

Financial Institution Industry Response

June 23, 2011

On the June 7, 2011 MTC financial institution work group conference call, participating industry members discussed the manner in which they generally apply the current MTC apportionment provision to source loan groups when computing the property factor. At the conclusion of that call, the Chair of the Work Group, Lennie Collins, requested that participating industry members prepare a brief written summary of how the provisions are generally applied. This document is submitted in response to that request.

Background

In an effort to provide an executive summary of the general loan group sourcing that has been applied by many financials since the adoption of the MTC provisions by the twenty, plus states in the mid-to-late 1990s, the following background facts are critical:

- the overall goals of the original financial institution apportionment provision project were that the resulting model be: 1) fair in approach; 2) *administratable*, and 3) adopted and applied consistently in a majority of states;
- Section 4(g) of the current MTC financial institution apportionment provisions (copy with some highlighted text is included in Appendix A) –
 - A loan is properly assigned to the regular place of business with which it has a *preponderance of substantive contacts*.
 - To determine the state in which the preponderance of substantive contacts relating to a loan have occurred, consideration shall be given to such *activities* as the solicitation, investigation, negotiation, approval and administration of the loan.
 - The terms "solicitation", "investigation", "negotiation", "approval" and "administration" are essentially defined as *activities or procedures* undertaken by employees and/or the customers.
 - More importantly, each of the SINAA *activities is located at* a business location of the taxpayer.
 - There is no mention of determining *substantive contacts* based on the amount of costs of individual or total SINAA activities that are incurred in a state. While costs incurred within a state may be a means of assigning each SINAA element to a state if more than a de minimus amount of the activities of an element are incurred in more than one state, this was not the intent of the provision. If it had been, the provision would have defined costs (see for example the definition under cost-of-performance provisions) and provided some guidance on handling sunk versus variable costs and how to attribute the costs to the various states.
- Page 51 of the Hearing Officers Report provides:
 - By regulation, New York addresses the proper assignment issue by analyzing the facts of a given loan transaction and *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”.

* * *

Representatives of some financial institutions complained that SINAA does not fairly solve the issue of loan assignment and *adds five more concepts* over which to argue.

- The Hearing Officer’s report and accompanying exhibits provide a number of examples that make it clear that the intent was that the inclusion of loans in the property factor of the final regulation was meant to have a production state bias. For example, according to a June 4, 1993 letter from the California Franchise Tax Board which is included as Exhibit J:25 of the Final Hearing Officer’s Report):

The property factor serves a different function than the receipts factor. It is intended to reflect the place where capital is employed by the business. . . . We believe that, given the “market” orientation of the receipts factor, a booking rule is appropriate for property factor purposes.

Executive Summary of How the CURRENT Loan Sourcing Provisions are Generally Applied

Loans typically are grouped by classes of similar instruments, by customer base, and/or another method (including a method combining instruments and customer bases) that reflects the taxpayer’s books and records. For example, loans could be grouped as consumer loans, real property loans and commercial loans. Consumer loans could be further grouped such as into installment loans, credit card receivables, student loans, etc. In large part the grouping of loans are based on the financial institutions’ loan tracking system and/or management reporting systems.

For each loan group, the institution determines the state with the preponderance of substantive contacts.

To determine the state in which the preponderance of substantive contacts relating to a loan group have occurred, the institution determines where the loan group is solicited, investigated, negotiated, approved and administered (SINAA).

To determine which state each of the SINAA elements for a loan group is located, the institution looks at the activities of its employees and/or customers.

The institution then assigns each of the SINAA elements for the loan group to the state where the greatest activities occur.

Once each of the SINAA elements for a loan group have been assigned to the location where the activities occur, then the loan group is sourced to the state in which the greatest number of SINAA elements are assigned.

Appendix A

Current Property Factor Language

Section 4. Property Factor.

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

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

(c) Value of property owned by the taxpayer.

- (1) The value of real property and tangible personal property owned by the taxpayer is the original cost or other basis of such property for Federal income tax purposes without regard to depletion, depreciation or amortization.
- (2) Loans are valued at their outstanding principal balance, without regard to any reserve for bad debts. If a loan is charged-off in whole or in part for Federal income tax purposes, the portion of the loan charged off is not outstanding. A specifically allocated reserve established pursuant to regulatory or financial accounting guidelines which is treated as charged-off for Federal income tax purposes shall be treated as charged-off for purposes of this section.
- (3) Credit card receivables are valued at their outstanding principal balance, without regard to any reserve for bad debts. If a credit card receivable is charged-off in whole or in part for Federal income tax purposes, the portion of the receivable charged-off is not outstanding.

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

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

- (1) The average value of real property and tangible personal property that the taxpayer has rented from another and which is not treated as property owned by the taxpayer for Federal income tax purposes, shall be determined annually by multiplying the gross rents payable during the taxable year by eight.
- (2) Where the use of the general method described in this subsection results in inaccurate valuations of rented property, any other method which properly reflects the value may be adopted by the [State Tax Administrator] or by the taxpayer when approved in writing by the [State Tax Administrator]. Once approved, such other method of valuation must be used on all subsequent returns unless the taxpayer receives prior approval from the [State Tax Administrator] or the [State Tax Administrator] requires a different method of valuation.

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

- (1) Except as described in paragraph (2) of this subsection, real property and tangible personal property owned by or rented to the taxpayer is considered to be located within this state if it is physically located, situated or used within this state.
- (2) Transportation property is included in the numerator of the property factor to the extent that the property is used in this state. The extent an aircraft will be deemed to be used in this state and the amount of value that is to be included in the numerator of this state's property factor is determined by multiplying the average value of the aircraft by a fraction, the numerator of which is the number of landings of the aircraft in this state and the denominator of which is the total number of landings of the aircraft everywhere. If the extent of the use of any transportation property within this state cannot be determined, then the property will be deemed to be used wholly in the state in which the property has its principal base of operations. A motor vehicle will be deemed to be used wholly in the state in which it is registered.

(g) Location of loans.

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

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

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

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

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

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

(2) In the case of a loan which is assigned by the taxpayer to a place without this state which is not a regular place of business, it shall be presumed, subject to rebuttal by the taxpayer on a showing supported by the preponderance of evidence, that the preponderance of substantive contacts regarding the loan occurred within this state if, at the time the loan was made the taxpayer's commercial domicile, as defined by subsection (c) of Section 2, was within this state.

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

(A) *Solicitation.* Solicitation is either active or passive. Active solicitation

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

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

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

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

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

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

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