

Multistate Tax Commission



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

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

by

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

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

The Exhibits to the Final Report have been selected from hundreds of documents that were either submitted during the public hearing process or otherwise available to the Hearing Officer. Clearly, it was not feasible to submit all of the Exhibits, comprising approximately 2,000 pages, with this Final Report. The several Exhibits that were selected for attachment to the Report are indicated by the symbol "●". These attachments were selected in an effort to provide an historical cross-section of how the proposal developed and their attachment does not imply that any one Exhibit has more importance than any other. However, the Hearing Officer attempted to attach Exhibits that were more policy-oriented, than technical, or those that represented various turning

points during this several year effort. It is recommended that all of the Exhibits, attached or not, be maintained by the Commission for reference purposes.

I.

INTRODUCTION AND BACKGROUND TO PROPOSAL

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

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

This revised draft regulation was referred out of the Uniformity Committee and on May 10, 1990, the Executive Committees called for a public hearing. (Exhibit C1●). Four public hearing sessions were held - in Washington, D.C.

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

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

By the Hearing Officer's Interim Report of November 9, 1990, the Executive Committee of the Commission was advised of the progress of the public hearing and the conclusion that the public record that had been developed to that point "[fell] short of providing sufficient data" upon which several issues, including the nexus issue, could turn. By its resolution of November 9, 1990, the Executive Committee agreed to remove the matter from its July, 1991 agenda, at which time it had anticipated taking action on the proposal. See Exhibit C2●. The proposal development process was being slowed in the interest of studying the matter in more depth than originally contemplated.

During this same period, however, a few states began adopting financial institutions apportionment approaches of their own and those approaches were

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

³ Compare IV.18.(i)(B)(5)(d) and IV.18.(i)(B)(5)(a)-(c) of Exhibit C1●.

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

B. *The Current Effort.*

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

- 1. The pending Commission regulation process would be suspended for a time to provide the SIMS group an opportunity to develop a proposal.**
- 2. A group of interested state representatives would meet with the FIST Coalition to chart the course to be taken.**

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

3. A more open and collaborative process involving both state and industry representatives would be pursued in an effort to develop a fair and administrable apportionment proposal.

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

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

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

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

⁶ This Subcommittee was composed of the following persons:

The second SIMS meeting was held in New York on April 29-30, 1992 at which time the group discussed specific approaches to the development of an apportionment formula. The major result of this meeting was the creation of a state/industry working group called "State/Industry Financial Working Group" ("S/IFWG") comprised of a subset of the SIMS members that would analyze selected issues, then draft and propose specific statutory/regulatory language for review and possible agreement by the broader SIMS group. Exhibit I3● sets forth the direction then being pursued by SIMS.

S/IFWG was broken down into 21 subcommittees to address twenty-one separate drafting sub-issues. Each S/IFWG Subcommittee was comprised of roughly an equal number of members representing state and industry. A description of the S/IFWG process and roster of the S/IFWG Subcommittees is found at Exhibits I1● and I2●.

Meanwhile, the states' economic and philosophical differences were yet to be reconciled among themselves. On the one hand, states such as Tennessee and Minnesota had already taken aggressive market-state approaches to apportioning the income of out-of-state financial institutions. On the other, New York State and New York City, being the commercial domicile of a great number of large financial institutions, had traditionally followed apportionment approaches that were skewed heavily toward the money-centers. The newly

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)	

formed State Subcommittee on Apportionment of Income from Financial Services met on several occasions between January and March of 1992 through teleconference calls, some lasting several hours. On March 9-10, 1992, several State Subcommittee members met in New York to attempt a reconciliation of the differences between the market-state and money-center state approaches. Exhibit H3⁷ sets forth minutes of this meeting to provide a flavor for the struggle that was occurring among the states. Gridlock (or, more appropriately, "factorlock") had set in. The state representatives were about to toss in their respective towels, when someone suggested consideration of a five-factor apportionment formula - a payroll factor, a property factor (including intangibles), a deposits factor and two receipts factors (one heavily market-state oriented, the other heavily money-center state oriented).⁷ While the five-factor approach was later determined to present too much administrative burden, it reflected the state representatives' willingness to explore different approaches to achieve a uniform apportionment formula.

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

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

assembled the various draft parts, filling in the gaps and making sure that consistent language was being used throughout draft.

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

The Interim Report of Hearing Officer dated May 10, 1993 (Exhibit E2*) sets forth the final product of the SIMS consensus process which, in turn, pointed the way for the development of all but a few of the provisions that are recommended here. Three of the four Appendices to that Interim Report set forth issues over which consensus was either not attempted or was not clearly reached. Those issues were: (1) the definition of a financial institution, (2) the use of book or tax basis reporting, and (3) the application of the concepts of SINAA to the assignment of certain intangibles to the property factor.⁸ These issues have been addressed in Section III of this Report.

It is important to underscore here, however, that the attached proposal represents a *new* proposal and not an amended version of that created by the SIMS process. Therefore, any changes from the SIMS version should not

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

represent or consist of any evidence of the Commission's or the drafter's intent with respect to the proposal set forth in Exhibit A.⁹

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

C. *Format of Proposal*

The proposal found at Exhibit A* has been drafted in the format of a detailed statute.¹⁰ Many states will be required by law or practice to adopt the proposal legislatively, while others may have already delegated sufficient authority to their State Tax Administrators to accomplish the same result by regulation. Again, it is to be emphasized that the proposed language does not act to impose any tax; it operates solely to apportion a tax that is already imposed on the types of financial institutions selected by the legislature for

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

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

taxation. Irrespective of the mechanism of adoption, it is critical that the measures adopted by the state legislatures and/or State Tax Administrators adhere very strictly to the language suggested in the proposal if the principal goal of uniformity is to be achieved.

II. RECOMMENDATIONS OF HEARING OFFICER

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

- A. That the states adopt by statute, regulation, or other formal process, the provisions of the apportionment method set forth in Exhibit A attached to this Final Report, as may be modified by technical fixes prior to its adoption by the Commission.¹¹**

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

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

whatever assistance the adopting states determine necessary for the purpose of analyzing and determining whether an adoption of an apportionment method is the same or substantially similar to the method adopted by the Commission.

- C. That the Commission staff organize and facilitate an annual meeting by teleconference or otherwise of representatives of the adopting states for the purpose of exchanging information and ideas regarding the implementation and effectiveness of the uniform method.
- D. That five years after the uniform method has been adopted by the Commission, its staff should survey all of the adopting states and a sample of affected financial institutions to determine what amendments, if any, should be made to the uniform method. The results of such a survey should be referred to the Executive Committee for its consideration and such further action it determines appropriate.

III.

DISCUSSION OF SPECIFIC ISSUES

A. Listing of Issues Presented for Discussion.

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

1. *What is the most appropriate definition of the terms "financial institution" and "business of a financial institution" for the purpose of statutory or regulatory coverage of the different kinds of financial institutions that are in substantial competition with one another?*
2. *Should the receipts factor reflect the delivery of a financial institution's services on a destination basis or on a majority of "cost of performance" basis?*

3. ***How should states treat intangible property in the form of unsecured or secured loans, investments in securities, etc. for income attribution purposes?***
4. ***With regard to states that apply the unitary business principle and combined reporting, what, if any, approach should the proposal take with regard to such principles.***
5. ***What, if any, approach should the proposal take with regard to nexus and/or de minimis concepts?***
6. ***Should a throwback, throwout or another approach be used to address the attribution of receipts that are sourced to states in which the taxpayer is not subject to taxation?***
7. ***Such other issues and suggestions that state representatives and other members of the taxpaying community may wish to present for consideration.***

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

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

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

B. Discussion of the Issues.

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

1. Definition of "Financial Institution".

a. In General.

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

The intended purpose of the definition of a "financial institution" found in Attachment A is to establish a focal point for those wishing to fashion a definition of "financial institution". It is intended to subject to the proposed

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

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

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

Section (11) of Attachment A sweeps within the definition of "financial institution" to which the proposed apportionment applies, all businesses that derive "more than fifty percent (50%) of [their] total gross income from activities" that traditional banks, savings and loan associations, finance companies, etc., are authorized to conduct. This "catch all" provision is intended to "catch" only

those who conduct activities that are in substantial competition with the traditional financial institutions. For this purpose, it is the quality or kind of activity that is at issue, not the quantity.

However, the "catch all" provision is not intended to cover those businesses whose activities are not directly in furtherance of providing financial services, i.e., those related to the lending of money, extending credit, or otherwise dealing in money capital. For an extreme example, assume that a traditional retail bank would be authorized to issue coupons or premiums to attract customers. A literal reading of Section (11) might suggest to some, therefore, that a grocery store chain that issues coupons or premiums to attract customers is, likewise, a financial institution. Such an unreasonable construction would be literally correct, but not logical, since sellers of food do not compete with financial institutions.

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

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

From the outset of the public hearing process, representatives of state credit unions, as well as state credit union supervisors, strongly advanced the position that state credit unions should be excluded from any definition of the term "financial institution". See Exhibits J3, J7, J27, J29, J30, J33, J37, J41, J44. On the other hand, representatives of mainline banks strongly suggested otherwise. See Exhibits J36 and J45. This presented one of the most difficult policy issues raised during the proceedings. Since federally-chartered credit unions are exempt from state franchise and income taxation

under the Federal Credit Union Act, 12 U.S.C. 1768, the argument raised is that the imposition of state operational taxes on state-chartered institutions "threatens to alter the very nature of credit unions" and will drive them to abandon their state charters for federal charters. Credit union representatives also suggest that since credit unions have such a small share of the financial services market compared to banks - \$191.3 billion in assets at 1992 year-end versus \$2,945.3 billion for banks - that their tax exempt status should remain protected.

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

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

capable of complying with the tax laws of the few states in which they are conducting business in competition with other covered financial institutions.

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

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

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

market demand. This is because, under UDITPA, all of the traditional factors - payroll, property and receipts - will be assigned most likely to the commercial domicile or headquarters of the taxpayers. Thus, in normal course, both the UDITPA and Compact apportionment provisions will often ignore any contribution of the market place to the income-producing activity of a financial institution. The apportionment method proposed here in Exhibit A, however, affords some recognition of the market state's contribution and adjusts the factor imbalance that would normally occur in the financial institution context.

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

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

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

3. The Treatment of Intangible Property the Apportionment Formula.

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

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

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

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

Even though the recommended approach will exclude intangibles, other than those classified as receivables from loans and credit cards, adjustments may be made to the property factor, as with any other factor, upon a proper showing. It is the intent of the proposal that where a particular financial institution conducts its income-producing activity in such a manner that (i) it relies upon its ownership and use of other types of intangible assets to a substantial degree in its income-producing activity and (ii) the exclusion of such assets from the property factor would result, when the formula is viewed as a whole, in an unconstitutional attribution of income, a showing may be made for inclusion of such assets under the relief provisions of Section 1(d). Should the income-producing activity of a particular financial institution involve the dealing in other types of intangible property, then either the institution may seek or the State Tax Administrator may require the inclusion of such property in the property factor, if its omission would result in an apportionment factor that

unfairly reflects the income-producing activities of the taxpayer in the state. Again, there should only be an adjustment under Section 1(d) where it is shown by the party desiring the adjustment that the exclusion of that particular type of intangible property results, *when the apportionment formula is considered as a whole*, in income being apportioned to the state that is grossly distorted or out of all appropriate proportion to the business transacted in the state. Cf. *Container* at 181.

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

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

It is important to note that the Commission's Uniformity Committee has been laboring hard to develop initial proposals defining the contours of a unitary business, as well as describing those business activities that create business income. It is recommended that when these uniformity proposals become subject to public discussion, their application to financial institutions be specifically addressed. At that time, both state and industry representatives should be provided an opportunity, once again, to work cooperatively to analyze and make whatever adjustments necessary to render the attached uniform apportionment proposal a better fit with the operations of various segments of the financial institutions industry.

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

a. *The Constitutional Nexus Dispute.*

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

It became apparent as early as 1987 - when the initial Uniformity Committee proposal was circulated to industry representatives - that the state and industry representatives would neither see "eye-to-eye", nor lower their voices, until the original nexus concepts based upon "economic presence" were set to one side. Irrespective of the magnitude of creditor/debtor or depository relationships that were developed by a financial institution within the state, industry representatives remained adamantly opposed to any concept of nexus that did not depend solely upon the institution's *physical presence* within the market state. The states were equally firm that "economic presence", i.e., the regular solicitation of the market by any means, created constitutional nexus. By mutual consent, this serious impediment to civil discourse was removed by anaesthetizing the nexus dispute for the time being. That issue remains asleep to this moment, despite the threat of the decisions in *Quill Corp. v. North Dakota*, 112 U.S. 1904 (1992) and *Geoffrey Inc. v. South Carolina Tax*

Commission, 437 S.E.2d 13 (1993), cert. denied, 62 U.S.L.W. 3375 (11/29/93) to awaken it.¹²

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

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

The Hearing Officer shares Mr. Adler's view that the first logical step in the application of a particular tax is the determination of what businesses are subjected to the tax. Nexus rules are an important part of this determination, as well as the determination of whether receipts are to be thrown back from a market-state to a money-center. The Hearing Officer is a firm supporter of the concept of "economic presence" as a basis for constitutional nexus and believes those nexus standards set forth in IV.18.(i)(B)(5)(d) on Exhibit C1 would be judicially sustained. The Hearing Officer has elsewhere set out his views on the impact of the *Quill* and *Wrigley* decisions on the requirements of nexus for operational tax purposes. So as not to require the reader of this Final Report to search further, one such discussion (addressing nexus issues in the context of apportioning net income from publishing activities) is applicable here and provided *verbatim* below:¹³

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

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

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

During the resumed public hearing, a general discussion was engaged in regarding the potential effect that the cases of *Quill Corp. v. North Dakota*, ___ U.S. ___, 112 S.Ct. 1904 (1992) and *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.*, 112 S.Ct. 2447 (1992) might have with respect to the proposed Publishing Regulation. In the *Quill* case, the Supreme Court ruled against the State of North Dakota's action seeking a declaratory judgment that would have applied its use tax collection statute to a direct marketer whose only significant contacts with the state were by mail and common carrier.¹⁴ More specifically, the Supreme Court was called upon to decide whether, under the Commerce Clause and the Due Process Clause of the Fourteenth Amendment, a taxing State may apply its use tax collection statute to a direct marketer that has established minimum contacts, but no physical presence, with the State by purposefully availing itself of carrying on business within the State. The Court re-affirmed part of its holding in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967) to the extent that the Commerce Clause "substantial nexus" prong established for sales and use tax collection purposes a "bright-line, physical presence" test. Does that same bright line nexus requirement require a publisher to have physical presence within a state before that state can constitutionally require compliance with its income or franchise tax laws?

In the *Wrigley* case, the Supreme Court addressed the type and quantum of activities that may be considered protected "solicitation" under P.L. 86-272. P.L. 86-272 prohibits states from taxing the net income derived from interstate business activities if the only activities within the state consist of the solicitation of orders for the sale of goods, if the orders are sent outside the state for acceptance and are delivered from a point located outside the state. Only activities that are determined to be "solicitations of orders" or "entirely ancillary" to such solicitations were held to fall

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

under the protection of P.L. 86-272. Under these standards, the training and evaluation of sales employees, the company's use of hotels and homes for sales-related meetings, and the like were viewed as being ancillary to solicitation. On the other hand, replacing retailers' stale gum without cost, occasionally using "agency stock checks" to sell gum to retailers and storing of gum for these purposes in the state were held not to be ancillary as these activities served independent business purposes. Assuming that P.L. 86-272 applies to all of the business activities engaged in by publishers, what application does the *Wrigley* case have to the proposed Regulation?

Conclusions:

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

1. *The Due Process Holding.*

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

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

developments in the law of due process.' (112 S.Ct. 1911).

The Court concluded that -

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

2. *The Commerce Clause Holding.*

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

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

indispensable power of taxation"; and (3) a "bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment...". (See, 112 S.Ct. 1914-1915).

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

Justice Byron White, the only current member of the Court that was on the *National Bellas Hess Court*, concurred with the majority with respect to its Due Process Clause holding and dissented with respect to the Commerce Clause aspect of the decision by concluding that the Commerce Clause aspect of *National Bellas Hess* should also be overruled. Justice White succinctly stated his position the "[t]he Court stops short, however, of giving *Bellas Hess* the complete burial it justly deserves." (112 S.Ct. 1917).

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

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

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

control. Additionally, Justice Scalia's concurring opinion lends support in this regard by his stating -

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

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

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

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

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

Bellas Hess to state-imposed duties to collect sales and use taxes. The Court noted -

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

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

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

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

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

standard - that of a regular or systematic or purposeful availment of the state's market - may be found sufficient, by itself, to satisfy the Commerce Clause's substantial nexus requirement with respect to the corporate income and franchise tax liability.

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

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

It makes good tax policy sense to set forth a nexus standard agreed to by the competing states (both money-center and market) and to apply that standard to both the market state's assertion of jurisdiction and the money-center or production state's assertion of throwback. The economic presence concept remains to be analyzed by the United States Supreme Court in the

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

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

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

"Issue 6:

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

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

"...adopt and recommend to its member states, that for the purposes of parity, service companies should be treated similarly to sellers of tangible personal property under P.L. 86-272. The FIST Coalition would be willing to work with the MTC to achieve this end." See Attachment 12.

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

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

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

The Hearing Officer supports the general principle that state tax systems should not distort investment choices and, to that extent, shares FIST's goal of achieving tax parity wherever it makes sense to do so. The Hearing Officer departs company with Mr. Ferguson and FIST on how to achieve that goal, as they would carve out yet another huge area of interstate commerce for protection from taxation under vague guidelines. The Hearing Officer believes that one solution lies in the repeal of Public Law 86-272, coupled with voluntary state action in establishing clear and quantifiable *de minimis* standards as to when an out-of-state business need file returns. Such standards (an example of which is suggested above with reference to Issue 6) would provide more clarity than the vagaries contained in Public Law 86-272; would identify readily those states in which an interstate seller must file returns; and

would protect smaller interstate businesses from having to comply with state tax laws when to do so would not be revenue productive.

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

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

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

A further example is found when a seller of goods also delivers those goods in its own trucks. There, while a protected solicitation of tangible personal property may have occurred earlier, the seller has engaged in a separate transaction in the market state - the providing of delivery services. At least where the seller has

imposed a charge for private carriage delivery services, the Public Law's "delivery or shipment" protection may not apply. This is because the seller would not be solely engaged in the solicitation of sales of tangible personal property in the state, but could be viewed as providing a business in the state as well. Thus, certain activities conducted by the seller remove the protection under the Public Law, unless all methods of shipment and delivery - by common carrier or by the seller's own trucks - were protected. See the discussion of Issue 3. above.

Recommendation:

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

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

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

15. The Hearing Officer does not wish to imply that FIST's suggestion is frivolous when viewed from its own perspective and is thankful for the opportunity to address it. However, the Hearing Officer declines to make any recommendation that does not stand a "snow ball's chance" of being widely accepted by State Tax Administrators. Recommending that the states further limit their right to assert taxing jurisdiction over service businesses contributing over one-half the GDP of the United States will only result in the State Tax Administrators making comments about the Hearing Officer, such as, "I told you so, he's crazy, simply crazy"; or "Remember the old saying - 'He who chases red herrings ends up smelling like dead fish'".

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

For the reasons noted above, the Hearing Officer recommends that Public Law 86-272 should be repealed, so that all interstate sellers, whether of services or tangible personal property, can be treated similarly with respect to the imposition of jurisdiction for state income taxation purposes. Should it be determined that a "bright line" be established in order to provide more clear notice to out-of-state sellers of their state tax responsibilities, then it is recommended that Congress empower the states to establish such bright lines through state legislation that specifies their respective *de minimis* levels above which jurisdiction will be asserted. For a discussion of the initial recommendations of the Hearing Officer concerning approaches to establishing *de minimis* levels, see the discussion in 5.c below.

c. *The De Minimis Concept.*

Every now and then during the SIMS discussions, while industry representatives would repeat their strong opposition to nexus provisions based upon "economic presence" principles, they would indicate that a *de minimis* provision might be welcome. The *de minimis* concept recently has been raised as a potential bar to a state's assertion of taxing nexus in two contexts. In *Quill*, the United States Supreme Court classified the in-state presence of certain

property (a few floppy diskettes) as, possibly, minimal nexus, but not the "substantial nexus" as required by the Commerce Clause in the mail order use tax context. *Quill*, fn. 8. In *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, ___ U.S. ___, 112 S.Ct. 2447 (1992), the Supreme Court underscored that a *de minimis* level of unprotected activity or contact of a trivial nature with a state will not be recognized as sufficient reason for withdrawal of the protection afforded out-of-state sellers of tangible personal property under Public Law 86-272.

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

"Issue 5:

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

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

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

Wrigley, 112 U.S. 2457-8.

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

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

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

From the perspective of the business taxpayer, how frustrating is it to be required to file a tax return in another state, when it costs more in accounting fees and other costs of compliance to file the return than the total tax that is due? Those that do business in an interstate environment, where minimal income (or loss) is at issue, continually face the issue of whether or not to incur filing burdens and comply with the tax laws of other states. Asserting the belief that common sense dictates their action, many businesses will avoid registration in states in which their activities create minimal tax consequences. Should the states apply a *de*

minimis level of income or activity - even beyond that protected by the Public Law - to ensure that government and private resources not be diverted from more productive activity? Is it good state tax policy, as well as in the public's best interest, for government to ensure that small businesses are not burdened by compliance duties where there is negligible, if any, tax revenue at issue?

The Hearing Officer notes that there has not as yet been a United States Supreme Court case in the income apportionment area under either the Due Process or Commerce Clauses of the United States Constitution that prohibits states from imposing a net income or franchise tax measured by net income on any amount of income derived from interstate activities, no matter how small, so long as the four-prong test of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) is satisfied.¹⁶ If the activities in the taxing state exceed those protected under Public Law 86-272, the business has little legal basis upon which to complain that it is required to comply with the state's general tax laws. But should our inquiry end there? Or, should the states now conduct a more in-depth review, from a joint perspective, of when it is appropriate to place upon interstate business activities the cumulative burdens of multijurisdictional tax compliance?

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

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

comply with a myriad of state and local jurisdictions' tax laws - may come into play in some future case.¹⁷

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

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

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

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

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

and delivery of services and income earned from intangibles. Tax Administrators of both state and local governments may feel more "bullish" than "bearish" in now asserting corporate income tax jurisdiction in these areas. Therefore, now may be an opportune time for state Tax Administrators to consider the wisdom of establishing *de minimis* activity or gross receipts levels before committing to compliance measures that are either not cost effective or that risk violation of Commerce Clause restrictions.¹⁸

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

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

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

"Recommendation":

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

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

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

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

(1) had gross receipts from interstate transactions-

(A) within the United states exceeding \$ _____, or

(B) within the State exceeding \$ _____; or

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

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

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

6. **The Throwback of Receipts.**

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

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

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

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

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

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

Under the throwback principle, sellers of tangible personal property will either assign the receipt from a sale to the numerator of the market or destination state's receipts factor; or, if that state does not have jurisdiction due to the operation of P.L 86-272 or the Due Process or Commerce Clauses, the receipt will be assigned generally to the numerator of the receipts factor of the state from which the goods were shipped. In this manner, *all* of the receipts will be assigned to a state that has a substantial connection to the transaction and the taxpayer. Absent a throwback rule being in force in the "shipped from" state (most often the commercial domicile here), a receipt that is not thrown back will

not be assigned anywhere, resulting in a portion of net income being unapportioned to any state and left untaxed.

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

EXAMPLE 1.

State A

<u>Payroll Factor</u>	<u>Property Factor</u>	<u>Receipts Factor</u>
500,000/500,000	1,500,000/1,500,000	40,000,000/60,000,000
1	1	.6666
	2.6666/3 = .8888 factor	

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

State B

<u>Payroll Factor</u>	<u>Property Factor</u>	<u>Receipts Factor</u>
0/500,000	0/1,500,000	20,000,000/60,000,000
0	0	.3333
	.3333/3 = .1111 factor	

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

EXAMPLE 2.

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

State A

<u>Payroll Factor</u>	<u>Property Factor</u>	<u>Receipts Factor</u>
500,000/500,000	1,500,000/1,500,000	60,000,000/60,000,000
1	1	1
	3/3 = 1.0000	

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

State B

<u>Payroll Factor</u>	<u>Property Factor</u>	<u>Receipts Factor</u>
0/500,000	0/1,500,000	0/60,000,000
0	0	0
	0/3 = .0000 factor	

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

EXAMPLE 3.

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

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

The Hearing Officer does not view the "throwback vs. no throwback" issue as one that, by itself, affects the possibility of duplicative taxation, i.e., the assigning of the identical receipt to two different state tax jurisdictions. The potential for double-counting of the identical receipt is an anathema which a widely adopted uniform approach seeks to avoid. So long as both the shipped from (production) state and the shipped to (market) state abide by the *same apportionment rule* and apply the *same jurisdictional standard*, double-counting will be avoided. If the production state wishes to forego taking into its sales factor numerator those receipts that would be sourced, but for lack of jurisdiction, to the market state, so be it. So long as the market state cannot or does not assert its taxing jurisdiction over the out-of-state business, it remains solely up to the taxing philosophy of the production state to determine the extent to which those receipts will be included in the production state's numerator.¹⁹

The throwback rule incorporated under UDITPA/Compact is limited to the throwing back of receipts from the sale of *tangible personal property*. See Article IV.16. Neither law directly provides for a throwback of those receipts from services that are assignable to a market state that does not have jurisdiction to tax the service provider. However, Article IV.17(b) often operates, in effect, as an automatic assignment of receipts from services to the production state. It provides that where the income-producing activity of a service provider is

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

performed in more than one state, *all* of the receipts from such activity are to be assigned to the state in which "*a greater proportion of the income-producing activity is performed...*". Even if the market state in which the income-producing activity is partially performed has taxing nexus over the service provider because its employees are physically present performing services at the customer's location within the market state, not \$1.00 of receipts from such services is assignable to the market state, unless a majority of the costs of performing such services was incurred in the market state. If, as is likely to occur often, the majority of such costs are incurred by the service provider within the state in which its offices and large portion of its employees are located, then 100% of the receipts will likely be assigned there. Therefore, apportionment of income from services under UDITPA/Compact often would result in no market state sharing of any income, since the receipts factor reflection is often 100% production state oriented through the current UDITPA/Compact rules of assignment. One of the issues intended to be addressed by the proposal is the under-attribution to the market states resulting from the application of the standard UDITPA/Compact approach to the sourcing of the receipts factor.

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

Until more definitive nexus standards are developed and accepted, either judicially or otherwise, the Hearing Officer recommends, consistent with the suggestion by the State of South Dakota (Exhibit J34*), that the money-center states (defined for this purpose as the state of commercial domicile) take assignment of all receipts that are not, *in fact*, included in the numerators of the market states. This assignment to the commercial domicile would occur, even when the market-state had jurisdiction over the taxpayer, *but did not subject the taxpayer to taxation*. For example, even when a market state, such as Nevada, has not enacted any corporate franchise or income tax that applies to the out-of-state financial institution, the receipts that would have been assigned to Nevada would then be assigned to the taxpayer's commercial domicile. This "full" throwback rule is set forth in the Section 2(s) definition of "taxable". Of course, the state of commercial domicile remains free as a matter of its own taxing policy not to enact any throwback rule, full or otherwise, and to permit the receipt to remain unassigned.²⁰

7. Discussion of Other Issues and Suggestions

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

During the SIMS process much discussion was had from the institutions' perspective of the potential for two states assigning the identical loan to their respective property factor numerators, since the phrase "preponderance of substantive contact" contained in Section 4(g)(1)(B) did not give clear guidance. From the states' perspective, the issue of whether a loan is "properly" booked or assigned became an issue. By regulation, New York addresses the proper assignment issue by analyzing the facts of a given loan transaction and

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

determining where the loan was solicited, investigated, negotiated, approved, and administered (the "SINAA" elements). The ultimate issue SINAA elements are used for is to determine if the state to which the loan (or credit card receivable) has been assigned is the state with the "preponderance of substantive contacts". The elements of SINAA are only applied if a question is raised on audit as to whether the loan was improperly assigned by the financial institution.

Representatives of some of the financial institutions complained that SINAA does not fairly solve the issue of loan assignment and adds five more concepts over which to argue. One suggestion was to create a presumption that the state in which the approval and administration were located should be assigned the loan. See I5, letter from Philip M. Plant of the Bank of America dated April 30, 1993. While this would add some more certainty, some states believed that this presumption would not lead to a reasonable assignment in many instances, especially after the original term of the loan had expired.

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

b. *The Book vs. Tax Accounting Issue*

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

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

c. *Process for Resolving Apportionment Conflicts*

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

While petard hoisting may be fitting in some settings, it is not here, where state/industry cooperation has fostered substantial communication and a corresponding appreciation of one another's perspectives. Therefore, the Hearing Officer recommends that the states consider a ground somewhere between the state-by-state application of a variety of interpretations of Due Process and Commerce Clause nexus requirements and complete surrender by one side or the other as to whether "physical presence" is the *sine qua non* of nexus. In the absence of any other suggestions, the Hearing Officer recommends that a process be agreed upon by the states that would point the way to resolving those conflicts that arise among states that risk double-counting of the identical item of receipt, property or payroll *where the double-counting results in more than 100% of the denominator of any factor being assigned to the numerators of the states*. The Hearing Officer recommends that the states adopting the proposal agree to certain starting points or points of deference. This agreement would not be set forth by any statutory or regulatory format, but by agreement between the states.

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

On rare occasions, however, certain assets, primarily unsecured loans, may fall within the contemplation of more than one state's grasp due to one or the other state's misapplication of the assignment rules. With respect to receipts, the lack of a nexus standard articulated in writing creates the potential for conflict between two states over which state is entitled to the assignment. With respect to asset assignment, such as unsecured loans, the application of the principle of which state has the "preponderance of substantive contact" (Section 4(g)(1)(B)) may be misinterpreted on occasion in a way that causes two or more states to assert their respective claims to the assignment of the intangible loan asset. A state-agreed upon dispute resolution process will work to reduce the risk of double-counting, even though such occasional double-

counting would not risk any potential violation of the internal consistency requirement of the Commerce Clause.

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

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

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

intangible property involve relations with more than one jurisdiction. *Curry v. McCandless*, 307 U.S. 357, 367 (1939).

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

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

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

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

With the arrival of full-scale branch banking in the near future, many nexus issues will be put to rest and the states will have need of an apportionment tool that will fairly approximate the income being derived within their borders by financial institutions. It is not very difficult to envision that a good number of states will seriously consider this proposal, because it has evolved from a collaborative process among representatives of both industry and states with support of the Commission and the Federation of Tax Administrators. The adoption of the proposal by a critical mass of states is most important. Whether the critical mass is actually twenty states as suggested in Section II.B. above, or a number slightly above or below that number, will depend largely upon the timing of adoption by a few of the larger, more market-state oriented jurisdictions. It is noteworthy that the State of Oregon has already adopted an earlier iteration of this proposal. Presumably that state will favorably entertain the suggestion to make the minor amendments necessary to conform its regulation to the version ultimately adopted by the Commission.

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

Because the SIMS process involved substantial discussions and compromises between the money-center and market-state interests, the proposal that evolved is fair to both types of states. Of course, the proposal will be viewed by some to be tipped too much in favor of the money-center states and by others as favoring too much the market-states. Thus, it appears to be within the range where it can be called "fair". With the input received from the

industry, certain conventions and presumptions were engaged in that have made the proposal "administrable", without the record keeping burdens earlier complained of concerning the original Commission proposals. The Hearing Officer concludes that two of the three goals of the SIMS process have been met thus far - the development of an apportionment proposal that is both fair and administrable. Presumably, the proposal's fairness and administrability will form the basis for its acceptance and endurance. It now remains for the states to determine whether the remaining goal - adoption by a critical mass of states - is also fulfilled.

IV. CONCLUSION

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

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

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

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

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

As important as the development of a fair and administrable proposal is, the SIMS and S/IFWG process also provided a healthy break from the type of state/industry dance that has played out during prior uniformity efforts. By sitting at the same worktable and through teaming the talents of those interested and wishing to share, much of the "our side" versus "their side" mentality dissipated. The good intentions of those sharing the same worktable quickly became apparent, and a more trusting atmosphere developed. This type of effort, whether it results in a widely-accepted uniformity measure or not, was successful because of the process alone. All of those involved know that "good government" was at work. Their efforts should be respected by others now taking the proposal and trying it on to see the fit.²¹

This Final Report of Hearing Officer is submitted this 28th day of April, 1994 by:



Alan H. Friedman
Hearing Officer

hofinfnlrpt.ahf4/28/94

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

**APPENDIX TO FINAL REPORT
OF HEARING OFFICER**

V.
APPENDIX TO FINAL REPORT

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

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

A. Definition of Financial Institution.

The following definition of financial institution or a variation thereof could be made part of a statutory proposal or could be adopted by regulation if the state legislature has already delegated the authority to do so to the State Tax Administrator or other administrative officer. Again, the following provides a starting point for discussion purposes and the lack of a uniformly adopted definition by all of the states, while affecting competitive balance, is not critical to the main thrust of the apportionment proposal.

"Financial institution" means:

- (1) Any corporation or other business entity registered under state law as a bank holding company or registered under the Federal Bank Holding Company Act of 1956, as amended, or registered as a savings and loan holding company under the Federal National Housing Act, as amended;**
- (2) A national bank organized and existing as a national bank association pursuant to the provisions of the National Bank Act, 12 U.S.C. §§21 et seq.;**
- (3) A savings association or federal savings bank as defined in the Federal Deposit Insurance Act, 12 U.S.C. § 1813(b)(1);**

(4) Any bank or thrift institution incorporated or organized under the laws of any state;

(5) Any corporation organized under the provisions of 12 U.S.C. 611 to 631.

(6) Any agency or branch of a foreign depository as defined in 12 U.S.C. 3101;

(7) A state credit union the loan assets of which exceed \$50,000,000 as of the first day of its taxable year;

(8) A production credit association organized under the Federal Farm Credit Act of 1933, all of whose stock held by the Federal Production Credit Corporation has been retired;

(9) Any corporation whose voting stock is more than fifty percent (50%) owned, directly or indirectly, by any person or business entity described in subsections (1) through (8) above other than an insurance company taxable under [insert applicable state statute] or a company taxable under [insert applicable state statute];

(10) A corporation or other business entity that derives more than fifty percent (50%) of its total gross income for financial accounting purposes from finance leases. For purposes of this subsection, a "finance lease" shall mean - any lease transaction which is the functional equivalent of an extension of credit and that transfers substantially all of the benefits and risks incident to the ownership of property. The phrase shall include any "direct financing lease" or "leverage lease" that meets the criteria of Financial Accounting Standards Board Statement No. 13, "Accounting for Leases" or any other lease that is accounted for as a financing by a lessor under generally accepted accounting principles.

For this classification to apply,

(a) the average of the gross income in the current tax year and immediately preceding two tax years must satisfy the more than fifty percent (50%) requirement; and

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

(11) Any other person or business entity, other than [an insurance company taxable under _____], [a real estate broker taxable under _____], [a securities dealer taxable under _____] or [a _____ company taxable under _____], which derives more than fifty percent (50%) of its gross income from activities that a person described in subsections (2) through (8) and (10) above is authorized to transact. For the purpose of this subsection, the computation of gross income shall not include income from non-recurring, extraordinary items.

(12) The [State Tax Administrator] is authorized to exclude any person from the application of subsection (11) upon such person proving, by clear and convincing evidence, that the income-producing activity of such person is not in substantial competition with those persons described subsections (2) through (8) and (10) above.

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

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

On those rare occasions when there still is an opportunity to timely address the issue, i.e., when the states' statutes of limitations permit it, then there should be a process in place that permits the taxpayer an inexpensive way to avoid the double-counting that would result in more than 100% of its income base from being apportioned. To this end, the Hearing Officer recommends that

the states that adopt the main proposal set out in this Final Report also enter into an agreement with one another as follows:

Agreement to Confer to Avoid Over-Taxation.

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

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

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