



MULTISTATE TAX COMMISSION

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To: Uniformity Committee, Income and Franchise Tax Subcommittee

From: Lennie Collins, Chair, MTC Financial Institutions Work Group

Date: July 22, 2011

Subject: Status Report, Financial Institutions Project

The purpose of this memo is to summarize the current status of the Income and Franchise Tax Subcommittee project to revise the MTC model apportionment formula for financial institutions.

The work group has held regular teleconferences since the subcommittee's March 2011 meeting in Denver. Discussions have largely been based on industry proposals submitted by the Financial Institutions State Tax Coalition (FIST) to revise the property factor for sourcing loans. Attached is the current regulation, including the definition of "regular place of business" from the definitions section.

The subcommittee discussions have focused on the following provisions of the current regulation.

1. Paragraph 4(g) (4)(E). One question is how should the SINAA activities be measured and whether loans must be considered on a loan by loan basis or can be considered as a class of loans. A proposal by California would assign the loan to the state in which the preponderance of substantive contacts related to the loan occurred. Loans would be grouped by classes of like instruments. The costs associated with each activity for the loan or group of loans would then be determined. The state with the highest costs incurred will be the state to which the loans are assigned. The work group realizes there are a significant number of details that need to be thought through and worked out (especially the definition of costs). In working through those issues, the overall goal will be to provide clarity in determining to which state(s) the loans should be sourced while retaining the intended production-state sourcing for loans in the property factor.

With respect to centralized consumer loans FIST would consider the individuals who have management responsibilities for the various INAA functions as the employees who perform the various INAA functions, FIST proposes defining management to mean middle management, not top management. Middle management is further defined as

“mainly accountable to the top management for the functioning of their department, division or section.”

2. Paragraphs 4(g)(4). Under the current loan location rule, it is not clear whether the SINAA factors are of equal weight or, conversely, whether the large presence of one factor can outweigh the absence of other SINAA factors. While industry participants noted that some clarification would be helpful, they did indicate that with the exception of a couple of states they are not encountering significant problems with the current SINAA sourcing provision. The work group is considering the application of the proposed INAA elements to centralized consumer loans. A question was raised as to whether such elements should be individual ratios, equally weighted (e.g. a five factor formula) or treated as a single ratio. E.g., if the SINAA activities were measured by employees, the formula could be stated either as:

$$\left(\frac{S_{\text{employees in state}}}{S_{\text{all employees}}} + \frac{I_{\text{employees in state}}}{I_{\text{all employees}}} + \frac{N_{\text{employees in state}}}{N_{\text{all employees}}} + \frac{A_{\text{employees in state}}}{A_{\text{all employees}}} + \frac{A_{\text{employees in state}}}{A_{\text{all employees}}} \div 5 \right)$$

Or

SINAA employees in state ÷ **SINAA** all employees

FIST has raised a question about whether all the SINAA elements should be retained. Industry has recommended dropping solicitation from the SINAA elements largely because solicitation is already used to source receipts and because it appears to be the SINAA element that causes the greatest disagreement between the states and industry.

3. Paragraph 4(i)(1). In addition, the term “change of material fact” in the loan assignment rule is undefined. A question has arisen as to whether the sale of a loan or pool of loans to another entity within the same controlled group of corporations as the seller constitutes a material change of fact. Both taxpayers and tax administrators would benefit from the inclusion of objective criteria to determine when there has been a material change of fact. Also, the work group proposes amending the paragraph to strike “as the seller.” Since the paragraph applies to all transfers to or from an entity that is within the same controlled group of corporations, it is immaterial whether the loans were transferred by means of a sale or otherwise.

In addition, FIST has proposed a number of examples to illustrate how to determine in which state the preponderance of substantive contacts relating to loans occurs based on the application of the SINAA (or the INAA) elements to various factual scenarios.

Finally, the work group is considering a memo prepared by Elliott Dubin and his staff that lists different options for approximating the geographic location of the value of loan assets of financial institutions.

Industry has noted a number of objections to the memo and it is in the process of revision based on those objections. Discussions of the memo will continue, no decisions having been made as to whether to adopt any of the suggestions.

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

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

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

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

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

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

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

Section 3. Receipts Factor.

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

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

state and one such regular place of business is outside this state, such asset or activity shall be considered to be located at the regular place of business of the taxpayer where the investment or trading policies or guidelines with respect to the asset or activity are established. Unless the taxpayer demonstrates to the contrary, such policies and guidelines shall be presumed to be established at the commercial domicile of the taxpayer.

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

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

Section 4. Property Factor.

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

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

(c) **Value of property owned by the taxpayer.**

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

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

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

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

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

(1) The average value of real property and tangible personal property that the taxpayer has rented from another and which is not treated as property owned by the taxpayer for Federal income tax purposes, shall be determined annually by multiplying the gross rents payable during the taxable year by eight.

(2) Where the use of the general method described in this subsection results in inaccurate valuations of rented property, any other method which properly reflects the value may be adopted by the [State Tax Administrator] or by the taxpayer when approved in writing by the [State Tax Administrator]. Once approved, such other method of valuation must be used on all subsequent returns unless the taxpayer receives prior approval from the [State Tax Administrator] or the [State Tax Administrator] requires a different method of valuation.

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

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

(2) Transportation property is included in the numerator of the property factor to the extent that the property is used in this state. The extent an aircraft will be deemed to be used in this state and the amount of value that is to be included in the numerator of

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

(g) Location of loans

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Section 5. Payroll Factor.

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

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

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

(1) The employee's services are performed entirely within this state.

(2) The employee's services are performed both within and without the state, but the service performed without the state is incidental to the employee's service within the state. The term "incidental" means any service which is temporary or transitory in nature, or which is rendered in connection with an isolated transaction.