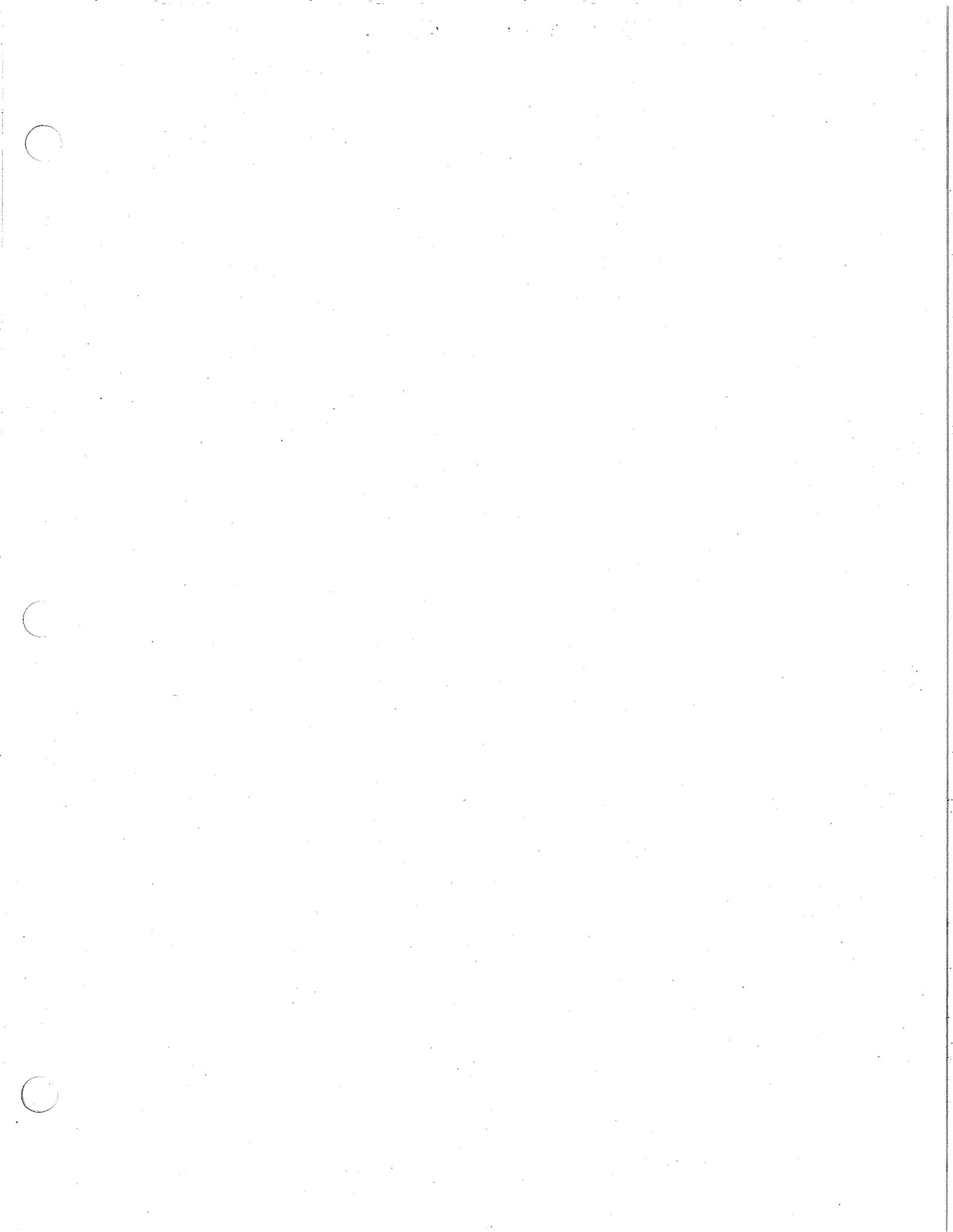
5. "Domicile" - your true home, of which for legal purposes you may have only one, in contrast to "residence", of which you may have as many as you like, including your chalet in Switzerland, your bungalow in Malibu, your pied-a-terre on Central Park West, and your place in line at the automobile registration window.
6. "Escheat" - the process by which the government takes possession of the property of persons who die without heirs. Derived from the verb "to cheat".
7. "Escrow" - an agreement between two persons for the delivery of money to a third person and for the release of money to one of the first two persons on the occurrence of some specified event. The arrangement is based on mutual distrust, the first two persons believing that in the absence of such an arrangement someone is likely to get "escrewed".
8. "Ex *lax*" - Latin, "from the lawyer". Refers to memos, briefs and other work products of lawyers.
9. "Fiduciary" - someone such as a bank trust officer or estate administrator on whom the law imposes a strict duty of loyalty and integrity. Usually a lawyer, because other people maintain those qualities out of a sense of decency.
10. "Goodwill" - in the law of corporations, a catchall category located on the asset side of a company's balance sheet to make its assets appear to equal its liabilities. It includes valuable intangibles, such as a recognizable brand name or favorable publicity. Eg., the arrest of John DeLorean did much to boost the goodwill of his DMC-12, the first car in history for which collectors almost had license plates handmade by the company president.
11. "Private placement" - an offering of stock for which no registration with federal or state securities authorities is required. Not to be confused with a "privates placement" - the syndication of a thoroughbred racehorse's stud rights.
12. "Taxes" - of life's two certainties, the only one for which you can get an automatic extension.
13. "Trust" - a device by which the "legal" and "beneficial" ownership of property are separated, as where a "donor" (say, your grandfather) places a "corpus" (the family fortune) under the legal control of a "trustee" (a bank) to be managed for a "beneficiary" (you). The term "trust" is ironic: If your grandfather had any trust in you, you might now have control of the family fortune.



STATE/INDUSTRY FINANCIAL WORKING GROUP

SUBCOMMITTEE MATERIALS

September 1, 1992



TEAM 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)

TERM: FINANCIAL INSTITUTION

"Financial Institution" means every corporation or association organized under the laws of any state or country which is authorized to do, or which is doing the business of a financial institution, including; (a) 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.; (b) A federal savings and loan association; (c) A credit union; (d) 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; (e) An international bank agency; (f) An international banking facility, including an Edge Act corporation organized pursuant to the provisions of §25(a) of the Federal Reserve Act, 12 U.S.C. §§611 et seq.; (g) A savings association or mutual savings bank; (h) A non-bank bank; (i) A holding company; (j) A regulated financial corporation; (k) A finance leasing company; or (l) A subsidiary or affiliate of any corporation or association described herein which derives more than 50 percent of its gross income from activities with financial institutions or from finance leasing.

TERM: BUSINESS OF A FINANCIAL INSTITUTION

A corporation is engaged in the "Business of a Financial Institution" if the corporation: (a) Conducts business activities, including finance leasing, that are substantially similar to the business which a corporation may be created to do under [state statutory citations]; or (b) Derives more than 50 percent of its gross income from lending activities (including discounting of obligations) in competition with regulated financial corporations. For the purpose of this subsection, the computation of the gross income of a corporation shall include transactions with affiliates but shall not include income from nonrecurring, extraordinary items. For the purpose of this subsection, a corporation is in competition with a regulated financial corporation if it makes loans that a regulated financial corporation is authorized to make, regardless of whether or not the terms and conditions of the transactions are similar. A corporation need not engage in all of the authorized activities of a regulated financial corporation to be in competition with a regulated financial corporation. It is sufficient if there is competition with some, but not all, phases of the business of regulated financial corporations; or (c) Receives more than 50 percent of its gross income from the sale of goods or services to a regulated financial corporation. For the purposes of this subsection, the corporation and the regulated financial corporation must be in the same unitary group and the goods or services must be provided exclusively for the benefit of the regulated financial corporation.

TERM: NON-BANK BANK

"Non-Bank Bank" means: (a) A corporation which either (i) accepts demand deposits; or (ii) engages in the business of making commercial loans, but does not qualify as a "bank" under 12 U.S.C. §1841(c); and (b) A consumer finance corporation.

TERM: HOLDING COMPANY

"Holding Company" means any corporation: (a) Subject to [state statutory citation regarding holding companies]; (b) Registered under the Federal Bank Holding Company Act of 1956, as amended; (c) Registered as a savings and loan holding company under the Federal National Housing Act, as amended; or (d) Who derives more than 50 percent of its total gross income from interest on loans to a subsidiary, as that term is defined in [cite section of this act].

TERM: REGULATED FINANCIAL CORPORATION

"Regulated Financial Corporation" means any institution the deposits or accounts of which are insured under the Federal Deposit Insurance Act; 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.

TERM: FINANCE LEASING COMPANY

"Finance Leasing Company" means a corporation, not affiliated with a financial institution, that derives more than 50 percent of its total gross income from leasing that is the functional equivalent of lending under financial accounting rules, provided that: (a) For this classification to change, there must be a shift in the predominant character of the gross income for two consecutive years and the average of the gross income in the current and the immediately preceding two years must fail, or satisfy, the predominance test; and (b) Substantial amounts of gross income from incidental or occasional sales shall be disregarded.

TERM: SUBSIDIARY

"Subsidiary" means a corporation whose voting stock is more than 50 percent owned, directly or indirectly, by a financial institution.

TERM: AFFILIATE

"Affiliate" means a corporation who is connected to another corporation through a common parent financial institution who owns or controls more than 80 percent of the voting stock, directly or indirectly, of both corporations.

SUMMARY

FINANCIAL INSTITUTION. The drafting team indicated a preference for utilizing the broadest, most inclusive approach possible in defining this term. Although members of the full SIFWG group had expressed a desire to not consider certain types of financial institutions (hereinafter "financials") at this time (i.e. consumer finance corporations, non-bank banks, etc.), Team 1 felt it prudent to make the initial definition as expansive as possible, thereby allowing more flexibility as the drafting process moves forward. The common denominator for inclusion of a financial in the definition was lending -- if the financial is engaged primarily in lending activities, then it should be included in the definition.

One concern expressed by the team was the creation of special problems for combined reporting states. For example, if a corporate group is predominately engaged in the business of a financial, but maintains affiliates that do not qualify as financials, would the entire group be subject to our proposed apportionment formula in a combined reporting state? Conversely, if the corporate group does not predominately engage in the business of a financial, are those affiliates that qualify as financials subject to the proposed formula? We attempted to address this concern by limiting the subsection definition of subsidiaries and affiliates to those who derive more than 50 percent of their total gross income from activities with a financial. This would exclude from the proposed formula those subsidiaries and affiliates who derive the majority of their gross income from activities with outside third parties. Affiliates that qualify as financials, but which belong to a "predominately non-financial group," however, would still be subject to the proposed formula.

This concern is also addressed through the definition of "Business of a Financial Institution." (See Attachment)

Finance leasing subsidiaries/affiliates and finance leasing companies were added to the definition. This was done on the recommendation by industry members that since all leasing by banks and affiliates is the functional equivalent of lending under regulatory and financial accounting, all leasing subsidiaries and affiliates of banks and other financials should be taxed under the same rules. In addition, any leasing company that is not affiliated with a financial but is substantially engaged in finance leasing should be treated in a like manner.

NON-BANK BANKS. Since a broad definition of financials was deemed appropriate and includes these entities, an additional definition for this term was required. The statutory citation 12 U.S.C. §1841(c) refers to the Douglas Amendment to the Bank Holding Company Act (BHCA), which defines a bank as a company that both (1) accepts demand deposits and (2) engages in making commercial loans. Therefore, an entity which engages in only one but not the other of these two activities, or which engages in both accepting demand deposits and making only consumer loans, is not a bank under the BHCA. The definition here attempts to reflect these provisions of the BHCA and also specifically includes consumer finance corporations since, arguably, they are not directly covered.

HOLDING COMPANY. This definition is fairly straightforward. It includes holding companies created under state BHC laws, the federal BHCA and savings and loan holding companies created under the Federal National Housing Act. Subsection (d) encompasses

what is commonly referred to as a "second tier holding company." For example, a BHC affiliate which is active in the commercial paper market making loans to non-bank banks would be a second tier holding company. Therefore, the definition was expanded to include those corporations which derive more than 50 percent of their gross income from interest on loans to a subsidiary. Team members expressed a concern that without the language of subsection (d), second tier holding companies would be excluded from the definition of a financial.

REGULATED FINANCIAL CORPORATION. This definition is a verbatim copy of the MTC regulation definition with one minor correction to delete the reference to the Federal Savings and Loan Insurance Corporation, as the FSLIC no longer exists. Team members felt this definition was adequate.

FINANCE LEASING COMPANY. As explained in the "Financial Institution" section above, this term was added to the definition, thereby creating an additional term for definition. The language used is a verbatim copy of California Reg. 23183(b).

SUBSIDIARY. This is a common definition found in most state statutes and was deemed adequate by the drafting team.

AFFILIATES. Although uncertain at first whether this term was necessary, the team determined that it should be included in the definition of a financial and then itself defined. State statutes vary as to the exact percentage of ownership required to constitute an affiliate. The 80 percent level was taken from the California definition of an affiliated group which treats these companies as sibling corporations.

MEMO

DATE: SEPTEMBER 1, 1992
TO: MARY JANE EGR, ATTORNEY
FROM: MIKE BOEKHAUS
SUBJECT: "BUSINESS OF A FINANCIAL INSTITUTION"

Just some quick explanations of the "business of a financial institution" definition.

I eliminated the phrase "corporation organized under the authority of the United States or organized under the laws of this state or any other state or country..." because I felt it was redundant. A state's general definition of a corporation should take these into account.

I also deleted "substantial competition" in favor of "competition." Here again I thought the phrase was not necessary. If a corporation is in competition with a regulated financial institution and derives over half of its gross revenues from those activities, then I would submit that the competition was substantial by definition. I don't think we need to get into a debate about what constitutes substantial competition.

I'm still not sure about the need for specifically including a reference to finance leasing. If finance leasing is an activity that a financial institution can engage in, then the definition should take that into account with all the other financial institution activities. Also, I'm concerned about the arguments that could be raised if one activity is specifically mentioned and others are not. Should we include a laundry list of financial institution activities as examples?

Finally, in the affiliate language in subsection (c) I included the requirement that the affiliate be in the same unitary group as the regulated financial institution. Its a concept we're all familiar with and would include affiliates. In fact it is a little broader. If anyone has a major problem with this, let me know.

That was quick and dirty, but we must meet our deadlines. Please call me if you have any questions.



MEMORANDUM

Federation of Tax Administrators • 444 North Capitol Street, N.W., Washington, D.C. 20001 • (202) 624-5890

MEMORANDUM

TO: Rod Felix
Michael Boekhaus
Fred Ferguson (Coordinator)
Alan Friedman (Coordinator) - via TaxExchange
Bob Heller
Phil Plant/Michael Folz
Don Adler/Bob Murphy
Michael Palko/Brad Ellison

FROM: Mary Jane Egr

DATE: August 25, 1992

SUBJECT: Drafting Team 1 -- State/Industry Financial Working Group (SIFWG)

I assume you all received Alan's memo of August 13 recapping our last conference call. Per his memo, we are to finish work on our definitions by September 1. Harley promised that we would have another draft out to you by Wednesday, August 26 -- and here it is. As you will recall, Harley and I took responsibility for all of our team's definitions, except for the term "business of a financial institution" which we graciously assigned to Mike Boekhaus *in absentia*.

I have tried to incorporate all your suggestions from the conference call, but obviously these definitions are still in need of refinement. Specifically, since we are including the phrase "non-bank bank" in the definition of a financial institution, I thought it prudent to define that phrase as well. I was not certain, however, whether a consumer finance corporation needs to be separately listed under this term or whether, assuming my definition is sufficient, it is subsumed by the definition. In addition, could non-bank banks be involved in consumer lending too, or just commercial lending? HELP!

In lieu of yet another conference call, I think it would be preferable to have you call me directly with your comments or fax them to me by close of business this Friday, August 28. If you feel a conference call is necessary, I will need to know by close of business Wednesday to allow sufficient time to set up the call for Friday.

I appreciate your assistance and patience.

TERM: FINANCIAL INSTITUTION

"Financial Institution" means every corporation or association organized under the laws of any state or country which is authorized to do, or which is doing the business of a financial institution, including; (a) 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.; (b) A federal savings and loan association; (c) A credit union; (d) 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; (e) An international bank agency; (f) An international banking facility, including an Edge Act corporation organized pursuant to the provisions of §25(a) of the Federal Reserve Act, 12 U.S.C. §§611 et seq.; (g) A savings association or mutual savings bank; (h) A non-bank bank; (i) A holding company; (j) A regulated financial corporation; or (k) A subsidiary or affiliates of any corporation or association described herein.

TERM: NON-BANK BANK

"Non-Bank Bank" means: (a) A corporation which either (i) accepts demand deposits; or (ii) engages in the business of making commercial loans, but does not qualify as a "bank" under 12 U.S.C. §1841(c); and (b) A consumer finance corporation.

TERM: HOLDING COMPANY

"Holding Company" means any corporation subject to [state statutory citation] 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, who derives more than 50 percent of its total gross income from interest on loans to a subsidiary, as that term is defined in [cite section of this act].

TERM: REGULATED FINANCIAL CORPORATION

"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.

TERM: SUBSIDIARY

"Subsidiary" means a corporation whose voting stock is more than 50 percent owned, directly or indirectly, by a financial institution.

TERM: AFFILIATES

"Affiliates" means corporations who are connected through a common parent financial institution who owns or controls more than 80 percent of the voting stock, directly or indirectly, of the affiliates.

MEMORANDUM

TO: Rod Felix
Michael Boekhaus
Fred Ferguson (Coordinator)
Alan Friedman (Coordinator) - via TaxExchange
Bob Heller
Phil Plant
Don Adler
Michael Palko

FROM: Harley Duncan
Mary Jane Egr

DATE: August 7, 1992

SUBJECT: Drafting Team 1 -- State/Industry Financial Working Group (SIFWG)

Greetings:

Well, Alan has beat us to the punch. We were about to send you all this fax today, when Alan's request came in for a conference call on the same day we were going to arrange one for our drafting team. Nevertheless, here is the compilation of various definitions for the terms our team has been assigned. Perhaps we could all remain on the line after the full conference call on Wednesday and discuss our definitions.

Thank you all for your responses to the June 15, 1992 memo requesting state and federal statutory definitions for these terms. Each term is printed in bold/underlined print, followed by several definitions from these various sources. We have used the Minnesota and New York definitions where available, since they arguably represent the "extremes." Also where available, we have included definitions from Florida and Washington, which could be considered more "neutral" states. We did not find definitions from these sources for the term "affiliate." Therefore, we have included the Black's Law Dictionary definition for now. The definitions used are printed verbatim. Words or phrases with brackets [] around them have been paraphrased. It would seem in most instances, that the MTC definitions are appropriate, perhaps with some slight modification.

Thank you again for your assistance. We look forward to talking with you on Wednesday.

TERM: FINANCIAL INSTITUTION

MTC

"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.

MINNESOTA

Identical to MTC.

FLORIDA

"Banking organization" means: (a) A bank organized and existing under the laws of any state; (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) An Edge Act corporation organized pursuant to the provisions of §25(a) of the Federal Reserve Act, 12 U.S.C. §§611 et seq.; (d) An international bank agency licensed pursuant to the laws of any state; (e) A federal agency licensed pursuant to §§4 and 5 of the International Banking Act of 1978; (f) A savings association organized and existing under the laws of any state; or (g) A federal association organized and existing pursuant to the provisions of the Home Owners' Loan Act of 1933, 12 U.S.C. §§1461 et seq.

WASHINGTON

"Bank"...means any corporation organized under the laws of this state engaged in banking, other than a trust company or a mutual savings bank.

"Commercial bank" shall include any bank other than one exclusively engaged in accepting deposits for savings accounts.

NEW YORK

"[A] banking corporation means: (1) Every corporation or association organized under the law of this state which is authorized to do a banking business, or which is doing a banking business; (2) every corporation or association organized under the laws of any state or country which is doing a banking business; (3) every national banking association organized under the authority of the United States which is doing a banking business; (4) every federal savings bank which is doing a banking business; (5) every federal savings and loan association which is doing a banking business; (6) a production credit association organized under the federal farm credit act of [1933], which is doing a banking business and all of whose stock held by the federal production credit corporation has been retired; (7) every other corporation or association organized under the authority of the United States which is doing a banking business; (8) [state specific provision]; (9) any corporation [65] percent or more of whose voting stock is owned or controlled, directly or indirectly, by a corporation or corporations subject to article [3A] of the banking law, or registered under the federal bank holding company act of [1956], as amended, or registered as a savings and loan holding company (but excluding a diversified savings and loan holding company) under the federal national housing act, as amended, or by a corporation or corporations described in any of the foregoing paragraphs of this subsection, provided the corporation whose voting stock is so owned or controlled is principally engaged in a business, regardless of where conducted, which (i) might be lawfully conducted by a corporation subject to article three of the banking law or by a national banking association or (ii) is so closely related to banking or managing or controlling banks as to be a proper incident thereto, as set forth in paragraph eight of subsection (c) of section four of the federal bank holding company act of [1956], as amended; and provided, further, that in no event shall a corporation principally engaged in a business described in section [183, 184

or 186] of this chapter be subject to the tax imposed under this article if any of its business receipts are from other than a corporation (A) which owns or controls, directly or indirectly, [65] percent or more of its voting stock, or (B) [65] percent or more of whose voting is owned or controlled, directly or indirectly, by the corporation engaged in such business, or (C) [65] percent or more of whose voting stock is owned or controlled, directly or indirectly, by the same interest.

FEDERAL 12 U.S.C. 1841§(c)(1)

....the term "bank" means any of the following: (A) An insured bank as defined in section 3(h) of the Federal Deposit Insurance Act [12 U.S.C.A. §1813(h)]; (B) An institution organized under the laws of the United States, any State of the United States, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands which both -- (i) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others and; (ii) is engaged in the business of making commercial loans.

TERM: BUSINESS OF A FINANCIAL INSTITUTION

MTC

....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 [state statutory citations] 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.

MINNESOTA

Substantially similar to MTC, except for finance leasing.

NEW YORK

The words "banking business" as used in this section mean such business as a corporation or association may be created to do under article [3, 3(b), 5, 5(a), 6, or 10] of the banking law or any business which a corporation or association is authorized by such article to do. However, with respect to a national banking association organized under the authority of the United States, a federal savings bank, a federal savings and loan association, the words "banking business" as used in this section mean such business as a national banking association, federal savings bank, federal savings and loan association or production credit association, respectively, may be created to do or is authorized to do under the laws of the United States or this state. The words "banking business" as used in this section shall also mean such business as any corporation or association organized under the authority of the United States or organized under the law of any other state or country has authority to do which is substantially similar to the business which a corporation or association may be created to do under article [3, 3(b), 5, 5(a), 6, or 10] of the banking law or any business which a corporation or association is authorized by such article to do.

TERM: HOLDING COMPANY

MTC

"Holding Company" means any corporation subject to [state statutory citation] 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.

MINNESTOA

Substantially similar to MTC.

NEW YORK

For purposes of this subsection, the term "bank holding company" means any corporation subject to article [3A] of the banking law, or registered under the federal bank holding company act of [1956], as amended, or registered as a savings and loan holding company (but excluding a diversified savings and loan holding company) under the federal national housing act, as amended....[Definition of "corporation"].

FEDERAL 12 U.S.C. §1841(a)(1) - (6) [ATTACHED]

TERM: SUBSIDIARY

MTC

"Subsidiary" means a corporation whose voting stock is more than 50% owned, directly or indirectly, by a financial institution.

NEW YORK

The term "subsidiary" means a corporation or association of which over fifty percent of the number of shares of stock entitling the holders thereof to vote for the election of directors or trustees is owned by the taxpayer.

FEDERAL 12 U.S.C. §1841(d)

"Subsidiary", with respect to a specified bank holding company, means (1) any company 23 per centum or more of whose voting shares (excluding shares owned by the United States or by any company wholly owned by the United States) is directly or indirectly owned or controlled by such bank holding company, or is held by it with power to vote; (2) any company the election of a majority of whose directors is controlled in any manner by such bank holding company; or (3) any company with respect to the management of policies of which such bank holding company has the power, directly or indirectly, to exercise a controlling influence, as determined by the Board, after notice and opportunity for hearing.

TERM: AFFILIATE

Signifies a condition of being united; being in close connection, allied, associated, or attached as a member or branch. *Affiliate Company*. Company effectively controlled by another company. Under Investment Company Act (15 U.S.C. §80a-2), company in which there is ownership (direct or indirect) of 5 percent or more of the voting stock. Corporations which are related as parent and subsidiary, characterized by identity of ownership of capital stock. See also *Holding Company*.

TERM: REGULATED FINANCIAL CORPORATION

MTC

"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.

MINNESOTA [Substantially similar to MTC]

"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 any State or any foreign country which is engaged in the business of receiving deposits, any corporation organized under the provisions 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.

Subchapter H—Banking Institutions

- Part I. Rules of general application to banking institutions.
Part II. Mutual savings banks, etc.

PART I—RULES OF GENERAL APPLICATION TO BANKING INSTITUTIONS

- Sec. 581. Definition of bank.
Sec. 582. Bad debts, losses, and gains with respect to securities held by financial institutions.
Sec. 584. Common trust funds.
Sec. 585. Reserves for losses on loans of banks.

[Sec. 581]

SEC. 581. DEFINITION OF BANK.

For purposes of sections 582 and 584, the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia) or of any State, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

Amendments

P.L. 94-455, § 1901(c)(5):

Substituted "or of any State" for ", of any State, or of any Territory" and struck out ", Territorial" in Code Sec. 581. Effective for taxable years beginning after December 31, 1976.

P.L. 87-722, § 5:

Amended Sec. 581 by substituting "authority of the Comptroller of the Currency" for "section 11(k) of the Federal Reserve Act (38 Stat. 262; 12 U. S. C. 248(k))". Effective 9-28-62.

TEAM 2. Definition of: Syndication, participation,
securitization, pass-through certificates

September 1, 1992

Mr. Alan Friedman
Multistate Tax Commission
386 University Avenue
Los Altos, CA. 94022

Dear Mr. Friedman:

Attached are the definitions for the terms State/Industry Financial Working Group Team #2 was assigned to define. Between Joe Taetle, Terry Baker, and myself, we felt it was necessary to define several additional terms to emphasize that securitization transactions may be treated as either sales or secured borrowings for Federal and state income tax purposes. Ed Campion, of the Franchise Tax Board, acknowledged the need to define these additional terms. Unless otherwise noted, the principal source of these definitions was a book authored by Andrea S. Kramer entitled Financial Products - Taxation, Regulation, and Design which was published in 1991. Two definitions are presented for the term syndication. The group felt the factor working groups could ultimately decide which definition best suits their needs.

If you have any questions or problems, please feel free to contact me.

Sincerely,


Robert M. Murphy
Staff Manager, Tax

Enclosures

cc: Donald N. Adler, Dean Witter
Joseph L. Taetle, Chase Manhattan Bank
Terry J. Baker, SunTrust Banks
Ed Campion, Franchise Tax Board
Marilyn N. Kaltenborn, NY Dept. of Taxation

Securitization - is the process whereby assets, such as loans with similar features, are combined into pools and used as collateral to form a new security, which may constitute debt or equity, that is underwritten and sold to investors.

Participation - undivided ownership interests on a pro rata basis in a single loan or a pool of loans and related collateral. In a loan participation, the credit originator initially makes the loan and then concurrently or subsequently resells all or a portion of it to other lenders. The participation may or may not be known to the borrower.

Syndication - where two or more financial institutions offer discrete portions of a total package of loans to a single borrower. The credit originator(s) and the ultimate lender(s) are the same entity(ies).

Syndication - is a participation, usually involving shares in a single loan, in which several participants agree to enter into an extension of credit under a bona fide binding agreement that provides that each participant shall fund and be at risk only up to a specified percentage of the total extension of credit or up to a specified dollar amount.*

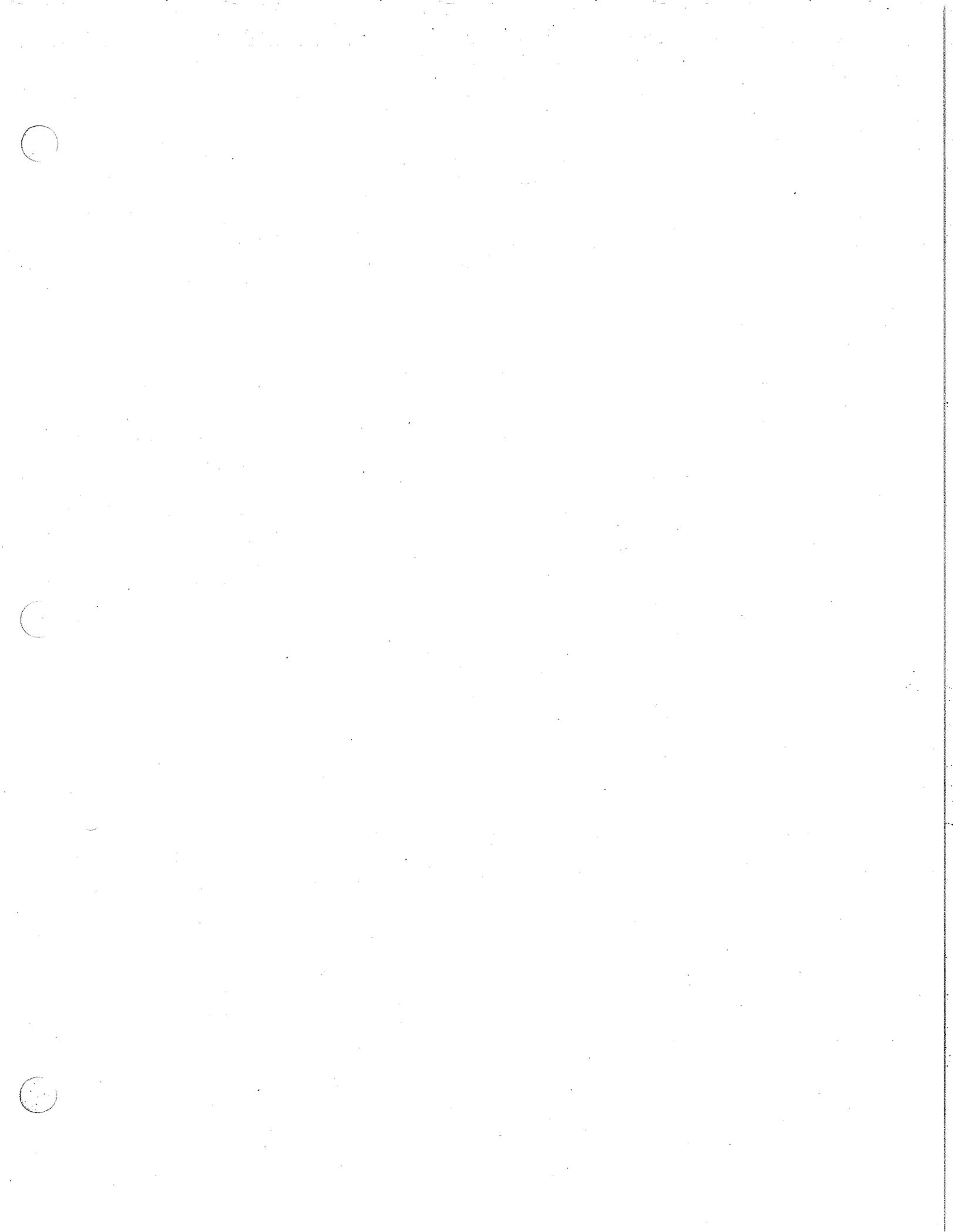
Pass-through Equity Certificates - represent fractional undivided ownership interests in a pool of identified assets maintained in a trust or custodial arrangement and held by a trustee or custodian for the benefit of the certificateholders. Cash flow from the pooled assets is distributed on a pro rata basis to the certificateholders.

Pass-through Debt Certificates - securities which are debt obligations of the originator of the securitization. The obligations are secured by a pool of assets, such as loans, which are transferred to a trust. The payment of interest and the repayment of principal to the certificateholders is supported by the cash flow from the underlying pool of assets.

Collateralized Mortgage Obligation (CMO) - A mortgage-backed bond on which principal is repaid periodically. CMOs generally consist of several tranches or classes with various classes receiving principal repayments in a prescribed order. Principal in the first class is retired before the mortgage amortization and prepayments are used to pay down the principal in the second class, and so on.**

* Federal Reserve instruction for preparing form FR Y-9C Consolidated Financial Statements for Bank Holding Companies

**"Banking Terminology" Third Edition - American Bankers Association



TEAM 3. Definition of: Finance lease, true or
operating lease



TEAM 4. Definition of: Merchant discount



Memorandum

To: Alan Friedman

From: Joseph Taetle

Date: August 17, 1992

Re: Merchant Discount

Attached is a proposed definition of merchant discount. It reflects the following considerations.

1. While more like a service fee (closer to factoring than lending), a specific rule siting the income in the state of the merchant has been adopted to follow the treatment in the proposed MTC regulations as well as long-standing rules in New York and California and more recent rules in Minnesota.
2. The definition is confined to the fee earned for services provided to the merchant (less chargebacks) by the merchant bank. Any issuers reimbursement fee earned by the cardholder's bank should be addressed under the rules for fee income earned by that bank. (See summary below).
3. Any attempt to localize the fee by the state of the underlying sale is complicated by extensive chargebacks for errors, returns and fraud. Moreover, existing bank systems do not capture such information on cumulative basis state-by-state for even a single merchant. (See summary below).
4. In choosing the situs of the merchant, please note that no invoice is generally submitted by the merchant (as provided under the current MTC draft). Rather, based on the charge slips accepted by the merchant, a deposit is recorded to a demand deposit account maintained by the merchant. The deposit may be net of the merchant discount or the fee may be debited at the end of the month. Assuming commercial domicile (as defined elsewhere) is a reasonable basis for sourcing interest from loans, it should be adopted as situs of the merchant for purposes of this definition.

In summary, a bank should not be required to capture information or to have its tax liability determined based on the activities of others beyond its control. Therefore, while it may be appropriate to report receipts from a contract with a merchant to the state of the merchant; a merchant bank or issuing bank should not be required to report receipts based on random card usage by a cardholder.

JT:llc

JT0333

Merchant Discount -- The fee (or negotiated discount) charged to a merchant by a financial institution for the privilege of participating in a program whereby a bank or other credit card, travel and entertainment card, or debit card is accepted in payment for merchandise or services sold to the cardholder.

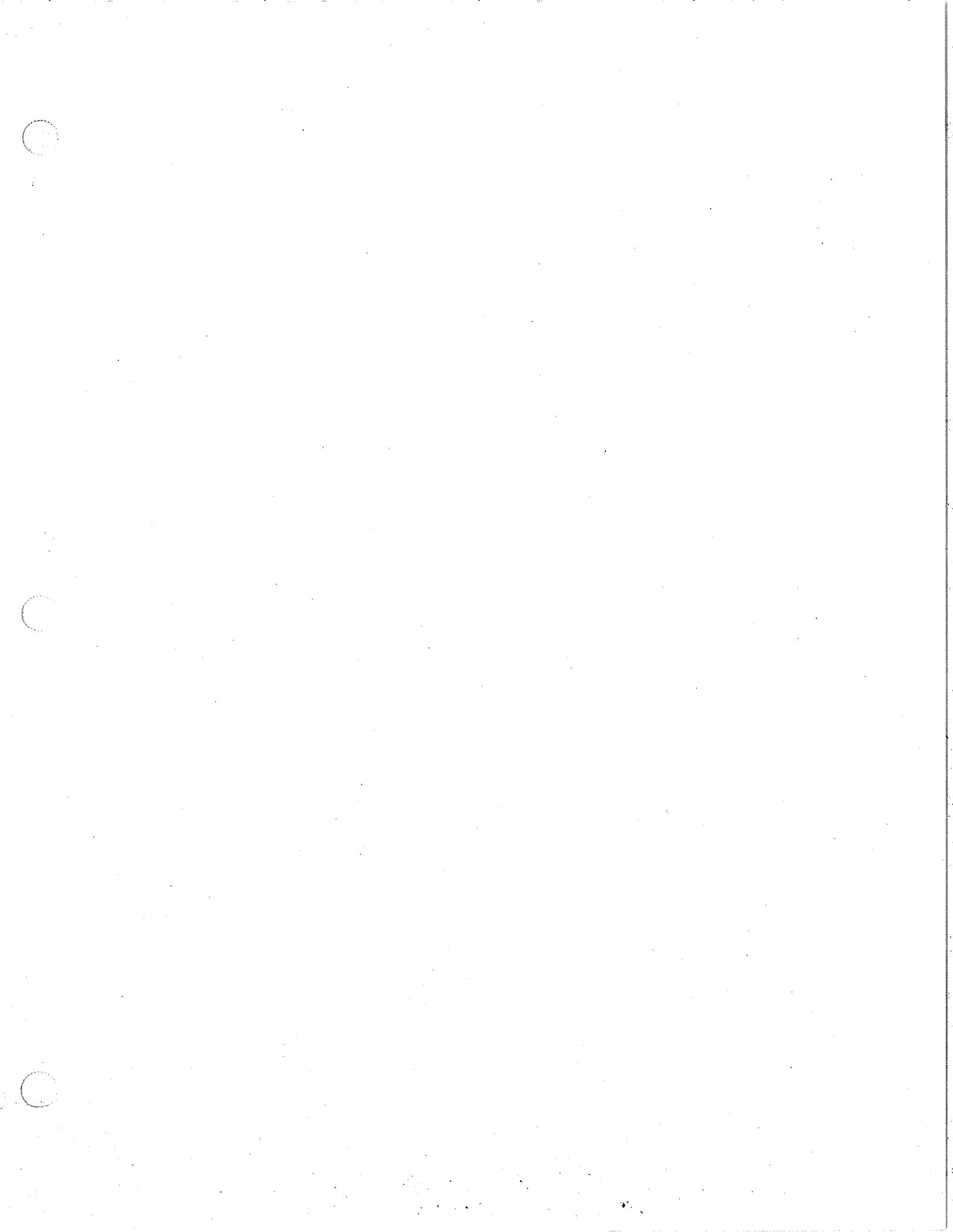
Such fee shall be computed net of any cardholder chargebacks, but shall not be reduced by any interchange transaction fee or by any issuers reimbursement fee paid to another financial institution for charges made by its cardholders.

[IV.18.(1)(D)(2) ... The numerator of the receipts factor shall include...]

(g) Merchant discount earned from cardholder transactions of merchants located in this state. A merchant shall be deemed to be located in the state in which it maintains its commercial domicile.

JT:llc

JT0334



TEAM 5. Definition of: Investment and trading

STATE OF CALIFORNIA
FRANCHISE TAX BOARD

Mailing Address:
Legal Division
P.O. Box 1468
Sacramento, CA 95812-1468
(916) 369-3323

August 24, 1992

In reply refer to
410:EJC:md:INVEST

Alan H. Friedman
General Counsel
Multistate Tax Commission
386 University Avenue
Los Altos, CA 94022

RE: Final Report of Drafting Team #5
("Investment and Trading")

Dear Alan:

The group co-leaders hereby transmit to you the following definitions of "investment" and "trading" in full satisfaction of our team assignment to define these terms. The remaining team members of John Malach (Illinois), Marilyn Kaltenborn (NY), Joe Taetle (Chase), and Don Adler (Dean Witter) were given the opportunity to review these proposals, and no comments were received.

TRADING, when applied to assets or accounts for purposes of determining the receipts factor of the apportionment formula, means activities involving or relating to the buying and selling, on a regular or frequent basis, of financial instruments and assets, in transactions with customers or other financial institutions. In general, a trading account is a segregated account in which assets are held for resale, and which is maintained in accordance with GAAP requirements. Trading assets are those assets held or required to be held in trading accounts in accordance with GAAP.

[This definition is derived from the Federal Reserve Board definition of trading account for purposes of Call reports. The financial accounting rules, as applied by the SEC, generally require the identification of trading assets and their inclusion in a trading account.]

INVESTMENT, when applied to assets or accounts for purposes of determining the receipts factor of the

Team #5
August 24, 1992
Page 2

apportionment formula, means financial instruments and assets, including securities, which are intended to be held for long-term periods or until maturity. Such assets do not include loans or other extensions of credit to customers made in the ordinary course of business of the financial institution.

Marilyn made the point during our August 12th telephone conference call, and we concur, that all we can hope for at this point is to draft a rough conceptual definition which can be "fine tuned" by the factor drafting teams.

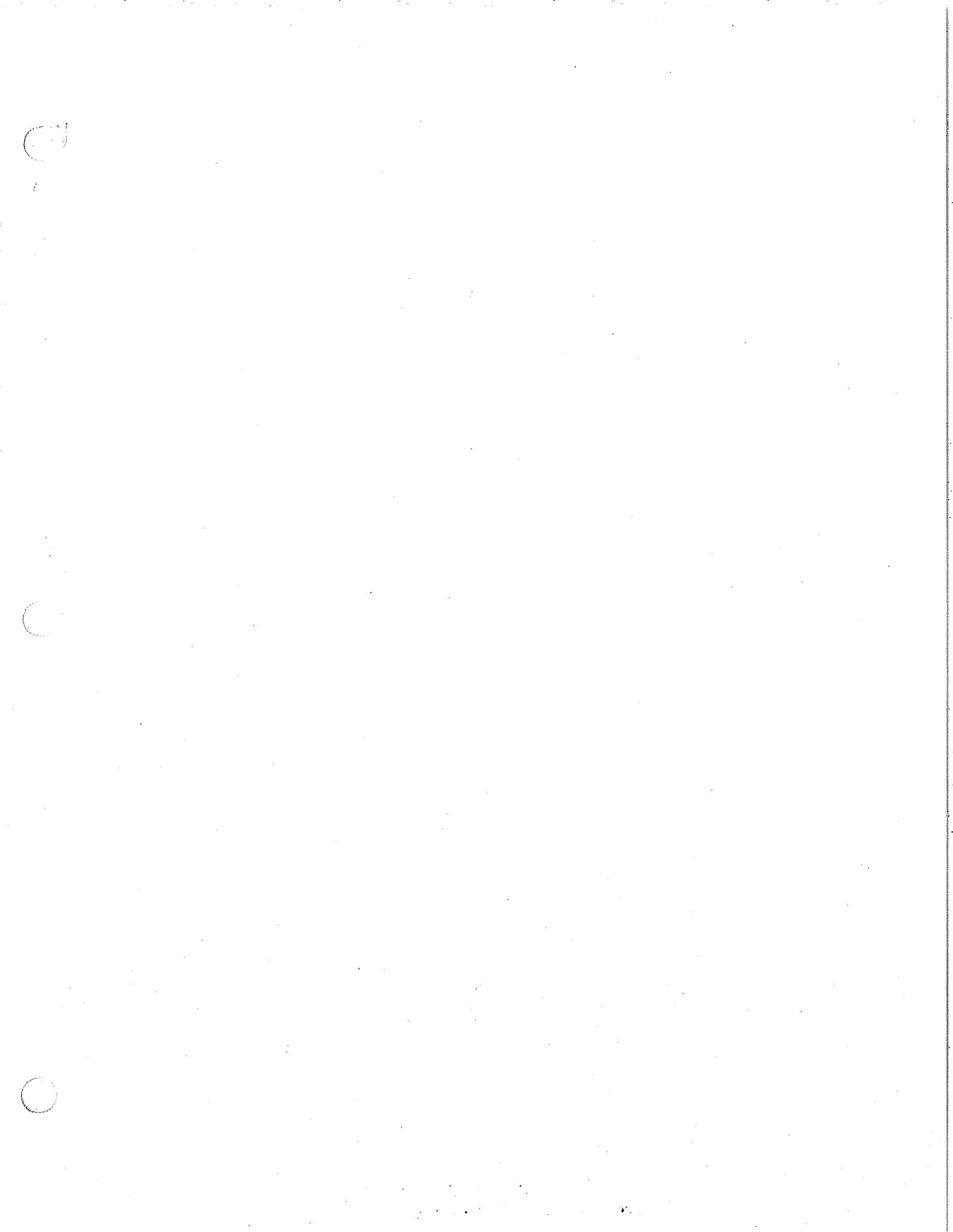
Please call if you have questions.

Very truly yours,

Eric J. Coffill + (for vacationing co-leader Hankell)

Eric J. Coffill
Supervising Counsel

cc: All Team Members
Fred Ferguson



TEAM 6. Definition of: Commercial domicile, branch,
billing address

State/Industry Financial Working Group

To: Jonathan R. Robin
Anne Dougherty
H.Duncan/Mary J.Egr
Haskell Edelstein
Alan H. Friedman
Fred Furguson

From: Brent Andersen

Re: Issue # 6

Date: 8/26/92

Enclosed are the issue # 6 definitions modified to reflect the comments on our conference call. Please let me know if you have any additional comments. My number is 704-386-1872.

Commercial domicile

Commercial domicile is the principal place of a trade or business, where that business is headquartered and from where it is managed and directed.

Branch

Any place of business of a bank which regularly engages in activities relating to the conduct of the banking business including, but not limited to, accepting deposits, making loans, or providing other services to customers.

Billing address

The location indicated in the books and records of the customer and the bank as the address where any statements and bills relating to customer's account are to be mailed.

Note: Also attached is a definition of branch used by New York City.

- (2) occasionally acquiring title to property located in New York City through the foreclosure of a security interest without otherwise doing business; or
- (3) the mere holding of meetings of the board of directors in New York City.

Section 1-2.8 Definition of bona fide office. (a) A "bona fide office" is an office at which the taxpayer is carrying on its business in a regular and systematic manner and which is continuously maintained, occupied and used by one or more employees of the taxpayer. For a taxpayer to be carrying on its business in a regular and systematic manner, its business must be conducted through its own employees who are regularly in attendance at such office during normal business hours. The occasional consummation of a transaction does not constitute the carrying on of a business in a regular and systematic manner.

(b) In determining whether the taxpayer has a bona fide office, consideration is given to such things as:

- (1) the nature and location of the business;
- (2) the nature of the activity engaged in at each location; and
- (3) the regularity, continuity and permanency of the activity at each location.

Section 1-2.9 Definition of branch. (a) A "branch" is a bona fide office, as defined in section 1-2.8 of this Subpart, which is used by the taxpayer on a regular and systematic basis to:

- (1) approve loans (regardless of whether the approval of certain classes of loans, such as loans over a set dollar amount, requires review for final approval or final approval by another office of the taxpayer);
 - (2) accept loan repayments;
 - (3) disburse funds; and
 - (4) conduct one or more of the other functions of a banking business, such as:
 - (i) paying withdrawals;
 - (ii) cashing checks, drafts and other similar items;
 - (iii) accepting deposits;
 - (iv) issuing cashier's checks, treasurer's checks, money orders or other similar items;
 - (v) buying, selling, paying or collecting bills of exchange;
 - (vi) issuing letters of credit;
 - (vii) receiving money for transmission or transmitting the same by draft, check, cable or otherwise; or
 - (viii) exercising fiduciary powers.
- (b) The following do not constitute a branch:
- (1) a loan production office;
 - (2) a representative office;
 - (3) a public accommodation office;

- (4) an automated teller machine or point-of-sale terminal;
- (5) a bona fide office, all of whose loans, pursuant to the taxpayer's business policies or practices, require on a regular and systematic basis review for final approval or final approval by another office or all of whose loans in fact receive on a regular and systematic basis review for final approval or final approval by another office;
- (6) an office or any other facility of an agent or correspondent of the taxpayer; or
- (7) any combination of the foregoing.

(c) For purposes of this section, "approval" shall mean "final approval" and "final approval" shall have the same meaning as set forth in paragraph (4) of subdivision (d) of section 4-6.2 of these regulations.

(d) Example: In 1982, a New York City office of a German bank was established. The New York City office does not have authority to give final approval to loans over \$50 million. Prior to 1985 and in 1986, the New York City office was involved with loans of less than \$50 million as well as loans in excess of \$50 million and gave final approval to those loans of less than \$50 million. In 1985, the New York City office did not give final approval to any loans since it was only involved with loans in excess of \$50 million. The New York City office has accepted loan repayments, disbursed funds and conducted one or more of the other functions of a banking business since it was established. The New York City office is a branch because it has been used on a regular and systematic basis to conduct all the functions required to qualify as a branch even though it did not approve any loans in 1985.

Section 1-2.10 Definition of place of business. (a) The term "place of business" means a bona fide office or branch of the taxpayer the income from which is required to be included in the computation of the taxpayer's alternative entire net income. For example, a banking corporation organized under the laws of Great Britain has a branch in London and a branch in New York City. None of the income or expenses of the London branch are included in the computation of the taxpayer's alternative entire net income. Therefore, the London branch is not a place of business of the taxpayer.

Section 1-2.11 Definition of a loan production office. (a) A loan production office is an office whose activities are limited to:

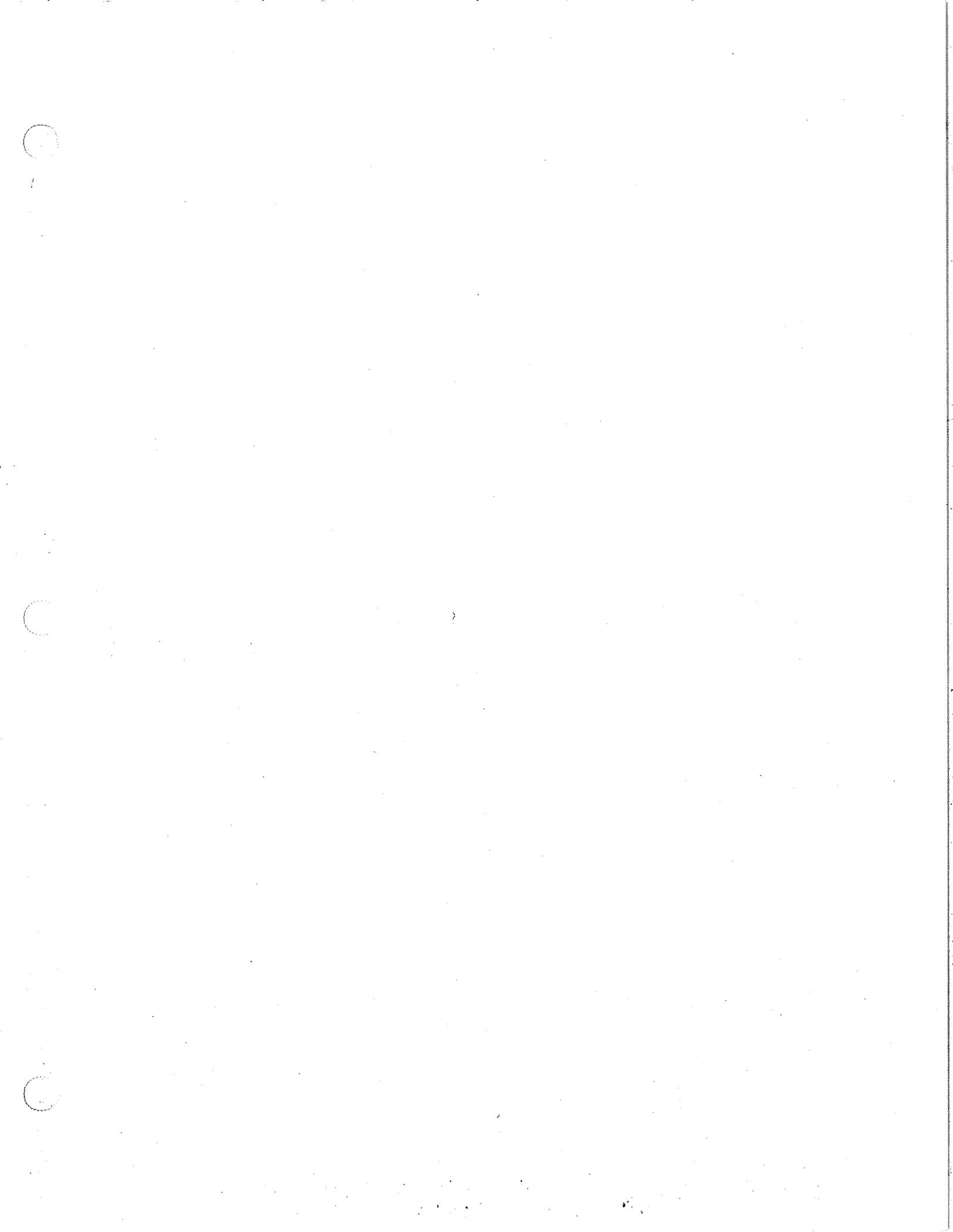
- (1) soliciting loans on behalf of the bank, and in connection with such solicitation --
 - (i) assembling credit information;
 - (ii) making property inspections and appraisals;
 - (iii) securing title information; and
 - (iv) preparing applications for such loans (including making recommendations with respect to action thereon);
- (2) soliciting investors to purchase loans from the bank;
- (3) searching for investors to contract with the bank for the servicing of such loans; and
- (4) engaging in other similar agent-type activities.

(b) An office which accepts deposits, accepts loan repayments, approves loans or disburses funds is not a loan production office.



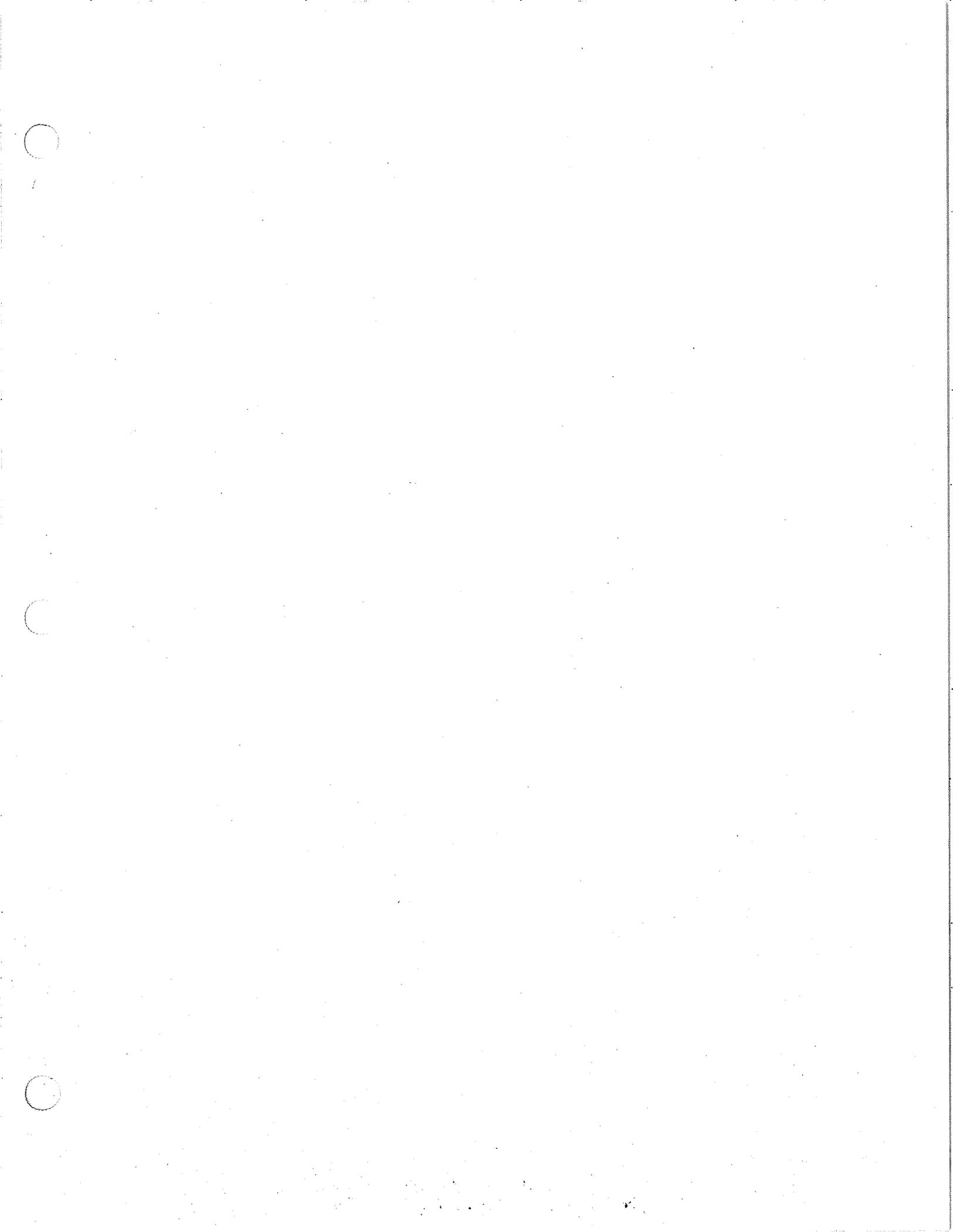
TEAM 7. Definition of: Deposits

[See definition of "deposit" contained in draft under TEAM 17]



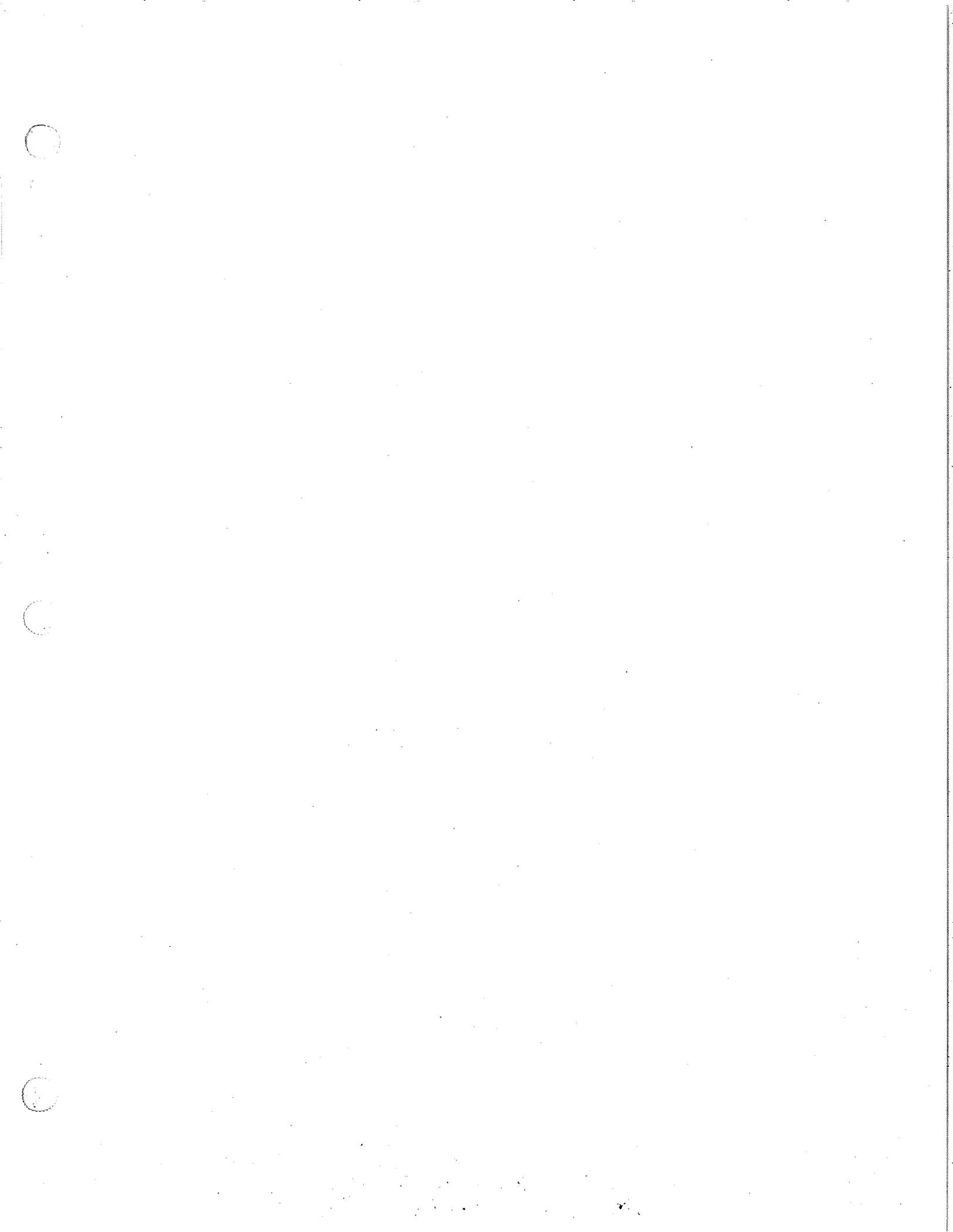
TEAM 8. Definition of: Holding company, subsidiary,
affiliate

[see report of TEAM 1 for these definitions]



TEAM 9. Definition of: Regulated financial corporation

[see report of TEAM 1 for this definition]



TEAM 10. Definition of: Resides/resident/residence



Bank of America

To Alan Friedman	From Michael J. Folz
Co.	Co. Bank of America
Dept.	Phone # 415 622-7258
Fax # 941-0557	Fax # 624-0709

Financial Controller's Division
General Tax Counsel #3245
September 1, 1992

MEMORANDUM

TO: Alan Friedman
Fred Ferguson
Co-Conveners
State/Industry Financial Working Group

FROM: Michael J. Folz

ISC: Confidential

RE: SIFWG Definition of Residence

With the agreement of co-chairs Stanley Arnold and Maurice Gilbert of the New Hampshire Department of Revenue, Phil Plant and I send you the definition of residence drafted by our subcommittee, accompanied by explanatory notes.

Definition

"Resides/Residence/Resident." For purposes of inclusion in the apportionment factors, a person shall be considered to reside or make his or her residence in or be a resident of a state during such period of time while a statement of account is mailed to an address in that state. For purposes of this regulation, corporations and partnerships shall be treated as residents of their states of commercial domicile.

Explanatory Notes

1. Residence of an individual is conclusively presumed to be the billing address. The MTC draft definition, which allows rebuttal of that presumption, would entail higher costs and uncertainties of compliance, but without materially affecting tax revenues given the low dollar amount of individual loans.
2. If the billing address changes during the year, figures from the bills sent to the new address would thenceforth generally be attributed to the new state of residence. A taxpayer on the accrual method of accounting would accrue receipts upon billing. This rule is consistent with billing

systems that keep totals on a month-by-month basis, and accordingly is easier to administer than the traditional 183-day presence test for residence.

3. This definition does not determine taxability, but rather what number should be included for apportionment purposes. Since apportionment is an approximation of activity in a state and these figures will not drastically impact on the apportionment percentage, the goal should be ease of compliance.

Michael J. Folz
Michael J. Folz
Tax Counsel
BA-net 622-7258

cc: Harley Duncan, Federation of Tax Administrators
Haskell Edelstein, Citibank
Maurice Gilbert, New Hampshire Department of Revenue
Philip M. Plant

MJF4:RESMTC4.MJF:ccg



Stanley R. Arnold
Commissioner

State of New Hampshire
Department of Revenue Administration
51 South Spring Street, P.O. Box 457
Concord, N.H. 03302-0457

July 15, 1992

Dan Bucks
MULTISTATE TAX COMMISSION
Suite 425, 444 N. Capitol St., N.W.
Washington, DC 20001

Subject: Taxation of Banks working group.

Dear Dan;

Attached is the definition of "Resides/Residence/Resident" that our small group developed. We started with the original definition by MTC and made our changes to that proposal. Below is the original definition with the shaded areas showing the words removed and the one word added-deemed-is underlined.

"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 deemed presumed, subject to rebuttal,~~ deemed to reside at (i.e., be a resident of, make his residence at) the address to which the statement of account is regularly mailed.

The second of the highlighted areas "... presumed, subject to rebuttal..." was removed at the suggestion of the Phil Plant. He felt that it added a degree of uncertainty that was not necessary for apportionment purposes. I have discussed this with Maurice Gilbert and we both agree that it is a valid argument. This definition does not determine taxability, but rather how apportionment numbers are arrived at. I believe everyone can agree that apportionment is never going to be an exact science. I can not see how any financial institution could use this for tax planning purposes to significantly impact an apportionment factor. In the final analysis, if at a future date we find that someone has managed to work this to their advantage, I suspect that the majority would agree to changing the rule. I talked to Mary Jane Egr and explained my reasoning and she agreed that we should go ahead and float this for comment whenever you and Alan feel we should.

I recommend removing the phrase "... a partnership or a corporation..." because it has no real meaning in the context of where they shall be deemed to reside. The preceding sentence says that they "...shall be treated as residents of their states of commercial domicile." Commercial domicile is the subject of another study group. If you have any questions or comments I will be away from 7/16 to 7/26 but feel free to contact Maurice.

Sincerely,

Stan
Stanley R. Arnold,
Commissioner

cc: Maurice Gilbert

RECEIVED

JUL 24 1992

Tel. (603) 271-2191
TTY/TDD 225-4033

MTC / DC

TEAM 11. Definition of: Taxable in a state (for
throwback)



TEAM 12. Definition of: Receipts (net or gross issues)



STATE OF TENNESSEE
DEPARTMENT OF REVENUE
ANDREW JACKSON STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37242

MEMORANDUM

TO: Members of S/IFWG, Subcommittee Team 12

FROM: Anne H. Dougherty, Assistant General Counsel *AAD*

RE: Minutes of Telephone Conference on August 26, 1992

DATE: August 27, 1992

A telephone conference was held between the members of Team 12 including Anne Dougherty, Brad Ellison sitting in for Michael Palko, Rod Felix, Bill Lunka, and Philip Plant with Michael Folz joining. Eric Coffill was unable to join the group. The assignment of this team is to define the term "receipts" as used in calculating the receipts factor of the apportionment formula applicable to financial institutions. In so doing, the emphasis is on issues generated by defining the term as either gross income or net income.

Traditionally, states, particularly those adopting the Uniform Division of Income for Tax Purposes Act, base the formula calculations on gross receipts with special provision for circumstances where the inclusion of gross income creates a distortion within the formula in which case only net gain is included. The exception addresses primarily the recognition of income from the occasional or incidental sale of fixed assets, such as a factory or plant, in the regular course of business.

The members of the subcommittee discuss the various special circumstances under which financial institutions may earn income that justifies a departure from the traditional definition of receipts as gross income. For example, in broad parameters, receipts from transactions which are conducted with frequency and involve large transfers of money but result only in modest returns when compared with the gross receipts generated should be reflected in the formula as net gain. Other areas of concern involve the treatment of receipts from foreign currency trading activities, sales of loans in the secondary market, money market transactions, and sales governed by Section 1286 of the Internal Revenue Code. Those members representing the industry have undertaken the task of further refining this class of

Members of S/IFWG, Subcommittee Team 12
Page 2
August 27, 1992

transactions. However, in general, the members recognize that receipts generated by ongoing operations such as the recognition of interest from outstanding loans or fees for services rendered should be reflected at gross in the formula.

Any definition of receipts in the context discussed above is dependent first upon whether the receipts reflected in the apportionment formula are based upon books and records or tax financial information, and, secondly, upon the types of receipts which will comprise the formula as developed by the receipts factor subcommittee. In recognition of this interrelationship, then, the conclusions of Team 12 are represented in a general statement of purpose subject to refinement as the other committee efforts develop.

Accordingly, it is the subcommittee's recommendation that the term "receipts" be defined as all gross income, including net taxable gain on the disposition of assets such as securities, loans, money market transactions, and personal and real property, when derived from transactions and activities in the regular course of business.

AHD:kro

9/1/92 - Suggested amendment to definition of the term "receipts" as set out above per memorandum from Michael Folz dated 8/28/92.

The term "receipts" is defined as all gross income, including net taxable gain on the disposition of assets such as securities, loans, money market transactions, foreign currency tradings, and personal and real property, when derived from transactions and activities in the regular course of business.



STATE OF TENNESSEE
DEPARTMENT OF REVENUE
ANDREW JACKSON STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37242

MEMORANDUM

TO: Members of S/IFWG, Subcommittee Team 12
FROM: Anne H. Dougherty, Assistant General Counsel *AHD*
RE: Addition to Committee Recommendations
DATE: August 31, 1992

Attached please find a copy of a memorandum forwarded by Michael Folz requesting that the definition of "receipts" specifically include the net taxable gain from foreign currency transactions. He also suggests that we earmark clearing house transactions as an area of concern and raises questions about the manner in which such transactions will be netted for state tax purposes. If there are no objections, I would suggest revising the definition of "receipts" as outlined in my memorandum dated August 27, 1992 to include the net taxable gain on foreign currency transactions. In addition, Michael's memorandum should be attached to the minutes of the August 26 meeting when forwarded to Alan Friedman in order to keep these areas of concern in everyone's mind as the factors of the formula are drafted.

Please let me know if you have any comments.

AHD:kro



Bank of America

Telecopy Transmittal

Bank of America NT&SA
General Tax Counsel #3245
799 Market Street, 6th Floor
San Francisco, CA 94103
P.O. Box 37000, San Francisco, CA 94137

FAX Machine (415) 624-0709

DATE: August 28, 1992 TIME: 11:20

TO: Anne Dougherty
Tennessee Department of Revenue
(615) 741-2348 FAX 741-0682

cc: Brad Ellison
Great Western Bank (818) 349-1467

Philip M. Plant

Telecopier No:

FROM: Michael J. Foltz
Tax Counsel
(415) 622-7258

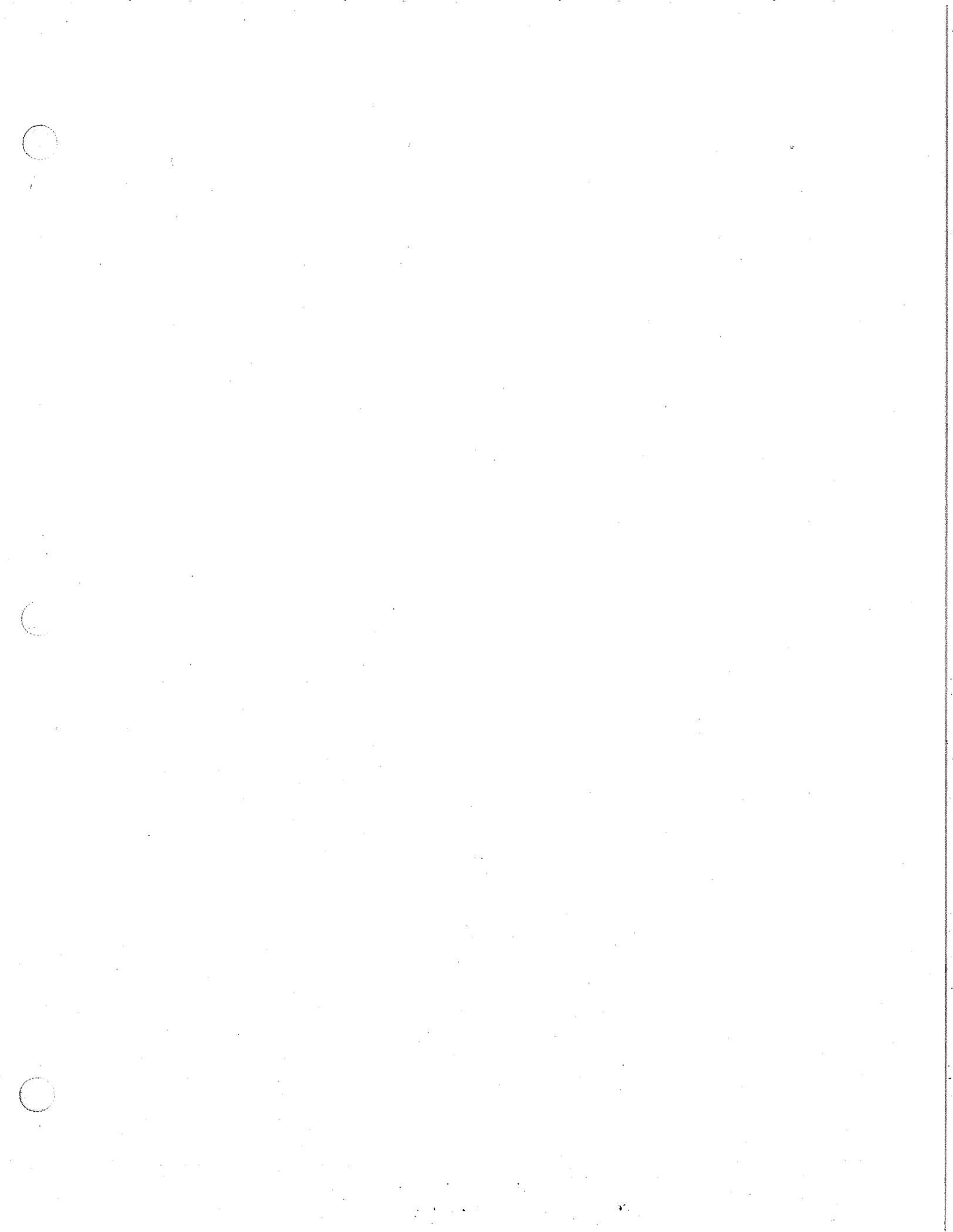
Number of Pages 1 (Including cover sheet)

Comments: We agree with your statement, in the Minutes, of broad parameters -- frequent, large volume transactions that generate modest returns -- that call for inclusion only of net gains in the receipts factor. We suggest that foreign currency trading falls precisely within these parameters, and accordingly should be specifically mentioned in the Committee's recommendation. Clearing-house transactions also come under these parameters, and so should be noted as an area of concern. A related technical issue, arising not only in clearing-house transactions but in many other types of transactions as well, is the manner of netting: by individual account, by type of asset, or by generic category. While we cannot expect to resolve that issue now, we should note it as another area of concern, to be addressed administratively.

Michael Foltz

Sent by: Carmen Cortez-Colez
(415) 622-4703

*Called
8-28-92
2:53*



TEAMS 13. and 14. Definitions of:

Money market instruments
and Securities

State/Industry Financial Working Group

To: John Malach
Marilyn N. Kalterborn
Bob Heller
Joseph L. Taetle
Alan H. Friedman
Fred Furguson

From: Brent Andersen

Re: Issues # 13 & 14

Date: 8/26/92

Enclosed are the issues # 13 & 14 definitions modified to reflect the comments on our conference call. Please let me know if you have any additional comments. My number is 704-386-1872.

Money market instruments

Short term instruments such as time deposits, commercial paper, banker's acceptances, federal funds sold, securities purchased under agreements to resell, and similar instruments.

Securities

a. Investment securities: securities acquired and held for the principal purpose of realizing investment income in the form of interest and gain from appreciation. Generally investment securities are held for a period in excess of one year or though maturity, if the maturity is less than one year. Investment securities are carried in an account designated for investment securities.

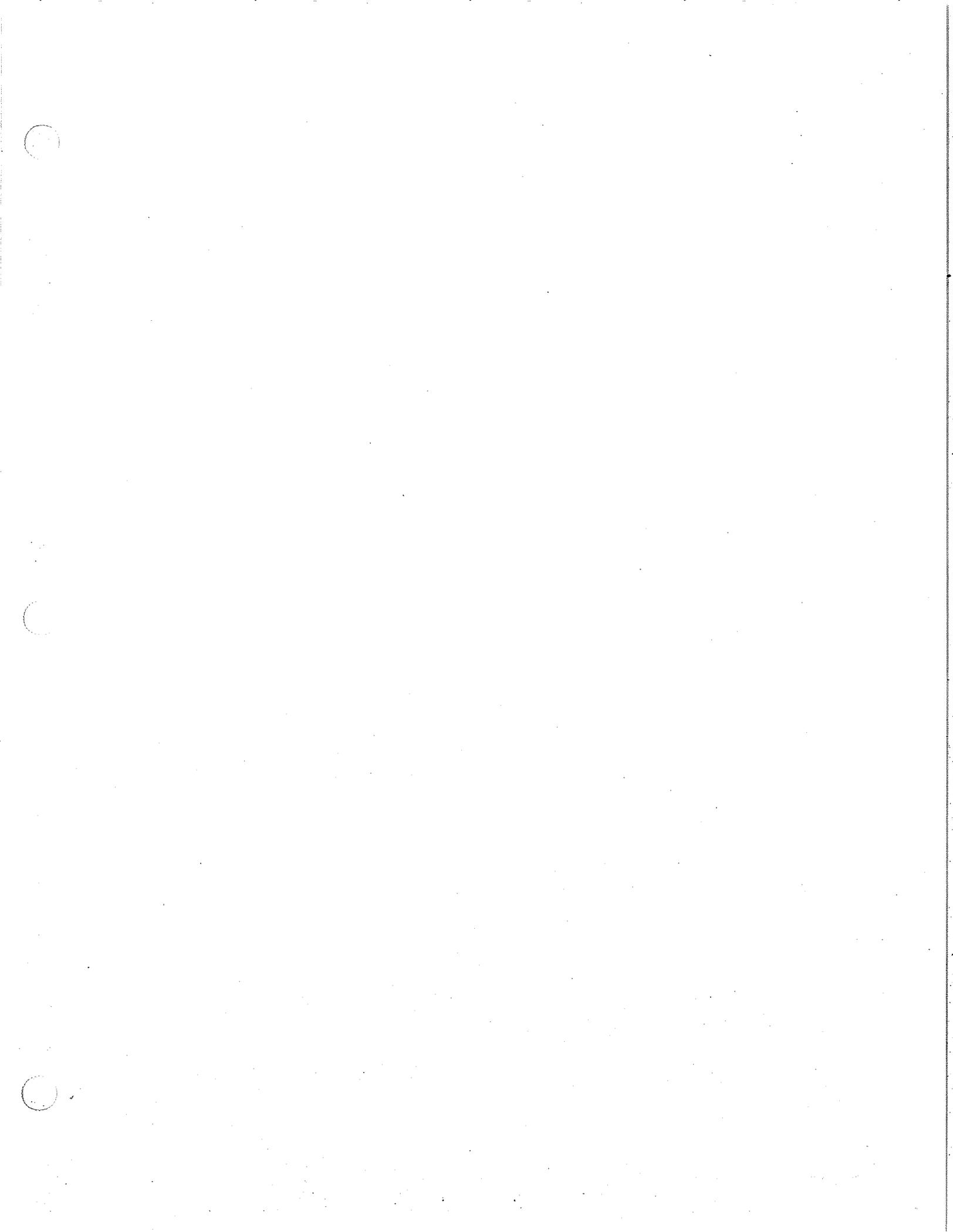
b. Trading securities: securities acquired and held for the principal purpose of short term speculation where profits are derived from short term swings in the market place. Generally the holding period of trading securities is less than 60 days. Trading securities are carried in an account designated for trading securities.

c. Dealer securities: securities acquired and held for sale to customers in the ordinary course of business with the intent to earn profits from mark-ups and commissions from sales.

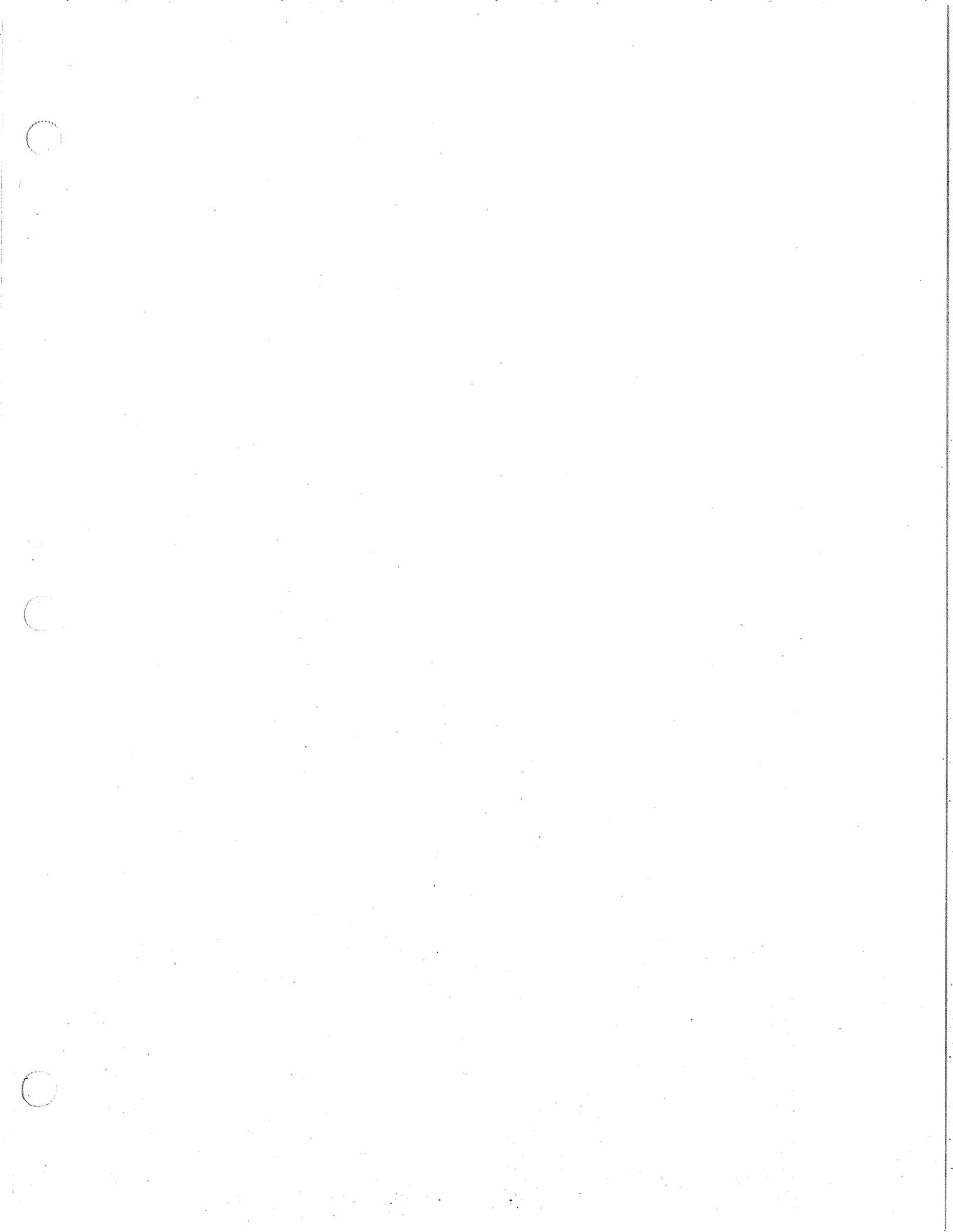
Note: Team # 14 decided to separately define the three categories of securities in the event different tax treatment is used for any of the above. The team also excluded from the definition of securities notional principal contracts but believes that this issue should be examined by the team(s) working on apportionment.



TEAM 15. Drafting of Payroll Factor



TEAM 20. Combination/consolidation reporting issues



TEAM 21. Book vs. tax basis reporting

TO: S/IFWG Issue 21 - Book vs. Tax Basis File
FROM: Jonathan W. Allen NC 31039
DATE: August 11, 1992
RE: Telephone Conference of August 11, 1992 Minutes

Committee members participating were Anne Dougherty (TN), John Malach (IL), Jonathan Robin (NYC), Jonathan Allen (NC-Wachovia) and Brad Ellison substituting for Michael Palko (US Savings League). Ted Thau of NYC also participated.

Allen began the discussion by stating a preference for use of book numbers in apportionment factors as a means of reducing complexity and cost to financial institutions and also expressed a view that it should make state audits easier. Robin stated that the distortion of using book numbers against a tax base defined by federal rules or a particular state's rules would provide better consistency. Robin also raised the issue of transition from NYC's current use of tax numbers. Malach, who joined the conference late, appeared willing to consider both methods. With the positions staked out, the debates began.

Both Robin and Dougherty had discussed with their respective audit divisions the use of book numbers versus tax numbers. The audit divisions of the two states leaned toward using tax numbers because of their use in the past and its consistency of being used as a factor for a base defined by tax numbers. Thau raised the issue of different accounting rules applicable to alien banks and asked the industry representatives to determine the significance of the variance in financial accounting rules for foreign vs. U.S. banks. Thau also raised the issue of having tax numbers used as a smell test by states processing multistate returns for determination of the reasonableness of apportionment factors; i.e., the determination of a tax based denominator from federal returns. Ellison said a book based factor could pass a smell test if financial statements were attached to the return. There was some discussion of consolidated financial statements vs. separate company financial statements.

A general discussion by Ellison and Allen followed on the complexities of tracing certain timing differences to a particular state under sourcing rules. It was mentioned that financial institutions applications systems (mainframe systems) were geared more to reporting financial amounts and that the tax departments normally made an adjustment to the tax base for a lump sum of the timing differences and to trace timing differences into state numerators would be burdensome although there were certain items of timing differences such as leasing that probably could be traced to a numerator.

Robin and Thau raised the issue of constitutionality of using book numbers citing a 1926 case involving a cement company. Dougherty did not seem to be terribly concerned about the constitutional issue. Their concern was a taxpayer contesting the use of book numbers as not being representative for apportioning the tax base. Allen and Ellison

said that, in the case of domestic companies, the book tax difference on timing items for receipts would normally be 1% or less for the majority of taxpayers. Robin asked Allen if it was a consensus among the financial institutions to use book numbers for apportionment. Allen said he had not sampled other industry participants or non participants on the issue but was merely focusing on the overall goal of holding down administrative costs, reducing audit complexity and keeping to a fairly simple consistent system.

The issue of gross vs. net was discussed. Ellison mentioned the situation where a financial institution was heavily involved in repo and reverse repo transactions that could artificially blow up a receipts factor. No conclusion was reached on the gross vs. net issue.

Allen suggested two alternatives to pure use of book numbers or tax numbers. The first was to take all timing differences and assign them to the numerator of a particular state such as the domiciliary state. Dougherty was opposed to this. Robin felt the constitutional issue could also be present from this approach. Allen's second alternative was to adopt a diminimus rule, i.e., use book numbers if the difference between the book numbers and the tax numbers was diminimus. However, if they were more than diminimus, use of tax numbers would be required. This proposal was received reasonably well. However, Dougherty said a definition of diminimus was needed and it probably should be a fixed percentage of something. Ellison agreed that it should be a clear cut rule so financial institutions would have certainty on their right to use book numbers or when tax numbers would be required.

Robin and Thau raised the issue of the effect of federal audit adjustments to the tax base that would also affect apportionment factors. Allen said he saw no problem in not adjusting apportionment factors if book numbers were used in that the acceleration of income, would affect the tax base but not the numerators or denominators for the audit years but would ultimately, affect the factors in later years even though the income would not be in the base. Allen also alluded to the difficulty of sourcing IRS adjustments that would affect apportionment factors.

With this smooth start, the subcommittee adjourned as some needed to attend other phone conferences.


JWA

JWA:jmr

a:\21-sifwg.jwa

S/IFWG
ISSUE 21
BOOK VS. TAX BASIS

JONATHAN W. ALLEN
INDUSTRY CO LEADER
JUNE 30, 1992

The objective of this paper is to provide a background for deciding whether the amounts used in apportionment factors are based on the amounts recorded in the financial institutions' books or the amounts reportable in a federal or state income tax return. The paper will identify some (but not all) book/tax differences, discuss the differences and complexities of using book or tax amounts.

Any recommendation of book amounts vs. tax amounts should consider:

1. Ease of state/city auditing
2. Record keeping burdens on industry
3. Industry startup costs for record systems
4. Impact on apportionment factors

Differences on book and tax amounts exist primarily due to differences in GAAP/RAP and federal and state income tax laws. A financial institution's audited financial statement may be certified as being prepared according to GAAP; however, certain non material items of income, expense or balance sheet items may not conform to GAAP or to tax accounting. Additionally, there may be federal and state differences due to a state not adopting

all of the provisions of the Internal Revenue Code (IRC) or having a definition of taxable income not based on the IRC. Differences can also arise through settlement of federal income tax examinations. It should also be noted that an item treated the same for book and tax purposes today may be different tomorrow due to changes to accounting principals, federal legislation, positions of IRS examiners, evolution of financial institutions' products and court decisions. Finally, there may be differences in tax reporting among financial institutions for the same item.

The choice of book or tax amounts will affect receipts, tangible and intangible assets and, in limited instances, liabilities.

The options are:

1. Use financial book amounts
2. Use federal tax amounts
3. Taxpayer choice (probably should be a one time election)
4. Combination of book and tax amounts

Some states currently tax capital rather than income. Others tax both. Additionally, some provide minimums of tax based on assets or deposits. The existing various schemes of taxing financial institutions may be a consideration in the choice of using book or tax amounts.

The following items and explanation of the book/tax difference is illustrative:

Interest Income from Loans

Current bank regulatory guidelines (Office of the Comptroller of the Currency [OCC], Federal Reserve Bank [FRB], Federal Deposit Insurance Corporation [FDIC], and state bank regulators [SBR]) require an accrual basis financial institution to stop accruing interest income after a loan becomes delinquent unless the loan is well secured and in the process of collection. The period of delinquency varies depending on the type of loan. A loan placed in nonaccrual status is effectively on a cash basis for GAAP/RAP.

The Internal Revenue Service may or may not accept the cash basis accounting for some nonaccrual loans, i.e., require accrual of interest even though the books reflect the loan on a cash basis. This results in a different amount of interest income for a particular tax year; however, cumulatively the amount of income over the life of the loan will ultimately be the same amount.

Financial institutions' loan systems are geared to report interest income under GAAP/RAP rules with any adjustments to book income in determining taxable income for nonaccrual loans handled on a manual basis. Financial institutions would find it difficult to source the book/tax differences.

Interest/Rental Income From Leases

Financial institutions generally account for leases under GAAP as either a financing lease or an operating lease. Finance lease accounting for GAAP is the most predominant. Finance lease accounting equates generally to loan interest accounting in that the excess of the total lease payments over the cost of the leased property less any residual value is recognized in financial income under simple interest methodology. Gain or loss would be reflected on the sale of the leased item upon its sale by the lessor based on the original residual value.

Certain leases accounted for as finance leases are reported for tax purposes as true leases, i.e., the lessor claims depreciation and considers all payments by the lessee as rental income. Gain or loss on the sale of the leased item by the lessor would be computed using the adjusted basis of the depreciated item.

Financial institutions can probably source the adjustments used for converting financial income to taxable income.

Lease Asset Value

The book/tax differences in accounting for income on leases also creates a difference in the asset value. A finance lease is initially recorded on the balance sheet as a lease receivable (term times lease payment) and a residual asset (the estimated

value of the leased item at lease maturity). The income to be recognized is recorded as unearned income. Generally, no distinction is made on the balance sheet for finance leases reported as true leases for tax purposes.

A tax balance sheet would reflect the lease item at cost less appropriate depreciation. The book/tax differences on finance leases/true leases can probably be sourced. Some financial institutions operate their leasing business in a nonbank subsidiary and have been filing multistate returns using tax basis for leased property.

Loan Fee Income

Financial Accounting Standards Board Statement (FASB) 91 requires certain loan fee income and their related expenses to be netted and amortized over the life of the loan. The IRC requires nonrefundable loan fees to be included in taxable income on the earlier of when received or when the right to receive becomes fixed. It should be noted that the IRC permits amortization of certain types of fees. For example, points paid in connection with a mortgage may be amortized for tax purposes if they were financed at the time of mortgage origination.

GAAP and IRC treatment can therefore result in unequal timing of income recognition for some fees and equal timing recognition for others. Necessary adjustments to financial income to convert

financial income to federal taxable income are usually manual adjustments i.e., the difference is not carried in mainframe computer application systems. Consequently, sourcing the adjustments would be difficult for financial institutions.

Loan Fee Assets/Liabilities

The FASB 91 treatment of loan fees and their related expenses also creates book/tax balance sheet intangible differences. If financial books are used, deferred expenses presents situs(?) questions. Should any deferred expenses be sourced to the commercial domicile or should they be sourced to the related deferred income? There are also likely to be numerator problems in adjusting book asset or liability numbers to tax return balance sheet numbers.

Investment Portfolio Income

Financial institutions accrete market discount into income on investment securities. Some financial institutions do not accrete market discount into taxable income while others are required to accrete market discount into taxable income. The jury is still out on the use of investment portfolio income in a receipts factor; however, should a receipts factor include income from the investment portfolio, the book/tax difference should be considered in the decision of book amounts versus tax amounts.

Investment Portfolio Assets

The accretion difference on market discount creates a basis difference on the investment portfolio. The basis in an investment portfolio is par value plus unamortized premium and less unaccreted discount. Should inclusion of the investment portfolio in a property factor be appropriate, it is suggested the use of par value may be the easiest touchstone of value.

Depreciable Asset Values

Currently, states generally use either historical cost or depreciated basis for a tangible property factor. Those that use depreciated value generally use tax depreciated value. Any use of depreciable tangible property in a property factor should be consistent among the states. Historical cost is probably the easiest for financial institutions' compliance and for state audits.

There will be some book/tax differences in historical cost due to involuntary conversions and nonrecognition of gains or losses for tax purposes due to like kind exchanges. Differences can also arise on asset acquisitions from the use of purchase accounting for financial accounting and pooling accounting for tax returns. Dividends of property are at fair market value for the tax return and historical cost for the financial statements.

Foreclosed Assets Values

Banks holding foreclosed assets (tangible and intangible) are required to annually appraise foreclosed assets. If the appraisal amount is less than the current carrying amount, then the foreclosed asset must be written down to the new appraised amount.

The writedown of the asset is generally not permitted for determining federal taxable income as the decline in value is not a realized event. Consequently, there is a book/tax difference in basis of foreclosed assets. Tracking the differences on foreclosed assets is feasible, i.e., banks could probably cope with tax basis; however, they would generally prefer to use book values if foreclosed assets are used in a property factor.

Tax accounting for foreclosed assets varies between banks and savings and loans. Savings and loans continue to treat a foreclosure as a loan whereas a bank removes the loan from its books and records a foreclosed property.

Gain/Loss on Foreclosed Assets

The writedown of foreclosed assets for financial statements but not for tax purposes also creates a book/tax difference on the gain or loss on the sale of the foreclosed asset. Use of gains and losses on foreclosed assets in a receipts factor should be

consistent with the values used for a property factor.

Other Asset Values

Merger expenses and goodwill are expensed or amortized on the financial books but capitalized for tax and are currently nonamortizable. Purchase accounting can also create book/tax differences in intangible asset values. Additionally, the amount of a core deposit intangible may be different for book and tax purposes in the amount of the core deposit intangible as well as the amortizable life.

It is suggested that items of this nature used in a property factor be based on book values due to sourcing problems and administrative burden that using tax values would entail.

Reserves - Loans, Leases, Other

Reserves for lease and loan losses are reflected as a contra asset in the GAAP balance sheet. Other reserves may be either a contra asset or a liability. Reserves for loan and lease losses of banks with assets of over \$500 million are not allowable for determining federal taxable income. Reserves for loan and lease losses of Savings and loans and banks under \$500 million are allowable for federal income tax purposes. The amount of the reserve for loan and lease losses for financial books may be more or less than the amount for federal income taxes. Other reserves

on the financial books are generally not allowable for federal income taxes.

Reserves for loan and lease losses and other reserves carried as a contra asset raises asset factor denominator issues. Since most reserves are not identifiable with a specific loan, lease or other asset, (some reserves are identifiable with a specific loan or asset) financial institutions could not attribute most reserves to any asset used in a property formula. Thus, any property factor using intangibles involving reserves should use the gross asset as a denominator rather than net of reserves.

Other Factors in Choosing Book Vs. Tax

The Security and Exchange Commission is currently pushing market value accounting. Should financial institutions have to adopt a market value approach to their balance sheet, the book values of assets will likely fluctuate more than the current historical cost used for book values and tax values.

Financial institutions generally do not prepare a tax balance sheet but use their financial balance sheet in preparing federal or state tax returns. Converting a financial balance sheet to a tax balance sheet would be a difficult task for many financial institutions.

Summary

The majority of income and asset book/tax differences would be impractical to source. Use of financial books (both income and assets) would help minimize compliance costs of interstate tax filings and should facilitate audit efforts of the states and cities. Use of financial books for apportionment factors with a state tax base of federal taxable income with adjustments should not be incompatible nor should it result in a distortion of a state's revenue if used consistently. The use of financial books for apportionment factors should not affect nexus; however nexus may be defined.

A combination of financial books and tax books (such as using tax amounts for true leases) would slightly increase compliance costs for financial institutions over the costs of using financial books 100%.

States having a capital type tax in lieu of an income based tax or in addition to an income tax would generally not be materially affected by the use of a financial balance sheet.

A MESSAGE FROM THE DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE



Illinois Department of Revenue

Douglas L. Whitley, Director
100 West Randolph, Suite 7-500
Chicago IL 60601

August 27, 1992

Alan H. Friedman
General Counsel
Multistate Tax Commission
386 University Avenue
Los Altos, California 94022

Dear Alan:

I am writing this letter to inform you that Illinois will no longer be able to contribute to the Bank Taxation Working Group. This has become necessary because of the continuing need to downsize the Illinois Department of Revenue and the resulting assignment of new Department duties and responsibilities to John Malach. These new duties and responsibilities will preclude him from being able to continue working on this project.

The Illinois Department of Revenue continues to be very interested in the results of the Bank Taxation Working Group. We will continue to internally review and study Illinois' and other states taxation of financial institutions.

The Illinois Department of Revenue fully supports the goals of the Bank Taxation Working Group. We feel that any steps that can be taken to achieve uniformity in the state taxation of financial institutions is good tax policy both for the states and for taxpayers. I am sorry that we cannot devote more resources to the working group at this time.

Please express my apologies to the other members of the working group.

Sincerely,

A handwritten signature in cursive script that reads "Doug".

Douglas L. Whitley, Director
Illinois Department of Revenue

DLW:jat

EXHIBIT J

**TESTIMONY, DOCUMENTS AND LETTERS SUBMITTED DURING
PUBLIC HEARING PROCESS**

EXHIBIT J: 1

**Testimony of Paul Claytor
(American Bankers Association) (August 21, 1990)**

TESTIMONY OF PAUL CLAYTOR
on behalf of the
AMERICAN BANKERS ASSOCIATION
before the
MULTISTATE TAX COMMISSION
August 21, 1990

My name is Paul Claytor, and I am Managing Director of Corporate Taxes for Continental Bank N.A. in Chicago, Illinois and Chairman of the Taxation Committee of the American Bankers Association ("ABA"). The American Bankers Association is the national trade and professional association for America's commercial banks of all sizes and types. Assets for ABA member banks are approximately 95 percent of the industry total. ABA member banks operate under state or national charters and engage in the business of banking subject to the restrictions on interstate activities imposed under state law and the McFadden Act (restricting interstate branching) and the Douglas Amendment (restricting interstate BHC acquisitions).

The proposed MTC regulations and similar formulations enacted in Minnesota (1987), Indiana (1989) and Tennessee (1990) embody what we refer to as the market state approach for taxation of income of financial institutions, including out-of-state banks. The introduction of the market state approach, which is a new concept applied to service industries such as financial

services, raises serious issues of unfair and undesirable additional tax and tax-related burdens on the financial services industry. The industry was protected against these burdens until the expiration of P.L. 93-100 which permitted only domiciliary states to tax banks based on income. Financial institutions should be entitled to the same consistent and commonly accepted "doing business" standard as retailers and manufacturers have under P.L. 86-272. The ABA has sought a fair resolution of this issue for many years. One possible approach was contained in a resolution adopted by the House of Delegates of the American Bar Association. The nexus rules of Legislative Recommendation 1981-3 were modelled after P.L. 86-272, and would establish minimal jurisdictional standards based on physical presence. This standard would simplify tax administration for both depository institutions and the states by providing uniformity and clarity of state tax rules. We generally support the American Bar Association's recommendation as the proper approach that is needed to prevent the inequities that would result from the significant overlaps and conflicts among states' tax rules that would be the consequence of the divergence from the long standing notions of state taxation of non-domiciliary financial institutions.

The action by the MTC to promulgate market state tax regulations will not only impose an unfair tax on financial institutions but it will have a detrimental effect on the states and their residents. MTC Executive Director Dan Bucks recently

stated that the apportionment rules for financial industries would adopt a balanced approach taking into account the concerns of the market and product states. It is our belief, however, that the current proposed MTC regulations do not achieve this balance. Instead, they create a fundamental split between these states. Several states are considering reciprocal market state taxation to retaliate against the financial institutions domiciled in Minnesota, Indiana and Tennessee and any other states that follow the same course. Moreover, the market state taxation scheme imposes enormous costs on the banking industry and the state governments as well as the residents of the market states. While it is our intent to make a constructive contribution today to the debate on market state taxation, the ABA, on behalf of the banking industry, must object strongly to the current MTC approach and urge its fundamental revision.

Our objection rests principally on three grounds. The MTC proposal:

- o Fails to provide any mechanism to prevent multiple taxation of the income due to inconsistent rules regarding jurisdiction and apportionment;
- o Constitutes a barrier to the interstate flow of funds which will hurt borrowers by raising the cost and reducing the availability of credit and hurt lenders by increasing portfolio risk and financial market instability; and

- o Imposes enormous compliance costs on the taxpayer and audit costs on the state which exceed, in virtually all cases, the amount of tax due to the state.

These concerns should trouble the state governments as well as the financial institutions. We therefore urge the MTC to confront these issues directly by joining with the ABA in seeking appropriate solutions to each of these problems. The complexity of the issues and lack of readily apparent solutions, however, make it essential to have a suitable period for analysis and exploration of solutions. We therefore urge that all affected parties join in seeking a two-year Federal moratorium on the enactment and application of the market state approach to taxation of financial institutions. During this period, the tax administrators and the industry could address multiple tax, economic impact and cost of compliance. This will further the MTC's quest for uniformity-- not just among market states, but for all states.

NEXUS/MULTIPLE TAXATION

Since 1940, the U.S. Supreme Court has used the term "nexus" as a shorthand for a requirement that state taxes be based on a minimum level of contact to survive constitutional scrutiny under the Commerce Clause and the Due Process Clause. Generally, the Commerce Clause requires that the activity being taxed have "substantial nexus" with the state seeking to impose the tax. In

decisions issued under the Commerce Clause, the Supreme Court has found substantial nexus where the taxpayer had a physical presence within the state. See Complete Auto Transit, Inc. v. Brady, 430 U.S. 275 (1977). Under the Due Process Clause, nexus is satisfied by some minimal connection between those activities being taxed and the taxing state. The Supreme Court determined in Miller Bros v. Maryland, 347 U.S. 340 (1954) and in National Bellas Hess Inc. v. Department of Revenue, 386 U.S. 753 (1967) that for the taxpayer to be subject to state tax it must have more activity in the state than the solicitation of the local market and the delivery of goods by common carrier.

The minimum contacts question has a unique application to banking. Banks have long sought removal of state law prohibitions against branching or acquiring offices beyond their home state. Even today, after years of progress, only 11 states permit non-reciprocal nationwide banking (but not interstate branching), while the remaining 39 strictly limit the banks ability to enter their markets. Many larger banks have aggressively sought to expand into new states; in some cases, exercising the Federal exception for acquiring failing institutions as the price for market entry. Thus, the banking industry is dumbfounded by the "market exploitation" and "branchless banking" arguments which are used to justify low nexus standards for market state taxation. How can a bank exploit a market when it cannot legally open an office in that state? Close customer contact gives local banks an enormous

marketing advantage over out-of-state institutions which attempt to compete by mail. Branchless banking may be cheaper for some high volume banking services, but it is no substitute for dealing with customers face to face. Moreover, retailers and manufacturers advertise and solicit business across state lines without physical presence or regular employee contact -- but that does not make them subject to state tax.

The banking industry does not object to legitimate state taxation but finds market based taxation offensive as unconstitutional because:

- o It is a method of "taxation without representation" since it does not require the minimal nexus of physical presence in the state.
- o It is unfairly discriminatory taxation which subjects an out-of-state financial institution to tax without allowing it to operate a branch in order to fairly compete with local banks.
- o It forces reciprocal and bias legislation of evermore complexity by non-market states to protect their revenue base.

Banks should not be singled out for special or discriminatory tax treatment compared to general corporations. General corporations are protected by P. L. 86-272 from taxability based on customer location even though they have

employees in the state soliciting orders from local customers. Public Law 86-272 is a minimum nexus standard that Congress has imposed (pursuant to its Commerce Clause powers) for the imposition of state taxes on income from the sale of tangible personal property. The financial industry enjoys no such legislative protection. This lack of a defined system of multistate taxation, in contrast to that enjoyed by general corporations, greatly magnifies the variations in determining local income and the resultant tax overlap. Such state taxation is thus disproportionate and unfairly cripples the ability of financial institutions to provide services in interstate commerce.

Commercial banks pay state taxes on all of their income under existing state tax systems. Home states either tax 100 percent of the income of local banks or provide that their income otherwise apportionable to states where the banks are not taxable is reassigned or "thrown back" to the home state. In this circumstance, it is evident that the conversion of state tax systems to the market state approach is totally unnecessary to prevent any portion of bank income from escaping state taxation. On the contrary, for the reasons described below, the market state approach promotes double taxation.

The proposed MTC regulations raise the issue of double taxation as they do not address taxation in the domicile state. The fact that the same dollars can be used in the numerator (for apportionment purposes) and the factors of the numerator can be

varied by each state consequently results in double taxation. Thus, the MTC's stated goal of producing uniformity and preventing conflicts in state taxation is not achieved. Such overlapping of taxation is in conflict with the Commerce Clause based doctrine of multiple taxation which was first enunciated in Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938). The Court in Japan Line Ltd. v. County of Los Angeles, 441 U.S. 434, 446 (1979) stated: "It is a common-place of constitutional jurisprudence that multiple taxation may well be offensive to the Commerce Clause." Since the Supreme Court has not consigned the multiple taxation doctrine to the scrap heap of Commerce Clause jurisprudence, the MTC proposal must address the serious constitutional question it raises regarding double taxation.

Furthermore, the fact that each state is able to select a method of determining taxable income in a way that maximizes revenue consistent with its own regional attributes is further proof that multiple taxation is inevitable under these proposed regulations. Although the MTC regulations have a three factor equally weighted standard, Tennessee and Indiana already have adopted a 100% receipts factor and Minnesota uses a 70% receipts factor. As a result, retaliatory taxes and a breakdown in interstate tax information sharing may result as residence-based and market-based states come into conflict.

Absent uniform rules based on reasonable nexus, the spread of state taxation based on location of a very few customers will generate a host of serious difficulties. These difficulties will

not only impact out-of-state financial institutions but will adversely affect states and their economies as well.

ECONOMIC IMPACT

The ABA has been concerned that there has been no economic analysis of the market state taxation of out-of-state banks, and no consideration of the economic risks of this new form of taxation on consumer access to low cost bank credit across state lines. In order to get an informed and independent judgment on these issues, the ABA sought the assistance of Doctor William J. Hunter, Associate Professor of Economics, Marquette University, Milwaukee Wisconsin. In a short period of time, Prof. Hunter has produced a paper which raises serious concerns about the economic impact of the tax on consumers and economic development likely to result from state taxation along the lines of the MTC proposal. A copy of Prof. Hunter's paper is attached to my testimony.

Prof. Hunter's initial conclusion is that the full cost of this tax to a state and its residents may far outweigh the benefits brought to the state through higher tax revenue. The economic consequences arising from state taxation which are likely to arise are:

- o Reduction of credit availability for consumers in the market state;
- o Reduction of credit for economic development in the market state;
- o Higher interest costs for borrowers able to

get credit;

- o Instability in financial markets in the market state;
- o Longer local economic downturns resulting from more limited access to out-of-state lending;
- o Excessive compliance costs on out-of-state lenders; and
- o Burdens on secondary market transactions.

The economic theory, according to Professor Hunter, is quite simple: the higher costs of out-of-state banks to provide credit will force these lending institutions to curtail, or in many cases completely eliminate lending to the market state. This means that the total credit available in state is less than otherwise and the remaining credit will be more costly -- if available at all for borrowers of low and moderate incomes.

While there is no empirical data to conclusively demonstrate the magnitude of these economic risks, both economic theory and experience with other restraints on the interstate flow of funds indicate that the risk could be, in Prof. Hunter's words, "substantial". One useful analogy which Prof. Hunter uses to illustrate the risk involves state usury laws. The literature on usury statues confirms that financial institutions consistently respond to state imposed reductions in their rates of return. The conclusion is that banks will have to either raise the rates of interest to borrowers in the market states or curtail their lending significantly. The impact of this

curtailment of credit will be felt most heavily on low and middle income borrowers, those that already face difficulties obtaining credit on reasonable terms.

Another serious aspect of the imposition of market state taxation will be evident in its effect on the secondary market for loans such as mortgage backed securities. This risk has been identified by Minnesota and Indiana when these states amended their statutes to exclude, from taxation, income earned by banks from the purchase of instruments in the secondary market which are secured by property in Minnesota or Indiana, respectively. Tennessee seems to be unclear about the application of its statute to such transactions. In a recent letter to the Tennessee Bankers Association, dated July 17, 1990, the Commissioner of Revenue indicated that these instruments "represent an asset in the nature of a loan as contemplated by the Act and, therefore, subject to tax notwithstanding their classification as a security for federal and state securities law purposes." Thus, a financial institution which holds a Federal National Mortgage Association guaranteed mortgage backed security collateralized by Tennessee mortgages may be subject to the Tennessee tax. Banks which are considering purchasing these securities will either select alternative investments or demand a premium to cover the cost of the Tennessee tax. Those actions illustrate the costs to Tennessee borrowers if the state bases its tax on the holding of secondary instruments.

Professor Hunter identified another major consequence of the

trade barrier for credit caused by market state taxation -- financial market instability. Among the many risks faced by banks, there is the risk due to major economic factors outside the bank's control. For example, business failures tend to rise during periods of economic recessions. If a bank's portfolio is not diversified geographically, it faces greater risk of failure. The market state based tax will likely force greater concentration of financial markets when out-of-state banks opt for lending to states without the tax. Local banks which lend in the taxing state will hold a loan portfolio which is more sensitive to local economic factors and the benefits of diversification will be lost.

The local economy may suffer another way from the adoption of market state taxation. When a region is attempting to recover from a recession in the economic cycle, it may need more funds than are readily available from local lenders. While the slack might normally be covered through a free market flow of funds from healthy areas of the country, that process will be inhibited by out-of-state lenders' unwillingness to bear the cost of market state taxation.

ADMINISTRATIVE COST OF COMPLIANCE

The MTC tax approach will be very costly to implement for both the taxpayer and tax collector. The taxpayer will incur substantial additional direct costs in many areas of the bank--lending, systems, finance and administration. For the tax

collector, the MTC proposal will be difficult to administer and enforce. It will involve substantial effort and added costs to identify the universe of taxpayers, predict total revenues for state budget consideration, and to audit those out-of-state taxpayers accurately and fairly.

The most obvious compliance burden stems from the nexus standard in the MTC proposal. Commercial banks will find themselves subject to taxation in states where they have no regular contacts and are not permitted to open an office. Since 9000 of the Nation's banks are small businesses which do not have in-house tax counsel, these banks will be unaware of the state tax laws where they are not permitted to engage in banking, thereby facing possible penalties and interest for failure to file tax returns. Even in those cases where the bank is aware of its tax exposure, the cost of calculating income based on state rules, filing the tax returns and estimated payments, and tracking further changes in the law will be excessive.

The fact that the MTC tax approach attributes income to the customer location compounds the compliance burden. The facts necessary to determine the institution's local taxable income (e.g., where the customer is "located"; where the services are "consumed") is often known only to the customer and may be virtually unattainable. Even when the facts can be obtained, they can change from year to year, and as such, it will be difficult to program this information on existing computer systems. This difficulty is compounded by variations in each

state's customer location rules. The administrative cost of compliance is not only expensive and requires significant lead time (no other area of the organization requires data collected in this fashion), but is an ongoing compounding process. Since each state can have (and has) different rules, the administrative burden escalates as the interrelationships between states present more and more potential combinations. The threshold of contacts giving rise to the taxability is so low under the MTC's proposal and the diversity/complexity of the new tax systems in Minnesota, Indiana and Tennessee demonstrate clearly that the compliance costs actually exceed the total tax due.

ABA member banks of all sizes that have considered the impact of either Minnesota, Tennessee or Indiana legislation upon their institutions calculate that the administrative compliance costs exceed the tax due by 250 percent or more. An Illinois community bank located near the Indiana border determined that it would cost at least \$7,000 to "gear up" even though the amount of tax due was less than \$3000. A large regional institution in the South determined that it would cost at least \$1 million in internal costs alone to comply with Tennessee law -- even though the bank may actually pay less tax than it currently remits to Tennessee. A major money center institution with a nationwide customer base estimated the range of its current liability in the three states with market state taxation at \$25,000. In preparing a tax return for one of these states, they indicated the bank could not calculate its liability with sufficient accuracy to

withstand audit scrutiny, even though the estimate was prepared in good faith and calculated on a worst case basis. In order to gather sufficient information to file a more accurate tax return, the bank would have to set up a recordkeeping system for loans based on the destination of the funds, with coding, so that the inconsistent state sourcing rules would be observed. Since Minnesota employs an ultimate use test, they would have to inquire of the lenders, who in turn would have to go back to the borrowers, to get information that is not in the loan file. The bank will have difficulty obtaining this information from existing customers who have already received loan funds, or from new loan customers where credit is based on revolving credit lines or unsecured loans. In addition, there are alternative tax calculations which complicate the tax return preparation. Going forward, the bank would have to train the lending officers to collect new information, develop a system of internal documentation for reporting that information, and hire a tax staff person to monitor and comply with state law and amendments to that law and state audits of the return. It should be obvious that the cost of these compliance activities would be many times the estimated tax liability of \$25,000.

The concerns of an administrative burden arising from apportionment complexity should be of concern to the state tax administrators as well as the banks. The required tracing of all income and the use of intangibles in the property factor together with the 100 customer base threshold means far more taxpayers

will be affected and far more complexity required even though there appears little justification for having this situation trigger taxability. For example, assume a money-center bank (\$10 billion in assets) with state taxable income of \$80 million (and ROA of .8%) and gross income of \$1 billion has \$36,000 of income generated from 100 credit card customers. These credit card customers live in a market state and each customer has an outstanding balance of \$2000 payable at 18%. A simple receipts formula would apportion \$2880 of the \$80 million in income to the market state ($\$36k/\$1B \text{ times } \$80m$) which would create a tax liability (assuming 10% tax rate) of \$288. Therefore, to base nexus solely on a specified number of customers would not appear to serve the best interests of a state or a financial institution when viewed with the attendant administrative monitoring burdens. If it is determined that it is not feasible to enact a comparable P.L. 86-272 rule for financial services, a more reasonable basis would be to eliminate any criteria on the number of accounts and to use an asset volume test in excess of \$50,000,000 only as the nexus mechanism.

The proposed MTC regulations provide an alternative test for assumed nexus which consists of an average of \$10 million dollars of assets and deposits during the tax period. Due to the ebb and flow of business relationships, it would not be easy for a financial institution to monitor this \$10 million dollar threshold during a tax year even with the rebuttable presumption. Additionally, a \$10 million dollar loan portfolio with customers

in a particular state is not likely to generate that much revenue under apportionment given the narrow interest rate spread between a financial institution's interest bearing assets and interest bearing liabilities. For example, assume \$10 million dollars of assets are in a state during the entire taxable year and the financial institution has a 4% net interest margin on the loans of \$10 million dollars. Even if administrative costs of managing the \$10 million dollars of loans are ignored, the state would reap \$3,000 or less of tax revenue if that state's base was \$400,000 with an apportionment factor of 7% and a state tax rate of 10%.

The complexity of the receipts sourcing rules for each and every type of receipt is critical. A typical regional bank has approximately eight loan application systems that would require extensive programming under the proposed regulations and operational overhead. Many bank application systems are monthly systems rather than annual systems. Typically, institutions have hundreds of categories for interest and non-interest income on its General Ledger. These numerous categories of interest and non-interest income are necessary for various regulatory, shareholder and management reporting analyses but are not geared to a state sourcing concept. The numerous application systems coupled with the huge volume of categories of book income and monthly cycles of application systems create enormous compliance responsibilities for each transaction with the attendant programming costs for each system to assimilate and aggregate the

tax data for all the accounts.

The MTC proposal for the property factor would include intangibles. The use of intangibles in a property factor has somewhat the same administrative burdens as attempting to source all receipts. Most multi-state taxpayers are familiar with the rules and sourcing for tangible property. Intangible sourcing would produce factors similar to a receipts factor under the MTC proposal. The impact is, in essence, a double weighted receipts factor, which ignores where the services are performed (an important aspect of any service business). In addition, the MTC proposed rule, with respect to sourcing intangibles, appears inconsistent with existing statutory and judicial interpretations of situs for intangibles and could be in conflict with existing state laws for taxation of intangibles.

All of these taxpayer filing problems are mirrored by corresponding state taxing audit problems. It will be more costly for the state to hire, train and ship-off revenue agents to determine the perceived out-of-state bank tax liability than the actual amount of tax due. The banking industry experience with Minnesota audits is limited, but the extensive questionnaires used by their auditors to determine if all of the banks activities have been reported are very complex. Frankly, we believe the Tennessee statute is unauditible. The burden, both administratively and monetarily, therefore rests upon the states to enforce their laws when the out-of-state banks have no physical presence upon which the state can seize.

RECOMMENDATIONS

Successful implementation of any fundamental change in the principles for taxing the income of financial institutions necessitates that there be uniformity of principles among all states--only in that way will conflicts among states be eliminated in terms of multiple taxation of the same income. A 2-year federal moratorium is needed during which time period, the ABA, MTC, State legislative and revenue representatives as well as Congress can meet to discuss and draft jurisdictional standards which provide for uniform state taxation without multiple taxes on banking transactions. The ABA invites the MTC to recognize the interests of its member states in supporting such a moratorium.

The ABA recommends that the draft model for the federal legislation should be modeled after the American Bar Association's Legislative Recommendation 1981-3. (See attached draft.) The fact that objective groups such as the American Bar Association, ACIR (in its 1975 study) and the Federal Reserve Board have indicated that federal legislation is needed should be sufficient impetus to delay the issuance of the final version of the MTC's Financial Institutions Allocation and Apportionment Regulations.

The ABA would like to make the following substantive recommendations regarding the regulations:

1. A mechanism is needed to prevent the same income from being sourced and subject to tax

in more than one jurisdiction.

- This problem will not exist if all states have consistent rules for determining both nexus and taxable income attributable to the taxing jurisdiction.

2. If the constitutionality of the minimum nexus laws such as those adopted by Minnesota, Indiana, and Tennessee and proposed by the MTC upheld, the nexus rules should be modified.

- The threshold should be increased to \$50 million in assets for a period prior to the taxable year and no customer threshold should be included.

3. If the borrower is located in one state and the collateral in another, income from secured loans should be removed from the receipts factor.

- Financial institutions do not either hold title or own any property unless the borrower defaults and the collateral located in the state is taken over. We would also suggest that by including receipts from securities of the taxing state would force financial institutions outside the state from purchasing those securities and consequently (because

of lesser competition), the rate on those securities would rise in the issuing state.

4. Interest income and gains or losses on taxable investment portfolio securities should not be included in the receipts factor.
 - The banks' opposition to including any income or gains on securities in the receipts factor based on the state issuing securities is due to the fact that these securities are often acquired in the open market rather than directly from an issuing state. A connection to activities in a state appears remote.
5. Receipts factor and any receipts nexus test for a depository should be limited to interest on loans, interest bearing bank balances, fed funds sold and securities sold under resale agreements. Interest on investment securities should be excluded from both the numerator and denominator of the receipts factor.
 - The calculation would be to first take the total income of these items of interest income as the receipts denominator. The numerator would consist of each state's portion of these items based on the destination or mailing address used for

billing or state of payment source in the event payments are made automatically. The depository's receipts factor numerators would contain the interest income from tax exempt loans (but not investment securities) which may be exempt from state taxation depending upon the scheme of taxation utilized by a state. This proposal would not remove any such exempt loan interest from the receipts factor; however, any exempt income would be removed from the state defined base if the state provided an exemption. Using total income for the receipts factor facilitates reconciling the denominator and numerators used for apportionment.

6. The definition of financial institution should be expanded to include any corporation that is not a depository institution under federal and state law but either accepts money market accounts, issues credit cards or lends dollars in an amount consistent with the nexus criteria or otherwise engages in activities performed by financial institutions.

* * * * *

In light of the foregoing, federal legislation is essential to establish a 2 year moratorium upon the taxation of out-of-state financial institutions based on mere customer location (traditional nexus rules would not be affected) until such time as a proposal can be drafted which minimizes the costs to banks and states, reduces the instances of double taxation, but provides a reasonable nexus for state taxation within constitutional limits.

**ABA'S RECOMMENDATION FOR: JURISDICTIONAL RULES FOR STATE
TAXATION OF NON-RESIDENT DEPOSITORY INSTITUTIONS.**

Sec. 1. JURISDICTION TO TAX

(a) No State or political subdivision thereof shall impose any tax on a depository unless such depository has a business location in the state or political subdivision during the taxable year.

(b) No State or political subdivision thereof shall impose taxes on any depository not having its principal office within the State if such taxes (when considered together with taxes imposed by the state in which is located its principal office) are more burdensome than the taxes imposed upon depositories transacting a similar character of business having their principal office within the taxing State.

Sec. 2. DEFINITIONS

For purpose of section 1, the following definitions shall apply:

[a] Business Location -

(1) General Rule - A depository has a "business location" in a State in a taxable year only if:

(A) such depository maintains an office in such State; or

(B) one or more employees of the depository has or have a regular presence in such State; or

(C) such depository owns or is a lessee of tangible property located in such State which it uses in connection with its activities within the State.

(2) Exceptions From General Rule Regarding Presence of Employees - No employee shall be deemed to have a regular presence in a State if the only activities engaged in by such employee within the State are, or are in connection with, one or more of the following:

(A) acquisition or purchase of loans, secured or unsecured, or any interest therein;

(B) participation in loans made by other depositories having offices in the State;

(C) solicitation of applications for loans which are sent outside the State for approval, deposits which are received and maintained at an office outside the State, or financial or depository services which are performed outside the State;

(D) investigation for credit purposes and physical inspections and appraisals of real and personal property securing or proposed to secure any loan, or collecting and servicing loans in any manner whatsoever.

(3) De Minimus Exception From Business Location - A depository shall not have a business location in a nondomiciliary State unless it has (during the taxable year) more than \$10,000,000 of either payroll, or property attributable to such State...

(4) General Exceptions From Business Location
Notwithstanding any other provision of this title, a depository shall not be deemed to have a business location in a State if the only activities of the depository in the State are, or are in connection with one or more of the following:

(A) maintaining or defending any action or suit;

(B) filing, modifying, renewing, extending or transferring a mortgage, deed of trust, or security interest;

(C) acquiring, holding, leasing, mortgaging, foreclosing, contracting with respect to, or otherwise protecting or conveying property in the State as a result of default under the terms of a mortgage, deed of trust, or other security instrument relating thereto;

(D) acting as an executor of an estate, trustee of a benefit plan, employees' pension, profit-sharing or other retirement plan, testamentary or inter vivos trust; corporate indenture, or in any other fiduciary capacity, including but not limited to holding title to real property in the State;

(E) maintaining an office in the State by one or more officers or directors of the depository who are not also employees of the depository;

(F) meetings of the board of directors of the depository; and

(G) maintaining an office in the State by one or more independent contractors, whether or not related to the depository performing ministerial processing, collection, servicing or other functions for that depository.

[b] Depository - A "depository" is an institution that deposits or accounts of which are insured under SAIF and BIF, 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 a State or any foreign country which is engaged in the business of receiving deposits in the United States, any corporation organized under the provisions of sections 611 to 631 of Title 12 (Edge Act Corporations), and any agency or branch of a foreign depository as defined in section 3101 of Title 12.

[c] Employee - Any individual to whom wages are paid within the meaning of section 3401 of Title 26 is an "employee."

[d] Maintains an Office - A depository "maintains an office" wherever it has established a regular, continuous and fixed place of business for its employees.

[e] Property Located in a State -

(1) General Rule - Except as otherwise provided in this section, tangible property shall be deemed to be located in the State in which such property is physically situated. Mere ownership of a charge card, credit card, debit card or other means utilized to access an account shall not constitute property located in a State.

(2) Moving Property- Tangible personal property which is characteristically moving property, such as motor vehicles, rolling stock, aircraft, vessels, mobile equipment, and the like, shall be deemed to be located in a State if:

(A) the operation of the property is entirely within the State, or the operation without the State is occasional or incidental to its operation within the State; or

(B) 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; or

[f] Regular Presence of Employees - An employee shall be deemed to have a regular presence in a State if:

(1) a majority of the employee's service is performed within the State, or

(2) the office from which his activities are directed or controlled is located in the State, where a majority of the employee's service is not performed in any one State.

[g] State - Any of the several States of the United States and the District of Columbia.

[h] Taxable Year -

(1) Unless the laws of a State require a corporation to prepay a tax imposed on, according to or measured by income, the calendar year, fiscal year or other period upon which its taxable income is computed for purposes of federal income tax.

(2) If the laws of a State require prepayment of a tax, the calendar year, fiscal year or other periods upon which the tax base is computed under the laws of such State.

[i] Lease - A lease is a leasing transaction where the financial institution leases the property for its own use and would be treated as owner of the leased property under the provisions of the Internal Revenue Code of 1954 prior to the enactment of the Economic Recovery Tax Act of 1981. All other transactions purporting to be leases shall be treated as loans for purposes of section 2 or this title.

* * *

EXHIBIT J: 2

**Testimony of Fred E. Ferguson
(Financial Institutions State Tax Coalition (FIST))
(August 21, 1990)**

Exhibit J 2 is Missing

EXHIBIT J: 3

**Testimony of Daniel Egan
(Credit Union National Association and Affiliates)
(August 21, 1990)**

OUTLINE OF REMARKS BY

DANIEL EGAN

PRESIDENT

MASSACHUSETTS CUNA CREDIT UNION ASSOCIATION

ON

INCOME APPORTIONMENT FOR STATE INCOME AND FRANCHISE TAXATION

OF

FINANCIAL INSTITUTIONS

BEFORE THE

MULTISTATE TAX COMMISSION

9:30 AM

AUGUST 21, 1990

HALL OF THE STATES, 444 NO. CAPITOL ST., N.W.

The Credit Union National Association and Affiliates (CUNA)

appreciates the opportunity to comment on the Multistate Tax Commission's proposal concerning income apportionment for state income and franchise taxation of financial institutions. CUNA represents approximately 14,000 of the nation's state and federally chartered credit unions through 52 member credit union leagues. These leagues are located in each of the states, the District of Columbia and Puerto Rico. I am Daniel Egan, President of the Massachusetts CUNA Credit Union Association.

The Multistate Tax Commission's proposed regulation Art.IV.18.(i) would modify the way in which state revenue departments impose and collect financial institution income and franchise taxes. Under this proposal, a state would tax the earnings derived from a financial institution's business activity in that state, regardless of the location of the financial institution's home office. Traditionally, states have taxed only those financial institutions physically located in their state.

As currently drafted, the proposal would affect 5,000 state-chartered credit unions and the CUSO (Credit Union Service Organization) activities of both state and federally chartered credit unions that are subject to state taxes. (Federally chartered credit unions are exempt from state income and franchise taxation by the Federal Credit Union Act, 12 U.S.C. 1768). A state-chartered credit union, or credit union CUSO, which has a branch or a member service agent in another state, or otherwise "transacts business" with at least 100 residents of another state, would be subject to tax in that other state whether or not it is tax-exempt in its home state.

On behalf of CUNA, I am here to request that the Multistate Tax Commission reconsider its recent action to include credit unions in its proposal. Credit unions are non-profit, member-owned cooperative financial institutions based on a simple idea: that people can pool their money and make loans to each other. Only members may belong or vote. The field of membership is limited to persons with a common bond -- for example, employment, association or geography. Credit unions are democratically controlled with each individual member of the credit union having one vote, regardless of the number of dollars on deposit at the credit union. These unique financial institutions return to their owner-members every penny of income earned in excess of operating expenses, required transferred reserves and undivided earnings. The earnings received by credit union members are subject to state and income taxes in the state where they reside.

Credit unions are special purpose financial institutions, primarily providing basic financial services at little or no cost to low and moderate income households. For example, most credit unions charge no monthly fee on their share draft (checking) accounts. Those few which do, charge an average monthly fee of \$3.25 as compared to \$5.11 charged by the traditional for-profit financial institutions. More than 60 million consumers have joined as member-owners of credit unions because they offer loans at reasonable rates and offer a high rate of return on member savings.

CUNA opposes any measure that would serve to deny a particular group access to cooperative, low cost financial services. The imposition of this tax on out-of-state credit union members would result in either denial of services across state lines, the application of an out-of-state service fee,

or conversion from a state credit union charter to a federal credit union charter.

CUNA is committed to the preservation of a strong dual chartering credit union system which this proposal would seriously undermine. The enactment of this proposal by state legislatures would provide a strong incentive to state-chartered credit unions to convert to federal credit union charters. While federal credit union CUSOs may be subject to state taxes, federal credit unions are exempt from income and franchise taxes because Congress intended credit unions be assured as an alternative to for-profit financial institutions to provide consumers accessible, low cost service. The tax exempt status generally granted to credit unions is a message from both Congress and the state legislatures that the service credit unions provide is valued as a unique alternative for consumers. Taxation threatens to alter the very nature of credit unions. Therefore, state chartered credit unions would have the ability to avoid this proposed tax and its administrative burden by converting to a federal charter.

CUNA believes the social and economic costs of imposing this multistate franchise tax on credit unions would far exceed the benefits to states of the limited revenue gains. Credit unions, for the most part, are small financial institutions which rely heavily on volunteer support. Nationwide, their assets make up about only 4% of total assets in depository institutions; 64% of state-chartered credit unions have less than \$5 million in assets. These credit unions do not have the necessary staff or technology to handle the recordkeeping required to comply with this franchise tax proposal.

Before credit unions were declared exempt from the Indiana multistate franchise tax, state-chartered credit unions in Michigan discovered through

practical experience how administratively burdensome and costly this type of franchise tax can be.

It cost, for example, the University of Michigan Credit Union in Ann Arbor over \$300, including 20 hours of labor, to calculate that they owed \$7.18 in franchise taxes. Put another way, the cost of calculating the tax was 42 times the amount of revenue raised.

It took the SOC Credit Union of Troy, Michigan four hours to calculate that they owed \$1.10. And it cost the Centel Credit Union of Owosso, Michigan over \$40 to calculate that the credit union did not owe the Indiana Revenue Department anything.

Twenty one of the twenty five credit unions which were instructed to pay franchise taxes to the Indiana Revenue Department sent checks for under \$5.00.

Think of the cost and hours that will be spent to calculate these taxes if more and more states attempt to extract these relative pennies.

Let me now turn to some specific examples of this proposal which would undermine the unique way credit unions operate. Credit unions' unique feature of organization around a particular field of membership magnifies the detrimental impact this proposed franchise tax would have on credit unions. In Chicago, the United Airline Employees Credit Union has members in all 50 states. The employment promotion policy in effect at United Airline requires that employees transfer to other states to move into higher positions. This policy is common to many corporations, so the movement of credit union members occurs in many of the 10,000 employment-based credit unions.

Members of the United Airline Credit Union who are transferred from Illinois choose to continue their credit union relationship for various reasons: to maintain ownership and an equal vote at their financial

institution, payroll deduction is convenient and cost effective, members prefer to do business with a company they know and trust, and the credit union offers them special services to fit their special needs. A pilot or flight attendant, for example, who spends many days at a time away from home, can walk into any United Airline Credit Union office and have most loans (excluding mortgages) approved and a check issued within minutes.

Retirement is another common reason that credit union members move to other states. The better rates and low fees offered at the credit union can make a significant impact upon someone living on a fixed income. Eleven thousand United Airline retirees maintain over \$500 million in the credit union, even though many have moved to warmer climates.

Another example is Great Lakes Credit Union of Great Lakes, Illinois, a defense credit union servicing the Naval Training Center in Great Lakes and the Naval Air Station in Glenview. (There are 55 state-chartered military credit unions across the nation which serve the special needs of our country's serviceman. By the nature of this membership, a large portion of these credit unions' members are stationed out of state.) After attending the Naval Training Center, many of the credit union's members are transferred to such areas as Charleston, San Diego, San Francisco, and even the Persian Gulf. Two-thirds of the credit union's members reside outside of Illinois.

The military personnel maintain their credit union relationship because it is geared to serve their special needs. A serviceman can call the credit union toll free from just about anywhere in the world and get a loan approved over the telephone and receive a check by over-night mail the following day.

And there are approximately 436 community development credit unions

across the country that provide financial services to people that would otherwise not qualify for basic financial services in traditional financial institutions. The First American Credit Union, located in Window Rock, Arizona, services the Navajo Reservation which extends into three states - Arizona, New Mexico, and Utah. Over twenty percent of this Arizona credit union's members reside in New Mexico.

The special purpose of this credit union is to meet the needs of the Indian population on the Reservation. The volunteer Board of Directors is made up entirely of Indians who understand the special circumstances of those who live on the Reservation. The size of loan which is most commonly required by this membership is \$200 -- about 3,000 of these small loans are made each month. This size of loan is not profitable and is generally not available at other in-state financial institutions, except through credit cards at a higher rate of interest. The Indians on this Reservation would not have access to necessary financial services without the credit union.

These examples show that credit union services are directed to improve the economic and social well-being of all members. Service to members is each credit union's primary motive, it distinguishes credit unions from other financial institutions. The credit union ideal is to extend affordable financial services to all who need it.

The Credit Union National Association, its state league partners and the nation's credit unions urge the Multistate Tax Commission to exempt credit unions from its financial institution franchise tax proposal. While raising little revenue, the tax proposal would severely undermine the nonprofit credit union alternative to the for-profit financial services sector. If credit

unions were taxed, the sixty million consumer-members distributed throughout the fifty states, the District of Columbia and Puerto Rico would be the losers.

EXHIBIT J: 4

**Memorandum from Edward N. Delaney
(Edward N. Delaney & Associates)
(August 21, 1990)**

LAW OFFICES

EDWARD N. DELANEY & ASSOCIATES

CHARTERED

1629 K STREET, NORTHWEST
WASHINGTON, D. C. 20006
(202) 955-5600

OF COUNSEL: CYNTHIA L. CROCKER

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EDWARD N. DELANEY
SHELL A. HOLLRAH
STEPHEN LEE
LISA S. SCIMECA

M E M O R A N D U M

TO: Multistate Tax Commission

FROM: Edward N. Delaney & Associates

SUBJECT: Comments with Respect to Proposed M.T.C. Regulation
ART.IV.18.(i) Concerning the Attribution of Income
from the Business of a Financial Institution

DATE: August 21, 1990

I. Apportionment Factor Refinement

Proposed M.T.C. Regulation Art.IV.18.(i), as currently drafted, creates the possibility that the sum of a financial institution's business income that is apportioned among the states will exceed the amount of business income actually earned.

The proposed regulation, at Prop. M.T.C. Reg. IV.18.(i).(D)(2) and (D)(3), essentially operates to adjust and fine-tune the receipts and property apportionment fractions that are initially calculated under the Multistate Tax Compact ("MTC") general apportionment principles. Under the proposal, the receipts and property apportionment fractions would be determined by performing two separate calculations, i.e., first calculating the apportionment fractions with respect to receipts and property under general MTC apportionment principles; and second, modifying the fractions to reflect an apportionment that, for a financial institution, would more clearly reflect the amount of business income earned within each of the various states.

Under the first calculation, after applying the general MTC apportionment principles, all of a business's receipts and property would have been apportioned to a state. With respect to receipts, for example, assuming the MTC apportionment principles were adopted by all states, the sum of the receipts apportionment fractions for all states would equal one. Since

Memorandum to Multistate Tax Commission
August 21, 1990
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the second calculation, applying the proposed regulation, would increase the numerator of the apportionment fraction for one or more states, but not provide for an offsetting decrease in the numerator for any other state nor provide for a concomitant increase in the fraction's denominator, the sum of receipts apportionment fractions for all states would exceed one. Under the same analysis, the sum of property apportionment fractions for all states also would exceed one. Consequently, the overall apportionment fraction, which is the average of the receipts, property and salary apportionment fractions, would exceed one.

An apportionment scheme that apportions in excess of 100% of a business' income would be vulnerable to constitutional challenge for violating the "internal consistency" doctrine. See, e.g., Container Corp. v. Franchise Tax Board, 463 U.S. 159, 169 (1983) (concluding that an apportionment formula, "must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed").

The redundant apportionment that would occur under the proposed regulation could be eliminated by providing that each state's apportionment fractions attributable to receipts and property be adjusted not only for additions to the numerator, based upon a more refined analysis of the items identified in the proposed regulation, but also for any subtractions from the numerator that would be appropriate under the refined analysis of those items. Furthermore, the proposed regulation should provide that in the event an item is added to the numerator of a state's apportionment fraction, under the proposed regulation, but would not have been included in the numerator of another state's apportionment fraction, under the general MTC apportionment principles, the denominator of the apportionment fraction is increased by the amount of such item.

If the regulation were amended as we suggest, for each addition to the numerator of a state's apportionment fraction made under the proposed regulation, either a counter-balancing subtraction to the numerator of another state's apportionment fraction or an addition to the denominator of each state's apportionment fraction would be made. Hence the sum of all states' apportionment fractions would once again equal one, and any potentially redundant apportionment would be eliminated.

Specifically, we propose that Prop. M.T.C. Reg. IV. 18.(i)(D)(2) be modified by adding immediately before the beginning of (D)(3) the following sentences:

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August 21, 1990
Page 3

The numerator of the receipts factor should exclude any of the foregoing items which were assignable to this state under [here include your citation to the Multistate Tax Compact or other applicable law] but would not be assignable to this state under this Prop. M.T.C. Reg. IV.18.(i)(D)(2).

Alternatively, any of the foregoing items that are added to the numerator under this Prop. M.T.C. Reg. IV.18.(i)(D)(2) but that would not have been subject to apportionment under [here include your citation to the Multistate Compact of other applicable law] should be added to the denominator of the receipts factor.

Furthermore, Prop. M.T.C. Reg. IV.18.(i)(D)(3) should be modified by adding immediately before the beginning of (D)(4) the following sentences:

The numerator of the property factor should exclude any of the foregoing items which were assignable to this state under [here include your citation to the Multistate Tax Compact or other applicable law] but would not be assignable to this state under this Prop. MTC Reg. IV.18.(i)(D)(3).

Alternatively, any of the foregoing items that are added to the numerator under this Prop. M.T.C. Reg. IV.18.(i)(D)(2)(3) but that would not have been subject to apportionment under [here include your citation to the Multistate Compact of other applicable law] should be added to the denominator of the property factor.

II. Miscellaneous

A. Potential Inclusion of Income Derived from Insurance Activities

According to Prop. M.T.C. Reg. IV.18.(i)(C), the income that is subject to the refined analysis contained in the proposed regulations is defined as all income which arises from the "business of a financial institution." The business of a financial institution is defined at Prop. M.T.C. Reg. IV.18.(i)(B)(2) as including the business

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Memorandum to Multistate Tax Commission
August 21, 1990
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activities 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." Proper regulatory authorities are not defined. The business of a financial institution is defined to also include business activities that "any corporation organized under the authority of the United States or ... under the laws of ... any state ... has authority to do if such corporation derives more than fifty-percent of its gross income from lending activities"

The aforesaid definitions of income that is subject to the refined apportionment analysis may include income earned through insurance activities. For example, recently, the state of Delaware enacted a law that would allow its banks to underwrite and sell insurance nationwide. Furthermore, South Dakota has enacted a law permitting banks to engage in insurance activities.

Many states tax insurance company income according to rules substantially different from the rules applicable to the taxation of income earned by corporations, in general, and also different from rules specifically applicable to the taxation of income earned through banking activities. Moreover, many states determine the multistate taxation of income generated through insurance activities according to principles that differ from principles applicable to income earned from other types of activities.

For these reasons, although the three-factor apportionment scheme, and the refinements proposed to that scheme under the proposed regulations, may be appropriate for the apportionment of income from banks and similar institutions, such principles would be inappropriate for determining the multistate taxation of insurance income.

Moreover, to the extent a three-factor apportionment scheme is believed to be appropriate for the taxation of insurance activities, it is submitted that the refinements contained in these proposed regulations, specifically directed toward banking activities, would not be appropriate refinements when applied to insurance activities. Finally, the aggregation of banking income together with insurance income, for determining the

Memorandum to Multistate Tax Commission
August 21, 1990
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apportionment of each, would distort the multistate taxation of each. For example, to determine the proper state within which insurance premium income should be taxed on where an institution earns its income from banking operations would distort the allocation of the institution's insurance income.

Consequently, it is recommended that the first sentence of Prop. M.T.C. Reg. IV.18.(i)(B)(2) be amended to insert after the phrase "includes the business activities, including finance leasing," the phrase: "but not including any insurance activities."

B. Payroll Factor Definition Omitting Key Words

Prop. M.T.C. Reg. IV.18.(i)(C)(4) defines the payroll factor as:

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.

The foregoing definition omits key words. The numerator should be limited to include compensation paid by the taxpayer during the year only in this state. Otherwise, as the definition is currently stated, the fraction would in all cases equal one.

Thus it is suggested that the first sentence of Prop. M.T.C. Reg. IV.18.(i)(C)(4) be amended by inserting after the phrase "the numerator of which is the total amount paid" the words "in this state." In addition, for clarity, at the end of the sentence should be added: "during the year."

Consequently, as restated, the definition would provide:

a fraction the numerator of which is the total amount paid in this state for compensation during the year, and the denominator of which is the total amount of compensation paid in every state during the year.

EXHIBIT J: 5

**Testimony of Haskell Edelstein
(Citicorp/Citibank)
(August 21, 1990)**

200 Park Avenue
York, NY
10043

Haskell Edelstein
Senior Vice President and
General Tax Counsel

September 18, 1990

Mr. Alan Friedman
Multistate Tax Commission
444 North Capitol Street
Suite 409, N.W.
Washington, D.C. 20001

Dear Alan:

Enclosed is a written version of the testimony I presented at the Multistate Tax Commission hearing on August 21, 1990. I hope this will be of some use in both your deliberations and those of the MTC itself. As I indicated, I plan to submit more technical comments regarding the proposed regulation before you complete your hearings process.

Sincerely,



Encl.

\ltr.fried



Multistate Tax Commission

Public Hearing on Proposed Regulations - Taxation of Financial Institutions

August 21, 1990

Comments of

Haskell Edelstein, Senior Vice President & General Tax Counsel

Citicorp/Citibank, N.A.

My testimony today will be limited to a discussion of fundamental issues. I wish to reserve my technical comments on the proposed regulations to a detailed written submission which will be provided at a later date.

While it is not necessary to reiterate in any detail my concern about the Constitutional validity of the proposed regulations, I feel it is essential to at least note that there is a continuing possibility that the basic proposal could become subject to a Supreme Court decision which upholds the National Bellas Hess principle and reaffirms that physical presence in a state (by way of an office and/or employee) is essential to establish taxing jurisdiction over a business for income and franchise tax purposes. In the light of that possibility, the Multistate Tax Commission (MTC) has at least an obligation to its members to advise them of the economic consequences of protracted litigation over the question of the Constitutional validity of the proposed regulations, as well as the impact of a determination that the regulations are invalid, which may not occur for many years. In that regard, I believe that, due to the inherent conflict between market states and headquarters states, there is a strong likelihood that most major multistate banking and other financial service businesses would inexorably be subject to multiple state taxation on the same income, which makes a strong case in favor of unconstitutionality.

While I could raise additional arguments that the proposed regulations,

even assuming they are valid, are unwise, I will pass over such discussion because I perceive that some states, and perhaps even the MTC, have already predetermined to apply the market state approach, in principle, regardless of the consequences. The reasons for such an apparently Draconian approach seem to be quite simple - revenue considerations. Given such an ultimate objective, any supporting rationalization will thus be accepted, and any contrary rationalization rejected, without regard to relative merits or other policy considerations. Nevertheless, I feel that in proposing the adoption of these regulations at this time, the MTC may not be serving the best interests of its members.

Leaving such fundamental issues aside, how should the proposals be evaluated? I suggest that, when evaluating any taxing system, several fundamental principles need to be adhered to:

1. The system must be self-policing or otherwise insure that there is no multiple taxation of the same income by more than one state.
2. The system must insure that both market states and headquarters states each receive their fair share of a single tax imposed or based upon the U.S.-generated income of the financial institution. This principle is essential if the MTC's goal of uniformity, based upon universal acceptance of its positions, is realizable.
3. Compliance with the rules, and auditability of the results, must be as simple as possible, without undue complexity, and most important, based upon

information available to the taxpayer in the normal course of its business operations without resort to or dependent upon either the actions or activities of its customers or information known only to the customers.

4. The right of a non-domiciliary state to impose a franchise tax should be dependent upon and coupled with the right of the financial institution to fully exercise its franchise in the state (whether or not it chooses to do so). States should have no right to impose a tax based on the privilege of doing business in the state if the taxpayer is at the same time denied that privilege.
5. The rules applicable to financial institutions should conform to the rules applicable to all other service businesses, because financial services is essentially a service business.
6. A financial institution should be able to readily ascertain, at the beginning of a taxable year, whether or not it is or will be subject to the taxing jurisdiction of a state. That will enable it to know, in

advance, the extent to which it may have an obligation to comply with the tax laws and rules of a state during that year. One example is the requirements for estimated tax payments. If a taxpayer cannot determine until after the end of a taxable year whether it is a taxpayer in a state, it can either unwittingly overpay estimated taxes where such payments are not in fact required, or underpay without knowing it is a taxpayer in the state. In addition, all factors taken into account in determining nexus should be based upon a point-in-time "snapshot" of readily available financial data, rather than a cumulation of data over time. Finally, the use of presumptions should be eliminated in favor of mandatory bright-line tests.

Having suggested some fundamental principles which the regulations ought to adhere to, how do the present proposals measure up?

With respect to the prevention of double taxation, the proposed regulations say nothing. Indeed, several rules dealing with sourcing of receipts can be easily interpreted in different ways by different states, thereby causing the same receipts to be simultaneously sourced to more than one state. In addition, the MTC cannot ignore the reality that, so long as there are both market states and headquarters

states, there will be multiple taxation.

As for the dichotomy between market and headquarters states, the proposals are heavily biased toward the market states, to which the headquarters states can be expected to express strong objections. The latter would undoubtedly claim that they have the primary right to tax all of the income earned from the services performed there, since they provide the principle (and vast majority) of the governmental services and protections which support the ability of financial institutions to earn their income. The bias in favor of the market states is derived from the fact that not only are receipts generally sourced based on customer location, but the property factor would include intangible property which is similarly sourced. That has the effect of duplicating the receipts factor.

Under present rules, banks cannot exercise their franchise outside their domiciliary state. Accordingly, the regulation should specifically state that the income of a bank which is taxable based on the privilege of doing business in the state is only subject to tax in that state if the bank is permitted, under the law of the state, to exercise its franchise to conduct the business of a bank to the same extent as a bank either incorporated under the laws of or having a branch located in that state.

With respect to simplicity, there are a number of proposed rules, bright-line tests, presumptions and approaches which could be simplified substantially. However, those items are best dealt with in more technical comments, which will be submitted as a separate item.

In conclusion, I am greatly troubled by these MTC proposals, because they raise unknown implications for nationwide banking and movements of funds and capital. The possibility of multiple taxation of the same income is almost a certainty. If the fundamental issues are to be resolved satisfactorily to all

affected parties, tremendous efforts are clearly going to be necessary. Therefore, I would strongly support the proposal for a 2 year moratorium on further state legislation in order to provide time to seek the necessary compromises.

Thank you for this opportunity to express some of my views.

Haskell Edelstein

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EXHIBIT J: 6:

**Outline of comments by Philip Plant
(Bank of America) (August 23, 1990)**

The MTC's objective is to promote uniform state taxation.

The minimum nexus approach contained in the proposed regulations governing the attribution of income of financial institutions will encourage a proliferation of diverse and conflicting state tax systems instead of promoting uniformity.

This is because the present environment as respects the multistate taxation of financial institutions is extremely unstructured.

This lack of structure arises from:

- (1) A lack of historical experience in taxing out-of-state financials in particular;
- (2) A lack of historical experience in taxing under a destination sourcing approach generally; and
- (3) The evolutionary posture of banking and bank products in this era of deregulation (e.g., secondary market problems in Minn., etc.)

The lack of structure is compounded by a demonstrated tendency of market states to adopt the minimum nexus approach at the slightest encouragement but to deviate from the MTC model in one or more significant particulars. This lack of conformity produces compliance burdens and promotes double taxation. This disregard of the MTC model can be reflected in sourcing and factor weighting variations. This disregard is attributed to:

(1) Revenue needs which cause states to fashion their tax system so as to maximize tax revenues consistent with their regional attributes (market states will weight receipt factors; money states will reject destination sourcing);

(2) Lack of ACIR endorsement implicit in the failure of the ACIR to recognize the MTC source-based approach as the "best" tax system; and

(3) Available alternatives such as the dual tax system with its single gross receipt factor currently promoted by respected consultants such as Sandra McCray.

The foregoing influences will coalesce to produce a patchwork of diverse state tax systems which will burden

multistate financial institutions in a manner disproportionate to the tax revenues generated thereby and virtually guarantee double taxation.

In this environment, the MTC should, at least as an interim measure, adopt more conservation nexus rules paralleling P.L. 86-272. During the interim, the following uncertainties should be alleviated:

- (1) Destination sourcing of receipts from services could be tested in the more stable environment of a §17 UDITPA modification;
- (2) The validity of concept that actual market state revenues, net of compliance/audit costs, is significant could be tested;
- (3) The impact of minimum nexus and destination sourcing on credit flows across state lines and the resultant affect on the local economy of the taxing state could be verified through economic analysis; and
- (4) The resolution of National Bellas Hess issue in the analogous use tax collection context could lend certainty to the constitutional validity of the minimum nexus approach.

EXHIBIT J: 7:

**Memorandum from Credit Union National
Association, Inc. (September 4, 1990)**

Credit Union National Association, Inc.

805 15th Street, NW, Suite 300, Washington, DC 20005-2207, 202-682-4200



Date: September 4, 1990

To: Alan Friedman, General Counsel
Multistate Tax Commission

From: Credit Union National Association, Inc.

RE: The suggestion to include only financial institutions with \$50 million or more in assets in the financial institution franchise tax proposal

A plan linking taxation to size would penalize efficient managers, discourage smaller institutions from expanding, and overall, curtail the credit union movement's ability to grow and fulfill consumers' demands for reasonably-priced financial services.

The larger credit unions are no less non-profit cooperatives than the smaller credit unions. Even the very largest credit unions are run by volunteer boards and committees. Larger credit unions haven't changed their member orientation. The only difference between the larger and smaller credit unions is that the larger credit unions have more members and as a result more assets. Credit unions have grown because they've provided better service to more members.

Credit unions are a movement, not an industry, because they operate in a cooperative system and you can't fundamentally change one part without undermining the entire system.

EXHIBIT J: 8:

**Letter from John R. Engler
(Security Bank & Trust) (October 3, 1990)**



JOHN R. ENGLER
PRESIDENT

16333 Trenton Road

Southgate, Michigan 48195

(313) 281-5185

October 3, 1990

Mr. Alan H. Friedman
386 University Avenue
Los Altos, California 94022

Re: Proposed MTC Regulations

Dear Mr. Friedman:

We are writing to you to express our concern regarding the proposed MTC regulations which embody the market state approach for taxation of income of financial institutions, including out-of-state banks. We are deeply concerned that this new concept of taxation for financial institutions raises unfair tax and tax related burdens on banks. We also believe that these proposals will have a serious detrimental effect on the residents of states which enact such regulations. The enormous costs imposed upon financial institutions by state governments should be carefully considered by you before enacting these regulations.

The failure of the regulations to deal with the issue of multiple taxation raises serious constitutional questions. These proposals constitute a barrier to the flow of funds from state to state which will hurt borrowers in those states which enact regulations such as these. The net effect will be to reduce the availability of credit to residents of the enacting state. Please consider the enormous compliance costs on the taxpayer as well as the cost to the states which will need to audit compliance with the regulations.

The lack of sufficient nexus between the taxing state and the financial institution raises such serious constitutional issues that these regulations constitute "taxation without representation." We are particularly galled by the discrimination which such taxation proposals cause because of other laws which prohibit the operation of branches across state lines. The discrimination is even more pronounced because of federal laws which protect general corporations from being taxed based on customer location even

Mr. Alan H. Friedman
October 3, 1990
Page 2

though they have employees in the state soliciting orders from local customers. Because banks enjoy no such similar protection, banks would be forced to bear a disproportionate share of the responsibility. The regulations seem unfair to us in that they do not address the issue of taxation within the domicile state and the burdens of double taxation.

Those within the academic community who have examined this issue have concluded that these proposals will result in the reduction of credit availability for consumers in the market state as well as a reduction of funds necessary for economic development. It appears inevitable that even higher interest costs for borrowers will need to be borne to make up for the additional tax imposed upon banks. Once out-of state lending becomes restricted, longer periods of economic downturn will occur because of the limited access to out-of-state funds. The inevitable result of these proposals will be that the market state base tax will force even greater concentrations of financial markets in those states which do not opt for implementing these regulations.

In summary, we urge you to consider supporting a two-year federal moratorium on this issue so that the matter can be carefully considered on a uniform basis at the federal level.

Very truly yours,

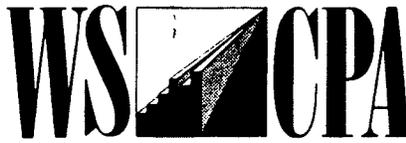


John R. Engler

c American Bankers Association

EXHIBIT J: 9:

**Comments by David Danielson
(Washington Society of CPAs) (November 16, 1990)**



**WASHINGTON SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

902 140th Ave. N.E. Bellevue, WA 98005 206.644.4800

November 16, 1990

Mr. Alan H. Friedman
Hearing Officer
Multistate Tax Commission
386 University Avenue
Los Altos, CA 94022

Dear Mr. Friedman :

MULTISTATE TAX COMMISSION

PROPOSED REGULATION IV.18.(i)

WRITTEN COMMENTS

WASHINGTON SOCIETY OF CPAs

We present these written comments on behalf of the Washington Society of CPAs (WSCPAs) in connection with the proposed Multistate Tax Commission (MTC) regulations dealing with taxation of interstate activities of banks and other financial institutions. The Washington Society of CPAs is the primary professional association representing certified public accountants in the State of Washington, and is associated with the American Institute of Certified Public Accountants.

Many members of our Society are vitally interested in the banking and financial institutions industry, both as employees of the industry and as professional service providers to the industry. As a result, the Society maintains a Financial Institutions Committee dedicated to the mutual interests of the industry and the professional accountants providing services to the industry. The following comments are presented by the Tax Sub-Committee of the WSCPAs Financial Institutions Committee.

PROBLEM AREAS IDENTIFIED

We would like to briefly discuss three problem areas, as follows :

1. Difficulties in Compliance
2. Uniformity in Application
3. Practical Considerations to the Taxing Jurisdictions

Difficulties in Compliance

Banks will have two down-to-earth, practical problems in complying with these regulations. The first of these is in capturing the data necessary to identify the source of transactions based on customer addresses. Current data processing programs utilized in tracking loan activity do not generally maintain a "data field" with which to sort the transactions by zip code, or by any other state code.

The cost of modifying, or replacing, existing computer systems is substantial for any size bank. Many of these costs for programming time and effort are fixed regardless of the size of the bank, i.e. the number of loans maintained on the system. For a "smaller" bank, say one with less than \$ 300 million in assets, the costs are much more significant in relation to the available programming resources, and in relation to the total state tax dollars generated. Alternatively, the smaller banks may have many manual systems and would incur excessive clerical time in lieu of programming costs.

It is important to note that even a \$ 300 million bank will likely produce total state tax revenues to all taxing jurisdictions of, at most, \$ 120,000 per year. This assumes that gross receipts total ten (10) percent of assets, that a healthy net income of four (4) percent of gross receipts is achieved and that an average state tax rate would equal ten (10) percent.

This is not a great deal of money to allocate among multiple jurisdictions, and significant programming costs should not be required for compliance. According to the Washington Banker's Association, only 848 of 12,191 commercial banks in the United States, or seven (7) percent, exceed \$ 300 million in assets.

This means the majority of financial institutions will pay less than \$ 120,000 in total state taxes per year.

The second out-of-pocket cost for the smaller institution are professional fees for CPAs to interpret both the MTC regulations and the related filing requirements of each state jurisdiction. While this may appear of benefit to a group of professional accountants such as ours, the tax liabilities would not generally be large enough to warrant a profitable fee.

The proposed regulation needs a higher de minimis rule to exclude the filing of tax returns for truly de minimis tax amounts. We would suggest a de minimis standard of \$ 25 million in assets, or 20 customers in a state which generate a minimum of \$ 1 million in gross receipts. Using our earlier assumed ratio of net income to gross receipts of four (4) percent, this results in a minimum tax of \$ 4,000 on \$ 1 million in gross receipts.

Uniformity in Application

The ideal of all taxpayers is to have a uniform set of rules, in order that they might program a uniform approach to state tax compliance. It is the stated intention of the MTC to promote such uniformity in proposing these regulations. Only nineteen (19) states are full MTC members and each state can, nevertheless, modify the MTC regulations with its own individual twists. It seems unlikely that real uniformity can be achieved in this format. The only format that can achieve a true sense of uniformity is that of federal legislation, which will apply equally to all states.

Practical Considerations to the Taxing Jurisdictions

The effect of implementing these regulations would appear to be the movement of state tax dollars among states. These tax dollars would not seem large enough, in most cases, to support the states' administration of regulations, forms, and compliance audits. As the same total tax dollars being collected today are moved from jurisdiction to jurisdiction, there will be winners and losers, but none of great consequence. The question arises of where the real benefits of this scheme lie.

Mr. Alan H. Friedman

Page 4

SUMMARY

The cost of compliance with these regulations is prohibitive for smaller banks, these being the majority of all banks. The regulations will not achieve a high level of uniformity in their application by the various states. The costs of administration to the states may not outweigh the minor potential benefits.

We appreciate the opportunity to present you with these comments. If you need clarification regarding any of these comments, please contact either Dave Danielson, Tax Sub-Committee Chairman, at (206) 292-3279, or Doug Wisdorf, Financial Institutions Committee Chairman, at (206) 461-3805.

Yours Very Truly,



David A. Danielson
WSCPFA Financial Institutions Committee
Tax Sub-Committee Chairman

EXHIBIT J: 10:

**Testimony of Bruce Baker
(Dean Witter Financial Services Group)
(December 3, 1990)**

Exhibit J 10 is Missing

EXHIBIT J: 11:

**Testimony of Ron Schreiner
(Secretary of Revenue of South Dakota)
(December 4, 1990)**

The following remarks are offered by Ron Schreiner, Secretary of Revenue in South Dakota, on behalf of the State of South Dakota to the Multi-state Tax Commission hearing on proposed regulations for financial institutions, Atlanta Georgia, December 4, 1990:

Mr. Hearing Examiner, I fully intended to present these remarks to you in person, but the uncertainties of winter travel from the Great Plains have once again ruled the day, and I am safe and warm in my office in Pierre - not circling a socked-in Minneapolis airport (which was one of the options discussed earlier as I was deciding to remain in Pierre). I will attempt to fax this document to you for inclusion in the official proceedings of the Atlanta hearing.

South Dakota approaches the taxation of services of a financial institution with a long history of service taxation. We've been in the business of taxing services since 1965, and in that time we have suffered through a fair number of court cases and legislative challenges. And just as no state's position is ever static, we have evolved with the realities of court decisions and other influences - not the least of which is simply the daily burden of making it work. Common sense, I believe it is sometimes called. And the common sense of the proposed MTC regulation is that it is contrary to the current trend.

States which tax services, and that, I believe, is exactly what we are talking about, have come to realize that the taxing jurisdiction is where the service work is performed. One need only consider the ease of administration to arrive at that conclusion. If the service is not used where the service is performed, then how are we to determine at that time where the service will be used? Should a haircut be taxed in all the taxing jurisdictions the hair owner will visit until the next haircut? How would one determine in advance which highways would be driven down by the recently repaired salesperson's car? If one were to attempt to establish legal nexus, what tests would be applied to the provision of the service? I submit that a service is consumed when performed and it cannot be transported or exported.

It seems to me the compliance and administrative problems brought about by the proposed regulation exceed any projected gains. Taxpayer concerns about administrative complexity are well taken. We live in a mobile society, where residences change often. The cost of tracking residence, or use, or purchase could force the taxpayer as

well as our own auditors into a monumental task in analyzing records and tracking transactions to determine compliance. In the face of complexity and high compliance costs, taxpayers are likely to fail to comply, gambling they will never be caught.

There are several legal hurdles which must be successfully negotiated:

- Jurisdiction to allocate and tax income to the market state is far from a settled question. Extensive, time consuming and expensive litigation will result
- Use of artificial and arbitrary thresholds to include/exclude certain taxpayers may fail constitutional tests with possible refund exposure for states
- Current sales tax nexus cases indicate the judicial view of siting income may still be as restrictive as the opinion in National Bellas Hess
 1. Current MTC proposed banking regulations are much more expansive than NBH making litigation an iffy proposition
 2. Philosophically coupling the proposed banking regulation to the MTC position on NBH is inappropriate and unnecessary, as the nexus asserted in the banking regulation is much more remote than the nexus question at issue in NBH

As the Secretary of one of the MTC member states, I urge my organization to reassign itself to the priorities at hand. The member states are divided on this issue. The MTC as an organization will not gain from pitting one member against another. We already have enough enemies and too few members. The MTC will lose credibility as it is too far out in front of the legal system on this issue. This is an idea whose time is not yet come!

MTC members are united on a host of other issues. Time and scarce resources would be more profitably directed to areas of greater general impact where members stand together.

There is no demonstrable need for the proposed regulation in my view. Banks are already subject to taxation and are already paying the tax to their home jurisdiction. The current method of allocating income is well established and administrable. And we as an organization don't need the costly, high-risk exposure this issue is bound to bring us.

Let's leave well enough alone.

EXHIBIT J: 12:

**Comments of Tom Neubig
(FIST) (December 4, 1990)**

COMMENTS OF
TOM NEUBIG
PRICE WATERHOUSE
ON BEHALF OF THE
FINANCIAL INSTITUTIONS STATE TAX COALITION
TUESDAY, DECEMBER 4, 1990
TO THE
MULTISTATE TAX COMMISSION
WITH RESPECT TO
REG. IV.18(i) SPECIAL RULES: FINANCIAL INSTITUTIONS

I am Tom Neubig, Director of Financial Sector Economics at Price Waterhouse's Washington National Tax Services. Previously, I was Director and Chief Economist of the U.S. Department of the Treasury's Office of Tax Analysis. I am here today to share with you some preliminary findings from a forthcoming economic study Price Waterhouse is preparing for the Financial Institutions State Tax Coalition. The study analyzes the effects of one state enacting destination-sourcing tax rules for financial institutions.

The economic study does not address whether a uniform origin- or residence-based system of taxing financial institutions is superior to a uniform destination-sourcing based system. That issue depends on several factors, including (1) the tax policy question of what distribution of tax revenue between states is appropriate; (2) the relative administrative and compliance costs of the alternative systems; and (3) the likelihood of non-uniform tax treatment across states, between financial institutions, and across industries (and the consequent adverse economic effects) under the alternative systems.

Recent experience with state taxation of financial institutions and the history of state taxation of interstate business does not indicate that a uniform state taxation method will be achieved. The recent changes in the Minnesota, Indiana, and Tennessee tax laws have increased the non-uniformity of taxation of financial institutions, and have significantly increased the potential of multiple taxation of income from interstate financial services. Multiple taxation of income from interstate financial institutions would impact adversely on residents and businesses located in a state imposing such a tax.

Thus, any state considering switching from residence-based taxation of financial institutions to destination-sourced based taxation, given the other states' current tax rules, must weigh the economic effects of such a change. The forthcoming Price Waterhouse study will analyze the economic effects of one state enacting destination-sourcing tax rules for financial institutions, similar to Minnesota's, Indiana's and Tennessee's rules.

The economic effects would include reduced capital availability and/or higher prices for credit and financial services in the destination-sourcing state; reduced interstate financial services and new capital barriers; penalties on traditional financial institutions relative to non-taxed financial service providers; and/or increased uncertainty, administrative, and compliance costs from the new tax rules.

Let me give some highlights of each of these effects.

Reduced capital availability

- Both in-state and out-of-state financial institutions would have an incentive at the margin to reduce their lending to residents and businesses in a state where a destination source-based tax has been enacted, similar to Tennessee's or Minnesota's new rules. These institutions have the alternative of increasing lending to borrowers in residence-based tax states to avoid the destination-based tax.
 - Financial institutions in the destination-sourcing state could reduce total state taxes by shifting lending activity to borrowers in states with residence-based tax systems.
 - Multiple taxation would occur on income from financial services provided to destination-source state residents and businesses by out-of-state financial institutions located in residence-based tax states. The income would be taxed twice: once by the resident-based tax state and again by the destination-sourcing tax state. Out-of-state financial institutions can avoid this multiple taxation by lending to borrowers in other states.
 - Reduced credit availability would occur in capital-importing states even if they adopted destination source-based taxation with a throw-back rule or a dual tax system.
- The reduction in credit availability would affect all borrowers in the destination-sourcing tax state, and particularly marginal borrowers:
 - Lower income persons, including recent entrants in the job market and those with low levels of education and skills, would be most affected by tighter credit standards.
 - Small and medium-sized businesses would be most affected by tighter credit, since larger firms have greater resources for collateral, retained earnings, and access to security markets.

Higher prices for credit and financial services

- Particularly for capital importing states, after an adjustment period the tax paid by out-of-state institutions would be likely to be passed through to consumers in the destination-sourcing tax state in the form of higher interest rates and prices for financial services, and/or reduced financial services.
 - By our estimates, two-thirds of all states are likely to be net capital importers, relying on credit from out-of-state financial institutions. See Table and Chart A. These capital importing states would be most likely to experience adverse economic effects of taxing financial institutions under a destination-sourcing system.
 - Fifteen percent of corporations in a sample of 4600 corporations reported a primary banking relationship with an out-of-state bank. See Table and Chart B. Secondary banking relationships, including loan participation and specialized services, would involve a higher percentage of out-of-state banks. Over 20 percent of middle-market corporations with annual sales between \$50 and \$500 million had an out-of-state primary banking relationship.
- Higher interest rates would affect households and businesses in the destination-sourcing state. For example, interest rates could increase 7-15 basis points depending on the type of loan assuming an 8.5 percent state corporate tax rate and a 100 percent receipts apportionment formula. Higher interest costs could increase:
 - annual payments on an average mortgage for new homes by \$145-\$170;
 - annual payments on debt of an average medium-sized manufacturing firm by \$7,600-\$12,600; and
 - annual total interest costs paid by residents and businesses in an "average" state with two percent of total U.S. borrowing by approximately \$120 million.
- These potential costs only include the impact of the direct destination-sourcing tax. The costs would be higher if they included the administrative and compliance costs associated with a destination-sourcing tax, which could be greater than the direct tax for many financial institutions.
- Reduced competition, reduced economies of scale, and increased concentration of geographic lending risks would increase upward pressure on the costs of capital and services provided by financial institutions.

- If passed forward to the destination-sourcing state's consumers, the increase in financial service costs borne by state residents would be greater than the amount of tax collected. Higher interest expenses and reduced economic development also would reduce the destination-sourcing state's income tax revenues.

Reduced interstate financial services and increased capital barriers

- If the additional tax cost is not borne by consumers in the destination-sourcing state, then the tax would fall on financial institutions providing services and loans between states. The tax would be a new barrier to the flow of capital within the United States.
- Reduced credit availability and/or higher credit costs in the destination-sourcing state would be harmful to state economic development efforts to attract and retain medium-sized businesses.

Additional effects

- Competitive neutrality between in-state and out-of-state financial institutions would not be achieved by one state adopting destination-sourcing tax rules or the MTC regulations as long as non-uniform apportionment rules and residence-based taxation in other states remain.
- A destination-sourcing tax on traditional financial institutions only would encourage the expansion of non-taxed financial service providers with a resulting loss in economic efficiency by substituting activity by higher cost but untaxed providers for activity by lower cost taxed providers.
- * A destination-sourcing tax would increase uncertainty and the administrative and compliance costs for many financial institutions. The required information is not currently collected or reported for regulatory or tax administration purposes, and would multiply to the extent states adopted non-uniform destination-sourcing rules.
 - These additional costs will be borne by the destination-sourcing state's residents in higher prices or reduced capital availability, or will become an additional tax on interstate financial institutions.

Measured against the generally-accepted objectives of "good" tax policy, a switch by one state to destination source-based taxation of financial institutions at the current time would raise serious questions about the efficiency, equity, and simplicity effects of the tax.

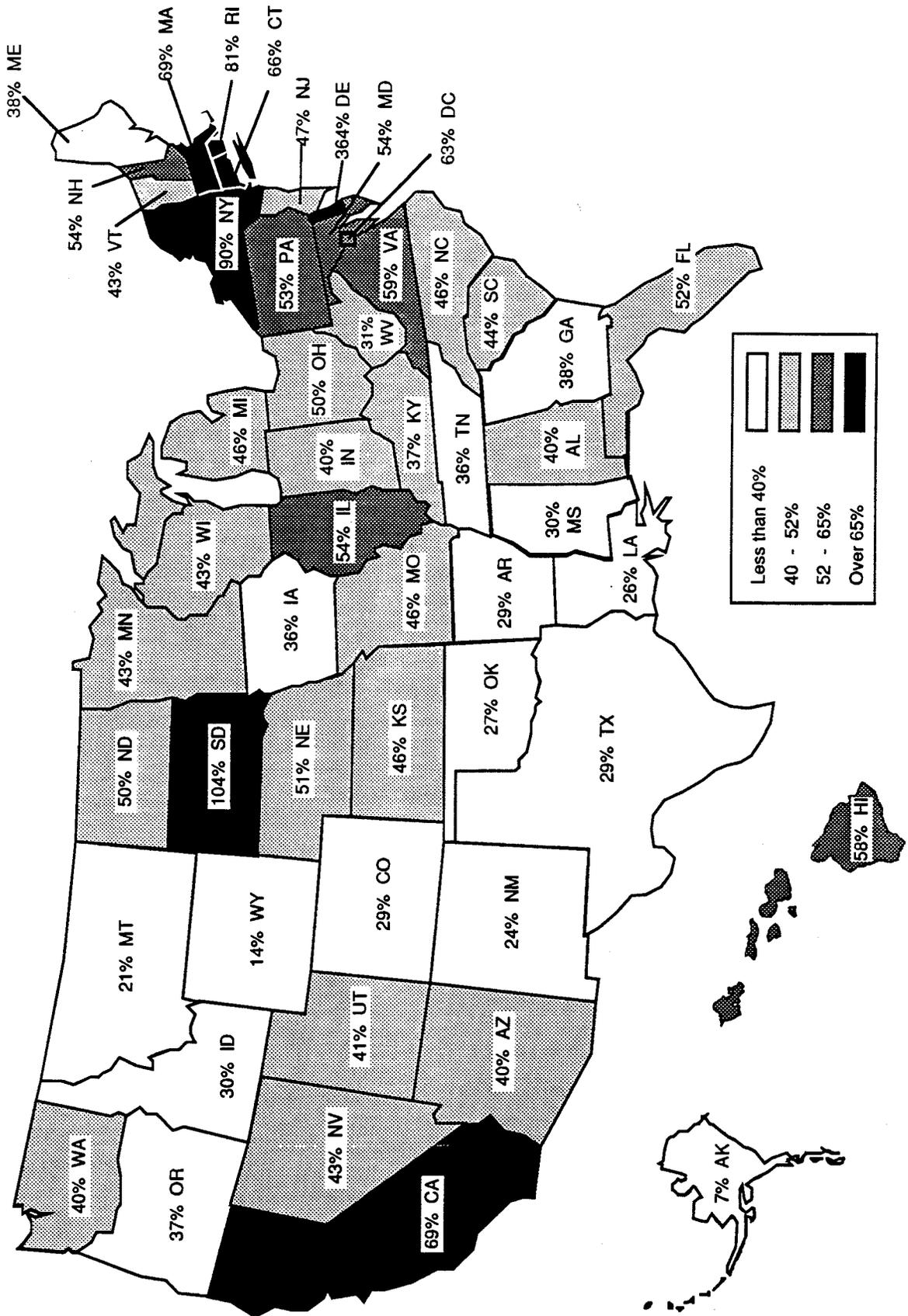
I appreciate the opportunity to make these abbreviated comments at this hearing, and will supply the final Price Waterhouse study for the record when it is completed.

Table A. States Ranked by 1989 Ratio of In-State Financial Institution Lending as Percent of Estimated State Borrowing (Percentages)

State	In-State FI Lending/ Estimated Borrowing	Rank
Delaware	364	1
South Dakota	104	2
New York	90	3
Rhode Island	81	4
California	69	5
Massachusetts	69	6
Connecticut	66	7
D.C.	63	8
Virginia	59	9
Hawaii	58	10
Illinois	54	11
Maryland	54	12
New Hampshire	54	13
Pennsylvania	53	14
Average for U.S.	52	--
Florida	52	15
Nebraska	51	16
Ohio	50	17
New Jersey	47	18
Kansas	46	19
Missouri	46	20
North Carolina	46	21
Michigan	46	22
South Carolina	44	23
Minnesota	43	24
Vermont	43	25
Nevada	43	26
Wisconsin	43	27
North Dakota	42	28
Utah	41	29
Washington	40	30
Arizona	40	31
Indiana	40	32
Alabama	40	33
Georgia	38	34
Maine	38	35
Kentucky	37	36
Oregon	37	37
Iowa	36	38
Tennessee	36	39
West Virginia	31	40
Mississippi	30	41
Idaho	30	42
Colorado	29	43
Texas	29	44
Arkansas	29	45
Oklahoma	27	46
Louisiana	26	47
New Mexico	24	48
Montana	21	49
Wyoming	14	50
Alaska	7	51

Price Waterhouse, Washington National Tax Services.
Source: Price Waterhouse estimates.

Figure A. Total In-State Financial Institution Lending as Percentage of Total Private Borrowing in 1989



Source: Price Waterhouse estimates.

Price Waterhouse, Washington National Tax Services.

**Table B. Percent of Corporations Reporting an Out-Of-State
Primary Banking Relationship by State, 1989**

State	Percent of Out-of-State Primary Banking Relationships
Alabama	13.5%
Alaska	28.6
Arizona	19.5
Arkansas	26.9
California	8.0
Colorado	17.6
Connecticut	27.2
Delaware	70.0
D.C.	7.1
Florida	14.1
Georgia	15.1
Hawaii	9.1
Idaho	33.3
Illinois	8.7
Indiana	20.6
Iowa	27.7
Kansas	34.1
Kentucky	17.5
Louisiana	14.8
Maine	16.0
Maryland	34.3
Massachusetts	5.5
Michigan	15.9
Minnesota	11.7
Mississippi	16.1
Missouri	13.3
Montana	12.5
Nebraska	13.3
Nevada	37.5
New Hampshire	46.9
New Jersey	28.8
New Mexico	18.2
New York	9.0
North Carolina	9.2
North Dakota	*
Ohio	8.9
Oklahoma	13.9
Oregon	10.2
Pennsylvania	12.0
Rhode Island	11.8
South Carolina	26.7
South Dakota	*
Tennessee	24.6
Texas	11.8
Utah	9.1
Vermont	40.0
Virginia	20.2
Washington	9.5
West Virginia	31.3
Wisconsin	16.7
Wyoming	*
Average for U.S.	14.8%

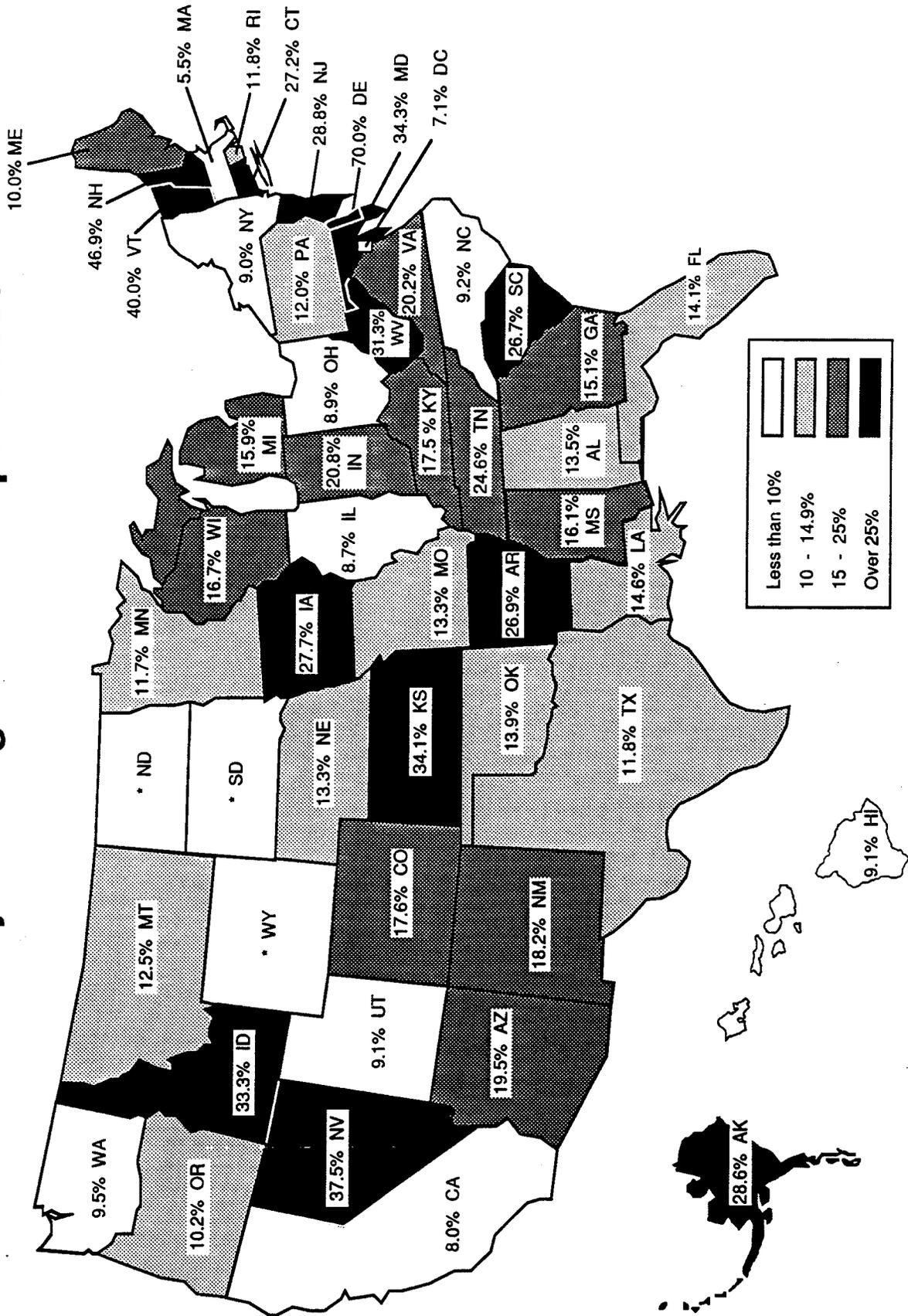
Price Waterhouse, Washington National Tax Services.

* Less than six corporations reporting a primary banking relationship.

Source: Standard and Poor's Compumark Data Services.

Compiled by Price Waterhouse from a sample of 4601
corporations reporting a primary banking relationship.

Figure B. Percentage of Firms with Out-of-State Primary Banking Relationships in 1989



* Sample includes fewer than five companies.

Source: Standard & Poors Compumark database. Sample by Price Waterhouse.

EXHIBIT J: 13:

**Testimony of Marcia Dieter
(Washington Bankers Association)
(December 7, 1990)**

Exhibit J 13 is Missing

EXHIBIT J: 14:

**Letter from Robert F. McCammon Jr.
(CoreStates) (December 19, 1990)**

CoreStates Financial Corp
FC 1-23-1
PO Box 7618
Philadelphia PA 19101-7618
215 973 3508

Robert F McCammon Jr
Senior Vice President



CoreStates

December 19, 1990

Alan H. Friedman, Esq.
386 University Ave
Los Altos, California 94022

Dear Mr. Friedman:

Re: Proposed MTC Allocation and
Apportionment Regulations for
Financial Institutions

In my testimony at the December 4, 1990 MTC hearing on multi-state taxation of financial institutions I suggested the MTC proposal puts banks at a competitive disadvantage to non-bank entrants into credit card and other financial services businesses. I still believe this to be the case and thought the enclosed article from the November, 1990 issue of Bank Management would be of interest to you.

It is my understanding the issuer of the Universal Card is Universal Bank, a banking subsidiary of Synovus Financial Corp, of Columbus, Georgia. While the Bank Holding Act precludes AT&T from having a majority ownership in Synovus I understand that AT&T effectively controls the entity, and provides 100 percent of the financial support for Universal Bank by purchasing on a regular basis all its credit card receivables.

Please feel free to call me if you wish to discuss this further.

Very truly yours,

Bob W. Cammon

Banks Cry "Foul" Over Competition

Universal Success of AT&T Card Prompts Re-Examination of Membership System

**By Helene Duffy
Contributing Editor**

Six months after welcoming giant AT&T into the bank card fold, Visa and MasterCard have disclosed plans to review the merits of non-bank access to their bank card systems.

The phenomenal success of AT&T's Universal card has prompted a re-examination of membership rules and regulations to ensure "a level playing field" for all card issuers. Addressing the recent National Bank Card Conference, the CEOs of both associations said limitations on membership are priority measures up for consideration by their respective boards.

Initially, the two card associations rationalized the entry of AT&T as a move that would benefit all bank card issuers. But as more member banks cry "foul" over skewed competition, their positions changed.

Charles T. Russell, Visa's CEO, said it was time to change the "complete no strings attached, open-door policy" with respect to membership in the bank card systems. This policy, he said, was established when "banks were banks, when finance companies made small loans, when auto companies assembled cars and trucks, when insurance companies wrote insurance policies and when telephone companies provided good telephone services."

However, time and deregulation have changed the ground rules and "what was a relatively level playing field" has become tilted because banking laws "have not kept pace with marketplace developments."

Impact of AT&T Card Entry

MasterCard CEO Alex W. Hart said AT&T's entry has been "catalytic" to the re-evaluation of

membership rules. There is no question, he said, the AT&T affinity program "has stretched the limits of the definition of membership." The AT&T card (issued by Synovus Financial Corp., Columbus, Ga.) is not an ordinary affinity arrangement. According to Hart: "We have very purposefully diminished the size of the MasterCard mark on the face of the card, in deference to the interest of our issuers." But new players have come along whose name may represent a "powerful global brand" and have "greater recognition than ours."

The issue of membership and ownership permeated the conference, both at the podium and among attendees. In a presentation calling for complete restructuring of the banking business, James L. Bailey, group executive in charge of credit cards at Citibank, said the bank card business has only recently met the full force and power of less regulated competition. "Today, some new entrants are willing to rent a bank in order to get a foothold in the bank card business — one of the few bank products with a good margin." But will these businesses "be interested in our low-profit-margin products? I doubt it."

Bailey said his bank "spent 20 years and billions of dollars building the infrastructure, the consumer confidence and reputation of our cards." In allowing new entrants into the bank card business, this investment should be taken into account, he said, particularly if these companies are not subject to the same regulatory constraints as banks.

Last spring, Citicorp — along with Chase Manhattan, Bank of America and Maryland National Bank — attacked AT&T's Universal card by filing complaints with the Federal

Reserve Board, the Federal Deposit Insurance Corp., the Georgia state banking commission and the Federal Communications Commission.

Potential Legal Questions

Both Visa and MasterCard are cognizant that putting restrictions on access to the bank card systems and changing membership policies can raise a host of legal issues. But one way or another, these issues must be addressed, says Visa's Russell. He cited three options available to bankers:

One, keep membership rules as they are, i.e., an open membership policy. Under these terms, non-banks, in effect, become "free riders" cashing in on the investments of the founders and developers of the business.

The second choice may be to close membership doors altogether and indicate the franchise is adequately served by the existing membership. How this policy would "fare in the courts, I can't say," Russell said. But it is an option that must be "seriously reviewed and considered," he added.

The third option: "The doors are open, but the bank card organization will level the playing field" with new operating rules. The price of admission will involve compensating existing members for the investment and risks they have taken in developing the bank card system.

Russell concluded by stating: "It would be disingenuous of me to imply that Visa has developed a simple solution to this membership-ownership dilemma." But it would be "negligent" of the management of Visa to ignore this problem and not develop "options for consideration and possible adoption."

BAI

(Continued on page 10)

EXHIBIT J: 15:

**Letter from Fred E. Ferguson
(January 21, 1991)**

Price Waterhouse



January 21, 1991

Mr. Alan H. Friedman
General Counsel
Multistate Tax Commission
386 University Avenue
Los Altos, California 94022

Dear Alan:

On behalf of the Financial Institutions State Tax Coalition, enclosed are the Coalition's detailed comments with respect to the Multistate Tax Commission Proposed Regulation Article IV.18(i), Special Rules: Financial Institutions (Proposed Regulation). As the comments indicate, and as the Coalition and its various member's testimony at the earlier public hearings stressed, the nexus standard based upon an "economic presence" is a theory strongly opposed. Nexus or jurisdiction rules are constitutional and statutory questions and as such, are not appropriately addressed through regulations, especially regulations which provide rules for attribution of income among the states.

If the MTC is insistent that the Proposed Regulation ultimately include nexus standards, the Coalition urges that the determination of sufficient nexus be made only at a point in time prior to the beginning of a taxable period.

Some of the major concerns of the Coalition are:

- o With respect to the apportionment rules contained in the Proposed Regulation, the Coalition's position has always been that the financial services industry is just that - a service industry. As such, income earned from the performance of services should most properly be attributable to the state in which such services are performed.
- o Bright-line tests rather than rebuttable presumptions should be used, thus avoiding unnecessary audit and compliance disputes without significantly affecting the ultimate results.

Mr. Alan H. Friedman
January 21, 1991
Page 2



- o Intangibles should be eliminated from the property factor because the sourcing rules for such property are the same as those used for receipts from such property, thus creating a double weighting of factors in favor of the "market" state. In the Coalition's opinion, this is inappropriate for a service business.

- o If the Proposed Regulation will require financial institutions to attribute income based, in part, upon their market, the Coalition urges that for ease of compliance the location of the customer be based solely upon billing address regardless of the type of receipt or property involved.

The enclosed comments go into further detail and provide the Multistate Tax Commission with meaningful concerns and recommendations. While many of these comments are self-explanatory, some may require further dialogue. Therefore, please feel free to contact me so that arrangements can be made to discuss any questions or comments you may have.

Sincerely,

Fred E. Ferguson
Director, State Tax Policy
Executive Director
Financial Institutions State Tax Coalition

Enclosures

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1. The Resolution and the opening sentence of the Multistate Tax Commission ("MTC") Proposed Regulation IV.18.(i) ("Proposed Regulation") state that the Proposed Regulation is intended to establish rules regarding attribution of income derived from the business of a financial institution. There is no mention of the intent to establish rules regarding jurisdiction to tax, yet the Proposed Regulation contains such rules. What is the MTC's authority for establishing rules regarding jurisdiction to tax?
2. With respect to the definition of "Borrower" [(B)(1)]:
 - a. In the situation where there is more than one party liable on a debt instrument, the respective interests in such instrument may not be determinable, e.g., joint and several liability. In addition, where the "borrower" consists of an affiliated group of entities, there should be only one "borrower" which perhaps should be the common parent of the affiliated group.
 - b. There is a conflict between this definition and the sourcing rules which presumptively look to the billing address of the borrower, which is likely to be a single address.
 - c. We recommend that a debt instrument be treated as a single instrument regardless of the number of individuals or entities liable on the instrument.
3. Definition of "Business of a Financial Institution" [(B)(2)]:
 - a. This definition could be incorporated into the definition of a "financial institution" in (B)(7) in order to simplify the Proposed Regulation.
 - b. The reference to "finance leasing" should be included in (B)(2)(c) as part of a more detailed definition of "lending activities."
4. Generally, the definition of "deposit" [(B)(3)] is far too broad for purposes of either determining jurisdiction to tax or apportioning receipts and property. For example, trust funds held by a financial institution but which are invested in someone else's behalf should not be considered a "deposit." Similarly, a letter of credit does not provide lendable funds. We recommend that deposits not be used for either determining jurisdiction to tax or apportioning receipts or property.

5. With respect to the definition of "Exercising a Corporate Franchise or Transacting Business in a State" [(B)(5)]:
- a. Jurisdiction to tax standards do not belong in attribution of income regulations.
 - b. If a state is exercising its right to tax an out-of-state financial institution as if it was transacting business in the state then the out-of-state financial institution should be afforded the privilege to maintain an office or branch in that state and conduct all of the activities which it is legally empowered to conduct under its charter.
 - c. It appears that a single lease of tangible personal property (e.g., automobile lease) [(B)(5)(a)] or a single "direct" mortgage loan [(B)(5)(b)] without respect to amount is sufficient to establish jurisdiction to tax. A de minimis rule (see comment h. below) would be preferable.
 - d. What is the definition of a "direct loan" [(B)(5)(b)]?
 - e. The reference to independent contractor [(B)(5)(c)] is undefined and is unduly broad (cf. P.L. 86-272 definition), so as to encompass anything from a correspondent bank to a law firm, credit bureau, collection agency, advertising agency, mailing or marketing firm or service bureau performing any of a wide variety of services for an out-of-state financial institution. Given the relatively broad extension of jurisdiction based upon loans or receipts, retention of the phrase is not necessary to provide the intended standard. The phrase also creates confusion in connection with the definition of "independent person not acting on behalf of the taxpayer" [(B)(9)].
 - f. The fact that an individual or an entity makes a decision to deposit funds in a depository (with or without solicitation by the depository) should have no bearing on jurisdiction to tax that depository. Jurisdiction to tax should be based on the activity of the entity subject to tax, not the activity or decision-making process of its customers. Furthermore, the presence of depositors in a state should have no bearing on jurisdiction to tax an institution when such institution is precluded from conducting deposit-taking activities in the same state claiming jurisdiction to tax. [(B)(5)(d)(ii)] Following the logic of the Proposed Regulation, a depositor should be subject to tax in the state of the payor depository (i.e., the borrower of the funds).

- g. A deposit-taking institution can be subject to tax in a state based upon its sources of funds (i.e. deposits) yet an entity that conducts the "business of a financial institution" but does not take deposits may not be subject to tax in that state because its sources of funds are not a factor in the jurisdictional presumption. [(B) (5) (d) (ii)]
- h. Does the Proposed Regulation intend that so long as there is regular solicitation, even a single customer created as a result of such solicitation is sufficient to be transacting business or should the presumptions be viewed as a de minimis standard? There is no reason for the Proposed Regulation to refer to "regular solicitation" and then include presumptions. Rather, the presumptions (to the extent they remain) should be used only as de minimis jurisdictional rules. [(B) (5) (d)]
- i. With respect to (B) (5) (d) (ii):
- (i) The Proposed Regulation attributes receipts, property and payroll to a state but not "assets." Therefore, it would be preferable to look to property attributable to sources within the state.
 - (ii) As discussed above, the amount of deposits should be irrelevant in determining jurisdiction to tax.
 - (iii) How is the "average" determined?
 - (iv) Use of an average during the tax year will not provide a taxpayer with certainty as to its tax compliance responsibilities until well into a tax period. Use of a "snapshot" determination at the beginning of a taxable year (or end of the prior year) should be applied prospectively only.
 - (v) By sourcing certain assets based upon deposits and at the same time looking at the amount of deposits attributable to a state, the Proposed Regulation has the effect of double counting deposits in determining jurisdiction to tax.
- j. With respect to (B) (5) (d) (iii), for institutions that enter into debtor/creditor relationships, the MTC did not do much by raising the asset threshold from \$5MM to \$10MM since it only takes \$5MM of assets at a 10% interest rate to yield \$500,000 in receipts. In addition, a financial institution with a substantial investment portfolio could have \$500,000 in receipts attributable to the state based upon de minimis deposits.

k. With respect to (B)(5)(e):

- (i) Can an institution qualify for the exemption if the loan participated was originated by that institution or if that institution is the lead bank in a syndication and the institution's sole and exclusive activities in the state relate to such loan?
- (ii) Subsections (v) and (vi) refer to assets yet look to receipts attribution rules rather than property attribution rules.
- (iii) With respect to subsection (viii), where the financial institution is not considered to be transacting business with respect to a loan to an individual, estate or trust, it should not be so considered in the case of the foreclosure of such loan.
- (iv) In subsection (viii) something more definitive than "a reasonable period of time" should be used, e.g., a permissible period for regulatory purposes.
- (v) Can a financial institution participating in a loan originated by a non-independent person be eligible for the exemption in subsection (i) assuming that its sole activity in the state is limited to evaluating, acquiring, maintaining and/or disposing of such participation?

6. The definition of "finance leasing" [(B)(6)] is confusing. First, any references to lessee treatment, including capital leases, should be eliminated. If it is intended that any lease which is treated for lessor accounting purposes under financial accounting rules is a financing transaction, then the definition should specifically so provide. We recommend, to the extent any definition is needed, that all leases where the financial institution is lessor should, for purposes of the Proposed Regulation, follow financial treatment for all purposes. Second, as noted above in 3, it would be consistent to clarify that any corporation primarily engaged in finance leasing as defined herein would be a "financial institution".

7. With respect to the definition of "financial institution" [(B)(7)]:

- a. The definition of "holding company" in (B)(8) can be incorporated into (B)(7)(a).

- b. As noted above, it would be less confusing if the definitions contained in (B)(2) were incorporated into (B)(7).
8. With respect to the definition of "independent person not acting on behalf of the taxpayer" [(B)(9)]:
- a. Why is the threshold 15% rather than a more substantial ownership percentage (e.g., 51%)?
 - b. Under the definition, if Company A owns 15% of Company B and Company B owns 15% of Company C, Company A is deemed to own 15% of Company C rather than 2.25% of Company C (i.e., 15% of 15%) under normal attribution rules (cf. Section 318 of the Internal Revenue Code of 1986, as amended).
 - c. What are "intermediary parties in the transaction"?
 - d. Under (b) and (c) of the definition, the consequences to the taxpayer should not rely on the actions of another entity, in this case the entity from which the taxpayer acquires the asset, etc.
 - e. What are "exempt assets, loans or property"?
9. Loan related fees [(B)(10)] should be treated separately from loan servicing fees [(B)(10) and (B)(11)]. Loan related fees should include items that are amortized for financial accounting purposes either as yield adjustments or commitment fees. Loan servicing fees should include, in addition to what is contained in the existing definition, purchased servicing rights. Because of the distinction between loan related fees and loan servicing fees, different apportionment rules should apply to each such fee (see below).
10. With respect to the bracketed portion of the definition of "presumption" [(B)(14)], the burden of proof should always be placed on the party seeking to escape the presumption. This should not vary by state.
11. With respect to the definition of "property located in this State" [(B)(15)], the general rule is in conflict with the presumption. If, for purposes of the Proposed Regulation, there are to be different rules for unsecured loans and loans secured by tangible property, there should be three rules for where property is located: the rule for real property should be where such property is physically situated (with no presumption); the rule for tangible personal property should be the billing address (and it should not be a rebuttable presumption); and the rule for moveable tangible property should be as contained in the Proposed Regulation.

12. The use of the word "transactions" in the parenthetical contained in the definition of "receipts" [(B)(16)] should be replaced with the word "instruments". In addition, the term "net taxable gain" needs to be defined. For example, is it determined on a per transaction basis, in the aggregate for each category of assets or in the aggregate for all assets? Note that this issue would impact the calculation of both the numerator and denominator of the receipts factor. In certain cases (e.g., hedging and other high volume transactions) it is essential, from both an economical and a compliance perspective, to aggregate transactions. Once aggregated, how should such receipts be sourced? We urge that they be sourced based upon where the trading activities occurred, which is the rule ultimately accepted by New York State in dealing with such transactions associated with foreign activities.
13. The reference to the Federal Savings and Loan Insurance Corporation in the definition of "regulated financial corporation" [(B)(17)] should be stricken due to the restructuring of the financial services industry. In addition, the presumption as to subsidiaries being "financial institutions" is unnecessary because of their respective inclusion in (B)(2) and (B)(7).
14. Given the presumption contained in the definition of "resides/residence/resident" [(B)(18)], the remainder of the definition is unnecessary. The references to days of residence and commercial domicile raise questions of fact which are not generally available to the taxpayer or may generate controversy among the states claiming residence or commercial domicile. We recommend, therefore, that billing address be used only and that it not be rebuttable presumption. Concerns as to address manipulation can be addressed by special rules as to distortion and clear reflection of income.
15. The definition of "taxable" and "taxable in another state" [(B)(23)] should apply for purposes of the General Method of apportionment and the property factor as well as the receipts factor (see use of term in (D)(1)(a) and in the apportionment rules relating to property). In (B)(23), add after the word "jurisdiction" in subsection (b), "under these regulations or under the laws of that State".
16. In addressing the distinction between business and non-business income in (C), the Proposed Regulation should provide either that subpart F income be excluded from the tax base or that the factors relating to the controlled foreign corporation be included in calculating the apportionment percentage.

17. With respect to the general apportionment method [(D)(1)], under the sourcing rules of the Proposed Regulation, use of a receipts factor and a property factor that includes intangible property sourced to the location of the borrower creates an overweighting of factors to the market state. As this is inappropriate for a service business, a more appropriate formula would either eliminate the receipts or property factor, or would double weight the payroll factor.
18. The following comments address issues relating to the receipts factor [(D)(2)]:
- a. In general, there appear to be too many rules covering the same type of income. There could be only two sourcing rules for interest income, i.e., one rule related to loans secured by real or tangible personal property and one rule for all other loans.
 - b. The confusion as to leasing is perpetuated here (and in the property factor). The phrase "true lease", which presumably refers to the federal income tax treatment, is introduced for the first time. The use of financial standards to define leasing within a tax regulation creates a question as to whether tax or financial accounting rules should apply for purposes of the factors. It would be advisable to allow the taxpayer the option to use either tax or book receipts (or property) as long as the same method is followed consistently from year to year.
 - c. In (D)(2)(b), when is a loan "primarily" secured? Do the circumstances change if the value of the security declines so that it is substantially less than the unpaid principal on the loan? The use of property values in the second sentence can create problems over the period that a loan is outstanding. Therefore, the necessary determination should be made only as of the time the loan is made.
 - d. In (D)(2)(d), what are "installment obligations" and how would they differ from ordinary commercial loans? In addition, how are receipts sourced if there are two borrowers residing in two different states and they are jointly and severally liable? The reference to "to the extent" should be stricken. Finally, how does a "debtor" differ from a "borrower"?
 - e. In (D)(2)(e), there should be an exclusion for syndications and participation to/from a party that is an "independent person not acting on behalf of the taxpayer" as modified by our above recommendations. This would be consistent with the policy to exclude such loans when

determining jurisdiction to tax.

- f. In (D)(2)(f), the references to "to the extent" should be stricken. Again, how does a "borrower" differ from a "debtor?"
- g. With respect to the sourcing of merchant discount [(D)(2)(g)], since merchants may be located in several states and a situation may arise where more than one state claims that such income should be sourced to that state, the rule (rather than a rebuttable presumption) should be the billing address of the merchant.
- h. With respect to the sourcing of receipts from the performance of services [(D)(2)(h)]:
 - 1. In (i), the reference to "loan servicing fees" should be stricken. Loan related fees should be sourced similarly to interest from loans. In those situations where loan related fees are recognized for tax purposes in a different period than for financial accounting purposes, such fees should be sourced in the same manner as interest income from such loans (or a similar method consistently applied). Loan servicing fees represent fees for services performed for a creditor, including collecting and paying over payments of interest, principal, etc., and, therefore, should be sourced based upon where the services are performed (i.e., as done under (v)).
 - 2. As previously noted, the location of the depositor should have no bearing on jurisdiction or apportionment. In addition, since deposit related fees are minimal, the cost to capture such information would far exceed any revenue derived from such attribution rule. Therefore, deposit related fees should be sourced based upon where the services are performed.
 - 3. What fees are included in the term "brokerage fee"? In addition, all such fees should be sourced based upon where the account is maintained, i.e., where the services are performed (see March 1989 version of the MTC regulations).
 - 4. Service fees related to estates or trusts (individual or corporate) should be sourced based upon where the services are performed. Sourcing services should not be based upon factors totally within the control of the customer; e.g. testator retires to Florida after having established the

fiduciary relationship while residing in New York.

5. In general, service related income should be sourced the same way for financial institutions as for non-financial institutions, i.e., based upon where the services are performed.
- i. With respect to the sourcing of receipts from investments in securities and from money market instruments [(D) (2) (j)]:
 1. The sourcing rule in the Proposed Regulation makes the unwarranted assumption that all such investments are made from or out of funds deposited. Deposits only represent a portion of a financial institution's source of funds. The more appropriate approach is to source such receipts to the commercial domicile of the financial institution or to the location where the investment decisions are made.
 2. The inappropriateness of this rule is highlighted in the situation where loans may be swapped/exchanged for foreign securities. Clearly the foreign securities bear no relationship to any particular state other than the state where the loan was originally booked.
 3. Regardless of whether the recipient is a regulated or unregulated financial institution, receipts from investments should be sourced based upon commercial domicile of the recipient or the location where the investment decisions are made.
 4. With respect to unregulated financial institutions the term "gross business income" is another new phrase which is introduced but is not defined. If it correlates to receipts then it is the equivalent of a throwout rule which in turn will result in the assignment of significant financial income to the state based on factors totally unrelated to the production of such income.
 - j. In (D) (2) (k), there may be a problem in determining commercial domicile. In addition, a state other than the state of commercial domicile may object to being subject to the tax rules of the state of commercial domicile. There should be no variation from state to state. Furthermore, how does this rule apply to the situation where the domiciliary state is not an MTC member state and does not adopt the Proposed Regulation? Finally, since the subsections under the receipts apportionment

rules relate only to the numerator, is a state precluded, in essence, from a full throwout rule and left with a choice between throwback and a reduction in the numerator only?

19. The following comments address issues relating to the property factor [(D)(3)]:
- a. In general, the use of a property factor that includes intangible property sourced similarly to the way receipts are sourced creates an overweighting of factors to the market state which is inappropriate for a service business. See comment 17 above.
 - b. For owned intangible property, the value should be current book value as opposed to "original cost." Recordkeeping systems currently in place would not readily provide information as to "original cost" in light of amortization, write-downs and write-offs of such intangible property.
 - c. See comment 18 above with respect to all property sourcing rules that are identical to the sourcing of receipts from such property.
 - d. With respect to (D)(3)(b) and (c), depending on the treatment of leases under the Proposed Regulation, both (b) and (c) may not be needed. If leases are treated as loans, then (b) is not needed. Even if leases are not treated as loans, then (b) should be deleted so as to avoid both the receivable and the underlying asset from being included in the property factor. If (b) remains, the term "lease financing receivables" should be defined.
 - e. Subsection (D)(3)(f) should be deleted as it refers to a liability of the financial institution and not an asset. Perhaps the language in (f) belongs in subsection (i) (compare March 1989 version of the MTC regulations).
 - f. With respect to the last paragraph of the rule, there may be a problem in determining commercial domicile. In addition, a state other than the state of commercial domicile may object to being subject to the tax rules of the state of commercial domicile. There should be no variation from state to state. Furthermore, how does this rule apply to the situation where the domiciliary state is not an MTC member state and does not adopt the Proposed Regulation? Finally, since the subsections under the property apportionment rules relate only to the numerator, is a state precluded, in essence, from a full throwout rule and left with a choice between throwback and a reduction in the numerator only?

20. The definition of payroll factor [(D)(4)], leads to a 100% payroll factor. It should probably read as follows:

The payroll factor is a fraction the numerator of which is the total amount paid by the taxpayer as compensation during the year to employees located in, or working in or out of an office or other place of business of the employer located in, the state, and the denominator of which is the total amount of compensation paid during the year to all employees of the taxpayer.

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EXHIBIT J: 16:

**Letter from Philip M. Plant
(Bank of America) (April 8, 1991)**



TAX DEPARTMENT
(415) 622-2877

PHILIP M. PLANT
Vice President and
Assistant General Tax Counsel

April 8, 1991

Alan Friedman
386 University Avenue
Los Altos, CA 94022

Re: Comments on MTC Proposed Regulation IV.18.(i)

Dear Alan:

I am writing to confirm an endorsement of the use of intangibles in the property factor of the MTC Proposed Regulation IV.18.(i). Fred E. Ferguson of Price Waterhouse has recently submitted comments on the proposed regulations on behalf of the Financial Institutions State Tax Coalition asserting, inter alia, that intangibles should be eliminated from the property factor. While Bank of America is a member of the Financial Institutions State Tax Coalition, and while the matters expressed in the Ferguson letter bear the imprimatur of that Coalition, I wish to note for the record that the Bank of America disagrees with this assertion. In this regard, I am authorized to relate that Richard A. Hayes, Senior Vice President and Director of Taxes of First Interstate Bancorp, another Coalition member, shares my opinion that intangibles be retained so long as a property factor is used in the apportionment formula.

At the top of page 2 of the January 21, 1991 cover letter from Fred E. Ferguson to you, it is stated:

Intangibles should be eliminated from the property factor because the sourcing rules for such property are the same as those used for receipts from such property, thus creating a double weighting of factors in favor of the "market" state. In the Coalition's opinion, this is inappropriate for a service business.

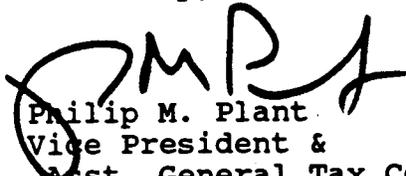
There is a valid concern that a double weighting of factors results when both a loan as an intangible and the interest paid thereon as a receipt are reflected in the property and receipts factors, respectively. This concern is best addressed, however, by the elimination of the property factor altogether, not the exclusion of intangibles from a property factor which is still retained.

As noted in the recent Oregon Tax Court decision of Crocker Equipment Leasing, Inc. vs. Department of Revenue, No. 2973, a property factor which is limited to real and tangible personal property ignores the bulk of a financial institution's business income producing activities and thus tends to distort the apportionment formula. If the double weighting effect described in the Ferguson letter is to be avoided without corrupting the apportionment mechanism, a factor must be eliminated or the relative weighting of the factors altered. The detailed comments attached to the Ferguson letter recognize this in paragraph 17 on page 7:

With respect to the general apportionment method [(D)(1)], under the sourcing rules of the Proposed Regulation, use of a receipts factor and a property factor that includes intangible property sourced to the location of the borrower creates an overweighting of factors to the market state. As this is inappropriate for a service business, a more appropriate formula would either eliminate the receipts or property factor, or would double weight the payroll factor. [emphasis added]

I hope the foregoing is responsive to your request for comment. The remaining comments of the Financial Institutions State Tax Coalition are endorsed by Bank of America unless inconsistent with the understandings reached during the Seattle meeting in October of 1988.

Sincerely,



Philip M. Plant
Vice President &
Asst. General Tax Counsel
(415) 622-2877

cc: Fred E. Ferguson
Richard A. Hayes

pmp3:049:cnc

EXHIBIT J: 17:

**Report by Thomas S. Neubig on "The Economic Effects
of One State Enacting Destination Source Taxation of
Financial Institutions" (April 18, 1991)**

Price Waterhouse



**THE ECONOMIC EFFECTS OF ONE STATE ENACTING
DESTINATION SOURCE TAXATION OF FINANCIAL INSTITUTIONS**

Presented By

**Thomas S. Neubig
Director of Financial Sector Economics
Price Waterhouse**

Presented at

The Multistate Taxation of Financial Institutions Forum

Co-sponsored by

The American Bankers Association

and

Price Waterhouse

Chicago, Illinois

April 18, 1991



THE ECONOMIC EFFECTS OF ONE STATE ENACTING DESTINATION SOURCE TAXATION OF FINANCIAL INSTITUTIONS

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THE ECONOMIC EFFECTS OF ONE STATE ENACTING DESTINATION SOURCE TAXATION OF FINANCIAL INSTITUTIONS

I. INTRODUCTION

Four states have recently enacted aggressive jurisdiction-to-tax nexus rules and destination-sourcing apportionment rules which will affect how interstate financial institutions conduct business. Budget problems in many states will increase pressure to adopt similar rules in an attempt to export taxes to non-domiciliary banks.

Overlapping tax jurisdictions and non-uniform apportionment rules have been recognized as a source of multiple taxation. Calls for more uniform state taxation are unlikely to be heeded, however, as states attempt to maximize revenue, especially from out-of-state institutions. Interstate financial institutions are caught in the middle of a revenue tug-of-war between "market" and "headquarter" states. To maintain profitability and market share, interstate banks will have to change their pricing and lending practices to reflect greater geographic cost differentials.

Depository institutions (commercial banks and savings and loan associations) generally have been taxed by state governments under the "residence" principle, where the institution is chartered and physically located. Four states - Minnesota, Indiana, Tennessee, and West Virginia - have recently enacted new tax rules for financial institutions based on the "destination source" principle, where the customer or the secured property is located. The Multistate Tax Commission has proposed regulations recommending that states switch from "residence" taxation of financial institutions to "destination source" taxation by changing the nexus rules from physical presence in the state to an "economic presence."

Multiple state taxation can result if financial institutions are subject to tax under destination source rules in the state of the customer (the "market" state) and under residence rules in the state of domicile (the "headquarter" state). Multiple state taxation has significant economic implications for financial service customers, for state governments and their tax

authorities, for the financial service industry, and for U.S. capital markets. A change by one state to destination source taxation will have potentially negative economic impacts on the state's residents and businesses.

Section II of this paper describes the potential sources of multiple taxation of interstate financial service providers. Section III analyzes the potential economic effects of a state switching to destination source taxation when most states tax depository institutions on a residence tax basis. Section IV provides some empirical measures of interstate financial services to show their importance for many states. Section V is a brief conclusion.

II. DIFFERENT METHODS OF STATE TAXATION OF FINANCIAL INSTITUTIONS

This section describes the different methods states use to tax financial institutions, describes the terms used in the later analysis, and identifies the circumstances creating potential multiple taxation.

A. Taxing Jurisdiction or "Nexus"

A state generally has taxing jurisdiction over a business entity if the entity has established a nexus to the taxing jurisdiction. For most states, nexus for depository institutions has been created where the institution is domiciled, received its charter, and is physically located.

A Multistate Tax Commission proposed regulation would establish nexus for financial institutions to a state where there is in-state ownership of property, an office or other place of business in the state, direct loans secured by in-state property, in-state presence of employees or independent contractors, or regular solicitation of in-state loans or deposits. Regular solicitation would be presumed to exist if a minimum number of residents were a debtor or creditor, the financial institution had a minimum amount of assets or deposits from state residents, or had a minimum amount of receipts from in-state sources. For example, Indiana presumes, subject to rebuttal, that a potential taxpayer regularly solicits business within Indiana if regular solicitation or transactions are conducted with 20 or more Indiana residents or the total loans and deposits attributable to Indiana exceed \$5 million.

The Multistate Tax Commission proposed regulation would move away from a physical presence for establishing nexus and toward a concept of an "economic presence" establishing nexus. Four states - Minnesota, Indiana, Tennessee, and West Virginia have enacted "economic presence" nexus rules. [Iowa has implemented similar rules through regulation.]

B. Attribution of Income from Interstate Activity

If nexus is established, the tax base of a multistate corporation must be allocated or apportioned among the states in which the corporation conducts its business activities. There are two general approaches to apportioning income from interstate activity of financial institutions: the residence-based (or origin source) method and the destination source method.

First, the residence-based method taxes the entire income of the financial institution in the state in which it is domiciled. Under the residence-based method, the state in which the financial institution is chartered or incorporated attributes 100 percent of the income to itself.

Some states apply the typical three factor formula for general business corporations based on equally weighted property, payroll, and receipts factors to depository institutions. With origin sourcing of receipts, the domiciliary state taxes 100 percent of the income since production facilities (property and payroll) are located in the domiciliary state and receipts are sourced to the origin of the receipts. For purposes of this report, origin sourcing is treated as equivalent to the residence-based method.

Second, the destination source method attributes income of multistate firms among different states based on the destination of receipts, with more of the income attributed to the market state. For example, Minnesota's new financial institution tax rule uses a destination source apportionment formula which applies a 15 percent weighting for payroll and property and 70 percent for receipts. Minnesota sources both receipts and financial assets (loans) to the destination state, so 85 percent of income from loans to Minnesota residents from out-of-state financial institutions can be subject to Minnesota tax. Indiana, Tennessee, West Virginia, and Iowa use a single factor receipts formula to apportion income of out-of-state financial institutions that have nexus to the state.

Two states, Indiana and West Virginia, have adopted a combination of the two approaches called the dual system. Under the dual system, in-state financial institutions are taxed according to the residence-based method with a tax credit for income taxes paid to other states. Out-of-state financial institutions are taxed under the destination sourcing method.

Some states use a so-called "throw-back rule" which changes the situs of the receipts factor from the destination state to the origin state if the company has nexus but an insufficient connection with the destination state.

C. Sources of Multiple Taxation

Multiple taxation can arise from non-uniform state taxation in several circumstances.

First, if states do not recognize the nexus to another state, then there is potential for multiple taxation. For example, a state enacting an "economic presence" nexus rule could create nexus with a depository institution domiciled in another state. Nexus based on physical presence of the depository institution which has been consistent with the regulatory limitations on depository institutions is inconsistent with an "economic presence" nexus. A domiciled financial institution in a residence method state is taxed on 100 percent of its income in that state, yet would also be subject to tax on income earned from loans or services provided to a state enacting an economic presence nexus and destination source attribution rules.

Second, multiple taxation can occur if the apportionment formulas are inconsistent across states. Non-uniform apportionment rules result from different factors included in the formulas, differences in the weighting of the factors, and differences in the definition of similar factors. For example, Indiana, Iowa, Tennessee, and West Virginia include only a single receipts factor, while Minnesota includes the typical three factor formula. Minnesota, however, weights receipts by 70 percent and property and payroll by only 15

percent. Minnesota includes loans in its property factor, while most states do not include financial assets in the property factor.

Third, differences in the rules governing the sourcing of factors can result in multiple taxation even with uniform apportionment formulas. For example, sourcing of receipts can attribute income to the destination state or the origin state. New York generally sites receipts from loans to where the greater portion of the income producing activity relating to the loan is performed. This occurs generally to the origin state in which the lending bank is physically located. The same receipts from the loan would be sourced to the state where the borrower lives or the property is secured under destination sourcing rules.

Lending or financial services provided from financial institutions in residence-based states to destination sourcing states where nexus has been created can result in significant multiple taxation of the income:

- A financial institution headquartered in a residence-based state lending to a borrower in a destination source tax state with a single receipts factor formula, such as Indiana or Tennessee, would have 200 percent of the income subject to state taxation. The entire income would be subject to tax in the residence-based state and in the destination source state.
- Loans from a residence-based state institution to Minnesota borrowers would have 185 percent of the income subject to state tax. The entire income would be subject to tax in the residence-based state and 85 percent of the income [70 percent from the receipts factor and 15 percent from the property (loan) factor] would be subject to tax in Minnesota.

III. THE ECONOMIC EFFECTS OF ONE STATE SWITCHING TO DESTINATION SOURCE TAXATION OF FINANCIAL INSTITUTIONS

A uniform residence-based state tax system (with the same tax base and tax rate) would have the same economic effects and same total state tax revenues as a uniform destination source tax system. The allocation of revenue among the states would be different, but the overall economic effects would be the same. Thus, the adverse economic effects of destination source taxation occur principally because most states still tax depository institutions under the residence principle. States considering switching from residence to destination source taxation of financial institutions, given the current environment of non-uniform taxation, must weigh the economic effects of such a change.

A. Economic Effects of a Switch to a Destination Source Tax

If a state (or a small group of states) switches from a residence-based tax to a destination source tax, the tax will be newly imposed on out-of-state financial institutions lending or providing services to in-state residents. In addition, the switch will reduce the tax on in-state financial institutions to the extent that they lend or provide services out-of-state. For this analysis, the destination source tax will be assumed to be apportioned 100 percent by receipts, similar to the Tennessee tax.

A destination source tax will provide an incentive to both in-state and out-of-state financial institutions to reduce lending to residents of the state. This occurs because a destination source tax increases the opportunity cost of lending to in-state borrowers relative to lending to borrowers in residence-tax states. Lenders can receive higher after-tax rates of return from lending to borrowers in residence-based states than to borrowers in destination source states, everything else the same.

The higher opportunity cost of lending to borrowers in a destination source tax state will result in a reduction in financial services supplied to state residents and businesses and an increase in the cost of financial services supplied. The reduction in capital availability will

depend on the demand for particular loans and financial services. The reduction in capital availability will most affect marginal borrowers who tend to be low-income individuals and higher risk businesses.

A switch to destination source taxation might encourage financial institutions to relocate from a residence-based state to a destination source state. For example, the multiple taxation of out-of-state institutions lending in-state could be avoided if a holding company established a subsidiary within the state to lend to in-state borrowers. Further, all state corporate tax could be avoided by having that subsidiary lend only to out-of-state customers located in residence-based states. It is important to note, however, that relocation of financial institutions into the destination source state would not reduce the effect of the destination source tax on credit availability and prices because all institutions would have an increased opportunity cost of lending to in-state borrowers.

B. Economic Effects of a Switch to a Destination Source Tax with a Throw-Back Rule or a Dual Tax System

The economic effects described above are potentially different if the state switches to a destination source tax but has a throw-back rule taxing the income to the state of domicile of the financial institution if it is not taxed elsewhere. In this case, a state switching to a destination source tax may not significantly affect the state tax liability of in-state banks and would not necessarily increase their opportunity cost of lending to in-state residents.

Similarly, if the state adopts a dual tax system with in-state institutions taxed under the residence principle and out-of-state institutions taxed under the destination source principle, then the in-state banks will remain indifferent between lending to in-state and out-of-state borrowers. In both cases, the additional tax would be imposed only on out-of-state banks lending to in-state borrowers.

If in-state financial institutions can not meet all of the financial service demands of in-state residents (a "capital importing" state), then the additional tax on out-of-state

institutions will affect financial service costs and capital availability. In a capital importing state, savings from within the state are less than the quantity demanded at the national market interest rate. If capital from other states were not available, then the interest rate in the capital importing state would have to be higher. Because out-of-state financial institutions provide funds at the margin to capital importing states, a destination sourcing tax will reduce capital availability to that state.

A switch to a dual tax system by a capital exporting state may not affect capital availability since in-state institutions could meet the needs of in-state residents. In-state institutions may replace out-of-state institutions in providing financial services to state residents. This substitution, however, is likely to involve additional costs that would be reflected in higher prices. Reduced competition, reduced economies of scale, and increased concentration of geographic lending risks would likely result in some upward pressure on the costs of financial services provided by in-state financial institutions.

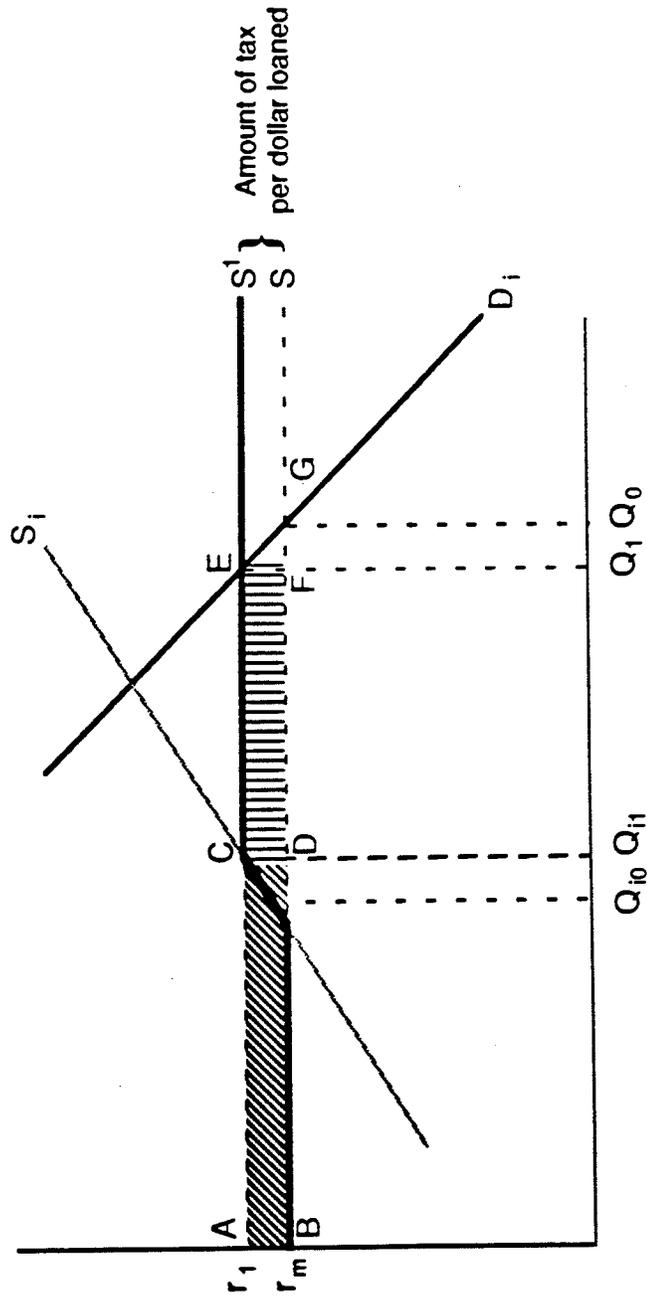
Capital importing states might attempt to become capital exporting states by attracting additional lendable funds. However, these additional lendable funds can only be attracted through higher deposit rates which increase the financial institutions' cost of funds and thus increase lending rates.

C. The Economic Costs Versus Revenue from Destination Source Taxation of Out-of-State Financial Institutions

One of the attractions of destination source taxation is the additional revenue from out-of-state financial institutions. However, the additional tax revenue collected from out-of-state financial institution under a destination source tax system is likely to be less than the additional burden on state residents and businesses.

Figure 1 shows the market for lendable funds in a capital importing state. The supply curve, S_i , is the lendable funds available from in-state financial institutions; the flat supply curve S_o , is the potential lendable funds from out-of-state lenders at the market interest

Figure 1
Additional Economic Costs and Tax Collected in Capital Importing State
Enacting a Destination Source State



- ABEF = Additional cost of financial services paid by in-state residents.
- CDEF = Tax collected from out-of-state financial institutions.
- EQ₁Q₀G = Additional burden on in-state residents from reduced capital availability.

rate. At the national market interest rate, r_m , the quantity supplied by in-state institutions, Q_o , is less than the quantity demanded by the state's residents, Q_o . The difference is lent by out-of-state financial institutions. If a destination source tax is imposed, the increase in the opportunity cost of lending to in-state borrowers requires out-of-state financial institutions to earn a higher pre-tax yield, r_i , the amount of destination source tax per dollar loaned. The higher rate reduces quantity demanded from Q_o to Q_1 .

At the higher pre-tax rate, the amount of lending by in-state institutions increases to Q_{i1} ; the amount of lending by out-of-state institutions falls to $Q_1 - Q_{i1}$. The amount of additional tax liability from out-of-state financial institutions is shown by the vertical striped area, CDEF, the amount of out-of-state lending multiplied by the amount of destination source tax per dollar loaned.

State residents and business borrowers will pay higher prices as a result of the destination source tax. The additional monetary cost of financial services to in-state consumers as a result of the destination source tax will be both the shaded and striped areas, ABEF, total borrowing multiplied by the amount of the destination source tax per dollar loaned. In addition, state borrowers will bear the burden of reduced capital availability, EQ_1Q_oG .

Thus, a capital importing state switching to a destination source tax is likely to impose larger economic costs on its residents than it will collect in taxes from out-of-state financial institutions. Higher borrowing cost for in-state firms would be an additional cost of doing business in the state, and thus make in-state firms less competitive in selling products nationally.

The effects of one state switching to destination source taxation will not necessarily occur immediately or in differential interest rates to the state's borrowers. Initially, the new destination source tax on out-of-state financial institutions would reduce the profitability of those financial institution, because they have outstanding loans and services to state residents. Interstate financial service providers and in-state institutions are likely to react

initially by altering their lending away from the most risky in-state borrowers. This reduction in credit availability will take the form of tighter credit standards and higher downpayments for in-state residents and businesses. As financial institutions adopt their pricing practices to reflect the differential state taxation, less obvious higher fees and charges on the state's consumers will occur in lieu of or in addition to higher interest rates.

IV. EMPIRICAL MEASURES OF CROSS-BORDER FINANCIAL SERVICES

The debate and discussion of taxation of interstate financial services has occurred without much empirical information on the extent of such services. Data on interstate capital flows and financial services have not been available, so many states do not know whether they are net capital importers or net capital exporters. As noted earlier, the potential economic effects of a state switching to destination source taxation are greater for capital importing states.

A. In-State Depository Institution Lending as a Percentage of Total Private Borrowing by State

We constructed a measure of states' likely capital importing status. Total lending by in-state depository institutions is compared with an estimate of the total private borrowing in the state. This ratio indicates the potential capacity of each state's financial institutions to provide credit to state borrowers at current market interest rates.

Total depository institution lending by state was obtained from regulatory information for commercial banks, savings and loan associations, and credit unions. Total lending for home mortgages, credit cards, other household borrowing, commercial and industrial loans, and all other loans were added for these institutions in each state.

Total private sector borrowing had to be estimated. Estimates of household borrowing by state were developed from regressions of historical national totals of mortgage, credit card, automobile, and other installment borrowing. Estimates of state borrowing by non-financial corporations were developed using information on borrowing rates of different industries from corporate financial data and the distribution of economic activity by industry for each state.

Depository institutions accounted for 45 percent of total home mortgages, 74 percent of credit card loans, 82 percent of other household installment loans, and 52 percent of non-

financial business debt in 1989. Other lenders including insurance companies, government sponsored agencies and mortgage pools, finance companies, pension funds, and non-financial businesses also hold significant amounts of total credit market claims. Since most of these other lenders would not be subject to a destination source tax, the tax would penalize depository institutions relative to other lenders.

Table 1 shows the ratio of in-state depository institution lending to estimated private borrowing by type of debt and by state. Depository institution lending was 52 percent of total household and non-financial business debt outstanding in 1989. The percent of state private borrowing that is currently lent by in-state depository institutions is less than 52 percent because some of their lending is currently to out-of-state borrowers.

Figure 2 shows the ratio for all private borrowing by state. The ratio varied from 364 percent in Delaware to seven percent in Alaska. Thirteen states plus the District of Columbia had above average in-state depository institution lending as a percent of the state's total private borrowing. The remaining two-thirds of the states had below average ratios, and thus are likely to be net capital importers.

States' ratios of in-state depository institution lending to state borrowing vary by type of loan. Several states have low total ratios yet exceed 100 percent for household borrowing other than for mortgages and credit cards. Large differences between types of loans may reflect specialization in those types of loans or imprecision in the estimates of borrowing for individual categories. The relative position of states for total lending and borrowing is the best indicator of whether a state is a net capital exporter or net capital importer.

B. Out-of-State Primary Banking Relationships

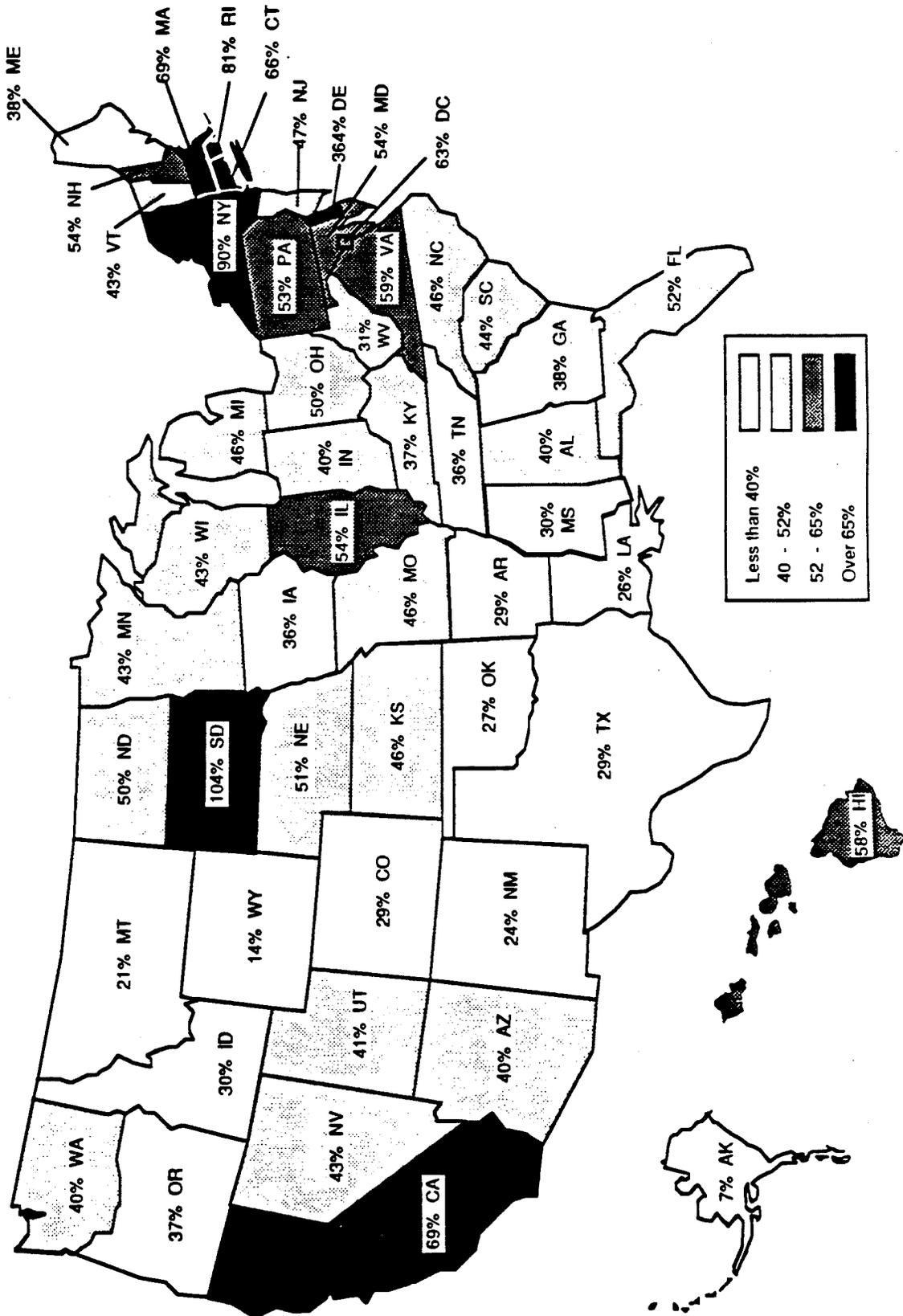
A second measure of the extent of cross-border lending and financial services was constructed from survey data on out-of-state primary banking relationships. Primary banking relationships generally provide businesses with an assured source of credit.

**Table 1. Lending by In-State Depository Institutions as
Percent of Estimated Borrowing, 1989
(Percentages)**

State	Home Mortgage	Credit Card	Other Installment	Non-Financial Business Debt	Total
Alabama	31%	33%	112%	36%	40%
Alaska	9	9	48	5	7
Arizona	27	57	90	42	40
Arkansas	27	14	70	25	29
California	85	62	53	61	69
Colorado	22	82	61	28	29
Connecticut	78	33	58	60	66
Delaware	50	7,774	160	141	364
D.C.	71	25	103	59	63
Florida	54	35	99	44	52
Georgia	31	87	87	34	38
Hawaii	59	40	88	55	58
Idaho	13	45	112	33	30
Illinois	47	22	66	59	54
Indiana	35	33	108	33	40
Iowa	30	38	84	34	36
Kansas	41	21	72	47	46
Kentucky	36	27	113	30	37
Louisiana	33	42	86	19	26
Maine	32	25	94	36	38
Maryland	44	81	72	56	54
Massachusetts	62	28	64	79	69
Michigan	32	26	81	52	46
Minnesota	27	42	90	47	43
Mississippi	24	16	115	25	30
Missouri	42	20	70	47	46
Montana	15	20	96	18	21
Nebraska	35	122	79	54	51
Nevada	20	1,001	61	22	43
New Hampshire	48	152	79	47	54
New Jersey	50	16	51	46	47
New Mexico	22	32	89	20	24
New York	43	45	118	123	90
North Carolina	44	46	81	43	46
North Dakota	35	36	115	39	42
Ohio	43	78	104	45	50
Oklahoma	25	9	81	23	27
Oregon	22	103	82	41	37
Pennsylvania	33	20	93	69	53
Rhode Island	50	57	88	123	81
South Carolina	35	76	85	42	44
South Dakota	19	2,616	137	41	104
Tennessee	31	40	101	30	36
Texas	26	12	72	26	29
Utah	33	77	116	36	41
Vermont	41	44	80	40	43
Virginia	53	85	109	52	59
Washington	35	70	73	39	40
West Virginia	31	23	126	20	31
Wisconsin	42	45	73	38	43
Wyoming	16	22	81	9	14
Total U.S.	45%	74%	82%	52%	52%

Source: Price Waterhouse estimates.

Figure 2. Total In-State Depository Institution Lending as Percentage of Total Private Borrowing in 1989



Price Waterhouse, Washington National Tax Services.

Source: Price Waterhouse estimates.

Primary banking relationships are generally very profitable because the businesses maintain large deposits with the bank and purchase other banking services. Primary banking relationships are important to "middle-market businesses", variously defined to include companies ranging from \$10 million to \$500 million in annual sales, which are too large to rely on a community bank or thrift but not large enough to access national securities markets.

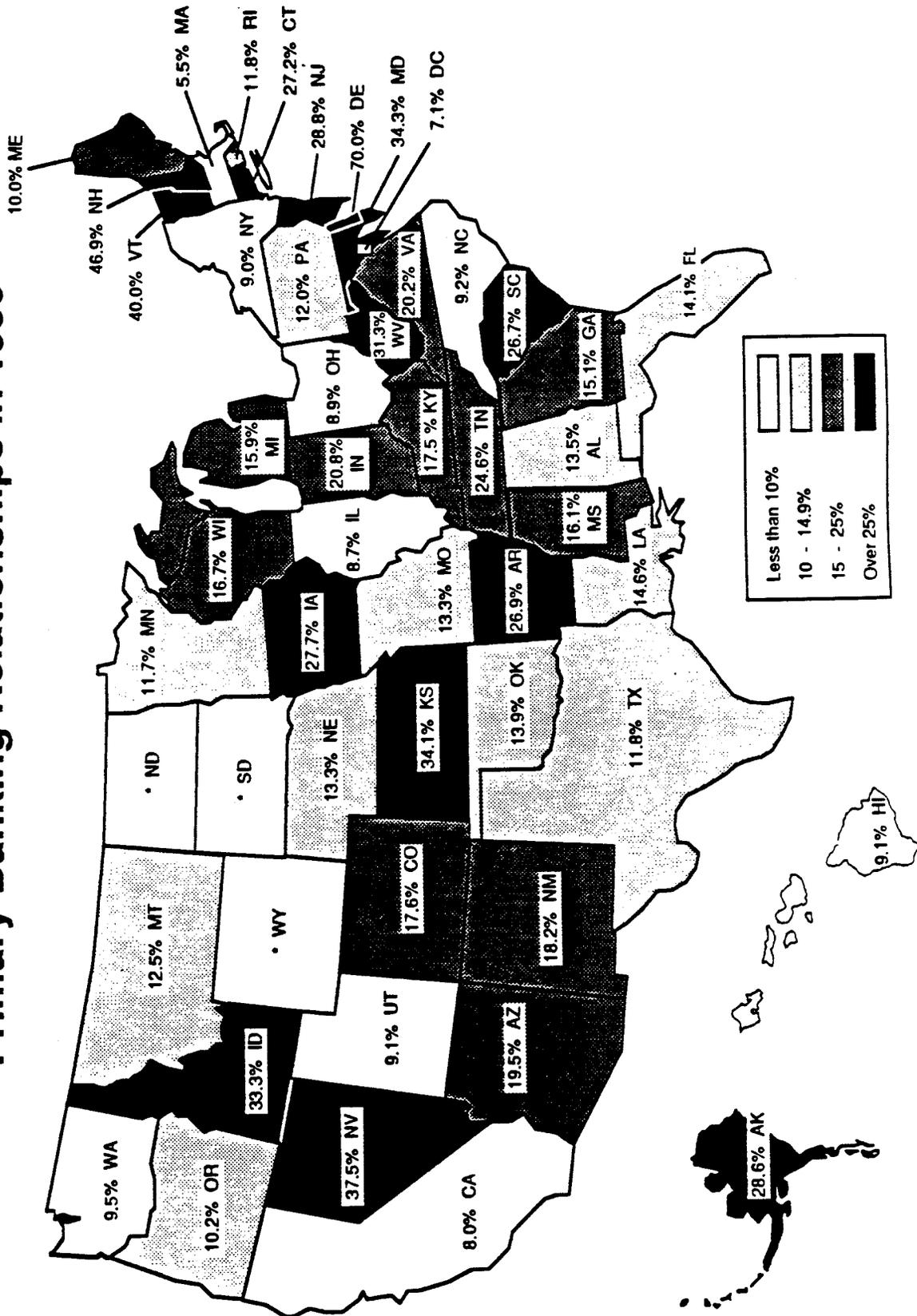
A sample of 6,000 corporations (of which 4,601 reported a primary banking relationship) was used to measure the percentage of out-of-state primary banking relationships in 1989. Fifteen percent of corporations reporting a primary banking relationship used an out-of-state bank.

Figure 3 shows the percentage of out-of-state banking relationships by state. Eight states had more than 30 percent of corporations in the state reporting an out-of-state primary banking relationship. These were Delaware, Indiana, Kansas, Maryland, New Hampshire, Nevada, Vermont, and West Virginia. Medium-sized companies with annual sales ranging from \$50 million to \$500 million were more likely than average to have an out-of-state primary banking relationship (22 percent). Mining (28 percent), transportation and public utilities (21 percent), and manufacturing firms (16.5 percent) were most likely to use an out-of-state bank.

C. Potential Increases in Annual Interest Costs of an Average Mortgage and Middle-Market Business

To illustrate the potential impact on borrowers for mortgage and commercial loans, an estimate of the direct tax impact in terms of higher interest rates was calculated. The actual incidence of a state's destination source tax is uncertain, and may take the form of reduced lending to higher-risk borrowers or the form of higher fees and other non-interest charges. Thus the following calculations are illustrative of the potential magnitude of a switch to destination source taxation by one state.

Figure 3. Percentage of Firms with Out-of-State Primary Banking Relationships in 1989



* Sample includes fewer than five companies.
 Source: Standard & Poors Compustat database. Sample by Price Waterhouse.

The potential additional interest cost necessary to provide the same after-tax rate of return to an interstate financial institution lending to a borrower in a destination source state is calculated. The calculation assumes a state corporate income tax similar to the Indiana financial institution tax: an 8.5 percent tax rate apportioned by a single receipts factor. The average mortgage loan on new homes in 1989 was \$117,000. Based upon data from the Functional Cost Analysis of the Federal Reserve Board, the net earnings rate on mortgage loans ranged from 2.25 percent for large banks to 2.65 percent for small banks in 1989. The interest cost necessary to compensate for the additional state tax ranges from 0.21 percent for large banks to 0.25 percent for small banks. This would represent an increase in annual mortgage payments of \$218 to \$264 on an average 30-year mortgage loan.

A medium-sized manufacturing company with total assets of \$35 million and total debt of \$10.85 million could face added annual interest costs of \$12,700 to \$20,965 if the additional state tax on financial institutions were passed through to the borrower. The average net earnings rate on commercial loans ranged from 1.26 percent for small banks to 2.08 percent for large banks in 1989.

Lending activity, of course, involves a large number of relatively small transactions, which can be very significant in the aggregate. The aggregate impact of the additional interest cost on an "average" state which accounted for two percent of total U.S. borrowing could be as high as \$110 million annually for individuals with a comparable increase for non-financial businesses. These costs would be higher if the compliance and administrative costs associated with the tax change could also be passed forward to borrowers.

V. CONCLUSION

States considering switching from residence to destination source taxation of financial institutions must consider the potential economic effects. Such a change is not a "free lunch" with only additional tax revenues from out-of-state financial institutions. Given the non-uniformity of state tax rules, financial institutions would have an incentive to reduce lending and financial services to consumers in a state enacting a destination source tax system, unless compensated for the additional tax. Reduced capital availability would be most likely to occur in "market" or capital importing states. The other adverse economic effects would occur in either "market" or a "headquarter," or capital exporting state, if it enacted destination source rules at the current time.

Higher credit costs in the state would be harmful to state economic development efforts and to higher-risk individual and small business borrowers. The potential revenue increase from out-of-state financial institutions is likely to be smaller than the economic costs borne by the state's residents and businesses.

The U.S. Treasury Department's proposal¹ for interstate branching would eliminate the need for economic presence nexus rules in many cases. Banks that currently are prohibited from establishing branches in a state could have a physical presence in the state in the form of branches, and thus could be subject to the state's general business apportionment rules. Interstate branching, however, will not eliminate the potential for states to attempt to export taxes through economic presence rules since electronic fund transfers, credit cards, and some banking services may be cost effective for some banks to provide without a physical presence in all states.

¹ See U.S. Department of the Treasury, "Modernizing the Financial System: Recommendations for Safer, More Competitive Banks," (February 1991).

Banks will adjust to increased state tax burdens and non-uniform state taxation. The budget problems facing many states are likely to continue for years, and out-of-state banks are an inviting political target. Interstate banks will continue to be caught in the middle between the revenue needs of the states, as states attempt to fine-tune their sourcing rules to maximize their own revenue.² Corporate taxes ultimately are borne by households (as customers, wage earners, savers, or shareholders). It is important that state policymakers realize that destination source taxes are most likely to be borne by the residents of their state.

² One proponent of destination source taxation states that a dual tax system "recognizes the truism that states act in their own self-interest" by maximizing that state's revenue. See Sandra B. McCray, "Viewpoint", 4 *Journal of Bank Taxation* 2 (Winter 1991), p. 43.

EXHIBIT J: 18:

**Letter from Haskell Edelstein
(Citicorp/Citibank) (May 2, 1991)**

399 Park Avenue
New York, NY
10043

Haskell Edelstein
Senior Vice President and
General Tax Counsel

May 2, 1991

Mr. Dan Bucks
Executive Director
Multistate Tax Commission
444 North Capitol Street, N.W. - Suite 409
Washington, D.C. 20001

RE: The Nature of Banking

Dear Dan:

I am sending you the enclosed article from American Banker because it provides an interesting insight into future developments in the banking business. It suggests that future banking and other financial services will become less customer oriented if banks handle lending activities like "investment portfolios" and focus even more on risk management. That suggests that income from such activities might properly be taxed as investment income - i.e., only by the state of domicile of the investor. At a minimum, the management of risk is becoming an even more important element of a bank's lending activities, the very point I have been making for quite some time.

In addition, the article demonstrates the increased emphasis on services, retreating from activities requiring heavy commitments of capital. That is in considerable part due to the scarcity of capital and sources of capital for banks, compelling them to look for activities - services - which do not require capital support. That is also the principal reason why banks "securitize" or sell off their loans.

Most important, however, is simply the fact that financial services is a rapidly changing industry. For state taxation to effectively deal with such an evolutionary environment over the next decade, it is essential to develop and put in place tax policies which are both flexible and consistent with the evolving nature of the industry, perhaps even to the extent of abandoning taxation based on income.

While these are weighty issues, the article is certainly thought-provoking and I hope you will find it of great interest.

Sincerely,



Enc.

cc: Alan Friedman
Fred Ferguson

As Loans Slip, Banks Push New Products and Strategy

By STEVEN LIPIN
Third of Four Articles

As blue-chip companies rely less on traditional commercial loans, America's big banks are responding by cutting staff, trying to make more loans to mid-size corporations, and pushing products such as cash management and commercial paper. But a few banks are going a step further.

In what could be the most fundamental strategic change in decades, these banks have begun to look at their lending operations in a totally new light, running them like investment portfolios.

This approach to banking is catching on at Citicorp, Mellon Bank Corp., BankAmerica Corp., and First Chicago Corp., among others. Even small banks - with assets as low as \$50 million - are taking an interest.

"We need to refine our portfolio management skills," said Barry Sullivan, chairman of First Chicago Corp., at a recent gathering of investors. "We're reevaluating who we conduct business with, what products we sell, and how we deliver them."

Widely used on Wall Street but previously shunned by banks, Modern Portfolio Theory holds that investors should carefully diversify their assets to control risk. For banks, one goal is to limit the risk of incurring heavy losses when a particular company or industry gets into trouble.

Banks are also using portfolio analysis to ensure that they are charging high-enough interest rates for their riskiest loans.

No Longer Heretical

The idea that a bank is an "investor" and a loan is just one type of asset on a balance sheet might have sounded heretical a few years ago. But now bankers are more willing to listen to new ideas, especially those humbled in recent years by heavy losses in Latin lending, LBO's, and and real estate.

The implications are enormous. By taking the portfolio approach, banks are likely to change their lending patterns markedly. For example, thorough risk analysis could cause some banks to cut way back on real estate loans or to charge

higher rates on lines of credit, even to high-quality borrowers such as Phillip Morris and Procter & Gamble.

One thing is clear: Assessing risks - and pricing loans accordingly - will be an increasingly important skill for bankers as the 1990s progress. Indeed, many big banks will decide to make fewer and fewer loans, opting instead to go for the sure money: fees for services such as foreign exchange trading or interest rate swaps.

An Obsolete Product?

Says George Vojta, vice chairman and chief strategist at Bankers Trust New York Corp.: "Classical lending is an obsolete product."

Already, U.S. banks get nearly 20% of their income from fees charged for various services, according to Sheshunoff Information Services Inc. of Austin, Texas. That's up from nearly nothing a decade ago. And the trend toward fee-based business is expected to continue.

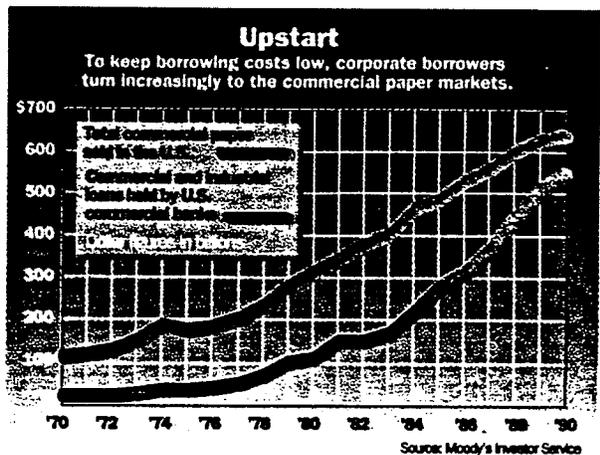
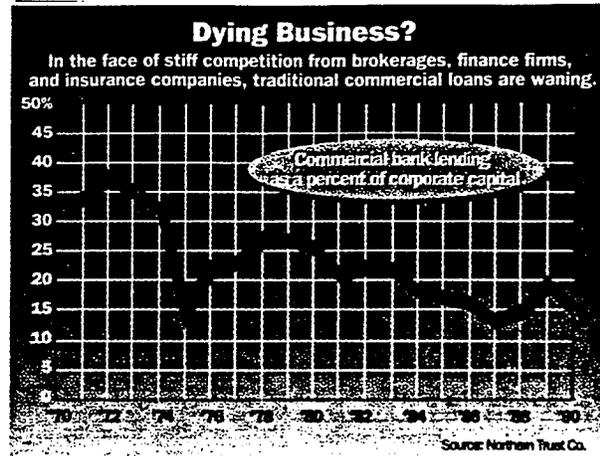
Customers Are Attuned

It is easy to see why. While traditional lending to big companies offers returns on equity of 5% to 7%, fee-based services such as cash management return 40% to 80%, according to a study by First Manhattan Consulting Group, the New York-based consulting firm. Foreign exchange and swaps products have returns above 30%.

Assessing risks - and pricing loans accordingly - will be an increasingly important skill.

Customers seem to understand the banks' emphasis on services. Says O. Gene Gabbard, chief financial officer of MCI Communications Inc., "It's just as important to get services from banks as loans." When it comes to functions such as cash management, says Mr. Gabbard, "banks are the only place to go for efficiency, accuracy, and timeliness."

With capital scarce, banks are especially eager to offer "off balance sheet" products such as commercial paper and swaps. "We want to use our brains rather than the brawn of our balance sheet," explains Maria Beechey, group executive at Chase Man-



hattan Corp. Accepting the old adage that if you can't beat 'em, join 'em, some banks are using a new technique to help their customers gain low-cost access to the commercial paper market.

Lower Rate Available

Here's how it works: The banks sell commercial paper through a shell corporation that is collateralized by the client's receivables. This gives the client funds at low rates, which the bank simply could not match if it were lending out regular deposits. It is also cheaper than having the customer go directly to the commercial paper market.

In such deals, the banks make the bulk of their profit on advisory fees and by arranging credit lines to back up the commercial paper. Once rare, this "pass-along" technique has been used to raise more than \$55 billion over the last 10 years. "It's one of the hottest financing markets," says one banking lawyer.

Of course, part of the profit squeeze on traditional lending is attributable to diminished demand. Right now, corporate America is struggling to pay off the heavy debt it took on over the past decade. According to Carroll McEntee & McGinley Inc., a unit of Hongkong and

Shanghai Banking Corp., half of all pre-tax corporate profits will go to interest payments over the next few years. How much more debt can companies handle?

Decline Seen as Durable

Even after the recession ends, big borrowers are likely to feel the hangover. "The decline in business credit demands is likely to be more prolonged this time," according to Lacy Hunt, Carroll McEntee's chief economist. "The corporate sector may need a much longer period of balance sheet readjustment than has typically been required after post-war recessions."

When lending does snap back, multibillion-dollar credit deals, such as the \$6 billion bank line Chemical Bank arranged for AT&T Corp.'s acquisition of NCR Corp. earlier this year, are likely to be few and far between.

If banks must make traditional loans, the best use of their franchise may be simply to originate the loan and then sell it in the secondary market. This way, the banks' capital can be freed up to originate more loans - and collect more origination fees.

While the secondary market for commercial loans is still relatively illiquid, it is growing rap-

CONTINUED

idly. Last year alone, almost \$200 billion of commercial bank loans changed hands. Long-term, this market could help banks generate higher profits from relatively little capital.

Improved Valuations

It will also help stock investors put realistic market values on the banks. "To the extent that you can have a market valuing assets, stocks will trade at higher price-earnings ratios," said Christopher L. Snyder Jr., president of Loan Pricing Corp.

For now, the one area of lending that still elicits optimism from bankers is the so-called middle market. This consists of borrowers who take out loans ranging from \$1 million to \$50 million. While not spectacular, returns on equity in this business often fall in the 10% to 20% range. That is double to triple what can be earned lending money to blue-chip companies.

This comes as no surprise to stodgy but consistently profitable banks such as NBD Bancorp, First Wachovia Corp., and Norwest Corp. — all experienced middle-market lenders whose profitability ratios are the envy of their peers.

The rush to middle-market loans is making many large banks look more and more like regional operations and less like national banks. Thus, in the

1990s, fewer banks will rank with Banker Trust, J.P. Morgan and Citibank as money-center banks. Says Robert E. Greene, executive vice president at First Interstate Bancorp in Los Angeles, "Banks will provide for local needs within their geographic knowledge bases."

As Citicorp's chairman, John Reed, put it recently, "There are no longer many money-centers."

Just as the entire banking industry cannot fit through the eye of a needle, all banks cannot survive by lending to mid-size bor-

of course, with Fleet/Norstar's takeover of Bank of New England. Arguably, the Federal Deposit Insurance Corp. picked Fleet over BankAmerica Corp., in part because the intramarket deal will take capacity out of the region, making recovery easier for other ailing Northeast banks.

But even as players are merged out of the market, newcomers keep rushing in, putting downward pressure on bank profits and rates. Last year, commercial bank loans accounted for only 16% of U.S. companies' borrowing needs, down from

in a particular area of lending or service, setting themselves apart from the competition. State Street Bank in Boston has done this, holding itself well above the ailing New England economy by concentrating on steady businesses such as stock custody and investment management.

Specialization Likely

Others will follow in their own ways. Few, if any, U.S. banks will try to be all things to all customers in the 1990s. While Bankers Trust and J.P. Morgan are great at securities and foreign exchange trading, they have no retail base. Chase Manhattan does have a strong retail network, but just exited the municipal bond market. Chemical is good in middle-market lending and loan syndications, but is not great at trading.

"We're focusing on five or six key products and services," says William B. Harrison Jr., vice chairman of Chemical Banking Corp. "Banks have to pick their spots."

It doesn't take a genius to figure out that traditional commercial lending is in a period of long-term decline at the nation's big banks. What takes true genius is assessing a bank's skills and resources, and then figuring out the right mix of products and services for the 1990s.

"The decline in business credit demands is likely to be more prolonged this time."

Lacy Hunt

Carroll McEntee & McGinley

rowers alone. The upshot: The banking industry is in for continued shrinkage.

This will probably come about through mergers of banks such as Security Pacific and Wells Fargo, or perhaps Manufacturers Hanover Trust with Chemical Bank. Such mergers can take capacity out of a geographic market.

Effect of Fleet Deal

This is what will happen in New England, to a lesser degree.

35% in the early 1970s and 80% in the 1930s.

"The activity of banking will be increasingly done by non-chartered banks like General Electric and General Motors," says Gary B. Gorton, a banking expert at the Wharton School of the University of Pennsylvania. Indeed, GM and Ford now rank as the nation's No. 1 and No. 2 commercial lenders, ahead of No. 3 Citicorp.

Many banks are responding by specializing, becoming expert

Citibank Absorbs Landmark Brokers Mutual Fund Sales Staff Is Put on Bank's Payroll

By LINDA CORMAN

Citibank has shifted 140 brokers of mutual funds and annuities to its payroll from that of Landmark Financial Services.

Oklahoma City-based Landmark began peddling mutual funds managed by Citibank through the bank's branches in 1988. Citibank, now the 10th-largest bank adviser of mutual funds, included a provision in that deal to put Landmark brokers on its payroll if it chose.

The employee shift, which leaves the companies independent, underscores Citibank's commitment to mutual funds and is expected to bolster sales in bank branches.

Terms of the transaction, completed April 16, were not disclosed. The deal included all of the Landmark brokers in the New York area but excluded about 25 employees who work out of Citibank branches in Chicago.

"There is no doubt that Citibank, given its actions, is clearly

committed to the long term in the mutual fund business," said Robert M. Kurucz, a partner with the law firm of Morrison & Foerster of Washington and general counsel for the Bank Securities Association.

The 140 brokers become Citi-

The employee shift

underscores

Citibank's

commitment to

mutual funds.

bank employees and will continue to work in specially designated areas in bank branches. But their signs have been changed to Citibank Investment Services from Landmark Investment Services.

"It's an evolutionary process," said Gene Podsiadlo, sales director-investment sales for Citibank. "The motivation is to

establish Citibank's presence in the business instead of relying on a third-party name.

"The only Landmark name that remains is in the name of the funds," Mr. Podsiadlo said. Banks are barred from managing funds with names similar to their own.

Sales Will Proceed as Before

The acquisition will not sub-

stantially alter the way mutual funds and annuities are sold in Citibank branches, said Allen W. Croessmann, vice president and director of investment products for Citicorp. One difference is that the space in which the brokers work is no longer leased.

Employees who had been paid by Landmark will now receive base pay from Citibank. Commissions for insurance sales will come from Citibank's insurance unit, and commissions for mutual fund sales will come from the securities unit.

Citibank had \$1.7 billion in mutual fund assets under management at the end of 1990. □

BANK LETTER

APRIL 29, 1991

DEPOSIT INSURANCE BILLS INTRODUCED.

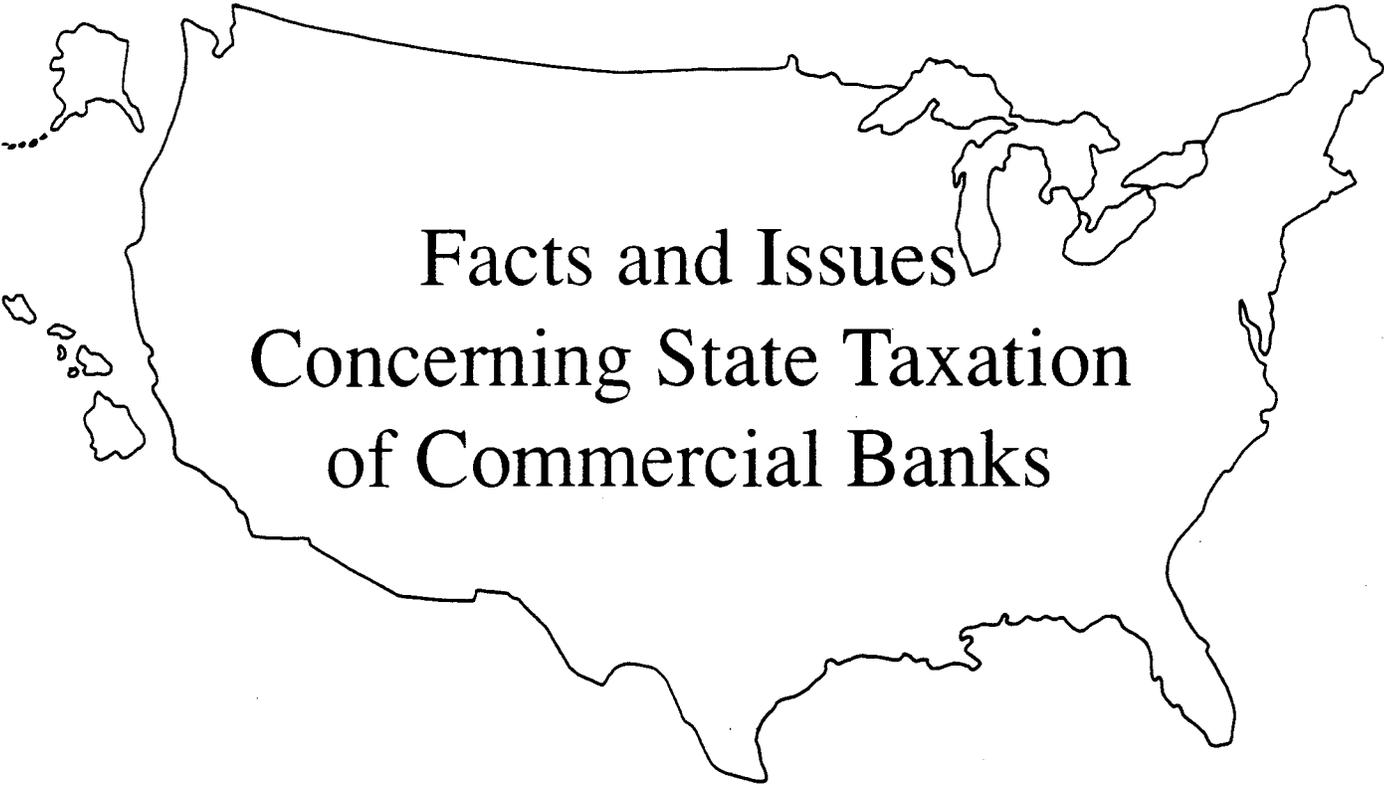
With House action on deposit insurance a distinct possibility before the end of spring, House members are surfacing more proposals they would like to have considered when the time comes. Last Tuesday, Rep. Matthew Rinaldo (R-N.J.) introduced a "sense of Congress" resolution that deposit insurance should not be reduced or restricted below present levels.

On the same day, Reps. Jim Leach (R-Iowa) and Ronald Machtly (R-R.I.) jointly introduced legislation to require all U.S. banks and thrifts to have federal deposit insurance. Leach has been offering similar bills since 1983 but the recent insolvency of a private Rhode Island insurance fund bolsters the case for requiring federal insurance cover.

EXHIBIT J: 19:

**Report of American Bankers Association on
"Facts and Issues Concerning State Taxation of
Commercial Banks" (1991)**

American Bankers Association



Facts and Issues
Concerning State Taxation
of Commercial Banks



AMERICAN BANKERS ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C. 20036

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From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.

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INTRODUCTION

Since Congress permitted the Federal prohibition on the taxation of income earned by nonresident financial institutions to lapse in 1976, the questions of whether and when the States would attempt to exercise their taxing authority outside their borders loomed in the minds of financial institutions. Over the last five years, however, both questions have been answered as the States have taken a keen interest in the ability to apply their income tax rules to out-of-state financial institutions which earn income outside their home states. With the arrival of electronic transmissions, relaxation of restraints on interstate banking, and expansion of entities performing bank-like activities, policymakers -- both Federal and State -- are faced with a range of issues and policy alternatives for structuring bank tax systems.

The intent in compiling various articles for this book was to present the facts surrounding the current dilemma of double taxation as the income earned across state lines becomes subject to non-uniform rules. This book begins with an historical review of the taxation of bank income including federal obligations and a review of the alternative methods of defining the bank net income base and then, discusses the key issues to be resolved by the legislatures.

Specific topics that are addressed include (1) the role of the Multistate Tax Commission (including copies of the Commission's draft of model nexus and apportionment rules and the industry's proposal for uniform rules), (2) the economic impact of double taxation upon the income earned by out-of-state financial institutions, (3) the impact of interstate branching and banking and (4) the constitutional and legal underpinnings of the present debate.

This book should provide the reader with an overview of the issues that are currently before tax administrators and taxpayers. Other reference sources that may be of interest to the reader include: the ACIR's State Taxation of Banks: Issues and Options paper (M-168, December 1989), the ACIR's "Report of a Study under P.L. 93-100" (May 1975), and the FRB's "Report of a Study under P.L. 91-156 and P.L. 92-213" (June 1972).

The American Bankers Association role in developing this project is to inform all participants -- Congress, State tax administrators and legislators, and financial institutions -- of the need for cooperation and simplification in the implementation of income tax rules. **The observations and conclusions stated in the documents are solely those of the respective authors and do not represent the opinions nor the endorsement of the American Bankers Association.**

CHAPTER HIGHLIGHTS

History of the Taxation of Commercial Banks

This chapter is divided into two sections. The first section explores the history of the statutory restrictions on the state's ability to tax the income earned by out-of-state financial institutions including the various court cases which prompted Congressional action, the action taken by Congress and the current activities of the States. The second section presents the history of the statute prohibiting discrimination against Federal obligations as well as the judicial decisions addressing the validity of particular state and local tax statutes upon Federal obligations held by banks.

State Taxes Currently Imposed on Commercial Banks

This chapter analyzes the two types of business taxes -- income and non-income based -- that are generally imposed upon financial institutions. A discussion of the two methods -- residence-based and source-based -- for apportioning the income of financial institutions is presented. Lastly, the chapter spells out the distinctions between the economic and physical presence theories and the money center versus the market state approaches.

Role and Activities of the MTC

This chapter introduces the Multistate Tax Commission ("MTC") and outlines its role and current activities. The member states of the MTC are noted and the various projects currently undertaken by the MTC are highlighted. In particular, the MTC's proposed regulations that identify activities by banks that would create a presumption of doing business in a particular state without a physical presence and rules for apportioning the income earned therein are presented as well as the banking industry's proposal for uniform rules.

Economic Analysis of the Market State Approach

This chapter introduces the economic impact of the double taxation debate. Issues covered include: an economic policy evaluation with a special emphasis on the impact of credit availability, taxation of credit markets, and the excess burden of market based bank taxation. Economic models are developed to explain the credit availability issues and the distinctions between the roles of net importers and exporters of funds are analyzed.

Importance of Interstate Branching and Banking

This chapter provides the history and concepts underlying interstate branching and banking. Attention is given to the issues involved in the market state approach as they impact the banks ability to open offices accross state lines. This chapter also analyzes the several state tax provisions that were included in both the House and Senate banking bills but were not adopted in the final legislation as Congress approved a narrow bill.

Constitutional Limitations of State Taxation of Interstate Branching

This chapter raises the question of the validity of the states ability to tax income earned by out-of-state banks. An overview of the Federal constitutional limitations is presented and includes a discussion of the cases involving nexus, apportionment, discrimination and the fairness of the tax in relation to the services provided by the state. The second portion of the paper involves a discussion of the constitutional limitations as applied to interstate banking activities for both nexus and apportionment purposes.

HISTORY OF THE TAXATION OF COMMERCIAL BANKS

State Taxation of Commercial Banks

by

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Background

State taxation of banks and other financial institutions is in a period of rapid transition. Both the Federal government and the individual state governments have exerted substantial power over the activities of banks and other financial institutions. The industries with which banks compete, the products they sell, the geographic areas where they operate, and the ways they can be taxed are all changing. Given the enormous pressure to raise revenues, states now have a challenging task to design a tax structure for this new environment which treats banks evenly relative to each other, relative to other industries, relative to other states, and does not curb economic growth.

Historically, the state bank tax structure has been dramatically influenced by constitutional and statutory limitations on the ability of states to tax national banks and to tax the interest earned on Federal securities. Banks have historically been exempt from most state and local taxation outside the states where they have full banking offices. Prior

to 1864, two Supreme Court decisions¹ governed the manner in which states taxed national banks. The Court adopted a Federal tax immunity standard for national banks which restricted the states from taxing either national banks or Federal obligations without Congressional permission. The National Bank Act of 1864 (Section 5219 of the Revised Statutes) and its successors imposed comprehensive restrictions upon the taxation of national banks by state and local governments.

Under this statute, states were permitted to tax the real property of national banks but limits were established to prevent taxation of shares, dividends or income at higher rates than were imposed on other entities. However, the state's authority to tax national banks or their shares was limited to banks with their principal offices within the state. The concept of Federal statutory limitations on state taxation, devised to protect national banks as Federal instrumentalities, remained intact throughout 1864-1969.

Congressional Action

Prompted by two U.S. Supreme Court decisions, Congress reassessed its position in 1969. In 1968, the U.S. Supreme Court upheld the contention of a Massachusetts national bank that Section 5219 protected it from sales and use taxes². In 1969, the Court affirmed that Florida could not require a national bank

¹ See McCulloch v. Maryland, 17 U.S. (4 Wheat.) 315 (1819); Weston v. Charleston, 27 U.S. 448 (1829).

² See Agricultural Bank v. Comm'r., 392 U.S. 339 (1968).

to pay a documentary tax³. These rulings precipitated the Congressional intervention that produced Public Law 91-156. According to the new law, a national bank was to be treated as a bank organized and existing under the laws of the state in which its principal office was located. The only remaining restriction on state taxation of national banks was that such taxes could not discriminate against national banks.

With the approval of Public Law 91-213, Congress delayed the effective date of the new law to January 1, 1973, in order to provide time for a study and a report by the Federal Reserve Board ("Board") on how state taxes on out-of-state national banks would affect the economic efficiency of the banking system and the mobility of capital. The Board's major recommendations related to two areas: (1) taxation of intangible personal property and (2) taxation by states other than the state in which a bank's principal office is located.

With respect to intangibles, the Board recommended that the denial of state and local government authority to tax intangible personal property of national banks, which was implicit in Section 5219 from the outset and made explicit in the 1969 "amendment", should be continued without a time limit and that such a denial be extended to cover state banks and other

³ See Dickinson v. First National Bank of Homestead, 393 U.S. 409 (1969).

depository institutions⁴. With respect to state taxation of nonresident banks, the Board suggested a Federal statute should be adopted that would "(1) establish uniform criteria for determining when a state can exercise jurisdiction to tax a nonresident bank; (2) provide parameters for certain common occurrences that do not by themselves constitute a sufficient connection with the state to establish jurisdiction to tax (i.e. holding of security interests in the state or solicitation of borrowers); (3) include rules for the division of each type of tax base when the rules for jurisdiction have been satisfied; and (4) set forth rules that will guide the states in their administrative procedures."⁵

In 1973, Congress extended its prior moratorium on state taxation of banks with the enactment of Public Law 93-100. From 1973 to 1976, the new moratorium prohibited states from imposing any tax measured by income or receipts or any other "doing business" taxes on Federally insured out-of-state depositories. In the same law, Congress directed the Advisory Commission Intergovernmental Relations ("ACIR") to undertake a study of all the pertinent matters relating to the application of state "doing business" taxes on out-of-state financial institutions. The ACIR study was to include recommendations for legislation that would provide equitable state taxation of those entities. The ACIR

⁴ See State and Local Taxation of Banks, "Report of a Study under P.L. 91-156 and P.L. 92-213", Prepared by the Board of Governors of the Federal Reserve System, June 1972 at page 2.

⁵ Id. at 4.

concluded that the precedent of P.L. 86-272 might advantageously be extended to interstate activities of depositories such as banks.⁶ The Federal legislation would, however, establish a higher and more specific threshold in terms of a substantial physical presence within the taxing state (i.e. regular office location or employees).⁷ The jurisdiction provision would be supplemented by a Congressional declaration of policy regulating interstate division of the taxable base of any depositories subject to a "doing business" tax outside the home-office state.⁸

Congress, however, failed to act and, in 1976, the language as originally drafted in 1969 became law. Thus, the permanent amendment to 12 U.S.C. 548 is now in effect, leaving the states free to impose any nondiscriminatory tax on any national or state bank having taxable nexus within the state. Proposed legislation has been drafted in response to the lapse of the moratorium of 12 U.S.C. 548 and in response to the ACIR report.

The American Bankers Association Taxation Committee prepared two bills: S. 3368, the Interstate Taxation Depositories Act of 1976, introduced in the 94th Congress, contained explicit provisions addressing the ACIR recommendations and certain failings of those recommendations and S. 1900, introduced in the

⁶ See State and Local "Doing Business" Taxes on Out-of-State Financial Depositories, "Report of a Study Under P.L. 93-100", Prepared by the ACIR, May 1975, at 49.

⁷ Id.

⁸ Id.

95th Congress, was a refinement of S. 3368. The refinements were reached as a result of discussions with the U.S. Savings League, with certain state tax administrators around the country and with Congressional aides. In addition, several Senators introduced S. 719 in the 95th Congress which provided for a jurisdictional standard based upon a business location which consisted of a brick and mortar or a regular presence of employees in the state. Both bills failed to be enacted. In 1981, the American Bar Association (working with the American Bankers Association) drafted proposed legislative language which provided for a nexus test similar to the language under P.L. 86-272 -- bricks and mortar or the regular presence of employees. The Bar proposal also contained apportionment rules which the commercial banking industry did not support and therefore, the Bar proposal did not receive wide support in Congress. Congressional activity with respect to the state taxation of banks has remained quiet since the late 1970's.

Current Activities

Yet, the bank regulatory climate today is one of expansiveness. While the Supreme Court has struck down restrictions on the interstate financial activities of nonbanks, Congress and state legislatures have permitted more traditional banking institutions to conduct limited interstate activities and to acquire other institutions within defined geographic areas. The New England states first instituted regional interstate banking on a reciprocal basis. The U.S. Supreme Court found

these New England reciprocal interstate statutes to be valid in Northeast Bancorporation, Inc. v. Board of Governors of the Federal Reserve System.⁹ In many states, interstate acquisition is permitted only on a reciprocal basis -- the state of the acquiring institution must grant banks from the home state of the target institution the ability to make the same sort of acquisitions in the acquiring bank's state. Under the 1982 Garn-St Germain banking legislation, Congress authorized the acquisition of failing banks by out-of-state banks and bank holding companies regardless of state law restrictions. As banks and other financial institutions look toward continued expansion of their products and services authorities and broadening of their markets, the states have begun to examine their traditional taxing systems to more aggressively tax those new and different products and activities. The Multistate Tax Commission ("MTC"), which has 19 member states (including D.C.) has studied, at some length, the issue of state taxation of banking activities and has promulgated a proposed regulation dealing with the application of the state income or net income franchise tax to interstate banking activities. The proposed regulation describes the maximum extent to which its drafters believe a state may venture in taxing interstate activities of the expanding banking industry. The proposed regulation has been drafted and redrafted on a number of occasions. Currently, the most recent draft is in

⁹ Northeast Bancorporation, Inc. v. Board of Governors of the Federal Reserve System, 472 U.S. 159 (1985).

limbo as the Multistate Tax Commission conducts additional studies into the economic impact of the proposed rules upon the states.

States generally did not contemplate legislation that would tax income earned by out-of-state banks until 1987 when the MTC published its first draft of model rules. The MTC's 1987 proposed rules would have subjected an out-of-state bank to taxation if the bank had either 20 customers or \$5 million in assets or deposits within the state. Minnesota adopted the MTC's first draft in 1987. In 1989, Indiana also adopted the MTC's first draft but with a major modification -- a credit for taxes paid on the same income elsewhere. In 1989, the MTC issued its second draft which increased the thresholds from 20 customers to 100 and the dollar amounts from \$5 million to \$10 million and provided an additional threshold test for receipts, \$500,000. At the end of 1989, Iowa made regulatory changes to its definition of "doing business" as it applies to a bank's activities in the state. Under the new definition, a bank does not have to be physically located in Iowa to be doing business. In 1990, Tennessee adopted a modified version of the MTC's first draft -- it included the \$5 million threshold for deposits and assets but did not include a minimum customer amount. On April 3, 1991, the West Virginia Governor signed a banking bill which will tax out-of-state financial institutions if they have 20 customers or \$100,000 in gross receipts in West Virginia beginning January 1, 1991.

Thus, today, the only statutory restriction on state taxation of national banks is that such taxes must not discriminate against national banks. The constitutionality, however, of the MTC rules and those adopted by the aforementioned states has not been judged to date.

State Taxation of Federal Obligations Held by Banks

by

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American Bankers Association

Background

Another aspect of bank taxation with a long history is the validity of particular state and local taxes on federal securities and obligations held by banks. This summary collects and analyzes the cases in which the United States Supreme Court and individual States' highest courts have considered the constitutionality of these taxes on federal obligations.

According to McCulloch v. Maryland¹, the theory of governmental tax immunity rests upon an effort to forestall undue interference, through the exercise of the taxing power by state and local governments, with the activities of the Federal Government and its operations under the United States Constitution. Federal securities cannot be subject to state and local taxation unless Congress consents to it. The governing statute, today, is 31 U.S.C. Section 3124 (1982).² This statute

¹ McCulloch v. Maryland, 17 U.S. (4 Wheat.) 315 (1819).

² In general, for purposes of this memo, taxes in question were paid prior to the reformulation of 31 U.S.C. Section 3124 in 1982. Thus, Revised Statute Section 3701, as amended, 31 U.S.C. Section 742 (1976), controlled the litigation. It should be

exempts from state and local taxation all obligations of the United States. Moreover, it forbids the states and localities even to consider United States obligations or the interest thereon directly or indirectly in calculating state or local taxes. It should be noted, however, that this exemption does not apply to franchise or other nonproperty taxes.

Congress enacted 31 U.S.C. Section 742 (current revision at 31 U.S.C. Section 3124) to protect federal obligations against discriminatory state taxation when federal obligations are offered for sale in competition with state securities. In an effort to secure and protect credit, Congress provided federal obligations with immunity from discriminatory state taxes and sought to prevent the slightest diminution of market value or investment attractiveness of federal obligations.

Judicial Decisions

The U.S. Supreme Court's first opportunity to decide whether a state or local tax is "nondiscriminatory" within the meaning of Section 742, occurred in January, 1983, when it decided Memphis Bank and Trust Co. v. Garner³. Here, the Court reviewed a Tennessee statute that imposed a tax on a bank's net earnings and defined net earnings to include income from obligations of the United States and its instrumentalities but excluded interest earned on the obligations of Tennessee and its political subdivisions. Each bank was required under the statute to pay

noted that both U.S.C. provisions embody the same concept.

³ Memphis Bank and Trust Co. v. Garner, 459 U.S. 392 (1983).

the local governments of Tennessee an excise tax of 3% of its net earnings for the preceding year, less 10% of the ad valorem taxes paid by the bank for that year. The Memphis Bank and Trust Company paid the required excise tax under protest and subsequently filed an action. The U.S. Supreme Court reversed the judgment of the Tennessee Supreme Court and held that the Tennessee bank tax violated the immunity of obligations of the United States from state and local taxation and found that the tax could not be characterized as nondiscriminatory under the exception for nondiscriminatory franchise taxes as provided for in 31 U.S.C. Section 742.

Five months later, the Supreme Court addressed state taxation of federal obligations in the context of a state bank shares tax.⁴ American Bank dealt with a direct property tax imposed on bank shares in Texas, the value of such shares measured by a computation including the value of federal obligations held by the bank, rather than a type of excise income tax on banks measured by net income as presented in Memphis Bank. The Court considered the Texas tax in light of Section 742 and concluded that since this section omitted shares taxes from the group of specific exemptions, Congress must have meant to bar bank shares taxes to the extent that they consider federal obligations in the computation of a property tax. The Court stated that under the plain language of Section 742, a tax is

⁴ See American Bank & Trust Co. v. Dallas County, 463 U.S. 855 (1983).

barred regardless of its form if federal obligations must be considered, either directly or indirectly in computing the tax.

In the first State Supreme Court decision not to reach the U.S. Supreme Court docket, the Nebraska Justices held in State Ex Rel. Douglas v. Karnes⁵, that the State's corporate franchise tax was discriminatory in light of the Memphis Bank decision. The State's franchise tax base excluded interest from state and local obligations but included interest on federal obligations. The Commissioner contended that the Nebraska franchise tax did not discriminate against federal obligations, because the tax did not single out the obligations for special, burdensome treatment. Although the Justices acknowledged that the State's franchise tax did not point directly to federal obligations as objects of special taxation, the franchise tax did result in disparate taxation of governmental securities which Memphis Bank condemned as discriminatory and therefore impermissible.

During the same year, Montana's State Supreme Court relied upon American Bank when it decided Schwinden v. Burlington Northern, Inc.⁶ Here, the justices had to determine whether Montana's corporation license tax was a nondiscriminatory franchise tax. The legal theory adopted by Montana's Court in reaching its decision was based on its reading of Congress' intent in 31 U.S.C. Section 3124 to provide a distinction between

⁵ State Ex Rel. Douglas v. Karnes, 346 N.W.2d 231 (1984).

⁶ Schwinden v. Burlington Northern, Inc., 691 P.2d 1351 (1984).

nondiscriminatory franchise taxes measured by tax-exempt obligations on the one hand and property taxes otherwise levied directly or indirectly by states on such federal items on the other. Montana's corporation license tax was found not to discriminate against holders of federal obligations because the statute taxes the interest earned by corporate holders of state obligations as well.

In 1985, the U.S. Supreme Court addressed a question left open in American Bank when it decided First National Bank of Atlanta v. Bartow County Board of Tax Assessors.⁷ Here, the Court ruled on the issue as to whether a state must, for property tax purposes, allow a bank to deduct from net worth, the full value of tax-exempt United States obligations it holds, or is Rev. Stat. Section 3701 satisfied by a limited deduction that excludes from net worth only that portion of the federal obligations properly attributable to assets rather than to liabilities. The Court affirmed Georgia's Supreme Court decision in which it held that banks can be limited to deducting only that percentage of assets attributable to federal obligations from its net worth when computing the property tax due on the fair market value of bank shares held. The Court reasoned that federal obligations can be acquired in part by liabilities and if they are, a pro rata method of allocating a fair share of those obligations to liabilities does not infringe upon the

⁷ First National Bank of Atlanta v. Bartow County Board of Tax Assessors, 470 U.S. 583 (1985).

constitutional or statutory immunity enjoyed by federal obligations under Section 3701, as amended.

The Supreme Court of New Jersey looked to Memphis Bank and American Bank when it decided Garfield Trust Co. v. Director,⁸ Division of Taxation. Here, the New Jersey Court had to determine whether or not the State enabling statutes exempted the principal and interest income of federal and state obligations from inclusion in the net worth and net income bases for calculating the corporate business tax. The Trust Company asserted by examples that the Director of Tax had not consistently required corporations to include in their bases for computing franchise taxes, the principal and interest income derived from otherwise tax-exempt obligations issued by state authorities. The New Jersey Supreme Court disagreed and held that both federal and state obligations have been consistently included in the bases.

In June 1987, the U.S. Supreme Court ruled that "Ginnie Mae's" are not exempt from taxation under 31 U.S.C. Section 3124.⁹ This decision affirmed the Illinois' Supreme Court ruling that these securities do not constitute "other obligations" of the United States exempt from state and local taxation under 31 U.S.C. Section 3124 and therefore, were properly included in the measure of the personal property tax

⁸ Garfield Trust Co. v. Director, Division of Taxation, 508 A.2d 1104 (1986).

⁹ See Rockford Life Insurance Co. v. Illinois Department of Revenue, 482 U.S. 182 (1987).

levied on Rockford Life's capital stock. The Court cited Ginnie Mae's failure to include a binding governmental promise to pay specified sums at specified dates as well as the Government's secondary and contingent obligation to make timely payment as indicia of proper exclusion from the constitutional principle of intergovernmental tax immunity.

In another state decision, the Florida Supreme Court held in Department of Revenue v. First Union National Bank of Florida,¹⁰ that the franchise tax on banks and savings associations was nondiscriminatory and therefore qualified as an exemption for United States obligations from state taxation. The financial institutions had claimed that the nonproperty excise tax on the privilege of operating within the state was prohibited under 31 U.S.C. Section 3124(a) because it was more like an income tax.

In 1988, the Missouri Supreme Court addressed the same issue.¹¹ In Centerre, the court determined that the bank tax imposed for the privilege of exercising its corporate franchise within the state according to and measured by its net income for the preceding was a nondiscriminatory franchise tax outside the scope of 31 U.S.C. 3124(a). The bank had claimed that the bank tax is not a bona fide franchise tax but an assessment against a banking corporation's property measured by yield.

In April 1988, the U.S. Supreme Court once again visited the

¹⁰ Department of Revenue v. First Union National Bank of Florida, 513 S.2d 114 (1987).

¹¹ See Centerre Bank of Crane v. Director of Revenue, 744 S.W.2d 754 (1988).

issue of taxation of federal obligations.¹² In South Carolina v. Baker, the Supreme Court held that the Federal government can impose income taxes on interest on state and local obligations. South Carolina focused on Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 which removed the Federal income tax exemption for interest earned on publicly offered long-term bonds issued by state and local governments unless those bonds are issued in registered form. South Carolina claimed that Section 310(b)(1) was unconstitutional under the Tenth Amendment and the doctrine of intergovernmental tax immunity. The Court determined that the Tenth Amendment was not implicated as South Carolina was not deprived of any right to participate in the natural political process. With respect to the question of intergovernmental immunity, the Court determined that the Federal government has the authority to tax state bond interest.

In 1989, the Supreme Court of Alaska determined that the tax under the Bank License Act was within the exception to Federal law exempting federal obligations from state taxation.¹³ The court determined that the license tax is like a franchise tax as it is a tax on the right to carry on business within the state. As such, it fell within the exception under 31 U.S.C. 742 because it is nondiscriminatory.

¹² See South Carolina v. Baker, 108 S.Ct. 1355 (1988).

¹³ See National Bank of Alaska v. Department of Revenue, 769 P.2d 990 (1989).

In June 1990, Minnesota banks partially won a law suit that declared the State's bank excise tax unconstitutional for years 1979-1983.¹⁴ In Cambridge State Bank, the Judge relied upon Memphis Bank when he determined that the bank excise tax discriminated against federal obligations in favor of state and local obligations. When the tax was adopted in 1941, the interest on state and local bonds was exempted. However, in 1983, after the U.S. Supreme Court decided Memphis Bank, the Minnesota legislature ended the exemptions for state and local bonds. The Minnesota Supreme Court, however, refused to permit the banks to collect refunds as the court would not apply the holding of Memphis Bank retroactively as such an action would cause hardship to the State.

In March 1991, the New York Court of Appeals let stand a New York State Supreme Court ruling that New York City's so-called bank tax is a franchise tax and therefore, income on U.S. obligations must be included in calculating the income-based tax.¹⁵ Bankers Trust sued the City of New York contending that the City's bank tax was technically not a franchise tax and therefore not included in the constitutional exclusion. The City successfully refuted this point by showing that the tax was imposed for the privilege of doing business in the city in a corporate or organized capacity and therefore was a franchise

¹⁴ See Cambridge State Bank et. al. v. Roemer, 457 N.W.2d 716 (1990).

¹⁵ See Bankers Trust New York Corporation v. Dep't of Finance of the City of New York, 567 N.Y.S.2d 438 (1991).

tax. This ruling could have serious ramifications for other New York banks and the Federal Government as well since many U.S. debt obligations are sold on a bid basis. The size of those bids would be affected by the yields the bonds could realize and the cost of borrowing for the U.S. Government is consequently increased.

Current Activities

In the most recent bank reform legislation before Congress, H.R. 6 and S. 543, the question of a state's ability to tax bank holdings of federal obligations arose in the context of interstate banking. Both Congress and the Treasury Department believed it was clear that states could tax the interest from federal obligations held by a branch of an out-of-state bank. Although requests for refunds under the previous statute are still addressed by the judicial system, it appears unlikely that future court cases will arise under the statute, 31 U.S.C. 3124.

STATE TAXES CURRENTLY IMPOSED ON COMMERCIAL BANKS

**State Taxes Currently Imposed
on Financial Institutions**

by

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Financial institutions are generally subject to two types of business taxes: income and non-income based taxes. Income-based taxes include direct net income tax, as well as franchise taxes measured by net income. Non-income based taxes include, among others, property, capital (e.g., bank shares tax), deposits, and gross receipts taxes. Income-based taxes have replaced the bank shares tax as the most popular method of taxation. The taxation of financial institutions has experienced rapid change in recent years. Novel theories (e.g., "market state" apportionment, and economic nexus) have been introduced. These concepts, as well as a general discussion of financial institution taxation, are presented below.

I. INCOME-BASED TAXES

Income-based taxes are classified as either direct net income or franchise taxes measured by net income. Presently, forty states tax financial institutions on some measure of net income.

A. Direct Net Income Tax

Direct net income taxes are imposed at a specific rate on the net income of a financial institution. "Net income" is separately defined by the tax laws of each state, but is generally based on federal taxable income with certain modifications. Federal law prohibits states from imposing a direct net income tax on federal obligations. The states imposing a direct net income tax on

financial institutions generally do so as part of their overall scheme to tax both financial and non-financial businesses.

B. Franchise Tax Measured by Net Income

Franchise taxes are imposed on corporations for the privilege of doing business in a state or for the granting of, or power to exercise, a corporate charter in a state. Federal law allows taxation of interest from federal obligations if the tax is non-discriminatory. Generally, the tax will be non-discriminatory if interest earned from a state's own obligations are also taxed. Although based on income, a majority of the states designate their financial institution levies as either a franchise or excise tax in order to tax federal obligations.

II. NON-INCOME BASED TAXES

A. Taxes on Property and Capital (Bank Shares)

Taxes on capital are imposed at a specific rate on some measure of a corporation's assets. Real property taxes and bank shares taxes were two common non-income based taxes. At one point in time, taxes on capital were the only permissible method of taxing national banks. As Congress subsequently authorized alternative methods of taxation, including income-based taxes, most states abandoned capital-based taxes in favor of income-based taxes. Income-based taxes are generally preferred since they better reflect a taxpayer's ability to pay and are better suited to the current

environment of interstate activity. Today, only three states (Pennsylvania, Louisiana and Kentucky) impose a bank shares tax.

B. Tax on Deposits

Taxes based on deposits are imposed at a specific rate on the amount of deposits. Deposits are an accurate measurement of traditional banking activities. However, financial institutions today have expanded and diversified into other financial activities including leasing, mortgage banking, commercial banking, securitization and the like. As a result, a tax based only on deposits does not accurately reflect how banks conduct business today. Further, similar to a capital-based tax, a deposit-based tax does not properly reflect a taxpayer's ability to pay.

C. Tax on Gross Receipts

A tax on gross receipts is an excise tax imposed at a specific rate on a financial institution's gross receipts or gross revenues. Again, a tax on gross receipts does not reflect the taxpayer's ability to pay. Presently, only two states impose a gross receipts tax on banks.

D. Tax on Net Worth

Taxes based on net worth are generally imposed at a specific rate on the state's definition of a corporation's "net worth". Most states compute the net worth of a corporation as some combination of the following: (1) total capital

stock issued; (2) paid-in capital or surplus and (3) total retained earnings. Currently, only Ohio and Texas impose a tax on net worth on banks.

III. DIVISION OF INCOME

States have used two methods for apportioning the income of financial institutions: residence-based or source-based. A residence-based tax subjects all income from whatever source to the resident state's taxing jurisdiction. This method is outmoded and constitutionally suspect because it does not recognize out-of-state contributions to the generation of the income and often results in multiple taxation.

The source-based method, on the other hand, attempts to attribute income to the state where it is earned, and as a result, provides a more fair and equitable method of taxing financial institutions. There are two source-based methods of income attribution: separate accounting and formulary apportionment.

Separate accounting attempts to specifically attribute the origin of income by assigning revenues and expenses to specific geographic regions. Formulary apportionment, on the other hand, attributes income to a state using a formula that compares business activities within a state to business activities everywhere. Most states using formulary apportionment impose a three-factor formula comprised of payroll, property and receipts. Recently, a number of states (so-called "market" states) have adopted apportionment schemes that employ only a single gross receipts factor.

IV. "ECONOMIC PRESENCE" V. "PHYSICAL PRESENCE"

Historically, states limited their taxation of financial institutions to those having a physical location in the state. Because financial institutions were, until recently, restricted by federal law from doing business outside their "home" state, the states did not have to grapple with the complex issue of tax jurisdiction (nexus) of financial institutions.

However, federal restrictions on interstate banking have been lifted. Banking and other diversified financial services are now regularly conducted in the multi-state area. Use of the mail, telephone, facsimile, computers and other means of electronic data transmission permit financial service providers to penetrate new markets — often without physical presence. Attempts by states to tax the income resulting from these interstate activities have prompted concern, confusion, and controversy.

Unable to apply traditional nexus rules that base taxing jurisdiction on physical presence, the states have turned to more innovative tactics, including the development of jurisdictional rules based on economic presence. Employing traditional nexus criteria, states can generally impose income and franchise taxes on businesses that have a physical presence in the state. Absent other restrictions on taxation, the presence of employees, agents or property in the state gives rise to a tax payment obligation. An out-of-state financial institution that conducts business in the state solely through the mail, by telephone, or by electronic means, has no in-state physical presence and, accordingly, no income or franchise tax obligation under traditional nexus theories. A majority of the states still base nexus on traditional criteria. However, the emerging trend among the states today is the

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extension of nexus for financial institutions based on principles of economic presence. As noted below, several states have enacted statutes that base nexus on the exploitation of the marketplace through actions such as the solicitation of business from customers in the state or the receipt of deposits from customers in the state. Other states claim their existing statute already gives them authority to tax out-of-state financial institutions based only on economic presence (e.g., Alabama).

The economic presence theory was first formulated and is encountered most often in mail-order sales and use tax collection cases. Recent case law has blurred the distinction between the nexus standards applicable to tax payments (e.g., income and franchise taxes) and the nexus standards applicable to tax collection duties. As a result, developments in the sales and use tax area may have some precedential value with respect to financial institution income and franchise tax issues.

In 1967, the U.S. Supreme Court in *National Bellas Hess v. Department of Revenue*, 386 U.S. 752 (1967), refused to adopt the economic presence theory. Instead, the Court, holding that an out-of-state mail order seller was not required to collect the use tax on its in-state sales, opted for a physical presence standard. In a strong **minority** opinion, the dissenting justices concluded that economic exploitation of the state's marketplace was sufficient to confer taxable nexus. This dissenting opinion has often been cited as the "roots" of the economic presence theory.

Despite the holding in *National Bellas Hess*, the states have increasingly strived to impose a use tax collection duty solely on the basis of economic presence. More than thirty states have enacted so-called anti-*National Bellas Hess* legislation. Typically, under these laws, out-of-state companies that solicit orders on a regular

and systematic basis are required to collect sales or use tax on sales made in-state. Taxpayers have challenged these statutes with varying degrees of success.

The constitutionality of the economic presence theory may again be considered by the U.S. Supreme Court. The Court recently granted certiorari in *Quill Corporation v. North Dakota*, 470 N.W. 2d 203 (N.D. Sup. Ct. May 7, 1991), *cert. granted*, Dkt. No. 91-194 (October 7, 1991). In its decision, the North Dakota Supreme Court held that Quill, an out-of-state mail-order and telemarketing vendor, was required to collect North Dakota use tax on sales to North Dakota residents. The North Dakota court questioned the continuing validity of *National Bellas Hess* and concluded that a state could base nexus on a corporation's "economic presence" in the state. Although in *National Bellas Hess* the U.S. Supreme court came out firmly against the economic presence theory, that case is old and many states, questioning whether it is still "good law," obviously do not feel constrained by its dictates.

Multistate Tax Commission Proposed Regulation

The Multistate Tax Commission ("MTC") is the administering arm under the Multistate Tax Compact, a voluntary association of states designed to promote uniformity in state income taxation. Under a proposed regulation of the MTC, nexus for financial institutions would be established through economic presence in the state. Under the proposed regulation, a state could impose a tax on an out-of-state financial institution that regularly solicits in-state loans or deposits. Moreover, under the regulation, there is a rebuttable presumption that regular solicitation has occurred if during the tax period, the financial institution has a minimum number of resident customers, a minimum amount of assets or deposits attributable to in-state sources, or a minimum amount of receipts from in-state sources.

Reportedly, the MTC proposed regulation on financial institutions is not particularly close to finalization. The proposed regulation covers not only nexus issues, but also apportionment and sourcing rules for financial institutions. Although not yet adopted, these regulations have been used as guidance by several states that have revamped their taxation of financial institutions.

VI. "MARKET" STATES V. "MONEY CENTER" STATES

To date, the economic presence theory has been adopted legislatively in Minnesota, Indiana, Tennessee and West Virginia. See Minn. Stat. §290.02; Ind. Code Ann. 6-5-5-3-1; Tenn. Code Ann. §43-16-148; and W. Va. Code §11-24-4, respectively. These states have recently established aggressive tax policies aimed at taxing the income of out-of-state financial institutions doing business with state residents. Based on the perception that they are "market" states (i.e., states where financial institutions are not heavily concentrated and that are net borrowers of capital) rather than "money center" states (i.e., states, where financial institutions are heavily concentrated and that are net lenders of capital), these states have chosen to attribute financial institution revenues to the place where the customer resides as opposed to the state from which the lending bank operates. These policies are expected to increase tax revenues as out-of-state corporations will be required to attribute more earnings to those states.

In general, in these four states, a financial institution is assumed economically present, and therefore subject to tax, if the financial institution engages in regular solicitation in that state (whether by traveling loan officers or other representatives, by mail, by telephone or other electronic means) which results in the creation of a depository or direct debtor/creditor relationship with a resident of the state.

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Although each state has adopted slightly different standards, an out-of-state financial institution is presumed (subject to rebuttal) to be regularly soliciting if:

- the financial institution obtains or solicits business with 20 or more customers of the taxing state; or
- has \$5 million or more of assets and deposits attributable to the taxing state.

In contrast to the market states, most states such as Illinois, can be considered money center states and reflect a lending state perspective; situs rules for receipts attribute income to the location where receipts are processed, services are performed, or credit card loans are made (rather than where the customer or property is located). Under these rules, deposits are typically sited to the branch where they are maintained as opposed to the state where the depositor resides.

The potential for overlapping taxation amongst market and money center states does exist. For example, income from a financial institution operating in both New York and any of the four market states is likely to be attributed to more than one state and hence taxed twice or more. Through federal legislation or voluntary state compact, the possibility for multiple taxation could be limited by establishing uniform tax methods and apportionment formulas among the states.

Conclusion

Like other areas of state taxation, taxation of out-of-state financial institutions is an area that continues to evolve. Even assuming some additional near-term guidance by the U.S. Supreme Court with respect to economic nexus, taxpayers, tax administrators, and

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undoubtedly, the courts will then begin to focus on other significant issues affecting financial institutions, including, among others, the development of income tax apportionment that more accurately reflect the operations and income producing activities of financial businesses.

ROLE AND ACTIVITIES OF THE MTC

Multistate Tax Commission -- Role and Activities

by

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Until the mid-1980's, the Multistate Tax Commission ("MTC") was not involved in the issue of state taxation of income earned by out-of-state banks. However, with the 1987 promulgation of proposed regulations addressing the allocation and apportionment of income earned by these entities, the MTC now enjoys a steady dialogue with the commercial banking industry. The purpose of this section is to highlight, in general, the role and activities of the MTC and specifically, its impact upon the commercial banking industry.

According to the the Multistate Tax Commission bylaws, the MTC is an agency of state governments designed to help make state tax systems fair, effective and efficient as they apply to interstate and international commerce and to protect state tax sovereignty. The MTC was created in 1967 through the Multistate Tax Compact, an interstate compact statute enacted by each full member state. The MTC currently has nineteen Members and fourteen Associate Members. Additional states are members of special MTC projects. States attain full membership by enacting the Multistate Tax Compact, an interstate compact among the participating states. The following tables summarize the current membership.

Full Members

Full Members Ranked by Multistate Tax Compact Revenues		National Rank by Total Tax Revenues	Date of Admission
1	California	1	January 1, 1976
2	Texas	3	August 4, 1967
3	Michigan	9	July 1, 1970
4	Minnesota	16	July 1, 1982
5	Washington	17	August 4, 1967
6	Missouri	20	October 13, 1967
7	Colorado	24	July 1, 1968
8	Kansas	31	August 4, 1967
9	Oregon	27	September 13, 1967
10	Hawaii	35	May 7, 1968
11	Arkansas	33	January 1, 1968
12	Utah	36	May 13, 1969
13	New Mexico	39	August 4, 1967
14	District of Columbia	40	July 1, 1980
15	Idaho	45	April 10, 1968
16	North Dakota	49	July 1, 1969
17	Montana	47	July 1, 1969
18	South Dakota	51	July 1, 1976
19	Alaska	41	July 1, 1970

Associate Members

Associate Members		National Rank by Tax Revenues	Date of Associate Membership
1	Pennsylvania	5	January 23, 1968
2	New Jersey	7	October 14, 1970
3	Ohio	8	June 11, 1971
4	Massachusetts	10	January 23, 1968
5	Georgia	12	June 11, 1971
6	Maryland	13	July 27, 1970
7	Connecticut	19	August 31, 1990
8	Arizona	21	June 7, 1968
9	Tennessee	22	June 20, 1969
10	Louisiana	23	October 27, 1969
11	Alabama	26	October 17, 1967
12	Maine	38	July 28, 1989
13	New Hampshire	44	October 27, 1989
14	West Virginia	37	August 2, 1991

Additionally, several states have joined the Full and

Associate Members in various projects of the MTC Commission. Florida, Iowa, Kentucky and South Carolina are part of the National Nexus Program which encourages non-complying multistate businesses to register and pay major state taxes. Nebraska participates in the Audit Program and Unitary Exchange which insures proper income tax reporting by major, multistate businesses.

Purpose

According to the MTC's Enabling Act, the MTC serves several purposes. First, the Commission encourages states to adopt uniform state laws and regulations that apply to multistate and multinational enterprises as the MTC maintains that greater uniformity in multistate taxation helps insure that interstate commerce is taxed properly and eliminates the danger that Congress will intervene state taxation. Second, the Commission encourages compliance by businesses with state tax laws as it maintains a Joint Audit Program that audits businesses for several states at the same time for both sales/use and corporate income taxes. The Commission also protects state taxing powers through active participation in significant Court cases and through educating Congress about state tax authority and interests.

Uniformity Projects

A primary purpose of the MTC is to encourage uniformity in state tax policies with respect to interstate and international commerce. Current and recent uniformity projects undertaken by

the Member States through the MTC that affect financial institutions include:

Regulation or Law Apportioning Income of the Financial Institutions Industry	Expected Spring 1992
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Regulation Responding to California Decision in <u>Finnigan Corp.</u> Case	Work-in-Progress
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Tax Compliance Programs

The MTC represents the only statutory, interstate tax agency in the nation. As such, the MTC is a unique means for states to use attain information concerning tax compliance data for multistate and multinational enterprises. Several tax compliance projects administered by the MTC fulfill this mission. These projects include:

Joint Audit Program -- This program (1) stresses proper compliance by multistate businesses with income and sales taxes; (2) achieves uniform application of comparable state laws; and (3) improves state knowledge of emerging audit issues. Twenty states participate in the Joint Audit Program.

National Bellas Hess Activities -- This program attempts to close the gap in interstate taxation caused by the National Bellas Hess decision. In this role, the MTC provides legal support for states to develop the "economic presence" concept of nexus.

National Nexus Program -- This program attempts to persuade non-complying multistate businesses to register and pay major state taxes. The MTC's activities include (1) voluntary tax

settlements; (2) public information; and (3) automated data exchange. In 1991, 24 states participated.

Unitary Exchange Project -- This program insures proper income tax reporting by major, multistate businesses by using interstate cross-matching of unitary information. In 1991, 12 states participated.

Educational Programs

The MTC is also involved in the educational process of Congress and State administrators. In this role, the MTC has focused on the need for the Federal government to reinforce federalism through policies that support state tax systems or that do not unnecessarily preempt state taxing powers.

Activities in this area include:

Rights of States to Tax and Audit Interstate Banking Operations
-- The MTC has been successful in obtaining language in both the House and Senate bank restructuring legislation. The language would permit States to audit national banks if the State believes the bank is "doing business" in its state and would permit States to audit state-chartered banks if the bank has a branch within that state.

Need to Reverse Effects of National Bellas Hess Decision --
The MTC has helped the states to focus on state solutions as Federal legislation has stalled. The MTC filed an amicus curiae brief in the Quill Corporation case which will be reviewed by the U.S. Supreme Court this term. The MTC worked directly with North Dakota on the Quill case which has the potential for

establishing the concept of economic presence as the constitutional standard of nexus for state tax purposes and for either limiting or overruling the National Bellas Hess decision.

Financial Institution Regulations

As mentioned above, the MTC has promulgated proposed regulations that would impact the method that states tax the income earned by out-of-state banks with no physical presence. The MTC first issued these proposed rules in July 1987. The proposed rules would have characterized an out-of-state bank as having an economic presence in a state if it had 20 customers (typically referred to by credit cards) or \$5 million in assets (i.e. loans) or deposits. The income earned would have been apportioned under a three-factor formula of payroll, property and receipts -- all equally weighted. Based upon comments received by the financial institutions sector, the MTC revised these rules and issued another set of proposed rules in May 1989. Under these revised rules, an out-of-state bank would be treated as doing business in a state if it had 100 customers, \$10 million in assets or deposits or \$500,000 in gross receipts. The three-factor formula for apportionment remained unchanged. The MTC held hearings on these proposed rules during August and December 1990. As a result of these hearings, the MTC decided that it needed additional time to further study the financial institutions industry before it could promulgate final regulations. The MTC met with the American Bankers Association and several bankers and state administrators in July 1991, to

review two proposals that the banking industry had put forth as reasonable regulations that would address the concerns expressed by the states and banks. The MTC is expected to produce its own rules as well as a possible response to the banking industry's proposals in early 1992. The MTC has expressed a desire to have the final rules promulgated in July 1992.

A copy of the MTC's most recent regulation project addressing the allocation and apportionment of financial institutions' income is attached. Additionally, the ABA's suggested regulatory alternative is attached.

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.

Finreg:5/9/90\ahf

Multistate Tax Commission Public Hearing Regarding

Proposed Regulation IV.18.(i)

(Financial Institutions)

DEFINITION OF "FINANCE LEASING".

The term "finance leasing" was not earlier defined in the proposed Regulation IV.18.(i). See, proposed Reg.IV.18.(i)B.(2), Reg.IV.18.(i)B.(6), and Reg. IV.18.(i)D.(2)(a). The definition of such term to be included in the proposed Regulation is as follows:

Reg.IV.18.(i)B.(6). "Finance leasing" or "finance lease" shall mean any type of capital lease to which a financial institution is a party, including sales-type, leveraged, and direct financing leases, that involves the transfer to the lessee of substantially all of the risks and burdens of ownership in the property subject to the lease. A "finance leasing or finance lease" is further evidenced by the lessee reporting such lease as an asset and a liability for financial accounting purposes. To the extent that it cannot be determined whether a capital lease falls within this definition of "finance leasing" or "finance lease", reference shall be made to the classification of leases set forth in Statement of Financial Accounting Standards No. 13, "Accounting for Leases" in effect as of the date of the adoption of this Regulation.

The public is invited to offer comment upon the foregoing definition, as well as upon any other provision of the Proposed Regulation by writing to:

Alan H. Friedman
Hearing Officer
386 University Avenue
Los Altos, CA 94022

**American Bankers Association
Proposed Regulation Attributing Income From the
Business of a Financial Institution**

Regulation -- Special Rules: Financial Institutions

Need - Authority for establishing rules regarding jurisdiction to tax.

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 -- Same as MTC.**

(B) **Definitions and General Provisions:**

(1) **"Borrower"**

- Debt instrument should be treated as a single instrument regardless of the number of individuals or entities liable on the instrument.

- Look to the billing address of the borrower which is likely to be a single address.

(2) **"Business of a Financial Institution"**

- This definition could be incorporated into the definition of "financial institution" for simplification purposes.

- Should be expanded to insure that credit card companies and financial companies and other businesses that are not commercial banks but compete with banks are covered.

- Reference to "finance leasing" should be included as part of a more detailed definition of lending activities.

(3) **"Deposit"**

- Deposits should be defined by whether they generate a source of lendable funds; i.e.

(a) trust funds held by a financial institution but which are invested on someone else's behalf should not be considered a "deposit", and

(b) letter of credit does not provide lendable funds.

- The FRB definition (attached) is closer than the FDIC's version which is used in the MTC approach.

- Money market funds should be included.

(4) "Exercising a Corporate Franchise or Transacting Business in a State"

- If a State is exercising its right to tax an out-of-state financial institution as if it was transacting business in the State then the out-of-state financial institution should be afforded the privilege to maintain an office or branch in that State and conduct all of the activities which it is legally empowered to conduct under its charter.

- A financial institution (determined on an individual corporation basis) is exercising a corporate franchise or transacting business in this State if it has:

(a) Loan assets in the State -- more than \$50MM of loans outstanding on the financial records (i.e., excluding written-off loans), or

(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, or

(c) 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 --

- Employee will not be deemed to conduct business in the State if the only activities engaged in by such employee within the State are:

(A) participation in loans made by other financial institutions having offices in the State; and

(B) investigation for credit purposes and physical inspections and appraisals of real and personal property securing or proposed to secure any loan or collecting and servicing loans in any manner whatsoever.

or

(d) Real or tangible property located in the State.

(e) "Non-Nexus Activities" - Same as MTC but add:

- foreclosures, to (viii) list,

- (x) federal fund transactions, and
- (xi) loan production offices.

(f) Nexus determination made on the basis of data as of the end of the third quarter of the preceding taxable year.

(6) "Financial Institution" - Same as MTC but add:

(d) all members of a bank holding company,

(e) all non-bank group companies performing same activities,

(f) credit card companies, financial companies and other businesses that are not commercial banks but do compete with banks, and

(g) any corporation primarily engaged in finance leasing.

(7) "Holding Company"

- Incorporate into definition of "financial institution".

(8) "Independent Person Not Acting on Behalf of the Taxpayer"

- Threshold should be 75%.

(9) "Property Located in this State"

- Rule for real property should be where the property is physically situated (with no presumption).

- Rule for tangible personal property should be the billing address (with no presumption).

- Rule for moveable tangible property should be same as MTC.

- Rule for intangible property should be the billing (or statement) address.

(10) "Regulated Financial Corporation" - Same as MTC but delete

- Reference to Federal Savings and Loan Insurance Corporation.

(11) "Resides/Residence/Resident"

- Billing (or statement) address only be used and that it not be a rebuttable presumption.

(12) "Securities" - Same as MTC.

(13) "State" - Same as MTC.

(14) "Subsidiary" - Same as MTC.

(15) "Syndication Loan" - Same as MTC.

(16) "Taxable and Taxable in Another State" - Same as MTC.

(17) "Taxpayer" - Same as MTC.

(C) **Business Income**

- Treat all income, except sales of businesses (including bank branches) and real estate used for business operations, as business income.

- Add that either Subpart F income be excluded from the tax base or that the factors relating to the controlled foreign corporation be included in calculating the apportionment percentage.

(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) Formula -- Three factors:

1. Payroll -- average annual salary and other compensation as shown on W-2 forms -- double-weighted.

2. Property -- tangible (including leases) and intangible (but limited to loans and receivables in the nature of loans).

3. Deposits and borrowings (including all stock

exempt common and perpetual preferred).

(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 (including leases) by physical location and intangibles (loans and receivables in the nature of loans) by billing (or statement) address.

(c) Deposits -- by statement mailing address.

(d) Other sources of funds -- by location of headquarters.

(3) Payroll Factor. In general. -- The payroll factor is a fraction consisting of a numerator which is the total amount paid by the taxpayer as compensation during the year to employees located in, or working in or out of an office or other place of business of the employer located in, the State, and a denominator which is the total amount of compensation paid during the year to all employees of the taxpayer.

(4) Property Factor. In general. -- The property factor is a fraction consisting of a numerator which is the average value of the taxpayer's real and tangible personal property owned or rented and used in (for leases -- the value is the cost), and intangible property attributed to this State during the tax period and a denominator which is the average value of all of the taxpayer's real and tangible personal property owned or rented and used in all States, and intangible property attributed to all States during the tax period.

(5) Deposits and Borrowings Factor. In general. -- The deposits factor is a fraction consisting of a numerator which is the total amount of deposits and borrowings located in the State, and a demoninator which is the total amount of deposits and borrowings held in all States during the year.

(6) The throwback rule should apply to income apportioned to a State having no taxable nexus.

(7) Every State should allow a loss carryback of at least 5 years.

(8) Sourcing of bad debt loss. In general. -- Taxable income should be determined by including all bad debt

losses in the calculation.

(9) 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.

(d) The Joyce holding should control (versus the Finnegan holding).

(10) In the case of sourcing loans under the intangible factor of the apportionment formula, loans attributable to leasing operations should be sourced as if tangible personal property. The value of such loans should be original cost.

(11) Tax Credit. -- Credit should be made available for taxes paid in other States on the same income until such time that all States adopt these jurisdictional rules.

(E) **Special Rules.** Same as MTC.

ECONOMIC ANALYSIS OF THE MARKET STATE APPROACH

**AN ECONOMIC ANALYSIS OF THE MARKET STATE APPROACH FOR THE
TAXATION OF INCOME EARNED BY OUT-OF-STATE BANKS**

by

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INTRODUCTION

The revolution in computer technology of the last two decades has vastly improved competition and the delivery of services in the banking industry. Automatic teller machines have freed the average banking customer from the limits that normal business hours place on her ability to conduct routine financial transactions. Computer technology has also provided firms and individuals of even modest means with the ability to "shop" nationally for the most favorable rates available for both deposits and loans. While the benefits of enhanced interstate competition might seem so obvious that they scarcely need to be enumerated, they are perhaps too obvious in that they are taken for granted in the current policy debate over state taxation of the earnings of out-of-state banks. Yet these taxes portend such a serious threat to interstate competition that the potential economic consequences should be the focal point of the debate.

The rationale for states taxing the income of out-of-state banks appears to rest on the assumption that financial transactions conducted by non-resident institutions constitutes

"market exploitation."¹ The exploitation theory would seem to imply that the benefits of competition such as greater consumer access to credit, new and innovative financial services and the reduction of financial market risk through the geographic diversification of credit are in some way exploitative. Thus, following the logic of the exploitation assumption, states need to take "corrective" action through the adoption of market-based tax regimes. From an economic perspective, the merit of such a theory is highly suspect for it completely ignores the benefits that free markets provide to borrowers and lenders.² Certainly, the assertion of market exploitation provides no basis for the evaluation of state tax policy. However, state systems designed to levy taxes on the income earned by out-of-state banks can and should be evaluated through generally accepted principles of good tax policy.

In contrast to the exploitation hypothesis, economic analysis of state taxation of non-domiciliary financial institutions raises a variety of cautionary flags. Indeed, the full cost of market-based taxes to a state and its residents may far outweigh any potential benefits to be derived from higher state tax revenues. Careful evaluation of market state taxation of non-resident banks raises serious concerns as to whether this form of taxation constitutes good policy. These concerns include

¹ Sandra B. McCray, "State Taxation of New Banking Procedures," Tax Notes (June 4, 1990) p. 1231.

² Roger S. Cohen, "State Taxation of New Banking Procedures: A Reply," Tax Notes (July 30, 1990) pp. 631-32.

the possibility of excessive compliance costs, the potential for market discrimination and the possibility the tax would constitute a barrier to trade. In addition, the excess burden of the tax -- economic jargon for the value of the change in consumer and firm behavior as a result of the tax -- may place a formidable cost on the economy of the state, its businesses and its residents. The elements that comprise the excess burden of state taxes on non-residents banks include fewer financial options for consumers and a reduction in inter-regional loans. This final aspect of the excess burden associated with market-based taxes, reduced inter-regional lending, translates into greater financial market instability for market tax states, particularly during regional business cycles, and higher levels of risk for the state financial system.

I. POLICY EVALUATION - TAXATION OF NON-DOMICILIARY BANKS

State taxation of the income that non-resident banks derive from transactions within that state borders raises several questions as to whether such taxes constitute reasonable tax policy. In particular, market-based taxes may violate several commonly accepted conditions necessary for effective tax policy. Specifically, market-state taxes can impose burdensome compliance costs on firms, are discriminatory in nature and reduce inter-state transactions. While the violation of any one of these principles is sufficient to raise questions of the appropriateness of the tax, the potential impact of market-based taxes on the efficiency of financial markets is cause for serious

concern. The excess burden, measured in terms of the reduced availability of credit, the adverse influence on state economic development and the potential for higher levels of financial market risk, are sufficiently great to raise a cautionary flag for policy makers in any state contemplating the adoption of this type of taxation.

It is generally accepted by economists and policy analysts that taxes should be imposed in a manner which tends to minimize their adverse effects on individuals, firms and markets. For example, Stiglitz³ enumerates five conditions which are necessarily present in a good tax system:

1. The tax system should not interfere with the efficient allocation of resources.
2. The tax system ought to be easy and relatively inexpensive to administer.
3. The tax system ought to be able to respond easily (in some cases automatically) to changed economic circumstances.
4. The tax system should be designed so that individuals can ascertain what they are paying so that the political system can more accurately reflect the preferences of individuals.
5. The tax system ought to be fair in its relative treatment of different individuals.

The application of these principles to the specific issue of state taxation of banks translates into several specific

³ Joseph E. Stiglitz, Economics of the Public Sector (New York: W. W. Norton & Company, Inc., 1988) p. 390.

requirements.⁴ Stiglitz's first condition, that taxes should not interfere with the efficient allocation of resources implies that bank taxes should not form a trade barrier and unduly hinder the interstate flow of capital or commerce. The second requirement implies that the administrative costs of compliance imposed on the taxpayer must also be low. Finally, the first and fifth conditions imply that the imposition of a tax should not discriminate among different lines of business. The current proposals to change some state tax systems from a residence-based approach to market-based approach seriously compromises these general principles of good taxation. Of particular concern are the economic inefficiencies visited on credit markets through the imposition of market-based taxes.

II. Taxation and Credit Market Efficiency

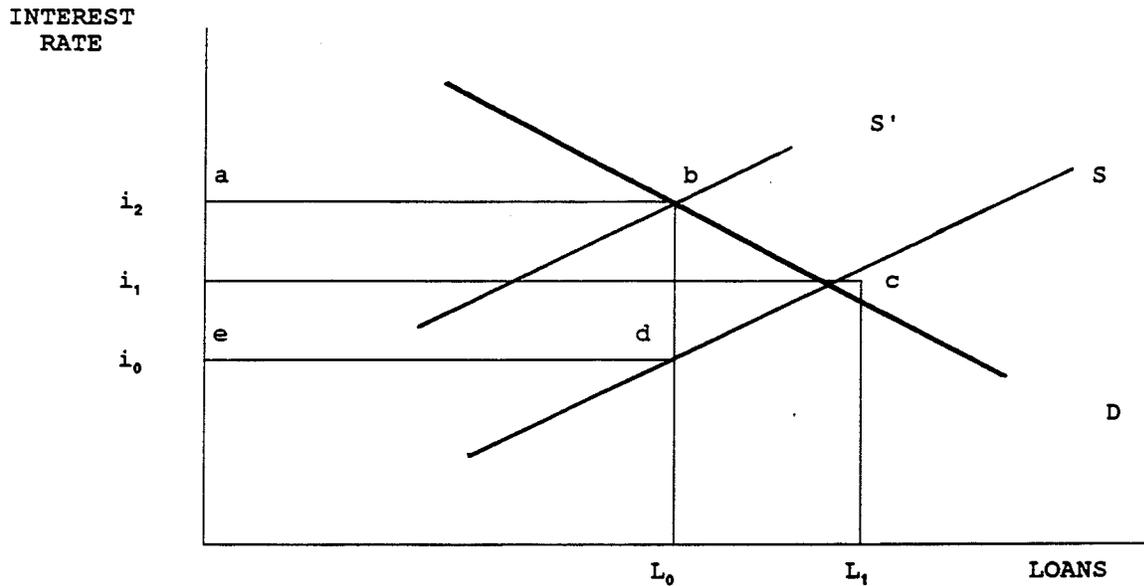
The impact of bank taxation on state credit markets is illustrated in figure 1. Banks act as a conduit for the conversion of savings into capital expenditures or investment. The supply of savings which banks loan out to individuals and firms is indicated by the supply curve, S. The demand for loanable funds is indicated by the investment demand curve, D. In the absence of any taxation the market clears at an interest rate of i_1 with L_1 quantity of funds loaned out.

The imposition of the bank tax causes the supply of loanable funds to be decreased as indicated in figure 1 by the supply curve

⁴ See Advisory Commission on Intergovernmental Relations, State Taxation of Banks: Issues and Options (December 1989) p. 7.

S' where the vertical distance between S and S' equals the tax per unit. The response of the market to the imposition of the tax

Figure 1: TAXATION OF CREDIT MARKETS



is two-fold. First, the market rate of interest on loans rises to i_2 . Second, the amount of loans extended by financial institutions is reduced from L_1 to L_0 . In short, individuals and firms face higher borrowing costs and as a consequence fewer loans are made in the market. For the state this means less private investment and a possible reduction in future economic growth.⁵

In addition to the changes in interest rates and lending, the tax also generates tax revenues equal to the rectangle abde

⁵ For a discussion of the consequences of reduced savings and investment resulting from taxation and policy alternatives to offset this see idem, Joseph E. Stiglitz, pp. 550-551.

in figure 1. A portion of the tax falls on borrowers through higher market interest rates (i_2) and part falls on lenders in the form of lower after tax returns (i_0). However, the overall cost of the tax to the society, quadrilateral abcde, exceeds the total amount of tax revenues collected. The total cost of the tax includes the value of the loans forgone because borrowers take on less debt when interest rates rise. This reduction in lending activity is a measure of the excess burden or the market inefficiency resulting from the imposition of the tax. The excess burden in figure 1 is equal to triangle bcd and measures the value to both the lenders and borrowers of the loans forgone because of the tax increase.

The generally accepted principle that tax systems be efficient is directly related to the value of the excess burden. Efficient taxation implies that a good tax system is one in which the total burden of tax system is minimized. The magnitude of the excess burden of a bank tax is determined by the response of borrowers to tax imposed rise in market interest rates and/or lenders to lower after-tax returns. The more sensitive the response, in either the willingness of lenders to make loans or the willingness of individuals and firms to borrow, the greater the excess burden. In general, economic efficiency requires that the higher tax rates be imposed on those markets or activities for which suppliers or consumers have the fewest alternatives. Efficient taxation implies that there will be little change in

market activity resulting from the imposition of the tax and, therefore, the excess burden will also be small.

A. The Burden of Market Based Bank Taxation

While the previous analysis described the effects of imposing a new tax on banks, the very same result would also occur if rates on existing taxes were merely increased. Some proponents of bank taxation have indicated that the switch from a residence-based tax to a market-based tax would not necessarily result in higher tax rates. Indeed they posit that the switch in tax regimes would merely rearrange tax revenues among the different state. However, the assertion that the introduction of market-based bank taxation would have no impact on credit markets is predicated upon the implicit assumption that several strict conditions will be met.

First, proponents assume that the adoption of a market approach will not increase tax rates on banks at all. This further requires that the adoption of market-based taxes will not lead to any double taxation of bank income. However, the possibility of double taxation can only be eliminated if market tax states adopt strictly uniform bank tax policies. Second, proponents of market-based taxes further assume that compliance costs will be negligible. That is to say, banks will be able to compile individual market tax information and will be able to comply with a variety of different state rules at virtually no additional cost over the current system. Both assumptions are unlikely. Indeed, double taxation and higher compliance costs are

certain to occur and will affect credit markets in a manner similar to that discussed above.

Double taxation will occur whenever individual states enact inconsistent rules regarding jurisdiction or the apportionment of bank income. Banks located in residence-based tax states will find that 100 percent of their income, regardless of the location of the loan activity, will be subject to home state taxation. In addition any income earned through lending in a market-based state will also be subject to the additional tax liability imposed by that state's market-based tax system.

An additional source of double taxation is the the enactment of different apportionment rules by the individual states. While the Multistate Tax Commission regulations recommend a three equal-weight-factor rule for the apportionment of bank income in a market-based tax, this is not currently the practice. In fact, the four states presently utilizing the market base approach have already enacted different rules. Tennessee, Indiana and West Virginia utilize a single factor, 100 percent receipts rule, while Minnesota utilizes a three factor rule but weighs receipts at 70 percent. The incentive is for states to adopt different rules, individually designed to maximize total tax collections.

The second cause of credit market inefficiency resulting from the adoption of market-based taxes is that these taxes impose new and potentially very high compliance costs on banks. High compliance costs has been the uniform experience of financial institutions lending in states that tax the earnings of

out-of-state banks. These costs can be excessive, especially for smaller institutions. First, market-based taxes require banks to alter their accounting procedures so as to be able to identify and track the location of their loans. Since this procedure is contrary to the way banks otherwise conduct business, market taxes may require new accounting practices and computer support.

Second, given individual state tax laws, banks will be required to use different accounting methods and procedures to calculate taxes due in each state. Indeed, as indicated above, the four states currently taxing the income generated by non-resident banks use a different apportionment factors for calculating taxable income. Switching accounting systems to accommodate not just market-based taxes but also the idiosyncracies of different state tax systems is likely to impose relatively high costs on banks whose lending activity covers several states. Small institutions will be particularly disadvantaged by this because they have relatively less loan volume over which to spread fixed costs. Consequently, banks with low out-of-state loan volume in general and small banks in particular are likely to experience rather high costs in complying with market based tax systems.⁶

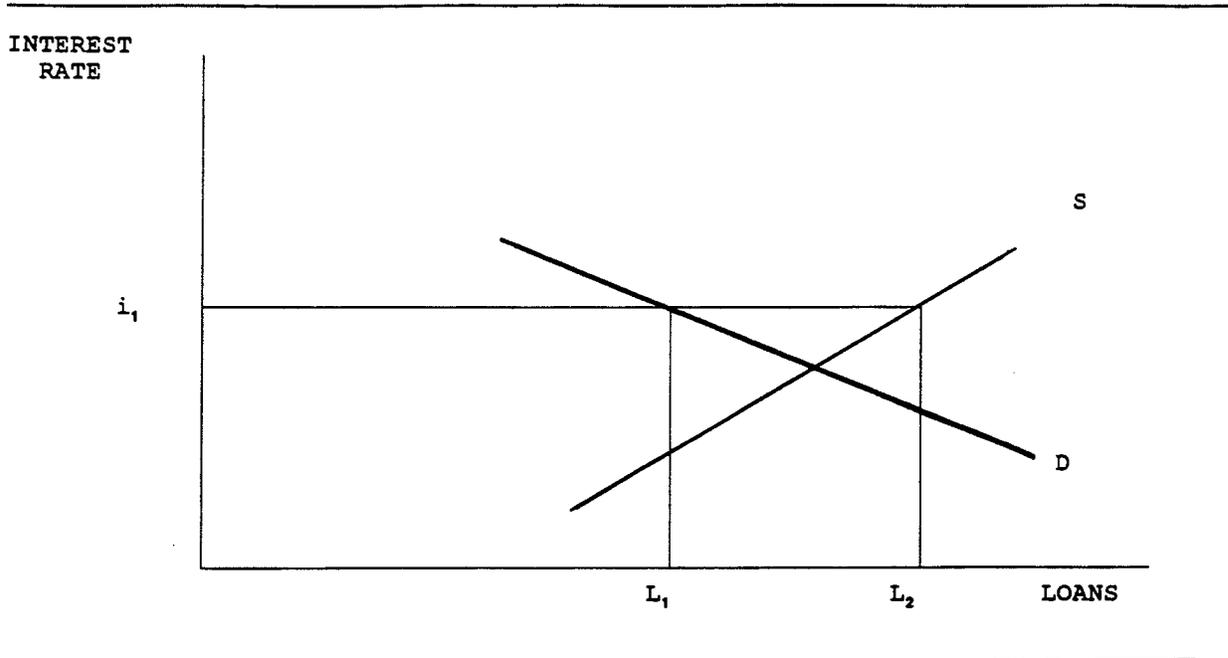
⁶ The compliance costs can differ dramatically across firms of different sizes. For example sales tax compliance cost have been calculated to vary by as much as 800 percent across retailers of different size and type. John F. Due and John L. Mikesell, Sales Taxation (Baltimore: Johns Hopkins University Press, 1983) p. 76.

B. Capital Importing and Capital Exporting States

The impact of market based taxes on individual state credit markets is determined by the net amount of interstate borrowing and lending conducted by resident institutions. Individual states are in effect small open economies because goods, services and capital freely flow across state borders with little or no impediment to their movement. Banks may be physically located in one state but they actually operate in a national credit market as borrowers and lenders routinely cross state borders in order to obtain the best possible rates of return. The net result is that the price of credit, the interest rate, is established nationally as the process of interstate borrowing and lending equalizes interest rates across states.

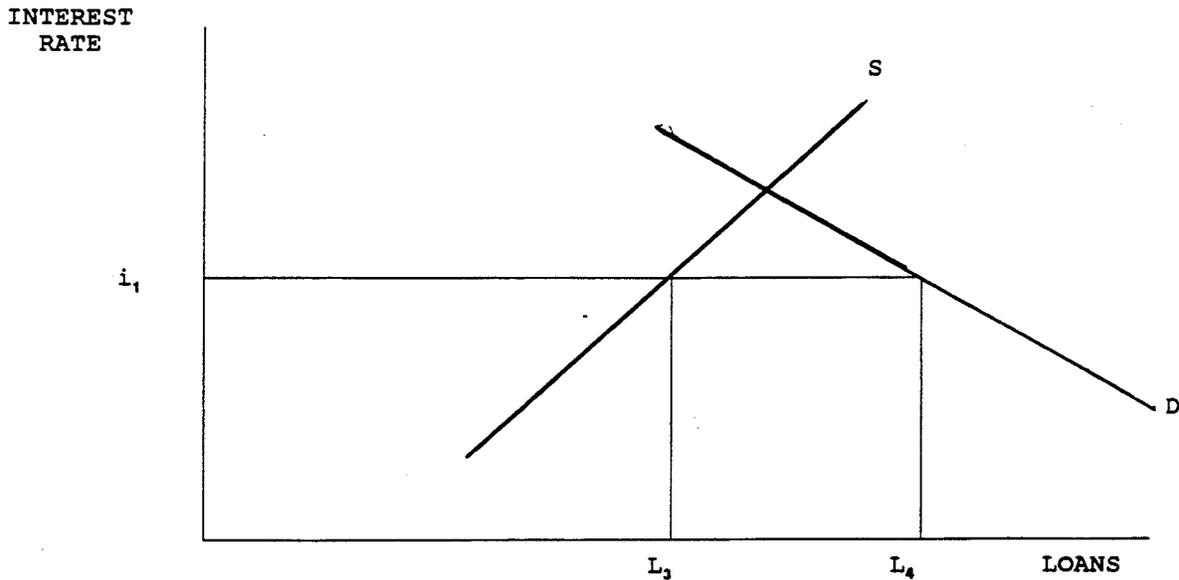
Depending upon resident bank lending activity, states will be either net importers or net exporters of capital. Figure 2 depicts the credit market for a capital exporting state. At the prevailing market interest rate (i_1) the banks in a capital exporting state are able to fully service in-state demand for loans at level L_1 . In addition, these banks have sufficient additional funds to be able to lend to out-of-state borrowers as well. Out-of-state lending is equal to the difference between the total amount of loans outstanding, L_2 , minus in-state lending L_1 .

Figure 2: CREDIT MARKET, CAPITAL EXPORTING STATE



In contrast banks in capital importing states do not command sufficient savings to service all local demand for loans. Figure 3 depicts a credit market for a net capital importing state. For the importing state the supply of local bank loans L_3 is insufficient to meet in-state demand at the prevailing interest rate i_1 . The additional in-state loan demand is satisfied through out-of-state bank lending equal to amount L_4 minus in-state lending L_3 . Out-of-state banks then are an important source of capital for individuals and firms residing in net capital importing states. In the absence of out-of-state bank lending,

Figure 3: CREDIT MARKET, CAPITAL IMPORTING STATE



the state would experience higher borrowing costs, lower loan activity and less capital formation.

Out-of-state banks provide needed liquidity and capital to credit importing states in return for which the banks also earn income. If the banks exporting capital operate in residence-based tax states their total income, regardless of loan location, is taxable to their resident state. Under a residence-base the capital importing state can derive tax revenue from bank income derived from out-of-state loans.

C. THE EXCESS BURDEN OF MARKET BASED BANK TAXATION

The distinction between capital importing and capital exporting states is important for it is most likely that capital importing states will look to market-based taxes for increased

revenues. Alternatively, capital exporting states have little incentive to make the switch from a residence-based bank tax approach. However, if some states change to market taxes while other states maintain a residence-base approach, there will be reduction in the availability of credit and a concomitant rise in the cost of credit in the market-based state. There are several reasons why this change in tax policy will affect state credit markets in this manner. First, in-state institutions will find it to their advantage to move some of their lending activity to states with a residence based tax. Shifting loans to residence-based states will reduce the total tax liability for these institution thereby raising their after-tax rate of return.⁷

The second source of credit market change arises from the double taxation of income earned by exporting banks residing in residence-based states. As was discussed previously, residence-based states may tax 100 percent of all income of domiciled banks regardless of the location of the loan activity. Market-based states will levy additional taxes on that portion of the out-of-state banks income attributable to lending activities in their state. Depending upon the apportionment rules adopted by the individual market-based states, the same income could in effect be subject to taxation by several jurisdictions.

The third factor that could adversely affect credit markets in market-based states is that rather market-based rules may

⁷ If the market based state can reduce the incentive for local banks to export funds by utilizing a throw-back rule. This rule allows the home state to tax bank income earned, but untaxed, in a residence-based state.

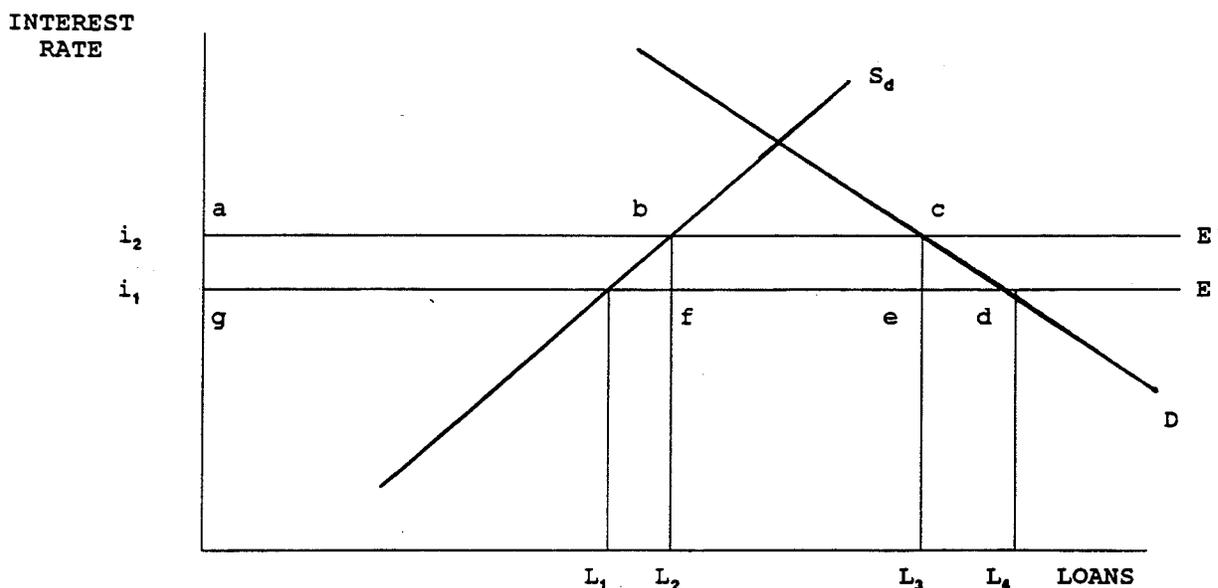
impose very high compliance costs on out-of-state banks. Compliance costs are in essence a cost of doing business which reduce both the rate of return for the bank and its ability to make loans. High compliance costs, therefore, impart all the negative consequences of higher tax rates but provide no offsetting increase in state tax revenue. Thus the only effect of high compliance costs is reduced credit market efficiency.

The effect of the market-base tax on the credit markets of capital importing states is illustrated in figure 4. The in-state supply of credit is indicated by curve S_0 and the willingness of out-of-state banks to supply credit is indicated by horizontal line E .⁸ Prior to the initiation of the market tax, the importing state credit market clears at an interest rate of i_1 with L_4 the amount of credit extended. Of this total, L_1 is provided by in-state banks and L_4 minus L_1 is imported from other states.

The imposition of the market-based tax on importing banks causes the supply of out-of-state funds to shift up to E' . The difference between these two lines then is the additional tax rate imposed on out-of-state banks only. Interest rates rise to i_2 and the total amount of credit extended to the market falls to L_3 . This reduction in total market loans comes entirely from

⁸ For the sake of simplicity the analysis assumes that the supply of exported funds is perfectly horizontal. For a more complete discussion of capital taxation in an open economy see *idem*, Stiglitz, pp. 551-553.

Figure 4: MARKET TAXATION IN A CAPITAL IMPORTING STATE CREDIT MARKET



reduced lending by out-of-state banks. The higher interest rate induces in-state banks to increase loans to L_2 and imported loans are reduced to L_3 minus L_2 .

The costs imposed by the tax on state residents and businesses are far in excess of the tax revenue earned. The total cost is indicated in figure 4 by quadrilateral $acdg$. Of this, state tax revenues increase only by the amount paid by out-of-state banks or rectangle $bcef$.⁹ The additional costs imposed by the tax includes the excess burden or the value of loans forgone, triangle cde and the higher borrowing costs imposed upon residents from loans made by in-state banks, rectangle $abfg$.

D. The Excess Burden of High Compliance Costs

⁹ If market approach rules require tax credits for in-state bank tax payments to other states, the increase in tax revenue would be offset by the amount of those credits.

Figure 4 can also be used to analyze the market distortion resulting from higher compliance costs. In this situation the difference between line E and E' may be considered to be the added cost of compliance imposed on out-of-state banks when lending in a market-based tax state. The impact of these added costs on the credit market is essentially the same as before. The market rate of interest rises to i_2 and total lending falls to L_3 . Again the reduction in loan activity comes entirely from the loss of loans made by out-of-state banks.

The difference between the compliance cost effect and a tax of equal value (as discussed in the previous section) is the excess burden. Under a higher compliance cost regime, the rectangle bcef, merely represents the additional cost that banks necessarily incur as part of doing business in a market-based tax state. Unfortunately the added cost provides no benefit to any of the market participants. Therefore, compliance costs are simply an additional excess burden associated with the tax. Thus for the credit market where the tax merely imposes higher compliance costs on out-of-state banks, the total excess burden from the tax is quadrilateral bcdf.

III. A POLICY EVALUATION OF MARKET-BASED TAXATION

Clearly the impact of a change from residence-based bank taxation to a market-based approach imposes serious costs on state residents and firms. The possibility that these taxes will impose significant inefficiencies on credit markets is both a cause for concern and a call for further investigation. Good

public policy requires that a number of issues be investigated and resolved before states switch to market-based bank taxation.

A. The Magnitude of Credit Market Inefficiency

Perhaps the most important criteria in the evaluation of tax policy is that taxes should be selected and levied in a way which minimizes the distortions (excess burden) they imposed on society.¹⁰ In the pervious analysis is was demonstrated that a switch to market-based approach to bank taxation will result in credit market inefficiencies, especially for credit importing states. However, it should be noted that every tax introduces some distortion into markets because individuals and firms always alter their behavior in response to a tax. For example, a tobacco excise tax will cause the price of cigarettes to rise and consumers will make fewer purchases. The excess burden of the tobacco tax is the value to consumers and producers of the cigarettes not purchased. Because states have open economies the excess burden may be quite large for a state that enacts a tax which is substantially different from that of surrounding jurisdictions. For example, it has been estimated that cigarette taxes in the State of Washington, which are higher than surrounding states, caused a decrease of 13% in state retail sales in the early 1970's.¹¹

¹⁰ For a more detailed analysis of efficient taxation see Robin W. Boadway and David E. Wildasin, Public Sector Economics (Boston: Little, Brown and Company, 1984) Chapter 9.

¹¹ Paul Manchester, "Interstate Cigarette Smuggling," Public Finance Quarterly (1976), 225-37.

Similarly, the excess burden associated with state taxation of out-of-state banks is the reduction in the bank loans and the concomitant higher credit costs imposed on individuals and firms. The reduction in credit is a direct consequence of the imposition of the tax which reduces the rate-of-return earned by the taxed institutions. Bank profits are reduced not only by the amount of the tax itself but also by the added compliance costs, which for some firms can easily exceed their total tax obligation. Banks and other financial institutions will respond to this loss in profit in one of two ways.

First, banks may simply refrain from conducting business within the taxing jurisdiction. This cessation of business is most likely to occur among small banks or banks with minimal exposure within the state because low volume makes these banks are particularly susceptible to high compliance costs. Second, financial institutions remaining active in the market will offset their lower profits by reducing their exposure to that market. Either response translate into fewer loans and a reduced availability of credit within the taxing jurisdiction.

The existence of the excess burden associated with taxing income of out-of-state financial institutions is undeniable. What is not known, however, is the magnitude of this burden. For state policy makers there are several important questions which need to be answered before considering the implementation of this tax. First, by how much will the tax raise the cost of borrowing within the state? Second, what impact will the tax have on the

availability of credit for resident firms and individuals? Unfortunately, due to the newness these taxes there is little information available to provide direct estimates of the impact of the tax on state credit markets. However, studies of the impact state usury laws may provide some insight into the response of out-of-state banks to the imposition of state taxation.

Usury laws were passed with the intention of helping borrowers but they had the opposite effect. Usury laws limit the availability of credit and ultimately raise borrowing cost for individuals. Market-based taxation of financial institutions will of course produce the same effect.

While usury laws and state taxation are mechanically different, they each have the same impact on the banks subject to their conditions. Both usury restrictions and bank income taxes reduce the rate-of-return on lending. Usury controls lower bank profits because interest ceilings reduce gross margins. Taxes, on the other hand, lower profit by reducing net returns and because they impose higher compliance costs on taxed institutions. Since the effects on financial institutions of both usury laws and taxation are the same, lower bank profits, usury studies can provide some insight into the potential impact of the market state approach to taxation on credit markets.

Economic studies market subject to usury rules indicate that financial institutions consistently respond to state imposed controls over interest rates in several ways. The most common

response is for banks to move credit out of restricted markets by either shifting credit to non-usury states or by switching to loans of a type not subject to interest rate control. This reaction is consistent with what would be the expected response of banks to states enacting market based income taxes. Banks will simply shift loans to states not utilizing market-based taxation.

The most disturbing aspect of the usury studies, and one which bodes ill for market based taxation of bank income, is the magnitude of the changes in credit availability attributable to interest rate controls. For example, one study of Tennessee found its limit of 10% interest caused a thirty percent reduction in finance company loans during the period August 1977 to March 1978.¹² In total, the decline in Tennessee based finance company loans outstanding was \$150 million during this period of time. Tennessee consumers also responded by transferring their business to neighboring states. For example, Tennessee experienced a sharp reduction in bank auto loans while auto loans made by banks in neighboring Alabama and Georgia rose sharply.¹³ Even small changes in bank rates of return can lead to substantial amounts of credit loss. During the first four months of 1974 the States of Missouri and Mississippi had an 8% interest limit on home mortgages loans when FHA loan rates averaged about 8.78%. This small reduction in gross returns (less than 10%) lead to an 18%

¹² Robert E. Keleher and B. Frank King, "Usury: The Recent Tennessee Experience," Economic Review: Federal Reserve Bank of Atlanta (July/August 1978) p. 75.

¹³ Ibid., p. 76.

greater decline in residential loan contracts in Mississippi and Missouri than in neighboring states without the 8% limit.¹⁴

Banks made up for their lower levels of local consumer loans by shifting funds out-of-state, particularly by lending in the Federal funds market.¹⁵

The evidence provided by usury studies suggest that states should act prudently when contemplating the imposition of the market state approach for taxing income from out-of-state banks. The impact of these taxes on state credit markets will be negative and, as indicated by a variety of usury studies, may be substantial. The possibility that the market state approach to taxation may seriously hamper state financial markets is not surprising for it merely reflects the flip side of the technology that has fostered the high level of interstate transactions. Technology has significantly reduced the cost to banks of entering out-of-state markets. That same technology means that banks can just as easily exit state markets when conditions dictate. Tax laws which reduce profits by imposing unreasonable high compliance costs on banks are likely to effect just such a market condition. Exiting a market may be so costless to out-of-state banks the overall impact on state credit markets could be substantial.

¹⁴ Norman N. Bowsher, "Usury Laws: Harmful When Effective," Review: Federal Reserve Bank of St. Louis (August 1974) p. 19.

¹⁵ Ibid., p. 22.

B. Compliance Costs of Market-based Bank Taxes

High compliance costs appear to be the trade mark of market-based taxes on out-of-state banks. These costs can be excessive, especially for smaller financial institutions. First, as discussed earlier the tax requires banks to alter their accounting procedures so as to be able to identify and track the location of their loans and other accounts contrary to the way they otherwise conduct business. Second, given individual state tax laws, banks will be required to use different accounting methods to calculate taxes due in each state. Recently Paul Claytor testified on behalf of the American Bankers Association (ABA) before the Multistate Tax Commission stating:

ABA member Banks of all sizes that have considered the impact of either Minnesota, Tennessee or Indiana legislation upon their institutions calculate that the administrative compliance costs exceed the tax due by 250 percent or more. An Illinois community bank located near the Indiana border determined that it would cost at least \$7,000 to "gear up" even though the amount of tax due was less than \$3,000. A large regional institution in the South determined that it would cost at least \$1 million in internal costs alone to comply with Tennessee law -- even though the bank may actually pay less tax than it currently remits to Tennessee. A major money center institution with a nationwide customer base estimated the range of its current liability in the three states with market state taxation at \$25,000. In preparing a tax return for one of these states, they indicated the bank could not calculate its liability with sufficient accuracy to withstand audit scrutiny, even though the estimate was prepared in good faith and calculated on a worst case basis. In order to gather sufficient information to file a more accurate return, the bank would have to set up a recordkeeping system for loans based on the destination of the funds, with coding, so that the inconsistent state sourcing rules would be observed. Since Minnesota employs an ultimate use test, they would have to inquire of the lenders, who in turn would have to go back to the borrowers, to get information that is not in the loan file... It should be obvious that the cost of these compliance activities

would be many times the estimated tax liability of \$25,000.¹⁶

In addition, there is the complicating factor of debt purchased on secondary markets. Financial institutions frequently sell debt, especially home mortgages, to other institutions or individuals. Typically, these loans are "bundled" together and a bundle may contain debt instruments from a variety of locations. Should secondary debt be included in a state's definition of taxable base even higher compliance cost would result. Indeed, it is quite possible that the holders of this secondary debt may not even be aware of the tax liability attributable to particular debt bundles. Markets are likely to adjust to these conditions by developing a two tier system. The secondary market which would evolve from this arrangement would cause residents of market base tax states to experience higher borrowing costs.

C. Credit Market Discrimination

The commonly accepted principle that of good tax policy that taxes should not discriminate among different lines of business is jeopardy for market-based taxes. Indeed, state taxation of out-of-state financial institutions on income earned from in-state transactions is in itself discriminatory because it sets a different standard for financial institutions compared to retailers and manufacturers who are subject to the conditions set forth in P.L. 86-272.

¹⁶ Paul Claytor testimony on behalf of the American Bankers Association before the Multistate Tax Commission, August 21, 1990, pp.14-15.

In addition, there is the potential for discrimination in the treatment of business conducted through secondary markets. As was noted above the compliance cost associated with secondary market activity may be particularly onerous. Perhaps in consideration of this fact, Minnesota which initially included secondary debt in its tax of out-of-state banks later provided it an exemption, as does Indiana. (The Tennessee situation is less clear but it seems that the state has not exempted most secondary market transactions from their tax.¹⁷) Yet exempting secondary market transactions sets a double standard for taxing identical sources of income. For example, the secondary market exemption would imply that a out-of-state bank would not liable for taxes on income produced by a mortgage it purchased from an in-state bank. However, the out-of-state institution would be liable for taxes if it originated the very same mortgage loan itself.

D. Market-based Bank Taxes as a Source of Trade Barriers

The criteria that a tax should not form an effective trade barrier by unduly hindering interstate markets or commerce is also violated by market-based bank taxes. States utilizing market taxation run a real risk of erecting significant barriers to their local credit markets which will subsequently affect national markets. These barriers result, in part, from the high compliance costs discussed above and will cause some banks to avoid conducting business in states which levy such taxes. In

¹⁷ Joe Huddleston, Commissioner, Tennessee Department of Revenue to Timothy L. Amos, General Counsel, Tennessee Bankers Association, correspondence dated July 17, 1990.

particular, these taxes are apt to substantially inhibit or even eliminate many smaller firms from participating in that state's financial markets. The loss of these firms, even though they may be small, can have a serious negative effect on the competitiveness of a state's financial markets. Indeed, the benefits of competition, lower borrowing costs and greater access to credit, will be reduced simply by the influence of the tax in dissuading outside banks even from considering an initial entry into that state's markets.¹⁸

IV. OTHER ISSUES IN MARKET STATE TAXATION

The magnitude of changes in state credit markets brought about by the imposition of a market state approach in taxing the earnings of out-of-state banks and financial institutions will be influenced by several factors. The first is the degree to which out-of-state firms participate in the state's markets. Greater participation indicates a potential for significant reductions in the availability of credit within the taxing state. The second element is the level of tax burden, including the compliance costs, which falls on individual banks. Again the greater the cost incurred by a bank, relative to their income earned within the state, the higher the probability it will retreat from the market. While the impact of the market state approach taxes on credit availability awaits empirical analysis, the types of changes states may expect in their credit markets are clear.

¹⁸ See William J. Baumol, John C. Panzar, and Robert D. Willig, Contestable Markets and the Theory of Industry Structure (San Diego: Harcourt Brace Jovnovich, 1982).

Taxed induced changes in state credit markets will have a predictable influence on:

1. market competition and consumer costs,
2. state economic development,
3. regional business cycles, and
4. the level of risk undertaken in state financial markets.

Each of these conditions will be discussed in turn.

A. Market Competition and Consumer Costs.

State bank regulations are highly restrictive and only eleven states permit non-reciprocal nationwide banking.¹⁹ Thus in the majority states, most out-of-state banks are prohibited from a brick and mortar presence. Indeed it is often in response to state restrictions that banks are forced to conduct business as a non-domiciliary institution. Yet, these banks often represent a significant competitive force in their out-of-state markets. Often out-of-state banks provide innovative products or services which may not be commonly available from local institutions. The motive for the out-of-state bank is enhanced profits which can only be accomplished when it provides value to local customers. Consequently, the more a state's financial markets are open to non-domiciliary institutions, the more local consumers benefit.

State imposed taxes on non-domiciliary banks will reduce market competition by forcing out-of-state to reduce their tax liability by limiting their market exposure. Financial markets in

¹⁹ Idem, Advisory Commission on Intergovernmental Relations, Table 1.

these states will become more concentrated as out-of-state banks either leave the state entirely or reduce their business volume. Consumers will suffer in several ways when local credit markets become more concentrated. First, a reduction in the number of out-of-state banks means that residents will have fewer credit options and are therefore likely to face higher borrowing costs. Some services provided by out-of-state banks may be eliminated entirely. Second, non-domiciliary banks may refuse to take on small loans in order to compensate for the higher fixed cost associated with compliance. Lower income individuals and new business ventures are most likely to be affected by this change in loan policy.

B. The Impact on State Economic Development

During the decade of the 1980's states and even cities committed billions of tax dollars to support private firms in an effort to promote and enlarge business development and employment opportunities. Tax dollars have been used to subsidize business plant and equipment, to provide interest subsidies for capital expansion, to provide venture capital for new businesses and to fund employee training. While these government efforts have committed billions of dollars to the cause of economic development, they pale in comparison to amount of private sector investments, in which banks play a major role. Indeed, commercial banks provide some \$600 billion in commercial and industrial loans alone.

State taxation of the income earned by out-of-state banks hinders economic development by reducing the amount of funds these banks will commit to state credit markets. Consequently, there will be fewer private funds available for direct capital investment. Interestingly, on the one hand states may commit billions of dollars in public funds to encourage private capital formation while simultaneously discouraging private investment through higher tax levies on out-of-state banks.

C. Regional Business Cycles

Generally, the business cycle is thought of as a national phenomenon but regional impacts are often far more pronounced. It is not uncommon for one part of the country to be in an economic expansion while other regions languish in recession. The regional business cycle visits different credit needs and credit market conditions on states in each phase of the cycle. In general, credit is readily available in states benefitting from an economic expansion. Although expansion implies heightened business need for capital, strong revenues make it likely that they will be able to finance their continued growth in part with internally generated funds. In addition, rising personal income adds to bank deposits and provides additional resources to state credit markets. In contrast, credit markets in states undergoing a recessionary phase of a regional business cycle are generally tighter because the recession induced decline in personal income reduces the growth in bank deposits as individuals draw down savings for living expenses.

As businesses move out of recession, they need credit to expand and build inventory but the depressed local credit market may not be able to accommodate their needs. Out-of-state banks are an excellent source of credit during critical periods when local markets are hard pressed to fulfill credit needs. In effect, the process by which banks loan outside of their region reduces the economic consequences of regional recessions by shifting some funds from healthy states to those just recovering from the cycle. By taxing the earnings of out-of-state banks, state may be erecting a barrier to this flow which could ultimately exacerbate local economic conditions. In effect, market-based state taxes could dampen total tax revenues by restricting the flow of an important source of business credit needed to lift the state out of recession.

D. Credit Market Risk

Banks and other financial institutions are subject to a variety of risks. First, there is the risk inherent in any loan for ultimately some borrowers may not be able to repay the loan. Second, there is risk contained in an entire loan portfolio which is often sensitive to macroeconomic factors outside the control of the bank. For example, business failures tend to rise during periods of economic recession. A deep recession can threaten a large portion of business loans held by individual banks.

As an offset to this risk, banks diversify their loan portfolios by including loans made to a variety of industries or purposes. Banks can further reduce risk through a geographical

diversification of their loans. Such diversification provides banks with additional safety, because even the depths of a severe national recession, many states and regions individually experience reasonably good economic conditions.

Market state based taxation encourages portfolio risk by inhibiting banks from making out of state loans. The impact of this is not merely limited to the portfolios of out-of-state banks alone but may cause local credit markets to incur more risk as well. The reason for the local market impact is simple. When a state discourages out-of-state banks from local lending, it forces its business firms to be more dependent on instate banks for credit. Local firms will have less access to credit, particularly when they need to offset the effects of the business cycle and will therefore, be more dependant on local banks for business loans. As a consequence, state bank loans will be more locally concentrated than would otherwise be the case. The reduced access to out-of-state markets in combination with local concentration of loans made by state banks carries with it a higher degree of market risk than would otherwise occur. Market based state tax policy can have a significant effect on the risk inherent in local financial markets.

V. CONCLUSION

States which enact a market state approach for taxing the income earned by out-of-state banks will reduce the availability of credit to its residents and businesses. Owing to the newness of this form of taxation there is little direct evidence to

determine the magnitude of this credit loss. However, economic theory suggests that states which enact this tax could experience a substantial loss of out-of-state bank credit. Theory implies that the tax could reduce financial market competition, raise borrowing costs, hinder state economic development and make state economies more susceptible to regional business cycles. All this suggests that states should act prudently by putting off the implementation of this tax until such time its full effects on markets are known.

IMPORTANCE OF INTERSTATE BRANCHING AND BANKING

State Taxation and Interstate Banking Legislation

by

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The enactment of Federal legislation on interstate banking and branching, if and when it does occur, will raise a host of new state tax questions for banks, bank holding companies ("BHC"), and state tax authorities. Up to the present time, Federal laws have effectively prevented nationwide banking and, until a few years ago, prevented state taxation of banking across state lines. The McFadden Act¹ and the Douglas Amendment² restrict where banks can open offices outside their home state. Prior to September 1976, Federal law prevented non-domiciliary states from taxing bank income.³ In spite of these restrictions, however, banks and bank holding companies have paid substantial income taxes outside their home state. In order to indicate the significance of interstate banking and branching on state taxation of banks, it is useful to review of the incidence of state taxation of non-domiciliary banks before nationwide banking.

¹ 12 U.S.C. 36 restricts interstate branching by national banks to those states which authorize branching by state banks.

² 12 U.S.C. 1843(d) prohibits multistate bank holding companies from acquiring a bank in another state unless expressly authorized by state law.

³ P.L. 93-100 limited any income tax or "doing business" taxes on banks to domiciliary states.

I. Before Nationwide Banking

Banks and holding companies provide banking services across state lines in many ways. First, the legal restrictions on bank branches or bank holding company acquisitions of banks across state lines do not inhibit banks from having customers across state lines. Both depositors and borrowers have always been free to patronize banks in other states, conducting business by mail or traveling to the bank. It is very common for persons who live in one state but work in another to have a banking relationship outside their home state. Large businesses routinely have banking relationships outside their home state,⁴ especially to seek large loans that may exceed the lending limits of local banks, or sometimes to seek a more competitive loan or deposit rate or special banking service. Usually these activities do not involve the customer's state obtaining jurisdiction to tax the bank, since the bank never sought to engage in business in the customer's state. The possibility that the loan might be secured by property in the customer's state (and that the bank might foreclose on the property in the case of a loan default) is not usually regarded as sufficient nexus to justify taxation by the customer's home state.⁵ While credit card operations were

⁴ See Thomas Neubig, "The Economic Effects of Destination-Source Taxation of Financial Institutions," The Journal of Bank Taxation, Summer 1991, p. 16.

⁵ Prof. Hellerstein's chapter discusses constitutional limitations on state taxation as applied to interstate banking. The New Jersey cases cited therein and the MTC's proposed regulations represent new developments in this area.

initially franchised to serve market areas, the growth of nationwide credit card operations by several large banks is now the most common form of bank lending across state lines. In some cases, the credit card issuers actively solicit customers in all 50 states.

Second, the restrictions on out-of-state commercial bank branches, etc., do not apply to non-bank affiliate corporations operating as subsidiaries of the bank or the bank holding company. The most common examples are consumer finance companies, mortgage finance companies, auto leasing and equipment leasing companies, loan production offices, and Edge Act⁶ corporations and branches. In these cases, the non-bank affiliate is taxable in the states where it is located and the parent company (bank or BHC) will usually file a state tax return for the affected company.

Third, exceptions to the Federal rule against bank holding companies acquiring banks and thrifts across state lines were enacted in 1982 to permit acquisitions of failing institutions.⁷ The principal rationale for these exceptions was to expand the number of possible acquirers for FDIC or (then) FSLIC-assisted transactions. Another crucial development which led to interstate acquisitions was the initiative in several states to authorize regional reciprocal bank acquisitions--which was upheld

⁶ Banks authorized under Section 25(a) of the Federal Reserve Act for international banking only.

⁷ See Garn-St. Germain Act of 1982, 12 U.S.C. 1823(f).

by the Supreme Court.⁸ Now, virtually all states permit some form of interstate acquisitions.

Given these many devices and circumstances in which banks and bank holding companies could "do business" across state boundaries, it should be easy to recognize that states have taxed affiliates of banks domiciled in other states. The basic principles of those taxes will be described next.

II. Tax Concepts Affecting Banking Across State Lines

A. Nexus/Status of Taxpayer/Reporting Requirements

The basic authority of a state to apply an income tax has traditionally turned on physical presence in the state. When a bank or bank holding company had a subsidiary located in another state, that state could tax the subsidiary--whether it be a bank, mortgage company, leasing company, etc. Jurisdiction to tax is now being expanded in a few states beyond physical presence to include "regular solicitation" which is presumed to exist if the bank has customers in the state.⁹ (See market state taxation discussed in Section IID.) Some of these bank subsidiaries will be taxed as general business corporations, and some will be subject to special rules for financial institutions. The definition of "financial institutions" varies depending on state law. In New York, a financial institution is any bank or any

⁸ See Northeast Bancorp v. Board of Gov., 472 U.S. 159 (1985).

⁹ For example, a Minnesota statute creates a rebuttable presumption of regular solicitation if the bank has 20 customers or \$5 million in assets and loans.

corporation which is 65% or more owned by a bank or bank holding company. In other states, a leasing company might always be taxed as non-financial corporations, regardless of ownership.

Several states have sought to put some teeth into their efforts to identify and tax out-of-state corporations that are doing business in the state by requiring businesses to file a business activities report. These reports must be filed as a condition for using the state courts to enforce contracts. Thus, an out-of-state lender might find it necessary to file a business activities report in order to have access to the courts if it has to foreclose on the security when the borrower defaults. Indeed, lenders often found it necessary to assert, in its loan documents, that it had complied with local law requirements, including filing the business activities report, at the time the loan was made. Typically, failure to file this report could be cured later by filing and paying back taxes.¹⁰ In one extreme example, however, a court ruled that a non-California corporation which failed to register to do business in the state and did not pay California franchise tax, could not cure the failure and that the contract was voidable at the option of either party.¹¹

B. Apportionment/Sourcing

Once a state has jurisdiction to tax a business, it must determine the amount of income attributable to that state. It is

¹⁰ See First Family Mortgage v. Durham, 528 A.2d. 1288 (N.J. 1987).

¹¹ See White Dragon Productions v. Performance Guarantees, 196 Cal. App. 3d 163 (1987).

not realistic to require taxpayers to maintain separate accounting to determine their income from the state, especially if they have complex operations in different states. Therefore, virtually all of the states use apportionment formulas to measure the amount of income-producing activity of a taxpayer that does business in more than one state. The traditional three factor formula for state taxes employs fractions based on property, sales (receipts) and payroll in the state. (States can alter the weighting of these factors or use other factors for special types of taxpayers.) In determining the receipts factor, the law has to provide a source rule for the state location of each receipt.

Some states have adopted special formulas for banks such as those in New York and Minnesota.¹² New York uses three factors to apportion bank income: receipts, deposits and payroll. The payroll factor is 80% of in-state wages, salaries and other compensation. The receipts and deposit factors are double weighted. In New York, the source rules for the receipts factor have a strong domiciliary state bias. For example, income from loans is sourced where the lender is located; income from credit card operations is sourced based on the residence of the credit card holder; and income from services performed by bank officers is sourced to states where their services are regularly performed.

¹² This discussion of the New York and Minnesota law has been extracted from an ACIR publication, State Taxation of Bank: Issues and Options December 1989 M-168. The principal author of this report is Sandra McCray.

In contrast, Minnesota uses the traditional factors of payroll, property and receipts, but with two major differences. First, the property factor includes not only tangible and real property, but also intangible property such as loans, securities and money market instruments. Second, Minnesota weights the factors differently, 70% of the receipts in the state, 15% for property and 15% for payroll. Moreover, the source rules for the receipts factor have a market state bias. Receipts from loans are sourced according to the location of the security of the loans or in the case of unsecured loans where the proceeds are used or where the borrower resides. Income from credit card operations are sourced to Minnesota if the fees and charges are regularly billed there. Receipts from performance of services by bank officers is sourced to Minnesota if the services are consumed in the state, regardless of where the employee performs the services.

The New York law (adopted in 1985) and the Minnesota law (adopted in 1987 and revised in 1988) reflect very different views on apportionment of income for bank taxes. New York, which is primarily a money center state, will get the bulk of its taxes on bank income from taxing banks located in the state. Minnesota, which is primarily a market state, will get a larger share of its tax base from out-of-state banks which have customers in Minnesota. Most importantly, it should be clear that a bank domiciled in New York, which has customers in

Minnesota may end up having double taxation on its income from those transactions, paying tax to Minnesota and New York on apportioned income which add up to more than 100% of their actual income.

C. Unitary Taxation

As noted earlier, banks often have affiliated non-bank corporations in other states which engage in related businesses such as mortgage banking, leasing financing, etc. The state revenue authority might argue that the leasing subsidiary is really just a division within the banking enterprise, and should not be treated as a separate legal entity for tax purposes. The state's position would be that the leasing company and the bank together are a unitary enterprise, regardless of their corporate form. In order to sustain that position, the state government must show unity of ownership, unity of operation and unity of use of the companies or that the operation of the business within the state contributes to or is dependent on the operation of the business outside the state. The U.S. Supreme Court upheld the unitary taxation approach, allowing the state to calculate the tax by applying its apportionment formula on the basis of the factors of the entire enterprise, e.g. the leasing company and the bank together.¹³

A recent court case in Oregon demonstrates the impact of

¹³ See Container Corporation of America v. Franchise Tax Board, 463 U.S. 159 (1983).

unitary tax on a bank and its subsidiary.¹⁴ Crocker National Bank headquartered in California owned a leasing subsidiary engaged in business in Oregon. The leasing business was the only Crocker corporation engaged in business in Oregon. The leasing company filed a separate tax return in Oregon, but the state determined that the leasing company was a unitary business with the California bank. The bank and leasing company then filed a state tax return in Oregon on a unitary basis, apportioning part of Crocker's unitary income to Oregon. In determining the Oregon property factor, Crocker included intangible property which makes up 98% of the earning assets of Crocker National Bank. This dramatically reduced the amount of property factor attributable to Oregon. The Oregon's tax authority argued that the property of the leasing company involved only tangible property, so the property factor should include only Oregon tangible property in the numerator and total tangible property in the denominator. The Court held that Crocker Bank could include intangible property because to exclude it would distort the amount of bank income apportioned to Oregon.

The application of unitary tax can increase or decrease the amount of tax paid in a state depending on the relative impact of changes affect the apportionment factors and the total amount of business of the combined enterprise. If commercial banks are able to change their out-of-state subsidiaries into branches, it

¹⁴ Crocker Equipment Leasing v. Oregon Department of Revenue, Oregon Tax Court, No. 2973, decided March 12, 1991. There is an appeal pending in this case.

would eliminate disputes over unitary since taxing the branch income would involve an apportioned tax on the entire enterprise. As long as banks continue to operate through multiple corporations, however, there will be concern over the scope of application over unitary tax.¹⁵

D. Market State Taxation

Banks have always had some customers who resided in other states, but advances in technology and acceptance of using bank products by mail have greatly increased the number of interstate bank customers. One commentator has characterized this development as "branchless banking"¹⁶ implying a form of market exploitation. State tax officials have viewed this development as an opportunity to tax these out-of-state banks, especially in light of the expiration of the Federal law preventing such taxation of banks. Indeed, the state of Alabama tried unsuccessfully to apply its Financial Institutions Excise Tax on Chase Manhattan Bank (and other out-of-state credit card issuers) on the basis of its 50,000 Visa and Mastercard accounts in Alabama.¹⁷ The Court ruled that the state law was drafted prior to 1976 and could not have been intended to violate the Federal law in effect at that time.

¹⁵ See Discussion of the Delaware Amendment in Section III B.

¹⁶ See Sandra McCray, "State Taxation of New Banking Procedures", Tax Notes, June 4, 1990, p. 1229-1235.

¹⁷ See Siegelman v. Chase Manhattan Bank, 575 So.2d 1041 (Ala. 1991).

The Multistate Tax Commission (MTC) has drafted model regulations for state taxation of banks based solely on the location of the customer. Four states, Minnesota (1987), Indiana (1989), Tennessee (1990), and West Virginia (1991), have leapfrogged final action on the MTC regulations by enacting legislation providing for market state taxation. Iowa adopted regulations defining "doing business" which appear to have the same effect.

The impact of market state taxation is only beginning to be felt. In general, this scheme creates the prospect of double taxation where the bank's home state taxes 100% of the bank's income. There is no credit for the tax paid in the market state. There is also a major compliance burden on banks based on the cost to calculate the market state tax.¹⁸

III. Tax Aspects of Nationwide Banking

The 1991 banking reform debate focussed extensive consideration on interstate banking and branching. In Congress, several tax aspects of interstate branching were raised, though no real change was made in the ability of states to tax banks or the tax burden that banks will bear.

A. Taxation of Federal Obligations

The Conference of State Bank Supervisors (CSBS) raised a tax issue very early in the interstate debate. CSBS commissioned a paper which suggested that if a bank holding company could

¹⁸ See ABA testimony by Paul Claytor before MTC hearing officer on August 21, 1990 which covered both of these banking industry concerns.

convert an out-of-state bank to a branch, the host state would lose the right to tax the branch's income from federal obligations.¹⁹ In effect, the paper argued that a state could not apply an otherwise permissible franchise tax²⁰ because it would not be granting a "franchise" to a branch of the bank chartered elsewhere. The Treasury Department disagreed with this provision and concluded that it was "not aware of any authority that would accord states a lesser right to tax in-state activities of a national or state bank that has its home office in another state".²¹ The Treasury Department concluded that the CSBS position was incorrect. This issue was also considered judicially. The Oregon Supreme Court had ruled that a state franchise tax may apply to interest on federal obligations held by an out-of-state federally chartered savings banks.²² Prof. Walter Hellerstein came to a similar conclusion in his testimony before the House Banking Committee.²³ This clear position on the merits of the CSBS paper took a back seat to a decision by the Congress to adopt clarifying language that existing Federal

¹⁹ See Sandra McCray, "The Effect of the Repeal of the McFadden Act on State Tax Revenue" (CSBS, March 1991).

²⁰ See 31 U.S.C. 3124 on permissible state taxes on federal obligations.

²¹ See Memo dated May 3, 1991 to Treasury Department Under Secretary Robert Glauder from John Bowman and Robert Wooten.

²² See Pacific First Federal Savings Bank v. Department of Revenue, 779 P.2d 1033 (Ore. 1989).

²³ May 15, 1991.

law permits a franchise tax on branches of out-of-state banks.²⁴ Banks regarded this position as merely a restatement of current law and did not oppose it.

B. Delaware Amendment

The state of Delaware has adopted a policy of encouraging the establishment of bank affiliates that could be chartered under favorable state law and provide services nationwide. One very important example of this is in the area of bank credit card operations. As a result, a number of commercial banks have established credit card affiliates in the state of Delaware.

The possible enactment of interstate banking and branching raised a question as to whether a host state could use the presence of this new branch as a basis for taxing not only the bank, but also the income from its credit card affiliate in Delaware. This created the possibility that Delaware might not continue to be an attractive location for credit card affiliates and possibly result in an erosion of Delaware's tax base. As a result, the State Bank Commissioner from Delaware actively sought an amendment during the Senate Banking Committee mark up of S. 543 which would prescribe the manner in which a branch would be taxed (as a "national bank located in that state") and then exclude the branch as a basis for other taxation. It appears that this amendment was intended to prevent the host state of a bank branch from applying unitary taxation to reach the Delaware

²⁴ See Section 309 of H.R. 6 as reported by House Banking Committee; Section 302 of S. 543 as reported by Senate Banking Committee.

affiliate, but it was not intended to prevent market-based taxation which is based on the residence of the credit card customer.

The Senate Banking Committee adopted language offered by Senator Roth on this issue, though the wording of the language proved problematic for all parties involved. During consideration on the Senate floor, the Ford amendment on interstate banking replaced the Roth language with a simple restatement of current law that state taxes cannot be discriminatory. Observers suggested that the amendment would not be significant, since the amendment had no practical effect whatsoever.

C. State Visitation Authority

A long standing provision of the Federal banking law restricts "visitation rights" for officials seeking access to national banks. Generally speaking, only the Comptroller of the Currency has regular access to the books and records of a national bank.²⁵ OCC interpretation of this authority clarifies routine access by certain Government officials in the normal course of their work.²⁶

The Treasury Department proposal on interstate branching contained language which was intended to clarify that state tax officials could audit national banks which branched into their states. The language was drafted, however, in such a broad

²⁵ See 12 U.S.C. 484.

²⁶ See OCC Banking Circular #174, November 16, 1982.

fashion that it appeared to authorize any state tax authority to visit any national bank for the purpose of inquiring into the tax compliance of the bank or any of its customers.²⁷ It was clear that this language was designed to revise the statute to cover more than just tax issues raised by interstate banking. There was a concern by many in the banking industry that this broad language could be construed as implying a Congressional endorsement of the market state nexus rule²⁸, in that it appeared to authorize a state to audit a national bank even though the bank was not located in that state. State tax officials have indicated that the visitation language was not intended to affect the nexus standard. The Ford Amendment language reverted to a physical presence standard instead of the doing business test in the original bill.

D. Senator Ford's Amendment on Interstate Banking

Senator Wendell Ford (D-KY) prepared an alternative approach to interstate banking and branching, to be offered as an amendment during the Senate Floor debate on S. 543. Senator Ford's amendment contained language covering each of the three tax issues raised earlier: (1) state taxation of Federal obligations held by banks; (2) the Delaware amendment; and (3) the state tax visitorial powers.

²⁷ See Section 310 of H.R. 6 as reported by House Banking Committee; Section 306 of S. 543 as reported by Senate Banking Committee.

²⁸ The market state statutes adopted in Minnesota, Indiana, Tennessee, and West Virginia and the regulations adopted in Iowa have not yet been tested or validated judicially.

Senator Ford's amendment on interstate banking also added a new section on taxation, intended to permit Kentucky to apply its capital shares tax to branches of out-of-state banks. The language of the provision was largely a permissive, authorizing a state to apply a shares tax on a branch on an out-of-state based on an allocation of net income, capital or net worth, and other factors employed by the state. The only restriction was that the allocation method should not unconstitutionally discriminate against out-of-state banks.

The interstate banking title was dropped from S.543 during the House-Senate conference. Thus, the related tax provisions were also dropped from the bill. It is likely that the final language in the Ford Amendment passed by the Senate will be the starting point for any future discussions of both the banking law and tax aspects of nationwide banking and branching.

E. Future Problems

Other tax aspects of interstate banking lurked in the shadows during the Congressional consideration of banking reform, but never resulted in legislative action.

First, Secretary Brady wanted to assure the states that the Treasury Department proposal for nationwide banking was not intended to undermine the states ability to tax financial institutions doing business in their state. The testimony, however, failed to distinguish between preserving the ability of the state to tax financial institutions and preserving the current level of tax revenues earned by the states. Indeed, the

Treasury Department rationale for nationwide banking included a strong endorsement of the efficiency that could result from streamlining operations which now have to be duplicated in separate banking entities. Almost by definition, the operational streamlining will alter the tax base for states. Moreover, it would be contrary to sound banking practice to have a Federal rule which prohibited banks from transferring assets across state lines or otherwise mandating that a bank maintain a certain tax base in the state. Fortunately, neither version of the banking bills reported by the House and Senate Committees attempt to guarantee the states that the states will lose no revenues, though the legislative history does contain some loose language in this regard.²⁹

Second, the Congressional debate on nationwide banking did not include consideration of a uniform Federal nexus rule for the state taxation of out-of-state banks comparable to the Federal restriction which applies to out-of-state manufacturers and retailers.³⁰ The new tax regimes established in Minnesota, Indiana, Tennessee, West Virginia and Iowa will not be restricted by this Federal legislation.

²⁹ See, e.g., Senate Banking Committee Report to accompany S. 543 says, "Concerns were raised that authorizing interstate branching could . . . cause states to lose tax revenues The Committee adopted a provision to preserve the status quo on such issues". page 74, Senate Report 102-167.

³⁰ See P.L. 86-272, found at 15 U.S.C. 381-384. The provision prevents market state taxation where the manufacturer or retailer does not have either a "bricks and mortar" presence or regular and continuous contact by salesmen.

There are several reasons why Congress did not act on the market state taxation issue. First, the fiscal situation of many states is very poor and thus, it was unlikely that the Congress would restrict the states ability to raise revenues in the absence of a clear demonstration of unfairness and a substantial outcry from the banking industry. One legacy of the Reagan era is a substantial reduction in the Federal program funds provided to the states, thus leaving the states with more responsibilities and less money with which to carry them out. Second, the actual impact of the market state taxation has been quite minimal so far because most financial institutions are still disputing the ability of the states to apply a market state tax approach. Thus, very little revenue has been collected and there has been no litigation over the question of the constitutionality of the market state schemes. Third, the banking reform measure raises the issue of state taxation only in the context of authorizing interstate branching and banking. Legislators and their staffs take the position that any state tax provisions of the bill would have to be limited to issues which arise because of interstate branching. Since branching into a state creates clear nexus for state taxation, there would be no need to consider market state taxation which is based solely on the residence of a customer.

The effect of these circumstances is that it is highly unlikely there will be Federal legislation to restrict the states ability to apply a market state tax. The banking industry was protected from market state taxation prior to 1976 and did not

need the benefit of P.L. 86-272 which applies to other businesses. Once the provision on nondomiciliary tax expired in 1976, it has proven politically impossible to extend the provisions of P.L. 86-272 to the banking industry. Perhaps in future years as the complexity of conflicting state taxes on banks multiply, there will be an effort in harmonizing tax efforts through uniform state laws or possibly, a Federal statute.

**CONSTITUTIONAL LIMITATIONS OF STATE TAXATION OF INTERSTATE
BRANCHING**

Constitutional Limitations on State Taxation of Interstate Banking

by

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The growth of interstate banking activity---coupled with the states' efforts to tax it--has spawned an acute interest in the federal constitutional limitations on state taxation of banks. Two developments in particular have been the focus of this interest. First, banking institutions are increasingly making loans and providing other financial services to customers in states in which the banks have no substantial physical presence. Second, the states have systematically been attacking the traditional rule that an out-of-state enterprise's physical presence in the state is a prerequisite to the state's power to tax it. This chapter considers the constitutional limitations on states' power to tax interstate banking activity in light of these two developments and State v. Quill Corp.,¹ which has squarely challenged the rule that physical presence is the sine qua non of state tax jurisdiction.

I. Overview of Federal Constitutional Limitations on State Taxation of Interstate Business

¹ 470 N.W.2d 203 (N.D. 1991), petition for certiorari granted, 60 U.S.L.W. 3221 (U.S. Oct. 8, 1991).

The federal constitutional restraints that generally limit the states' power to tax interstate business are equally applicable to financial institutions, and it will be useful to begin with an overview of those restraints. The Commerce and Due Process Clauses are the two principal constitutional restraints on the states' power to tax interstate business. Under the Commerce Clause, a tax will pass muster if (1) there is a substantial nexus between the taxpayer and the taxing state; (2) the tax is fairly apportioned to the taxpayer's activities in the taxing state; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to the services provided by the state.² Under the Due Process Clause, the Court has likewise insisted that there be (1) a minimum connection or nexus between the taxpayer of its activities and the taxing state and (2) a fair relationship between the tax and the taxpayer's activities in the taxing state.³ As a matter of substance, the nexus and apportionment requirements embodied in the Commerce and Due Process Clauses are indistinguishable, and the Court has so declared.⁴

A. Nexus

The nexus requirement reflects the fundamental notion that there must be "some definite link, some minimum connection between a state and the person, property, or

² Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

³ Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978).

⁴ National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753, 756 (1967) (nexus); Ott v. Mississippi Barge Line Co., 336 U.S. 169, 174 (1949) (apportionment).

transaction it seeks to tax.⁵ In recent years, the Court has been quite indulgent to the states in finding the requisite nexus sufficient to justify the exercise of state tax power. The Court has sustained a state's power to impose a use tax on catalogs shipped from outside the state directly to the taxpayer's in-state customers.⁶ It has sustained a state's power to tax all the receipts derived by an out-of-state supplier from sales to an in-state purchaser on the basis of the supplier's single resident employee.⁷ It has sustained a state's power to apply its fuel use tax to aviation fuel stored temporarily in the state prior to loading aboard aircraft for consumption in interstate flights.⁸ And, while rejecting the notion that the "slightest presence" of an out-of-state vendor constitutes a sufficient nexus to require the vendor to collect use taxes,⁹ the Court has nevertheless sustained use tax collection liability on the basis of in-state activities that many would regard as insubstantial.¹⁰

B. Apportionment

⁵ Miller Bros. v. Maryland, 347 U.S. 340, 344-45 (1954).

⁶ D.H. Holmes Co. v. McNamara, 486 U.S. 24 (1988).

⁷ Standard Pressed Steel Co. v. Department of Revenue, 419 U.S. 560, 562 (1975).

⁸ United Air Lines v. Mahin, 410 U.S. 623 (1973).

⁹ National Geographic Soc'y v. State Bd. of Equalization, 430 U.S. 551, 556 (1977).

¹⁰ See id. (magazine employed four in-state employees at two offices to solicit advertising unrelated to mail-order sales on which tax was imposed); Scripto, Inc. v. Carson, 362 U.S. 207 (1960) (company used ten independent contractors to make sales).

The requirement that a state tax affecting interstate commerce be fairly apportioned to the taxpayer's activities in the taxing state is a venerable one.¹¹ It has acquired greater significance, however, as the Court's decisions have broadened the states' taxing powers. With the abandonment of the formal criteria that once created an irreducible zone of tax immunity for interstate commerce, the Court's emphasis has shifted from the question whether interstate commerce may be taxed at all to the question whether interstate commerce is being made to bear its fair share---or more than its fair share---of the state tax burden. If a tax is fairly apportioned to the taxpayer's activities in the taxing state, there is no risk, at least in principle, that a tax will subject a taxpayer engaged in interstate commerce to more than its fair share of the tax burden and expose it to a risk of multiple taxation not borne by local commerce.

Most of the controversies involving the fair apportionment criterion have focused on the formulas that states employ to divide a multistate enterprise's tax base among the states. Over the years, the Court has sustained a wide variety of methods of apportioning an equally wide variety of tax bases among the states. The Court has approved formulas employing such factors as track mileage, barge line mileage, designated assets, gross receipts, property, and payroll for apportioning such tax bases as tangible personal property, capital stock, gross receipts, and net income.¹² The Court

¹¹ See, e.g., Pullman's Palace Car Co. v. Pennsylvania, 141 U.S. 18, 26 (1891); Maine v. Grand Trunk Ry., 142 U.S. 217, 278 (1891).

¹² See generally W. Hellerstein, State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication, 41 Tax Law. 37, 57-58 (1987).

has suggested that a formula may be inherently arbitrary,¹³ but the Court has never held an apportionment formula unconstitutional on its face. Moreover, the Court has rarely invalidated the application of a state apportionment formula to a multistate business. Indeed, only once in the past 50 years has the Court struck down on constitutional grounds the application of a state apportionment formula to a tax base that was, in principle, apportionable.¹⁴

C. Discrimination

The rule forbidding state taxes that discriminate against interstate commerce has been a central tenet of the Court's Commerce Clause doctrine ever since the Court invoked the Commerce Clause more than a century ago as the basis for invalidating a state tax. Although the concept of discrimination is not self-defining and the Court has never precisely delineated the scope of the prohibition against discriminatory taxes, the essential meaning of discrimination as a criterion for adjudicating the constitutionality of state taxes affecting interstate commerce emerges unmistakably from the Court's numerous decisions addressing the issue: a tax that by its terms or operation imposes greater burdens on out-of-state goods,¹⁵ activities,¹⁶ or enterprises,¹⁷ than on competing

¹³ Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 121 (1920); Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123, 133 (1931).

¹⁴ Norfolk & W. Ry. v. State Tax Comm'n, 390 U.S. 317 (1968).

¹⁵ Bacchus Imports, Ltd. v. Dias, 468 U.S. 263 (1984).

¹⁶ Westinghouse Elec. Corp. v. Tully, 466 U.S. 388 (1984).

in-state goods, activities, or enterprises will be struck down as discriminatory under the Commerce Clause.

In contrast to the deference that the Court has accorded the states when confronted with allegations that a tax lacks sufficient nexus with or is unfairly apportioned to the taxing state, the Court has scrutinized claims that a tax discriminates against interstate commerce with considerable vigilance. In recent years, the Court has been quick to strike down state taxes that in its view favor local over out-of-state products, activities, or enterprises. Although the Court has occasionally sanctioned different treatment of interstate and local businesses, its decisions strongly adhere to the principle that "[n]o State, consistent with the Commerce Clause, may 'impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.'"¹⁸

D. Fair Relation Between the Is and the Services

Provided by the State

In Commonwealth Edison Co. v. Montana,¹⁹ which considered a challenge to Montana's 30 percent coal severance tax, the Court lifted the shroud of uncertainty that

¹⁷ American Trucking Ass'ns v. Scheiner, 483 U.S. 266 (1987).

¹⁸ Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 329 (1977) (quoting Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457 (1958)).

¹⁹ 453 U.S. 609 (1981).

had obscured the meaning of the "fairly related" test and made it clear that the test was not an invitation to judicial review of taxes for excessiveness. The Court held that the relevant inquiry under the "fairly related" test is whether the tax is reasonably related to the extent of the taxpayer's contact with the state, "since it is the activities or presence of the taxpayer in the State that may properly be made to bear a 'just share of state tax burden.'"²⁰ Justice Blackmun, the author of Complete Auto Transit, vigorously dissented from the Court's view of the meaning of the "fairly related" test, asserting that the Court had "emasculated" the fourth prong and left it utterly without meaning.²¹

Cases following Commonwealth Edison vindicate Justice Blackmun's complaint. The "fairly related" test appears to have little independent significance as a limitation on state tax power. Any tax held to violate the "fairly related" test is likely to flunk some other portion of the Court's Commerce Clause standard as well. And it is hard to conceive of any tax that would satisfy the substantial nexus, fair apportionment, and nondiscrimination criteria that would not also satisfy the "fairly related" test.

II. Constitutional Limitations on State Taxation as Applied to Interstate Banking Activity

²⁰ Id. at 626 (quoting Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 254 (1938)).

²¹ Id. at 626 (quoting Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 254 (1938)).

The two most significant federal constitutional issues raised by state taxation of interstate banking concern nexus and apportionment. The key nexus question is whether the states have the power to tax out-of-state financial institutions with little or no physical presence in the taxing state. The key apportionment issues are whether the states may apportion the income of out-of-state banks based on their exploitation of the state's market and, if so, what implications that has for the power of the state in which the bank is domiciled to tax all of the bank's income. We address each of these issues in turn.

A. Nexus

Because banks have historically been limited in their ability to engage in operations outside the state in which they have their principal offices and because the states, in turn, have typically sought to tax only those banks which have their principal offices within the state's borders, there has been relatively little litigation over the power of states to tax out-of-state financial institutions. No doubt this will soon change as banks begin to test the expansive statutes enacted by states such as Indiana, Minnesota, and Tennessee. For the moment, however, the most relevant case law dealing with state taxation of out-of-state banks is found in series of New Jersey cases dealing with the taxation of out-of-state bank affiliates and loan companies.

In Tuition Plan of New Hampshire v. Director, Division of Taxation,²² a New

²² 4 N.J. Tax 470 (1982).

Hampshire-based bank made loans to parents of students of private secondary schools and colleges, including students in New Jersey. Tuition Plan mailed its brochures from New Hampshire directly to students as well as to the schools and colleges with which it dealt, which passed the brochures on to the students. When Tuition Plan received a loan application in New Hampshire, it mailed a loan agreement to the borrower and conducted a credit check by telephone or mail from New Hampshire. The loan funds were disbursed from New Hampshire, and payments of principal and interest were made to Tuition Plan in New Hampshire. During the years at issue, the principal amount of outstanding loans to New Jersey borrowers ranged from \$1,700,000 to \$2,150,000. If a payment was not made within ten days of the due date, the New Hampshire office followed up with telephone calls and correspondence. Delinquent accounts were referred to a New Jersey law firm to institute action. During the three years at issue, suits to recover delinquencies of approximately \$13,000 were commenced.

Tuition plan had no physical property in New Jersey, except for automobiles that it owned or leased and provided to its employees who operated in the state. Tuition Plan had no permanent employees within the state, although it had two district managers, residing respectively in New York and Maryland, who were responsible for its New Jersey operations. These district managers called on school officials and their financial officers and, through these contacts, obtained the names and addresses of prospective borrowers. One of the district managers estimated that he spent three percent of his time in New Jersey; the other estimated that he spent fifteen to twenty percent of his time there.

Over the taxpayer's objection that New Jersey lacked sufficient nexus with Tuition Plan to subject it to New Jersey's Corporation Business Tax, the court declared:

Plaintiff's district managers were physically present in this State more than one day per week, on average, throughout all the years in issue. . . .

. . . [P]laintiff's contacts with New Jersey Went beyond mere solicitation.

They indicate a vigorous, systematic and persistent effort, aided by substantial physical presence, to exploit the New Jersey tuition loan market.

Under these circumstances, the fact that plaintiff's New Jersey district managers did not reside in this State is of no significance.²³

The court concluded that "in the present case it can fairly be said that plaintiff's extensive activities within New Jersey enjoyed the protection and services provided by state and local government for which the State is entitled to something in return."²⁴

In contrast to the Tuition Plan decision, the New Jersey Tax Court reached a different conclusion in a case involving an affiliate of Chemical Bank of New York, which was engaged in real estate lending and financing. In Chemical Realty Core. v. Taxation

²³ 4 N.J. Tax at 480-81.

²⁴ Id. at 481.

Division Director,²⁵ the taxpayer had no office or employees in New Jersey, and it solicited no business there. It maintained no bank accounts and had no mailing address or telephone listing in the state. The principal function of the corporation was to participate in loans with other banks, including loans on New Jersey real estate, on the solicitation of the "lead" bank handling the large loan. Most of Chemical Realty's work in evaluating the New Jersey loans was done in New York although, in a few cases, the company's employees visited New Jersey to appraise the property. The loan and participation agreements were signed in New York. All the New Jersey loans in which the taxpayer participated were secured by New Jersey real estate. Payments of principal and interest were sent to the taxpayer's New York office. No occasion arose in which the taxpayer had found it necessary to resort to the New Jersey courts or otherwise to become involved in any efforts to collect delinquent loans to New Jersey borrowers.

In addressing Chemical's contention that the Due Process Clause precluded New Jersey from subjecting it to tax, the court observed that "due process does not require a local business office within the state" or "a local employee to solicit business" in order to subject an out-of-state enterprise to tax in the state.²⁶ Nevertheless, the court concluded that "[i]n sum, plaintiff's activities in New Jersey do not reach the level of the minimal connection with this State that will satisfy due process."²⁷

²⁵ 5 N.J. Tax 581 (1983).

²⁶ 5 N.J. Tax at 613.

²⁷ Id. at 616.

Two other New Jersey loan company cases provide further illumination as to the nature of the local activities of an out-of-state loan company that determine taxability. In AVCO Financial Services Consumer Discount Co. One, Inc. v. Director, Division of Taxation,²⁸ AVCO, a Pennsylvania corporation, conducted an extensive consumer finance business through sixty consumer loan offices in Pennsylvania. The company maintained no offices and had no employees in New Jersey, and it had no real or tangible property there. Virtually all of AVCO's business was handled in Pennsylvania. The New Jersey business usually came as a result of recommendations by other borrowers and, in some cases, through general radio advertising broadcast by AVCO's parent corporation.

Six of AVCO's loan offices were in areas bordering New Jersey. New Jersey customer desiring a loan normally communicated with or visited one of these offices. The credit of such customers was checked through a New Jersey credit service. The loan papers were signed at and checks delivered from the Pennsylvania offices. Loan and interest payments were made to the Pennsylvania offices, except at times they were made to one of several affiliates of AVCO, which maintained offices in New Jersey.

Most of the loans were unsecured, although AVCO sometimes took a security interest in its borrowers' real or personal property. CollectiOn of delinquent loans was

²⁸ 100 N.J. 27, 494 A.2d 788 (1985).

generally sought by mail or telephone from AVCO's Pennsylvania offices. In addition, once or twice a month personnel of AVCO's Pennsylvania offices would visit an average of three New Jersey customers in an effort to collect on loans. The managers of the taxpayer's Pennsylvania offices bordering on New Jersey spent approximately three to five percent of their working hours in New Jersey. In cases of default by New Jersey borrowers, AVCO retained New Jersey counsel to effect collection, which averaged about six cases a year with collections averaging about \$3,000 per year.

While the New Jersey Tax Court had found that AVCO's activities fall "far short of the systematic, continuous exploitation of local markets through on-site employees and independent contractors, which the United States Supreme Court has found to constitute substantial nexus for taxing purposes,"²⁹ the New Jersey Supreme Court held that AVCO was taxable. In finding the minimum contacts between the taxpayer and the State to justify imposition of the tax, the court observed that (1) the presence of AVCO's employees in the state to collect overdue loans evidenced a vigorous, systematic, and persistent effort, aided by substantial presence, to exploit the New Jersey market;³⁰ (2) the use by AVCO of its affiliate offices in New Jersey to receive payments "made possible the realization and continuance of valuable contractual relation" between AVCO and its New Jersey borrowers;³¹ and (3) the ongoing use of New Jersey's courts

²⁹ 4 N.J. Tax at 357.

³⁰ 494 A.2d at 794.

³¹ *Id.* (quoting Standard Pressed Steel Co. v. Department of Revenue, 419 U.S. 560 (1975)).

to enforce its obligations demonstrated that AVCO's activities enjoyed the state's protection for which it is entitled to something in return. ³²

Finally, in CIT Financial Services Consumer Discount Co. v. Director, Division of Taxation,³³ the court held that another Pennsylvania-based loan company was taxable in New Jersey because its operations had been merged with the lending activities of sister companies that conducted loan businesses in the state. The court declared:

Ordinarily, the separate entities of two or more related corporations is recognized for tax purposes. However, where the separate corporate entities of related corporations are not preserved in the conduct of there overall business, each corporation is regarded as the agent or alter ego of the other so that the presence of one corporation in a state is the presence of the Other. Such is the case here. plaintiff and its two sister corporations, all being under the common ownership of CIT Financial Corporation, were engaged in the consumer loan business. The corporate network was divided into areas and regions, irrespective of the separate corporate entities involved. The area supervisor employed by one of the three sister corporations exercised supervision over branch managers employee by plaintiff and the two sister corporations operated in New Jersey. The

³² Id.

³³ 4 N.J. Tax 568 (1982).

General Supervisor, located at the headquarters of the Philadelphia region in Marlton, New Jersey, although employed by CIT Financial Services Corp., exercised supervision over the area supervisors for the six areas within his region. It is reasonable to infer that at least some of those area supervisors were employed by other corporations in the CIT family.³⁴

While existing case law pays lip service to the notion that there must be a substantial local presence in the state to justify the assertion of jurisdiction over an out-of-state financial corporation, the holdings of these cases make it clear that out-of-state banks can be subjected to taxation with only the thinnest and most transient of physical contacts with the state. Thus the sporadic presence in the state of the bank's employees, the activities of related entities in the state on its behalf, and even its use of the state's legal system have been invoked as sufficient to sustain a state's tax jurisdiction over the out-of-state bank. While there are cases like Chemical Realty, which suggest that there are some limits to the states' power to tax an out-of-state financial institution, there are almost invariably some "local incidents" of a bank's out-of-state activity upon which courts can seize to find the requisite local presence to satisfy due process standards.³⁵

³⁴ Id. at 576 (citations omitted). See also Western Acceptance Corp. v. State Dep't of Revenue, 472 So. 2d 497 (Fla. Dist. Ct. App. 1985) (jurisdiction over out-of-state financial subsidiary with no physical presence in the state sustained because the parent corporation's in-state activities on behalf of its subsidiary).

³⁵ Cf. Siegelman v. Chase Manhattan Bank, 575 So. 2d 1041 (Ala. 1991), in which it was argued that the presence of the out-of-state bank's property in the state--in the form of its ownership of the credit cards used by its customers--created a constitutionally sufficient nexus to tax the bank.

Of potentially even greater significance, however, is the possibility that the U.S. Supreme Court will abandon the position that physical presence in the state is a prerequisite to the exercise of state tax jurisdiction under the Due Process Clause. The Court embraced this principle in National Bellas Hess, Inc. v. Department of Revenue,³⁶ which held that a state could not force an out-of-state mail order seller, with no physical presence in the state, to collect the state's use tax on goods sold to in-state customers. In so holding, the Court effectively rejected the argument advanced by the dissent that the out-of-state enterprise's systematic "exploitation of the local market" satisfied the nexus requirement of the Due Process Clause.

This holding has come under attack in recent years, particularly from states which feel that they are unjustifiably being deprived of large amounts of use taxes due on the increasing volume of sales made by the mail-order industry. Indeed, in State v. Quill Corporation,³⁷ the Supreme Court of North Dakota upheld the state's power to require an out-of-state mail order seller to collect the state's use tax on sales to local customers. It reasoned that "[t]he economic, social, and commercial landscape upon which Bellas Hess was premised no longer exists, save perhaps in the fertile imaginations of attorneys representing mail order interests."³⁸ It also observed that the Court itself had repudiated

³⁶ 386 U.S. 753 (1967).

³⁷ 470 N.W.2d 203 (N.D. 1991).

³⁸ Id. at 208.

the physical presence test in analogous contexts.³⁹ The Court's grant of Quill's petition for certiorari in the case,⁴⁰ virtually assures that the Court will provide additional guidance with respect to the constitutional nexus standards that limit a state's taxing jurisdiction. Should the Court agree with North Dakota and overrule Bellas Hess, it will clearly undermine the arguments that out-of-state financial institutions have traditionally advanced in resisting the efforts of "market" states to subject them to tax.

B. Apportionment

Assuming that "market" states will continue their efforts to assert jurisdiction over out-of-state banks to the outer limits of their constitutional power, the question arises as to the appropriate standards for apportioning the tax to which such banks may be increasingly subjected. As indicated above, the U.S. Supreme Court has never struck down a state tax apportionment formula as invalid on its face, and state taxpayers cannot expect to secure relief from the courts, unless they carry the heavy burden of demonstrating that the tax has attributed to the state value "out of all appropriate proportion to the business transacted . . . in the State," or has "led to a grossly distorted result."⁴¹

³⁹ See Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985).

⁴⁰ See 60 U.S.L.W. 3221 (U.S. Oct. 8, 1991).

⁴¹ Moorman Manufacturing Co. v. Bair, 437 U.S. 267, 274 (1978).

While this means that particular methods of apportionment of an out-of-state bank's income are unlikely to be subject to successful constitutional challenge, it raises the question whether the state of the bank's principal place of business or commercial domicile will be able to tax the bank's income on an unapportioned basis at the same time that "market" states are taxing such income on an apportioned basis. As the ensuing discussion suggests, the answer to this question should be "no" because the Commerce and Due Process Clauses, as construed by the U.S. Supreme Court, preclude one state from taxing the unapportioned value of property or income which is subject to taxation in other states on an apportioned basis.

Standard Oil Co. v. Peck,⁴² established the underlying rule. The taxpayer, an Ohio-based corporation, owned boats and barges that it employed for the transportation of oil along the Mississippi and Ohio Rivers. The vessels, though registered in Cincinnati, made only occasional stops in Ohio for repairs. Their main terminals were in other states. Ohio assessed an ad valorem personal property tax on the unapportioned value of the vessels. The taxpayer challenged the assessment on the ground that it violated the Due Process Clause.

The Supreme Court had recently sustained the power of a nondomiciliary state to tax an apportioned share of the value of vessels that operated within the state in Ott v.

⁴² 342 U.S. 382 (1952).

Mississippi Valley Barge Line Co.⁴³ Ohio contended that this decision did not deprive the domiciliary state from taxing the entire value of the vessels, which clearly would have been appropriate under the Court's earlier doctrine. The earlier doctrine held that vessels were taxable in full at their owner's domicile or where they had acquired a taxable situs based on their permanent location elsewhere. The Court flatly rejected Ohio's contention. Observing that earlier cases sustaining the power of the domiciliary state to tax the full value of personal property were predicated on the fact that the property had not acquired a taxable situs elsewhere, the Court declared that these cases

have no application here since most, if not all, of the barges and boats which Ohio has taxed were almost continuously outside Ohio during the taxable year. . . . [M]ost, if not all, of them were operating in other waters and therefore under Ott v. Mississippi Barge Line Co. . . . could be taxed by the several states on an apportionment basis. The rule which permits taxation by two or more states on an apportionment basis precludes taxation of all of the property by the state of the domicile. . Otherwise there would be multiple taxation of interstate operations and the tax would have no relation to the opportunities, benefits, or protection which the taxing state gives those operations.⁴⁴

⁴³ 336 U.S. 169 (1949).

⁴⁴ Standard Oil Co., 342 U.S. at 384-85 (emphasis supplied).

The Court has persisted in its view that the power of the domiciliary state to tax the unapportioned value of personal property cannot be sustained when other states have the power to tax such property on an apportioned basis. Thus, in Central Railroad Co. of Pennsylvania v. Pennsylvania,⁴⁵ the Court, while sustaining the power of the state to impose a tax on the unapportioned value of the taxpayer's rolling stock because it had failed to establish that it was subject to an apportioned tax elsewhere, nevertheless observed that "'multiple taxation' of interstate operations . . . offends the Commerce Clause,"⁴⁶ and "multiple taxation is possible . . . if there exists some jurisdiction, in addition to the domicile of the taxpayer, which may constitutionally impose an ad valorem tax."⁴⁷ And in Japan Lines, Ltd. v. County of Los Angeles,⁴⁸ the Court, in delineating the constitutional restraints on state taxation of the instrumentalities of interstate commerce under the Commerce Clause, unequivocally declared that "[t]he corollary of the apportionment principle, of course, is that no jurisdiction may tax the instrumentality in full."⁴⁹

Moreover, in Mobil Oil Core. v. Commissioner of Taxes of Vermont,⁵⁰ the Court

⁴⁵ 370 U.S. 607 (1962).

⁴⁶ Id. at 612.

⁴⁷ Id.

⁴⁸ 441 U.S. 434, 447 (1979).

⁴⁹ Id. at 447.

⁵⁰ 445 U.S. 425 (1980).

strongly suggested that the principle precluding the domiciliary state from taxing the unapportioned share of a tax base that is taxable by apportionment in other states---a principle the court first articulated in the personal property context---applied equally to the apportionment of income. In Mobil, the question was whether Vermont could tax an apportioned share of the dividends that Mobil Oil Corporation, a New York domiciliary, received from its foreign subsidiaries. One of the arguments advanced by Mobil was that Vermont could not tax an apportioned share of such income because it would expose Mobil to the risk of multiple taxation in light of New York's alleged power as Mobil's commercial domicile to the dividends on an unapportioned basis.

The Supreme Court made short shrift of the underlying premise of Mobil's argument. After reiterating the fundamental principle that "[t]axation by apportionment and taxation by allocation to a single situs are theoretically incommensurate,"⁵¹ the Court declared:

The reasons for allocation to a single situs that often apply in the case of property taxation carry little force in the present context. Mobil no doubt enjoys privileges and protections conferred by New York law with respect to ownership of stock holdings, and its activities in that State no doubt supply some nexus for jurisdiction to tax. . . . Although we do not presume to pass on the constitutionality of a hypothetical New York tax, we may

⁵¹ Id. at at 444.

assume, for the present purposes, that the State of commercial domicile has the power to lay some tax on the appellant's dividend income. 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 the circumstances in which apportionment is ordinarily the accepted method."⁵²

In short, because one state may not tax on an unapportioned basis property or income that other states may tax on an apportioned basis, it follows that a state of bank's commercial domicile may not tax its property or income on an unapportioned basis if "market" states have the power to tax such income or property on an apportioned basis.

⁵² Id. at 445-46 (emphasis supplied).