Comments from Participating Financial Institutions Regarding Multistate Tax Commission Proposed Amendments to the Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions

When the July 2007 Multistate Tax Commission (MTC) Income/Franchise Tax Uniformity Committee agenda indicated that the committee would be reviewing the Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions ("MTC model industry apportionment provisions"), a group of financial institutions requested that they be allowed to participate in the process -- similar to the manner in which many of them had participated in the development of the original model industry apportionment provisions.

We appreciate the MTC accommodating our request and creating a state-industry working group, with participation being open not only to the requesting institutions, but to the entire industry and the public. Below are our comments on the process, the proposed amendments, and Wood Miller's May 8, 2014 letter to the MTC Executive Committee.

The Process

We valued being at the table during the review of the MTC model industry apportionment provisions. For the record, however, we believe it is important to note that after California FTB representatives discontinued participation, the "working group" qualities deteriorated considerably. Industry could make suggestions and raise issues, but had no vote or meaningful input in decisions that were made. More importantly, many of the participating states exhibited such a high distrust of taxpayers that the majority of our suggestions to make the provisions more administrable were quickly disregarded or rejected without meaningful discussion. There clearly was no give and take – nor could there have been when many of the participating states viewed every industry suggestion as a ploy to deceive the states and cheat them out of revenue. The resulting resistant and at times combative response from the state representatives made the industry representatives very hesitant to participate, and substantially decreased the collaborative effort of the group that had been working together to draft a solution that was acceptable to all parties. See for example, our January 2011 comments where we ask the states to re-focus on the goals and work with us rather than against us (copy attached).

The Proposed Amendments

Maintain Focus on the Goals of Original Model Apportionment Drafters

The overall goals of the original MTC model financial institution apportionment provision project were that the resulting model be:

1) fair in approach,
2) administrable, 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 MTC model industry apportionment provisions. While we recognize the states' rights to adopt different apportionment formulas, the overall goal of any revisions to the MTC model industry apportionment provision should be to retain a high level of uniformity. This, ostensibly, was the primary concern of the participating states: that taxpayers could avail themselves of benefits created by variability among states' apportionment methodologies. It strikes us as odd that the represented states are less concerned with uniformity and more concerned with complaining when taxpayers try to comply with the vast array of different laws if their application occasionally works out in some taxpayers' favor.

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 of the states would create an environment that is even less consistent and uniform than exists today. Accordingly, the proposed amended model industry apportionment provisions should be modified to require that the amendments not become effective in any state until <u>at least</u> 50% of the states that currently have similar apportionment provisions adopt the amendments.

Any Amendments to the Current Provisions Require Safeguards to Not Source More than 100% of Income

As noted above, approximately 20 states have adopted provisions similar to the MTC model statute. Proposed revisions to the current apportionment model result in additional streams of income being market sourced and call for the exclusion of loans from the property factor, which also will result in increasing the apportionment percentage for market states. Since these proposed amendments shift a greater percentage to market states and away from production states, it is likely that the market states will adopt the amendments, while the production states will NOT adopt the amendments.

Accordingly, the industry representatives are fearful that the model act, if changed as currently proposed, will result in multiple taxation of certain revenue streams because some states will source the receipts using a market approach, and others will deem the same receipts to be sourced to their state under a cost of performance approach – typically, the larger, money-center states, in which the banks have significant operations. This was the reason for the "compromise" reached in the initial model industry provisions, which recognized both the value of the market and of the operational infrastructure of the bank in generating income for the company. Industry has advocated for some sort of "safe harbor" that could be implemented to prevent this type of double tax situation, and we continue to believe that there should be a mechanism for it.

Incidental Receipts Should NOT be Changed to Market Sourcing

The costs of determining the "market" for numerous small revenue streams and then programing each account to reflect the determined market sourcing can be very costly – both for the taxpayer and for the state. The *de minimus* impact on the overall apportionment factor doesn't justify the cost.

Accordingly, to maintain the "administrable" goal of the model industry apportionment provision, incidental receipts that don't comprise more than some small percentage (1%, 2%, etc.) of total receipts should either be sourced using the current methodology or using the same percentage as all other receipts.

The Inverse of Uniformity is to Permit the States to Pick Among Options When the Desire for the Options is not Based on Administrative Costs or Incidental Amounts

The proposed amendments to the model industry apportionment provisions permit the states to select among two alternative options the manner in which receipts from services are sourced. According to the proposed amendments:

> [Note - States should choose one of the following two options for this section:
>
> > Alternative Option A. The numerator of the receipts factor includes receipts from services not otherwise apportioned under this section, which receipts shall be sourced in accordance with Reg. IV.17 of the Multistate Tax Commission Allocation and Apportionment Regulations, as amended.
> >
> > Alternative Option B. Delete this proposed Section 3 (m).]

The Merriam-Webster dictionary defines "uniformity" as: the quality or state of being the same; the quality or state of being uniform or identical. It is not a uniform rule if each state can pick the alternative that suits it. Except to facilitate ease of administration, a "model" act, predicated on the concept of uniformity, should not have multiple options.

Moreover, during our many working group conference calls, every time industry suggested giving taxpayers an option to make the apportionment provisions more administrable, the states were quick to object to the concept of options because taxpayers might pick the option that is most favorable to them. For the states to give themselves an option to source receipts from services is duplicitous. This option for services is not necessary for administrative purposes, and the receipts from services are not incidental (e.g., is not less than 2% of the total receipts for most financial organizations.)

Notwithstanding industry opposition, if Options A and B are retained, then it is important to note for the record that Option B above would delete the separate section (m) describing the sourcing of receipts from services, which then would source service receipts according to the "All Other Receipts" category [proposed amended section (o)], which would source receipts from services pursuant to specified other state rules and would NOT source receipts from services to the "Commercial Domicile" category [proposed amended section (p)] under which receipts that are not sourced to other states are thrown back to commercial domicile. The proposed amendments should be modified to clarify how receipts from services are sourced if a state selects Option B.

Bait and Switch?

For the record, we would like to express our disappointment with the participating states' complicity in shifting what had been the working group's property factor goal, after California FTB representatives discontinued their involvement in the working group.

Prior to the December 2012 working group conference call, the MTC Working Group had concluded and reported to the MTC Income/Franchise Tax Uniformity Subcommittee on many occasions that:

> **Property Factor: State and Industry Overarching Goal** – the intent is not to recreate the 1994 apportionment outcome of sourcing property to particular states. Rather, the intent is to attempt to maintain the 1994 policy of sourcing property to the location of loan activity.

Moreover, the property factor issues to be worked on were reported as being:

> <u>Problems to be addressed:</u> Under the current loan location rule, it is not clear whether the SINAA factors are of equal weight or, conversely, whether the large presence of one factor can outweigh the absence of other SINAA factors. As a result, it is unclear, both to tax

administrators and to financial institutions, how the SINAA factors should be applied in individual cases. While industry participants noted that some clarification would be helpful, they did indicate that, with the exception of a couple of states, they are not encountering significant problems with the current SINAA sourcing provision.

In addition, the term "change of material fact" in the loan assignment rule is undefined. A question has arisen as to whether the sale of a loan or pool of loans to another entity within the same controlled group of corporations as the seller constitutes a material change of fact. Both taxpayers and tax administrators would benefit from the inclusion of objective criteria to determine when there has been a material change of fact.

And later the areas to be worked on were summarized as:

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

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

Accordingly, participating industry members were shocked by the December 2012 "fresh look" request by the then participating states, which subsequently resulted in the states deciding to eliminate loans from the property factor.

The original MTC model industry apportionment provisions' mix of market state and greater cost of performance sourcing of the receipts factor and production state sourcing of loans represented a balanced compromise between the market states and the production states. The increased receipts market sourcing and elimination of loans from the property factor included in the proposed amendments to the MTC model industry apportionment provisions changes the balance between market states and production states.

Wood Miller's May 8, 2014 Letter to the MTC Executive Committee

In reading through Wood Miller's May 8, 2014 letter to the MTC Executive Committee regarding "Uniformity Committee Report of Draft Amendments, Formula for the Apportionment and Allocation of Net Income of Financial Institutions", we identified several inaccuracies that warrant mentioning for the record.

Sourcing of Trust Fees

Starting on the bottom of page 4, "D. Receipts from Investment and Trading Assets and Activities on Behalf of 3rd Party (trust accounts)" misrepresents that the states voted on a separate sourcing provision for services related to trust fees. While the working group discussed possible options for sourcing such services, the group concluded that trust fees would not be treated differently than other service receipts. Accordingly, the state representatives, and subsequently the uniformity subcommittee and full committee, did not make a recommendation specific to the sourcing of trust fees.

Sourcing of Service Receipts

Starting on the top of page 6, "E. Non-specific Receipts, Other Non-Specified Receipts, and Attribution of certain receipts to commercial domicile, §§ 3(l), (n) and (o)" misrepresents that:

1. the state representatives, and subsequently the uniformity subcommittee and full committee, recommended that service receipts be sourced in accordance with Reg.IV.17 of the MTC Allocation and Apportionment Regulations, as amended; and

2. the state representatives, and subsequently the uniformity subcommittee and full committee, recommended retaining the current sourcing rule for Section 3(n) (all other receipts).

With respect to the sourcing of service receipts, as reflected in the MTC's draft FI Apportionment Amendments document dated 12/5/13, the states' recommendation was to provide an option for the states to source service receipts based on: 1) Reg.IV.17 of the MTC Allocation and Apportionment Regulations, as amended; or 2) Section 3(n) specified other state rules.

With respect to the sourcing rule for Section 3(n), the working group never discussed making any changes to Section 3(n) and accordingly no recommendation was suggested or voted-on to retain the current sourcing for receipts that fall under Section 3(n).

Effective Date of Revisions

Wood Miller's letter to the MTC Executive Committee does not mention that the state representatives, and subsequently the uniformity subcommittee and full committee, recommended that if the proposed revisions are adopted by the MTC Executive Committee that the revisions not be effective until tax years beginning on or after January 1, 2016. The Hearing Officer's Report should highlight this effective date to inform states that may consider adopting the revisions.

Appendix of Work Group Members

We were surprised by the listing of group members. On the majority of working group calls, there were as many financial institution employees participating as there were state representatives. Yet, an uninformed party would assume from this list that only one bank and about a dozen consultants who likely represented interested industry members participated on the working group calls.

Attachment

January 2011

Comment Regarding December Income Tax Uniformity Subcommittee Report

During the status report of the financial institutions working group project at the December MTC Income & Franchise Tax Uniformity Subcommittee meeting, Shirley Sicilian noted that states that have adopted a receipts factor only formula, now have what they need to move forward in making changes to their statutes/regulations. Industry believes that Shirley Sicilian did not intend to make this statement because while the working group has a draft of the revisions to the receipts factor section, the revised model apportionment provisions have not been through the hearing process. Moreover, the participating industry members would like to remind the states and MTC staff that it does not agree with many of the receipts factor revisions and thus does plan to submit written comments summarizing the issues we raised during the revision process for future consideration before adoption of the revisions.

Let's Step Back and Allow Common Sense to Proceed

- Re-focus on goals
- Work with us – Not against us

Re-focus on Goals

In order to move this project forward on a timely basis, we believe that the working group needs to re-focus on its goals.

Fair, Administrable, and Applied Consistently

As noted throughout this revision project, we believe it is important for the MTC staff and the states to step back and again review 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 <u>all three facets</u> are critical and thus should remain the goals of any revisions made to the model apportionment provision.

As we continue to work through the property factor revisions, we need to be mindful of the administrable goal. In order for the apportionment provisions to be administratable, industry needs to be able to use documents and systems already in place and we should NOT create a model that will require financials to incur significant unwarranted costs to prove the proper sourcing of loans in the property factor.

In addition, 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 of the approximately 20 states would create an environment that is less consistent and uniform than exists today. Similarly, allowing state optional provisions within the model also creates an environment that is less consistent and uniform than exists today.

Maintain the Original Sourcing Outcome

As noted in the June 22, 2009 Financial Institutions Apportionment Work Group Report to members of the MTC Income & Franchise Tax Uniformity Subcommittee, with respect to the property factor, the work group recommendations included:

> The Property Factor: State and Industry Members Overarching goal – the intent is not to recreate the 1994 apportionment outcome of sourcing property to particular states. Rather, the intent is to attempt to maintain the 1994 policy of sourcing property to location of loan activity.

Work with us – Not Against Us

Many industry members were upset with the nature and tone of the November working group call. Industry strongly believes that in setting forth its suggested approaches and written comments, we have been mindful of the states' objectives (although we may not agree with them) and try to set forth what we believe are industry-compromised positions in order to move this project forward.[1] In contrast, some of the states and MTC staff appear to have approached industry suggestions as being false and deceptive, and thus, rather than objectively consider industry comments, they automatically suggest overly burdensome approaches to in their minds "fix" the industry suggestions.

We understand that some states may have had what they view as "poor experiences" with a few financials on audits. And on the flip side, some financials have had what they view as "poor experiences" with states on audits. Accordingly, both sides can point to one or more poor experiences with the other side.

[1] For example, when one of the states suggested that the work group review the property factor sourcing method proposed by Minnesota during the development of the initial apportionment provisions, industry did not suggest that the states consider sourcing loans to the "main office of the original lender", because we were mindful that the states would not want to adopt such an approach.

Nevertheless, we should not be working towards developing overly burdensome revisions that will cover those limited exceptions because states have other means of dealing with such situations. Instead, we should be focusing on revisions that fit the majority of situations and can be more easily administered by both the states and industry.

In hindsight, it is possible that some of these issues have arisen because industry members are very familiar with the current MTC model apportionment provisions, as well as the industry and their company's operations, while most states and MTC staff have only marginal understanding of the industry and of the actual application of the MTC apportionment provisions in practice. Assuming this has fostered some of the perceived issues, prior to providing future suggestions industry will attempt to provide what they believe is an overview of the issues and why they believe their suggestion makes sense. This additional education hopefully will bridge the knowledge gap and allow the project to move along in a smoother and timelier pace.

We also 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. To date, industry believes that there has been little compromise from the states and moreover, based on past working group calls if even one state that may or may not even have adopted the current MTC apportionment provisions comments that they don't "think" they like the suggestion (without even expressing a valid reason why they think so), then the discussion has been treated as having been completed and the suggestion is off of the table.

In comparison to the original development of the MTC financial institutions apportionment provision, we note that what the revision work group is missing is a moderator, who would step in when one side isn't listening or unwilling to make compromises. We believe that the states and industry need to do this within their own ranks if we want move this project forward on a timely basis.

Use of Management Reports for Loan Groupings

Being mindful of the goals noted above, industry strongly believes that management reports should be one of the means allowable in selecting loan groupings.

As industry explained, and Carl Joseph confirmed, management reports are what a company's management uses to determine which products to offer, discontinue and make other changes to the operation of the company – these clearly are not reports devised for tax planning purposes. YET, a large portion of the November working group call focused on whether the states could obtain such reports that have been "audited" and other comments related to states' fears that anything industry suggests must be wrong.

We would like to reiterate that the top management of the country's largest financial organizations have much larger issues to focus on than to try to manipulate management reports in order to shift a couple of percentages of receipts among the states, which essentially would have a minimal impact the earnings of the company. In an effort to overcome the states' paranoia, we have inserted in the draft revisions that the management reports used must reasonably reflect the taxpayer's products/services sold.

We also would like to note that since the adoption of the MTC apportionment provisions, for purposes of sourcing loans, most (if not all) of the financials have been grouping loans based on management reports. Thus, the suggested language in the draft revisions would not change anything that the financials are already doing – thus satisfying the working group's administratable goal. Accordingly, the suggested language was NOT a change in manner in which financials have been sourcing loans and instead was merely an attempt to put in writing the practice that has been used to source loans for more than 10 years. In addition, the current manner in which the financials have been grouping loans has not been a significant audit issue addressed by the states – thus implying that the method that the financials have been using has been working for the states as well as the industry.

Use of Segment Reporting has no Merit

On the November call, the use of segment reporting required under FAS 131was suggested by a state as a possible requirement for the grouping of loans. Anyone who has spent 10 minutes looking at the segment reporting for large companies will see that the suggestion has no merit other than to extent the revision project by focusing the group on red herrings.

Need to Consider Other Approaches Instead of the Cost Determination

As noted on the November working group call, industry believes that based on their operations, the majority of financial institutions have been able to prove the sourcing of its loans without having to undertake a very costly "cost-study".[2] Moreover, with respect to the use of cost of performance for sourcing certain services, the states have continually voiced that the method needs to be changed because determining costs is too difficult to administer. Accordingly, the working group should consider developing an approach to loan-sourcing that does not require all financials to undertake a cost study if their facts would not otherwise require them to do so.

If the working group concludes that there are some situations in which the preparation of a cost study would be warranted, it might be helpful if Carl Joseph could share with the group some of the "cost" approaches that he noted California has permitted financials to use to source loans.

[2] We do acknowledge that some financials had incorrectly sourced their loans on originally filed returns and thus in order to prove their refund claims, they needed to prepare such costly reports. However, the majority of financial institutions have NOT prepared such cost-studies.

The Sourcing of Loans Would be Made Much Easier if the S is taken out of SINAA

As noted in our November 24, 2010 written comments, currently, the institutions that have been participating on the working group believe that there is merit in retaining SINAA with one adjustment – removing solicitation – and thus retaining INAA.

As Shirley observed on an earlier call, since the solicitation efforts end up being sourced in the receipts factor, retaining solicitation as one of the factors to consider in determining the preponderance of contacts in sourcing the loans in the property factor is not appropriate.

Industry members believe that the largest part of the issues the states have with trying to apply SINAA is the solicitation element and if solicitation were removed, the group may be able to develop means of determining the INAA factors that would be much simpler and less time consuming than a cost determination (i.e., Administration would be given to the state where the loans are serviced without having to determine the costs incurred in servicing each of the loan groupings).

Moreover, it is very clear that if the only element that is within a state is solicitation, then it is impossible for the loan to be sourced to that state. Thus, it seems that in most situations taking the S out, would make the sourcing more administratable both for the states and industry. If the states believe that there are limited situations within which S should be taken into consideration in sourcing, then maybe we can craft language that include S only those situations. For example, if the I and N are in one state and AA are in another state, then unless the working group decides it would be appropriate to give one of the INAA factors more weight than the other 3 elements, then maybe solicitation could be used as the tie-breaker.

Now for the Entertaining Portion of our Comments

Most of the industry participants got a good chuckle from a comment made by Carl Joseph's on the November call. Assuming our notes are correct, Carl noted that if the basic operational facts are clear that 80% of costs are outside of the state, then a state wouldn't have reason to do any further work related to the sourcing of loans. However, based on audit experience, industry notes that as silly as it might seem at least one state will not accept such a position on audit and instead demands extensive work on the part of industry before they will even consider conceding that the loans should not be included in their state's numerator.

As noted above, both sides can point to one or more poor audit experiences with the other side.