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

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. <u>We believe that no revisions should be considered that cannot likely achieve actual adoption in a majority of the states</u>. 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.

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

[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.

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.

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.

[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.

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.