

March 3, 2011

The Multistate Tax Commission Considers Changes to Its Model Financial Institution Apportionment Rule

On March 2, 2011, a subcommittee of the Multistate Tax Commission (MTC) considered significant changes to its model financial institution apportionment rule.

Background

As reported in Sutherland's SALT Shaker newsletter issued on February 18, 2011, a work group of MTC member states and staff are engaged in discussions with industry representatives regarding the drafting of various proposed amendments to the model rule for the apportionment and allocation of net income applicable to financial institutions (the Model). The Model, first adopted by the MTC in 1994, is being reviewed by MTC's Income and Franchise Tax Uniformity Subcommittee. The initial focus of the work group was to consider proposed amendments to the receipts factor, including amendments related to credit/debit card-related receipts (including definitional changes and changes to the sourcing of receipts from merchant discount), receipts from automated teller machine services, and receipts from services not otherwise apportioned by specific rules within the regulation.

Apportionment Factor Changes

In his March 2, 2011 status report memorandum submitted to the Subcommittee, MTC Counsel Sheldon Laskin indicated that "[t]he work group has completed its work on the receipts factor, subject to further direction by the subcommittee." Mr. Laskin reported to the Subcommittee that the work group is resuming its focus on amendments to the Model related to the property factor. These amendments relate to the sourcing of loans, including credit card receivables, included in the property factor calculation. Under the Model, a loan or credit card receivable is generally sourced to a state based on the regular place of business with which it has a preponderance of substantive contact. To determine the state in which the preponderance of substantive contacts has occurred, consideration is given to the solicitation, investigation, negotiation, approval and administration (SINAA) of the loan or credit card receivable.

Mr. Laskin reported to the Subcommittee that the industry has suggested that all but the solicitation component of SINAA be retained and that loan sourcing not be done on a loan-by-loan basis but rather on a group basis based on the financial institution's management reports. He reported further that California representatives of the work group previously suggested that another way to apply the sourcing rule for these assets would be based on the costs associated with each of the SINAA components. This "cost" approach has been criticized by industry representatives because of the significant burden it would place on them.

Material Change in Fact

Under the Model, a loan or credit card receivable, once sourced to a state, remains sourced to that state for its original term unless there is a material change of fact warranting re-sourcing to another state. Issues related to what constitutes a "material change of fact" so that a loan or credit card receivable can be re-sourced from the state to which it was originally sourced was also highlighted to the Subcommittee. Mr. Laskin stated that the MTC member states on the work group take the position that a transfer of a loan or pool of loans from one member of a controlled group of corporations to a related member should

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not be considered a material change of fact that would support a re-sourcing. Industry representatives believe that an acquisition of loans from an unrelated third party is a material change of fact that would support a re-sourcing.

Next Steps

With respect to the work group's next steps, Mr. Laskin indicated that the states and industry have been tasked with drafting various amendments to the Model's property factor language. Included in such drafting assignments are: (1) the sourcing of loans and credit card receivables in the situation where solicitation is no longer a component of SINAA, the remaining four components are given equal weight and they are equally divided between two states; (2) the sourcing of loans on a group basis; and (3) the definition of "material change of fact."

While there were no official public comments, there was a lively discussion after Phil Horowitz of Colorado's Department of Revenue asked whether the work group had considered dropping the property factor from the apportionment calculation, leaving just a receipts factor and a payroll factor. While Mr. Laskin responded that the states in the work group initially focused on that possibility and that industry was opposed to the suggestion, Mr. Horowitz requested that it be considered further by the work group because it will relieve the states of arguing with taxpayers over the application of SINAA. After Mr. Horowitz further questioned why there should be a property factor, industry representatives volunteered to provide details on the reasons for retaining the property factor and for inclusion of loans in that factor.

Ben Miller, a consultant to the California Franchise Tax Board (who was actively involved with drafting the Model), reminded the Subcommittee that the inclusion of the property factor and the method of sourcing loans in the Model was a compromise between so-called "market" and "headquarter" states. Mr. Horowitz, while agreeing with Mr. Miller about the initial compromise, opined that if the goal of the property factor is to capture the location of capital then SINAA does a poor job of achieving that goal. He believes that the receipts and payroll factors better reflect the location of capital. In addition, he believes that, from an operational perspective, deletion of the property factor relieves the states and industry from the need to resolve controversies generated by the use of SINAA. Therefore, he reiterated his request that the work group further consider deletion of the property factor, with the receipts and payroll factors being equally weighted.

Sutherland Observation: Given the significant proposed changes to the Model discussed during the MTC meeting, representatives of the financial institutions industry are encouraged to closely monitor the work group's and the Subcommittee's activities and proposals. Significant changes to the receipts factor and the potential elimination of the property factor could materially affect the state taxation of most financial institutions.

The Chair of the Subcommittee concluded the discussion by stating that the property factor and the issues related thereto will be an agenda item for further discussion at the Subcommittee's next meeting. In the meantime, the work group's next conference call is scheduled for March 21, 2011.



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