MULTISTATE TAX COMMISSION

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To: Wood Miller, Chair
Members of the MTC Income & Franchise Tax Uniformity Subcommittee

From: Financial Institutions Apportionment Work Group

Date: June 9, 2009

Subject: Work Group Recommendations

The MTC promulgated its model Financial Institutions Apportionment Rule in 1994. Twenty states adopted the model, in whole or in part.[1] Today, a number of those states are considering amendments that would move away from the model. In light of this movement, the Executive Committee directed the Income & Franchise Tax Uniformity Subcommittee to develop proposed amendments for the model. The Subcommittee created the Financial Institutions Apportionment work group to review the model, identify problem areas and recommend amendments. The purpose of this memo is to provide the Subcommittee with the Work Group's list of identified issues and recommended conceptual amendments to address those issues.

The memo incorporates the consensus recommendations that the work group has developed. In addition, the memo notes two issues for which the Work Group has not been able to reach a consensus recommendation -- the sourcing of receipts from trust accounts and the sourcing of receipts from transactions that are not otherwise specifically covered by the rule. A discussion of the possible options for those issues is included.

I. The Sales Factor:

State Members Overarching goals –reflect the market

Industry Members Overarching Goals - (1) Each receipt should only be included in the sales factor numerator of one state (i.e., the sum of all of the states' receipts factors should not exceed 100%); (2) Current receipts sourcing should not be changed if it will result in immediate double taxation; (3) Receipts from services should be sourced in the same manner that such receipts would be

[1] The states are AL, AR, CA, CO, HI, ID, KY, MA, MD, ME, MS, ND, NH, NM, KS, NH, OH, OR, RI, WA

sourced for non-financial organizations; (4) Incidental receipts should NOT be changed to market sourcing; (5) All receipts should be included in the denominator of the sales factor; (6) Sourcing methods should be practical, not overly burdensome and readily available without programming changes; and (7) No revisions should be considered that cannot likely achieve actual adoption in a majority of the states, since adoption by only a few states of the approximately 20 states would create an environment that is less consistent and uniform than exists today.

A. ATM Fees

Current rule:
There is no current rule that specifically governs the sourcing of receipts from ATM fees. Instead, these receipts are currently sourced under Section 3(l), as are all receipts from services not otherwise apportioned under the rule. Section 3(l) currently provides;

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

Problem to be addressed: Under the current greater COP sourcing rule, ATM fees are sourced to the production state, rather than to the market state.

Possible solutions:

- Source to the location of the ATM machines.
- Source to states where the transaction processing takes place.

Recommended solution: Add a new section to source ATM receipts to the location of the machines in order to better reflect the location of the market. This appears to be the most logical and easily administrable solution The locations of the machines should be readily determinable from the taxpayer's records. Sourcing to states where the transaction processing takes place may not reflect the location of the market for these services.

Industry participants realize that the recommended solution does not meet our goals in that it likely will result in more than 100% of ATM fees being included in the numerator of more than one state's receipts factors and result in immediate double taxation for institutions where the processing activity is located in states that apply a greater COP sourcing rule. Nevertheless, since the information on ATM location is available and the percentages of fees are small, the industry participants conceded to this recommendation.

B. Merchant Discount, §3(j)

Current rule:

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

Problem to be addressed: The commercial domicile of the merchant is generally unknown and may not accurately reflect the market.

Possible solutions:

- Source merchant discount to the location of the merchant.
- Source merchant discount to the location of the merchant bank.
- Source merchant discount on the basis of the ratio used to source interest and fees from credit card receivables.
- Source based on cost of performance.

Recommended solution: The working group recommends that merchant discount be sourced to the location of the merchant, if the financial institution has readily available information as to that location. Otherwise, source merchant discount based on the ratio used to source interest and fees from credit card receivables. The choice would be applied uniformly by the taxpayer in all states that have adopted the MTC financial organization apportionment provision in which the taxpayer is doing business. Note, this credit card interest income proxy is similar to that in use in the model provision for apportioning credit card issuer's reimbursement fees.

Ideally, sourcing merchant discount to the location of the merchant should in all instances accurately reflect the financial institution's merchant discount market. But financial institutions do not necessarily know the merchant's location especially for Big Box Retailers, as it is not necessary for the financial institution to capture that information in order to properly account for merchant discount incurred as a result of use of an issuing bank's credit cards. The proposed default rule should be a fairly accurate predictor of the merchant's location, as it is reasonable that a credit card holder would use his card at a local merchant in a large number, if not a majority, of cases. In such cases, the location of the merchant discount market is the same as the market for credit card receivables – the location of the card user.

C. Receipts From Investment and Trading Assets and Activities, §3(m)

Current rule:

(m) Receipts from investment assets and activities and trading assets and activities.
(1) Interest, dividends, net gains (but not less than zero) and other income from investment assets and activities and from trading assets and activities shall be included in the receipts factor. Investment assets and activities and trading assets and activities include but are not limited to: investment securities; trading account assets; federal funds; securities purchased and sold under agreements to resell or repurchase; options; futures contracts; forward contracts; notional principal contracts such as swaps; equities; and foreign currency transactions. With respect to the investment and trading

assets and activities described in subparagraphs (A) and (B) of this paragraph, the receipts factor shall include the amounts described in such subparagraphs. [REMAINDER OF RULE OMITTED]

Problem to be addressed: In developing the original apportionment provision, Sec. 3(m) was intended to cover income from investment assets and trading assets that are reflected in the financial institution's call report. However, the provision does not specifically limit its application to those assets/activities and at least one state noted that a taxpayer had suggested that Sec. 3(m) should cover fees related to investment activities conducted on behalf of its customers.

Recommended solution: Clarify the rule to state explicitly that it includes income from investment and trading assets reflected on the financial institution's call report or similar regulatory report or that would be required to be reported on such report if the taxpayer were a regulated financial institution. As an alternative, modify Sec, 3(m) to specifically provide that it does not cover fees received from conducting investment services for customers.

D. Receipts From Investment and Trading Assets and Activities on Behalf of 3d Party (trust accounts).[2]

Current rule: As is currently the case with receipts from ATM fees, these receipts currently fall under the rule for unspecified service receipts (§3(l)), which are sourced based on the greater cost of performance.

Problem to be addressed: Under the current greater COP sourcing rule such trust fees are sourced to the production state, rather than to the market state.

Possible solutions: There are a number of ways that these receipts can appropriately be sourced. The goal should be to reflect the market, unless the market is too easily manipulable or it is unreasonably difficult for financial institutions to comply. Possible sourcing rules include;

- Location of trust assets
- Location where the trust was formed
- Location of the trustee(s)
- Location of the trustor(s)
- Location of the trust office
- Location of beneficiaries, or
- Using a proxy for the location of the trust. Trust receipts could be apportioned on the basis of a formula that assigns shares of total trust receipts to each state in proportion to the ratio of deposits in that state to total deposits of the institution.

[2] The discussion of income from trust accounts in the text is not meant to imply that trust accounts are the only source of income from investment activity undertaken on behalf of a third party. To the extent that a financial institution receives income from such investment activity, such income would currently be subject to the same COP sourcing rule as income from trust accounts and would therefore also not reflect the market for the investment activity.

- Source under §3(l) as "receipts from services" that are "not otherwise apportioned."

Recommended solution: At the present time, the state members of the work group have not reached a consensus on a recommended solution. Industry participants would prefer to maintain the existing sourcing rules of §3(l) which would retain the greater cost of performance rule for receipts from services because a change to market sourcing will result in immediate double taxation, be burdensome, and require significant programming. In the alternative, industry participants would prefer that such service receipts be sourced in the same manner as such receipts are sourced for non-financial organizations in order that there is a level playing field.

E. Non-specified Service Receipts, Other Non-Specified Receipts, and Attribution of certain receipts to commercial domicile, §§3(l), (n) and (o).

Current rules:

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

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

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

Problem to be addressed: Under the current greater COP sourcing rule provided in (l), receipts from other services are sourced to the production state, rather than to the market state. In addition, there is no exception for determining sourcing for the receipts that fall within a specific sourcing rule, but that are below a *de minimus* amount. Receipts from fees for administering 3rd party trust accounts are an example. This could result in needless administrative cost and complexity, both for financial institutions and for tax administrators.

Possible solutions:

- Retain the existing rules: source receipts from services that are not otherwise explicitly sourced using greater cost of performance, and source receipts from all other transactions that are not explicitly sourced using the state's general apportionment rules.

- Receipts from services that are not otherwise explicitly sourced could be sourced in the same proportion as all other receipts are sourced.
- In addition, a de minimis rule could be established to allow similar treatment for receipts that would normally be sourced according to a specific rule, but that fall below a threshold percentage of total receipts.
- Eliminate (l) (i.e., greater COP sourcing for other services) and thus provide that under (n) all other services are sourced in accordance with the state's general apportionment rule applicable to other industries.

Recommended solution: At the present time, the work group has not reached a consensus on a recommended solution. The state members of the work group recommend that receipts from services that are not explicitly sourced be sourced in the same proportion as all other receipts or simply not included in the factor. In addition, the state members recommend similarly sourcing specified receipts that fall below 1% of total receipts. Industry participants do not agree with the states' proposal and would prefer to maintain the existing sourcing rules of §§3(l) and (n). This would retain the greater cost of performance rule for receipts from services and source other receipts in the same manner as services for other taxpayers are sourced. In the alternative, industry participants would prefer that other service receipts be sourced in the same manner as such receipts are sourced for non-financial organizations (i.e., expanding (n) to include other services).

F. RICS and REMICs*:* the work group will take up the issue of sourcing receipts from RICs and REMICs at the end of the project.

II. The Property Factor: State and Industry Members Overarching goal – the intent is not to recreate the 1994 apportionment outcome of sourcing property to particular states. Rather, the intent is to attempt to maintain the 1994 policy of sourcing property to location of loan activity.

Current rules:

§4(g) Location of loans
(1) (A) A loan is considered to be located within this state if it is properly assigned to a regular place of business of the taxpayer within this state.
(B) A loan is properly assigned to the regular place of business with which it has a preponderance of substantive contacts….

(3) To determine the state in which the preponderance of substantive contacts relating to a loan have occurred, the facts and circumstances regarding the loan at issue shall be reviewed on a case-by-case basis and consideration shall be given to such activities as the solicitation, investigation, negotiation, approval and administratin of the loan [SINAA]….

[REMAINDER OF RULE OMITTED]
…
§4(i) Period for which properly assigned loan remains assigned. A loan that has been

properly assigned to a state shall, absent any change of material fact, remain assigned to said state for the length of the original term of the loan. Thereafter, said loan may be properly assigned to another state if said loan has a preponderance of substantive contact to a regular place of business there.

Problems to be addressed: Under the current loan location rule, it is not clear whether the SINAA factors are of equal weight or, conversely, whether the large presence of one factor can outweigh the absence of other SINAA factors. As a result, it is unclear both to tax administrators and to financial institutions, how the SINAA factors should be applied in individual cases. While industry participants noted that some clarification would be helpful, they did indicate that with the exception of a couple of states they are not encountering significant problems with the current SINAA sourcing provision.

In addition, the term "change of material fact" in the loan assignment rule is undefined. A question has arisen as to whether the sale of a loan or pool of loans to another entity within the same controlled group of corporations as the seller constitutes a material change of fact. Both taxpayers and tax administrators would benefit from the inclusion of objective criteria to determine when there has been a material change of fact.

Recommended solution: California has proposed, and the work group recommends, a solution to both issues. As for the location of a loan, California would assign the loan to the state in which the preponderance of substantive contacts related to the loan occurred. Loans would be grouped by classes of like instruments. The costs associated with each activity for the loan or group of loans would then be determined. The state with the highest costs incurred will be the state to which the loans are assigned. The work group realizes that there are a significant number of details that need to be thought through and worked out (especially the definition of costs). In working through those issues, the overall goal will be to provide clarity in determining to which state(s) the loans should be sourced while retaining the intended production-state sourcing for loans in the property factor.

In addition, a special rule would be provided for automated loans programs. If the preponderance of substantive contacts are performed primarily through the use of automated systems, such as computerized investigation and approval processes, the loans shall be assigned to the location of the automated systems.

As to the definition of "change of material fact", language would be added to indicate that a sale of loans within the same controlled group of corporations shall not, by itself, constitute a material change of fact. Section 1563(a)(1) of the Internal Revenue Code would be used to determine the members of a controlled group, substituting a "more than 50 percent" ownership test for the "at least 80 percent" test in the statute. Industry workgroup representatives suggest that the rule should create a rebuttable presumption that such loan sales do not constitute a material change of fact rather than a conclusive principle of law applicable in all such cases.

III. Definition of a Financial Institution, subject to the model provision: State Members Overarching goal – Uniform applicability of the rule to entities that are engaged in similar activity.

The work group recommends retaining the focus of the rule on financial institutions rather than on financial activity. Thus, the work group recommends retaining the definition of "financial institution" in Appendix A. Other specified institutions that are currently known to be heavily engaged in financial activity, such as investment banks, should be added to the definition, if not already included.