Financial **I**nstitutions **S**tate **T**ax Coalition

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Property Factor

Sourcing of Loans in the Property Factor was meant to have a Production State Focus

We believe the current apportionment provision represent a balanced-compromise between the loan production states, the market-states, and industry.

A review of the MTC Hearing Officer's Report and supporting records indicate that the issue of sourcing loans on a market-based approach was thoroughly discussed during the development of the original provision in a balanced format including money-center states and market states and industry and was discarded in favor of the current sourcing provision, which was meant to have a production state focus.[1] In addition, there were several alternatives that were discussed during the development of the original apportionment provision which also were discarded in favor of the current provision.

The initial draft proposal of the regulation dated July 1987 would have provided a market focused approach to sourcing loans in the property factor -- loans secured by property would have been attributable to the state where the security property was located and unsecured loans would have been attributed to the borrower's resident state. (See Exhibit B:1, Final Report, Proceedings of the MTC Regarding Uniform Apportionment of Income earned from the Business of a Financial Institution.) However, after many years of working together to develop a fair and equitable apportionment provision, the market-states, production states and industry, discarded this market-based sourcing in exchange for the current rule, which clearly has a production state focus.

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[1] The goal of the SINAA activities is to reflect what happens at the loan "production" location; thus, we will refer to "production state. For clarification purposes, when we refer to production states we mean numerous states outside of the traditional loan production states such as New York and North Carolina. For purposes of a specific bank, a production state can include any state in which the institution has significant facilities where loan production functions are preformed. In addition, the separate subsidiaries within a financial group generally would have different states which would be considered to be their loan production state. For example, the loan production center for the mortgage subsidiary of a New York bank, likely is to be outside of New York. Similarly the loan production center of its leasing subsidiary likely is outside of New York and outside of the states in which the mortgage subsidiary's loan production center is located. "

The location of the loan production center for many of the separate businesses within a bank is the result of compromises during or after merger negotiations. For example, if a New York bank acquired a leasing company in Georgia, the loan production center of the leasing business typically would remain in Georgia. Similarly, if the New York bank acquired a mortgage company located in Maryland, the loan production center for the mortgage company typically remained in Maryland. It cannot be assumed that the loan production operations default to the headquarters of the acquirer or survivor legal entity without sufficient evidence to support such conclusion.

Applying a market-sourcing approach to source loans would have significantly increased the percentage of income apportioned to market states because both the receipts and the property factor would have been sourced to the market. Thus, having the effect of duplicating the receipts factor. (Note for many large financials, the total loans are substantially greater than the total owned and rented real and tangible property.) As noted in the May 5, 1989 letter to Alan Friedman from the South Dakota Department of Revenue, duplication of the elements between the receipts factor and the property factor (i.e., applying a market-sourcing or attribution to both factors) "'doubles' the effect of a large population and virtually eliminates any effect the property factor would have in reducing the distortion resulting from population dissimilarities."

Moreover, attributing the loans to the production state has the same impact as the application of the standard three-factor formula in a manufacturing situation where the plant and property are attributed to the state where they are located and the income is attributed to the location of the customers purchasing the product. In the context of a financial institution, the property (loans) is attributed to the state where the facility that created the property is located – the production state, while the income from the loan is assigned to the states of the borrower-customers – the market state.

As noted above, a property factor that includes intangible property sourced similarly to the way receipts are sourced would have created an overweighting of factors to the market state. Among the alternatives mentioned during the development of the MTC apportionment provisions to solve this overweighting, were to eliminate the receipts or property factor, or double weight the payroll factor. These alternatives that were discarded in favor of the current provision.

We believe that 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 Focus. 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.

Similarly, the May 1993 Interim Hearing Officer's Report provides accolades of the collective effort of the parties and the clear "compromise" that was reached between the production states and the market-states. Since the sales factor sources the largest components of a financial organization's income (interest, fees in the nature of interest, and gain on the sale of loans) to the market state, there would NOT have been the clear compromise noted in the Hearing Officer's report if the loans also were intended to be sourced to the market state.

Issues with SINAA Application Voiced by the States

Under the MTC financial organization apportionment provision, loans are sourced to the states based on where the preponderance of substantive contacts relating to a loan has occurred, based on the following activities: solicitation, investigation, negotiation, approval and administration of the loan (these activities generally are referred to as SINAA".

Based on a property factor subcommittee call, it is our understanding that the states noted the following two areas where clarity might be needed in the application of SINAA in sourcing loans.

- Whether there is a Negotiation activity for credit cards and, if not, how to weigh the remaining four factors if there is a tie among the states.

- In the case of loans acquired via the internet, to which state the Investigation and Approval activities should be attributed when they have been automated via elaborate software and information technologies embedded with sophisticated company specific loan approval polices.

Is there Negotiation Activity for Credit Cards, and if not, how to Weigh Remaining Factors

In situations where the customer is not able to negotiate the rate or fees on a card credit, the negotiation element of SINAA could be removed in determining the preponderance of substantive contacts. Only in cases in which there would otherwise be a tie among the states in determining in which state to include the credit card receivables in the numerator of the property factor, than (and only then), the administration element should be accorded greater weight than the other factors, because administration requires more on-going and frequent contact with the customer, than do the other 3 factors.

Attribution of Investigation and Approval in Highly-Automated Systems

The investigation and approval facets in highly automated systems should be attributed to the state in which the greatest cost of the activity occurs. The investigation and approval facets are occurring on all loans, and the mere fact that some elements are automated, rather painstakingly done by employees, should not discount the weight of these two activities. Contrary to what some might think - automation does not result in no or little cost.

We currently are in the process of determining the relevant costs that are incurred in these activities and thus should be taken into consideration.