



Working Together Since 1967 to Preserve Federalism and Tax Fairness

To: Lennie Collins, Shirley Sicilian, and Sheldon Laskin
From: Elliott Dubin
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Subject: Apportionment of Net Income of Financial Institutions

During the last teleconference a number of the state representatives stated that they would accept the inclusion of loans and/or loan pools¹ in the property factor of the apportionment formula. These state representatives also made it clear that they would **not** accept the use of the SINAA² elements to apportion the value of the loans to the states because:

1. SINAA or INAA is unworkable due to the difficulty in verifying the location of these activities on audit.
2. Even if it were possible to use SINAA or INAA to locate these loans geographically, this method ounces loans to the single state with the greatest number of substantial contacts despite the high degree of probability that significant loan generation takes place in many other states.

Net loans and leases accounted for more than 52 percent of the total assets of all depository institutions as of December 31, 2012 thus, it may seem reasonable to include them in the property factor.³ However, the inclusion of loans and other intangible assets in apportionment formulas has detractors. For example, noted public finance scholar, Charles McLure, acknowledges that it is often impossible to attribute intangible assets, such as loans, to a particular location with precision.⁴ Other noted public finance scholars, William Fox and Michael Kelsay, argue that states should apportion the net income of financial institutions according to the geographic distribution of receipts situated on a destination basis only; i.e., single sales factor apportionment⁵. McLure, however, does not suggest that states entirely eliminate the property and payroll factors

¹ These loans are typically are grouped by classes of similar instruments, by customer base, and/or another method (including a method combining instruments and customer bases) that reflects the taxpayer's books and records. For example, loans could be grouped as consumer loans, real property loans and commercial loans. Consumer loans could be further grouped such as into installment loans, credit card receivables, student loans, etc. In large part the grouping of loans are based on the financial institutions' loan tracking system and/or management reporting systems.

² Solicitation, Investigation, Negotiation, Approval, and, Administration.

³ Federal Deposit Insurance Corporation, Statistics of Depository Institutions.
<http://www2.fdic.gov/sdi/main.asp>

⁴ Charles E. McLure, Jr., "Implementing State Corporate Income Taxes in the Digital Age." *National Tax Journal*, Vol. LIII, No. 4, Part 3, December 2000, p. 1302.

⁵ William F. Fox and Michael Kelsay, "Neutral Taxation of Financial Institutions During the 1990's," in *State Taxation of Business: Issues and Policy Options*, Thomas Pogue, editor. Praeger, Westport, CT, 1992, page 201.

from the apportionment formula.⁶ Currently, the European Union is in the process of adopting a Common Consolidated Corporate Tax base (CCCTB) for all the nations comprising the European Union replacing the 27 disparate corporate income tax regimes currently in use. Their preliminary findings suggest that intangible assets should be excluded from the apportionment formula:

“The formula for apportioning the consolidated tax base should comprise three equally weighted factors (labour, assets and sales). The labour factor should be computed on the basis of payroll and the number of employees (each item counting for half). The asset factor should consist of all fixed tangible assets. *Intangibles and financial assets should be excluded from the formula due to their mobile nature and the risks of circumventing the system.* [Italics mine] The use of these factors gives appropriate weight to the interests of the Member State of origin. Finally, sales should be taken into account in order to ensure fair participation of the Member State of destination. Those factors and weightings should ensure that profits are taxed where they are earned. As an exception to the general principle, where the outcome of the apportionment does not fairly represent the extent of business activity, a safeguard clause provides for an alternative method.”⁷

If the Working Group (WG) decides to include loans in the apportionment formula, an acceptable method must be found to allocate the value of loans to the various states in which the institution conducts business. I suggest that the WG adopt an allocation method that is fairly simple and that can be measured, or estimated, on a geographic basis. One plausible method would be to allocate the value of the loans to the various states according to the distribution of the apportionment factors already being used – payroll and property.

Adoption of the property and payroll factors to allocate the value of loans among the states is fairly straightforward. The state by state location of these factors is usually known to the institutions; and, can be verified on audit by the states. Further, adoption of property and payroll to allocate loans to the states is somewhat albeit weakly analogous to the treatment of non-financial institutions. That is, we are assuming that intangible assets, such as loans and other financial instruments are “produced” by financial institutions in a manner analogous to the production of tangible goods and of services -- by a combination of capital (real and tangible property) and labor inputs (payroll and employees). Furthermore, I suggest keeping the method for allocating the value loans to the various states simple. There is no reason to strive for extreme precision when we really don’t have any knowledge of the accuracy of the resultant allocation.

MATHEMATICAL EXPOSITION of ALTERNATIVE APPORTIONMENT METHODS

⁶ Charles E. McLure, Jr. *op. cit.*

⁷ European Commission, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, Brussels, 2011, page 14.

The net income of multistate business (j) is apportioned to each state in which it conducts business according to the traditional three factor apportionment formula:

$$(1) \quad \Pi_{ij} = \Pi_j * \{(\alpha_i * (S_{ij}/S_j)) + (\beta_i * (L_{ij}/L_j)) + (\gamma_i * (P_{ij}/P_j))\}$$

Where:

Π_{ij} is the net income of company (j) apportioned to State (i).

Π_j is the total net income of company (j).

α_i is the weight of the receipts factor in state (i).

S_{ij}/S_j is the ratio of receipts of company (j) in state (i) to the total receipts of company (j).

β_i is the weight of the payroll factor in state (i).

L_{ij}/L_j is the ratio of payroll of company (j) in state (i) to total payroll of company (j).

γ_i is the weight of the property factor in state (i).

P_{ij}/P_j is the ratio of real and tangible property of company (j) in state (i) to total real and tangible property of company (j).

$$\alpha_i + \beta_i + \gamma_i = 1$$

However, this apportionment method may not be suitable for financial institution, notably banks because the major service they provide is an intangible asset – loans and loan pools and bundles. These financial assets are inherently different from tangible assets – buildings, land, office machines, computer software, inventories, etc. In addition to being inherently different from the physical capital employed by these institutions, the financial assets dwarf the physical capital in value. I propose the five factor apportionment formula as the proper apportionment formula to apportion the net income of financial institutions:

$$(2) \quad \Pi_{ij} = \Pi_j * \{(\alpha_i * (S_{ij}/S_j)) + (\beta_i * (L_{ij}/L_j)) + (\zeta_i * (N_{ij}/N_j)) + (\gamma_i * (P_{ij}/P_j)) + (\rho_i * (F_{ij}/F_j))\}$$

Where:

Π_{ij} is the net income of company (j) apportioned to State (i).

Π_j is the total net income of company (j).

α_i is the weight of the receipts factor in state (i).

S_{ij}/S_j is the ratio of receipts of company (j) in state (i) to the total receipts of company (j).

β_i is the weight of the payroll factor, measured by wages and salaries, in state (i).

L_{ij}/L_j is the ratio of payroll, measured by wages and salaries of company (j) in state (i) to total payroll, measured by wages and salaries, of company (j).

ζ_i is the weight of the payroll factor, measured by wages and salaries in state (i).

N_{ij}/N_j is the ratio of payroll, measured by number of employees (FTE) of company (j) in state (i) to total payroll, measured by number of employees (FTE), of company (j).

γ_i is the weight of the property factor, measured by the value of tangible personal property in state (i).

P_{ij}/P_j is the ratio of property, measured by value of tangible personal property of company (j) in state (i) to total property, measured by value of tangible personal property of company (j).

$\dot{\rho}_i$ is the weight of the property factor, measured by the value of financial assets, in state (i).

F_{ij}/F_j is the ratio of property, measured by value of financial assets of company (j) in state (i) to total property, measured by value of financial assets of company (j).

$$\alpha_i + \beta_i + \zeta_i + \gamma_i + \dot{\rho}_i = 1$$

The five factor apportionment formula presented above allows for loans, loan pools, and other types of institutionally created intangible assets to be included in the property factor without overwhelming the state-by-state distribution of tangible personal property. Similarly, bifurcation of the payroll factor into the state-by-state distribution of employee compensation allows for the differential treatment of “money center” states which can have disproportionate numbers of highly compensated officers relative to all employees and differential treatment of other employees. Thus, if the Working Group decided to employ the traditional equally weighted factors, α_i would be (1/3); and the sum of β_i , ζ_i , γ_i , and $\dot{\rho}_i$ would be (2/3). If the Working Group decided that the apportionment formula should double weight the sales factor, then the weights would be $\alpha_i = (1/2)$; and the sum of β_i , ζ_i , γ_i , and $\dot{\rho}_i$ would be (1/2).

Possible Method for Estimation of the Financial Assets of Company (j) in a State

The most significant obstacle in implementing this apportionment formula is that the level of financial assets for an institution in any state, (F_{ij}), is not known, but must be estimated. A simple, straightforward method would set the distribution of the financial assets of the institution equal to the sum of the distributions of the nonfinancial assets and the labor inputs divided by 3.

$$F_{ij}/F_j = (1/3)*(P_{ij}/P_j + L_{ij}/L_j + N_{ij}/N_j)$$

Substituting this term into the apportionment formula and combining like terms, the resulting apportionment formula is:

$$\Pi_{ij} = \Pi_j * \{(\alpha_i * (S_{ij}/S_j)) + ((\beta_i + \dot{\rho}_i/3) * (L_{ij}/L_j)) + ((\zeta_i + \dot{\rho}_i/3) * (N_{ij}/N_j)) + ((\gamma_i + \dot{\rho}_i/3) * (P_{ij}/P_j))\}$$

The resulting apportionment formula, as shown above, incorporates the distribution of the institution’s financial assets but uses only the four, directly measurable factors: receipts; payroll; number of full-time equivalent employees; and, real and tangible property to apportion the institution’s net income among the states. This method was chosen for its relative simplicity; there are an infinite number of possible methods that can be used to derive the apportionment formula that incorporates the institution’s financial assets but uses only the measurable factors.