



Financial Institutions Apportionment
Property Factor Issues for Discussion Purposes Only

Showing Work Group Recommendations and Discussion Issues
DRAFT 11-22-2013

1. Overarching issue to be resolved: At its July 2013 meeting, the Subcommittee directed the workgroup to move forward with the approach of the property factor being real and tangible personal property and eliminating any aspect of SINAA from the property factor. Some subcommittee members understood the rationale for this decision to be that real and tangible personal property serve as a proxy for location of loans. The work group is now considering whether that rationale would still require loans to be sourced if some physical property has nothing to do with loans.

2. If loans (or a proxy for loans) are to be retained in the property factor, clarify “change of material fact”

- a. **Current Language:** §4(i) *Period for which properly assigned loan remains assigned.* A loan that has been properly assigned to a state shall, absent any change of material fact, remain assigned to said state for the length of the original term of the loan. Thereafter, said loan may be properly assigned to another state if said loan has a preponderance of substantive contact to a regular place of business there.
- b. **Problem to be Addressed:** The term “change of material fact” in the loan assignment rule is undefined. A question has arisen as to whether the sale of a loan or pool of loans to another entity within the same controlled group of corporations as the seller constitutes a material change of fact. Both taxpayers and tax administrators would benefit from objective criteria to determine when there has been a material change of fact.
- c. **Work Group Recommendation:**

The workgroup originally-proposed amendments to §4(i), as shown below. However, at its July 2013 meeting, the subcommittee directed the workgroup to redraft the financial institutions apportionment model in a way that does not include loans in the property factor, which obviates the need for re-sourcing loans under SINAA and makes §4(i) unnecessary.

ORIGINALLY PROPOSED AMENDMENTS (i) **Period for which properly assigned loan remains assigned.** A loan that has been properly assigned to a state shall, absent any

change of material fact, remain assigned to said state for the length of the original term of the loan. Thereafter, said loan may be properly assigned to another state if said loan has a preponderance of substantive contact to a regular place of business there. For purposes of this section, “change of material fact” is a facts and circumstances test.

(1) The direct or indirect acquisition or transfer of a loan or a pool of loans to or from an entity that is within the same controlled group of corporations at the time of the acquisition or transfer is not a change of material fact. But, this prohibition does not, by itself, preclude other possible changes of fact from being considered in determining where there has been a change of material fact.

(2) The direct or indirect acquisition or transfer of a loan or a pool of loans to or from an entity that is not within the same controlled group of corporations at the time of the acquisition or transfer is a change of material fact.

(3) For purposes of this subsection, “controlled group of corporations” means [Insert one of the following as appropriate:

Combined reporting states -

- “‘combined group’ as defined in the [citation to state combined reporting statute].”

Non-combined reporting states -

- If have an add-back statute
“‘related’ [or ‘affiliated’] entity as that term is defined for purposes of [citation to state’s add-back statute].”
- If no add-back statute
“‘controlled group of corporations’ as defined in 1563(a) of the Internal Revenue Code, except that “more than 50 percent” shall be substituted for “at least 80 percent” each place it appears in Section 1563(a)(1) of the Internal Revenue Code.”]

2. Determine Whether the SINAA loan assignment rule used in the property factor should be retained

Shortly after this project was initiated, in 2008, the work group determined that it wanted to make narrow, “surgical” changes to address specific problems while maintaining the balance between money-center and market states that was struck under the original proposal. In April of 2009, the work group communicated to the Subcommittee its recommended overarching goal to “retain the equal-weighted, three factor model, rather than move to single sales factor model.” Also In April of 2009, the work group communicated to the Subcommittee that its recommended overarching goal is not to recreate the 1994 apportionment outcome of sourcing property to particular states; rather, the goal is to attempt to maintain the 1994 policy of sourcing property to location of loan activity. In March of 2013, the Subcommittee asked the workgroup to include these three questions in its considerations: Does SINAA reflect the policies behind the property factor? If not,

should loans be retained in the property factor? If they should not be retained, should the property factor be included at all? If it is to be included, should there be alternative weighting for each of the factors?

a. Current MTC model rule:

A loan is in a state if it is properly assigned to a regular place of business of the taxpayer within this state. (4)(g)(1)(A). A “regular place of business” is defined as an office at which the taxpayer carries on its business in a regular and systematic manner and which is continuously maintained, occupied and used by employees of the taxpayer. (2)(q). A loan is properly assigned to the regular place of business with which it has a preponderance of substantive contacts. (4)(g)(1)(B). There are presumptions that come into play if the loan is assigned outside the state. To determine the state in which the preponderance of substantive contacts relating to a loan have occurred, the facts and circumstances are reviewed on a case-by-case basis and “consideration shall be given to such activities as the solicitation, investigation, negotiation, approval and administration of the loan. (4)(g)(3).”

b. Do we want to continue to use SINAA for sourcing loans in the property factor?

- i. Does SINAA reflect the policies behind the property factor? State members of the workgroup expressed concern that, in today’s electronic age, SINAA factors were less reflective of the policies behind the property factor and less helpful for geographically locating intangible property. Industry members expressed belief that at least the INAA factors continue to reflect the policies behind the property factor.

ii. Is SINAA practicable?

Industry believes it has suggested a SINAA approach to sourcing computerized loans that would satisfy the criteria of good tax policy and administrative efficiency and that the group should continue to explore other options for sourcing these and other loans in the property factor.

State members of the workgroup have commented that sourcing loans, as is true of any intangible, is notoriously difficult, and that SINAA does not seem to relieve this difficulty to the point that sourcing loans becomes a practicable part of the property factor.

- iii. If SINAA reflects property factor policy and/or is practicable, what should the SINAA loan assignment rule be?** State members of the workgroup raised concerns that SINAA does not adequately reflect the property factor policy and is not practicable.

A. Which activities? (add and/or subtract from “SINAA”)?

Industry has recommended “INAA” See industry documents dated Nov. 24, 2010, Jan. 2011, Mar. 15, 2011, Apr. 26, 2011 and Jul. 11, 2011

setting forth the reasons for this recommendation and draft amended property factor language.

B. How to measure the activities (e.g., employees, costs, etc.)?

Industry has recommended that the current measurement of activity be retained (attribute each activity to the state where the financial institution primarily performs that function) rather than creating a new costly system that will not change the result but will be difficult to implement and to audit. See industry documents dated Nov. 24, 2010, Jan. 2011, Mar. 15, 2011, Apr. 26, 2011 and Jul. 11, 2011 setting forth the reasons for this recommendation and draft amended property factor language.

C. How to weight each of the SINAA factors (equal weight individual factors, self-weight by lumping dollar costs of each activity all into one big factor, etc.)?

Industry has recommended sourcing to the location where the greatest number of the SINAA functions are performed, consistent with how they have interpreted the current provision since it was adopted in 1994 and have reiterated on numerous working group calls as well as in industry documents dated Mar. 15, 2011, Apr. 26, 2011, Jun. 23, 2011 and Jul. 11, 2011, without receiving interpretations to the contrary.

Industry also indicated that upon the filing of refund claims based on applying a cost of performance (COP) analysis in sourcing loans, the states that have adopted the MTC financial organization apportionment provisions have rejected applying COP in determining the preponderance of contacts based on SINAA.

D. What should the rule apply to? (e.g., a loan, a group of loans, how to determine the group?)

The work group recommended that, if SINAA is retained in some form, the rule should apply to groups of loans. Industry proposed language:

To determine the preponderance of substantive contacts relating to loans, loans may be grouped by classes of similar instruments, by customer base, and/or another method (including a method combining instruments and customer bases) that reflects the taxpayer's books and records. For example, loans could be grouped as consumer loans, real property loans and commercial loans. Consumer loans could be further grouped such as into installment loans, credit card receivables, student loans, etc. The method of grouping should be consistent with the method of tracking loans within the taxpayer's own books and records used in the normal course of business that reasonably reflects the products/services sold as identified by the taxpayer. The taxpayer's

loan groupings will be presumed to have been properly determined if the taxpayer applies the groupings consistently from year to year unless there has been a material change of fact with respect to that loan group. If a taxpayer cannot group loans, the preponderance of substantive contacts shall be determined on a loan by loan basis.

- E. What changes are then needed for the presumptions? (section 4(g)(1)(B)-(C))
- F. **Subcommittee Action:** At its meeting of July 2013, the subcommittee voted to eliminate SINAA from the collection of the property factor.

c. **If we do not want to continue to use SINAA for sourcing loans in the property factor, is there an alternative method that reflects property factor policy and is practicable?** Alternatives were discussed. State members felt that the alternatives brought forward were not an improvement on the current process as they were too subjective and reflected back to something that cannot be established on audit.

d. **If there is not a good alternative method for sourcing loans, should loans be excluded from the property factor?**

State members of the workgroup have commented that sourcing loans, as is true of any intangible, is notoriously difficult. This difficulty is particularly significant as applied to loans. State members do not think that including loans in the property factor is necessary. The state members are not convinced that any concept of sourcing loans has emerged from work group discussions that would satisfy criteria of either good tax policy or administrative efficiency. On the other hand, industry believes that it is necessary to include loans in the property factor for a financial institution. See Oregon's *Crocker Equipment Leasing* case.

At its July, 2013 meeting, the subcommittee noted concerns raised with SINAA and alternatives, and directed the workgroup to redraft the financial institutions apportionment model in a way that does not include loans in the property factor.

e. **If loans should be excluded from the property factor, should the property factor be included at all?** At its July 2013 meeting, the subcommittee directed that the property factor should be retained, but that loans should be excluded. Some members of the subcommittee noted that elimination of loans is more like a return to the traditional approach of the sales factor being a market representation and the property factor moving back to physical location. So, some members noted, it is more reasonable to view exclusion of loans from the property factor as a return to traditional notions of apportionment. Physical property continues to be a useful reflection of activity in the state. Thus, under this view, the property factor should be retained in the apportionment formula

f. **If the property factor should be included even without loans, should there be alternative weighting for each of the factors?**