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MULTISTATE TAX COMMISSION

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To: MTC Executive Committee
From: Wood Miller, Chair, MTC Uniformity Committee
Date: May 8, 2014
Subject: Uniformity Committee Report on Draft Amendments, Formula for the Apportionment and Allocation of Net Income of Financial Institutions

Introduction

The MTC promulgated its current 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, or have adopted, amendments that would move away from the model. In light of this movement, in July 2007 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. Lennie Collins of the North Carolina Department of Revenue, was appointed as chair of the work group.²

The project commenced in 2008 with the preparation of an issues list to be considered by the work group.³ The work group completed its work on revisions to the receipts factor by June 2009. The work group continued its earlier preliminary work on revisions to the property factor. The main focus of those efforts was to determine whether revisions to the SINAA factors for sourcing receipts from loan activities were feasible and, if not, whether loans be removed from the property factor entirely. The work group completed its work on the property factor in December 2013 and the Uniformity Committee approved the entire draft model at its meeting in New Orleans in December 2013.⁴

The purpose of this memo is to summarize the Uniformity Committee's approach to the issues and to submit the model for this committee to consider for public hearing.

I. The Sales Factor:

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

² The Uniformity Committee would like to thank the members of the work group, both from the states and from the public, who worked extremely diligently over the past six years to complete the project. The committee especially appreciates the time and effort put into the project by members of the public who participated. A list of the work group members is attached to this report as an appendix.

³ A copy of the original issues list, dated February 20, 2008, is attached as Exhibit 1.

⁴ A copy of the model as approved by the Uniformity Committee is attached as Exhibit 2.

State Members' Overarching Goals – to Reflect the Market for Financial Activities.

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 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 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(1), as are all receipts from services not otherwise specifically apportioned under the rule. Section 3(1) 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 3(k) 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 note that the recommended solution does not meet their goal of avoiding duplicate taxation since some states will continue to utilize cost of performance (COP) standards and apportion income from these fees to processing centers while other states will follow the “market” approach. Nevertheless, since the information on ATM location is available and the percentages of fees are small, the industry participants agreed not to contest 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 at which the credit card transaction occurred.
- 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 Uniformity Committee 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 institutions apportionment provision in which the taxpayer is doing business. Note, this credit card interest income proxy is similar to that used in the current model provision for apportioning credit card issuer's reimbursement fees.

Generally, sourcing merchant discount to the location of the merchant should accurately reflect the financial institution's merchant discount market. But financial institutions do not necessarily know the merchant's location especially for large national retailers with

multiple locations. 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 financial statements, call reports or similar reports.

D. Receipts from Investment and Trading Assets and Activities on Behalf of 3d Party (trust accounts).⁵

Current rule:

⁵ 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

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 subject to manipulation 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.
- Source under §3(l) as “receipts from services” that are “not otherwise apportioned.”

Recommended solution:

The Uniformity Committee recommends a new Section 3(m), which consists of two alternative proposals for the states to consider in sourcing receipts from trust accounts. Alternative Option A would source these receipts in accordance with Reg.IV.17 of the MTC Allocation and Apportionment Regulations, as amended. Alternative Option B would simply delete the proposed new Section 3(m). This would result in continuing to source the receipts under Section 3(l).

Industry participants would prefer to maintain the existing COP sourcing rules of §3(l) which would retain the greater cost of performance rule for receipts from services. Industry representatives are concerned that a change to market sourcing will result in immediate double taxation, be burdensome, and will 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), above, 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 minimis* 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:

The Uniformity Committee makes the following recommendations as to the indicated receipts:

Section 3(l) (Receipts from services). The committee recommends sourcing these receipts in accordance with Reg.IV.17 of the MTC Allocation and Apportionment Regulations, as amended.

Sections 3(n) (all other receipts) and (o) (attribution of certain receipts to commercial domicile). The committee recommends retaining the current sourcing rule for these receipts.

Industry participants do not agree with the states' proposal for §3(l) and would prefer to maintain the existing COP sourcing rule. 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). Industry representatives noted that implementing changes to sourcing of receipts is not only time-consuming, but also costly. Thus they suggest a "floor" amount of receipts or activity for which the current COP sourcing rule would be maintained. The committee did not accept this as a valid argument for creating a floor amount of "other services" income which would continue to be sourced under CAP rules.

F. RICS and REMICs: Originally, the work group planned to take up the issue of sourcing receipts from RICS and REMICs at the end of the project. However, the work group did not revisit this issue at the conclusion of the project. It is unclear whether there is still interest in doing so. The Executive Committee might consider asking the Uniformity Committee to consider this issue for a new project.

II. The Property Factor:

State and Industry Members Overarching Goal: maintain the current policy of apportioning the location of loan "property" to the states in which loan activity occurs, while reducing complexity and ambiguity of current model.

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 administration 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 unclear both to tax administrators and to financial institutions how the SINAA factors should be applied in individual cases. For instance, there is no consensus on whether the SINAA factors should be weighed equally, or whether a significant presence of one activity can outweigh the absence of other SINAA factors in a particular jurisdiction. While industry participants noted that some clarification would be helpful, they did indicate that with a few exceptions, the industry is not encountering significant problems with the current SINAA sourcing provision.

A second problem is that the term “change of material fact” in the loan assignment rule fails to give adequate guidance as to its application. For instance, 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 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:

The issue of whether to retain loans in the property factor and, if so, how the SINAA factors could or should be modified took up by far the greatest time and effort in the work group’s discussion of revisions to the model. The state representatives ultimately concluded that revising application of the SINAA factors so that some version of those factors would allow for an accurate, predictable and easily administrable method of sourcing loans would likely prove unfeasible. In addition, the state representatives concluded that, in most cases, the location of a financial institution’s real and tangible property would reflect the location of economic activity associated with the institution’s loans. In July 2013, the Income and Franchise Tax Subcommittee directed the work group to “move forward with the approach of the property factor being real and tangible personal property and eliminating any aspect of SINAA from the property factor.” Industry continues to believe that a modified version of SINAA, perhaps eliminating solicitation, is workable and that loans should therefore be retained in the property factor.

The work group drafted language limiting the property factor to real and tangible property as requested by the Subcommittee. At its December 2013 meeting, the Uniformity Committee approved the new model. As a result, clarification of both SINAA application and “change of material fact” analysis is now moot.⁶

III. Definition of a Financial Institution, Subject to Apportionment Under the Model: State Members Overarching Goal – Uniform applicability of the rule to entities that are engaged in similar activity.

The work group recommends retaining the application of the Model to financial institutions rather than applying the model to income from non-financial entities that may be engaged in some financial activity. The current model uses a 50% test to determine if an institution’s income should be apportioned under the model as a financial institution. Appendix A to the model defines financial institutions to include entities (other than an insurance company, real estate broker, or securities dealer) that derive more than 50% of their gross income from activities that a financial institution is authorized to transact. The work group recommends retaining the definition of “financial institution” in Appendix A unchanged.

IV. Other Definitions

The work group added, or modified, the following definitions in Section 2 of the model. Section references are to the draft revisions.

Section 2(f). Provides for a more specific definition of “credit card” than under the present model.

Section 2 (g). This is a new definition to reflect the emergence of debit cards since the present model was adopted.

Section 2(k). Removed an obsolete reference to Section 595 of the Internal Revenue Code from the definition of “loan”.

Section 2(m). Provides for a more specific definition of “merchant discount” than under the present model.

Section 2(u). Clarifies that the term “taxable” includes income that is subject to a tax which is imposed upon or measured by “gross or net income”.

⁶ The elimination of loans from the property factor could arguably result in distortion of income apportionment in some instances where the physical property of the taxpayer does not adequately reflect the degree of its economic presence in a given state. See, e.g., *Crocker Leasing v. Oregon* (1992). The problem could be particularly pronounced in separate –entity states, since ownership of intangible property can be easily transferred between related entities. Resort to the model’s equitable apportionment procedures and inclusion of loans or other intangible property through the use of SINAA or similar factors may be appropriate in those instances.

Appendix

Work Group Members

State Representatives

Lennie Collins, Chair (NC)
Chris Coffman (WA)
Phil Horwitz (CO)
Deborah Liebman (NY)
Jessica Lesczinski (NY)
Michael Fatale (MA)
Amy Gill (PA)
Marilyn Harbur (OR)
Helen Armstrong (AZ)
Jennifer Hays (KY)
Carl Joseph (until 2012) (CA)
Lee Baerlocher (MT)
Brian Staley (MT)
Gene Walborn (MT)
Matt Peyerl (ND)
Donnita Wald (ND)
Mike Boekhaus (KS)
Phil Skinner (ID)

Public Representatives (organizations are for identification purposes only)

Dawn Justice (Idaho Bankers Association)
Eric J. Coffill (Morrison Foerster)
Ferdinand Hogroian (Council on State Taxation)
Fran Mordi (American Bankers Association)
Jeff Friedman (Sutherland Asbill & Brennan)
Karen Boucher (Deloitte Tax)
Karen Nakamara (Price Waterhouse Coopers)

Marc Simonetti (Sutherland Asbill & Brennan)

Nancy Lancia (Securities Industry and Financial Markets Association)

Rebecca Paulsen (US Bank)

Todd Lard (Sutherland Asbill & Brennan)

Jeffrey Serether (Ernst & Young)