Taxation of financial institutions is a complex and developing area. As the definitions of a "financial institution" are progressively broadened, a number of corporations are being subject to tax under these complex, and often inconsistent, laws. While bank taxation has never been a particularly uniform practice, there are increasingly difficult issues, including entity classification, nexus, apportionment, combined reporting and due process.

The extent to which states tax financial institutions has broadened due to the evolution of the federal and state bank regulatory regimes. Initially, national banks were immune from state taxation.1 The power of states to tax national banks gradually expanded from the ability to tax real estate and shares of stock to the imposition of income-based taxes and, eventually, the ability to tax national banks and state-chartered banks equally.2 Furthermore, the states’ ability to exercise jurisdiction has changed from only consisting of taxing banks having principal places of business within the state to also including banks having principal places of business outside the state.3 Finally, the definition of a financial institution has been expanded and can now include corporations that predominantly deal in money or moneyed capital, if that corporation competes with banks.4 With these expansions, numerous questions arise regarding if, and how, a multistate financial institution should be taxed in each state. This article addresses the nexus and apportionment challenges in today’s landscape presented by the various state approaches. These issues affect traditional financial institutions, as well as other corporations that now fall within the expanded definitions.

Nexus

With the prevalence of Internet banking and the expansion of financial services offered by financial institutions and other corporations, the assertion of nexus on these entities is an ever-developing area. Prior to the allowance of interstate banking, the locations of a financial institution’s headquarters and its branches were typically the only locations in which the company was doing business and, therefore, subject to tax. However, the analysis is no longer that simple.

In the mid-1980s, the Multistate Tax Commission (“MTC”) undertook a project to draft uniform apportionment regulations for financial institutions.5 Along the way, draft regulations regarding nexus were added.6 The uniformity project was an attempt to balance the interests of “money-center states” and “market-center states.”7 The money-center states were those in which large financial institutions were domiciled.8 The market-center states were those in which the significance of customers in the state exceeded the number of financial institutions domiciled there.9 The money-center states, such as New York, were focused on taxing financial institutions where the lending decisions were made and the loan management occurred.10 The market-center states, such as Indiana, sought to tax the income that banks derived from residents of that state.11 While the project was arguably successful in that uniform regulations were developed for the apportionment of income, as we discuss later, the draft nexus provisions were abandoned because it was felt that the nexus provisions could not be “effectively addressed” at that time.12 With the states left to their own devices, a number of nexus approaches have developed that extend beyond the required physical presence.

Nexus—Economic Presence Standards

Almost 30 years ago, in 1985, the Tennessee Department of Revenue assessed J.C. Penney National Bank on the basis that it was doing business in the State, even though its activities in the State were limited to the solicitation of Tennessee customers.13 The Tennessee statute provided that The definition of a financial institution has been expanded and can now include corporations that predominantly deal in money or moneyed capital, if that corporation competes with banks. a corporation was doing business in the State if it “regularly engage[d] in transactions with customers in this state that involve intangible property, including loans, and result in receipts flowing to the taxpayer from within this state.”14 The Tennessee Court of Appeals declined to uphold the assessment when the Department could not point to any case “in which the Supreme Court of the United States has upheld a state tax where the out-of-state taxpayer had absolutely no physical presence in the taxing state.”15
In *Tax Commissioner of West Virginia v. MBNA America Bank*, N.A, MBNA America Bank, N.A. (“MBNA”) offered unsecured credit cards to customers in West Virginia. MBNA had no tangible personal property or employees in West Virginia and solicited customers in the State by telephone and mail. The West Virginia Supreme Court of Appeals held that MBNA’s systematic and continuous solicitations and promotion in the State, combined with the significant gross receipts attributable to West Virginia customers was sufficient for the State to subject MBNA to tax.

However, just what constitutes the necessary solicitation and promotion is unclear. What if email solicitations were sent to West Virginia residents? What if the solicitation occurred as part of a national advertising campaign that ran advertisements during a nationally televised broadcast?

Even the West Virginia Supreme Court of Appeals struggles with the nexus requirements. In *Griffith v. ConAgra Brands, Inc.*, the court distinguished MBNA and prohibited the West Virginia State Tax Commissioner from assessing a corporation that licensed intellectual property to related and unrelated parties. In addition, in his well-reasoned concurring opinion, Justice Benjamin sought to overrule MBNA. Justice Benjamin argued that if MBNA is allowed to stand, it “will continue to linger like a dormant virus in our body of law, threatening to erupt into a full-blown infection.”

**Nexus—Presumptions**

As initially attempted by the MTC in the draft regulations, some states have endeavored to create more bright-line tests to determine if a financial institution is subject to tax in the state. In Minnesota, absent a physical presence, there is a rebuttable presumption that a financial institution is subject to tax if it has assets and deposits attributable to sources within Minnesota that equal or exceed $5 million or if it has 20 or more customers in the State.

However, even if a financial institution satisfies the presumption, there are arguments that the corporation’s connection to Minnesota would be insufficient under the U.S. Constitution. The Due Process Clause “requires some definite link, some minimum connection, between a state and the [corporation] it seeks to tax.” A financial institution with only 20 customers in a state arguably does not satisfy that test. Even though the Tennessee Court of Appeals held that J.C. Penney National Bank’s solicitation of credit cards for customers in Tennessee was sufficient to meet the Due Process Clause, that corporation had between 11,000 and 17,000 customers in Tennessee during the years at issue.

Another constitutional hurdle is the Commerce Clause, which requires that a corporation have “substantial nexus” with the taxing state. Whether having only 20 customers under Minnesota’s presumption would pass that hurdle is challengeable. Tennessee’s assessment against J.C. Penney National Bank, with over 500 times that amount of customers, failed to meet the necessary requirements of the Commerce Clause.

Provisions similar to Minnesota’s can be found in a number of states, including Kentucky and Tennessee. In Kentucky, a financial institution is presumed to be subject to the State’s franchise tax if it obtains or solicits business from 20 or more people within the State or if it has $100,000 or more in receipts attributable to sources within Kentucky.

The Tennessee statute provides a number of activities under which a financial institution is presumed to be doing business in the State, including regularly soliciting business in the State and regularly soliciting and receiving deposits from customers in the State. However, the statute should be tempered by the Tennessee Court of Appeals decision that held that an out-of-state credit card bank could only be subject to tax in the State if it had a physical presence.

**Apportionment**

Another continuously developing area is the specialized apportionment provisions that states have enacted for financial institutions. In 1994, the MTC adopted proposed apportionment regulations for financial institutions. These provisions reflected the attempt to balance the interests of the money-center states and the market-center states. A number of states have enacted the MTC provisions (which some states have subsequently repealed) or enacted modified versions of the provisions.

**Apportionment—Property Factor**
Under the current MTC apportionment provisions for financial institutions, the assignment of loans in the property factor tends to incite the most angst between taxpayers and taxing authorities. In essence, loans are assigned to the regular place of business of the taxpayer with which the loans have a preponderance of “substantive contacts.” The relevant factors for determining “substantive contacts” include solicitation, investigation, negotiation, approval and administration of the loans (“SINAA”). The development of these factors shows acquiescence to the interests of the money-center states. Twenty years ago, the SINAA factors generally occurred at the headquarters location of a bank where most lending decisions were made. Indeed, prior to appearing in the MTC’s regulations, the SINAA factors were already part of New York’s taxing scheme for banks. However, today the application of the SINAA factors is not so clear cut.

If customers apply for loans through a financial institution’s website, where did the solicitation of those loans occur? One possibility would be where the financial institution developed its advertising campaigns and maintained its website, typically at its headquarters. However, a state may argue that the location where the customer accessed the website is where the solicitation occurred. Unfortunately, in today’s world it is no longer as simple as looking to where a postcard advertisement was mailed. And solicitation is only one of the five factors to analyze when determining the assignment of loans.

Financial institutions also face inconsistent provisions with respect to the property factor, as some states have enacted market-based sourcing provisions for the assignment of loans, while other states exclude loans entirely from the property factor. Financial institutions can easily get whipsawed by the competing interests of states under these provisions. For example, if a customer is located in Minnesota and the financial institution is located in Kentucky, the loan may be assigned to both states.

Apportionment—Sales Factor

As many states turn to a single sales factor formula to apportion income, issues abound with the assignment of receipts based upon the costs of performance. Commonly, different types of receipts are assigned to a state based upon the costs of performance. In Oregon, receipts that are not specifically enumerated are assigned to the location of the income producing activity, based on the costs of performance. For a financial institution, these receipts can include a variety of different fees, including late payment fees and overdraft fees.

If a customer in Oregon is charged late payment fees, in which state is the income producing activity related to those fees? Although it could be argued that the action that generated the fees was the customer’s untimely payment, the customer’s actions are not considered in the income producing activity analysis as the customer is not the taxpayer. Furthermore, the determination of the costs of performance for each type of fee can be difficult. Are the costs of developing the program that automatically assessed the late payment penalty included? What about the costs of cashing the check that included the payment of the fee? In addition, there is a trend among states to apply market sourcing rules to assign certain receipts, even though costs of performance rules have been enacted by the state.

Conclusion

With the nuances that traditional financial institutions and other corporations face in the area of state taxation, it is important that the ever-changing landscape is monitored. The states are limited by the constraints of the U.S. Constitution in both the assertion of nexus and the apportionment of income. With the resurgence of the Due Process Clause in recent state tax cases, financial institutions and other corporations should analyze whether they have the necessary minimum contacts with a state, as well as the substantial nexus connections of the Commerce Clause.