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

September 16, 2008

COMMENTS RELATING TO CALIFORNIA'S LOAN SOURCING PROPOSAL DATED AUGUST 25, 2008 AND OREGON'S PROPOSED TRUST FEE SOURCING DATED AUGUST 22, 2008

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.

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.

CALIFORNIA'S LOAN SOURCING PROPOSAL DATED AUGUST 25, 2008 (See Appendix A)

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.

OREGON'S PROPOSED TRUST FEE SOURCING DATED AUGUST 22, 2008 (See Appendix B)

Trust Fees do not belong in Section (m) of the MTC Model Apportionment Provision

Trust fees do not belong in Section (m), Receipts from Investment Assets and Activities and Trading Assets and Activities of the MTC model apportionment provision; thus, Alternatives I and III [which would include trust fees within the scope of section (m)] are NOT appropriate.

Section (m) is intended to cover the assets that are reflected in the Trading Assets and Liabilities section of a Call Report (i.e., as receipts resulting from the financial organization's trading and investment activities conducted on its own behalf). Moreover, as noted in the title to section (m), this section covers income earned from trading and investment "ASSETS" – the only trading and investment ASSETS are items owned by the financial organization. If a financial organization manages investments owned by a customer, the financial organization does not own the ASSETS and accordingly the fees for managing its customers' investments clearly would not fall into section (m). Fees for managing customers' investment assets are covered in Section (l), Receipts from Services.

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.

Discussions of States Selecting Different Sourcing Approaches was Disturbing

While we recognize the states' rights to adopt different apportionment formulas, we found the discussion on the August call that would result in double inclusion of trust income disturbing.

On the call, we mentioned that if revisions to the current apportionment model result in trust 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. Representatives from one or more states spoke up to said that the manner in which one state sources a component of income should not impact how another state sources that same type of income. While this is true, we do not share the view that double- or triple-taxation of the same income is something that should be sought after or encouraged, and indeed, it is inherently counter-productive to the goal of encouraging business development in the state. However, what wasn't mentioned was that unless all states participating on that call changed to uniformly market source such income, then more than 100% of the income from New York based financial organizations that provide trust services would be included in the numerator of the receipts factor.

It has been the long standing rule in New York and other traditional production center states that trust services are apportioned based on where the service is performed. As noted above, this receipts factor representation is true for all services, not just trust type services, and it is also the norm for most states, not just production center states. For example, accounting and legal services are not sourced based on market (where the service is received) but rather based on some type of cost of performance (where the service is performed). It is the exception for states to deviate from this treatment.

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.

APPENDIX A
CALIFORNIA'S LOAN SOURCING PROPOSAL DATED AUGUST 25, 2008

THIS IS A DRAFT FOR DISCUSSION PURPOSES AND DOES NOT NECESSARILY REPRESENT THE POSTION OF THE FRANCHISE TAX BOARD BUT ONLY REFLECTS THE OPINION OF THE AUTHOR.

(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)~~ (1) Loans shall be assigned to the state in which the preponderance of substantive contacts related to the loan occurred.

(A) To determine the preponderance of substantive contacts related to loans, loans may be grouped by classes of like instruments. For example, loans could be grouped as consumer loans, real property loans and commercial loans. The method of grouping should be consistent with the method of tracking loans within the taxpayer's own books and records. If a taxpayer cannot group loans together into classes, the preponderance of substantive contacts shall be determined on a loan by loan basis.

(B) To determine the state in which the preponderance of substantive contacts relating to ~~a~~ loans ~~have~~ has occurred, the facts and circumstances regarding the loans 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 loans.

(C) The determination of "preponderance of substantive contacts" shall be made by determining the costs associated with each activity for the loan or group of loans, by state. The state with the highest costs incurred will be the state to which the loans are assigned.

a. Example: Taxpayer makes commercial loans in states A,B, and C. The taxpayer has employees who solicit customers and negotiate loans with customers in all three states but the investigation, approval and administration of the loans all occurs in state A. The taxpayer determines that for the class of loans, it incurs costs of $5,000 for solicitation in each state, $3,000 for negotiations in each state and $10,000 in State A due to the approval and administration of the loans. The class of loans shall be assigned in full to State A as State A has the preponderance of substantive contacts as demonstrated by incurred costs of $18,000.

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) Special Rule for automated loans programs

If the substantive contacts are performed primarily through the use of automated systems, such as computerized investigation and approval processes, the loans shall be assigned to the location where these activities are undertaken by the bank.

1. Example. Taxpayer makes credit card loans to consumers in all 50 states. The process by which these cards are solicited is through the mail and the Internet. The process of approving the applications for the cards and administering the accounts all takes place utilizing a centralized computer system in State A. The loans will all be assigned to State A.
2. Example. Customers in State A pick up applications for the loans at their local branches and submit them back to local branches in State A. All substantive decisions regarding approval, investigation and administration of the loans are performed in State B. The loans are assigned to State B as the preponderance of substantive contacts occur in State B.

~~(h)~~ (i) **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 subsections (g) and (h) of this section.

~~(i)~~ (j) **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 contacts to a regular place of business there.

(1) The sale of a loan, or a pool of loans, to another entity that is within the same controlled group of corporations, as the seller shall not be considered as a material change of fact.

(2) For purposes of this subsection, "controlled group of corporations" means "controlled group of corporations" as defined in Section 1563(a) of the Internal Revenue Code , except that:

(a) "More than 50 percent" shall be substituted for "at least 80 percent" each place it appears in Section 1563(a)(1) of the Internal Revenue Code.

(b) The determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of Section 1563 of the Internal Revenue Code.

APPENDIX B

OREGON'S PROPOSED TRUST FEE SOURCING DATED AUGUST 22, 2008

I. Add a new subsection under Definitions:

> "Investment assets and activities and trading assets and activities" includes all such assets and activities whether the financial institution is acting in a fiduciary capacity (e.g., trustee) or otherwise."

II. Add a new subsection under "Section 3. Receipts Factor" to read as follows:

> "Receipts from trust and investment management activities. The numerator of the receipts factor includes fees and other receipts from trust services and investment management assets, activities, and services provided by a financial institution on behalf of its customers if the trustor, beneficiary, or investment client is located within this state as determined by the address provided to the financial institution for correspondence.

III. Revise (m) to add:

> "(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<u>, whether derived from activity as a fiduciary or otherwise,</u> shall be included in the receipts factor. * * *. [the underlined clause is the addition]

These proposals are "in the alternative," except the definition could be adopted with the revision to (m). And if II. is adopted, then some definition of trust, investment management, or other terms in the subsection might be useful.