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

February 23, 2009

COMMENTS RELATING TO STATES' CONCEPTUAL POLICY GOALS FOR FINANCIAL INSTITUTION APPORTIONMENT DATED FEBRUARY 2, 2009 (SEE APPENDIX A)

GENERAL COMMENTS

Maintain Focus on the Goals of Original Model Apportionment Drafters

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.

We believe that these three facets are critical and thus should remain the goals of any revisions made to the model apportionment provision. While we recognize the states' rights to adopt different apportionment formulas, the overall goal of any revisions to the MTC model financial organization apportionment provision should be to retain a high level of uniformity.

Currently, there are approximately 20 states that have adopted apportionment provisions similar to the MTC model. We believe that no revisions should be considered that cannot likely achieve actual adoption in a majority of the states. Adoption by only a few states of the approximately 20 states would create an environment that is less consistent and uniform than exists today.

We also would like to note that as a result of the complexities and competing interests between the states and industry as well as among the states, the completion of the original MTC financial organization apportionment provision took more than 5 years and covers numerous binders of memos/comments. Thus, it is unrealistic to expect a well thought out major rewrite to be completed in 3-6 months.

Foundation of Compromise

As we consider any proposed changes, we are mindful that the element of compromise of the original drafters is woven throughout the foundation of the model as it operates today. The May 1993 Interim Hearing Officer's Report applauds the collective effort of the parties and the clear "compromise" that was reached between the production states and the market-states. Based on the Hearing Officer's report and supporting documents, it is clear that the model apportionment provisions were largely founded on that compromise. We believe any change to that balance should be carefully weighed before it is considered.

The Final Hearing Officer's Report on the Financial Institution Apportionment Regulation and accompanying documents made it clear that there was significant struggle between the market and headquartered states regarding sourcing of the apportionment factors – which the Hearing Officer referred to as "factorlock" (see for example Exhibit H3 of the Final Report).

Moreover, as noted in the Hearing Officer's Report:

> The basic purpose of this effort – the achievement of a fair, administrable and uniform apportionment methodology – will be ***greatly undermined should states modify, in any substantial manner, the attribution or factor*** weighting rules that are suggested by a uniform apportionment method. ***(Emphasis Added)*** . . .

Service Income Should be Same as for General Corporations

We strongly believe that service fee income earned by a financial organization should be sourced in the same manner as like income under the states' general business corporation apportionment provisions. We find no compelling reason why such income earned by a financial organization should be sourced differently than if the income is earned by a corporation not classified as a financial organization.

Moreover, as is easily recognizable from reading the front pages of all major newspapers or tuning in to any news channel, the financial services industry is not in the financial condition to expect them to incur significant costs in order to compute a change in policy of how a small percentage of income is sourced among the states. The resources within the industry need to be focused on stabilizing financial conditions and the market – not on complying with a new way to divide up a small percentage of income among the states.

In addition, as noted in the economic information distribution by Elliott Dubin, more than 70% of the income for traditional financial institutions is derived from interest and prior to the last year or so gains on sale of loans, both of which already are market-sourced under the current MTC apportionment provision. Accordingly, financial organizations already apply market sourcing to a large portion of their incomes – which is substantially more than other industries in most MTC states.

SPECIFIC COMMENTS

Merchant Discount Income

The states' conceptual policy related to the sourcing of merchant discount would be to either: source the discount to the location of the merchant or to throwout the receipts out of the receipts factor. As noted in calls during the summer, for the institutions involved in these discussions, information regarding the location of the merchant is not available. For some institutions we believe that information regarding the name of the retailer may be available, but not the location of the specific store from which the sale occurs (e.g., a credit card statement might know a purchase was made at XYZ Department Store # 221, but the credit card company would not know in which state store #221 is located). Moreover, for some financials, the merchant discount related to Big Box retailers are attributed to a central location, rather than to individual store locations. If the states have information identifying that store location information is readily available to the majority of institutions receiving merchant discount, please provide us with the source of that data.

Otherwise, we thought we had clearly and carefully covered a practical, simplified method of sourcing merchant discount this summer. See Appendix B with industry's comments as to the difficulty in complying with the current sourcing rule and providing an administratable, practical solution. Please note that a market-sourcing approach is applied in the industry suggested solution.

Trust Related Services

The states' conceptual policy document provides a list of options for sourcing trust related services. Options a through e would be very time-consuming and costly to implement and complex to administer. Thus, we believe all of those options would be unreasonably difficult to comply with. Option f – ratio of deposits – has no relation to the generation of trust-related services and accordingly would be inappropriate to use.

Trust/Fiduciary Fees should be Sourced the Same as Services under State's General Business Corporation Approach

For the reasons noted below, we strongly believe that changing the sourcing of trust and investment management fees provided by financial organizations is NOT justifiable.

Assuming our memory is correct, Shirley Sicilian mentioned on one of the July conference calls that under the MTC's general approach to special industry apportionment provisions, the industry specific income is specially sourced and then the other income is sourced in the same manner as like income under the state's general business corporation apportionment provisions. This is consistent with the MTC model financial organization apportionment provisions – interest and fees in the nature of interest are market sourced, while service income is sourced by applying the greater cost of performance provisions which is the same receipts factor sourcing provision that would apply to service income earned by general corporations. As noted, in the next paragraph this is exactly what the drafters of the 1994 MTC model provision concluded was the appropriate approach that should be taken.

As Oregon noted on an earlier call, the early draft of the MTC financial organization apportionment provision would have applied a market sourcing for trust service fees. As noted in the summary of the March 1992 meeting of the state-industry work group, that is included in the supporting documents to the MTC Hearing Officer's Report:

> With regard to other services, such as trust services, merger and acquisition advisory services, economic forecasting, data processing, transfer agency services, payment of municipal bond interest through banking services, and the like, the same issues exist as to where the services were performed v. where the customer is located or the services consumed issues were raised and left undecided. The group agreed that states should use the same receipts situsing rules for these service fees as they use for general business corporations. It is noted that, absent any special rule adopted to the

contrary, UDITPA would situs such services to the state in which the majority of the cost of performance of the service were incurred. See, UDITPA, Section 17.

We do not believe there is any compelling reason why service fee income earned by a financial organization should be sourced in a manner that is different from how a general corporation sources its fee income.

Moreover, changing the sourcing of trust fees only for corporations that fall within the financial organization definition, while allowing a different sourcing scheme for similar services provided by a general corporation creates an un-level playing field. For example, if the trust department of a financial institution prepares trust tax returns for a fee, then those fees should be sourced in the same way as the fees would be sourced if the return was prepared by an accounting or law firm. Accordingly, if such income is sourced applying a greater cost of performance standard for the accounting firm, it should similarly be sourced based on a greater cost of performance standard for a financial institution.

Market Sourcing Under UDITPA should be Vetted in NCCUSL Study Group

As noted above, we agree with the drafters of the original MTC model financial organization apportionment provision that states should use the same receipts situsing rules for service fees as they use for general business corporations. We further believe that an in-depth analysis of market versus greater cost of performance sourcing for service income should be appropriately vetted in the NCCUSL study committee forum in conjunction with other discussions related to UDITPA section 17. It is not appropriate to address in isolation for certain income components of financial organizations.

Magnitude of Fiduciary Income Has Not Increased

Based on the economic data provided by Elliott Dubin on one of our calls, the magnitude of fiduciary income in terms of the percentage of the financial industry's income has slightly decreased since the 1994 adoption of the MTC model financial organization apportionment provisions.

The data also showed that over this period of time more than 70% of the income of the financial organizations included in that base data was derived from interest income, which is market sourced under the MTC apportionment. Note, loan servicing fees also are market sourced under the MTC model, but that component of income does not appear to have been specifically identified in the data provided by Mr. Dubin.

Accordingly, we do not believe that the circumstances have changed since the 1994 adoption that would validate a change to the balance of the apportionment compromises reached by the states and industry in the drafting of the current model apportionment provision.

If the MTC were to adopt a market sourcing rule for trust services, services that have been sourced to where such a service is performed since the adoption of the financial institution apportionment provisions in 1994, it will result in double taxation immediately. For example, trust services performed in New York will be represented in the New York sales factor at 100%, and then also would be included in MTC states based on market sourcing.

In the same fashion as those states that participated in the drafting of the 1994 model apportionment provision, we believe that the states participating in any revisions should be focused on identifying the uniform single manner in which a component of income should be sourced – i.e., compromising on the how the income component should be sourced – rather than on how more than one state can source the same component of income.

We strongly believe that before any suggested revision to the model apportionment provisions more forward, the state-industry working group should agree that the change is fair in approach, administrable, will be adopted and applied consistently in a majority of states and retains the production state/market state compromise balance.

Any Changes to Market-Source for Components of Income Require Safeguards to Not Source More than 100% of Income

If revisions to the current apportionment model result in additional streams of income being market sourced, some mechanism should be adopted to protect financial institutions from sourcing more than 100% of those types of receipts resulting from some states adopting a market sourcing approach, while others retain the greater of cost of performance approach. For example, the revision language could provide that any income that already is included in the numerators of other states based on a cost of performance standard, can NOT be market-sourced.

Incidental Receipts Should NOT be Changed to Market Sourcing

To maintain the "administrable" goal of the original apportionment provision, receipts that are incidental for the majority of financial institutions should not be changed to market sourcing. Incidental receipts might be defined as those that generally comprise less than 2% of gross receipts for the majority of financials.

100% of Business Receipts should be Included in Receipts Factor

We strongly believe that all business receipts should be included in the receipts factor.

Activity Based Sourcing of Income

Income that typically is minor for the industry should be sourced the same way as it is for non-financial institutions. For example, if the trust department of a financial institution prepares trust tax returns for a fee, then those fees should be sourced in the same way as if prepared by a local accounting or law firm. Accordingly, if such income is sourced applying a cost of performance standard for the accounting firm, it should similarly be sourced based on a cost of performance standard for a financial institution.

However, an in-depth analysis of activity based sourcing of income should be appropriately vetted in the NCCUSL study committee forum in conjunction with other discussions related to UDITPA section 17. It is not appropriate for just one industry to attempt to address in isolation.

Generally, Determining SINAA based on Cost has Merit

As discussed on the August call, while there are a significant number of details that need to be thought through and worked out (especially the definition of costs), overall we believe that California's proposal to determine SINAA based on costs generally has merit.

Our initial comments/concerns on the proposal include:

- The loan class language included in (g)(1)(A) should be expanded by providing more examples of other grouping methodologies and include language to make sure that other groupings are acceptable, for instance as mentioned on the call, groupings by origination channel (e.g., branch, phone bank, internet).

- Once we better define possible grouping methodologies, the (g)(1)(A) phrase "consistent with the method of tracking loans within the taxpayer's own books and records" will need to be tweaked to ensure that it is not limited to general ledger and/or financial statements since such groupings don't always coincide with how the taxpayer's business is structured and therefore don't necessarily facilitate the required analysis. For example, for SEC financial statements, all mortgage loans might be combined into a single amount, rather than by origination channel (e.g., branch, phone bank, internet).

- Currently, the MTC model includes a presumption that the taxpayer has properly assigned the loans. We believe a similar provision should be included regarding the grouping of loans by the taxpayer to ensure that the states can not easily attempt to re-group the taxpayer's loans to increase the amount of loans included in the numerator of the property factor. Such language could provide that the taxpayer's loan groupings will be presumed to have been properly determined if the taxpayer applies the grouping consistently from year to year unless there has been a material change of facts. In addition, once the language in the bullet point immediately above is worked out, such language could be worked into this provision.

- The component that will need the greatest amount of work will be in defining which costs should be taken into consideration in determining the costs associated with each SINAA activity for the groups of loans. We believe that including the by-state costs of unrelated third parties would overly complicate what already could be a very complex and time consuming calculation. Thus, we believe that the definition of costs should exclude costs of unrelated third parties.

- As discussed on the August conference call, section (j)(1) Period of Loan Assignment when Loans sold within a Controlled Group should be modified to provide that there is a rebuttable presumption that a sale of loans within the same controlled group of corporations shall not by itself constitute a material change of facts.

Moreover, since the majority of a financial institution's business is taking deposits and making loans of various types, trying to define an entity as a financial institution because it derives more than 50% of its income from services or activities that a traditional financial institution might derive as incidental income could easily create an illogical result. For example, should a law firm that specializes in trust-related work be treated as a financial organization because more than 50% of its gross receipts are derived from trust services? Or an accounting firm that specializes in wealth management?

APPENDIX A
STATES' CONCEPTUAL POLICY GOALS FOR FINANCIAL INSTITUTION APPORTIONMENT - FEBRUARY 2, 2009

I. Retain three factor model, rather than move to single sales factor model

II. Sales factor: Overarching goal – reflect the market

A. ATM fees §3(c) – location of ATMs.

B. Merchant Discount §3(j) – location of merchant

C. Receipts from banks own investment and trading assets and activities §3(m) – clarify this rule applies to the bank's own assets and activities.

D. Receipts from investment and trading assets and activities on behalf of 3^{rd} Party (trust accounts) new § –

1. Overarching goal – reflect market, unless too easily manipulable or unreasonably difficult for banks to comply.

2. List of Acceptable Options for the Sourcing Rule:
   a. location of trust assets
   b. location where trust formed
   c. location of trustee
   d. location of trustor
   e. location of beneficiaries, or
   f. a share of total trust account receipts equal to the ratio of deposits in the state to total deposits of the institution

E. Other? Are there other types of receipts, not covered under the current rule, that generally make up a large enough portion of total receipts to justify specified numerator sourcing? (RICs and REMICs, will be dealt with at end of project.)

F. Non-specified receipts, §§3(l) and (n), and specified receipts that fall below a certain percentage of total receipts –

1. Not included in the apportionment factor, or
2. Included in same proportion as all other receipts

III. Property factor: Overarching goal – not trying to recreate the 1994 apportionment outcome (source to particular states), rather trying to recreate the 1994 policy (source to location of loan activity).

A. Location of Loans §4(g) – Clarify sourcing using California's proposal dated 8/25/08.

B. Material Change §4(i) - Clarify “material change” using California’s proposal dated 8/25/08

IV. Definitions: Overarching goal – retain focus on financial Institution (rather than financial activity) and add other specified institutions that are heavily engaged in financial activity.

   A. Retain appendix A

   B. Add investment banks, if not already included

   C. Are there other types of institutions that should be added?

APPENDIX B

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

Proposed Merchant Discount Receipts Sourcing Proxy
June 23, 2008

The current MTC provision for sourcing receipts from merchant discounts is as follows:

> (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.

Based on discussions with a number of financial institutions, sourcing merchant discount to the commercial domicile of the merchant is difficult and often impossible to do for most financial institutions. However, since the population of entities we have talked to is relatively small and we do not believe that a change to sourcing merchant discount income should be required if the organization underwent laborious programming changes to comply with the sourcing provision, we strongly believe that any change should permit the user to continue to use the prior method if its system can obtain that information. Of our current Financial Institution State Tax group, very few of our members have been able to modify their systems in order to obtain the commercial domicile of the merchant. However, for those that have made such a laborious change to comply with the law, they should not be penalized and prohibited from using that approach. We also understand that some merchant banks might have information regarding the location of merchant readily available, and in such cases use of merchant location may be appropriate.

Nevertheless, as noted above, such information is not available to many financial institutions and thus a proxy tied to credit card interest income, similar to that in use for apportioning credit card issuer's reimbursement fees, would be an easily administrable means of sourcing the merchant discount and would result in "market sourcing" these receipts. We do not believe that using this proxy would provide a materially different result from sourcing based on merchant location and will give the states that adopt the MTC financial apportionment provisions a market state result. We recognize that a sourcing methodology that is impossible or at best administratively burdensome is counter to industry's and the states' goals of having an apportionment provision that is fair in approach, administrable and uniformly adopted by a large number of states.

The current MTC provisions for sourcing credit card issuer's reimbursement fees are as follows:

> (i) **Credit card issuer's reimbursement fees**. The numerator of the receipts factor includes all credit card issuer's reimbursement fees multiplied by a fraction, the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (g) of this section and the denominator of which is the taxpayer's total amount of interest and fees or penalties in the nature of interest from credit card receivables and fees charged to card holders.
>
> (g) **Receipts from credit card receivables.** The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from credit card receivables and receipts from fees charged to card holders, such as annual fees, if the billing address of the card holder is in this state.

Suggested change to sourcing of merchant discount:

REDLINE VERSION

(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.

(1) If the financial institution has readily available information regarding the commercial domicile or location of the merchant, then the numerator of the receipts factor includes receipts from merchant discount if the commercial domicile or location of the merchant is in this state.

(2) If the financial institution does not have readily available information regarding the commercial domicile or location of the merchant, then the numerator of the receipts factor includes receipts from merchant discount multiplied by a fraction, the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (g) of this section and the denominator of which is the taxpayer's total amount of interest and fees or penalties in the nature of interest from credit card receivables and fees charged to card holders.

(3) The method used for sourcing merchant discount must be consistently applied in all states that have adopted provisions (1) and (2) above and also must be used on all subsequent returns unless the taxpayer receives prior permission from the State Tax Administrator to use a different method.

CLEAN VERSION

(j) **Receipts from merchant discount**. 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.

(1) If the financial institution has readily available information regarding the commercial domicile or location of the merchant, then the numerator of the receipts factor includes receipts from merchant discount if the commercial domicile or location of the merchant is in this state.

(2) If the financial institution does not have readily available information regarding the commercial domicile or location of the merchant, then the numerator of the receipts factor includes receipts from merchant discount multiplied by a fraction, the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (g) of this section and the denominator of which is the taxpayer's total amount of interest and fees or penalties in the nature of interest from credit card receivables and fees charged to card holders.

(3) The method used for sourcing merchant discount must be consistently applied in all states that have adopted provisions (1) and (2) above and also must be used on all subsequent returns unless the taxpayer receives prior permission from the State Tax Administrator to use a different method.