

Can You Take This to the Bank? State Taxation of Financial Institutions

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In this installment of A Pinch of SALT, we analyze some of the difficult state tax issues for financial institutions, including entity classification, nexus, apportionment, and combined reporting, and examine the implications that the changing federal regulatory scheme may have on state taxation of financial institutions.

Traditional notions of what constitutes a financial institution are becoming increasingly blurry under modern state tax regimes. Many states are broadening their definition of financial institution to include not only those types of entities traditionally considered financials, such as banks and savings and loan associations, but also corporations that conduct activities similar to those activities that may be conducted by traditional financial institutions. Also, these expanded definitions may include entities that simply own or are otherwise affiliated with traditional financial institutions. As one could predict, these definitions are anything but consistent among the states. For entities engaged in a business that is not in the traditional sense a banking business, but are providing a service or deriving income from activities that may be similar to that of banks, today's landscape presents numerous challenges. The various state approaches create a compliance nightmare for many taxpayers, requiring careful attention to the varying tax bases, apportionment rules, rates, treatment of tax attributes, and filing methods. Also, a careful eye must be kept on regulatory changes, as this may lead to changes in entity classification.

What Is a Financial Institution and Does Your Entity Qualify?

The first step of this journey is to determine if an entity is in fact a financial institution. Appendix A of the Multistate Tax Commission's Model Financial Institution Regulations suggests a definition of financial institution. It includes entities such as bank holding companies, savings and loan holding companies, national banks, savings associations or federal savings banks, banks or thrift institutions organized under state law, state credit unions with a loan asset that exceeds \$50 million, corporations whose voting stock is more than 50 percent owned by another financial institution, and business entities that derive more than 50 percent of their total gross income from finance leases.

The suggested definition of financial institution also contains what can be referred to as a catchall provision that includes any entity, other than an insurance company, a real estate broker, or securities dealer, that derives more than 50 percent of its gross income from activities that one of the specifically enumerated entities in the definition is authorized to transact. Although this suggested definition was floated by the MTC over 15 years ago, only some jurisdictions have adopted it or a slightly modified version.¹ Other jurisdictions have more limited definitions that are restricted to only traditional financial institutions such as banks and savings and loan companies,² while others have a

¹See, e.g., Colorado (Colo. Code Regs. section 1 CCR 201-3, Sp. Reg. 7A(1)(b)(vi)(1)-(11)); Arkansas (Ark. Code Ann. section 26-51-1402(8)); Utah (Utah Admin. R. R865-6F-32).

²See, e.g., Del. State Bank Commr. Regs. 1103 (limiting Delaware's bank franchise tax to banking organizations, trust companies, and federal savings banks not headquartered in Delaware but maintaining branches in the state); see also Fla. Stat. sections 220.63 and 220.65 (limiting Florida's bank franchise tax to bank holding companies or banks and trust companies a substantial part of the business, which consists of receiving deposits and making loans and discounts or of exercising fiduciary powers similar to those permitted to national banks).

different catchall provision under which entity classification may be more difficult to determine or is linked to financial institution regulatory definitions.³

For instance, California imposes a franchise tax on corporations, banks, and financial corporations doing business in the state,⁴ and defines financial corporations as corporations that predominantly deal in money or moneyed capital in substantial competition with the business of national banks.⁵ However, the generally understood meaning of substantial differs from California's, as well as others states',⁶ understanding of that term. The relevant California regulation provides that "the activities of a corporation need not be identical to those performed by a national bank in order to constitute substantial competition, it is sufficient if there is competition with some . . . phases of the business of national banks."⁷

Some states chose to modify the MTC model catchall provision. For example, Indiana law imposes its financial institutions tax (FIT) on entities that carry on the business of a financial institution,⁸ which includes a company that derives 80 percent or more of its gross income from secured or unsecured consumer loans, installment obligations, mortgage or other secured loans on real estate or tangible personal property, credit card loans, secured and unsecured commercial loans of any type, letters of credit and acceptance of drafts, loans arising in factoring, or any other transactions with a comparable economic effect.⁹ Thus, any entity whose pri-

mary activity is extending lines of credit would likely be subject to Indiana's FIT.

As mentioned above, some states base the determination as to whether an entity is a financial institution on whether the entity conducts an activity that is subject to bank or bank-type regulation. Changes in federal regulations could affect an entity's classification in those states. One example is Illinois, whose catchall provision includes within the definition of financial organization those entities with 80 percent (50 percent in the case of a sales finance company) of their gross income being derived from a business that is identical in all material respects to the characteristic business of an entity specifically defined under Illinois law.¹⁰ However, the same provision also specifies that for an entity's business to be identical in all material respects to the business of one of the defined types of organizations, the entity must be subject to regulation by the Illinois or federal agency that regulates the defined type of organization.¹¹

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Because there is no one test for determining whether an entity is a financial institution, close attention must be paid to each state's definition of financial institution. Many of these definitions are not static and may be affected by changes in regulatory classifications, as well as changes in levels and types of income.

Unique Tax Regimes and Tax Bases

Just as the definitions of what constitutes a financial institution vary, so do the methods under which they are taxed. Once the determination is made that an entity is a financial institution, the next task often becomes a determination of whether a special taxation regime applies, either in addition to or in lieu of the traditional corporate income tax.

Imposition of a specific tax regime for financial institutions often is in lieu of a state's corporate income tax.¹² That is the case with what may be the most well-known (for better or for worse) financial

³See, e.g., N.Y. Tax Law section 1452 (including in the definition of banking corporation any corporation "doing a banking business"). A banking business is defined as the business a corporation may do under article 3 (Banks and Trust Companies), article 3-B (Subsidiary Trust Companies), article 5 (Foreign Banking Corporations and National Banks), article 5-A (New York Business Development Corporation), article 6 (Savings Banks) or article 10 (Savings and Loan Associations) of the New York State Banking Law or the business a corporation is authorized to do by such article. 20 NYCRR 16-2.6(a). A corporation is also engaged in a banking business if it is authorized to engage in a substantially similar line of business. *Id.* at 16-2.6(b).

⁴Calif. Revenue and Taxation Code sections 23151, 23181, and 23183.

⁵Calif. Revenue and Taxation Code section 23183(a). "Predominantly" means that over 50 percent of a corporation's total gross income is attributable to dealings in money or moneyed capital in substantial competition with the business of national banks. *Id.* at section 23183(b). Money or moneyed capital includes coin, cash, currency, mortgages, deeds of trust, conditional sales contracts, loans, commercial paper, installment notes, credit cards, and accounts receivable. *Id.*

⁶See, e.g., Idaho Admin. Rules 35.01.01.582(02).

⁷Calif. Revenue and Taxation Code section 23183(b)(4).

⁸Ind. Code section 6-5.5-1-17(a).

⁹*Id.* at section 6-5.5-1-17(d)(2).

¹⁰Ill. Admin. Code 100.9710(b).

¹¹*Id.* at 100.9710(c).

¹²See, e.g., Ala. Code section 40-18-32(4); Haw. Rev. Stat. section 241-3; Mich. Comp. Laws. Ann. sections 208.1263 and 208.1265(1); N.D. Cent. Code section 57-35.3-04; S.C. Code Ann. section 12-11-20; S.C. Code Ann. section 12-11-30; Va. Code Ann. section 58.1-1202.

institution tax regime in the country, the New York banking corporation franchise tax. Banking corporations doing business in New York are not subject to the general corporation franchise tax,¹³ but instead are subject to the banking corporation franchise tax under Article 32 of the New York Tax Law.¹⁴

However, taxpayers should not assume that being subject to a state's financial institution tax automatically exempts an entity from the corporate income tax. For example, some entities subject to Missouri's financial institution franchise tax are also subject to the state's corporate income tax,¹⁵ although there is an allowable credit against the franchise tax for other taxes paid to Missouri.¹⁶

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Although unique financial institution tax regimes may be imposed on net income, net income may be determined differently under a general corporate income tax. For example, under Missouri's financial institution franchise tax, income attributable to Missouri is determined under a separate accounting method, as opposed to formulary apportionment.¹⁷ Further, although many financial institution taxes imposed on net income are based on federal taxable income,¹⁸ that is not always the case. Net income for purposes of Alabama's financial institution excise tax is determined by applying some allowable deductions to gross income.¹⁹ And even if a state's net income tax base applicable to financial institutions starts with federal taxable income, there can be state modifications, net operating loss rules,²⁰ and

other tax base items for financial institutions that are different from those applicable to general corporations.²¹

Nexus

When determining whether an entity is a financial institution, it is also important to understand where it is doing business. It is generally easy to determine where a financial institution is licensed to do business, is actually physically doing business, or is subject to specific regulatory requirements as a result of its activities.²² But what happens if a financial institution has loan receivables, an interest in a real estate mortgage investment conduit, or an interest in a real estate investment trust that happens to generate income from sources in a state? Does that ownership mean the financial institution has nexus, even though it has no other contacts with the state?

With the ever-broadening interpretations of constitutional nexus theory, economic nexus continues to be unpredictable. *West Virginia Tax Commissioner v. MBNA America Bank, N.A.*²³ and *Capital One Bank v. Commissioner of Revenue*²⁴ are recent examples of the evolution of nexus as applied to financial institutions.

A favorite tactic of states is to subject corporations to a state's taxing authority if they are doing business or deriving income from sources within the state. New Jersey²⁵ and Connecticut²⁶ apply this

²¹For example, under Article 32, which provides New York's tax on banking corporations, taxpayers are permitted a 60 percent dividends received deduction for dividends from subsidiaries, while under Article 9-A, New York's general corporation franchise tax, 100 percent of dividends received from more than 50 percent owned subsidiaries is excluded from the tax base. N.Y. Tax Law sections 1453(e)(11)(ii) and 208(9)(a)(2).

²²States such as Alabama and Illinois will impose tax return filing responsibilities if a corporation merely registers to do business or becomes licensed in the state. See Ala. Code section 40-18-2; 35 ILCS section 5/503(b).

²³640 S.E.2d 226 (W.Va., 2006), *cert. denied*, 551 U.S. 1141 (2007).

²⁴899 N.E.2d 76 (Mass. 2009), *cert. denied*, 129 S. Ct. 2827 (2009).

²⁵New Jersey Division of Taxation Technical Bulletin TAM-6, 01/10/2011.

²⁶Conn. Gen. Stat. section 12-216a. A corporation has nexus with Connecticut if it derives income from sources within the state, or has a substantial economic presence within this state, evidenced by a purposeful direction of business toward Connecticut, examined in light of the frequency, quantity, and systematic nature of a company's economic contacts with Connecticut, without regard to physical presence, and to the extent permitted by the Constitution of the United States. Connecticut has issued guidance with respect to determining if a company's purposeful direction of business activities meets the frequency, quantity, and systematic nature requirement of the statute by stating that an out-of-state corporation will be deemed to have economic

(Footnote continued on next page.)

¹³N.Y. Tax Law section 209(4); 20 NYCRR section 1-3.4.

¹⁴N.Y. Tax Law section 209(4); 20 NYCRR section 1-3.4.

¹⁵Mo. Rev. Stat. Ann. sections 143.071, 143.441, and 148.620(3).

¹⁶Mo. Rev. Stat. Ann. sections 148.030, 148.064, and 148.140.

¹⁷Mo. Rev. Stat. Ann. sections 148.140.1 and 148.150(2), (4).

¹⁸See, e.g., Fla. Stat. section 220.13; Ind. Code sections 6-5.5-2-1 and 6-5.5-2-2; N.Y. Tax Law section 1453(a).

¹⁹Ala. Admin. Code 810-9-1-.01(2)-(4).

²⁰For example, Massachusetts does not permit financial institutions to carry forward net operating losses. 830 Code Mass. Regs. section 63.32B.2(8)(a).

approach. States are also trending toward factor presence nexus standards. For example, California provides that a company will have nexus if its California sales exceed the lesser of \$500,000 or 25 percent of its total sales.²⁷ These broad nexus standards tend to be alarming to financial institutions (and to some general corporations) because it is unclear whether they are expansive enough to reach income or receipts derived from activities in the secondary market.

Some states address this issue and set minimum standards specifically for financial institution nexus. For example, a financial organization has nexus with Florida if it earns or receives interest from loans secured by real or tangible personal property in the state.²⁸ Similar to Florida, the Illinois Department of Revenue issued a general information letter stating that owning a security interest in Illinois property could result in an out-of-state company having nexus with the state.²⁹ In contrast, New York provides that the mere acquisition of one or more security interests in New York real or personal property or the acquisition of title to property located in New York through the foreclosure of a security interest without otherwise doing business will not give rise to nexus.³⁰ Also, the New York State Department of Taxation and Finance ruled that making loans to New York residents and businesses, when the loans are accepted, processed, approved, and serviced outside New York, does not constitute doing business in the state merely because the lender acquired a security interest in property in the state and even obtained title to property through foreclosure.³¹ Even after adopting an expansive financial institution economic nexus statute, Minnesota recognized the need to preserve the secondary market and carved out from the nexus-creating provisions some investments in which the underlying collateral may have been located in the state.³²

Even though some states have specifically addressed nexus issues, many others have not. The continued adoption of increasingly broad nexus

nexus with Connecticut if it has \$500,000 or more in receipts from business activities that are attributable to Connecticut sources during a tax year. An example given by Connecticut of an out-of-state corporation that has economic nexus with the state is a car loan corporation with no physical presence in Connecticut that generates substantial interest and other income from its loans to Connecticut customers.

²⁷Calif. Revenue and Taxation Code section 23101(b).

²⁸Fla. Admin. Code Ann. section 12C-1.011(1)(s).

²⁹Illinois Dept. of Rev. General Information Letter IT 96-0026-GIL, Feb. 20, 1996.

³⁰20 NYCRR section 16-2.7(e).

³¹Bleakley Platt & Schmidt, New York Advisory Opinion TSB-A-90(25)C, Dec. 13, 1990.

³²Minn. Stat. section 290.015, subd. 2(b).

standards will likely cause financial institutions, which traditionally rely on concepts of physical presence nexus, to incur risk.

Apportionment

Once a taxpayer has determined that it is classified as a financial institution in a particular state, the taxpayer must determine the consequences of that characterization, including the application of special apportionment rules.

If an entity qualifies as a financial institution, it is likely that it will be subject to special apportionment provisions. Although some states have their own unique method of apportioning income from financial institutions, many apply a modified version of the MTC's model regulations for the apportionment of financial institution income.³³ The MTC's model provisions use an equally weighted three-factor formula consisting of property, payroll, and sales factors.³⁴

Regarding the property factor, in addition to the standard inclusion in the factor of real and tangible personal property, the MTC model regulations provide for financial institutions to take into account the average value of loans and credit card receivables.³⁵ For purposes of calculating the numerator of the property factor, the MTC's rules for determining the location of that property are somewhat akin to a costs-of-performance analysis used in the MTC's general sourcing rules applied to receipts from sales other than sales of tangible personal property. For instance, a loan is located within a state if it has a preponderance of substantive contacts with a regular place of business of the taxpayer within the state, with solicitation, investigation, negotiation, approval, and administration of the loan being the relevant factors in making that determination.³⁶ Thus, an entity's property factor can be heavily weighted to one state when the taxpayer performs

³³See, e.g., Ark. Code Ann. section 26-51-1401 to 1405; Haw. Admin. Rules 18-241-4-03 to -05; Utah Admin. R. R865-6F.

³⁴One of the MTC's current uniformity projects is the revision of the model financial institution apportionment regulations. The current draft amendments maintain an equally weighted three-factor formula, but include multiple changes/additions to the receipts factor sourcing rules. Most notably, the proposed amendments include the addition of specific rules for sourcing of debit card issuers' reimbursement fees, more detailed rules of sourcing of receipts from merchant discount, the addition of sourcing rules for ATM fees, and the linking of the sourcing rules for services not otherwise apportioned under the regulations to section 17 of the MTC Allocation and Apportionment Regulations.

³⁵MTC Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions, section 4(a).

³⁶*Id.*

most of these activities in one location. The underlying purpose of the MTC's property factor sourcing rule at the time it was originally proposed was, in fact, to source loans and credit card receivables to the financial institution's headquarters state as opposed to the market state.

Recently, Idaho, which previously fully adopted the MTC's model regulations, adopted a change to its property factor sourcing rules for determining the location of loans to reflect a more market based approach. Idaho now considers a secured loan to be located in Idaho if 50 percent or more of the value of collateral is located in Idaho, and an unsecured loan to be located in Idaho if the billing address of the borrower is in Idaho.³⁷ This change, which is contrary to the original purpose of the MTC's property factor determination, represents a dramatic shift from the sourcing rule under the prior version of the regulation.

For purposes of the sales factor, the MTC model financial institution apportionment provisions require the inclusion of numerous types of receipts, including:

- receipts from the lease of real property and tangible personal property;
- interest from loans;
- net gains from the sale of loans;
- loan servicing fees;
- receipts from credit card receivables;
- receipts from merchant discount; and
- receipts from investment assets and activities and trading assets and activities.³⁸

The sourcing rules for many of these receipts are market based. For example, for interest from loans secured by real property, the numerator of the sales factor includes interest and fees or penalties in the nature of interest from loans secured by real property if the property is located within this state.³⁹ Interestingly, receipts from services not otherwise specifically addressed in the MTC's model regulations are sourced based on where the greater proportion of the income-producing activity is performed based on costs of performance.⁴⁰ That approach is inconsistent with the general market state receipts sourcing rules in the model regulation.

Utah, which uses a modified version of the MTC's regulations, has recently addressed this inconsistency by changing its sourcing rule for all other services performed by financial institutions to a market-based rule. The Utah regulation now provides that financial institutions must include in the Utah sales factor numerator receipts from services

not otherwise specifically addressed in the regulation if the greater benefit of the service is received in Utah.⁴¹ Not only is this change more consistent with most of the other sourcing provisions in the financial institution regulations, but also Utah's general corporation apportionment rules similarly provide for sourcing of receipts from services based on where the purchaser receives the benefit of the service.⁴²

Another deviation among states' treatment of financial institution apportionment relates to the use of a single sales factor. Colorado and Connecticut use such a formula.⁴³ The District of Columbia provides that financial institutions must apportion business income using a two-factor apportionment formula consisting of a payroll factor and a gross income factor.⁴⁴ Finally, New York uses a three-factor formula for the banking corporation franchise tax, but the formula consists of payroll, receipts, and deposits.⁴⁵ As the source of the MTC's use of solicitation, investigation, negotiation, approval, and administration of loans to determine the location of loans for purposes of the property factor, New York also uses these factors for sourcing interest income from loans and financing leases for purposes of the receipts factor.⁴⁶ Thus, given all the varying apportionment rules around the country, it is easy to see that determining the apportionment method, factors, and sourcing for a multistate financial institution can become a daunting task.

Filing Methods

Filing methods applicable to financial institutions vary among the states. For instance, Tennessee, which generally is a separate return state, requires financial institutions forming a unitary business to file a combined return.⁴⁷ Typically, if a financial institution is subject to the general corporate income tax in a state and that state requires the filing of a combined report for unitary groups, the financial institution will be included in the combined report.⁴⁸

⁴¹Utah Admin. R. R865-6F-32(3)(1).

⁴²Utah Code Ann. section 59-7-319.

⁴³Colo. Code Regs. section 1 CCR 201-3, Sp. Reg. 7A(1)(c)(iv); Conn. Gen. Stat. section 12-218b.

⁴⁴D.C. Mun. Regs. Tit. 9 section 129.1.

⁴⁵N.Y. Tax Law section 1465(b)(1); 20 NYCRR section 19-2.2.

⁴⁶N.Y. Tax Law section 1454(a)(2); 20 NYCRR section 19-6.2(c).

⁴⁷Tenn. Code Ann. section 67-4-2006(a)(3).

⁴⁸See, e.g., Mass. Gen. L., Ch. 63 section 32B(c)(1); Idaho Code section 63-3027(t); Utah Code Ann. section 59-7-402. Note that the inclusion of a financial institution in a unitary combined report often is based on the lack of any authority excluding them from the definition of unitary group and the broad meaning of corporation for purposes of the corporate income tax. See, e.g., Utah Code Ann. sections 59-7-101(30) and 59-7-402(1).

³⁷*Id.* at 35.01.01.586(07).

³⁸MTC Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions, section 3.

³⁹*Id.* at section 3(d).

⁴⁰*Id.* at section 3(l).

However, combined reporting rules vary significantly. In West Virginia, financial organizations use a single sales factor to apportion business income,⁴⁹ while general corporations use a three-factor formula.⁵⁰ For purposes of combined reporting, financial organizations are considered “special apportionment members,” whose income and factors cannot be included in the combined reporting group of members using the general three-factor formula.⁵¹ Compare this treatment with that in Illinois, where both general corporations and financial organizations use a single sales factor to apportion income.⁵² However, such entities are prohibited from inclusion in the same unitary business group return.⁵³

Further complicating the landscape are states such as California and Massachusetts that allow financial institutions to be included in unitary combined returns with entities using different apportionment formulas.⁵⁴ In California a financial corporation uses an equally weighted three-factor apportionment formula⁵⁵ as opposed to the general corporation formula, which includes a double-weighted sales factor.⁵⁶ For purposes of a unitary combined return that includes both general and financial corporations, an equally weighted three-factor formula, as opposed to the double-weighted sales factor formula, is required if the combined group has more than 50 percent of its gross receipts from banking or financial institution activity.⁵⁷

In Massachusetts each entity included in a combined report separately calculates its own apportionment percentage using the apportionment rules applicable to that entity type.⁵⁸ The denominators of

each entity’s factors include the denominators of all members of the group.⁵⁹ Furthermore, an entity that uses a three-factor formula (for example, financial institutions) includes the property and payroll denominators of entities that otherwise use a single sales factor (for example, manufacturing companies).⁶⁰ Also, when a combined group includes one or more members that are financial institutions and one or more members that are nonfinancial institutions, some adjustments must be made to the members’ factors.⁶¹ For example, in these mixed groups, financial institutions’ intangible property values in the property factor must be reduced to 20 percent of the otherwise determined amounts, and some receipts that would be otherwise excluded from the sales factor of members that are not financial institutions are added to the denominators of such members.⁶²

The complexities surrounding financial institution taxation can hardly be understated and are expected to become increasingly complicated as states focus more on their taxation and the momentum of regulatory reform continues.

Bring on the Reform: The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) was signed into law with lofty hopes of reforming the financial services industry. The stated purpose of the legislation is “to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices.”⁶³ Under Dodd-Frank, protection translates into both increased and different regulatory oversight.

Although a dissertation on the regulatory provisions of Dodd-Frank is beyond the scope of this article, there are some headlining provisions worthy of consideration for state tax purposes:

- the abolishment of the Office of Thrift Supervision (OTS) and the increased supervision and regulation of the Board of Governors of the Federal Reserve System over some bank holding companies and some non-bank financial companies (covered non-bank financial companies);

⁴⁹*Id.* at section 63.32B.2(7)(d).

⁶⁰*Id.*

⁶¹*Id.* at section 63.32B.2(7)(h).

⁶²*Id.*

⁶³Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. No. 111-203, 124 Stat. 1376 (2010).

⁴⁹W.Va. Code section 11-24-13f.

⁵⁰W.Va. Code section 11-24-7(e) provides a three-factor apportionment with a double-weighted sales factor for apportioning the income of most corporations doing business within and without West Virginia.

⁵¹W.Va. Code section 110-24-7a.1.a.1.

⁵²35 ILCS section 5/304.

⁵³“In no event . . . may any unitary business group include members which are ordinarily required to apportion business income under different subsections of ILCS section 5/304.” 35 ILCS section 5/1501(a)(27). *See also* Illinois Private Letter Ruling IT 01-0003-PLR, Feb. 9, 2001.

⁵⁴Cal. Code Regs. section 25137-10; Mass. Gen. L., Ch. section 32B(c)(1).

⁵⁵Calif. Revenue and Taxation Code section 25128(b); Cal. Code Regs. section 25137-4.2(a)(2).

⁵⁶Calif. Revenue and Taxation Code section 25128. Effective January 1, 2011, corporations, other than those conducting a qualified business activity, can make an irrevocable annual election on an original timely filed return to apportion income based on a single-sales-factor formula. Calif. Revenue and Taxation Code section 25128.5. A qualified business activity includes a banking or financial business activity. Calif. Revenue and Taxation Code section 25128(c).

⁵⁷Cal. Code Regs. 25106.5(c)(7)(A); *see* Cal. Code Regs. section 25137-10(d) and (f).

⁵⁸830 Code Mass. Regs. section 63.32B.2(7)(a).

- the requirement under some circumstances to divest of particular types of business activities; and
- the provisions requiring the creation of resolution plans or “living wills” for some bank holding companies and covered non-bank financial companies.⁶⁴

Hasta la Vista, OTS

Title III of Dodd-Frank abolishes the OTS and generally transfers its responsibilities for the supervision and regulation of federal savings associations to the Office of the Comptroller of the Currency, state savings associations to the Federal Deposit Insurance Corporation, and savings and loan holding companies to the board of governors.⁶⁵ This transfer will be effective one year after the enactment of Dodd-Frank, unless extended for up to an additional six months by the Treasury secretary.⁶⁶ Together with the abolishment of the OTS comes increased regulatory oversight by the board for some bank holding companies and covered non-bank financial companies.⁶⁷ Of importance to state tax professionals is the fact that it does not generally

appear that either the changes in regulatory governing bodies or the increased regulatory oversight of covered non-bank financial institutions will affect the entity classification of those entities for state tax purposes.

Getting Skinny

Some provisions of Dodd-Frank require financial institutions to dispose of various components of their business that carry the most inherent risks, such as some trading activities. For example, “the Volcker Rule [Section 619 of the Act], generally prohibits banking entities and nonbank financial entities supervised by the Board under Section 102 of the Act from engaging in proprietary trading or acquiring or retaining an ownership interest in or sponsoring a hedge fund or a private equity fund.”⁶⁸ To the extent that states define or classify financial institutions by virtue of the activities that such entities engage in, the changes contained in the Volcker Rule or elsewhere in the federal legislation could affect an entity’s classification determination. For example, in determining whether a financial institution is excluded from Ohio’s commercial activity tax and is instead subject to the Ohio franchise tax, the definitional provisions for excluded financial organizations refer to activities “permissible” from a regulatory perspective.⁶⁹ Thus, if an entity engaged in activities that were permissible to some institutions from a regulatory perspective in 2010 but those activities are no longer permissible in a later year, a question arises as to whether the entity is subject to the Ohio franchise tax or the commercial activity tax. Also, to the extent that some activities must be divested, when the sell-off begins, consideration should be given to the state tax effect of those divestitures.

Grab the Paddles

Everyone, including the legislators who drafted Dodd-Frank, understands the importance of having a will when you are on life support. Under Dodd-Frank, the board and FDIC will require some bank holding companies and covered non-bank financial companies to prepare resolution plans, or living wills, the intent of which is to map out how they would be safely wound down in the case of financial distress or failure.⁷⁰ As with other restructurings,

⁶⁴Another hot topic for state tax purposes are the provisions regarding surplus line brokers and non-admitted insurers. The surplus lines provisions of Dodd-Frank are slated to take effect July 21, 2011. The provisions generally make a policyholder’s home state the sole regulator of any surplus line transaction, provide that certain premium taxes will be paid to the policyholder’s home state, and call on states to develop a method for the allocation of certain premium taxes. 15 U.S.C section 8201 et seq. States have begun to move on corresponding surplus line reform legislation, with California (AB 315 introduced on February 9, 2011) and New York (S 2811 and companion A A4011, introduced on February 1, 2011) being among the first.

⁶⁵Section 312 of Dodd-Frank. See also Sutherland Asbill & Brennan LLP Regulatory Reform Taskforce, *Summary Title III — Transfer of Powers to the Comptroller of the Currency, the Corporation, and the Board of Governors*, available at <http://www.regulatoryreformtaskforce.com/thebilliii/>.

⁶⁶Section 311 of Dodd-Frank.

⁶⁷Section 113 of Dodd-Frank grants the Financial Stability Oversight Council the authority to require certain U.S. and foreign non-bank financial companies to be supervised by the board of governors. Such board supervision will occur if the Financial Stability Oversight Council determines that material financial distress at such company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities at the company, could pose a threat to the financial stability of the United States. See *Sutherland Legal Alert: The Financial Stability Oversight Council Takes Action: New Insight Into Determination of Which Insurers May Be Subject to Enhanced Oversight* (Feb. 18, 2011), <http://www.sutherland.com/files/News/322b8284-fad7-4206-b010-25d7d2f563e0/Presentation/NewsAttachment/5b4d8935-3068-43ac-81f8-265c65e27f34/Regulatory%20Reform%20Task%20Force%20Alert%202.18.11.pdf>; see also Sutherland Asbill & Brennan LLP Regulatory Reform Taskforce, *Summary Title I — Financial Stability*, available at <http://www.regulatoryreformtaskforce.com/thebilli/>.

⁶⁸See Sutherland Asbill & Brennan LLP Regulatory Reform Taskforce, *Summary Title VI, Improvements Regulation of Banks and Savings Association Holding Companies and Depository Institutions*, available at <http://www.regulatoryreformtaskforce.com/titlevi/>.

⁶⁹Ohio Rev. Code section 5751.01(E).

⁷⁰Section 165(d) of Dodd-Frank. “The FRB must require each FRB-supervised nonbank financial company and BHC with at least \$50 billion in total consolidated assets to report periodically to the FRB, Council, and FDIC on its plan for

(Footnote continued on next page.)

liquidations, reorganizations, and so on, the state tax implications associated with devising a living will should be considered. Thus, to avoid future state tax calamity if an institution is subject to the living will requirements, state tax professionals are advised to be involved with their regulatory advisers to determine what the living will contains and how implementing it will affect state tax liabilities. If this state tax analysis is postponed until the living will is implemented (that is, when financial distress or failure has already occurred), it will be too late to focus on state taxation.

While the federal government and its agencies continue to wrestle with Dodd-Frank and flesh out many of its provisions, keeping track of those items and staying close to regulatory advisers regarding the issues that may affect state tax determinations and liabilities are critical.

rapid and orderly resolution (living wills) in the event of material financial distress or failure.” FDIC Staff Summary of Certain Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Sept. 10, 2010).

Conclusion

Determining whether an entity is taxable as a financial institution and the attendant consequences of the classification is becoming increasingly difficult and overly complicated. The answers to the critical questions not only change from state to state, but also are subject to varying interpretations. Finally, given that the federal government heavily regulates financial entities, simply looking to state tax law is inadequate as the evolving federal and state regulatory scheme can directly affect the state tax treatment of financial institutions. ☆

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Sutherland's SALT Practice is composed of more than 20 attorneys who focus on planning and controversy associated with income, franchise, sales and use, and property tax matters, as well as unclaimed property matters. Sutherland's SALT Practice also monitors and comments on state legislative and political efforts.