MULTISTATE TAX COMMISSION

Report of the Hearing Officer Regarding Proposed Amendments to the Formula for the Apportionment and Allocation of Net Income of Financial Institutions
July 2014

I. Procedural Summary

A. Development of the Proposal

Financial institutions are excluded from UDITPA, and thus from Article IV. The Commission began a project to develop a uniform model financial institutions apportionment rule in 1970, just three years after the Commission was created, but that project was eventually abandoned. The Commission then took up the project again in the mid-1980's, and it proceeded very slowly due to the complexity of the issues and serious conceptual disagreements between the state and industry representatives. But, nearly 10 years later, after creating an elaborate system of industry/state workgroups which met regularly in person as well as by telephone, the current rule was adopted in 1994.

This project began in 2007. The work group charged with reexamining the Commission's 1994 model statute in light of the dramatic changes in the financial industry recommended amendments to the subcommittee. These changes in the industry were caused both by deregulation as a result of the repeal of Glass-Steagall, and by technological innovations. Together these changes allow financial institutions to provide a full range of services, such as mortgage loan and credit card application processing, credit approval and account servicing -- in many cases entirely online.

The work group consisted of representatives of MTC member states and of the financial industry.[1] Meeting regularly by teleconference, the work group has worked to update three aspects of the current rule: (1) the definition of a financial institution, (2) the sourcing of financial institutions specific receipts in the sales factor, and (3) the sourcing of financial institutions loans in the property factor.

After initially identifying several issues regarding the application of the property factor to financial institutions,[2] the work group turned its attention to definitional issues and refining the receipts factor. The work group completed its work on definitions and the receipts factor in 2011 and then returned to consideration of the property factor. The work group completed its work on the project in December 2013 and the Uniformity Committee approved the model as drafted by the work group, on December 11, 2013. The Executive Committee approved the model for public hearing on May 8, 2014.

II. Summary of Proposal

A. Definitions

In the current model, the definition of "financial institution" is grounded in the institution that provides financial services, rather than on the nature of the activities in which that institution engages. That definition includes entities (other than an insurance company, real estate broker, or securities dealer) that derive more than 50% of their gross income form activities that a financial institution is authorized to transact. Ultimately, the work group recommended retaining the existing definition of "financial institution" in the current model.

B. The Receipts Factor

The state members of the work group defined their overarching goal for the receipts factor to be that it reflect the market, rather than the production state.

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[1] A list of the members of the work group is attached hereto as an appendix. The Hearing Officer wishes to thank the members of the work group, both state representatives and representatives of industry, for their participation over the extended history of this project.

[2] These issues largely revolved around whether reliance on the SINAA (sourcing, investigation, negotiation, approval and administration) factors for sourcing loans in the property factor is administrable and if not, how they should be modified or replaced.

This is consistent with a more general trend among the states to source receipts from sales of services and intangible property to the market. Industry defined its goals to be: (1) inclusion of a receipt in a state's sales factor numerator such that the sum of all state numerators should not exceed 100% of the denominator, (2) current receipt sourcing should not be changed if doing so would immediately result in double taxation, (3) receipts from services should be sourced in the same manner that such receipts are sourced for non-financial organizations, (4) incidental receipts should NOT be changed to market sourcing, (5) all receipts should be included in the denominator of the receipts factor, (6) sourcing methods should be practical, not overly burdensome and readily available without programming changes, and (7) no revisions should be considered that cannot likely achieve actual adoption in a majority of states, since adoption by only a few states of the approximately 20 that have adopted the current MTC model would create an environment that is less consistent and uniform than exists today.

The work group recommended the following revisions to the receipts factor. Unless otherwise indicated, the citations are to the current model.

1. ATM Fees, §3(k)

This is a new section designed to source ATM receipts to the location of the machines in order to better reflect the market. Industry representatives conceded to this recommendation, notwithstanding that it will likely result in more than 100% of total ATM fees being included in the combined state factor numerators and will also result in immediate double taxation for institutions where the processing activity is located in states that apply a greater cost of performance (COP) sourcing rule. Industry acquiesced because the information on ATM location is readily available and the relative percentages of fees are small.

2. Merchant Discount, §3(j)

The working group recommended that merchant discount receipts be sourced to the location of the merchant, if the financial institution has readily available information as to that location. Otherwise, merchant discount receipts should be sourced based on the ratio used to source interest and fees from credit, debit or other customer card receivables.

3. Receipts From Investment and Trading Assets and Activities, §3(m)

The work group recommended that the rule be clarified to explicitly state that these receipts include income from investment and trading assets as reflected on the financial institution's call report or similar regulatory report or that would be required to be reported on such report if the taxpayer were a regulated financial institution.

4. Receipts From Investment and Trading Assets and Activities on Behalf of Third Party, §3(l)[3]

As is currently the case with receipts from ATM fees, these receipts currently fall under the rule of unspecified service receipts (§3(l)), which are sourced based on the greater cost of performance. The state members of the work group recommended sourcing these receipts under new section 3(m), which would source them as receipts from services that are not otherwise apportioned in accordance with Reg. IV.17 of the Multistate Tax Commission Allocation and Apportionment Regulations.[4] Industry preferred maintaining the existing sourcing rules which would retain COP sourcing. Industry believes the proposed change to market sourcing will result in immediate double taxation, be burdensome and require significant programming. In the alternative, industry would prefer that such receipts be sourced in the same manner as such receipts are sourced for non-financial organizations in order for there to be a level playing field. As a compromise, ultimately the state members proposed two alternative options for the states to consider. The first would source these receipts in accordance with Reg. IV.17. The second option would have the states source these receipts as they currently do. This issue is discussed in greater detail below, as part of the Hearing Officer's response to the financial institutions' written comments.

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[3] These receipts would include, but not necessarily be limited to, receipts from trust accounts.

[4] Currently, Section 17 sources receipts from services and intangibles based on COP. However, the Commission is engaged in revising Section 17 such that these services would be sourced to the market. The model has been submitted to the states under Bylaw 7 and a majority of affected states have indicated they will consider adopting it. The model will be presented to the Commission on July 31, 2014, for final approval and recommendation that the states adopt it. The financial institutions model is written with the assumption that a large number of states will adopt market-based sourcing under Section 17. But it must be noted that Section 17 is currently in a state of transition.

5. Non-Specified Service Receipts, Other Non-Specified Receipts, and Attribution of Certain Receipts to Commercial Domicile, §§3(l), (n) and (o).

Under current section 3(l) receipts from non-specified service receipts are sourced using COP. The state members of the work group recommended sourcing them in accordance with Reg. IV.17 of the MTC Apportionment Regulations and eliminating section 3(l). Industry does not agree and would retain COP sourcing, at least if these receipts fall below a certain percentage of receipts or, alternatively, source these receipts in the same manner as such receipts are sourced for non-financial organizations (i.e., expanding current (n) to include other services). Industry believes that the move to market based sourcing combined with removing loans from the property factor will result in an increase in its apportionment percentages in market states such that industry should not also have to incur the costs of accounting for the receipts of non-specified services if the overall percentage of such receipts is small.

The state members of the work group proposed retaining current sections 3(n) and (o) -- renumbered as 3(o) and (p) – for other receipts and for the attribution of certain receipts to the commercial domicile.

D. The Property Factor

In May 2009, the work group articulated the state member goals regarding the property factor. As stated in a staff memo of May 22, 2009 to the work group, the state members' "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." Participating industry members take the position that this goal can best be achieved by modifying the so-called SINAA factors (solicitation, investigation, negotiation, approval and administration) so as to eliminate solicitation as a factor in locating loans in the property factor and retaining the remaining four factors (INAA).

Originally, the work group explored various options to retain loans in the property factor. After the work group renewed its focus on the property factor in 2011, the issues the work group examined were (1) should the apportionment formula for financial institutions continue to include a property factor, (2) if so, should loans continue to be included in the property factor in light of current electronic banking practices, (3) and if so, how – and if there is no good way to do so, should – we reconsider including loans, or a property factor at all? [5]

As the work group continued its teleconferences in 2012 and 2013, the state members increasingly raised concerns similar to those associated with sourcing any intangible property, and began to consider that it may not be possible to properly reflect loans in the financial institution's property factor. The state members therefore reconsidered whether the property factor should be eliminated entirely or alternatively, whether loans should be excluded from the property factor. Participating industry members are of the view that the property factor should be retained and that the need for including loans in the property factor for financial institutions is supported by case law. *Crocker Equipment Leasing, Inc. v. Department of Reve*nue*,* 838 P.2d 552 (OR 1992).

At its July 2013 meeting, the MTC Uniformity Committee, Income and Franchise Tax Subcommittee voted to recommend that loans be removed from the property factor.

III. Public Hearing

After more than 30 days' notice to the public and interested parties, a public hearing was held on June 23, 2014 in Washington, DC.[6] Written public comments were submitted by certain Participating Financial Institutions as prepared by Karen Boucher of Deloitte Tax.[7]

A. Summary of Written Comments and Hearing Officer's Response

The numbered, bold headings that follow are taken verbatim from the headings in the financial institutions' written comments. The Hearing Officer's response follows a summary of each numbered item.

1. Maintain Focus on the Goals of Original Model Apportionment Drafters

[5] Loan receipts are of course included in the receipts factor in the current model.
[6] A copy of the Notice of Public Hearing and proposed model regulation is attached hereto as Exhibit A.
[7] A copy of the Participating Financial Institutions written comments is attached hereto as Exhibit B.

The Participating Financial Institutions note that the overall goals of the original MTC model financial institution apportionment regulation were that the resulting model should be:

1) fair in approach,
2) administrable, and
3) adopted and applied consistently in a majority of states.

One may presume that the Commission and its member states would agree that these are appropriate goals of any MTC uniformity project, including this one. But the participating financial institutions' proposed solution to accomplishing these goals is not realistic. They propose that the model should not become effective in any state until at least 50% of the states that currently have similar apportionment provisions adopt the amendments. The state members of the work group responded to industry's concerns about the costs of changing systems to comply with the new regulations by deferring the effective date of the model to tax years that begin on or after January 1, 2016. That date is not carved in stone. Should the Executive Committee wish to further delay the effective date, doing so is certainly feasible. But to indefinitely postpone the effective date based on enactment by 50% of states with similar apportionment provisions will not necessarily further the goal of ultimately achieving uniformity.

2. Any Amendments for the Current Provision Require Safeguards to Not Source More than 100% of Income

The participating financial institutions are fearful that the current draft of the model, if adopted, will result in multiple taxation because some states will source receipts using a market approach while others will source the receipts to their state under a cost of performance (COP) approach. But that same possibility of disuniformity exists now, both because states that source receipts based on cost of performance do not necessarily do so uniformly and because some states currently use a market approach to sourcing receipts. For example, the District of Columbia sources the receipts of financial institutions from sales other than sales of tangible personal property to the jurisdiction where the greater proportion of the income-producing activity is performed than in any other state, based on cost of performance.   DC ST §47-1810.02(g)(3)(B). Kentucky also utilizes cost of performance to source financial institution receipts but does so by means of a formula that focuses exclusively on offices located in Kentucky and elsewhere through which loans or other receipt sources are negotiated. KRS 41.120(10)(b), 103 KAR 16:150, Section 2.   On the other hand, Illinois sources financial institution receipts to the market. 35 ILCA 5/304(c)(3). If anything, the adoption of the model would be expected to serve to reduce disuniformity rather than to increase it. More broadly, the overall trend of sourcing receipts from services or intangible property under UDITPA is to source to the market.[8] There appears to be no sound conceptual reason why similar receipts of financial institutions should not be similarly sourced.

3. Incidental Receipts Should NOT be Changed to Market Sourcing

The participating financial institutions note that the costs of determining the market for numerous categories of small receipt streams can be very costly, such that the effort may well not be cost-effective either for the taxpayer or for the states. Therefore, the financial institutions propose a *de minimis* exception to sourcing minimal revenue streams to the market. The proposal is to source any category of incidental receipts listed in renumbered Section 3(m) below some small percentage of total receipts (i.e., less than 1 or 2 percent) using the current methodology or using the same percentage as all other receipts.

This proposal was discussed in the work group. Some state representatives felt that this would establish a precedent for other industries under UDITPA. The Hearing Officer believes that sourcing incidental receipts using the current methodology is not theoretically justified as the result in many jurisdictions would be to retain COP sourcing precisely for the smallest revenue streams. However, sourcing incidental receipts below a defined percentage of total revenue as other receipts are sourced does not do violence to market sourcing principles and may well reduce the costs of administration and compliance both for industry and for the states. The Hearing Officer therefore recommends a de minimis exception for incidental receipts that fall below a threshold of 1% of total receipts. The attached draft includes the Hearing Officer's suggested language.

[8] The following states have adopted market-based sourcing for receipts from services and/or intangible property under UDITPA: Alabama; Arizona; California; Georgia; Illinois; Iowa; Maine; Maryland; Massachusetts: Michigan; Minnesota; Nebraska; Ohio; Oklahoma; Pennsylvania; Utah; Washington; and Wisconsin.

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

The financial institutions note that proposed Section 3 (m) sets forth two alternative options for sourcing receipts not otherwise apportioned under Section 3.

> 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).

Should a state opt not to adopt proposed Section 3 (m),[9] sourcing this category of receipts would default to Section 3(o), which provides;

> (o) **All other receipts.** The numerator of the receipts factor includes all other receipts pursuant to the rules set forth in [insert your state's regular situsing rules for the receipts rules for the receipts not covered by this section].

The financial institutions note that to the extent states choose not to adopt Section 3(m), the effect of Section 3(o) will be to increase disuniformity among the states. The financial institutions are not entirely incorrect in their analysis. But the resulting disuniformity is more the result of the fact that this project is occurring at a time when the states are shifting from COP to market-based sourcing than it is due to Option B itself.

At the present time, Section 17 sourcing is still based on COP. But as noted above, proposed model Section 17 will be based on market based sourcing. It may well take some years for the states to adopt proposed Section 17 in general

[9] The Hearing Officer finds the word "delete" not to be entirely accurate in Section 3(m). The Hearing Officer recognizes that the alternatives are drafted as notes to the state draftsperson and that therefore the word is appropriate for that purpose. More broadly, if a State chooses not to adopt alternative option A, that state would not be "deleting" Section 3(m). It would simply not adopt any Section 3(m) at all.

and these financial institution regulations specifically. The intent behind Section 3(m) was to require market based sourcing. In the transitional period in which the states and taxpayers currently find themselves, simply requiring sourcing based on Section 17 would *itself* have produced disuniform results. The option not to include Section 3(m) allows a state to require its own sourcing rule, be it market based or COP, during this transitional period.[10]

5. Bait and Switch?

The financial institutions express their disappointment that the state members of the work group ultimately recommended dropping loans from the property factor, notwithstanding that the group's original goal had been to retain loans in the property factor.

The issue of whether to retain loans in the property factor and, if so, how the SINAA factors could or should be modified took up by far the greatest time and effort in the work group's discussion of revisions to the model. The state representatives ultimately concluded that revising application of the SINAA factors so that some version of those factors would allow for an accurate, predictable and easily administrable method of sourcing loans would likely prove unfeasible. In addition, the state representatives concluded that, in most cases, the location of a financial institution's real and tangible property would reflect the location of economic activity associated with the institution's loans. In July 2013, the Income and Franchise Tax Subcommittee directed the work group to "move forward with the approach of the property factor being real and tangible personal property and eliminating any aspect of SINAA from the property factor." The participating financial institutions continue to maintain that a modified version of SINAA, perhaps eliminating solicitation, is workable and that loans should therefore be retained in the property factor. Nevertheless, after fully considering the feasibility of doing so, the state members of the work group drafted language limiting the property factor to real and tangible property as requested by the Subcommittee. At its December 2013 meeting, the Uniformity Committee approved the new model.

6. Wood Miller's May 8, 2014 Letter (sic) to the MTC Executive Committee

[10] As noted above, even a COP sourcing rule can produce disuniform results, as the states do not use uniform COP sourcing principles.

The Hearing Officer notes that the participating financial institutions question the accuracy of certain statements in Mr. Miller's May 8, 2014 memo to the Executive Committee. At this point, the Hearing Officer doesn't see any value in debating the accuracy of those statements and simply acknowledges the financial institutions' objections. The Hearing Officer has tried to describe the model's provisions as accurately as possible in this report.

7. Effective Date of Revisions

As noted by industry, the proposed effective date for the model is tax years beginning on or after January 1, 2016. See "effective date" note following Section 5 (Payroll Factor) discussion.

Hearing Officer Recommendation

The Hearing Officer recommends that the proposed model regulation be adopted as modified.

Respectfully submitted,

Sheldon H. Laskin
Hearing Officer

Appendix

Work Group Members

State Representatives

Lennie Collins, Chair (NC)
Chris Coffman (WA)
Phil Horwitz (CO)
Deborah Liebman (NY)
Jessica Lesczinski (NY)
Michael Fatale (MA)
Amy Gill (PA)
Marilyn Harbur (OR)
Helen Armstrong (AZ)
Jennifer Hays (KY)
Carl Joseph (until 2012) (CA)
Lee Baerlocher (MT)
Brian Staley (MT)
Gene Walborn (MT)
Matt Peyerl (ND)
Donnita Wald (ND)
Mike Boekhaus (KS)
Phil Skinner (ID)

Public Representatives (organizations are for identification purposes only. This list is not necessarily all inclusive. Not all members of the public identified themselves on conference calls. The Hearing Officer has compiled the list from emails exchanged during the course of the project.)

Dawn Justice (Idaho Bankers Association)
Eric J. Coffill (Morrison Foerster)
Ferdinand Hogroian (Council on State Taxation)
Fran Mordi (American Bankers Association)
Jeff Friedman (Sutherland Asbill & Brennan)
Karen Boucher (Deloitte Tax)
Karen Nakamara (Price Waterhouse Coopers)
Marc Simonetti (Sutherland Asbill & Brennan)

Nancy Lancia (Securities Industry and Financial Markets Association)
Rebecca Paulsen (US Bank)
Todd Lard (Sutherland Asbill & Brennan)
Jeffrey Serether (Ernst & Young)