

MTC APPORTIONMENT AND ALLOCATION RULES FOR FINANCIAL INSTITUTIONS

On the July 8, 2008 definitions working group conference call, states were asked to submit written comments outlining the issues that each state would encounter if they were to adopt the MTC's model regulations for financial institutions in their entirety. Below is New York's analysis of the model regulations.

SECTION 1: APPORTIONMENT AND ALLOCATION

- Financial institutions whose business activity is taxable both within and without the state apportion business income using an apportionment percentage. Nonbusiness income is allocated pursuant to the individual state's statutes.
- The apportionment percentage is a three factor formula of receipts, property, and payroll weighted equally.
- Allows the taxpayer to petition for or the Tax Administrator to require certain actions be taken if the apportionment does not fairly represent activity in the state.

New York's treatment of allocation and apportionment is different in some respects. The three-factor formula as defined by the MTC is no longer used by any financial institution in New York. Banks, many of their 65 percent or more owned subsidiaries, and often their parent holding companies, use a three-factor formula that differs from the one used by the MTC in that it utilizes a deposits factor in lieu of a property factor. Other financial companies, such as broker dealers, taxed as general business corporations under Article 9-A use a single receipts factor. Banks also must be doing business outside the state to have the right to allocate. It would be a significant change in policy to adopt a uniform apportionment formula for financial institutions.

The rule for non-business income would not cause any difficulty for financial institutions taxed as general businesses as we would have it reference our rules for investment income and the investment allocation percentage. However, it could create problems for banks since New York treats all bank income as business income. Therefore, we would have to create new rules for nonbusiness income of banks. New York currently has in its law the same type of discretionary adjustment provided by the MTC.

The New York receipts factor sources receipts to New York if the greater portion of income producing activity, with respect to the loan that generates income, occurred in New York. The MTC receipts factor on the other hand uses customer location to source similar income. Therefore, the New York receipts factor is more akin to the MTC property factor than the MTC receipts factor.

International Banking Facilities (IBFs) – New York has special rules providing preferential treatment for banks that own IBFs located in the state. A bank with a New York IBF may choose to either exclude the IBF's wages, receipts, and deposits from the numerator of its apportionment formula, or deduct from its taxable income the income of the IBF, in which case the IBF is taken out of the apportionment formula altogether. The MTC apportionment formula does not provide any preferential treatment for IBFs.

SECTION 2: DEFINITIONS

- Provides a definition for nearly all relevant terms referenced in the apportionment scheme. Allows states to create their own definition of financial institution. Provides a standard definition to be used as a starting point (Appendix A).

New York has definitional issues regarding our own dual tax structure, as outlined in our prior submission to the group, imposed on financial institutions, and adopting the MTC's definitions would likely not solve these issues. Most of the entities included in the MTC's definition are also included in New York's definition of a banking corporation. However, the MTC definition explicitly excludes certain types of companies such as real estate brokers and securities dealers. Adopting the MTC definitions would not simplify our situation, as New York already taxes these types of other financial companies separately under a different tax article. Additionally, neither the regulations for financial institutions or general businesses create sourcing rules for income specific to these types of entities. Therefore, the lack of directive may cause income to be inconsistently sourced.

Like the MTC, New York's definition of a bank includes a corporation owned by a bank or bank holding company, but our ownership threshold is 65% while the MTC's is 50%. We feel that this provision, because it is similar to New York's, would lead to the same issues we have seen in our own law regarding tax article classification. In addition, New York varies slightly from the MTC since we exempt state credit unions from any corporate tax, and the MTC does not call for their uniform exemption from taxation. It is also unclear how REMICs, REITs, and RICs are taxed under the MTC rules, and whether they currently fall within the definition of a financial institution. Currently New York requires captive REITs & RICs to file a combined return with their closest controlling stockholder.

SECTION 3: RECEIPTS FACTOR

- **Receipts from the lease, rental, or sublease of real property located within the state.** Receipts are included if the property is located in the state.

New York includes these receipts in the receipts factor and sources them the same way as the MTC. We have not encountered any problems with this provision.

- **Receipts from the lease of tangible personal property.** Includes property that is located within the state when it is first placed in service by lessee. Provides that the lease or rental of transportation property is included to the extent that the property is used in the state. If extent of use cannot be determined, then it will be wholly sourced to the state in which it has its principal base of operations. Specifies that motor vehicles are used wholly in the state they are registered. Provides special rules for aircraft.

Aside from transportation property, New York includes these receipts in the receipts factor and sources them the same way as the MTC. New York has no special rules for transportation property owned or leased by a financial institution, sourcing it the same as other tangible personal property. The MTC rule would not appear to present any problem.

- **Interest from loans secured by real property**
If located in more than one state, then include if more than 50% of fair market value of property is located within the state. If more than 50% of fair market value is not located in any one state, then include if the borrower is located in the state.

- **Interest from loans not secured by real property.** Included if the borrower is located in the state. Location is defined as commercial domicile for borrowers engaged in a trade or business and billing address for borrowers not engaged in a trade of business.
- **Net gains from the sale of loans.** The amount of net gains from the sale of loans secured by real property or not secured by real property is calculated based on the proportion of interest allocable to the state from the loans.
- **Receipts from credit card receivables.** Interest and fees are included if the billing address of the card holder is in the state.
- **Net gains from the sale of credit card receivables.** The amount of net gains included is based on the proportion of credit card receivables allocable to the state.
- **Credit card issuer's reimbursement fees.** The amount of reimbursement fees included is based on the proportion of credit card receivables allocable to the state.
- **Loan servicing fees.** The fees are sourced the same as net gains from the sale of loans. Provides that in cases where the taxpayer receives fees for servicing secured or unsecured loans of another, fees are included if the borrower is located in the state.

The MTC's market state approach to sourcing loan and credit card receipts would work well for New York. New York has already moved in this direction with our recent legislation regarding credit card companies.

- **Receipts from merchant discount.** Included if the commercial domicile of the merchant is in the state. The receipts are net of any cardholder charge backs.

New York sources merchant discount to the location of the merchant. This is at odds with the method preferred by the MTC as well as the recent industry proposal to use customer location as a proxy for merchant location. These issues have been discussed at length by the receipts work group. New York has not seen any significant problems with sourcing to the merchant location since the rule has been in effect, and we believe it is a more accurate sourcing method than either commercial domicile or customer location.

- **Receipts from services.** Included if the service is performed in the state. If services are provided within and without the state, then included if a greater portion of income-producing activity is performed in the state based on cost of performance.

New York generally sources receipts from services to New York if the services are performed in New York. In addition, a bank or Article 9-A company that provides services to a regulated investment company (RIC) must allocate the receipts from these services based on the domicile of the shareholders of the RIC. This approach is based on the theory that the services are for the benefit of the shareholders, which are the customers in this instance, and the services are allocated based on where the customers are located.

- **Receipts from investment assets and activities and trading assets and activities.**
 - Interest, dividends, net gains, and other income from investment and trading assets and activities are included. The amount attributable to investment assets and activities is determined based on the proportion of the average value of such assets that are properly assigned to a regular place of business of the taxpayer within this state.

- Specifies that the amount by which interest from federal funds sold and securities purchased under resale agreements exceeds the interest expense shall be included. The amount attributable to the state is determined based on the proportion of the average value of federal funds sold and securities purchased under agreements to resell which are properly assigned to a place of business in the state.
- Specifies that the amount by which interest, dividends, gains, and other income from trading assets and activities exceeds the amounts paid in lieu of interest and dividends, and losses from such assets and activities shall be included. The amount attributable to the state is determined based on the proportion of the average value of such trading assets which are properly assigned to a regular place of business of the taxpayer within the state.
- The rules provide that a taxpayer may elect or the Tax Administrator may require the taxpayer to substitute gross income for average value in the allocation rules.

New York includes these receipts in the receipts factor and sources them the same way. We do not have the alternative method of using gross income instead of average value. Based on the wording of the rule, we do not think adding this alternative would present a problem, as long as the Department can maintain discretionary authority to prevent distortion of tax liability.

- **All other receipts.** No uniform provision-allows states to determine.

This would not be a problem. New York has a similar rule for all other business receipts. We also have a separate method for the allocation of royalties received by banks, based on the location of the taxpayer's actual seat of management or control, which would presumably be included in this category under the MTC rule.

- **Attribution to certain receipts to commercial domicile.** The MTC rules provide a throwback rule for taxpayers whose commercial domicile is in the state.

This provision would present a problem since New York has no throwback (or throwout) rule under either article. Adopting one would be a major change in policy that could encounter significant opposition.

SECTION 4: PROPERTY FACTOR

- **General.** Include average value of real property and tangible personal property rented to the taxpayer or owned by the taxpayer that is located or used within the state and the average value of the taxpayer's loans and credit card receivables that are located within the state.

Financial institutions taxed under Article 9-A currently apportion their income based solely on receipts, while banks use a deposits factor in lieu of the traditional property factor. It would therefore be a big change for all taxpayers concerned to adopt the MTC's property factor. It would be a huge change for banks, which have always used a factor solely based on deposits in lieu of a traditional property factor. However, the deposits factor may not be the best or fairest way to represent the property of a bank, and the MTC's rules may offer an improvement over our current law. For securities broker/dealers taxable as general business corporations under Article 9-A, the MTC property factor would be similar in several respects to the property factor that used to be present in Article 9-A.

- **Property Included.** Include only income or expenses which are included in the computation of the apportionable income base.
- **Value of Property Owned by the Taxpayer.** Value of real property and tangible personal property is the original cost or other basis for Federal tax purposes without depletion, depreciation, or amortization. Loans and credit cards are valued at outstanding balance, without regard to any reserve for bad debts. Provides that portions charged-off for Federal purposes are not considered outstanding.

Under the prior three factor formula for general corporations, taxpayers generally used the adjusted basis of the property for Federal tax purposes to value their property. Additionally, taxpayers were given the opportunity to make a one-time revocable election to value real and tangible personal property at the fair market value. Therefore, the MTC provisions would be inconsistent to past practices of the Department.

- **Average Value of Property Owned by the Taxpayer.** Average value is determined on an annual basis. Allows for more frequent valuation if the method does not properly reflect the average value.

When New York used a property factor for financial institutions taxed as general business corporations, these entities generally computed their average on a quarterly basis. Since the MTC regulations allow for more frequent valuation, this would not seem to present a significant problem for New York.

- **Average Value of Real Property and Tangible Personal Property Rented to the Taxpayer.** Average value of property rented by the taxpayer that is not treated as owned by the taxpayer for Federal tax purposes is calculated annually by multiplying the gross rents by eight. Allows for another method to be used if the method results in inaccurate valuation.

New York used the same method to annualize rents for tax reporting purposes. Therefore, this rule would not present a problem for New York.

- **Location of Real Property and Tangible Personal Property Owned by or Rented to the Taxpayer.** Considered to be located in the state if it is physically located, situated, or used within the state. Provides the same provisions for transportation property as under the receipts factor.

As with the receipts factor, New York did not have special rules for transportation property owned or leased by a financial institution, sourcing it the same as other tangible personal property. The MTC rule would not appear to present any problem.

- **Location of Loans.** Considered to be located in the state if properly assigned to a regular place of business of the taxpayer within the state based on a preponderance of substantial contacts. The burden is on the state to rebut the assignment of a loan outside of the state. To determine the state in which the preponderance of substantive contacts occurred, facts and circumstances shall be reviewed on a case by case basis with consideration given for solicitation, investigation, negotiation, approval, and administration (SINAA method).

Our comments on this provision are under the location of credit card receivables provision.

- **Location of Credit Card Receivables.** Treated as loans and sourced by the same method.

Since financial institutions in New York do not utilize a property factor but do utilize a receipts factor, income from loans and credit card receivables are only included in the receipts factor. Implementing a property factor to represent additional income from these sources would be a change for New York. It would effectively mean these intangible assets were being counted twice, as both property and receipts.

The MTC rules would make it easier for a bank in New York to source a loan outside the state. The MTC rules look to see if a loan sourced outside the state is sourced to a regular place of business, and it is presumed that the taxpayer sourced the loan correctly unless the state can prove otherwise. For comparison, New York's current rule for sourcing income from loans and financing leases for purposes of the receipts factor is not a blanket provision. Instead the statute looks to see if the loan is sourced to a branch before it determines the party on which the burden of proof is placed. If it is sourced to a branch, the burden is with the state, and if not sourced to a branch the burden is with the taxpayer. Presumption of proper sourcing may be rebutted by showing where the greater portion of income-producing activity occurred.

The MTC rules also provide that a state use the SINAA model to rebut the presumption that a taxpayer has sourced a loan incorrectly. New York also uses SINAA to determine the source of income-producing activity for the sourcing of loans in the receipts factor. However, the group has acknowledged that the SINAA model has become outdated, especially with the increased use of automated processes to conduct the work traditionally done by bank employees. Moving forward, the group should amend the model to reflect the changes in technology.

- **Period for which properly assigned loan remains assigned.** Once properly assigned to a state, absent any material changes, the loan shall remain assigned to that state for the original term of the loan. After such period, the loan can be assigned to another state if the loan has substantial contact to a regular place of business to the state.

New York used a similar rule for the period of assignment for the property factor. Therefore, this provision does not seem to present a conflict for New York.

SECTION 5: PAYROLL FACTOR

- **General.** The payroll factor is the total amount of compensation paid in this state divided by total amount of compensation paid both within and without the state.
- **Compensation Relating to Nonbusiness Income and Independent Contractors.** Excluded from payroll is any compensation of any employee for services/activities which are connected with the production of nonbusiness income and payments made to any independent contractor or other person not classified as an employee.
- **When compensation paid in this state.** To determine if paid in state, one of the following tests must be met (a) Employee's services are performed entirely in the state; (b) services are within and without the state, but service without the state is incidental to the service within the state; (c) if services are within and without the state, compensation

attributable (i) if employee's principal base of operations is within the state, or (ii) if no principal base exists, the place from which the services are directed or controlled is in the state, (iii) if no principal base exists and place from which services are directed or controlled are not in any state, the employee's residence is in this state.

New York's wage factor has some important differences with the MTC payroll factor. New York provides that the numerator of the wage factor is discounted by 20% for banks, with the result that the wage factor cannot exceed 80%. The practical effect of this provision is to give multistate banks an added bonus, while allowing smaller in-state banks to receive the benefit of apportionment, even if they have no business outside the state. New York has also traditionally excluded from the wage factor compensation of general executive officers with company-wide authority. New York adopted this provision to encourage corporations to locate their headquarters in the state. In addition, as pointed out above, other financial companies taxed under Article 9-A now use a single receipts factor.