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ARTICLES

STATE TAXATION OF INTERSTATE BANKING

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> All subjects over which the sovereign power of a State extends, are objects of taxation; but those over which it does not extend, are, upon the soundest principles, exempt from taxation.[1]
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> I find little difficulty in concluding that exaction of a tax by a State which has no jurisdiction or lawful authority to impose it is a taking of property without due process of law. The difficulty is that the concept of jurisdiction is not defined by the Constitution.[2]

More than a century of judicial exposition separated the rule announced with such certainty by Justice Marshall in 1819 from the retort by Justice Jackson in 1942 that Marshall's rule defined nothing. Yet it was not until 1945 and *International Shoe Co. v. Washington*[3] that the Court abandoned the sweeping absolutism of early concepts of jurisdiction and began to craft a judicial response

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[1] McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 429 (1819) (Marshall, C.J.).

[2] State Tax Comm'n v. Aldrich, 316 U.S. 174, 201 (1942) (Jackson, J., dissenting).

[3] 326 U.S. 310 (1945) (noting that jurisdiction may be based on minimum contacts with a forum).

to the vexing question of jurisdiction in our federal system. In *International Shoe*, the Court moved away from its early "power" theory of jurisdiction—basing jurisdiction solely on the physical presence of individuals or corporate entities within the state—and replaced it with a sophisticated fairness standard. The new standard presents no constitutional impediment to a state's exercise of jurisdiction over nonresident and absent defendants/taxpayers when certain minimum contacts with the state are present.[4]

State assertion of taxing jurisdiction over multijurisdictional banking corporations, however, remains mired in the Marshall era of physical presence. States have typically sought to tax only those banks that have their principal offices within state borders. The most important reason for the failure of states to assert taxing jurisdiction over in-state banking activities conducted by an out-of-state bank is the persistent myth that because federal and state laws prohibit interstate *branching*, banks do not engage in interstate *banking*. By popular perception, interstate branching (prohibited unless state law expressly permits it) is equated with interstate banking (prohibited by neither state nor federal law). Thus, in structuring their bank taxation laws, most states have not tried to reach the income that is earned from in-state sources by out-of-state banks.

It is time for states to draft new legislation that addresses modern banking activities. Several recent developments lead to that conclusion. First, in 1976, Congress effectively repealed the 1842 federal statute that had drastically curtailed state power to tax national banks and, because of regulatory competition, had the indirect effect of limiting state taxation of state-chartered banks.[5] States are now free to tax national banks as they do any other business corporation, provided that they do not discriminate be-

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[4] *Id.* at 316.

[5] *See infra* notes 40-53 and accompanying text. For many years, a federal statute restricted state taxation of *national* banks to one of four kinds of taxes. Another federal statute similarly restricted state taxation of *federal* obligations. These restrictions had a profound effect on state taxation of *state-chartered* banks and even *state* obligations because states were loathe to tax their own banks and obligations more harshly than they taxed national banks and federal obligations; states have typically taxed their own banks and obligations in a manner consistent with the restrictive federal scheme.

tween national banks and state banks. Second, in the last decade the Supreme Court has changed its interpretation of the restrictions the commerce clause imposes on state taxation of interstate business in a way that permits states greater flexibility in the methods they choose.[6] Third, several recent Supreme Court decisions have struck down state taxes on national banks, requiring the affected states, as well as states with similar statutes, to amend their bank tax laws.[7] Fourth, state regional compacts that formally permit interstate branching within defined areas are bound to accelerate the spread of informal interstate banking. Finally, the increasing sophistication of computer technology promises to revolutionize banking practices, raising a real possibility that local brick-and-mortar banks will become less important—if not extinct.

This article will show that market states have jurisdiction to tax out-of-state banks that earn income within those states by soliciting loans and deposits there and by providing services to resident customers. The article urges states to adopt a tax that will allow them to reach, via an apportionment formula, that part of the entire net income earned by in-state and out-of-state banks that is attributable to sources within their borders. The optimal tax for this purpose is a franchise tax measured by net income. Part I will briefly review the statutory and judicial framework within which state and national banks must operate. It will also examine the statutory and legislative restrictions on state taxation of banks. In part II, the scope and character of interstate bank and bank-related activities will be considered. This section will examine whether states can, consistent with the due process and commerce clauses, tax banks that conduct such activities. Finally, part III will trace the judicial history of the corporate franchise tax. The article will then conclude that a like tax on banks, measured by the banks' net income, would allow states to reach all of the income that they are con-

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[6] *See, e.g.*, Western and Southern Life Ins. Co. v. State Bd. of Equalization, 451 U.S. 648 (1981) (California's retaliatory tax does not violate the commerce clause); Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980) (Vermont's taxation of "foreign source" dividend income does not violate the commerce clause).

[7] *See, e.g.*, American Bank & Trust Co. v. Dallas County, 463 U.S. 855 (1983) (Texas bank shares tax violated statute precluding a tax based on federal obligations).

stitutionally permitted to tax and therefore be the optimal tax.

I. THE STATUTORY AND JUDICIAL STRUCTURE OF BANKING[8]

A. *Branch Banking*

Unless expressly permitted by state law, both state-chartered and federally-chartered banks are prohibited from operating interstate through branch banks. Prior to 1927, national banks, but not state banks, were forbidden to engage in any branch banking whether interstate or intrastate.[9] In that year, Congress enacted the McFadden Act[10] which amended the National Bank Act[11] to allow national banks to establish branch banks within the states in which they were located "if such establishment and operation are . . . expressly authorized to State banks by the law of the State in question . . . ."[12] The McFadden Act also applies to state banks that are members of the Federal Reserve System.[13] The Act did not

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[8] For a detailed history of the federal legislative and judicial roots of modern banking laws, see ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, 94TH CONG., 1ST SESS., REPORT OF A STUDY UNDER PUBLIC LAW 93-100, STATE AND LOCAL "DOING BUSINESS" TAXES ON OUT-OF-STATE FINANCIAL DEPOSITORIES, BEFORE THE SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS (Comm. Print 1975); BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, 92ND CONG., 1ST SESS., REPORT OF A STUDY UNDER PUBLIC LAW 91-156, STATE AND LOCAL TAXATION OF BANKS, BEFORE THE SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS (Comm. Print 1971).

[9] Before 1927, the National Bank Act, ch. 106, 13 Stat. 101 (1864), provided that the "usual business" of a national bank "shall be transacted at an office or banking house located in the place specified in its organization certificate." *Id.* § 8, 13 Stat. at 102. In First National Bank v. Missouri, 263 U.S. 640 (1924), the Supreme Court, interpreting the Act, held that (a) national banks can exercise only those powers that are expressly granted them under the National Bank Act or such incidental powers as are necessary to carry on the business for which they are established, (b) the power to operate a branch bank was neither expressly granted in nor necessarily implied from the National Bank Act, and (c) therefore, the First National Bank was subject to the Missouri laws that prohibited intrastate branch banking. This opinion created an imbalance between state-chartered and federally-chartered banks because state-chartered banks were not subject to a judicially-imposed, per se ban.

[10] Ch. 191, 44 Stat. 1224 (1927) (codified as amended in scattered sections of 12 U.S.C.). For easier reference, further citations to the McFadden Act will direct the reader to the *United States Code*.

[11] Ch. 106, 13 Stat. 101 (1864).

[12] 12 U.S.C. § 36(c)(1) (1982).

[13] The Federal Reserve Act, ch. 6, § 9, 38 Stat. 251, 259 (1913), provided that state banks that are members of the Federal Reserve System are subject to the same branching restrictions that apply to national banks under 12 U.S.C. § 36 (1982).

lift the ban on *interstate* branching, however;[14] although the McFadden Act authorizes both state and national banks to establish intrastate branches to the extent allowed by the laws of the states in which they are located, it does not empower either state or national banks to engage in interstate branching regardless of state law.[15]

If the McFadden Act does not authorize national banks to engage in interstate *branching*, it does not prohibit national banks from engaging in interstate *banking*. According to the Act, a branch "include[s] any branch bank, branch office, branch agency, additional office or any branch place of business . . . at which deposits are received, or checks paid, or money lent."[16] Although the language defining the prohibited activity is framed in the disjunctive, there is plenty of room within the definition for an out-of-state national bank to engage in banking and bank-like activity without violating the McFadden Act. For example, if a national bank transacts business in the host state through the mail or by telephone, it has not established a *place* of business in the host state. The out-of-state bank is not operating through a branch.[17]

The interstate branching ban did not prevent all branching activity. Some national banks found a loophole in the law through which they were effectively able to engage in interstate branching. If the Act prevented a bank from branching directly, it did not prohibit a parent bank holding company from acquiring or establishing separately chartered and separately capitalized subsidiary banks in different locations throughout a state as well as across state lines.

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[14] *See* 12 U.S.C. § 81 (1982). The statutory restrictions on where a national bank can conduct activities are as follows: "The general business of each national banking association shall be transacted in the place specified in its organization certificate and in the branch or branches, if any, established or maintained by it in accordance with the provisions of section 36 of this title." *Id.* Section 36 then authorizes national banks to establish and operate branches within the states in which they are located if state law allows state banks to branch. 12 U.S.C. § 36(c)(1) (1982).

[15] The McFadden Act authorizes the Comptroller of the Currency (for national banks) and the Federal Reserve Board (for state member banks) to approve a branch of a national or state member bank only if the law of the bank's home state specifically authorizes such a branch for state banks and then only "at any point within the State in which [it] is situated." 12 U.S.C. § 36(c) (1982).

[16] *Id.* § 36(f).

[17] *See infra* notes 91-92.

The Bank Holding Company Act,[18] however, closed the loophole by prohibiting interstate branching through subsidiary banks.[19]

According to section 3(a) of the Bank Holding Company Act,[20] the Board of Governors of the Federal Reserve System[21] must approve all bank acquisitions by a bank or a bank holding company.[22] Section 3(d) of the Act,[23] popularly known as the Douglas Amendment, provides that under certain circumstances the Board of Governors may not approve an application submitted by a bank or a bank holding company to acquire a bank. If the bank sought to be acquired is located outside the holding company's principal state of operation, the application will be rejected unless the laws of the state in which the bank is to be acquired or established expressly provide for such entry.[24] Thus, unlike the McFadden Act, the Douglas Amendment authorizes interstate branching through subsidiary banks if state law allows.

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[18] Ch. 240, 70 Stat. 133 (1956) (codified at 12 U.S.C. §§ 1841-50 (1982)). For easier reference, further citations to the Bank Holding Company Act will direct the reader to the *United States Code*.

[19] *See* 12 U.S.C. § 1843(d)(1) (1982). The Bank Holding Company Act (and the Douglas Amendment thereto, *see infra* note 23 and accompanying text) applied only to multibank holding companies. In 1970, the Bank Holding Company Act was amended to bring one-bank holding companies under the supervision of the Federal Reserve Board and to subject them to the geographical restrictions of the Douglas Amendment. Act of Dec. 31, 1970, Pub. L. No. 91-607, § 101, 84 Stat. 1760, 1760 (codified at 12 U.S.C. § 1841(a)(1) (1982)).

[20] 12 U.S.C. § 1842(a) (1982).

[21] The Board of Governors of the Federal Reserve System is the primary regulator of bank holding companies. *See id.* § 1844(c).

[22] The Act applies to both banks and bank holding companies. Because the Act defines a bank holding company as any corporation, partnership, business trust, association or similar organization that owns or has control over a bank or another bank holding company, *see id.* § 1841(a)(1), (b), a bank that proposes to acquire another bank would thereby become a bank holding company. The Act controls all acquisitions of banks by entities that are or that *would become* bank holding companies after the acquisition. A bank holding company is deemed to have control over a bank when (a) it has the power to vote 25% or more of any class of voting securities of the bank, (b) it has the power to elect or influence the election of directors or trustees of the bank, or (c) the Board of Governors of the Federal Reserve System determines that it exercises a controlling influence over the management or policies of the bank. *See id.* § 1841(a)(2); 12 C.F.R. § 225.2(d) (1985). The Act applies equally to acquisitions of state-chartered and federally-chartered banks.

[23] 12 U.S.C. § 1842(d) (1982).

[24] *Id.*

The Douglas Amendment restrictions apply only to interstate acquisitions of "banks." Section 2(c) of the Act defines a bank as a company that both accepts demand deposits and engages in the business of making commercial loans.[25] Bank holding companies may expand by acquiring or establishing "non-bank" subsidiaries without violating the Act and without regard to state law.[26]

To summarize, branch banking is controlled by both state and federal law. First, for those banks subject to the McFadden Act, the following rules apply: each state's law will determine whether a national or state bank may engage in branch banking within its borders, and each state's law will determine which activities engaged in by *state* banks constitute branch banking. The federal McFadden Act will determine whether any particular operation engaged in or facility established by *national* banks constitutes branch banking.[27] Because the McFadden Act provides only a skeletal definition of the term "branch," the administrative and judicial interpretations set the parameters of the covered activities.[28]

Second, for those entities subject to the Douglas Amendment, the following rules apply: state law will determine whether a bank or bank holding company can acquire a subsidiary bank within a state. Again, however, federal law will determine whether a particular entity acquired by a bank holding company is a "bank." For example, since the Bank Holding Company Act defines a bank as an entity that both accepts deposits *and* engages in the business of making commercial loans, a subsidiary that accepts demand depos-

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[25] *Id.* § 1841(c).

[26] States cannot by legislation forbid the entry of non-bank organizations without running afoul of the commerce clause. *See* Lewis v. BT Inv. Managers, Inc., 447 U.S. 27 (1980) (Florida statute prohibiting out-of-state banks, holding companies, and trust companies from owning any Florida investment advisory services violates commerce clause); *see also* Board of Governors v. Dimension Fin. Corp., 474 U.S. 361 (1986) (non-bank banks are not subject to restrictions of the Bank Holding Company Act); Florida Dep't of Banking and Fin. v. Board of Governors, 760 F.2d 1135 (11th Cir. 1985) (non-bank banks are not subject to the geographical restrictions of the Douglas Amendment), *vacated*, 106 S. Ct. 875, *rev'd on remand*, 800 F.2d 1534 (11th Cir. 1986), *cert. denied*, 107 S. Ct. 1887 (1987).

[27] *See* First Nat'l Bank v. Dickinson, 396 U.S. 122 (1969) (the definition of "branch" found in the McFadden Act must not be given a "restrictive" meaning that would frustrate congressional intent).

[28] *See infra* notes 86-88.

its and makes only consumer loans or makes commercial loans but does not accept demand deposits is not a forbidden "bank."[29] A bank holding company may acquire such a subsidiary without regard to either the McFadden Act or state law.[30] As this indicates, although interstate branching is restricted by statutes, there is wide latitude within this complex state-federal scheme for banks to engage in interstate banking and bank-like activities. These activities will be explored in depth in part II.

B. State Taxation of Banks[31]

In 1819, in *McCulloch v. Maryland*,[32] the Supreme Court first announced its doctrine of intergovernmental tax immunity. The case involved the constitutionality of a Maryland law that imposed a tax on bank notes issued by any bank or branch not chartered by Maryland. Maryland state-chartered banks were not subject to the same or similar tax. When branches of the Bank of the United States refused to comply with Maryland's taxing statute, the state brought suit to recover the tax and penalties. In a sweeping opinion in which Justice Marshall uttered his famous statement that the "power to tax involves the power to destroy,"[33] the Court held

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[29] *See* 12 U.S.C. § 1842(c), (d) (1982).

[30] The acquisition of a non-bank subsidiary does not violate the McFadden Act because that Act applies to national banks, not to bank holding companies. For purposes of the Bank Holding Company Act, the Supreme Court has held fast to a strict interpretation of the terms "deposit" and "commercial loan," *see* Board of Governors v. Dimension Fin. Corp., 474 U.S. 361 (1986), and to the requirement that the definition of the term "bank" be read in the conjunctive. *See* Florida Dep't of Banking and Fin. v. Board of Governors, 760 F.2d 1135 (11th Cir. 1985), *vacated*, 106 S. Ct. 875, *rev'd on remand*, 800 F.2d 1534 (1986), *cert. denied*, 107 S. Ct. 1887 (1987).

[31] *See generally* P. HARTMAN, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION §§ 6:1-6:28 (1981) (extensive review of the history of the intergovernmental immunity doctrine); J. HELLERSTEIN, STATE TAXATION §§ 7.1, 7.4, 10.5[1] (1983) (discussion of franchise taxes, income from federal and state obligations, and financial businesses).

[32] 17 U.S. (4 Wheat.) 316 (1819).

[33] *Id.* at 431. Justice Holmes declared in his equally famous retort that "[t]he power to tax is not the power to destroy while this Court sits." Panhandle Oil Co. v. Mississippi, 277 U.S. 218, 223 (1927) (Holmes, J., dissenting), *overruled*, Alabama v. King & Boozer, 314 U.S. 1 (1941). Justice Frankfurter called the Marshall aphorism a "flourish of rhetoric" and a "seductive *cliche*." Graves v. New York, 306 U.S. 466, 489 (1939) (Frankfurter, J., concurring).

unconstitutional almost all state taxes levied on a governmental instrumentality such as a national bank. The necessary and proper clause and the supremacy clause formed the constitutional basis for the Court's holding.[34]

In 1829, the Court applied its intergovernmental tax immunity doctrine to strike down a property tax imposed by Charleston, South Carolina on stock issued by the Bank of the United States and held by a private individual.[35] Like the Maryland law in *McCulloch*, the Charleston ordinance exempted from the tax all stock issued by the state of South Carolina.[36] According to the *Weston v. Charleston*[37] Court, the tax violated the borrowing clause of the Constitution[38] because it was a tax on the power "to borrow Money on the credit of the United States."[39]

Congress later codified these two prongs of the judicially- created intergovernmental immunity doctrine. In 1862, Congress adopted a legislative exemption from state taxation for "all stocks, bonds, and other securities of the United States held by individuals, corporations or associations within the United States,"[40] mirroring the *Weston* decision. In 1864, Congress passed the National Bank Act,[41] which permitted state taxation of national banks only on their real estate and on their shares[42]—the two methods left open by the *McCulloch* decision.[43]

1. The Intergovernmental Immunity Doctrine and State Taxation of National Banks. From the latter half of the nineteenth century

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[34] 17 U.S. at 411-37. According to the *McCulloch* Court, because a national bank would facilitate the exercise of the fiscal powers expressly delegated to the national government, Congress could properly conclude that a national bank was necessary to carry out those powers. Because a national bank was necessary and proper, the decision of Congress to incorporate such banks was part of the supreme law of the land. *Id*; *see* U.S. CONST. art. I, § 8, cl. 18 (necessary and proper clause); *id.* art. VI, cl. 2 (supremacy clause).

[35] Weston v. Charleston, 27 U.S. (2 Pet.) 449, 467-69 (1829).

[36] *Id.* at 449-50.

[37] *Id.* at 449.

[38] U.S. CONST. art I, § 8, cl. 2.

[39] *Id., cited in Weston*, 27 U.S. at 464.

[40] Act of Feb. 25, 1862, ch. 33, § 2, 12 Stat. 345, 346 (current version at 31 U.S.C. § 3124 (1982)) (referred to as section 3701).

[41] Ch. 106, 13 Stat. 99 (1864).

[42] *Id.* § 8, 13 Stat. at 101.

[43] 17 U.S. at 436-37.

through the beginning of this century, the Supreme Court broadened the scope of the intergovernmental immunity doctrine. The Court invalidated state taxes imposed on all governmental instrumentalities,[44] salaries of private parties who were employees of governmental instrumentalities,[45] and revenue earned by third parties who were doing business with the government or its instrumentalities by selling goods or services to them.[46] In the late 1930's, however, the Court began to constrict the doctrine by chipping away at some of these exemptions.[47]

After the Court sanctioned the power of Congress to control state and local taxation by either granting tax exemptions to its instruments or waiving constitutionally implied exemptions,[48] that

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[44] *See* Cleveland v. United States, 323 U.S. 329 (1945) (lands acquired by United States by condemnation exempt from state taxation); Federal Land Bank v. Bismarck Lumber Co., 314 U.S. 95, 102 (1941) ("Congress has the power to protect the instrumentalities which it has constitutionally created"); Pittman v. Home Owners' Loan Corp., 308 U.S. 21 (1939) (mortgages secured under the congressionally-created Home Owners' Loan Corporation exempt from state and municipal taxation); Long v. Rockwood, 277 U.S. 142 (1928) (royalties received from patents could not be taxed by a state), *overruled*, Fox Film Corp. v. Doyal, 286 U.S. 123 (1932); First Nat'l Bank v. Anderson, 269 U.S. 341 (1926) (county not permitted to tax national banks at a higher rate than competing "moneyed capital" of individual state residents).

[45] *See* Collector v. Day, 78 U.S. (11 Wall.) 113 (1870) (the governmental tax immunity granted to federal officers is reciprocal; state officers are therefore protected against federal taxation to the same degree that federal officers are protected against state taxation), *overruled*, Graves v. New York, 306 U.S. 466 (1938); Dobbins v. Commissioner of Erie County, 41 U.S. (16 Pet.) 435 (1842) (states cannot tax the employment income of federal officers).

[46] *See* Panhandle Oil Co. v. Mississippi, 277 U.S. 218 (1928) (voiding a state tax imposed on gasoline dealers as applied to sales to the Coast Guard and a Veterans' hospital), *overruled*, Alabama v. King & Boozer, 314 U.S. 1 (1941).

[47] *See, e.g.*, Alabama v. King & Boozer, 314 U.S. 1 (1941) (no sales tax immunity for a contractor purchasing building materials for use in performing a "cost-plus" building contract for the government); Graves v. New York, 306 U.S. 466 (1938) (employee of Home Owners' Loan Corporation is not exempt from non-discriminatory state taxation of his salary); *see generally* Rakestraw, *The Reciprocal Rule of Governmental Tax Immunity—A Legal Myth*, 3 OKLA. L. REV. 131 (1950) (changing policies regarding tax immunities result from judicial decisions); Symons, *State Taxation of Banks: Federal Limitations*, 99 BANKING L.J. 817 (1982) (state taxation of banks is supported by constitutional and statutory history dating back to *McCulloch*).

[48] *See* Helvering v. Gerhardt, 304 U.S. 405, 411-12 (1938) ("Congress may *curtail* an immunity which might otherwise be implied . . . or enlarge it beyond the point where, Congress being silent, the Court would set its limits.") (emphasis

legislative body too became a more active participant in the tax immunity arena. Congress gradually withdrew the judicially-created tax immunity of national banks. For example, in 1923 and 1926, Congress revised its early statute limiting state taxation of national banks to real property taxes and bank share taxes. Section 5219 added three new methods by which a state could tax a national bank: including bank share dividends in the taxable income of a shareholder; imposing a net income tax; and levying a franchise tax according to or measured by net income.[49]

Congress added the last method in order to correct the imbalance created when the Supreme Court upheld state franchise taxes on *state-chartered* banks measured by net income, including income from federal securities,[50] but struck down a similar state franchise tax levied against a national bank.[51] Finally, in 1976, Congress removed all prior statutory restrictions on state taxation of national banks.[52] The law currently provides that "[f]or the purposes of any tax law enacted under authority of the United States or any State,

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added); Oklahoma v. Barnsdall Refineries, 296 U.S. 521, 556 (1936) (an act of Congress which waives the immunity from state taxation of instrumentalities of the Federal Government, such as leases of Indian oil lands, should be strictly construed), *overruled*, Oklahoma Tax Comm'n v. Texas Co., 336 U.S. 342 (1949); Owensboro Nat'l Bank v. Owensboro, 173 U.S. 664 (1899) (state power to tax national banks only permitted within the purview of the authority conferred by Congress); Mercantile Nat'l Bank v. New York, 121 U.S. 138 (1887) (bonds of municipal corporations are not within the scope of Congress' intent for the taxation of national banks); Van Allen v. Assessors, 70 U.S. (3 Wall.) 573 (1865) (state cannot tax *shares* of national banking associations unless there is an equivalent tax on *shares* in state banks).

[49] Act of Mar. 4, 1923, ch. 267, 42 Stat. 1499 (codified as amended at 12 U.S.C. § 548 (1982)); Act of Mar. 25, 1926, ch. 88, 44 Stat. 223 (codified as amended at 12 U.S.C. § 548 (1982)).

[50] *See, e.g.*, Home Ins. Co. v. New York, 134 U.S. 594 (1890) (state tax on corporate dividends is valid even though some of those dividends may be derived from Government bonds); Society for Sav. v. Coite, 73 U.S. (6 Wall.) 594 (1867) (state tax on "savings societies" is valid); Provident Inst. for Sav. v. Massachusetts, 73 U.S. (6 Wall.) 611 (1867) (state tax on the amount of deposits assessed against every institution for saving incorporated in Massachusetts upheld).

[51] *See* Owensboro Nat'l Bank v. Owensboro, 173 U.S. 664 (1899) (states have power to tax national banks on the shares of stock in the names of the shareholders and on an assessment of the real estate of the bank); *see also* 67 CONG. REC. 6083-84 (1926); *infra* note 173.

[52] *See* State Taxation of Depositories Act, Pub. L. No. 94-222, §§ 1, 4, 90 Stat. 197, 198 (1976).

a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located."[53] The only remaining restriction on state taxation of national banks is that such taxes must not discriminate against national banks.

2. The Intergovernmental Immunity Doctrine and State Taxation of Federal Obligations. Like the early legislation exempting national banks from state taxation, the legislation exempting federal securities from state taxation mirrored the per se judicial prohibition.[54] In the case of federal securities, however, there was no need for a gradual relaxation of the strict language. Because the Court had upheld both bank shares taxes, measured by the value of all bank assets including federal obligations,[55] and franchise taxes, measured by the entire net income of the corporation including income from federal obligations,[56] the per se prohibition of the statute was ineffective. The original 1862 statute remained intact until 1959. In that year, section 3701 was amended[57] to make clear that an Idaho individual income tax on interest earned on federal obligations violated the exemption.[58] The judicially-created exemption for franchise taxes measured by net income was also added. The section currently provides:

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[53] 12 U.S.C. § 548 (1982).

[54] "[A]ll stocks, bonds, and other securities of the United States held by individuals, corporations, or associations, within the United States, shall be exempt from taxation by or under State authority." Act of Feb. 25, 1862, ch. 33, § 2, 12 Stat. 345, 346 (codified as amended at 31 U.S.C. § 3124 (1982)).

[55] *See* Home Ins. Co. v. New York, 134 U.S. 594 (1890) (state tax on the dividends derived from federal bonds held valid). In American Bank & Trust Co. v. Dallas County, 463 U.S. 855 (1983), the Supreme Court struck down as violative of section 3701 a state property tax on bank shares computed on the basis of the bank's net assets because the tax included in its measure the value of federal obligations. *Id.* at 862-65.

[56] *See* Society for Sav. v. Coite, 73 U.S. (6 Wall.) 594 (1867) (state franchise tax measured by net income including income from federal obligations levied on a *state-chartered* bank held valid).

[57] Act of Sept. 22, 1959, Pub. L. No. 86-346, § 105(a), 73 Stat. 621, 622.

[58] *See Hearings on Public Debt Ceiling and Interest Rate Ceiling on Bonds Before the House Comm. on Ways and Means*, 86th Cong., 1st Sess. 69-72 (1959) (supplemental statement of Secretary of the Treasury Robert B. Anderson); American Bank & Trust Co. v. Dallas County, 463 U.S. 855, 866-67 (1983) ("Congress intended to sweep away formal distinctions and to invalidate all taxes measured directly or undirectly by the value of federal obligations, except those specified in the amendment.").

> Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, *except* . . . a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation . . . .[59]

Although the holdings of the Supreme Court eased the congressional ban against state taxation of federal obligations, the prohibitory legislation profoundly affected state taxation of bank income. For example, the judicially-created franchise tax exception to the per se ban on state taxation of federal obligations caused many states to choose a franchise tax in order to reach this significant portion of bank income.[60] However, another judicially-created restriction prohibited states from taxing businesses engaged in interstate commerce by means of a franchise tax.[61]

With only one kind of bank tax, states could not reach income from both interstate activities and from federal obligations. The

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[59] 31 U.S.C. § 3124(a) (1982) (emphasis added). The 1959 amendment ratified the earlier Supreme Court decisions upholding franchise taxes measured by net income including income from federal obligations. *See, e.g.*, Reuben L. Anderson-Cherne Inc. v. Commissioner of Taxation, 303 Minn. 124, 226 N.W.2d 611 (corporate franchise tax measured by net income including income from federal obligations does not violate federal law), *appeal dismissed*, 423 U.S. 886 (1975). In *Anderson-Cherne*, the Supreme Court dismissed the appeal for want of a substantial federal question. 423 U.S. at 886-87. Such a dismissal is a determination of the case on the merits and has res judicata effect. *See* Hicks v. Miranda, 422 U.S. 332 (1975); Ohio *ex rel.* Eaton v. Price, 360 U.S. 246, 247 (1959); *see also* Note, *The Insubstantial Federal Question*, 62 HARV. L. REV. 488, 489 (1949) (noting that the bases for the court's determinations of a lack of "substantial federal question" are not clear).

[60] Although the Court's rulings restricting state taxation of income from federal obligations applied to all corporations, the problem was more acute in the case of banks because investments in federal obligations comprise a significant portion of bank income-producing assets. *See infra* note 166.

[61] *See* Spector Motor Service v. O'Connor, 340 U.S. 602 (1951), *overruled*, Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). The distinction between a franchise tax on *the privilege of engaging in interstate commerce* (forbidden by the commerce clause) and a direct net income tax on *interstate commerce* was eliminated by the 1977 decision of the Supreme Court in *Complete Auto Transit*.

problem continues today because section 3701 still restricts state taxation of federal obligations by requiring states to use a franchise tax. Part III considers whether a state can, by means of a franchise tax, reach income generated from sources in-state by a bank engaged solely in interstate commerce.

II. State Taxing Jurisdiction over the Interstate Activities of Banks

> There is only one way to do banking, and that is on a branch basis, with one capitalization, one charter, and one responsibility . . . . It is coming, gentlemen, and you cannot stop it, and you are bucking up against a stone wall if you try. You cannot buck economic forces.[62]

Fifty-six years after A.P. Giannini made that statement before the House Committee on Banking and Currency, his threat of the inevitability of interstate branching has yet to become a reality. Although during the 1980's the majority of states have passed laws permitting some form of interstate banking, most of these have chosen to permit interstate banking only in the form of separately chartered and separately capitalized bank holding company subsidiaries.[63] Only one state permits direct interstate branching.[64] Some commentators argue that a direct branching approach to interstate banking would destroy the viability of the dual banking system.[65]

Interstate banking legislation typically authorizes regional or nationwide interstate banking through multistate bank holding companies on a reciprocal basis. Such legislation has withstood constitutional challenge. For example, the Supreme Court recently upheld Massachusetts and Connecticut statutes providing that an out-of-state bank holding company with its principal place of business in one of the other New England states may acquire an in-

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[62] *Branch, Chain, and Group Banking: Hearings on H.R. 141 Before the House Comm. on Banking and Currency*, 71st Cong., 2d Sess. 1537 (1930) (statement of A.P. Giannini, founder of Transamerica Corporation).

[63] *See supra* text accompanying note 22.

[64] *See Trigger Dates: A Rundown of Interstate Banking Laws*, American Banker, Apr. 22, 1986, at 10, 24.

[65] *See, e.g.*, Ginsburg, *Interstate Banking*, 9 Hofstra L. Rev. 1133, 1314-41 (1981).

state bank provided that the other state grants equivalent reciprocal privileges.[66]

The economic implications of Giannini's prediction have also not become a reality. Indeed, in an era of proliferating non-bank banks, retailer-issued credit cards with interest- bearing deposit balances, home computer banking and pocket terminals, Giannini's proclamation appears quaint. The removal of statutory prohibitions against interstate branching may not produce a branch bank on every corner. It will, however, accelerate the development and deployment of new electronic bank service delivery systems by eliminating regulatory and litigation battles over whether the method of delivery is a forbidden branch.

For that reason, permissive interstate branching may aggravate the task of state revenue authorities who seek to tax income earned in their states by out-of-state banks. When an out-of-state bank conducts its activities through a "branch"[67] within a state's borders, that state clearly can assert taxing jurisdiction over the branch.[68] However, when the same activities are not conducted through a branch, the jurisdictional rules are less clear. State authorities attempting to levy taxes on an out-of-state bank that earns income through in-state activities carried on through the mail, computer terminals and telephone connections must struggle not only with outdated state statutes but also with constitutional restraints.

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[66] Northeast Bancorp., Inc. v. Board of Governors, 472 U.S. 159, 174-78 (1985). The New England states covered by the legislation are Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont. *Id.* at 164.

[67] The term "branch" as used here includes both a direct branch of an out-of-state national bank subject to the McFadden Act and a separately incorporated subsidiary bank of an out-of-state bank holding company subject to the Bank Holding Company Act.

[68] As it is usually thought of, a "branch" is established by a brick and mortar presence, and a state clearly has jurisdiction to tax a nonresident entity that owns or leases an in-state office. Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959). Moreover, if an out-of-state bank conducts in-state activities that are deemed branching, the branch is subject to state regulation including state law restrictions governing the location of the branches and state law requirements as to minimum capital stock and surplus. *See* 12 U.S.C. § 36(c) (1982). The legal and regulatory benefits and protections the out-of-state bank thus receives will support the host state's taxing jurisdiction under both the due process and commerce clauses. *See* Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940). But if branch banking is not prohibited, the very need to define the term "branch" disappears and, with it, all jurisdictional certainty.

This part considers under what conditions a market state can assert jurisdiction over the in-state activities of an out-of-state bank in order to tax that fraction of the nonresident's income that is earned from sources within its borders.

A. Principles Governing State Taxing Jurisdiction over Interstate Activities of National and State Banks

National and state banks may conduct multistate operations directly through their out-of-state branches where state law permits or through non-branch methods such as the mail and electronic means. These banks may also pursue interstate profits indirectly through the use of "non-bank" organizations. These organizations include consumer finance companies, mortgage bank companies, securities brokerage firms, leasing corporations, data processing entities and non-bank banks.[69]

1. Loan Production Offices, Call Programs and Automatic Teller Machines: Interstate Activities Requiring an In-State Presence. An out-of-state bank may choose to make loans in a host state by several means entailing a physical presence in the state; loan production offices (LPO's), call programs (whereby representatives are sent into the state to solicit business), and automatic teller machines (ATM's) are quite common. Accurate figures on the number of LPO's are difficult to obtain. According to a 1983 survey conducted by the Board of Governors of the Federal Reserve System, the top 200 banking institutions controlled 202 LPO's.[70] Commentators, however, have estimated that the total number of such offices is 400.[71] The difficulty in ascertaining the number of LPO's stems from the fact that states do not uniformly require banks to license or register their LPO's.[72] Even though the number of loan

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[69] For a complete list of the kinds of interstate activities engaged in by banks, see Ginsburg, *supra* note 65. *See also infra* text accompanying note 140.

[70] D. WHITEHEAD, A GUIDE TO INTERSTATE BANKING 1983, at 106-20 (1983) (statistics supplied by the Federal Reserve Bank of Atlanta).

[71] *See* Frieder, *Legislating for Interstate Bank Expansion: Financial Deregulation and Public Policy*, 9 J. CORP. L. 673, 684 n.49 (1984) (estimating that nearly 400 LPO's operate in about half the states).

[72] Neither the due process clause nor the commerce clause would bar state laws requiring the registration of all LPO's. In some states LPO's are deemed branches. In those states, an LPO established by a nonresident bank must seek the host state's permission to branch in-state and comply with the branching regulations

production offices is not easy to measure, the reason for their existence is clear. Because these offices generally cannot close loans[73] and do not accept deposits or paychecks, some states have decided that they are not branches. Thus, a national bank can establish a significant local presence by soliciting and originating loans within a state without running afoul of the McFadden Act.[74] Moreover,

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the state imposes on its own banks. Even in those states that do not deem LPO's to be branches, the presence of in-state offices and employees provides a sufficient nexus to support state taxing jurisdiction. *See, e.g.*, Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959) (a state clearly has jurisdiction to tax a nonresident entity which owns or leases an in-state office). A registration requirement that is then imposed upon *all* LPO's in order to enforce tax compliance will not violate the commerce clause. Lewis v. BT Investment Managers, Inc., 447 U.S. 27, 38 (1980) (the commerce clause does not prohibit narrowly drawn state regulatory legislation affecting interstate and intrastate business equally, particularly in an area of "profound local concern" such as banking and related financial activities); *see also* Pike v. Bruce Church, Inc., 397 U.S. 137, 145 (1970) (the kind of state regulation that is the serious concern of the commerce clause is the kind that creates economic protectionism).

At least one state court has considered the constitutionality of a host state's imposing a reporting requirement on a nonresident corporation that has neither employees nor an office in the host state. In Associates Consumer Discount Co. v. Bozzarello, 149 N.J. Super. 358, 373 A.2d 1016 (1977), a nonresident corporation that had no employees and no office in New Jersey was barred from maintaining suit in a New Jersey court because it had not filed a Notice of Business Activities as required by state law. *Id.* at 361, 373 A.2d at 1018. According to a New Jersey statute, all foreign corporations that had not qualified to do business in the state but carried on activities there (i.e., received payments from persons residing in New Jersey or from businesses located in New Jersey in excess of $25,000 or received income from sources within the state) were required to file a Notice of Business Activities. The failure to do so would prevent the business from suing in the state or federal courts. *Id.* at 361-62, 373 A.2d at 1018. The New Jersey Superior Court upheld the constitutionality of the statute as an information-gathering measure to safeguard the state's revenue and to reduce unfair tax-free competition with businesses that pay taxes to the state. *Id.* at 362-63, 373 A.2d at 1018-19. A similar decision by the New Jersey Superior Court is now on appeal to the state's supreme court. *See* First Family Mortgage Corp. v. Durham, 205 N.J. Super. 251, 500 A.2d 746 (1985); *leave to file appeal granted*, 511 A.2d 675 (N.J. 1986).

[73] Although the loan is solicited through the loan production office and the terms are negotiated there, generally the loan is accepted only at the home office of the bank.

[74] The Conference of State Bank Supervisors has reported that the following states permit loan production offices but do not consider them branches: Arizona, Georgia, Indiana, Massachusetts, Ohio, and California. Brief of Amicus Curiae, Independent Bankers Ass'n v. Heimann, 627 F.2d 408 (D.C. Cir. 1980).

if the LPO is established in a host state by a bank holding company, it will not violate the Bank Holding Company Act because it is not a bank.

The legal status of LPO's established by national banks is considerably less clear.[75] The Supreme Court has not considered this particular activity and is unlikely to do so now since interstate banking by loophole is less important in the current atmosphere. In an analogous situation, however, the Court has held that the place at which a deposit is accepted for purposes of creating a debtor-creditor contractual relationship is not controlling for purposes of determining whether a bank has engaged in branch banking under the McFadden Act.[76] Numerous circuit court decisions have held that ATM's are branches.[77] It is therefore likely that the Court would find that LPO's are branches.

If LPO's are a recent phenomenon, interstate solicitation of loans and deposits is not. According to a 1972 Federal Reserve System study, banks have solicited interstate loans and deposits for several decades by relying on "call programs"; banks send "call officers" across state lines to solicit and negotiate business loans.[78] Again, because the in-state solicitation of loans and deposits by representatives of an out-of-state bank is not deemed to be a branch operation, data revealing the extent to which this activity generates income is not available.

Like loan production offices, call programs require the out-of-state bank to have a regular physical business presence in the host state. Such physical presence is sufficient under the due process and commerce clauses to support the host state's taxing jurisdic-

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[75] Only one case challenging the validity of LPO's under the Douglas Amendment has reached a United States court of appeals. In Independent Bankers Ass'n v. Heimann, 627 F.2d 486 (D.C. Cir. 1980), the court declined to decide whether an LPO operated by an out-of-state bank in a non-consenting state was a prohibited branch. *Id.* at 488 & n.**. Instead, the court held that the claim was barred by laches. *Id.*

[76] First Nat'l Bank v. Dickinson, 396 U.S. 122 (1969).

[77] *See infra* notes 86-88 and accompanying text.

[78] *See* Hellerstein, *Federal Constitutional Limitations on State Taxation of Multistate Banks*, in BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, 92ND CONG., 1ST SESS., REPORT OF A STUDY UNDER PUBLIC LAW 91-156, STATE AND LOCAL TAXATION OF BANKS, BEFORE THE SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS 506 (Comm. Print 1971).

tion.[79] Of course the host state must have the proper statutory authority. Both a substantive statute permitting the exercise of jurisdiction over a nonresident business doing business within the state, transacting business within the state or earning income from sources within the state, and a longarm statute that will reach a nonresident entity transacting business in the state are required.

Banks have recently expanded their interstate activities through the use of electronic funds transfer (EFT) systems. These systems include ATM's, point of sale (POS) terminals, check guarantees, wire transfers and other types of customer-bank communication terminals (CBCT's).[80] If the activity that the bank conducts through the use of an EFT system requires it to establish a physical structure in the host state, or if the particular EFT system utilized is deemed a branch, the host state can tax the income earned from in-state activities without violating either the due process or commerce clauses.[81] Many courts have considered whether an EFT system is a branch, particularly with regard to the use of ATM's. The case law on ATM's illuminates the issues likely to arise in

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[79] *See* International Shoe Co. v. Washington, 326 U.S. 310 (1945) (addressing the due process clause only); Standard Pressed Steel Co. v. Washington Dep't of Revenue, 419 U.S. 560 (1975) (addressing the due process and commerce clauses). Although loans solicited and/or negotiated by call officers in the host state are generally subject to final acceptance by the home office, that fact does not divest the host state of jurisdiction to tax the out-of-state lender. *See* Scripto, Inc. v. Carson, 362 U.S. 207 (1960) (an out-of-state seller's use of independent contractors to solicit orders, even if sale is contingent upon acceptance by the seller at its home office, subjects the out-of-state seller to host state jurisdiction).

[80] CBCT's are defined broadly as automatic electronic units, manned or unmanned, through which a bank customer can access his or her account to make a deposit, withdraw cash, make loan payments, transfer money between accounts or immediately debit his or her account at the time a retail purchase is made. *See generally* Fraser, *Structural and Competitive Implications of Interstate Banking*, 9 J. CORP. LAW 643 (1984) (focusing on the interstate banking aspect of deregulation); Note, *Interstate Branch Banking: That Someday Is Today*, 21 WASHBURN L.J. 266 (1982) (interstate branching is sounding the "death knell" of unit banking); Comment, *Customer-Bank Communication Terminals Under the McFadden Act*, 47 COLO. L. REV. 765 (1976) (examining the competitive advantages of CBCT use and efforts to control usage); Comment, *Customer-Bank Communication Terminals and the McFadden Act Definition of a "Branch Bank"*, 42 CHI. L. REV. 362 (1975) (discussing whether CBCT's fall within the McFadden Act definition of "branch").

[81] *See supra* note 69 and accompanying text.

determining when the use of any other EFT system will be deemed a branch operation.

A complex web of state and federal legislation, regulations and interpretations governs the establishment and use of ATM's.[82] However, because federal law controls the definition of branching, that law alone determines whether the use of an ATM is a branch.[83] According to that law as currently interpreted by the federal courts, an ATM *established by a national bank* is a branch of the establishing bank.[84] One federal court has held, however, that an ATM established by a *non-bank* entity is *not* a branch of those banks using it.[85]

In reaching its decision that an ATM established by a national bank is a branch of that bank, the Court of Appeals for the District of Columbia held that the fact that the customer accesses his or her funds by a plastic card rather than by writing a check is only a matter of form: the substance of the transaction is still the payment of an order to withdraw funds.[86] In a similar vein, other circuit courts have held that, although a bank customer's deposit is not credited to his or her account until the home bank actually receives and verifies it, the bank has received the deposit for purposes of the McFadden Act at the time it is placed in the

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[82] Many states have special laws governing EFT systems. For example, Colorado, a unit banking state, permits state and national banks to establish, operate and use ATM's without running afoul of branching prohibitions if the use of the ATM is open to all banks (shared-use ATMs). *See* COLO. REV. STAT. §§ 11-6.5-102 to -6.5-111 (Branford-Robinson 1973 & Supp. 1985).

[83] First Nat'l Bank v. Dickinson, 396 U.S. 122, 133-34 (1969).

[84] A national bank that arranges for its customers to use, on a transactional fee basis, a CBCT established by another financial institution is not required to apply for a separate charter. 12 C.F.R. § 5.31(f)(4) (1986).

[85] *See* Independent Bankers Ass'n v. Marine Midland Bank, 757 F.2d 453 (2d Cir. 1985), *cert. denied*, 106 S. Ct. 2926 (1986). According to the Second Circuit, an ATM that is not established by a bank is not a branch because the express language of the National Bank Act provides that a national bank is engaged in branching only if it "establishes" or "operates" any place "at which deposits are received, or checks paid, or money lent." *Id.* at 456.

[86] *See* Independent Bankers Ass'n v. Smith, 534 F.2d 921, 944 (D.C. Cir.), *cert. denied*, 429 U.S. 862 (1976); *see also* Missouri *ex rel.* Kostman v. First Nat'l Bank, 538 F.2d 219, 220 (8th Cir.) (CBCT's installed by national banks constituted "branch banks"), *cert. denied*, 429 U.S. 941 (1976); Illinois *ex rel.* Lignoul v. Continental Ill. Nat'l Bank & Trust Co., 536 F.2d 176, 177 (7th Cir.) (CBCT's fall within statutory definition of "branch"), *cert. denied*, 429 U.S. 871 (1976).

ATM.[87] These courts have rebuffed other challenges based on the proposition that money is not "lent" at the ATM but merely advanced pursuant to an earlier loan made at the home office of the bank.[88]

As noted previously, if the ATM (or any other EFT system) is deemed a branch of an out-of-state bank, the host state can tax the bank on income earned within the state. However, even if the ATM is not deemed a branch and the out-of-state bank has no other physical presence within the host state, it is still possible for the state to tax the out-of-state bank. The relevant jurisdictional rinciples are discussed in the next subsection.

2. Banking by Mail, Telephone and other Electronic Means: Interstate Activities Not Requiring an In-State Physical Presence. Additional interstate banking activities are conducted without a local physical business presence. In fact, nearly one in ten Americans use banks across state lines.[89] For example, out-of-state banks have for some time issued credit cards to residents of a host state through the United States mail. Today the interstate credit card business is booming. According to a recent survey conducted by *American Banker*, one-third of the responding banks had at least thirty per-

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[87] *See, e.g.*, Utah *ex rel.* Dep't of Fin. Inst. v. Zions First Nat'l Bank, 615 F.2d 903, 905-06 (10th Cir. 1980) (drive-in facility that maintained different hours and limited services constituted a "branch"); Independent Bankers Assn' v. Smith, 534 F.2d 921, 931 (D.C. Cir.) (noting that Congress intended the McFadden Act to include virtually all off-premises banking operations), *cert. denied*, 439 U.S. 862 (1976); *cf.* First Nat'l Bank v. Dickinson, 396 U.S. 122 (1969). In *Dickinson*, the Court held:

> The money is given and received for deposit even though the parties have agreed that its technical status as a "deposit" which may be drawn on is to remain inchoate for the brief period of time it is in transit to the chartered bank premises. The intended deposits are delivered and received as . . . part of a large-scale continuing mode of conducting the banking business designed to bring basic bank services to the customers.

Id. at 137.

[88] *See* Independent Bankers Ass'n v. Smith, 534 F.2d at 948 (noting that money is considered "lent" when bank customer receives funds on which he immediately begins to pay interest); Colorado *ex rel.* State Banking Bd. v. First Nat'l Bank, 540 F.2d 497, 500 (10th Cir. 1976) (the withdrawal or transfer of funds is a "traditional banking transaction"), *cert. denied*, 429 U.S. 1091 (1977).

[89] *See Mail and Phone Operations Rev Up Banks' Interstate Business*, AMERICAN BANKER, Oct. 20, 1985, at 4.

cent of their cardholder accounts outside their home state. The credit card business is also extremely profitable, earning a return on assets considerably higher than all other bank products.[90]

More recently, out-of-state banks have begun to offer full-service banking to host state residents through a combination of the mail and the telephone.[91] Such activities without an in-state physical presence are not deemed to be branching. Under some circumstances, a physically absent out-of-state bank that solicits deposits, makes loans, or provides other fee-generating services may be subject to the taxing jurisdiction of the market state.[92]

First, because a taxing state must be able to assert jurisdiction over an out-of-state bank in order to enforce its tax laws, a state seeking to impose its tax on such a taxpayer must show that due process requirements are met. According to the Supreme Court, a foreign corporation that has conducted business from an office located within a forum state or through in-state representatives is subject to in personam jurisdiction in that forum state.[93] The Su-

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[90] *See Credit Card Business Mushrooms at Large Banks*, AMERICAN BANKER, Aug. 14, 1986, at 1, 6. The questionnaire was sent to 130 top financial institutions, with 77 responding. According to their answers, the return on assets from their credit business averaged from four to five percent. Approximately seventy-five percent of the credit card revenues came from interest income. The remainder came from the annual fees and interchange fees, which constitute fees paid by the merchant bank to the card-issuing bank for each transaction. See *id.* The credit card business carried on by commercial banks is highly concentrated. More than seventy-eight percent of all banks' credit card loans are made by the top one hundred insured commercial banks. *See Big Players Win More of Bank Card Credit Market*, AMERICAN BANKER, Sept. 8, 1986, at 3.

[91] One such service is offered by Chemical Bank of New York to residents of Connecticut. The service, called "Premium Banking," operates as follows: (a) Connecticut customers can call a New York toll-free number manned seven days a week from 7:00 a.m. to 11:00 p.m. by Chemical Bank staff members specially trained to conduct banking business over the phone; (b) customers receive instant access to credit lines, a MasterCard and a single monthly statement listing all checking, savings, credit, and charge card activities; and (c) customers who need cash immediately can make withdrawals at any automated teller machine linked to the New York Cash Exchange. *Chemical Enters Connecticut Consumer Market with Phone and Mail "Premium Banking" Service*, AMERICAN BANKER, Dec. 17, 1985, at 24, col. 1.

[92] According to a recent survey of state bank taxation conducted by the Multistate Tax Commission, only Minnesota has revised its law to assert taxing jurisdiction over absent out-of-state banks.

[93] International Shoe Co. v. Washington, 326 U.S. 310 (1945) (systematic and continuous solicitation in forum state caused foreign company to be subject to jurisdiction).

preme Court has also held that, even in the absence of the defendant's physical presence within the forum, the necessary contacts are present if the nonresident defendant has purposefully established a relationship with the forum,[94] has purposefully directed his activities at residents of the forum,[95] has created a continuing contractual obligation with a citizen of the forum,[96] or has deliberately engaged in significant activities within a state.[97] Once any of the above contacts are established, jurisdiction cannot be avoided merely because the defendant did not physically enter the state: "it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted."[98]

Second, a state seeking to impose its tax on a nonresident taxpayer must consider whether the due process requirements for *taxing* jurisdiction are different from those for *judicial* jurisdiction. I have argued elsewhere that the due process requirements for the exercise of taxing jurisdiction are identical to those required for judicial jurisdiction.[99] There I traced the historical development of the Court's analysis of the restraints the due process clause imposes on state taxing and judicial jurisdiction and showed how the Court has equated the due process requirements for both kinds of jurisdiction in insurance taxing cases.[100] Thus, an out-of-state bank that has purposefully solicited deposits and loans from a host state and

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[94] Hanson v. Denckla, 357 U.S. 235, 253 (1958) ("there must be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws").

[95] Worldwide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980) (New York automobile wholesaler and retailer not subject to suit in Oklahoma because accident in Oklahoma did not result from any activity or solicitation on the defendants' part in Oklahoma).

[96] McGee v. International Life Ins. Co., 355 U.S. 220 (1957) (jurisdiction based on single mail-order life insurance policy upheld).

[97] Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985) (franchise contract between Michigan resident and Florida corporation constituted a "meaningful contact" with the state of Florida).

[98] *Id.* at 476.

[99] *See* McCray, *Overturning* Bellas Hess: *Due Process Considerations*, 1985 B.Y.U. L. Rev. 265.

[100] *Id.* at 269-78.

earns income therefrom has created sufficient contacts with that state and its residents upon which to base taxing jurisdiction.

The commerce clause places additional constraints on the states' power to tax nonresident corporations. That clause requires a taxing state to tax in-state and out-of-state banks similarly and to tax only that fraction of the income of the out-of-state bank earned from in-state sources.[101] In sum, an in-state physical presence is sufficient under both the due process and commerce clauses to support state taxing jurisdiction over a nonresident bank, but such a presence is not necessary.

The same result is reached by focusing on the primary source of bank income and then considering the jurisdictional principles that govern state taxation of income from intangibles. Because an intangible can be created easily between residents of different states without either party having to enter the other party's state, and because the document representing the intangible so created can be moved easily from state to state, a court could not easily determine where to "site" the intangible for purposes of state taxation.

Consequently, in its early decisions, the Supreme Court upheld state quasi-in-rem taxing jurisdiction over income from intangibles on several different theories.[102] Then, fearing that permitting more

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[101] Although the Court uses a four-pronged test to measure the validity of a state tax under the commerce clause, *see* Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977), the first and fourth prongs of the test are similar to due process requirements. *See* Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207 (1980) (citing *Mobil Oil Corp.*); Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980) (requiring a "minimal connection" between the interstate activities and the taxing state and a rational relationship between the income attributed to the state and the interstate value of the enterprise). The second and third prongs require that the tax be apportioned and not discriminate against interstate commerce so that the tax falls in like measure on interstate and intrastate commerce. *Complete Auto Transit*, 430 U.S. at 279.

[102] The Court initially recognized three different places at which the situs of a debt might be fixed: the domicile of the owner (creditor), Kirtland v. Hotchkiss, 100 U.S. 491, 498 (1879); State Tax on Foreign-Held Bonds, 82 U.S. (15 Wall.) 300, 324 (1872); the domicile of the debtor, Blackstone v. Miller, 188 U.S. 189, 205 (1903), *overruled*, Farmers Loan & Trust Co. v. Minnesota, 280 U.S. 204 (1929); and the state in which the debt has a business situs, i.e., where the debt originated in the course of business transacted in a state, Metropolitan Life Ins. Co. v. New Orleans, 205 U.S. 395, 402 (1907); Bristol v. Washington County, 177 U.S. 133, 143-44 (1900); New Orleans v. Stempel, 175 U.S. 309, 322-23 (1899). According to the Court, each of those states offered the taxpayer the benefits and protections of its laws.

than one state to tax the intangibles would create intolerable friction in our federalist system, the Court held that taxing jurisdiction rested exclusively in one state.[103] This decree was abandoned after the Court finally conceded that the due process clause does not prohibit multiple taxation.[104] Thereafter the Court regularly upheld state taxes on intangibles by states other than the creditor's domicile, which was generally the state where the debt had a business situs. According to the Court, a debt had a business situs in any state where the nonresident company transacted business and received governmental benefits and protections.[105]

In these early decisions, the Court analyzed the validity of a state tax imposed upon an absent nonresident and enforced by means of quasi-in-rem jurisdiction.[106] The decisions illustrate the kinds of contacts that the due process clause requires for taxing jurisdiction and are still valid. Although the Court in *Shaffer v. Heitner*[107] overruled its early judicial jurisdiction decisions, which

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[103] *See* Farmers Loan & Trust Co. v. Minnesota, 280 U.S. 204, 209 (1929). Stating that any rule that permitted taxation of intangibles by more than one state would "disturb good relations among the States and produce the kind of discontent expected to subside after establishment of the Union," the Court restricted jurisdiction over intangibles to the state of the creditor's residence or domicile. *Id.*

[104] *See* Curry v. McCanless, 307 U.S. 357, 369-70 (1939); *see also infra* text accompanying note 116.

[105] *See, e.g.*, New Orleans v. Stempel, 175 U.S. 309, 322 (1899) (bank bills and municipal bonds subject to taxation "where found," irrespective of the owner's domicile).

[106] To adjudicate an action in rem or quasi-in-rem (i.e., an action seeking to determine claims to or rights in property even though the claimants are not subject to personal jurisdiction in the state), a court must have jurisdiction over the res. R. CASAD, JURISDICTION IN CIVIL ACTIONS § 1.01[3] (1983).

[107] 433 U.S. 186 (1977). In *Shaffer*, the plaintiff, a nonresident of Delaware, filed suit in Delaware against a corporation and twenty-eight corporate officers and directors who were nonresidents of Delaware. Because the individual defendants were not present in Delaware, the plaintiff began his suit by sequestering their property. The sequestered property—shares of the Delaware company's common stock—that formed the basis of plaintiff's asserted quasi-in-rem jurisdiction was present in Delaware. *Id.* at 189-92. Under the old *Pennoyer* test mandating physical presence, the Delaware court clearly had jurisdiction. But the Court held that because the cause of action was not related to the res and the defendants had no other contacts with the state, the relationship between the defendants and the state was not sufficient for Delaware jurisdiction. *Id.* at 213-17. In other words, the Court, applying the new minimum contacts standard, held that mere presence within the forum state was not a sufficient basis for quasi-in-rem jurisdiction under the due process clause.

were based on in rem and quasi-in-rem jurisdiction, *Shaffer* actually supports the continuing validity of the early in rem and quasi-in-rem taxing jurisdiction opinions. The distinction between the Court's early quasi-in-rem judicial jurisdiction decisions and its early quasi-in-rem taxing jurisdiction cases can be seen by comparing *Harris v. Balk*[108] with *Curry v. McCanless*.[109]

In both of those cases the Court analyzed the contested exercise of quasi-in-rem jurisdiction by reflecting on the "situs" of the debt. In *Harris v. Balk*, the Court applied the maxim *mobilia sequuntur personam* ("the debt follows the owner"), to uphold Maryland's exercise of judicial jurisdiction over a debt owed by an absent nonresident to a resident. According to the Court, quasi-in-rem jurisdiction existed in any state in which the creditor was present, whether or not that presence was temporary and casual, because the debt was sited there.[110] Because that logic did not include *Shaffer*'s requirement of the existence of a prior relationship among the defendant, the litigation and the forum, the *Shaffer* decision superseded *Harris*.

In its taxing jurisdiction opinions, however, the Court has never applied a transitory presence rule.[111] Instead, the Court very early crafted an in rem and quasi-in-rem taxing jurisdiction rule identical to its modern minimum contacts standard. Consider, for example,

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[108] 198 U.S. 215 (1905), *overruled*, Shaffer v. Heitner, 433 U.S. 186, 211-12 (1977).

[109] 307 U.S. 357 (1939).

[110] *Harris*, 198 U.S. at 222-23. Harris was a North Carolina resident who admittedly owed a debt to Balk, also a North Carolina resident. At a time when Harris was temporarily in Maryland, he was served with process by Epstein, a creditor of Balk. Epstein sought to garnish the debt owed by Harris to Balk in order to satisfy his claim against Balk. The Maryland court assumed jurisdiction over the debt and held in Epstein's favor. Harris paid Epstein. On his return to North Carolina, Harris was sued by Balk; Harris defended on the ground that he had already paid the debt to Epstein. The North Carolina court refused to give full faith and credit to the Maryland decision and Harris appealed. The Supreme Court upheld the Maryland judgment. The Court reasoned that because *Balk* could have sued Harris *in any state* (the debt follows the creditor), Epstein, who was in fact nothing more than the representative of Balk, could also sue Harris in any state where he was present. *Id.* at 225-26.

[111] *See, e.g.*, Buck v. Beach, 206 U.S. 392 (1907) (the mere presence of evidences of debts within a state that is not the residence or domicile of the owner and in which the owner has not transacted his business is not sufficient to support taxing jurisdiction).

the Court's holding in *Curry v. McCanless*.[112] That case involved a suit for declaratory judgment brought by executors of two states, Tennessee and Alabama, to determine which of those states could impose a death tax on the transfer by will of certain intangible property held by an Alabama trust company. The Supreme Court held that both states could tax the transfer.

In *Curry*, the Court considered the following facts. During her lifetime the decedent, a Tennessee domiciliary, had created a trust in Alabama. That trust was administered in Alabama by a local trust company. The decedent also owned property in Tennessee administered by a Tennessee trust company. According to the terms of the will, each trust company was appointed executor over the trust property within the state. Both states claimed the right to tax the transfer of the Alabama trust property. The case reached the Supreme Court on appeal from a decision of the Supreme Court of Tennessee that *only* Tennessee, as the domiciliary state, could tax the transfer.[113] Because the two states agreed that the intangibles could be taxed only at their situs, the parties framed the issue as follows: was the situs of the intangibles in Tennessee (the residence of the owner) or in Alabama (the location of the trust instrument)?

Justice Stone wrote for the Court. He noted that because rights in intangibles are not related to physical things, the governmental protection given intangibles does not depend on the physical location or situs of the intangibles. The source of rights in intangibles, the Court held, was the relationship between persons and entities, which is enforceable in court. Finally, Justice Stone remarked, if the owner of the intangible (the creditor) has availed herself of the benefits and protections of a state by creating rights and relationships enforceable in court there, that state has jurisdiction to tax interests in those rights.[114]

Thus, although the decedent was neither a resident of nor present in Alabama, and according to the early maxim the situs of the intangible was in Tennessee (the domicile of the owner), the Court held that Alabama could tax the transfer because the decedent had deliberately created a relationship between the intangible taxed and

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[112] 307 U.S. 357 (1939).
[113] *Id.* at 362.
[114] *Id.* at 365-68.

the state. In language strikingly similar to that used by the modern Court, Justice Stone explained that the rule of the debt following the owner was merely a shorthand expression of the required relationship among the intangible, the taxpayer and the state. The rule produced a rational result "[i]n cases where the owner of intangibles confines his activity to the place of his domicile."[115] He added, however, that the logic of the rule fails when the creditor extends "his activities with respect to his intangibles, so as to avail himself of the protection and benefit of the laws of another state."[116] In that circumstance, both states have jurisdiction to tax.

At the time *Curry* was decided, the Court had interpreted the due process clause to require an in-state physical presence to support a state's exercise of in personam jurisdiction over a foreign corporation. A state could enforce its tax against an absent foreign corporation only through in rem or quasi-in-rem jurisdiction. The Court no longer interprets the due process clause to require a physical presence within a state for the exercise of personal jurisdiction. According to the Court's modern interpretation of judicial jurisdiction, an absent nonresident business that has purposefully engaged in activities within a host state and so received its governmental benefits and protections is subject to in personam jurisdiction there.[117]

An absent nonresident bank that purposefully solicits credit card business in a host state through the mail, by telephone or by other electronic means has created relationships that are enforceable in court in the host state. Indeed, in many cases, the host state may be the only state in which the out-of-state bank can judicially enforce its contract with the host state's resident.[118] Those delib-

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[115] *Id.* at 367.

[116] *Id.* This analysis is similar to the earlier business situs rule. *See supra* text accompanying note 105. For example, according to that rule, foreign-owned intangibles have a business situs in a host state if the nonresident corporation carries on a continuous course of lending money or granting credits within the taxing state and if the intangibles taxed grow out of those transactions. *See* Newark Fire Ins. Co. v. State Bd., 307 U.S. 313, 319 (1939) (duty rests upon the court to inquire as to the existence of a business situs for the purpose of taxation).

[117] *See* Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985).

[118] In applying the new due process standards to jurisdiction over interstate (mail order and telephone) sellers and buyers, courts have identified a distinction between buyers and sellers when the buyer is a passive purchaser not conducting

erately created relationships are the constitutionally required minimum contacts permitting a state to exercise its taxing jurisdiction over the nonresident bank. Once jurisdiction has attached as a result of those minimum contacts, the host state can enforce its tax through the exercise of personal jurisdiction over the absent out-of-state bank. The nonresident bank cannot avoid personal jurisdiction merely because it did not physically enter the state.[119]

3. Special Problems: Edge Act Corporations. An Edge Act[120] corporation is an entity, typically a subsidiary of a bank, chartered by the Board of Governors of the Federal Reserve System to en-

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business in the forum state. *See, e.g.*, Scullin Steel Co. v. National Ry. Utilization Corp., 676 F.2d 309, 313 (8th Cir. 1982) (nonresident buyer who transacted business over the telephone and made payments in Missouri not subject to jurisdiction); Lakeside Bridge & Steel Co. v. Mountain State Constr. Co., 597 F.2d 596, 600, 603 (7th Cir. 1979) (acts of out-of-state defendant in ordering goods from Wisconsin company, with knowledge that they were likely to be manufactured in and shipped from Wisconsin insufficient to warrant personal jurisdiction in Wisconsin), *cert. denied*, 445 U.S. 907 (1980); Whittaker Corp. v. United Aircraft Corp., 482 F.2d 1079, 1083-84 (1st Cir. 1973) (conduct of foreign buyer in actively supervising or participating in manufacture of goods in Massachusetts was sufficient to support personal jurisdiction); In-flight Devices Corp. v. Van Dusen Air, Inc., 466 F.2d 220, 226-27 (6th Cir. 1972) (Minnesota corporation subject to jurisdiction in Ohio where it entered into contract negotiations involving a "substantial order" for goods manufactured in Ohio); *see also* Anderson v. Shiflett, 435 F.2d 1036, 1038 (10th Cir. 1971) (Texas defendant who hired Oklahoma architect to design a project located in Texas not subject to jurisdiction in Oklahoma); Southern Idaho Pipe & Steel Co. v. Cal-Cut Pipe & Supply, Inc., 98 Idaho 495, 497-98, 567 P.2d 1246, 1248-49 (1977) (foreign corporation that used mail advertising and telephone calls to solicit sales transactions subject to jurisdiction), *cert. denied*, 434 U.S. 1056 (1978); "Automatic" Sprinkler Corp. of America v. Seneca Foods Corp., 361 Mass. 441, 444-45, 280 N.E.2d 423, 425-26 (1972) (mailing and receiving purchase order by nonresident defendant insufficient to confer jurisdiction in forum state); Architectural Bldg. Components Corp. v. Comfort, 528 P.2d 307, 308, 310 (Okla. 1974) (foreign corporation that ordered goods from domestic corporation by telephone and mail not subject to jurisdiction). The Supreme Court has not specifically considered this buyer/seller, passive/active distinction. However, the distinction is implicit in the modern due process analysis that requires purposeful availment of the forum by the active conduct of business.

[119] *See* Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985); *see also supra* text accompanying note 117.

[120] Ch. 18, 41 Stat. 378 (1919) (codified as amended at 12 U.S.C. §§ 611-31 (1982)). For easier reference, further citations to the Edge Act will direct the reader to the *United States Code*. The Edge Act is named after Senator Walter Edge of New Jersey, the Act's principal sponsor.

gage in international banking and finance. From the initial authorization by Congress in 1919 until 1978, a national bank could establish an Edge corporation only under certain circumstances. It had to agree to (a) comply with the minimum capital requirement of $2,000,000,[121] (b) appoint only United States citizens as directors,[122] (c) invest no more than ten percent of its capital and surplus in the Edge corporation,[123] and (d) limit all transactions to those incidental to international business as determined by the Board of Governors of the Federal Reserve System.[124]

Although the original Act permitted Edge corporations to establish branches and agencies in foreign countries,[125] it was silent as to interstate branching within the United States. In 1920, the Federal Reserve Board[126] promulgated Regulation K, which prohibited interstate branching by Edge corporations.[127] Because Edge corporations were subject to neither the McFadden Act nor the Bank Holding Company Act,[128] Regulation K was the only prohibition against branching affecting Edge corporations. Edge corporations could not establish interstate branches but could establish interstate "agencies" subject to the Board's prior approval.[129] These agencies had to be separately incorporated and separately capitalized in each state.

One section of the original Act authorized state taxation of an Edge corporation's income if its home office was located within the state:

> Any corporation organized under the provisions of this subchapter shall be subject to tax by the State within

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[121] 12 U.S.C. § 618 (1976), *amended by* Pub. L. No. 95-369, § 3(d), 92 Stat. 607, 609 (1978) (codified as amended at 12 U.S.C. § 618 (1982)).

[122] *Id.* § 614.

[123] *Id.* § 618.

[124] *Id.* § 615(a).

[125] *Id.* § 615(b).

[126] In 1935 the name of the Federal Reserve Board was changed to Board of Governors of the Federal Reserve System.

[127] 12 C.F.R. § 211.6(a) (1978), *amended by* 12 C.F.R. § 211.4(c) (1982).

[128] The McFadden Act expressly applies only to national banks. *See* 12 U.S.C. § 36(c) (1982). The Bank Holding Company Act expressly exempts all banks organized under section 25 or section 25(a) of the Federal Reserve Act, which includes Edge Act corporations. *See id.* § 1841(c). Bank holding companies are permitted to own Edge Act corporations. *See id.* § 1843(c)(13).

[129] 12 C.F.R. § 211.6(a) (1978).

> which its home office is located in the same manner and to the same extent as other corporations organized under the laws of that State which are transacting a similar character of business . . . .[130]

Although the authorizing language included the phrase "home office," the section did not prevent taxation of Edge Act offices by the state in which the agency was located. Because of the regulatory requirement of separate incorporation and separate capitalization, each state in which an Edge corporation established an agency was the home office location of that agency.

Since 1978 the status of the interstate offices of Edge corporations has changed, and the legality of state taxation of those offices has become less clear. In 1978, Congress passed the International Banking Act (IBA)[131] which, in addition to subjecting foreign banks to the regulatory authority of the Federal Reserve Board,[132] changed certain provisions of the Edge Act.[133] For purposes of state taxation of Edge corporations, the most important section of the IBA is the congressional directive to the Board of Governors of the Federal Reserve System to review the rules, regulations, and interpretations issued pursuant to the Edge Act. Congress mandated the elimination or modification of any provisions that discriminated

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[130] 12 U.S.C. § 627 (1982).

[131] Pub. L. No. 95-369, 92 Stat. 607 (1978) (codified as amended in scattered sections of 12 U.S.C). For easier reference, further citations to the IBA will direct the reader to the *United States Code*.

[132] Until the enactment of the IBA, foreign banks that conducted banking activities in the United States through branches and agencies were not subject to federal regulation and were free to expand across state lines, subject only to state statutory limitations. Foreign banks are now subject to federal regulation in a manner analogous to that applicable to national banks. For example, a foreign bank operating a federally-licensed branch or agency is subject to the McFadden Act limitations on interstate branching. Thus, a foreign bank cannot establish or operate a federal agency or branch outside its home state unless expressly permitted by state law. 12 U.S.C. § 3103(a)(1), (3) (1982). For purposes of state taxation, foreign banks should be treated in the same manner as national banks.

[133] Section 3(a) of the IBA contained three significant amendments to the Edge Act: (1) the removal of the requirement that all owners of an Edge Corporation be American citizens; (2) the elimination of two statutory restrictions—the mandatory ten percent reserve requirement on all domestic deposits and the limitation on the level of liabilities an Edge Corporation could issue; and (3) the inclusion of a statement of national purposes which set forth the broad objectives of Congress regarding Edge corporations. 12 U.S.C. § 611 (1982).

against foreign-owned banking institutions, restricted Edge corporations in competing with foreign-owned banking institutions, or impeded the attainment of congressional purposes.[134]

The Board responded to this general directive by amending Regulation K to allow Edge corporations to establish interstate branches with the prior approval of the Board.[135] The Board's action created the following state tax dilemma. Prior to the passage of the IBA, a state in which an Edge corporation was established could tax the income of the agency because each agency was a separately incorporated and separately capitalized "home office." After the passage of the IBA, an Edge corporation could establish interstate offices as branches. These branches are neither separately incorporated nor separately capitalized. Some commentators have argued that host states cannot tax these branches because they are not home offices and section 627[136] authorizes

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[134] *Id.* As set forth in the IBA, the congressional purposes are:

> to provide for the establishment of international banking and financial corporations operating under Federal supervision with powers sufficiently broad to enable them to compete effectively with similar foreign-owned institutions in the United States and abroad; to afford to the United States exporter and importer in particular, and to United states commerce, industry, and agriculture in general, at all times a means of financing international trade, especially United States exports; to foster the participation by regional and smaller banks throughout the United States in the provision of international banking and financing services to all segments of United States agriculture, commerce, and industry, and, in particular, small business and farming concerns; to stimulate competition in the provision of international banking and financing services throughout the United States; and, in conjunction with each of the preceding purposes, to facilitate and stimulate the export of United States goods, wares, merchandise, commodities, and services to achieve a sound United States international trade position . . . .

12 U.S.C. § 611(a) (1982).

[135] 12 C.F.R. § 211.4(c) (1986); *see supra* note 127. Pursuant to other amendments to Regulation K, Edge corporations are now permitted to finance the *production* of goods and services for export. 12 C.F.R. § 214.4(e)(4)(v) (1986). Previously, Edge corporations were only permitted to finance the export or import *sale* and *transportation* directly related to international trade. Moreover, Regulation K now permits Edge corporations to accept savings deposits as well as demand deposits. The deposit receipt power remains restricted to foreign-related activities. 12 C.F.R. § 211.4(e)(1), (2) (1986).

[136] 12 U.S.C. § 627 (1982). Because Congress did not specifically authorize Edge Act corporations to branch interstate, it could not have foreseen the need to amend section 627.

only "home office" states to tax Edge corporation income.[137]

Other commentators have thoroughly analyzed whether section 627 in fact prevents host state taxation of Edge Act branches and have come to different conclusions.[138] Those arguments need not be repeated here. The issue will only be finally settled either by congressional action to amend section 627 or by a long process of litigation and appeal. Meanwhile, states have not hesitated to act. The major host states have uniformly taken the position that the branches are taxable.[139] Significantly, there have been few challenges to this position.[140]

4. Non-bank organizations. The term non-bank organization refers to two distinct types of entities: non-bank banks and non-bank

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[137] *See, e.g.*, O'Brien, *State and Local Taxation of Branches of Edge Act Corporations—Opportunities and Limitations*, 96 BANKING L.J. 893 (1979) (arguing that section 627 prevents a host state from taxing an Edge Act branch and urging banks to establish their Edge corporations' home offices in low tax jurisdictions and branches in higher tax jurisdictions); Note, *New Rules for Edge Act Corporations Under the International Banking Act of 1978*, 3 FORDHAM INT'L L.F. 193 (1980) (a "strict reading" of section 627 would prohibit states from taxing the operations of Edge Act branches which have parents located in another state).

[138] *See, e.g.*, Note, *A Constitutional and Statutory Analysis of State Taxation of Edge Act Corporate Branches*, 51 FORDHAM L. REV. 991 (1983) (states can tax Edge Act branches regardless of the location of the home office).

[139] The majority of Edge corporate branches are located in California, Florida, Illinois, New York and Texas. *See* Frieder, *supra* note 71, at 706 (discussing non-bank interstate subsidiaries). The first four states currently tax those Edge Act branches located within their borders. Texas uses a bank shares tax rather than an income tax imposed on the corporation. Arguably, section 627 does not restrict the imposition of a bank shares tax to the home state. The last sentence of section 627 refers directly to shares taxes as follows: "The shares of stock in such corporation shall also be subject to tax as the personal property of the owners or holders thereof in the same manner and to the same extent as the shares of stock in similar State corporations." 12 U.S.C. § 627 (1982); *see also* Note, *A Constitutional and Statutory Analysis*, *supra* note 138, at 1000-07 (legislative history of section 627 does not support an interpretation that would exempt an Edge corporate branch from taxation in the state where it was doing business).

[140] The only case specifically addressing the issue of state taxation of Edge Act branches appears to be Houston v. Morgan Guaranty International Bank, 666 S.W.2d 524 (Tex. Ct. App. 1983), *cert. denied*, 469 U.S. 1213 (1985). The Texas court validated a Texas ad valorem tax on the shares of an Edge Act branch whose home office was in Miami, Florida. The court broadly held that while section 627 expressly permits the domiciliary state to tax Edge Act corporations, nothing in that section restricts or forbids taxation by any other state; the section only requires that all taxing states treat Edge Act banks the same as they treat their own state banks. *Id.* at 530.

subsidiaries. A non-bank bank is an institution that offers services similar to those offered by banks, i.e., a non-bank bank may accept deposits, offer checking accounts, and make consumer or commerical loans. A depository non-bank bank will even have a bank charter. All non-bank banks conduct their business so as to place themselves outside the definition of a "bank" in section 2(c) of the Bank Holding Company Act.[141] Thus, non-bank banks either accept deposits or make commercial loans, but not both.

In 1985, the Eleventh Circuit Court of Appeals held in *Florida Department of Banks and Finance v. Board of Governors*[142] that the Douglas Amendment prohibited a New York bank holding company from owning or controlling a non-bank bank in Florida because Florida law did not authorize interstate branch banking. On remand from the Supreme Court, the Eleventh Circuit reversed its earlier decision and held that the Douglas Amendment does *not* apply to the establishment of non-bank banks. Thus, bank holding companies are now free to operate interstate through non-bank banks.

A non-bank subsidiary is an affiliate of a bank holding company that is engaged in one of the non-banking activities that are specifically authorized under section 4 of the BHCA. Because there are no federal restrictions on interstate expansion of BHC's through non-bank subsidiaries, and because states cannot prohibit these non-bank subsidiaries from operating within their borders,[143] bank holding companies have long used non-bank subsidiaries to establish a local presence within the states.

There are federal restrictions, however, on the activities of these non-bank subsidiaries. Section 4 of the Bank Holding Company

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[141] According to the Bank Holding Company Act, a "bank" is an institution that: (1) accepts deposits that the depositor has a legal right to withdraw on demand, *and* (2) engages in the business of making commercial loans. 12 U.S.C. § 1841(c) (1982). Any institution chartered by the FHLBB or insured by the FSLIC does not qualify as a "bank." *See id.* On August 10, 1987, President Reagan signed into law the Competitive Equality Banking Act of 1987. The Act purports to ban non-bank banks while exempting more than 160 existing non-bank banks from its provisions. It also imposes a year moratorium on expanded securities, real estate and insurance powers for banks.

[142] 760 F.2d 1135 (11th Cir. 1985), *vacated*, 106 S. Ct. 875, *rev'd on remand*, 800 F.2d 1534 (11th Cir. 1986), *rev. denied*, 55 U.S.L.W. 3706 (U.S. 1987).

[143] *See supra* note 26.

Act prohibits BHC's from owning or controlling any entity that is not a bank unless the subsidiary's activities fit within one of fifteen listed categories.[144] Most non-bank subsidiaries are established as section 4(c)(8) subsidiaries.[145] According to that section, a BHC may acquire the shares of any company "the activities of which the Board . . . has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto."[146] Pursuant to this authority, the Board has promulgated Regulation Y, which authorizes a wide variety of permissible non-bank activities for BHC's, including mortgage banking, extension of credit through finance companies, issuance of credit cards, provision of bookkeeping or data processing services, issuance and sale of traveler's checks, and operation of industrial banks.[147]

In sum, a BHC may freely establish one or more non-bank subsidiaries within states and across state lines as long as the subsidiary is engaged in an approved activity. BHC's have established a vast network of interstate offices by these means. According to one study, BHC's control 382 section (4)(c)(8) subsidiaries with a total of 5500 interstate offices.[148]

Although a bank holding company is free to operate across state lines through a network of non-bank organizations, a national bank is not. A variety of federal and state statutory provisions and judicial interpretations have combined to prohibit a national bank from expanding through the use of non-bank organizations. First, like BHC's, national banks are restricted in their activities by fed-

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[144] 12 U.S.C. § 1843(c) (1982).

[145] *See* 12 U.S.C. § 1843(c)(8) (1982).

[146] *Id.*

[147] For a complete current list of approved activities, see 12 C.F.R. § 225.4 (1986). The Board permits other activities by order. *See* Frieder, *supra* note 71, at 773 app. V (listing "Permissible Nonbank Activities for Bank Holding Companies Under Section 4 (c)(8) of Regulation Y, February, 1983"). Commentators have argued that the Board should encourage greater product expansion in the banking industry. *See generally* DeSanto, *Product Expansion in the Banking Industry: An Analysis and Revision of Section 4(c)(8) of the Bank Holding Company Act*, 53 FORDHAM L. REV. 1127 (1985); Note, *Restriction on Bank Underwriting of Corporate Securities: A Proposal for More Permissive Regulation*, 97 HARV. L. REV. 720 (1984).

[148] Frieder, *supra* note 71, at 773.

eral law. According to statutory law, a national bank has specific power to carry on "the business of banking," and all such "incidental powers as shall be necessary to carry on the business of banking."[149] Unlike the narrow definition of a bank in the Bank Holding Company Act,[150] the National Bank Act defines the business of banking both broadly and in the disjunctive.[151] For example, a national bank that either discounts promissory notes and other evidences of debt, receives deposits, lends money on personal security, or undertakes business incidental to the above[152] is engaged in the business of banking.

Second, according to the National Bank Act, national banks may not establish interstate branches, and they may establish intrastate branches only through the grace of state law.[153] Courts also have liberally construed the definition of a branch in the McFadden Act to include not only a place of business at which deposits are received or checks paid or money lent, but also any place away from its home office where the national bank is transacting the same business it carries on at its main office.[154] Courts have interpreted

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[149] 12 U.S.C. § 24 (1984).

[150] *See supra* note 22.

[151] *See* 12 U.S.C. § 24 (1982).

[152] The activities of a national bank that courts have found permissible under the "incidental power" provision are those that are directly related to one or another of a national bank's express powers. *See, e.g.*, Arnold Tours, Inc. v. Camp, 400 U.S. 45, 46 (1970) (national banks may not provide travel services for customers); *see also* National Retailers Corp. v. Valley Nat'l Bank, 604 F.2d 32, 34 (9th Cir. 1979) (electronic data processing services not an incidental power when offered to the public at large); M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377, 1383 (9th Cir. 1977) (leasing of personal property is an exercise of incidental powers), *cert. denied*, 436 U.S. 956 (1978); St. Louis County Nat'l Bank v. Mercentile Trust Co. Nat'l Ass'n, 548 F.2d 716, 719 (8th Cir.) (offering trust services is a part of the business of banking), *cert. denied*, 433 U.S. 909 (1976). A current list of the activities approved by the Comptroller of the Currency can be found at 12 C.F.R. §§ 7.7000-7.800 (1986).

[153] *See supra* notes 10-12 and accompanying text.

[154] *See, e.g.*, First Nat'l Bank v. Dickinson, 396 U.S. 122 (1969); Utah *ex rel.* Dep't of Fin. Insts. v. Zions First Nat'l Bank, 615 F.2d 903 (10th Cir. 1980); Independent Bankers Ass'n v. Smith, 534 F.2d 921 (D.C. Cir.), *cert. denied*, 429 U.S. 862 (1976). Congress intended to confine the scope of § 36(f) by forbidding banks from establishing branches outside the limits of the town or city in which the parent bank was located. *See* 68 CONG. REC. 5816 (1927); *see also* Independent Bankers Ass'n v. Smith, 534 F.2d 921, 943 (D.C. Cir. 1976) (stating that a "restrictive" interpretation of the McFadden Act would frustrate congressional

the "deposits received" and "loans made" language broadly (e.g., to find that ATM's established by national banks are branches) as well. In doing so, they have found that national banks that offer other (non-deposit and non-loan) bank services at offices apart from their home offices are engaged in branch banking.[155] Most national banks thus prefer to operate their subsidiaries through BHC's.[156]

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intent); *cf.* First Nat'l Bank v. Dickinson, 396 U.S. 122, 137 (1969) (the term "branch bank" includes *any* place where deposits are received other than the bank).

[155] *See, e.g.*, St. Louis County Nat'l Bank v. Mercantile Trust Co. Nat'l Ass'n, 548 F.2d 716, 720 (8th Cir. 1976) (separate suburban trust office of national bank violated section 36), *cert. denied*, 433 U.S. 909 (1977); Securities Indus. v. Comptroller of Currency, 577 F. Supp. 252 (D.D.C. 1983) (proposed acquisition and operation of brokerage subsidiary by national bank is a branch within meaning of section 36(f)), *aff'd per curiam*, 758 F.2d 739 (D.C. Cir. 1985), *cert. denied*, 106 S. Ct. 790 (1986).

[156] Although the interstate activities of BHC subsidiaries have been challenged in court as branching, these challenges have seldom been successful. Because the Bank Holding Company Act permits BHC's to engage in activities closely related to banking and because that Act specifically exempts approved non-bank activities from the geographical restrictions in the Douglas Amendment, courts are reluctant to find that a BHC subsidiary conducting activities approved under the Bank Holding Company Act is operating illegally under the McFadden Act. For example, in Connecticut Bankers Association v. Board of Governors, 627 F.2d 245 (D.C. Cir. 1980), the plaintiff challenged the application of Citicorp (a BHC) to establish an office in Connecticut through its subsidiary, Person-to-Person Finance Center. The subsidiary planned to engage in second-mortgage lending and the sale of credit-related insurance, both of which were approved non-bank activities. The plaintiff claimed that Person-to-Person would be an unlawful branch of Citibank (a bank subsidiary of Citicorp). The court held that the mere fact of common ownership among the entities was not sufficient to constitute branching. According to the court, Congress had sanctioned BHC entry through non-bank banks into geographical areas where subsidiary banks are excluded; therefore, a BHC and its bank and non-bank subsidiaries were branching only if they were a "unitary operation." *Id.* at 252. In other words, the challenger must prove that a nonresident bank subsidiary of a BHC is doing business in a host state through the instrument of the non-bank entity. (The test is the same test that courts use to pierce the corporate veil.) *Accord* Commercial Nat'l Bank v. Board of Governors, 451 F.2d 86, 89 (8th Cir. 1971) (BHC is "branching" when one of its subsidiary banks is doing business through instrumentality of another subsidiary bank); First Nat'l Bank v. First Bank Stock Corp., 306 F.2d 937, 940 (9th Cir. 1962) (BHC that acquired a state bank prior to Bank Holding Company Act did not violate that Act). *But see* Jackson v. First Nat'l Bank, 430 F.2d 1200 (5th Cir. 1970) (a federally-chartered bank could not use an armoured car service that had been transferred to a subsidiary of the bank holding company), *cert. denied*, 401 U.S.

State jurisdiction to tax the offices of non-bank entities that operate within their borders is assured by well-settled judicial principles.[157] Non-bank organizations that conduct their in-state activities solely through the mail, by telephone, or other electronic means are subject to a host state's taxing jurisdiction on the same judicial principles that subject absent out-of-state banks to the taxing jurisdiction of a market state.[158] Those states using the unitary business principle to calculate the tax liability of multijurisdictional enterprises doing business within and without their borders must determine which entities may be included in the unitary group for purposes of combined reporting.[159] According to the principles outlined by the Supreme Court, the unitary group should consist of

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947 (1971). The "unitary operation" standard should not be confused with the unitary business principle, which describes a relationship among commonly controlled entities for a completely different purpose. *See infra* text accompanying notes 160-61.

[157] *See supra* note 69.

[158] According to *American Banker*, one such example of a non-bank bank, the Colonial National Bank of Wilmington, Delaware, has depositors from all fifty states, makes loans to customers in forty-five states, and solicits all its business by direct mail. In fact, only ten million of Colonial National's $525,000,000 in deposits comes from walk-in trade in Wilmington. Most of the bank's customers bank by long-distance telephone lines, wire transfers, mail, nationwide ATM's, debit and credit cards, and checks. *See TSO Welcomes Long-Distance Nationwide Customers with System That Could Make Walk-in Banking Passe*, AMERICAN BANKER, Aug. 4, 1986, back cover.

[159] The purpose of combined reporting is to determine the income of the in-state taxpayer by viewing the taxpayer as part of the unitary business and applying the apportionment factors of the entire unitary business to the taxable net income (apportionable base) of the unitary business. Generally, for a manufacturing or mercantile business, states use the following three-factor formula to determine the tax liability of the members of the unitary group over which the taxing state has jurisdiction: 1/3 (payroll in state/payroll everywhere + tangible property in state/tangible property everywhere + sales in state/sales everywhere) (apportionable net income base) = (taxable income) (state tax rate) = state tax. For discussions of the use of combined reporting, see P. HARTMAN, *supra* note 31, §§ 9:24-9:29 (examining the constitutional doctrine applicable to division of corporate net income); J. HELLERSTEIN, *supra* note 31, §§ 8.11-8.12 (division of the tax base); Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practices*, 42 J. TAX'N 106 (1975) (analyzing the increasing use of combined reporting); Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171 (1970) (supporting combined reporting for corporate groups). Different apportionment factors must be used to apportion the income of a unitary banking business. Jerome Hellerstein has suggested the use of a deposits factor. *See* J. HELLERSTEIN, *supra* note 31, § 10.5 (1983) (examining financial businesses).

the BHC and any subsidiaries engaged in activities related to banking.[160] Only those subsidiaries engaged in a discrete business enterprise are not part of the unitary group.[161]

As a practical matter, however, no BHC subsidiaries can be excluded from the unitary group because BHC's are not permitted to own or control any subsidiary not engaged in banking or those approved activities closely related to banking. The guidelines used by the Board to determine whether a non-bank activity is closely related to banking underscore the essential unitary relationship between banking activities and activities closely related to banking. According to those guidelines, an activity is closely related to banking within the meaning of section 4(c)(8) if any one of the following is demonstrated: (1) banks generally have in fact provided the proposed services; (2) banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed services; or (3) banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form.[162] Hence, there are no constitutional obstacles to state taxation of local non-bank subsidiaries of out-of-state BHC's or to combining the income of the entire unitary group of which they are a part in the apportionable net income tax base.

III. The Corporate Franchise Tax Measured by Net Income

A well-designed state corporate tax system would uniformly apportion the entire taxable business net income[163] of a multijuris-

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[160] *See* Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 175-84 (1983) (evaluating California's use of the "three-factor" formula and the "unitary business" principle to tax corporations); Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 439-42 (1979) (no showing that foreign operations of appellant's subsidiaries were "distinct" in any business or economic sense).

[161] According to the Supreme Court, the Constitution permits state apportionment of the income of a unitary business conducted within and without the state if (1) at least some part of the unitary business is conducted within the state; (2) there is some bond of ownership or control uniting the unitary business; and (3) the out-of-state activity is related to the in-state activity of the unitary business. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 166 (1983).

[162] These guidelines were announced in National Courier Ass'n v. Board of Governors, 516 F.2d 1229, 1237 (D.C. Cir. 1975), *vacated in part*, 558 F.2d 729 (5th Cir. 1977), *cert. denied*, 435 U.S. 904 (1978). *See also* Securities Indus. Ass'n v. Board of Governors, 468 U.S. 207, 210 n.5 (1984) (citing the guidelines).

[163] In order to promote uniformity, the measure of the tax would be the net

dictional business among the states in a manner that approximates the level of activity in each state. To accomplish this task for the business of banking, a state would consider the various kinds of activities in which a bank may engage, such as portfolio investments, lending, and services; the sources of a bank's funding, including deposits, borrowings, capital accounts; and the geographical origins of the former activities.

Banks earn income primarily in six ways. These methods include (1) investments in federal obligations, Treasury securities, and state and municipal obligations; (2) interest and fees on consumer and commercial loans; (3) direct lease financing; (4) service fees for activities such as data processing, and earned in connection with instruments such as securitized loans, banker's acceptances and letters of credit; (5) fiduciary activities; and (6) federal funds sold. Because all of the above income is business income, an apportioned state tax on banks would include all of it, on a net basis, in the tax base.

Federal statutory prohibitions, however, prevent states from including income from federal obligations[164] in their tax base unless they use a franchise tax.[165] Because federal obligations typically make up a large fraction of a bank's assets and income,[166] states

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income of the corporation because that measure is used by nearly all the states that impose a corporate tax. Forty-six states (including the District of Columbia) levy a corporate *net income* tax. J. HELLERSTEIN, *supra* note 31, § 9.6. However, a state that imposes a franchise tax measured by *net worth* can also include the value of federal obligations in the computation of net worth. *See* Werner Machine Co. v. Director of Taxation, 350 U.S. 492, 494 (1956) (New Jersey corporation tax including federal bonds in determination of net worth is nondiscriminatory).

[164] According to Smith v. Davis, 323 U.S. 111 (1944), "obligations" of the United States include interest-bearing securities, authorized by Congress, whose payment is guaranteed by the credit and faith of the United States Government. *Id.* at 117.

[165] If a state imposes a franchise tax on banks that includes in its measure the income from federal obligations, that state must also tax the income from its own state and local obligations. Memphis Bank & Trust Co. v. Garner, 459 U.S. 392, 398 (1983).

[166] According to data collected by the Federal Deposit Insurance Corporation (FDIC), the United States Treasury and other federal sources, securities plus state and local obligations comprised from 13% to 17% of the assets of insured commercial banks in the years 1983, 1984, and 1985 through September of that year. Income from these securities ranged from 12% to 14% of gross operating income during the same years. (There is no similar data available to show what fraction

should consider using a franchise tax.[167] Provided that the remaining pieces of bank income can be reached by a franchise tax, then that tax is, by definition, the optimal state bank tax.

There are two parts to the question of whether a state can impose a franchise tax measured by net income on a bank that earns income from in-state sources. The first is whether a state can impose a franchise tax on a federally-chartered bank. The second is whether a state can impose a franchise tax on a corporation engaged in solely interstate commerce.

A. The Imposition of State Franchise Taxes on National Banks

State use of the franchise tax to tax banks has a long judicial and legislative history. As early as 1867, the Supreme Court upheld state franchise taxes measured by net income, including income from federal obligations, imposed on *state-chartered* banks.[168] States did not fare so well, however, when they attempted to impose the same tax on *federally-chartered* banks. For example, in *Owensboro*

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of *net* operating income consists of income from governmental securities. That fraction would be significantly higher, however.) Such income was the second largest piece of bank operating income during those years; fees and interest from loans generated the most income. *See* FDIC, BANK OPERATING STATISTICS (1983); Telephone interview with Jack A. Pinion, Information Analyst, Data Administration Unit, Federal Deposit Insurance Corporation (Feb. 25, 1986) (providing unpublished 1984 and 1985 data).

[167] The Supreme Court has distinguished between a franchise tax measured by net income and a direct net income tax. In general, if the tax requires that earning income and exercising the privilege of doing business coincide before liability is imposed, the tax is a franchise tax. *See* Educational Films Corp. v. Ward, 282 U.S. 279 (1931); Pacific Co. v. Johnson, 285 U.S. 480 (1931). Recently, several banks and thrifts have challenged the validity of state franchise taxes levied on the income from state and local bonds which were issued pursuant to specific state statutes granting the obligations tax-exempt status. In Garfield Trust Co. v. Director, Division of Taxation, 102 N.J. 420, 508 A.2d 1104 (1986), *appeal dismissed*, No. 86-261, 55 U.S.L.W. 3308 (U.S. 1986), the New Jersey supreme court upheld the validity of the state's franchise tax, which included interest income from state obligations notwithstanding the specific state tax exemption or exclusion. The Supreme Court dismissed the appeal for want of a substantial federal question, a decision on the merits. *But see* Commonwealth Securities v. Commonwealth of Pennsylvania, 88 Pa. 184, 488 A.2d 1187 (1985) (state corporate net income tax was a direct net income tax, as its name "ineluctably compels," not a franchise tax; therefore, the inclusion of income from state obligations specifically exempted from tax was unlawful).

[168] *See supra* note 51.

National Bank v. Owensboro,[169] the Supreme Court struck down a state franchise tax levied by Kentucky on the Owensboro National Bank. According to the Court, a state did not have power to levy any tax upon an instrumentality of the federal government unless expressly authorized to do so by Congress.[170] This decision, which created an imbalance between state taxation of national and state banks, provided the impetus for a change in the law.[171]

In 1926, Congress amended section 5219 of the National Bank Act to add a fourth method to the three methods it had previously authorized. In addition to levying bank share taxes, bank share dividend taxes, and net income taxes, states could impose a franchise tax measured by net income on national banks.[172] The express purpose of this fourth method was to establish parity between state taxation of state-chartered and federally-chartered banks.[173]

Finally, in 1976, all remaining statutory restrictions on state taxation of national banks were lifted. Section 5219 now provides: "For the purposes of any tax law enacted under authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other

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[169] 173 U.S. 664 (1899).

[170] *Id.* at 668.

[171] *See supra* text accompanying notes 51-53.

[172] Act of Mar. 25, 1926, ch. 88, 44 Stat. 223 (codified as amended at 12 U.S.C. 548 (1982)). In the early cases involving the imposition of state franchise taxes on state-chartered banks, the Supreme Court had theorized that a state franchise tax on federal obligations was permissible without congressional authorization because the franchise (charter) taxed was a separate right created by the taxing state; a state had the power to tax a privilege it bestowed on a corporation. Because a state did not bestow a franchise on a national bank, express congressional authorization was required before a state could impose a franchise tax on a federally-chartered bank. *See Tradesmen Bank v. Tax Comm'n*, 309 U.S. 560, 564 (1939).

[173] Congress did *not* amend section 3701, which, until 1959, on its face barred *all* state taxes on federal obligations. *See supra* notes 54, 55. Because the Supreme Court had validated state franchise taxes imposed on state-chartered banks measured by the value of federal obligations, the members of Congress apparently thought that by amending section 5219 they had accomplished two purposes: the addition of a new method by which states could tax national banks and authorization for state taxation of federal obligations. *See* 67 CONG. REC. 6083-6084 (1926). Neither Congress nor the Court has, until recently, drawn a careful distinction between sections 3701 and 5219. *See* American Bank & Trust Co. v. Dallas County, 463 U.S. 855, 856 (1983) ("Section 5219 is capable of coexistence with the plain language of § 3701").

jurisdiction within which its principal office is located."[174] A state is now free to tax a national bank by any method, in addition to the long-approved four methods, as long as the method chosen does not discriminate against national banks.

B. The Imposition of Franchise Taxes on Corporations Engaged in Interstate Commerce

The franchise tax was originally a license fee imposed upon the franchise (or corporate charter) granted by a state. The early franchise tax was measured by the value of the corporation's capital stock attributable to the taxing state. In the late nineteenth century, states began to use net income as a measure of the tax, and the economic effect of the tax was very like that of a direct net income tax. The legal effect of the two taxes, however, was significantly different.

Throughout the early years of the Court's struggle with the scope of the prohibitions in the dormant commerce clause, states were rebuffed in their attempts to impose franchise taxes on corporate entities engaged in interstate commerce. The Court viewed a franchise tax as a tax imposed on a *privilege*. Because the privilege of engaging in interstate commerce was not a privilege that a state had the power to grant or deny, the Court ruled that a franchise tax could not be imposed on an entity engaged in interstate commerce.[175]

Some states responded to this judicially-created prohibition by switching to direct net income taxes. The Court eventually held that these taxes did not violate the commerce clause if the required due process connection was present. The due process requirements were phrased variously as "presence" and as "doing business" under the Court's early analyses; the Court currently uses the phrase "minimum contacts." Other states changed the language of their statutes to provide for a franchise tax on foreign corporations for the privilege of "doing of business within this state in a corporate form," or "the exercising of its charter . . . within this state."[176]

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[174] 12 U.S.C. § 548 (1982).

[175] *See, e.g.*, Crutcher v. Kentucky, 141 U.S. 47, 57 (1890) (Congress' power over interstate commerce is absolute).

[176] Colonial Pipeline Co. v. Traigle, 421 U.S. 100, 102-103 (1975). Of course a

Finally, in 1977, the Court abandoned the distinction it had drawn between the effects on interstate commerce of a direct net income tax and a franchise tax. In *Complete Auto Transit v. Brady*,[177] the Court validated a Mississippi franchise tax imposed on a business operating solely in interstate commerce. The Court held that the constitutional requirements that govern state franchise taxes levied on businesses engaged in interstate commerce were identical to those that govern state net income taxes[178] and henceforth no longer considered such franchise taxes *per se* unconstitutional if they satisfied a four-pronged test.[179] As the law stands today, then, a state franchise tax measured by net income, including the income from federal obligations earned by a bank operating in interstate commerce, is valid if (1) the bank has, by means of regular and deliberate contacts with the state, earned income from sources therein, and (2) the tax is fairly apportioned and does not discriminate against banks operating in interstate commerce.

CONCLUSION

Vast changes of the last ten years have had a great impact on state taxation of banks. First, banks have greatly expanded their interstate activities through the use of electronic transactions and non-bank subsidiaries outside the state of their principal office. Second, federal statutory provisions restricting state taxation of national banks have been completely removed (although some restrictions remain on state taxation of federal obligations). Third, the Supreme Court has changed its previous interpretation of the commerce clause, which restricted state use of the franchise tax.

Yet most states remain stuck in the thinking of an earlier era when the interstate activities of banks were much more limited and the legislative and judicial restrictions were far greater. Although

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state is free to levy a franchise tax on a foreign corporation even if that corporation is not licensed by the taxing state. *See, e.g.*, Memphis Natural Gas Co. v. Stone, 335 U.S. 80 (1948).

[177] 430 U.S. 274 (1977).

[178] *Id.* at 288-89 & n.15.

[179] According to the *Complete Auto Transit* commerce clause test, a franchise tax imposed on interstate commerce is valid if: (1) the tax is applied to an activity with a substantial nexus with the taxing state; (2) the tax is fairly apportioned; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to the services provided by the state. *Id.* at 279.

states regularly apportion the interstate income of general business corporations that operate within their borders, most states do not attempt to apportion the interstate income of banks that operate similarly. In 1973, Congress enacted the State Taxation of Depositories Act[180] which provided that until January 1, 1976, no state could impose any "doing business" tax on any insured depository not having its principal office within the taxing state.[181] On January 1, 1976, that ban lapsed and states were free to tax out-of-state banks as they do other foreign corporations. To date, however, few states have responded to the challenge of designing and implementing a uniform and equitable system to apportion bank income.

The states that have updated their banking laws and regulations are typically the "money center" states—those states in which the largest banks and the banks most active in interstate operations have their principal offices. These money center states, then, are the primary recipients of increasing bank tax revenue from interstate operations. In the meantime, many states that provide significant sources of bank funds and income to fuel the activities of these large banks have been slow to respond to the changes.

This article has shown that these market states can tax an apportioned share of the income of those out-of-state banking businesses that transact business within their borders. By using a franchise tax measured by net income, these states may include the value of federal obligations in the apportionable tax base. The stage is thus set for states to take the first step toward equalizing the tax treatment of general corporations and financial corporations. That first step would be the enactment of a franchise tax measured by the net income of each banking business over which the state has jurisdiction.

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[180] Pub. L. No. 93-100, 87 Stat. 347 (1973) (codified as amended at 12 U.S.C. § 548 (1982)).

[181] *Id.* § 7(c), 87 Stat. at 347.

EXHIBIT K: 34

McCray, Sandra B., "Interstate Banking and State Taxes", Proceedings of the Seventy-Ninth Annual Conference of the National Tax Association—Tax Institute of America (November, 1986) pp. 56-61

SECOND CONCURRENT CONFERENCE SESSION

CURRENT LEGAL ISSUES IN STATE TAXATION OF SPECIALIZED INDUSTRIES: FINANCE, INSURANCE, TELECOMMUNICATIONS AND TRANSPORTATION

MONDAY, NOVEMBER 10, 1986, 2:00 P.M.

RICHARD D. POMP, *presiding*.

INTERSTATE BANKING AND STATE TAXES*

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Today, nearly every state has passed some form of legislation authorizing interstate branching.[1] Many of the new state statutes permit interstate branching on a conditional basis. For example, a typical statute might provide that an out-of-state bank may acquire an in-state or host state bank if and only if the state of domicile of the out-of-state bank passes reciprocal legislation; that is, grants the same privilege to those banks domiciled in the host state.[2] But even before this new legislation, banks had engaged in many interstate activities. Federal and state laws which have for years restricted interstate *branching* have never prohibited interstate *banking*.[3] For example, for many years banks have made interstate loans through Loan Production offices or LPOs located in a host state and through "call programs" by which out-of-state banks send representatives into a host state to solicit and to negotiate commercial loans. More recently, banks solicit consumer loans through the mail by sending credit card applications to consumers all over the country. In addition to this interstate lending activity, out-of-state banks solicit deposits from residents of all fifty states.

Yet, with all of this interstate activity, the Multistate Tax Commission has found through its recent survey of state banking practices that the majority of states continue to tax banks as if they were corporations operating in only one state—their state of domicile. This discrepancy between the actual, extensive interstate activities of banks and the state practice of taxing only their domiciliary banks raises some interesting questions. I will begin by considering three of those questions. First, what are some of the income-generating activities of *non-domiciliary* banks that a market or host state could tax that it is not now taxing? Second, how significant are these interstate activities and how can states discover the activities? Third, if the market or host state is not taxing these activities, which state or states are taxing them? After discussing these three preliminary questions, I will comment on three important elements that must be considered in drafting new laws and regulations governing interstate banking: the jurisdictional standards, the type of tax and the use of combined reporting.

1. SOME INCOME-GENERATING INTERSTATE ACTIVITIES OF NON-DOMICILIARY BANKS THAT A HOST STATE COULD TAX.

a. Branches.

A state which authorizes interstate branching can and should tax the income of each branch of a nondomiciliary bank which is within the host state's borders. This is an obvious proposition, yet, in our survey, we found that some states had out-dated statutes which limited their taxation of bank branches to those established by their domiciliary banks. These states must, therefore, pass new legislation to overcome such restrictions.

*This paper briefly summarizes the content of an article entitled "State Taxation" of Interstate Banking" which will be published in 21 GA. L. REV. no. 2 in early 1987.

b. Loan Production Offices (LPOs).

If a nondomiciliary bank establishes a brick-and-mortar presence such as a Loan Production Office in a host state, that state can and should be taxing the interest and fee income which the bank earns on the loans solicited at the loan production office.[4] The fact that those loans are "closed" or finalized at the home office of the nondomiciliary bank does not deprive the host state of jurisdiction to tax.[5] Nor does the fact that a particular state may not consider an LPO a "branch" of the out-of-state bank deprive the host state of jurisdiction to tax. The question of whether a particular activity constitutes a branch under federal law is separate from the question of whether the same activity creates a constitutionally sufficient nexus to support taxing jurisdiction.

c. Call Programs

An out-of-state bank that sends "call officers" into a market state to solicit from in-state residents has created a taxable nexus in the host state. The market state can and should tax the interest and fee income that the out-of-state bank earns from those loans.[6] Again, the fact that the loan is accepted or finalized only out-of-state at the nondomiciliary bank's home office does not deprive the host state of jurisdiction to tax.[7]

d. Solicitation by Mail and/or by Electronic Means.

If an out-of-state bank solicits loans in a market state by mail or through electronic means and thereby creates a debtor/creditor type relationship with residents of the host state, that state has jurisdiction to tax the out-of-state bank on the income and fees that it earns on those transactions.[8]

2. THE SIGNIFICANCE OF INTERSTATE ACTIVITIES AND THE DIFFICULTIES INVOLVED IN DISCOVERING THEM.

a. Branches.

Interstate branch banking is permissible only by specific state statutory authorization. Therefore, the extent of interstate branch banking will vary from state to state. The number of branches in any state should be very easy to discover by contacting the Banking Department of a state which will have records of local branches.

b. LPOs and Call Officers

According to a survey conducted by the Federal Reserve Board,[9] the top 200 banking institutions control 202 LPOs. Commentators have estimated that the total number of such offices is 400.[10] It is difficult to ascertain the exact number of LPOs because states do not uniformly require banks to license or register their LPOs.

The number of call officers is even more difficult to determine. However, according to a 1972 Federal Reserve Board study authored by Professor Hellerstein, banks have solicited interstate loans and deposits through call officers for several decades.[11]

How can states learn about the extent of interstate activities conducted through loan production offices or by call officers? In those states which treat LPOs as "branches," the state's banking department will have records. In those states which do not consider LPOs to be branches, the task of finding the LPOs is more difficult. States will encounter similar problems in attempting to discover loans solicited by call officers. In both of these cases, states will need to pass legislation requiring registration of all LPOs and call officers.

Such legislation should not be barred by either the due process clause or the commerce clause. The nexus mandate of the due process clause is satisfied by the actual physical presence within the host state of a brick and mortar building in the case of LPOs and by the presence of a representative of the out-of-state bank in the case of the call programs. The mandate of the Commerce Clause is satisfied if the reporting requirement is imposed upon all LPOs and call officers uniformly for the purpose of enforcing tax compliance.[12]

c. Solicitation by Mail and/or Electronic Means.

The extent of interstate banking activities conducted through the US mail or by electronic means is the most difficult to discover. However, it is clear that the amount of such activity is very large, is very profitable and is conducted primarily by the big banks which have their domiciles in the money

center states. For example, according to an August, 1986 survey conducted by the *American Banker*, one-third of the top 100 banks had at least 30 percent of their credit card holder accounts with residents outside their state of domicile. That same bank periodical reported that more than 78 percent of all bank credit card loans are made by the top 100 commercial banks and that the banks' return on assets from their credit card business is considerably higher than on all other bank products.[13] But credit card loans are not the only interstate activities conducted by out-of-state banks without a physical presence in the host state. Today, many banks offer full-service banking to out-of-state residents through a combination of the US mail, the telephone and other electronic means.[14] And, recently, a New England savings bank was granted a charter although it had no place of business in which it conducted a walk-in trade. That savings bank informed its chartering authorities that it intended to make its loans and solicit its deposits solely by mail, by telephone and by other electronic means.

Again, a reporting requirement is needed in order for states to ascertain which banks are earning income in this manner.

3. Which States Are Taxing the Large and Growing Amount of Income From These Interstate Activities?

Most states still tax their domiciliary banks on a residence principle; that is, these states tax the income of their domiciliary banks "from whatever source derived." In such states, a domiciliary bank is taxed on the income it earns from both its in-state and its out-of-state activities. During the times when the interstate activities of banks were less extensive and when states did not attempt to tax the income of nondomiciliary banks, such residence-based taxation did not pose any great problems for banks. However, times and state taxing schemes have changed. Today, at least some states have passed new laws and regulations which provide for taxation of nondomiciliary banks on a source basis.

The combination of residence-based taxation applied to domiciliary banks and source-based taxation applied to nondomiciliary banks can subject banks to double taxation as follows:

Assume that Bank A is a bank which is engaged in interstate banking in several states through LPOs or through the solicitation of business through mail and telephone activities. Assume further that Bank A is domiciled in State A, a state which taxes its banks on a residence basis. Thus, Bank A pays taxes to State A on its income derived from both in-state and from out-of-state activities. If Bank A conducts any of its interstate activities in a market state which has a new law providing for source-based taxation, it will pay taxes to that market state on the income sourced to that state. In such a case, some of Bank A's income will be subject to double taxation.

Under another typical scenario, some of Bank A's income will escape taxation entirely. For example, assume now that Bank A has a credit card subsidiary in State Z. This subsidiary solicits its credit card loans from residents of every state except State Z. Assume further that State Z does not tax any of the income from these credit card activities, either because State Z does not have an income tax or because State Z does not tax income which is earned from interstate sources. If, then, Bank A's state of domicile does not tax the out-of-state subsidiaries of its domiciliary banks which do not have a physical presence within State A, the income from Bank A's credit card operations will go untaxed.

These two examples illustrate the chaotic and haphazard nature of state taxation of interstate banking. But, more important than the haphazard nature of state taxation of interstate banking are the Commerce Clause implications of the double taxation of and the discriminatory taxation against interstate banking. In sum, currently, state laws governing the taxation of banks are not only constitutionally suspect, but they also lag far behind the reality of modern banking practices. States are not taxing some income that they are entitled to tax and they are taxing some income that should be apportioned elsewhere.

What should states do to bring their bank tax laws up to date? In this part of my talk I will consider three important elements of a modern state tax on interstate banking. In particular, I shall discuss the conditions under which a state can assert its jurisdiction to tax a nondomiciliary bank, what type of tax a state should use, and in the case of a state which uses the unitary business principle, what entities the state can include in a water's edge combined report.

1. Jurisdiction

Under what circumstances will an *absent* out-of-state bank which makes loans, or provides other fee-generating services within a state be subject to the taxing jurisdiction of the host state?

First, since a taxing state must be able to assert judicial jurisdiction over an out-of-state bank in order to enforce its tax laws, a state which seeks to impose its levy on such a taxpayer must show that the due process clause requirements for the assertion of *judicial* jurisdiction are met.[15] According to the orthodox Supreme Court interpretation of the Due Process Clause, a foreign corporation which has conducted business from an office located within a forum state or through an in-state representative is subject *in personam* jurisdiction there.[16] The Supreme Court has also held that even in the absence of the nonresident's physical presence within the state, the necessary minimum contacts for *in personam* jurisdiction are present if the nonresident has either: purposefully established a relationship with the forum,[17] purposefully directed his activities at residents of the forum,[18] created a continuing contractual obligation with a citizen of the forum,[19] or deliberately engaged in significant activities within the forum.[20] According to the Supreme Court in the case of *Burger King v. Rudzewicz*, once any of those contacts are established, a nonresident defendant cannot avoid *in personam* jurisdiction merely because he did not physically enter the state since "it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a state in which business is conducted."[21] This language, from *Burger King*, is tailor-made for banks which conduct their interstate activities solely by mail, telephone or other electronic means.[22]

But, are the minimum contacts that the due process clause requires for *in personam* jurisdiction identical to those contacts that are necessary for taxing jurisdiction? I have argued elsewhere that the contacts which are sufficient for *in personam* jurisdiction are also sufficient for taxing jurisdiction.[23] There, I traced the historical development of the Supreme Court's analysis of the restraints which the Due Process Clause imposes on state taxing and judicial jurisdiction and showed how the Court has equated the due process requirements for both kinds of jurisdiction. According to that analysis, an out-of-state bank which has purposefully solicited loans from a host state and earns income therefrom has created sufficient contacts with that state and its residents upon which to base taxing jurisdiction.

The same result is reached by focusing on the primary source of bank income—intangibles—and then considering the jurisdictional principles that govern state taxation of income from intangibles. Because an intangible can be created easily between residents of different states without either party having to enter the other party's state, and because the document which is the physical manifestation of the intangible can be moved easily from state to state, the Court could not easily determine where to "site" the intangible for purposes of state taxation. After several false starts, the Supreme Court finally found a coherent analysis. In *Curry v. McCanless*,[24] the Court held: (a) that, since rights in intangibles are not related to physical things, the governmental protection given intangibles does not depend on the physical location or situs of the intangible; (b) that the source of rights in intangibles is the relationship between persons and entities, which is enforceable in court; and (c) that if the owner of the intangible (the creditor) has availed himself of the benefits and protections of a state by creating rights and relationships enforceable in court there, that state has jurisdiction to tax interests in those rights.

Thus, the crucial fact in assessing the validity of a state's assertion of taxing jurisdiction over an out-of-state bank that has no physical presence within the taxing state is: did the bank earn income from transactions with residents of the host state through the purposeful establishment of a relationship with the host state? For most interstate activities conducted by banks this fact will be present and hence the due process minimum contacts test will be met.

Of course, state taxes on income earned by a bank operating in interstate commerce must also meet the commerce clause commands. That clause imposes two additional requirements[25] on a taxing state: (a) the state must tax in-state and out-of-state banks similarly; and (b) the state must tax only that fraction of the income of the out-of-state bank which is earned from in-state sources. States can meet these two requirements easily by passing a carefully drafted nondiscriminatory, source-based state statute.

In sum, a state can constitutionally tax its apportioned share of the income of nondomiciliary banks if that income is earned from sources within the state whether or not the out-of-state bank has a physical presence there.

2. Type of Tax

A well-designed state corporate tax system would uniformly apportion the entire taxable net income of a multijurisdictional business among the states in which it transacts business in a manner which approximates the level of activity of the business in each state. To accomplish this task for the business of banking, a state should begin by considering how banks earn their income.

In general, banks earn income primarily from: (1) investments in federal obligations, Treasury securities and state and municipal obligations; (2) interest and fees on consumer and commercial loans; (3) direct lease financing; (4) service fees for activities such as data processing, and in connection with instruments such as banker's acceptances and letters of credit; (5) fiduciary activities, and (6) federal funds sold. Since all of the above income is business income, a point which I will discuss next when I consider combined reporting, an apportioned state tax on banks should include all of the above income in the tax base.

However, federal statutory prohibitions prevent states from including income from federal obli-

gations in their tax base unless they use a franchise tax.[26] Because federal obligations typically make up a large fraction of a bank's assets, the statutory prohibition should not be ignored. Since a state can tax the income from these securities only if it uses a franchise tax, that tax (measured by net income) is the optimal state bank tax.[27]

3. Combined Reporting

States which use the unitary business principle and combined reporting to apportion the income of a unitary banking enterprise that transacts business within their territory, must determine: which entities under common control can be included in the combined report.

According to the principles outlined by the Supreme Court, the group which consists of a corporation and those of its controlled subsidiaries which engage in related activities may be included in a combined report.[28] Under the Supreme Court test, all controlled subsidiaries of a bank or bank holding company are includible in a combined report since national banks and bank holding companies are not permitted to control any subsidiaries that are not in engaged in banking or those activities "incidental to the business of banking" (national banks) or "closely related to banking or managing or controlling banks" (bank holding companies).[29]

Thus, there are no constitutional obstacles to including all controlled subsidiaries of banks and bank holding companies within a combined report.

Conclusion

In summary, there are no obstacles to states updating their statutes and regulations in order to bring them in line with modern banking practices and modern constitutional law. Unfortunately, to date few states have responded to this challenge. Those that have responded are the "money center" states. Their responses have been to apportion the income of both domiciliary and nondomiciliary banks. However, in many cases these states have passed laws and regulations which attribute all income from interstate banking activities to their states by, for example, fixing the situs of income from loans to the state in which the loan is "booked" (in most cases the state of domicile of the bank) or by fixing the situs of receipts at the banks' commercial domicile. On the other hand, the states which provide significant sources of bank funds (deposits) and income (interest income) to fuel the activities of these large banks have been slow to respond and are thereby feeding the fisc of another sovereign. The time for all states to act and to act in a uniform manner is now.

Footnotes

[1]The phrase "interstate branching" as used here includes both direct branch banking and indirect branch banking that is accomplished through separately incorporated subsidiary banks.

[2]Such statutes are constitutional. *Northeast Bancorp. v. Bd. of Governors*, 105 S. Ct. 2545 (1985).

[3]The phrase interstate banking is used here to mean any one or more of those activities that a bank regularly engages in; thus, the phrase is broader than the regulatory definition.

[4]A nonresident corporation that has an office within a host state is subject to that state's taxing jurisdiction. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

[5]*Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).

[6]A foreign corporation that solicits its business within a market state through the use of employees or independent contractors there is subject to the taxing jurisdiction of the taxing state. *International Shoe v. Washington*, 326 U.S. 310 (1945); *Standard Pressed Steel v. Dept. of Revenue*, 419 U.S. 560 (1975).

[7]*Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).

[8]McCray, "Overturning *Bellas Hess:* Due Process Considerations" 1985 BYU L. REV. 265.

[9]D. Whitehead, "A Guide to Interstate Banking 1983," Federal Reserve Bank of Atlanta (1983).

[10]L. Frieder, "Legislating for Interstate Bank Expansion: Financial Deregulation and Public Policy," 9 J. CORP. L. 673, 684 (1984).

[11]Hellerstein, Federal Constitutional Limitations on State Taxation of Multistate Banks, in COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 92nd CONG., 2d SESS., STATE AND LOCAL TAXATION OF BANKS PARTS I, II, III, AND IV 505 (Comm. Print 1972).

[12]*Lewis v. BT Investment Managers, Inc.*, 447 U.S. 27, 38 (1980), (The Commerce Clause does not prohibit narrowly drawn state regulatory legislation which affects interstate and intrastate business equally, particularly in an area of "profound local concern" such as banking and related financial activities). *Pike v. Bruce Church*, 397 U.S, 137 (1970) (the king of state regulation which is the serious concern of the Commerce Clause is the kind that creates economic protectionism).

[13]The questionnaire was sent to 130 top financial institutions; 77 of those institutions responded. According to their answers to the questionnaire, the return on assets from their credit card business averaged from 4% to 5%. Approximately 75% of the credit card revenues came from interest income. The other 25% came from annual fees and interchange fees (the fees paid by the merchant's bank to the card-issuing bank for each transaction). *American Banker*, "Credit Card Business Mushrooms at Large Banks," p. 1, 6, August 14, 1986. The credit card business carried on by commercial banks is highly concentrated. More than 78% of all banks' credit card loans are made by the top 100 insured commercial banks. *American Banker*, "Big Players Win More of Bank Card Credit Market," p. 3, September 8, 1986.

[14]The interstate activities conducted in this manner by one such bank are reported in *American Banker*, "Chemical Enters Connecticut Consumer Market with Phone and Mail Premium Banking Service," p. 23–4, December 17, 1985.

[15]A state court can render a valid judgment against a nonresident defendant only if the court has jurisdiction over the property (*in rem* jurisdiction) or the person (*in personam* jurisdiction) of the defendant. To adjudicate an action *in rem* or *quasi in rem* (i.e. an action seeking to determine claims to or rights in property even though the claimants are not subject to personally present in the state) a court must have jurisdiction over the *res*. To adjudicate an action *in personam* (i.e. an action seeking to impose upon the defendants a duty to do or refrain from doing some specific act or to pay a sum of money) a court must have jurisdiction over the person of the defendant. According to the Supreme Court, the minimum contacts required by the due process clause are the same whether the action is *in rem* or *in personam*. *Shaffer v. Heitner*, 433 U.S. 186 (1977).

[16]Of course, these two methods of conducting business also subject a foreign corporation to the taxing jurisdiction of the host state. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959); *Standard Pressed Steel v. Washington Department of Rev.*, 419 U.S. 560 (1975).

[17]*Hanson v. Denckla*, 357 U.S. 235 (1958).

[18]*Worldwide Volkswagen Corp. v. Woodson*, 444 U.S. 286 (1980).

[19]*McGee v. International Life Insurance Co.* 355 U.S. 220 (1957).

[20]*Burger King Corp. v. Rudzewicz*, 105 S. Ct. 2174 (1985).

[21]*Id.* at 2184.

[22]See text at n. 11 and 12.

[23]McCray, "Overturning *Bellas Hess:* Due Process Considerations," 1985 BYU L.REV. 265.

[24]307 U.S. 357 (1939).

[25]Although the Court uses a four-prong test to measure the validity of a state tax under the Commerce Clause (*Complete Auto Transit v. Brady*, 430 U.S. 274 (1977)), the first and fourth prongs of the test are similar to due process requirements. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); *Exxon Corp. v. Dept. of Revenue*, 447 U.S. 207 (1980). The second and third prongs require that the tax be apportioned and not discriminate against interstate commerce.

[26]12 USC sec. 3124 (a). This section provides: "All stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, *except* nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations.

[27]The jurisdictional standards for direct net income taxes on banks and franchise taxes measured by net income are identical. *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977).

[28]*Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1979); *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).

[29]National banks are restricted in their activities by federal law. According to statutory law, a national bank has specific power to carry on "the business of banking," and all such "incidental powers as shall be necessary to carry on the business of banking." 12 USC 24 (1984). Likewise, bank holding companies are restricted in their ownership of subsidiaries. Section 4 of the Bank Holding Company Act prohibits a bank holding company from acquiring direct or indirect ownership or control of any voting shares of any company which is not a bank. 12 USC 1843(a)(1982). The Act provides some exemptions from that broad prohibition (12 USC 1843(c)); however, none of the exemptions permit a bank holding company to own more than 5% of the shares of a U.S. based company which is not engaged in activities closely related to banking. Most "nonbank" banks owned by bank holding companies are established as section 4(c)(8) subsidiaries. According to that section, a BHC may acquire the shares of any company "the activities of which the Board . . . has determined are so closely related to banking or managing or controlling banks as to be a proper incident thereto." 12 USC 1843(c)(8)(1982). State banks are similarly restricted in their investments.

EXHIBIT K: 35

McCray, Sandra B., "Constitutional Issues in State Income Taxes: Financial Institutions", Albany Law Review (Spring/Summer 1987) pp. 895-933

CONSTITUTIONAL ISSUES IN STATE INCOME TAXES: FINANCIAL INSTITUTIONS

*Sandra B. McCray**

INTRODUCTION

Nearly every state in the United States taxes bank income using methods based upon statutory restrictions, constitutional barriers, and regulatory definitions that were developed in the late 19th and early 20th centuries. Yet, the actual business of banking has changed dramatically in just the last decade. Deregulation and competition from within and without the industry have drastically changed both the business of banking and the types of players in the financial marketplace.

Formerly, financial intermediation was the sole business and exclusive domain of banks. Banks attracted funds from savers by offering a secure repository for their deposits, and these deposits in turn became the source of funds for commercial and consumer loans which generated interest income for banks.

Until recently, banks had no competitors in this financial intermediation marketplace. First, banks had a virtual monopoly on the market for deposits, precluding competition for such funds from nonbank institutions. Second, federal law restricted the rate of interest that banks could pay depositors, eliminating competition among banks. Thus, bank profitability, achieved through the recycling of funds from savers to borrowers, was virtually assured. Bankers merely had to pay an interest rate for their deposits that was lower than the rate they charged their borrowers.

Today, banks face stiff competition for deposits from pension funds, insurance companies and brokerage houses, and federal law no longer restricts the amount of interest that banks can pay to depositors.[1] Moreover, these rival institutions are challenging the role of banks as financial intermediaries. Cash-rich, they have become efficient financial intermediaries between investor/savers and corporate bor-

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[1] The Depository Institutions Deregulation Act of 1980 authorized a phase-out of the ceilings on the maximum rates of interest and dividends that could be paid on deposits. 12 U.S.C. § 3506 (1982). Accordingly, the Federal Reserve Board, by Regulation Q, 12 C.F.R. § 217.0 (1983), lifted its prior interest rate restrictions imposed pursuant to 12 U.S.C. § 371 (1982 & Supp. IV 1986).

rowers. In this new environment, corporate borrowers often bypass banks as lenders, preferring instead to fund their activities by selling their notes to institutional investors on the commercial paper market.[2] Other institutions, such as retailers and automobile manufacturers, are usurping the role of banks as lenders to consumers.[3]

In order to meet this new competition, banks have sought relief from the geographic restraints that have confined them to single locations and from the regulatory restraints that have limited their activities. Such relief has been forthcoming from several areas, including state legislatures, state and federal regulators, and the judiciary. By mid-1987, forty-four states had passed new laws lifting their former geographic bans on interstate branch banking,[4] and several state regulators had interpreted existing state laws to allow state banks to underwrite securities.[5] Federal regulators, too, have recently re-interpreted old laws to allow banks to engage in new activities, such as securities underwriting.[6] Finally, the courts have played a role in dislodging the legislative and regulatory restrictions on banks.

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[2] Since 1978, corporate borrowing through the issuance of bonds has quadrupled. *See Banks Bound by Old Rules Losing Role as Credit Intermediators*, AMERICAN BANKER, July 25, 1986, at 4.

[3] For example, Sears, through its Discover card, actively competes with bank credit card issuers in the consumer credit market. The captive finance companies of automobile manufacturers, such as General Motors Acceptance Corporation (GMAC), Ford Credit, and Chrysler Financial Corporation, are also expanding beyond automobile financing into new financial services, such as non-automotive lending and insurance. *Automakers Look Beyond Financing New Cars*, AMERICAN BANKER, Mar. 20, 1987, at 4.

[4] According to a recent survey, 44 states and the District of Columbia have passed legislation authorizing some form of interstate branch banking. *Rundown of State Laws Granting Banks Interstate Powers*, AMERICAN BANKER, June 30, 1987, at 20.

[5] For example, in 1987, the New York State Superintendent of Banks issued a formal ruling that New York State's "little Glass-Steagall Act," N.Y. BANKING LAW § 103(9) (McKinney 1971), permitted a state-chartered bank to be affiliated with a securities firm if such affiliate was not principally engaged in underwriting corporate securities. *New York Banking Superintendent's Ruling on Securities Firm Affiliations*, AMERICAN BANKER, Jan. 2, 1987, at 2.

[6] In June, 1987, the Comptroller of the Currency ruled that national banks can issue and sell mortgage-backed or any other asset-backed security without violating the Glass-Steagall Act. Banking (Glass-Steagall) Act of 1933, ch. 89, 48 Stat. 162 (codified at 12 U.S.C. §§ 24 (Seventh), 221a, 377-378 (1982 & Supp. IV 1986). According to the Comptroller's ruling, the Glass-Steagall Act does not restrict the means by which national banks may sell or transfer interests in their assets, including their mortgages and mortgage-related assets. *See* Letter from Robert L. Clarke, Comptroller of the Currency, to Security Pacific National Bank, in *Comptroller's Ruling on Sale of Asset-Backed Securities by Banks*, AMERICAN BANKER, June 30, 1987, at 15. In April 1987, the Federal Reserve Board issued an order approving the applications of three banks to engage (through subsidiaries) in underwriting commercial paper, one- to four-family mortgage-backed securities, and municipal bonds. The FRB found that under section 20 of the Glass-Steagall Act, affiliates of Federal Reserve system member banks can participate in underwriting and dealing in certain securities so long as they are not principally engaged in this activity. *See Summary of Fed Decision Allowing Limited Underwriting*, AMERICAN BANKER, May 4, 1987, at 21.

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Two recent United States Circuit Court of Appeals opinions have paved the way for banks and similar entities to engage in *de facto* interstate branch banking through the medium of automatic teller machines (ATMs)[7] and through nonbank banks in those states that still forbid interstate branch banking.[8]

As a result of these developments, banks are no longer confined to a single state or a single activity, and the business of financial intermediation is no longer limited to those institutions that hold a bank charter. Yet, most state bank tax laws retain the presumption that each bank provides a specialized, noncompetitive service at a single location.

The attempt to apply tax laws containing rules and definitions developed in the late 19th and early 20th centuries to the modern business of banking creates several problems for both states and banks. This Article examines one of the most significant of those problems: the apportionment of the income of financial institutions. Part I sets the stage by reviewing the statutory and judicial framework within which state- and nationally-chartered banks operate. Part II addresses the need for state tax systems that prevent multiple taxation of the income of banks operating across state lines, focusing on the constitutional clash between residence-based and source-based principles for state bank income tax systems. Part III describes and analyzes current and new state bank apportionment formulas, and concludes that, as states act to develop new bank income apportionment formulas, the differing formulas may prove troublesome for banks operating across state lines.

I. BACKGROUND

A. *Branch Banking: Historical Framework and Current Status*

The National Bank Act of 1864 provided that the "usual business" of a national bank "shall be transacted at an office or banking house located in the place specified in its organization certificate."[9] In 1924, the United States Supreme Court interpreted the Act as prohibiting

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[7] Independent Bankers Ass'n of N.Y., Inc. v. Marine Midland Bank, N.A., 757 F.2d 453 (2d Cir. 1985), *cert. denied*, 476 U.S. 1186 (1986).

[8] Florida Dep't of Banking and Fin. v. Board of Governors, 760 F.2d 1135 (11th Cir. 1985), *vacated sub nom.* U.S. Trust Corp. v. Board of Governors, 474 U.S. 1098 (1986), *aff'd on remand sub nom.* Florida Dep't of Banking and Fin. v. Board of Governors, 800 F.2d 1534 (1986), *cert. denied*, 107 S. Ct. 1887 (1987).

[9] Ch. 106, § 8, 13 Stat. 99, 102.

national banks from operating branch banks within their home state.[10]

In 1927, Congress passed the McFadden Act, thereby amending the National Bank Act to allow national banks to establish branch banks within the state in which they were located "if such establishment and operation are . . . expressly authorized to State banks by the law of the State in question . . . ."[11] Although the McFadden Act provided for *intrastate* branching, it did not empower national banks to operate *interstate* branches. Until very recently, all states had laws that prohibited interstate branch banking. Nevertheless, banks and bank holding companies were able to engage in interstate branch banking through several loopholes in the federal laws.

For example, the McFadden Act did not prevent national banks from engaging in interstate activities provided that those activities were not conducted at a "branch."[12] According to the Act, a branch includes any branch bank, office, agency, or place of business at which deposits are received or checks paid or money lent.[13] There is plenty of room within this definition of a branch for an out-of-state national bank to engage in banking and bank-like activity without violating the McFadden Act. For example, a national bank transacting business in a host state solely through the mail or by telephone has not established a *place* of business in the host state and therefore is not operating through a branch.

Several other loopholes in federal laws have allowed banks to engage in further interstate banking activity. Although the McFadden Act prevented a bank from directly branching into another state, it did not prohibit the bank from acquiring or establishing a separately chartered and separately capitalized subsidiary bank in another state (indirect branching).[14] The Congress closed this loophole in 1956 with

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[10] First Nat'l Bank v. Missouri, 263 U.S. 640 (1924). In its decision, the Supreme Court held that (a) national banks can exercise only those powers that are expressly granted them under the National Bank Act "or such incidental powers as are necessary to carry on the business for which they are established," *id.* at 656 (citations omitted), and (b) the power to operate a branch bank was neither expressly granted in nor necessarily implied from the National Bank Act, *id.* at 657-58.

[11] 12 U.S.C. § 36(c) (1982). For a detailed history of the federal legislative and judicial roots of modern banking laws, see ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, 94TH CONG., 1ST SESS., REPORT OF A STUDY UNDER PUBLIC LAW 93-100, STATE AND LOCAL "DOING BUSINESS" TAXES ON OUT-OF-STATE FINANCIAL DEPOSITORIES, BEFORE THE SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS (Comm. Print 1975); BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, 92ND CONG., 1ST SESS., REPORT OF A STUDY UNDER PUBLIC LAW 91-156, STATE AND LOCAL TAX'N OF BANKS, BEFORE THE SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS (Comm. Print 1971).

[12] *See generally* 12 U.S.C. § 36 (1982).

[13] *Id.* § 36(f).

[14] *See generally id.* § 36.

the passage of the Bank Holding Company Act (BHCA).[15] The BHCA (and later amendments passed in 1970) bars a bank or bank holding company from owning a *bank subsidiary* in another state, but does not preclude the ownership of certain *nonbank subsidiaries* in another state.[16] According to the BHCA, these nonbank subsidiaries can engage in only those activities which the Federal Reserve Board has determined to be "so closely related to banking or managing or controlling banks as to be a proper incident thereto."[17] Pursuant to this authority, the Federal Reserve Board has published an extensive list of permissible activities, including mortgage banking, loan production, credit insurance, consumer finance, investment and financial advisory services, the issuance of credit cards, the issuance and sale of traveler's checks, and the operation of industrial banks.[18]

More recently, the United States Supreme Court has permitted banks to expand across state lines through the use of nonbank banks regardless of state laws prohibiting interstate branch banking.[19] A nonbank bank operates under a bank charter, but is not considered a bank under the BHCA because it either (1) accepts demand deposits or (2) engages in the business of making commercial loans, but not both.[20] Finally, the Douglas Amendment[21] to the McFadden Act permits a bank or bank holding company to acquire or establish a true bank subsidiary in another state if the laws of that state expressly authorize the acquisition.[22]

By mid-1987, forty-four states and the District of Columbia had authorized some form of interstate branch banking.[23] The interstate activities permitted by the new state laws range from unlimited nationwide branch banking to regional reciprocal branch banking and

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[15] Act of May 9, 1956, ch. 240, § 2, 70 Stat. 133, 133.

[16] 12 U.S.C. § 1843 (1982) (as amended by Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760).

[17] *Id.*

[18] For a complete current list of approved activities, see 12 C.F.R. § 225.25 (1988).

[19] Florida Dep't of Banking and Fin. v. Board of Governors, 760 F.2d 1135 (11th Cir. 1985), *vacated sub nom.* U.S. Trust Corp. v. Board of Governors, 474 U.S. 1098 (1986), *aff'd on remand sub nom.* Florida Dep't of Banking and Fin. v. Board of Governors, 800 F.2d 1534 (1986), *cert. denied,* 107 S. Ct. 1887 (1987).

[20] The entity is not a "bank" within the definition of that term because the BHCA requires that a bank engage in both activities. 12 U.S.C. § 1841(c) (1982). The Competitive Equality Banking Act of 1987, Pub. L. 100-86, § 101(a), 101 Stat. 552, 554-57, closed the nonbank bank loophole by designating all FDIC-insured institutions as banks. Although the loophole is closed, about 170 nonbank banks established prior to March 5, 1982 are protected in part by the grandfather clause in the Act.

[21] 12 U.S.C. § 1842(d) (1982).

[22] *Id.*

[23] *See supra* note 4.

limited purpose branch banking.[24]

Nearly every state that has authorized interstate branch banking has done so through the Douglas Amendment, which provides that an out-of-state bank or bank holding company may enter a host state only by establishing a separately chartered subsidiary in that state.[25] A few states permit direct branching. For example, Massachusetts allows direct branching on a reciprocal basis by an out-of-state bank that is domiciled in one of the states within its regional group.[26]

B. State Taxation of Banks: Judicial and Legislative Framework

In 1819, the U.S. Supreme Court issued its momentous decision in *McCulloch v. Maryland,*[27] which set the standard for all state taxes on banks for the next century and a half. In *McCulloch,* the Court struck down a Maryland statute that imposed a tax on bank notes issued by any bank or branch not chartered by Maryland.[28] In a sweeping opinion, Chief Justice John Marshall held unconstitutional all state taxes—other than a real property tax or a tax on bank shares—levied on a governmental instrumentality such as a national bank.[29] The Supreme Court held that national banks are immune from state taxation unless the Congress authorizes such taxation.[30]

Later, the Congress codified the judicially-created immunity doctrine. In 1864, it passed the National Bank Act, which permitted state taxation of national banks only on their real estate and on their shares—the two methods left open by the *McCulloch* decision.[31] At first, the doctrine applied only to the federal government and the instruments through which it carried on its operations,[32] but inevitably

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[24] *Id.*

[25] 12 U.S.C. § 1842(d) (1982).

[26] *See* MASS. ANN. LAWS ch. 167A, § 2 (Law. Co-op. 1987). The regional group consists of Connecticut, Maine, New Hampshire, Rhode Island, and Vermont. *Id.*

[27] 17 U.S. (4 Wheat.) 316 (1819).

[28] *Id.* at 437.

[29] *Id.* at 436-37.

[30] *See id.* at 431-34.

[31] Ch. 106, 13 Stat. 99 (1864).

[32] A second prong of the federal immunity doctrine holds that a state cannot levy a tax on the income from federal obligations because such a levy is a tax on the power to borrow money on the credit of the United States and therefore violates the borrowing clause of the Constitution. U.S. Const. art. I, § 8, cl. 2. Today, this second prong of the federal immunity doctrine is codified at 31 U.S.C. § 3124(a) (1982). According to section 3214(a), "[s]tocks and obligations of the United States" are exempt from state or municipal taxation. *Id.* However, the statute contains an exception for "a nondiscriminatory franchise tax or another nonproperty tax." *Id.*

it was expanded to other entities.[33] In its heyday, the doctrine protected both state and federal agencies from taxation as entities, and it even protected state and federal officials from taxation as individuals.[34]

The growing tax immunity brought a reaction from the Congress, which gradually narrowed the scope of the judicially created tax immunity of government officials and governmental instrumentalities, including national banks. In 1923 and 1926, Congress revised its 1864 statute, which had limited state taxation of national banks to real property taxes and bank share taxes. It enacted section 5219 to add three new methods by which a state could tax a national bank: (1) by including bank share dividends in the taxable income of a shareholder, (2) by imposing a net income tax, and (3) by levying a franchise tax according to or measured by net income.[35] This statute permitted a state to tax only those national banks located within its boundaries. Because states drafted their bank tax laws to conform to this location rule, they taxed only their domiciliary banks, *i.e.*, state banks chartered by the home state and national banks having their principal office in the home state.

Finally, in 1976, the Congress removed all prior statutory restrictions on state taxation of national banks.[36] Currently, federal law provides: "For the purposes of any tax law enacted under authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located."[37] Thus, the only remaining restriction on state taxation of national banks is that

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[33] *See generally* P. HARTMAN, FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION §§ 6:1-6:28, at 219-379 (1981) (providing an extensive review of the history of the intergovernmental immunity doctrine); 1 J. HELLERSTEIN, STATE TAXATION ¶ ¶ 7.1, 7.4, 10.5[1] (1983) (discussing franchise taxes, income from federal and state obligations, and financial businesses).

[34] *See, e.g.*, Federal Land Bank v. Bismarck Lumber Co., 314 U.S. 95, 102 (1941) ("Congress has the power to protect the instrumentalities which it has constitutionally created"); Pittman v. Home Owners' Loan Corp., 308 U.S. 21 (1939) (mortgages secured under the congressionally created Home Owners' Loan Corporation are exempt from all state and municipal taxation); Collector v. Day, 78 U.S. (11 Wall.) 113 (1870) (governmental tax immunity granted to federal officers is reciprocal; state officers are therefore protected against federal taxation to the same degree that federal officers are protected against state taxation) *overruled by,* Graves v. New York, 306 U.S. 466 (1939) (receipt of salary by New York resident as attorney for a loan corporation is constitutionally subject to non-discriminatory taxation by state); Dobbins v. Commissioners of Erie County, 41 U.S. (16 Pet.) 435 (1842) (states cannot tax the employment income of federal officers).

[35] Act of June 30, 1926, ch. 712, tit. 12, ch. 4, § 548, 44 Stat. pt. 1, 1, 289-90 (enacting into the U.S. Code, Act of Mar. 4, 1923, ch. 267, 42 Stat. pt. 1, 1499, 1499-1500).

[36] *See* State Taxation of Depositories Act, Pub. L. No. 93-100, § 7, 87 Stat. 342, 347-48, *as amended by* Act of Oct. 28, 1974, Pub. L. No. 93-495, § 114, 88 Stat. 1500, 1507; Act of Feb. 27, 1976, Pub. L. No. 94-222, §§ 1, 4, 90 Stat. 197, 197-98.

[37] 12 U.S.C. § 548 (1982).

such taxes must not discriminate against national banks. The previous location rule is no longer required. Nevertheless, only a handful of states have amended their bank tax laws to take advantage of this new freedom.[38]

II. "Pure" Residence-Based State Bank Income Taxes: The Constitutional Issue

According to a recent survey conducted by the Multistate Tax Commission,[39] most states tax the income of banks either by imposing a special bank tax that does not permit income apportionment or by including banks within their general corporate income apportionment provisions. Both methods contain serious flaws. The following section will analyze the constitutional infirmity in the former method, while Part III will address the policy shortcomings in the latter system.

A. The Constitutional Defect in Residence-Based Taxation of Multistate Banks

1. Overview of the Problem

States that impose a separate income tax on banks use "pure" residence-based principles of taxation; that is, the state's bank tax operates on the entire income of the domiciliary bank without regard to the source of its income and without allowing a credit for taxes paid to other states. Pure residence-based taxation is a product of an era when banks were located in and doing business in only one state. Now, however, banks and bank-like entities transact business freely across state lines.

Banks engage in interstate branch banking not only through legislatively-sanctioned affiliation with bank subsidiaries located in other states, but also through judicially-sanctioned affiliation with nonbank

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[38] *See, e.g.*, Act of May 7, 1988, ch. 719, art. 2, § 7, 1988 Minn. Sess. Law Serv. 1225, 1242 (West) (to be codified at Minn. Stat. Ann. § 290.01(5)); N.Y. Tax Law §§ 1450-1468 (McKinney 1987 & Supp. 1988).

[39] Multistate Tax Comm'n, State Tax'n of Banks and Financial Institutions: Results of Recent Surveys (June 1986). In a second, unpublished survey conducted by the Multistate Tax Commission in 1987, seventeen states indicated that they apportioned the income of domestic banks, while eighteen states answered that they did not allow domiciliary banks to apportion their income. Eighteen states apportioned the income of nondomiciliary banks, while seventeen states did not tax nondomiciliary banks at all. *Id.*

banks and through "branchless banking." As noted previously, a nonbank bank is an entity that operates under a bank charter, but is not considered a bank under the BHCA, because it either (1) accepts demand deposits or (2) engages in the business of making commercial loans, but not both.[40] Prior to the passage of the Competitive Equality Banking Act of 1987 (CEBA), such an entity was not deemed a "bank" as that term was defined in the BHCA, because the BHCA required that a "bank" engage in both activities.[41] According to federal precedent, states cannot constitutionally prohibit banks from expanding across state lines through the use of affiliated nonbank banks.[42] Those nonbank banks in existence prior to the passage of CEBA can continue to engage in interstate banking regardless of state law.

A branchless bank is a bank that does business in several states without establishing a brick and mortar presence there. A recent Second Circuit Court of Appeals decision, *Independent Bankers Association of New York v. Marine Midland Bank*,[43] has made it easier for banks to conduct branchless bank activities across state lines. In *Marine Midland*, the court held that a bank that effected loan and deposit transactions with its customers electronically through a shared-use automatic teller machine (ATM) did not thereby engage in branch banking.[44] According to the court, federal law does not deem an ATM a "branch" of a bank if the bank is a mere user, as opposed to an owner, of the machine.[45]

Today, many banks engage in interstate branchless banking. For example, the New England Federal Savings Bank of Wellesley, Massachusetts, chartered in 1986, has no walk-in place of business in any state, not even in Massachusetts.[46] Customers of the New England Federal Savings Bank make their deposits by mail, by telephone, or via shared-use ATMs. Nonetheless, it is a full-service bank that makes home mortgage loans and commercial real estate loans; provides Mastercard, Visa and American Express card services; and offers individual retirement and Keogh accounts.[47]

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[40] *See* 12 U.S.C. § 1841(c) (1982); *supra* note 20.

[41] 12 U.S.C. § 1841(c), *supra* note 20.

[42] Florida Dep't of Banking and Fin. v. Board of Governors, 800 F.2d 1534 (11th Cir. 1986), *cert. denied*, 107 S. Ct. 1887 (1987).

[43] 757 F.2d 453 (2d Cir. 1985), *cert. denied*, 476 U.S. 1186 (1986).

[44] *Id.* at 454.

[45] *Id.* at 463.

[46] *New England Bank Without Walls Depends on U.S. Mail to Bring Deposits Offering Investors Higher Rates*, AMERICAN BANKER, June 23, 1986, at 24.

[47] *Id.*

Other banks offer limited or special branchless banking services across state lines. Perhaps the best known example is that of the bank credit card subsidiary that is located in one state and issues credit cards by mail to customers in all fifty states.

In this context, the continued use of residence-based taxation can cause serious problems. Consider, for example, the following situation:

> States *X* and *Y* have the same income tax rate. State *X* taxes its domestic banks on their entire income, regardless of where it is earned and does not allow a credit for taxes paid to other states. Bank *A* is domiciled in State *X*. It does 70% of its business in State *X* and 30% in State *Y;* it conducts its activities in State *Y* solely by mail and electronic means. State *Y* uses source-based taxation to tax foreign banks transacting business there, whether or not the bank has a physical presence within the state.[48] Bank *A* will pay tax to its domiciliary state on 100% of its income and tax to State *Y* on 30% of its income. Thus, 130% of its income will be subject to tax.

As this example illustrates, the application of the two systems of taxation—pure residence-based taxation by a domiciliary state and source-based taxation by a non-domiciliary state—can lead to multiple taxation. Obviously, the problem will become more serious as other states join State *Y* in taxing the income earned by non-domiciliary banks from transactions in their market.

2. Recent Case Law

Although the Supreme Court has not yet ruled on the constitutionality of a residence-based tax (without an allowance for a credit) as applied to a corporation that is doing business in and taxed by nondomiciliary states, recent activity at the state level suggests that it may soon be faced with this issue. For example, in *Commercial Credit Consumer Services v. Norberg,*[49] the Rhode Island Supreme Court considered whether that state could levy a residence-based tax on the entire income of a domestic loan and investment company that did business in and was taxed by North Carolina, Virginia,

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[48] *See, e.g.,* MINN. STAT. ANN. § 290.01(5) (West Supp. 1988). Such a tax should be constitutional. *See, e.g.,* McCray, *State Tax'n of Interstate Banking,* 21 GA. L. REV. 283 (1986); McCray, *Overturning* Bellas Hess: *Due Process Considerations,* 1985 B.Y.U. L. REV. 265.

[49] 518 A.2d 1336 (R.I. 1986).

Alabama, and Maryland.[50] The tax in question was the Rhode Island bank income tax; the company in question, Commercial Credit, was classified as a bank under the state's statute.[51] The Rhode Island Supreme Court upheld the state's residence-based bank income tax, finding that neither the due process clause nor the commerce clause prevented a state from taxing the entire income of its domestic corporations.[52] According to this court, domicile affords the necessary nexus under the due process clause for a state to levy a residence-based tax on its domestic corporations.[53]

Addressing the commerce clause issue, the Rhode Island court first distinguished *Complete Auto Transit, Inc. v. Brady*.[54] It held that the rule announced in *Complete Auto Transit*, which requires that state taxes on interstate commerce be "fairly apportioned,"[55] applied only to state taxation of *foreign* corporations. Next, the Rhode Island court cited *Mobil Oil Corp. v. Commissioner of Taxes*[56] as authority for the proposition that the state of domicile can tax all of the income of its domestic corporations without allowing a credit for taxes paid to other states.[57] Finally, the court held that the statutory allowance of

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[50] *Id.* The validity of a state residence-based bank income tax is also currently before the Appellate Tax Board in Massachusetts. *See* First Nat'l Bank of Boston v. Commissioner of Rev., Nos. 140012-140018, 140099.

[51] 518 A.2d 1336 (R.I. 1986).

[52] *Id.* at 1338-39.

[53] *Id.* at 1338.

[54] 430 U.S. 274 (1977).

[55] *Id.* at 287. The entire *Complete Auto Transit* rule provides that a state tax on interstate commerce is valid if it (a) is applied to an activity with a substantial nexus with the taxing state, (b) is fairly apportioned, (c) does not discriminate against interstate commerce, and (d) is fairly related to the services provided by the state. *Id.*

[56] 445 U.S. 425 (1980).

[57] *Norberg*, 518 A.2d at 1338. As further support for its position, the Rhode Island Supreme Court cited a 1950 treatise entitled *Allocation of Income in State Taxation*, written by G. Altman and F. Keesling, *id.*, in which those authors, relying on several early Supreme Court cases, opined that "[i]t seems fair to conclude that a nondiscriminatory tax on or measured by net income, imposed by the state of the taxpayer's domicile, may include in its base the entire net income regardless of its source without being subject to any constitutional infirmity." *Norberg*, 518 A.2d at 1337-38 (quoting G. ALTMAN & F. KEESLING, ALLOCATION OF INCOME IN ST. TAX'N 31 (2d ed. 1950)). These commentators relied on the following three U.S. Supreme Court cases as authority for their position: Matson Navigation Co. v. State Bd. of Equalization, 297 U.S. 441 (1936); Lawrence v. State Tax Comm'n, 286 U.S. 276 (1932); and Cream of Wheat Co. v. County of Grand Forks, 253 U.S. 325 (1920). *See* G. ALTMAN & F. KEESLING, *supra*, at 30-33. A close reading of these cases shows that none of them provides any support for the proposition that a state may tax the entire income of its domestic corporations without allowing a credit for taxes paid to other states, however.

In *Matson*, the court considered the validity of a California law that levied an apportioned corporate net income tax on its domestic corporations. 297 U.S. 441 (1936). The Matson company was engaged in an intrastate, interstate and foreign transportation business. *Id.* at 442-43. In computing its California tax liability, the company included only its intrastate income.

a *deduction,* but not a credit, for taxes paid to other states reduced the possibility of multiple taxation "to a level wherein constitutional limitations are satisfied."[58]

Although the Rhode Island Supreme Court's holding that domicile

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Id. at 443. The California tax commissioner recomputed Matson's income, including a portion of the company's net income from interstate and foreign business. *Id.* Matson contended that the California law violated the commerce clause by taxing income from interstate commerce. *Id.* The Supreme Court disagreed, holding that the commerce clause does not prohibit a domiciliary state from assessing a net income tax on all of the income of its domestic corporations *that is attributable to business done within the state. Id.* at 445.

In *dicta,* the *Matson* Court noted that a foreign corporation whose sole business in California is interstate and foreign commerce cannot be subjected to the tax in question. *Id.* at 446. The statement suggests only that a nondomiciliary state cannot tax a foreign corporation that engages in no local activities. Given the presence of a local business, however, the Court makes no distinction between the power of a domiciliary state and a nondomiciliary state to levy an apportioned net income tax.

Cream of Wheat Co. involved a North Dakota tax levied on the excess of the market value of the corporation's outstanding stock over the value of its real and personal property. 253 U.S. 325 (1920). One issue in the case was whether the North Dakota tax was a franchise tax or an intangible property tax. *Id.* at 328. The Court did not address the issue of the nature of the tax because it found the levy to be valid under either theory. *Id.* at 329.

The Cream of Wheat Company was a North Dakota domestic company which, however, did no business and owned no property within that state. *Id.* at 327. Nevertheless, North Dakota assessed its tax on the company based upon the value of its bonds and stocks. *Id.* The company argued that the tax violated the due process clause of the fourteenth amendment because the "situs" of the intangible property was outside the state, and that North Dakota therefore had no jurisdiction over it. *Id.* at 328. The Court upheld the tax, finding that the domiciliary state could impose a tax on or measured by corporate intangible property even if the same property were taxed by another state, because the *due process clause does not prohibit double taxation of intangibles. Id.* at 330.

In *Lawrence,* another fourteenth amendment due process clause case, a citizen of Mississippi brought a suit to set aside the assessment of the state's personal income tax because it included the income that he had made from a business conducted entirely in another state. 286 U.S. at 279. Lawrence maintained that the attempt by Mississippi to tax the fraction of his income that he had earned outside the state deprived him of his property without due process of law, and that by taxing domestic corporations on only that portion of their income derived from sources within the state, Mississippi had denied Lawrence his constitutional right to equal protection under the law. *Id.*

The Court sustained the tax over both of these objections. *Id.* at 284. First, the Court found that domicile itself afforded a basis for jurisdiction under the due process clause, stating that "[e]njoyment of the privileges of residence within the state, and the attendant right to invoke the protection of its laws, are inseparable from the responsibility for sharing the costs of government." *Id.* at 279. Second, although the Court recognized that the Mississippi law compelled Lawrence to pay a tax which his competitors, domestic corporations, did not have to pay, it held that there is "no constitutional requirement [under the equal protection clause of the fourteenth amendment] that a system of taxation should be uniform as applied to individuals and corporations." *Id.* at 283.

The holdings of these three cases remain valid today. *See infra* notes 66-120 and accompanying text. The commerce clause does not prevent a state from levying a tax on the income of a domestic corporation as long as the tax does not create multiple taxation. The due process clause does not prohibit multiple taxation of intangibles. Lawrence v. State Tax Comm'n, 286 U.S. 276 (1932); Cream of Wheat Co. v. County of Grand Forks, 253 U.S. 325 (1920).

[58] *Norberg,* 518 A.2d at 1339.

alone provides sufficient nexus for purposes of the due process clause is correct, its analysis of the commerce clause is faulty in several respects. First, the early judicial history of the commerce clause shows that the United States Supreme Court has consistently held that (1) the commerce clause prohibits multiple taxation,[59] and (2) the presence or absence of domicile is irrelevant to this multiple taxation issue.[60]

Second, *Mobil Oil Corp.* does not contradict these holdings. The Mobil Oil Company contested a Vermont income tax, calculated by means of an apportionment formula, on the grounds that the state included dividend income from Mobil's foreign subsidiaries in the company's apportionable tax base.[61] According to Mobil, its dividend income was foreign source income. Therefore, Vermont's attempt to tax it violated the due process clause.[62] The company alleged further that the tax violated the commerce clause because New York, Mobil's domiciliary state, could tax the entire dividend income.[63] Under such circumstances, Vermont could not tax a fractional share without creating double taxation. Nevertheless, the United States Supreme Court held that the Vermont tax violated neither the due process nor the commerce clause.[64] The language from *Mobil* that the Rhode Island Supreme Court relied on merely states the obvious:

> Mobil no doubt enjoys privileges and protections conferred by New York law with respect to ownership of its stock holdings, and its activities in that State no doubt supply *some* nexus for jurisdiction to tax. Although we do not now presume to pass on the constitutionality of a hypothetical New York tax, we may assume, for present purposes, that the State of commercial domicile has the authority to lay *some* tax on appellant's dividend income as well as on the value of its stock.[65]

While the court did not discuss whether New York could assess its tax on Mobil's entire net income without allowing a credit for taxes paid to other states, a fair reading of the above quotation suggests that it could not.

Finally, as is shown in the next section, the allowance of a *deduction* for taxes paid to other states will not satisfy the commerce clause requirement of the elimination of multiple taxation.

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[59] *See infra* notes 79-103 and accompanying text.
[60] *See id.*
[61] *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 432 (1980).
[62] *Id.* at 432-36.
[63] *Id.* at 436.
[64] *Id.* at 449.
[65] *Id.* at 445 (citation omitted & emphasis added).

B. *The Solution*

1. Background: The Judicial Evolution of State Property and Income Taxes

To understand how the Supreme Court might solve the problem of the multiple taxation that is created by the coincidence of pure residence-based taxation and source-based taxation, one must begin by reviewing the judicial history of the interplay between the due process and commerce clauses.

The Supreme Court has struggled with the twin issues of under- and over-taxation of the property and income of multistate corporations for well over a century. The Court recognized very early that a multistate corporation would face multiple taxation if every state in which it operated could tax its property or income, and that this could foreseebly destroy the national market.[66] This realization led to constitutional interpretations that ranged from limiting to outright banning of state taxation of interstate commerce.[67] On the other hand, the justices of the high Court also recognized that, if at least one state did not have the power to tax the entire income of a multijurisdictional corporation, such a corporation could escape all state taxation by conducting its activities entirely in interstate commerce.[68]

In its early decisions, the Court's attempts to find a solution to these two problems led it down several blind alleys. For example, the Court initially used the due process clause to solve the problems of under- and over-taxation by assigning property to a single taxing jurisdiction.[69] The rule that the Court settled on was as follows: property has a tax situs in the state in which it is located.[70] This

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[66] *See, e.g.*, Fargo v. Michigan, 121 U.S. 230 (1887) (striking down state taxes for foreign entries); Robbins v. Shelby Taxing Dist., 120 U.S. 489 (1887).

[67] *Compare* Wiloil Corp. v. Pennsylvania, 294 U.S. 169 (1935) (limiting state taxation on interstate commerce) *and* Superior Oil Co. v. Mississippi, 280 U.S. 390 (1930) *with* Freeman v. Hewit, 329 U.S. 249 (1946) (banning state taxation on interstate commerce), McLeod v. J.E. Dilworth Co., 322 U.S. 327 (1944), *and* J.D. Adams Mfg. Co. v. Storen, 304 U.S. 307 (1938).

[68] *See, e.g.*, Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938).

[69] *E.g.*, Baldwin v. Missouri, 281 U.S. 586 (1930); Union Refrigerator Transit Co. v. Kentucky, 199 U.S. 194 (1905); *see* Lowndes, *Spurious Conceptions of the Constitutional Law of Taxation*, 47 HARV. L. REV. 628 (1934) [hereinafter Lowndes, *Spurious Conceptions*]; Lowndes, *The Passing of Situs—Jurisdiction to Tax Shares of Corporate Stock*, 45 HARV. L. REV. 777 (1932) [hereinafter Lowndes, *Passing of Situs*]; Note, *Withdrawal of Due Process Limitations on State Tax Jurisdiction*, 50 YALE L.J. 900 (1941).

[70] *See Union Refrigerator Transit*, 199 U.S. at 211. The concept of "situs" is based on the proscriptions of the due process clause. According to the Court's interpretation of that clause, states were forbidden to tax property that was located beyond their jurisdiction. *See, e.g.*, Louisville & Jeffersonville Ferry Co. v. Kentucky, 188 U.S. 385 (1903). Early notions of

system worked well with real property and with tangible personal property that was permanently situated in one state. Problems arose, however, with movable tangible property and with intangible property.

By its nature, movable property is not permanently located in one taxing jurisdiction. If all states into which movable property travels were permitted to tax the property, multiple taxation would result. To solve this problem, the Court found that only the state in which the property had acquired a permanent situs could tax it.[71] Because most movable property will likely not have a permanent situs in any state, the result of this rule was to exempt such property from taxation.[72] This problem was solved by another judicial edict: the state of domicile of persons having an interest in the movable property retains jurisdiction to tax property that has not acquired a permanent situs outside the domiciliary state.[73]

Like movable tangible property, intangible property does not have a permanent location in any state. Somewhat arbitrarily, the Court found that intangible property had its tax situs in the state which was the legal domicile of its multistate corporate owner.[74] As the basis for this rule, the Court cited the common law maxim "mobilia sequuntur personam" (movables follow the person)[75] without any further attempt at constitutional analysis.[76] Also, the Court assigned

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jurisdiction were based in turn on physical or legal power over the object taxed. A tax situs could, therefore, exist in the state in which the property was actually (physically) located or deemed (legally) located. One commentator has called situs "simply the Supreme Court's specific [remedy] for the ills of multiple taxation." Lowndes, *Spurious Conceptions*, *supra* note 69, at 630; *see also* Lowndes, *Passing of Situs*, *supra* note 69.

[71] *See, e.g., Union Refrigerator Transit*, 199 U.S. at 206; P. HARTMAN, *supra* note 33, at § 2:8. If, however, the movable property consisted of railroad cars owned by a railroad company that was engaged in running the cars through several states, the U.S. Supreme Court interpreted the constitution to permit states to tax such property by assessing an apportioned share of the company's capital stock based on the ratio of the number of miles of railroad track within the state to the number of miles in all states. *See, e.g.*, Union Refrigerator Transit Co. v. Lynch, 177 U.S. 149, 154 (1900); Pullman's Palace Car Co. v. Pennsylvania, 141 U.S. 18 (1891).

[72] *Union Refrigerator Transit*, 199 U.S. at 205; P. HARTMAN, *supra* note 33, § 2:8, at 41-42.

[73] *See, e.g.*, Central R.R. v. Pennsylvania, 370 U.S. 607 (1962); Treichler v. Wisconsin, 338 U.S. 251 (1949); New York *ex rel.* N.Y. Central & Hudson River R.R. v. Miller, 202 U.S. 584 (1906); P. HARTMAN, *supra* note 33, § 2:8, at 41-42.

[74] *See* Safe Deposit & Trust Co. of Baltimore v. Virginia, 280 U.S. 83, 93 (1929); Fidelity & Columbia Trust Co. v. City of Louisville, 245 U.S. 54, 59 (1917); Kirtland v. Hotchkiss, 100 U.S. 491, 499 (1879); P. HARTMAN, *supra* note 33, § 2:8, at 43-44.

[75] BLACK'S LAW DICTIONARY 905 (5th ed. 1979).

[76] The Court itself recognized the obvious limitations of the maxim. In First Bank Stock Corp. v. Minnesota, 301 U.S. 234 (1937), the Court observed that the maxim "states a rule without disclosing the reasons for it." 301 U.S. at 241; *see Safe Deposit & Trust*, 280 U.S. at 93; *Fidelity & Columbia Trust*, 245 U.S. at 59 (which as its rationale simply cited to Kirtland v. Hotchkiss); *Kirtland*, 100 U.S. at 499 (noting that there is no constitutional impairment if the state has jurisdiction over the taxpayer).

the intangibles that were used in the company's business to a "business situs" in the state of commercial domicile.[77] Thus, a state could tax a nonresident on the value of its intangibles connected with the conduct o. business in the taxing state.[78]

This system worked, as long as the Court held that the due process clause prohibited multiple taxation of income produced in a multistate transaction. But, by 1938, the Court had changed its interpretation of the due process clause and held that the due process clause does not ban multiple taxation of intangibles.[79] This remains the rule today.[80]

"For tax purposes, net income falls in the category of intangibles . . . ."[81] Therefore, the due process clause does not prohibit multiple taxation of net income.[82] By using an analogy to state taxation of intangible property, the state of domicile can tax the entire income of its citizens without violating the due process clause, even though another state has also taxed a portion of the income.[83]

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[77] Wheeling Steel Corp. v. Fox, 298 U.S. 193, 197 (1936); Metropolitan Life Ins. Co. v. City of New Orleans, 205 U.S. 395 (1907); New Orleans v. Stempel, 175 U.S. 309, 313 (1899); *see* Bristol v. Washington County, 177 U.S. 133 (1900). In the case of multistate corporations, the Court has not ruled on whether the state of legal or commercial domicile is the "state of domicile" for purposes of a residence-based tax. *See* J. HELLERSTEIN & W. HELLERSTEIN, STATE AND LOCAL TAXATION 706-08 (4th ed. 1978). For example, the Court has upheld residence-based taxation of intangibles by the state of commercial domicile, *see* Wheeling Steel Corp. v. Fox, 298 U.S. 193 (1936), and by the state of legal domicile, Cream of Wheat Co. v. County of Grand Forks, 253 U.S. 325 (1920). However, commentators have questioned the current validity of that portion of the *Cream of Wheat* decision, which holds that the state of legal domicile can tax the intangible property of its domestic corporations even when such corporations do no business within the state and are taxed by the state of their commercial domicile. 1 J. HELLERSTEIN, *supra* note 33, ¶ 8.2[2], at 307. In *Cream of Wheat*, the company conducted its manufacturing, commercial and financial business wholly outside North Dakota. Nevertheless, the Court upheld the North Dakota residence-based intangibles tax over the company's objection that the tax violated the due process clause because no part of its business or property was located in North Dakota. *Cream of Wheat*, 253 U.S. at 326-29. The holding of the *Cream of Wheat* Court was based upon a view of corporate law that is now discredited, namely, that a corporation "must dwell in the place of its creation, and cannot migrate to another sovereignty." *Id.* at 328 (quoting Bank of Augusta v. Earle, 38 U.S. (13 Pet.) 517, 588 (1839)). It seems unlikely that the Court would now uphold a tax levied by the state of legal domicile on a multistate corporation that did no business there. *Cf.* Memphis Natural Gas Co. v. Beeler, 315 U.S. 649, 652 (1942).

[78] *First Bank Stock Corp.*, 301 U.S. at 240-41; *Wheeling Steel Corp.*, 298 U.S. at 210-11.

[79] Gradually, exceptions to the majority rule were introduced. *See, e.g.*, First Bank Stock Corp. v. Minnesota, 301 U.S. 234 (1937); Wheeling Steel Corp. v. Fox, 298 U.S. 193 (1936); New York *ex rel.* Cohn v. Graves, 300 U.S. 308 (1937). The rule finally collapsed from a lack of substance. Curry v. McCanless, 307 U.S. 357 (1939); Guaranty Trust Co. v. Virginia, 305 U.S. 19, 22 (1938).

[80] *See, e.g.*, Cory v. White, 457 U.S. 85, 92-101 & n.6 (1982) (Powell, J., dissenting).

[81] P. HARTMAN, *supra* note 33, § 9:2, at 462.

[82] Lawrence v. State Tax Comm'n, 286 U.S. 276, 281 (1932) (allowing state taxation of income generated without the state) (citing Maguire v. Trefrey, 253 U.S. 12, 16-17 (1920)).

[83] P. HARTMAN, *supra* note 33, § 2:8, at 48-49.

In the case of multistate corporations, the solution to the overtaxation problem is found in the commerce clause.[84] In general, state net income taxes have received favored treatment under the commerce clause.[85] Unlike gross receipts or sales taxes, which the Court had held invalid under the commerce clause for nearly a century,[86] state corporate net income taxes levied on income derived from interstate commerce have been upheld by the Court since 1918.[87] The distinction between sales taxes and net income taxes lies in the different methods used by states to calculate the tax base.[88] State sales taxes are imposed on the entire gross revenue from the interstate sale.[89] Therefore, if both the seller's state and the buyer's state can levy a sales tax on the interstate sale, the single transaction will be taxed twice. If a third state, such as the state from which the goods are shipped, also taxes the sale, the transaction will be taxed three times, and so on.

States impose corporate net income taxes in a very different manner. Since the inception of the state corporate net income tax, states have either allowed their domestic corporations a credit for income taxes paid to other states or have apportioned such taxes on multistate corporations.[90] Wisconsin was the first state to impose a corporate net income tax.[91] The 1911 Wisconsin law determined the net taxable

[84] For a discussion of the "thorny and vexing" problem of multiple taxation of the intangibles of individuals, see P. HARTMAN, *supra* note 33, §§ 2:8.1-2:17, at 14-20 (Supp. 1986).

[85] *See* United States Glue Co. v. Town of Oak Creek, 247 U.S. 321 (1918).

[86] The decisions span the time period from 1887, Robbins v. Shelby County Taxing Dist., 120 U.S. 489 (1887), to 1977, Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). During this time, the Court struggled with two inconsistent interpretations of the restraints the commerce clause placed on state gross receipts or sales taxes. Under one view, the commerce clause created an "area of free trade" in interstate commerce, which the states could not tax at all. *See, e.g.*, Freeman v. Hewit, 329 U.S. 249 (1946); McLeod v. J.E. Dilworth Co., 322 U.S. 327 (1944); J.D. Adams Mfg. Co. v. Storen, 304 U.S. 307, 309-14 (1938). This principle, which led to a per se ban on state taxation of interstate sales, found its roots in the problem of multiple taxation. If every state which had a connection to the transaction could tax it, multiple taxation would be the inevitable result. *See* P. HARTMAN, *supra* note 33, § 9:26, at 554-57. Another view of the Commerce Clause held that "[e]ven interstate business must pay its way." *Id.* §§ 2:13-2:14, at 65-76 (citation omitted). This view rejected the absolute ban and focused instead on the effects of a particular state tax. *See* Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938). If the state tax on interstate commerce being challenged did not lead to cumulative burdens in the form of multiple taxation, it would be deemed valid. *Western Live Stock*, 303 U.S. at 258. Finally in 1977, the *Western Live Stock* test won out. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). Under the *Complete Auto Transit* test, a state tax on interstate commerce is valid if it is "applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." 430 U.S. at 279.

[87] United States Glue Co. v. Town of Oak Creek, 247 U.S. 321 (1918).

[88] *See generally* 1 J. HELLERSTEIN, *supra* note 33, ¶ 8.2[2].

[89] *See* J. HELLERSTEIN & W. HELLERSTEIN, STATE AND LOCAL TAXATION 551-52 (1978).

[90] 1 J. HELLERSTEIN, *supra* note 33, ¶ 8.2[2], at 305.

[91] *Id.* at 305 & n.24 (citing ch. 658, 1911 Wis. Laws; United States Glue Co. v. Town of Oak Creek, 247 U.S. 321 (1918)).

income of a multistate domestic corporation through the use of an apportionment formula. The numerator was made up of the company's gross Wisconsin business in dollars; the denominator consisted of the company's total gross business in dollars both within and without the state.[92] Thereafter, every state except Alabama[93] followed the Wisconsin pattern. In *United States Glue Co. v. Oak Creek*,[94] the Court upheld the Wisconsin tax, which was levied on a domestic corporation, against a commerce clause challenge.[95] Specifically, the Court noted that (a) the tax was nondiscriminatory because it was imposed on domiciliary and foreign corporations alike,[96] and (b) the tax would not subject the corporation's income to multiple taxation because it was imposed upon only that portion of the corporation's income that was attributable to business transacted within Wisconsin.[97]

For a short period, the Court seemed to limit its holding in *United States Glue Co.* to domiciliary states.[98] That is, a nondomiciliary state could not tax any of the income of a foreign corporation engaged in interstate commerce within its borders.[99] However, this apparent distinction proved to be based not on domicile but on the presence or absence of local activities.[100] As early as 1920, the Court ignored the domestic/foreign distinction and upheld apportioned state taxes levied on a foreign corporation when the state proved that the foreign corporation was engaged in both intra- and interstate activities within its borders.[101] Finally, in 1959, the Court upheld a "fairly apportioned" state corporate net income tax imposed on a foreign corporation engaged "exclusively" in interstate commerce.[102]

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[92] *Id.* at 305-06; *United States Glue Co.*, 247 U.S. at 324-25.

[93] Alabama follows the federal income tax method in taxing domestic corporations. State law provides that domestic corporations are taxed on their income from whatever source derived, subject to a credit allowed for net income based taxes paid to other states. *See* 1 J. HELLERSTEIN, *supra* note 33, ¶ 8.2[2], at 306.

[94] 247 U.S. 321 (1918).

[95] *Id.* at 326-27.

[96] *Id.* at 327.

[97] *Id.* at 328-29.

[98] *See, e.g.*, Alpha Portland Cement Co. v. Massachusetts, 268 U.S. 203 (1925).

[99] *Id.*

[100] *See, e.g., id.* 268 U.S. 203. Note that local activities are presumed to exist in the domiciliary state.

[101] *See, e.g.*, Norfolk & W. Ry. Co. v. North Carolina, 297 U.S. 682 (1936); Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n, 266 U.S. 271 (1924); Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920).

[102] Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 460 (1959). The Court specifically noted that "the presence of such a circumstance [domicile] is not controlling [as] is shown by the cases of Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924), and Norfolk & W. Ry. Co. v. North Carolina, 297 U.S. 682 (1936)." *Id.* at

As this brief review illustrates, multiple taxation of the income of a multijurisdictional corporation does not violate the due process clause, but does violate the commerce clause.[103] Indeed, a key element in the Court's interpretation of the latter clause is that state taxes which lead "inevitably" to multiple taxation of corporate income are constitutionally flawed, while those state taxes that avoid multiple taxation are valid.

2. What Does the Commerce Clause Require: Apportionment, Deductions, or Credits?

The modern commerce clause test announced in *Complete Auto Transit, Inc. v. Brady*[104] explicitly requires fair apportionment of the income of a multijurisdictional corporation. The Rhode Island Supreme Court, however, found that this requirement applies only to taxes levied by nondomiciliary states.[105] Accordingly, the court held that a domiciliary state is free to tax the entire income of its multistate corporations even though such corporations are taxed by other states. The problem, however, is that under such a system, all multistate corporations would be subject to double taxation unless the domiciliary state allows its domestic corporations a credit for taxes paid to other states. Consider the following example:

> State *X* and State *Y* have the same income tax structure and use the same tax base and rate. State *X* applies its tax rate to (a) the entire net income of its domestic corporations without allowing a credit for taxes paid to other states and (b) its fractional share of the net income of all foreign corporations which are doing business there. Corporation *A* is domiciled in State *X* and does 70% of its business in State *X* and 30% of its business in State *Y*. State *Y* has the same rule as State *X*. That is, State *Y* uses pure residence-based principles to tax its domestic corporations and source-based principles to tax foreign corporations doing business there. Corporation *B* is domiciled in State *Y* and does 80%

459; *see also* West Publishing Co. v. McColgan, 27 Cal. 2d 705, 166 P.2d (1946) (holding that activities establishing corporation's presence in a state also subject it to taxation by that state and to suit to recover such tax), *aff'd*, 328 U.S. 823 (1946).

[103] Because a domiciliary state has, by definition, the requisite nexus with its domestic corporations; i.e. domicile alone provides sufficient nexus. *See* cases cited *supra* notes 77 & 86 (state can apply a residence-based tax to such corporations without violating the due process clause).

[104] 430 U.S. 274 (1977).

[105] Commercial Credit Consumer Serv. v. Norberg, 518 A.2d 1336, 1337 n.1 (R.I. 1986).

of its business in State *Y* and 20% of its business in State *X*.

Corporation *A* will pay taxes to State *X* on its entire income and taxes to State *Y* on 30% of its income; thus, 130% of its income will be subject to tax. Corporation *B* will pay taxes to State *Y* on its entire income and taxes to State *X* on 20% of its income; thus, 120% of its income will be subject to tax.

A state tax system that combines residence-based taxation (without allowing a credit for taxes paid to other states) with source-based taxation, as described above, "inevitably" results in double taxation in violation of the Constitution.[106]

The multiple taxation problem cannot be solved by the allowance of a deduction as the Rhode Island Supreme Court held.[107] A domestic multistate corporation that deducts taxes paid to other states will be subject to inevitable multiple taxation. Thus, even if every state uses the same tax base, rate and structure, a multistate corporation will still be taxed on more than 100% of its tax base (as well as having a higher aggregate tax burden than under an apportionment scheme) as the following examples illustrate:

Situation 1 (Source-Based Taxation with Formulary Apportionment)

Assume that Corporation *A* does business in and is taxed by three states: *X*, *Y* and *Z*. State *X* is the domicile of Corporation *A*. Assume further that Corporation *A* has $1,000,000 of net income for fiscal year 1.[108] Corporation *A* earned this income in all three states, and all three states use formulary apportionment to calculate the company's tax liability. According to the state formulas, 70% of the company's income is attributable to its activities in State *X*, 20% to those in State *Y* and 10% to those in State *Z*. If all three states had the same 5% tax rate, Corporation *A* would pay $35,000 income tax to State *X* (70% x $1,000,000 = $700,000 x 5% = $35,000); $10,000 tax to State *Y* (20% x $1,000,000 = $200,000 x 5% = $10,000); and $5000 tax to State *Z* (10% x $1,000,000 = $100,000 x 5% = $5000). Thus, Corporation *A* pays tax on 100% of its income and its total tax liability is $50,000.

Situation 2 (Residence-Based Taxation with a *Deduction* for Taxes Paid to Other States)

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[106] *See* Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 189-93 (1983); Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 447 (1979).

[107] *Norberg*, 518 A.2d at 1338-39.

[108] For the purpose of this and the following examples, I have assumed that all states would calculate Corporation *A*'s net income using the same method.

Make the same assumptions as above, except one. In this example, assume that the domiciliary state, State *X*, assesses its tax on the entire net income of Corporation *A* less a deduction for taxes paid to States *Y* and *Z*. Assume that all three states have the same tax rate. In this case, Corporation *A* will pay $49,250 in tax to State *X* ($1,000,000 − $10,000 − $5000 = $985,000 x 5% = $49,250). The company would still pay $10,000 in tax to State *Y* and $5000 in tax to State *Z*. Thus, Corporation *A* pays tax on 128.5% of its income and its total tax liability is $64,250.

An increase in Corporation *A*'s aggregate tax burden standing alone, however, does not establish unconstitutional double taxation. In general, multiple taxation that results from the interplay among different methods of state taxation of interstate income does not violate the Constitution if the state's method itself is valid, *i.e.*, does not lead to "inevitable" multiple taxation.[109] As is illustrated by the above examples, however, the Rhode Island system fails this test.[110] Its effect in all cases is to subject more than 100% of the tax base of the corporation to state income tax. This is true regardless of the state tax rates or how the states calculate their tax bases.[111] Thus, the Rhode Island law fails the multiple taxation test.

The Rhode Island system also fails the related internal consistency

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[109] *See, e.g., Container Corp. of America*, 463 U.S. at 188; Moorman Mfg. Co. v. Bair, 437 U.S. 267, 278-80 (1978).

[110] In *Container Corp.*, the Court noted that the combination of residence-based taxation and source-based taxation does not "conclusively demonstrate the existence of double taxation" if the domiciliary state allows deductions, exemptions and adjustments which *eliminate the overlapping taxation*. 463 U.S. at 187 n.22.

[111] For example, if State *X* has a lower tax rate than either State *Y* or State *Z*, Corporation *A* will still have a higher aggregate tax bill under the deduction method than under the apportionment method. If State *X* has a higher tax rate than either State *Y* or State *Z*, the tax increase is even more significant. Consider the following two examples.

Example a

Make the same assumptions as in Situation 2 in the text, except that the states' tax rates are different. State *X* has a tax rate of 5%, State *Y*'s rate is 6% and State *Z*'s rate is 9%. Now Corporation *A* will pay $48,950 income tax to State *X* ($1,000,000 − $12,000 − $9000 = $979,000 x 5% = 48,950); $12,000 income tax to State *Y* ($1,000,000 x 20% = $200,000 x 6% = $12,000); and $9000 income tax to State *Z* ($1,000,000 x 10% = $100,000 x 9% = $9000). Thus, Corporation *A* pays tax on 127.9% of its income, and its total tax liability is $69,950.

Example b

Make the same assumptions as in Situation 3 in the text, but assume that State *X* has a tax rate of 9%, State *Y*'s rate is 6%, and State *Z*'s rate is 5%. Under these circumstances, Corporation *A* will pay $88,470 income tax to State *X* ($1,000,000 − $12,000 − $5000 = $983,000 x 9% = $88,470); $12,000 in tax to State *Y* ($1,000,000 x 20% = $200,000 x 6% = $12,000); and $5000 in tax to State *Z* ($1,000,000 x 10% = $100,000 x 5% = $5,000). Thus, Corporation *A* pays tax on 128.3% of its income and its total tax liability is $105,470.

test.[112] Under this test, a tax " 'must be such that, if applied by every jurisdiction,' there would be no impermissible interference with free trade."[113] But, even if every state adopted the Rhode Island system, multistate corporations would still be subject to multiple taxation. This multiple taxation is not caused by the interaction of the laws of two or more states, but by an inconsistency within the Rhode Island law itself.[114] Thus a state tax system that applies residence-based taxes to its domestic corporations and source-based taxes to foreign corporations, with a deduction, but not a credit, for taxes paid to other states, cannot be valid, because it inevitably leads to multiple taxation.

A state residence-based tax system that provides a credit (rather than a deduction) for the taxes that its domiciliary corporation pays to other states does *not* lead inevitably to multiple taxation.[115] The following example, which is based on the assumption that the state of domicile applies its tax rate to 100% of the net income of its multistate corporations but allows those corporations a credit for taxes paid to other states (not to exceed the domiciliary state's tax rate), illustrates this point:

Situation 3 (Residence-Based Taxation with a *Credit* for Taxes Paid to Other States)

> Corporation *A* does business in and is taxable in three states: States *X*, *Y*, and *Z*. Each state has a 5% tax rate. State *X* is the

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[112] *See* Armco Inc. v. Hardesty, 467 U.S. 638, 644-46 (1984); *Container Corp. of America*, 463 U.S. at 169.

[113] *Armco Inc.*, 467 U.S. at 644 (quoting *Container Corp.*, 463 U.S. at 169).

[114] In this regard the Rhode Island law is unlike the Iowa statute at issue in Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978). *See infra* notes 187-91 and accompanying text.

[115] The Court has on two occasions indicated a preference for formulary apportionment, but that preference is based solely upon the constitutional prohibition against multiple taxation. For example, in *Standard Oil Co. v. Peck*, the court struck down an ad valorem personal property tax levied by Ohio on all the boats and barges owned by its domiciliary corporation, holding that "[t]he rule which permits taxation by two or more states on an apportionment basis precludes taxation of all of the property by the state of the domicile. . . . *Otherwise there would be multiple taxation of interstate operations* . . . ." 342 U.S. 382, 384-85 (1952) (citation omitted and emphasis added). In *Japan Line, Ltd. v. Los Angeles*, the Court again addressed the need for formulary apportionment, stating: *"In order to prevent multiple taxation of interstate commerce,* this Court has required that taxes be apportioned among taxing jurisdictions, so that no instrumentality of commerce is subjected to more than one tax on its full value. The corollary of the apportionment principle is, of course, that no jurisdiction may tax the instrumentality in full." 441 U.S. 434, 446-47 (1979) (emphasis added). As shown, a tax credit would satisfy the constitutional ban on multiple taxation. Recently, the Court found in connection with a Louisiana use tax that the allowance of a credit for sales taxes paid to other states satisfied the commerce clause requirement of fair apportionment. D.H. Holmes Co. v. McNamara, 108 S. Ct. 1619 (1988).

domicile of Corporation *A*. Corporation *A* has $1,000,000 of net income for fiscal year 1. Corporation *A* earned income in all three states. State *Y* has apportioned $200,000 of *A*'s income to itself, and State *Z* has apportioned $100,000 to itself. State *X* assesses its tax on the entire net income of Corporation *A* but gives a credit for the taxes the corporation pays to States *Y* and *Z*. Given these rules, Corporation *A* would pay a $10,000 income tax to State *Y* ($200,000 x 5% = $10,000); a $5000 income tax to State *Z* ($100,000 x 5% = $5000); and a $35,000 income tax to State *X* ($1,000,000 x 5% = $50,000 − $15,000 tax credit = $35,000). Thus, Corporation *A* pays tax on 100% of its income, and its total tax liability is $50,000. This is the same tax liability that it would pay if all three states used formulary apportionment.[116]

It is true that Corporation *A*'s aggregate tax burden might be higher under a system of tax credits than it would be under formulary apportionment if the tax rate of the domiciliary state is higher than that of any of the other states taxing the corporation.[117] Such a situation, however, ensues from differences in state tax rates, not from any internal inconsistency in the credit method itself. If every state used the above credit method, multiple taxation could not result. A state tax system that is internally consistent (such as that described in Situation 3 above) is not unconstitutional simply because the tax rate of another state increases the aggregate tax burden on a multistate

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[116] *See supra* note 108 and accompanying text.

[117] The total tax burden on Corporation *A* will be the same under formulary apportionment and a system of tax credits as long as State *A* has a tax rate which is equal to or less than that of all other states taxing the corporation. Corporation *A*'s aggregate tax burden will be greater if the domiciliary state uses a credit system *and* a tax rate that is higher than that of the other states which tax the corporation, as the following example shows:

Example c

Assume, as in Situation 1, that Corporation *A* does business in and is taxed by three states: *X*, *Y*, and *Z*. State *X* is the domicile of Corporation *A*. Assume further that Corporation *A* has $1,000,000 of net income for Fiscal Year 1. Corporation *A* earned this income in all 3 states: 70% in State *X*, 20% in State *Y*, and 10% in State *Z*. State *X* has a tax rate of 9%, State *Y*'s rate is 6%, and State *Z*'s rate is 5%. State *A* applies its residence-based tax to the entire net income of Corporation *A* and then gives the corporation a tax credit for the taxes it pays to States *Y* and *Z*. Corporation *A*'s aggregate tax burden is, then, $90,000. It pays State *X* $73,000 ($1,000,000 x 9% = $90,000 − $5,000 − $12,000 = $73,000); State *Y* $12,000 ($200,000 x 6% = $12,000); State *Z* $5000 ($100,000 x 5% = $5000). $73,000 + $12,000 + $5,000 = $90,000. In effect, Corporation *A* has paid tax on $1,000,000 at the rate of 9%. Compare the result under formulary apportionment. Corporation *A*'s aggregate tax burden would have been $80,000, rather than $90,000. It would have paid $63,000 to State *A* ($1,000,000 x 70% = $700,000 x 9% = $63,000); $12,000 to State *Y*; and $5000 to State *Z*. $63,000 + $12,000 + $5,000 = $80,000.

corporation.[118]

In summary, if the commerce clause requires a state to use a system of taxation that is *designed to eliminate* double taxation, then either formulary apportionment or a system of credits[119] should pass constitutional muster, but the Rhode Island scheme of deductions would not. If the term "apportionment," however, refers to any state taxation plan that is *designed to mitigate* rather than eliminate double taxation, then the Rhode Island method may be valid.

The former construction of the commerce clause, requiring that a state tax on multistate corporate income be designed to eliminate double taxation, is more consistent with the Court's previous interpretations of the commerce clause than is the latter construction.[120] Moreover, the Rhode Island statute is not internally consistent. Because the defect in the law is internal (*i.e.*, it is not tied to the tax policy of another state), it is therefore fatal.

III. New State Apportionment Formulas

The constitution does not dictate any particular apportionment formula.[121] States are apparently free both to develop their own factors (as long as those factors are reasonably related to the taxpayer's in-state income-producing activities) and to weight those factors to their advantage.[122] Some uniformity among state apportionment formulas, however, is prescribed by the purpose of an apportionment formula.

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[118] The Supreme Court has long held that the constitutionality of a particular state's tax should not depend on the vagaries of the tax policy of another state. *See, e.g.*, Armco Inc. v. Hardesty, 467 U.S. 638, 644-645 (1984); Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980).

[119] A system of credits should satisfy both the due process and commerce clauses. As argued previously, *see supra* notes 79-80 and accompanying text, the due process clause does not prohibit multiple taxation. Therefore, the domiciliary state is not precluded from taxing the entire income of its domestic corporations. The commerce clause is satisfied because the credit system will not produce multiple taxation if applied by every state. I have argued elsewhere that such a system should satisfy the fair apportionment requirement in the context of state sales taxes on interstate sales. *See* McCray, *Commerce Clause Sanctions Against Taxation on Mail Order Sales: A Re-Evaluation*, 17 Urb. Law. 529 (1985); *see also D.H. Holmes*, 108 S. Ct. 1619.

[120] Because the Court has always equated the apportionment requirement with the prevention of multiple taxation, and because the Court has shown great tolerance for differences in state tax systems, it should find that the fair apportionment requirement is met by *any* method designed to eliminate multiple taxation.

[121] "States have wide latitude in the selection of apportionment formulas . . . ." Moorman Mfg. Co. v. Bair, 437 U.S. 267, 274 (1978).

[122] *See generally id.*

A. *The Purpose of an Apportionment Formula: The Uniform Division of Income for Tax Purposes Act*

The purpose of an apportionment formula is to determine the fraction of a multijurisdictional corporate taxpayer's income that should be attributed to a given state. The formula does this by comparing the taxpayer's in-state income-producing activities with such activities everywhere.[123] Therefore, the particular formula chosen will reflect how and where the taxpayer earns its income: the factors represent how the taxpayer generates its income, and the situs rules govern where the income is earned. As a general rule then, a fair apportionment formula should comply with two principles: (1) the factors should bear a reasonable relationship to the income being apportioned,[124] and (2) the situs rules should represent the location of the activities or property of the taxpayer (by reference to the benefits and protections that the taxing state offers to the taxpayer's property and/or activities).[125]

Unlike the situation with financial institutions, states have had extensive experience with the apportionment of the income of multistate manufacturing companies. The history of state taxation of those corporations is therefore instructive.

In the years before state income taxes became prevalent, most states levied capital stock taxes on corporations.[126] These states apportioned the capital stock of a multistate business according to the ratio of the corporation's real and tangible personal property within the state to the total of such property everywhere.[127] With the advent of state net income taxes, the single-factor property formula gave

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[123] 1 J. HELLERSTEIN, *supra* note 33, ¶ 9.2, at 479.

[124] According to the Supreme Court, a valid state apportionment formula must have "external consistency—the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 169 (1983).

[125] *See generally* Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940).

> "Taxable event," "jurisdiction to tax," "business situs," "extraterritoriality," are all compendious ways of implying the impotence of state power because state power has nothing on which to operate. . . . The simple but controlling question is whether the state has given anything for which it can ask for a return. The substantial privilege of carrying on business in Wisconsin . . . clearly supports the tax, and the state has not given the less merely because it has conditioned the demand of the exaction upon happenings outside its own borders. The fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction.

311 U.S. 435, 444-45 (1940) (citations omitted).

[126] *See generally*, 1 J. HELLERSTEIN, *supra* note 33, ¶ 8.6, at 333-34.

[127] *Id.*

way to more sophisticated methods of dividing the net income base.[128] At first, there was little uniformity among the states in the factors chosen.[129] Gradually, though, a consensus emerged for the use of a three-factor formula consisting of property (plant, machinery, etc.), payroll (employees), and receipts (from the sales of goods produced by the plant, machinery and employees).[130] Today, most states agree that the fraction of income of a manufacturing company that should be attributed to a given state can be measured by the following formula:[131]

$$1/3x \left[\frac{\text{payroll in state}}{\text{payroll in all states}} + \frac{\text{tangible prop. in state}}{\text{tangible prop. in all states}} + \frac{\text{sales in state}}{\text{sales in all states}} \right]$$

Having chosen the formula that represents how the taxpayer generates its income, a state must then adopt rules for determining where the income is earned. These "situs rules" control what elements go into the numerator of the three-factor formula.

For example, if employee *Z* works part time in State *A* and part time in State *B*, an issue arises as to which state should include the employee's wages in its numerator for purposes of the payroll factor. A similar problem arises if Product *X* is manufactured in State A and sold to a customer in State *B*. The question then centers on which state should include the receipts from the sale in the numerator of the sales factor. The "situs rules" of a state control these decisions.

Although there is widespread acceptance among the states of the three-factor formula, there is little agreement on the appropriate situs rules.[132] In 1957, the three-factor formula and detailed situs rules were codified as a uniform state law in the Uniform Division of Income for Tax Purposes Act (UDITPA).[133] The UDITPA and the fairness of its rules have been broadly affirmed by the Supreme Court.[134]

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[128] *Id.*

[129] For a comprehensive discussion of state apportionment practices prior to the adoption of UDITPA, see Silverstein, *Problems of Apportionment in Tax'n of Multistate Business*, 4 TAX L. REV. 207 (1949).

[130] 1 J. HELLERSTEIN, *supra* note 33, ¶ 9.6 at 495.

[131] *See id.* ¶ 9.1, at 479.

[132] *Id.* ¶¶ 9.2-9.3, at 481-86.

[133] 7A U.L.A. 331 (West 1985).

[134] *See* Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983); General Motors Corp. v. District of Columbia, 380 U.S. 553, 561 (1965); Butler Bros. v. McColgan, 315 U.S. 501 (1942).

Indeed, in upholding California's use of that formula to apportion the income of a multinational corporation and its unitary subsidiaries, the Court declared:

> [N]ot only has the three-factor formula met with our approval, but it has become . . . something of a benchmark against which other apportionment formulas are judged.[135]
>
> The three-factor formula used by California has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated. It is therefore able to avoid the sorts of distortions that were present in *Hans Rees' Sons, Inc.*[136]

Currently, twenty-four states and the District of Columbia use some version of the UDITPA formula.[137] Some tax overlap remains, however, because even those states using the basic three-factor formula have modified it in some manner.[138]

The three-factor formula, which was developed to apportion the income of manufacturing companies, cannot be used to apportion the income of financial institutions, however. In fact, the Act itself specifically excludes financial institutions.[139] Manufacturing companies employ capital (in the form of plants, equipment and machinery) and labor to produce a product, which is then sold to produce income. The UDITPA factors reflect the income-producing elements of the manufacturing by incorporating a sales factor, a real and tangible property factor and a payroll factor.

The income-producing elements of the business of banking are very different from those of a manufacturing company. A bank earns income primarily by soliciting deposits, which it uses to create loans (intangible property) which in turn generate interest and fee income. Banks also earn a significant amount of income from dealings in intangibles other than loans, such as securities and money market instruments, and by providing a variety of financial services. Thus, in the case of bank income, elements such as payroll, receipts, in-

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[135] *Container Corp.*, 463 U.S. at 170.

[136] *Id.* at 183 (citing Hans Rees' Sons, Inc. v. North Carolina *ex rel.* Maxwell, 283 U.S. 123 (1936)).

[137] *See* 1 J. HELLERSTEIN, *supra* note 33, ¶ 9.6, at 496-98 (for charts listing jurisdictions which have adopted UDITPA and notes on statutory variations).

[138] For example, twelve states, Connecticut, Florida, Illinois, Iowa, Kentucky, Massachusetts, Minnesota, Nebraska, New York, Ohio, West Virginia, and Wisconsin do not weight the three factors evenly as did the original UDITPA formula. Some of these states double-weight the sales factor. *Id.* ¶ 9.6, at 475 n.73, Table 9-2, at 618-19. Moreover, state situs rules, particularly for intangibles, vary considerably. *See id.* ¶¶ 9.1-.11, at 511-36.

[139] UDITPA § 2, 7A U.L.A. 331, 340 (West 1985).

tangible property, and deposits are all potential factors.

Given the importance of intangibles as an income-producing item for banks, the failure of the UDITPA to include intangible property in its property factor is a serious deficiency. While this omission may not rise to the level of a constitutional flaw, it significantly changes how the income of a bank is spread among the states in which it transacts business. On the one hand, the situs of real and tangible personal property (those items included in the UDITPA property factor) is in the state in which the property is physically located. In most cases, such property will be found in the domiciliary state of a financial institution. Consequently, an apportionment formula that uses only real and tangible property will benefit the domiciliary state. On the other hand, the situs of intangible property can exist in more than one state.[140] In some cases, the Supreme Court has held that the situs of intangibles is at the domicile of the creditor; in other cases, at the residence of the debtor.[141] At least in the case of consumer loans, the addition of an intangible property factor coupled with a situs rule based on the residence of the debtor would benefit market states.

As banking institutions become larger and the use of electronic delivery services becomes more prevalent, real and tangible personal property are likely to contribute less to a bank's profits, while intangible property will contribute more. In this context, the use of the UDITPA tangible property factor will attribute a disproportionate share of a bank's income to the state of its commercial domicile at the expense of market states.

B. New State Apportionment Formulas

As noted previously, several states use pure residence-based taxation for their domestic banks, and other states use the UDITPA three-

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[140] Such property is also easily moved from state to state or even outside the United States. The Congress recently grappled with this problem in the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. According to the House Committee report, "the lending of money is an activity that can often be located in any convenient jurisdiction, simply by incorporating an entity in that jurisdiction and booking loans through that entity, even if the source of the funds, the use of the funds, and substantial activities connected with the loans are located elsewhere." *See* H.R. REP. No. 426, 99th Cong., 1st Sess. 393 (1986).

[141] In fact, the Court has recognized three different places at which the situs of a debt might be fixed: (1) the domicile of the owner (creditor), Kirtland v. Hotchkiss, 100 U.S. 491 (1879); State Tax on Foreign-held Bonds, 82 U.S. (15 Wall.) 300 (1872); (2) the domicile of the debtor, Blackstone v. Miller, 188 U.S. 189 (1903), *overruled* Farmers Loan & Trust Co. v. Minnesota, 280 U.S. 204 (1930), and (3) the state in which the debt has a business situs, *i.e.* where the debt originated in the course of business transacted in a state, Metropolitan Life Ins. Co. v. City of New Orleans, 205 U.S. 395 (1907); Bristol v. Washington County, 177 U.S. 133 (1900); New Orleans v. Stempel, 175 U.S. 309 (1899).

factor manufacturing formula to apportion the income of domiciliary and non-domiciliary banks.[142] Both methods contain serious flaws. To overcome these flaws, a few states have revised their bank tax laws by adopting a special formula for financial institutions. This section describes the new laws of two states, New York and Minnesota. It also analyzes some of the differences between them.

1. The New York Law

In 1985, New York revised its bank tax to make it similar to the state's tax on general business corporations.[143] Before this revision, New York had not significantly changed its bank tax law since its enactment in 1926.[144]

The new law applies to every "banking corporation" that is exercising its franchise or is doing business in New York.[145] A "banking corporation" is defined as:

> (a) any corporation that is organized under the laws of New York, or of any other state or country (U.S. or foreign) which is doing a banking business, or
>
> (b) any corporation the stock of which is 65 percent or more owned or controlled by a bank holding company and that is engaged in a business that can be lawfully conducted by an entity described in (a) above, or is engaged in a business that "is so closely related to banking or managing or controlling banks as to be a proper incident thereto."[146]

Essentially, then, a banking corporation is an entity that is either doing a banking business or is a subsidiary of a bank holding company. The law defines a "banking business" as the business that a traditional bank is authorized to do and the business that any other corporation can do which is substantially similar to the business of a traditional bank.[147]

The New York law requires all domestic and foreign banking corporations doing business within and without New York to apportion

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[142] *See supra* note 39 and accompanying text.

[143] N.Y. TAX LAW §§ 1450-1468 (McKinney 1987 & Supp. 1988).

[144] Kaltenborn, *Is New York's Bank Tax Ready for the 1990s?*, 4 J. STATE TAX'N 225 (1985).

[145] N.Y. TAX LAW § 1451(a), (b) (McKinney 1987 & Supp. 1988).

[146] N.Y. TAX LAW § 1452 (a)(1), (2), (9) (McKinney Supp. 1988); N.Y. COMP. CODES R. & REGS. tit. 20, § 16-2.5 (1985).

[147] N.Y. TAX LAW § 1452(b) (McKinney Supp. 1988); N.Y. COMP. CODES R. & REGS. tit. 20, § 16-2.6 (1985).

their income according to a three-factor formula.[148] A banking corporation is deemed to be "doing business" in New York if it does any of the following within the state: (1) operates a branch, (2) operates a loan production office, (3) operates a representative office, or (4) operates a bona fide office.[149] To be regarded as doing business in New York, a banking corporation must have a physical presence there. New York does not consider an out-of-state "branchless bank" to be doing business in the state regardless of the number of loans made to or deposits received from New York residents.[150]

In New York, the factors used to apportion the income of banking corporations are receipts, deposits, and payroll.[151] As in the UDITPA model, the receipts factor is the ratio of receipts earned within New York to receipts earned everywhere. It includes: all income from loans and financing leases; receipts from leases and rents; service charges; fees and income from bank, credit, travel and entertainment cards; net gains from trading and investment activities; fees from the issuance of letters of credit and traveler's checks; and all income from government bonds, although a portion of such income is excluded from the tax base.[152]

The regulation contains separate "situs" rules for each receipt.[153] Consider, for example, the following receipts' situs rules:

(1) The situs of income from loans (other than credit card loans) is in New York if the loan is "located in New York."[154] A loan is deemed located in New York if the "greater portion of income-producing activity relating to the loan"—*i.e.*, if the solicitation, investigation, negotiation, approval and administration take place in New York.[155] The definitions of these terms make it clear that in most cases all of the income-producing activity will be deemed to take place in the state in which the lending bank is located.[156]

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[148] N.Y. TAX LAW § 1454 (McKinney Supp. 1988).

[149] N.Y. TAX LAW §§ 1451(a), 1462(f) (McKinney 1987 & Supp. 1988); N.Y. COMP. CODES R. & REGS. tit. 20, § 16-2.7 (1985).

[150] N.Y. COMP. CODES R. & REGS. tit. 20, § 16-2.7(a)-(e) (1985); Conversation with Marilyn Kaltenborn, Chief of Tax Regulations, New York State Department of Taxation and Finance (July 17, 1987).

[151] N.Y. TAX LAW § 1454(a) (McKinney Supp. 1988).

[152] N.Y. COMP. CODES R. & REGS. tit. 20, §§ 19-6.1 to 19-6.9 (1985).

[153] *See id.*

[154] N.Y. TAX LAW § 1454 (McKinney Supp. 1988); N.Y. COMP. CODES R. & REGS. tit. 20, § 19-6.2(a) (1985).

[155] N.Y. COMP. CODES R. & REGS. tit. 20, § 19-6.2(a), (c) (1985).

[156] Consider, for example, the following definitions of the terms "solicitation," "investigation," "negotiation," and "administration." According to the regulation, "[a]ctive solicitation occurs when an employee of the [banking corporation] initiates the contact with the customer." *Id.* § 19-6.2(d)(1)(i). Such activity is located at the office where the bank's employee is regularly

(2) The situs of income from bank, credit, travel, entertainment and other card operations is the state of domicile of the credit card holder.[157]

(3) The situs of receipts for "services performed by the taxpayer's employees regularly connected with or working out of a New York State office" is New York if such services are performed within New York.[158] The regulation deems a service to be performed in the state in which the costs of performance are incurred.[159]

The other factors include deposits and payroll. The deposits factor is the ratio of the average value of deposits maintained at branches within New York to the average value of all deposits maintained at branches both within and without New York.[160] Deposits made by an out-of-state individual or business are deemed to exist in the state in which the deposit is maintained.[161] The New York situs rule for deposits, therefore, is that deposits exist in the state of the creditor.[162]

The payroll factor is the ratio of 80% of in-state "wages, salaries and other personal service compensation" to total "wages, salaries and other personal service compensation."[163]

2. The Minnesota Law

Minnesota revised its bank income tax law in 1987. The new law applies to all "financial institutions."[164] Like the "banking corpora-

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connected, "regardless of where the services of such employee were actually performed." Passive solicitation occurs when the customer initiates the contact with the taxpayer. *Id.* § 19-6.2(d)(1)(ii). If the customer's initial contact was not at an office of the taxpayer, the office where the passive solicitation is deemed to have occurred is determined by the facts in each case. "Investigation" is located at the office where the taxpayer's employees are regularly connected, "regardless of where the services of such employees were actually performed." *Id.* § 19-6.2(d)(2). "Negotiation" and "approval" are located according to the same rule for "investigation." *Id.* § 19-6.2(d)(3), (4)"Administration" is located at the office that oversees the activity of bookkeeping, collecting the payments, corresponding with the customer, and proceeding against the borrower if it is in default. *Id.* § 19-6.2(d)(5).

[157] N.Y. TAX LAW § 1454 (McKinney Supp. 1988); N.Y. COMP. CODES R. & REGS. tit. 20, § 19-6.4. (1985).

[158] N.Y. TAX LAW § 1454; N.Y. COMP. CODES R. & REGS. tit. 20, § 19-6.7. (1985).

[159] N.Y. COMP. CODES R. & REGS. tit. 20, § 19-6.7 (1985).

[160] N.Y. TAX LAW § 1454(a)(3) (McKinney Supp. 1988); N.Y. COMP. CODES R. & REGS. tit. 20, § 19-7.1 (1985).

[161] N.Y. COMP. CODES R. & REGS. tit. 20, § 19-7.3 (1985).

[162] *Id.* Because New York banks can choose where to maintain the deposits, the situs rule for deposits is entirely under the control of the bank.

[163] N.Y. COMP. CODES R. & REGS. tit. 20, § 19-5.1 (1985). The numerator of the payroll factor was limited to 80% to encourage banks to maintain a large employee base in New York. N.Y. TAX LAW § 1454(a)(1) (McKinney 1987).

[164] MINN. STAT. ANN. § 290.01(4a)(a) (West Supp 1988).

tion" under New York law, a financial institution includes an entity that is engaged in the business of banking or is a subsidiary of a bank holding company. However, the Minnesota definition is somewhat broader than the New York definition in that it also encompasses corporations that derive "more than 50% of their gross income from lending activities . . . in substantial competition with [institutions that are doing a banking business in Minnesota]."[165]

The Minnesota tax jurisdiction rules are also broader than the New York rules. Activities that create jurisdiction to tax in Minnesota include both the traditional doing business test, which is based upon the taxpayer's physical presence within the state, and a regular solicitation standard, which does not rely on an in-state physical presence.[166] For example, according to the Minnesota law, a financial institution is subject to tax if it conducts a trade or business regularly and obtains or solicits business from within the state. "Solicitation" includes:

1. Distribution by mail or otherwise of catalogs, periodicals, advertising flyers, or other written solicitations of business to customers in Minnesota;
2. display of advertisements on billboards or other outdoor advertising in Minnesota;
3. advertising in Minnesota newspapers;
4. advertising on Minnesota radio or television.[167]

The law deems a financial institution to have "regularly" solicited business from within the state if it has conducted "activities . . . with 20 or more persons within [Minnesota] during any tax period; or . . . the sum of its assets and the absolute value of its deposits attributable to Minnesota sources equals or exceeds $5,000,000. . . ."[168]

The factors chosen by Minnesota to apportion the income of financial institutions are receipts, tangible and intangible property and payroll. Like the UDITPA formula, the Minnesota formula uses a receipts factor, a property factor and a payroll factor. The similarity between the two formulas ends there, however. Two differences are particularly important. First, the Minnesota formula includes intan-

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[165] *Id.* § 290.01(4a)(a)(3), (d)(3).

[166] Act of May 7, 1988, ch. 719, art. 2, § 15, 1988 Minn. Sess. Law Serv. 1225, 1246-47 (West) (to be codified at MINN. STAT. ANN. § 290.015(1)(a), (b)).

[167] *Id.*, 1988 Minn. Sess. Law Serv. at 1247 (West) (to be codified at MINN. STAT. ANN. § 290.015(1)(a), (d)(1)-(3), (7)). The new Minnesota law also contains the traditional bases for the exercise of tax jurisdiction over a foreign corporation, such as the presence of an office or employees within the state.

[168] *Id.* § 16, 1988 Minn. Sess. Law Serv. at 1247-48 (West) (to be codified at MINN. STAT. ANN. § 290.015(2)(a)(1), (2)).

gibles in the property factor.[169] Second, under the Minnesota law the three factors are not evenly weighted. Instead, the income apportioned to Minnesota by the formula is arrived at by comparing 70% of the receipts in state to receipts in all states, 15% of the property in state to property in all states, and 15% of the payroll in state to payroll in all states.[170]

The Minnesota situs rules also differ significantly from the New York rules. The following comparison illustrates these differences:

Example: Receipts from Loans

1. The situs of income and other receipts from loans secured by real estate or tangible income is in Minnesota if such property is located in the state.[171] The situs of income and other receipts from unsecured commercial loans is in Minnesota if the proceeds of the loan are to be applied in the state.[172] The situs of income and other receipts from unsecured consumer loans is in Minnesota if the borrower is a resident of Minnesota.[173]

According to the New York situs rules, the income from each of these loans would be attributed to the state where the lending bank is located.[174]

2. The situs of income and other receipts from credit card and travel and entertainment cards is in Minnesota if the card charges and fees are regularly billed there.[175]

3. The situs of receipts from the performance of services is in Minnesota if the services are consumed in the state, regardless of where the services are performed.[176] By contrast to the Minnesota situs rule, which attributes service income to the market state, the New York rule attributes service income to the state in which the costs of performance are incurred, which is generally the state of commercial domicile.[177]

The state's situs rules for the property factor track those of the

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[169] MINN. STAT. ANN. § 290.191(9)-(11). (West Supp. 1988).
[170] *Id.* § 290.191(3).
[171] *Id.* § 290.191(6)(f).
[172] Act of May 7, 1988, *supra* note 166, § 34, 1988 Minn. Sess. Law Serv. at 1257 (West) (to be codified at MINN. STAT. ANN. § 290.191(6)(h)).
[173] MINN. STAT. ANN. § 290.191(6)(g).
[174] *See supra* notes 153-55 and accompanying text.
[175] MINN. STAT. ANN. § 290.191(6)(j) (West Supp. 1988).
[176] Act of May 7, 1988, *supra* note 166, § 34, 1988 Minn. Sess. Law Serv. at 1258 (West) (to be codified at MINN. STAT. ANN. § 290.191(6)(l).
[177] *See supra* notes 157-58 and accompanying text.

receipts factor.[178] Payroll is attributed to Minnesota if an employee is (a) employed within the state, (b) actually working within the state, or (c) "accountable to an office within" the state.[179]

C. *Variations in State Apportionment Formulas: What Does the Constitution Require?*

1. The Constitutional Standard

The Supreme Court has shown great tolerance for differences in state apportionment formulas. Generally, the Court has sustained any state formula that is reasonably designed to determine the amount of income attributable to local business activity.[180] The leading case in this area is *Moorman Manufacturing Co. v. Bair*.[181] In *Moorman*, the Court held that an Iowa single-factor sales formula sustained due process and commerce clause challenges.[182]

The Moorman company was "an Illinois corporation engaged in the manufacture and sale of animal feed."[183] The company argued that the Iowa formula, which required it to calculate the percentage of its income that would be attributed to Iowa by comparing its gross sales in Iowa to its total gross sales in all states, violated the due process clause.[184] The alleged constitutional defect consisted of the failure of the formula to recognize the contribution made by the company's property and manufacturing activities located in Illinois.[185] If, for example, Iowa had used the UDITPA three-factor formula, the company's Illinois operations would have been reflected in the denominator of the property and payroll factors while the numerator of those factors would have been zero, reducing the percentage of income attributable to Iowa.[186] The Court did not accept the company's due process argument.[187] According to the majority, once a state has

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[178] MINN. STAT. ANN. § 290.191(9)-(11) (West Supp. 1988).

[179] *Id.* § 290.191(12).

[180] *See, e.g.*, Moorman Mfg. Co. v. Bair, 437 U.S. 267, 272-75 (1978); International Harvester Co. v. Evatt, 329 U.S. 416, 419-23 (1947); Ford Motor Co. v. Beauchamp, 308 U.S. 331, 334-37 (1939); Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n., 266 U.S. 271, 282-85 (1924); Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 121 (1920).

[181] 437 U.S. 267 (1978).

[182] *Id.* at 271-81.

[183] *Id.* at 269.

[184] *Id.* at 271-72.

[185] *Id.* at 272.

[186] *See supra* notes 131-34 and accompanying text.

[187] *Moorman*, 437 U.S. at 272-75.

demonstrated the requisite "minimal connection" or nexus between it and the in-state activities of the taxpayer, the due process clause requires only that the income attributed to the state be "reasonably related to the activities conducted within the taxing State."[188] Both the Iowa single-factor formula and the traditional three-factor formula are used only as "rough approximation[s] of a corporation's income" and each may over-reflect or under-reflect income attributable to the state.[189] However, such imprecision does not render a formula unconstitutional.[190] Noting that it had previously held single-factor formulas to be presumptively valid,[191] the *Moorman* Court declared that it would strike down a state's formula only if the application of a particular formula results in the attribution of income to a state that is " 'out of all appropriate proportions to the business transacted . . . in that State' . . . or has 'led to a grossly distorted result.' "[192]

In *Moorman,* the company also contended that the Iowa formula violated the commerce clause because the clash of the two formulas—the Iowa single-factor sales formula and the Illinois three-factor formula—caused double taxation.[193] The Court's analysis of this argument focuses on the difficulty of crafting a judicial solution to the problem created by the use of differing apportionment formulas.[194] Some of those problems are:

1. If the Constitution does not allow tax overlap in the application of apportionment formulas, which particular state formula should the Court find at fault?[195]

2. If the Constitution of its own accord mandates the use of a uniform formula, such as the UDITPA three-factor formula, does

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[188] *Id.* at 272.

[189] *Id.* at 273; Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 182-84 (1983).

[190] *See supra* note 188.

[191] *Moorman,* 437 U.S. at 273, (citing Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920)). Although the Supreme Court has held that a single-factor formula is presumptively valid, it continues to have reservations about such formulas. In *Container Corp.,* the Court noted that single-factor formulas "are particularly problematic because they focus on only a small part of the spectrum of activities by which value is generated." 463 U.S. at 182.

[192] *Moorman,* 437 U.S. at 274 (quoting Hans Rees' Sons, Inc. V. North Carolina *ex rel.* Maxwell, 283 U.S. 123 (1931); Norfolk & Western Ry. Co. v. Missouri State Tax Comm'n, 390 U.S. 317, 326 (1968)). In Hans Rees' Sons, Inc. v. North Carolina *ex rel.* Maxwell, 283 U.S. 123 (1931), the New York-based Hans Rees company produced evidence which the Court found sufficient to support a claim that the North Carolina single-factor (property) formula produced an unconstitutional result. According to the company's evidence, the North Carolina formula generated a tax on 66% to 85% of the company's income, 283 U.S. at 128, whereas only 21.7% of that income actually had its source in the state, a difference of over 250%. 283 U.S. at 134 (*cited in* Container Corp., 463 U.S. at 183).

[193] *Moorman,* 437 U.S. at 276-78.

[194] *Id.* at 278-79.

[195] *See supra* note 124.

it also mandate uniform definitions of "business income,"[196] uniform rules for the allocation of "nonbusiness income,"[197] and uniform situs rules?

3. If the Constitution of its own accord mandates the use of a uniform formula, how shall the Court choose among competing new industry multifactor formulas; for example, is the New York bank formula better in a constitutional sense than the Minnesota formula?[198]

In fact, these and other similar issues are not susceptible to a judicial solution. As the *Moorman* Court recognized, the content of a uniform state apportionment rule, if there is to be such a rule, should be handled through a legislative body, which can give due consideration to the interests of all affected states.[199] For these reasons, the Court declined to strike down a fairly apportioned tax simply because the formula differs from the prevailing approach adopted by the states.[200]

Nevertheless, the Court looks with special favor upon the evenly-weighted three-factor UDITPA formula. In *Container Corp. of America v. Franchise Tax Board,*[201] the Court indicated that such a formula is constitutionally unassailable.[202]

2. Evidence of Tax Overlap Caused by Differing Apportionment Formulas

Most of the evidence for tax overlap caused by differing apportionment formulas is intuitive. If State *A* decides to adopt a single-factor sales formula or to amend its three-factor formula to double-weight the sales factor, it must be because State *A* expects the change to increase its share of the tax base of multistate corporations. If, then, State *A* succeeds in increasing its share of the tax base in this manner, while other states retain the evenly-weighted three-factor

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[196] UDITPA defines "business income" as follows: " 'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." § 1(a), 7A U.L.A. 336, 336 (West 1985).

[197] UDITPA defines "nonbusiness income" as follows: " 'Nonbusiness income' means all income other than business income." § 1(e), 7A U.L.A. 336, 337.

[198] *See generally Moorman,* 437 U.S. at 278-80.

[199] *Id.* at 280.

[200] *Id.*

[201] 463 U.S. 159 (1983).

[202] *Id.* at 181-84.

formula, the aggregate tax base of a multistate corporation (100% of which was subjected to tax under an evenly-weighted three-factor formula) must have increased, causing tax overlap.

The validity of the above tax overlap hypothesis has been subjected to little scrutiny. One study, conducted in 1984 by Steven Sheffrin and Jack Fulcher of the University of California, Davis,[203] did attempt to measure the amount of under- or over-apportionment of corporate income resulting from the use of alternative apportionment formulas.[204]

To evaluate the effect of variations in the factors of state apportionment formulas, the authors conducted an experiment in which they applied three different formulas to the income bases of thirty-five industries that were assumed to be doing business in every state. Those formulas were: (a) a single-factor sales formula, (b) a single-factor payroll formula, and (c) a two-factor payroll (double weighted) and sales formula.[205] After calculating the amount of income that each formula would attribute to the states, the authors chose the formula that would maximize each state's claim on the tax base.[206] The authors found that, if each state chose the formula that would attribute the most income to it,[207] $227.8 billion of corporate income would be subjected to state tax as compared to $214.6 billion in actual corporate income, a 6.14% overlap.[208]

In the second part of their experiment, the authors assumed that states used different formulas for thirty-four specific industries such as farming, oil and gas extraction, furniture, timber, communications, motor vehicles, and services.[209] Again, the authors chose the formula that would maximize each state's revenue collections for each industry.[210] Under this system, the authors found a 17.1% increase in the tax base for all industries as a whole.[211]

Neither of these percentage increases in the corporate income base rise to the level of gross distortion as the Supreme Court has inter-

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[203] Sheffrin & Fulcher, *Alternative Divisions of the Tax Base: How Much is at Stake?* in THE ST. CORP. INCOME TAX: ISSUES IN WORLDWIDE UNITARY COMBINATION 192 (C. McLure ed. 1984).

[204] *Id.*

[205] *Id.* at 195.

[206] *Id.*

[207] As noted by the authors, in reality, this is an unlikely event because states typically do not have sufficient information to pick the correct formula. *Id.*

[208] *Id.*

[209] *Id.* at 198-200.

[210] *Id.* at 198.

[211] *Id.*

preted that phrase.[212] Instead, the percentage increases are within the range found in *Container Corp.* to be "within the substantial margin of error inherent in any method of attributing income among the components of a unitary business."[213]

In summary, the high Court has never struck down a *multifactor* state apportionment formula. Indeed, under the Court's current interpretation of the constitutional restraints on apportionment formulas, it is difficult to see how the Court could do so. The empirical evidence supports the Court's tolerant approach to the differing state apportionment formulas: even if states had perfect knowledge and could, therefore, choose the correct formula to maximize their revenue, the amount at stake is simply not that great.

IV. Conclusion

Nearly a third of the states currently tax their domestic banks using pure residence principles of taxation. These states tax 100% of the income of their domestic banks without regard to the source of that income and without allowing a credit for taxes paid to other states. Pure residence-based taxation is a product of an era when banks were located and doing business in only one state. When banks were confined to one state, pure residence-based taxation did not cause multiple taxation problems. Now, however, banks and bank-like entities transact business freely across state lines electronically and by mail, as well as through the establishment of offices. Moreover, some states have recently adopted source-based taxation of out-of-state banks that operate electronically and by mail as well as by more traditional methods. In this context, the continued use of pure residence-based taxation will cause serious problems of multiple taxation.

The due process clause does not prohibit multiple taxation, but the commerce clause does. States that apply pure residence-based taxes to the income of their domestic corporations that do business in and are taxed by other states create "inevitable" multiple taxation of such corporations in violation of the commerce clause. Moreover, such taxes fail the commerce clause "internal consistency" test in that, if applied by every state, they would interfere with free trade. To satisfy the mandate of the commerce clause, states must use a tax system

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[212] *See* Hans Rees' Sons, Inc. v. North Carolina *ex rel.* Maxwell, 283 U.S. 123 (1931).

[213] Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 184 (1983). The amount of tax overlap in *Container* was 14%. *Id.*

that is designed to eliminate multiple taxation. Domiciliary states can fulfill this mandate in one of two ways: through the use of formulary apportionment or by allowing domestic corporations a tax credit for taxes paid to non-domiciliary states.

States have wide latitude in their choice of apportionment formulas. According to its current interpretation of the due process and commerce clauses, the Supreme Court will not invalidate a multifactor apportionment formula if the particular factors and situs rules chosen reasonably represent how and where the particular business earns its income, and if the state applies the formula to only those corporations over which it has a tax nexus. Some tax overlap is a problem that is inherent in any method of sourcing income, but the tax increase that may be caused by differing state apportionment formulas will likely not reach the level of a constitutional defect.

As the radically different New York and Minnesota bank income apportionment rules testify, there is more than one apportionment formula that can satisfy all constitutional demands for a valid apportionment formula. But, if differing apportionment formulas do not create extraterritorial taxation or unconstitutional multiple taxation, the conflicting formulas and situs rules can create significant administrative burdens. While the Court has refrained from intervening in state apportionment formulas, Congress may at some point decide that the diversity of apportionment formulas and situs rules creates an obstacle to the free flow of credit in interstate commerce that is intolerable under the commerce clause.

Federal intervention at this point in the development of state bank income taxes would be unfortunate. States do not yet have enough experience with bank taxes to know which method of taxation is most suitable. Very little data is available on the revenue effect of even the first new state formula—the New York formula. Continuing state experiments with alternative methods of taxation and alternative apportionment formulas will provide the experience needed to reach agreement on the most effective bank tax. Working toward a state consensus may be frustrating, but it will yield a better result than a federal fiat.

EXHIBIT K: 36

McCray, Sandra B., "Interstate Banking: Current Status and Unfinished Agenda", The Journal of Federalism 17 (Summer 1987) p. 179-194

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See pp.
192-93

Interstate Banking: Current Status and Unfinished Agendas

Sandra B. McCray
Multistate Tax Commission

In 1986, most of the centuries-old barriers against interstate branch banking fell. By the end of the year, thirty-seven states had passed legislation authorizing some form of interstate branch banking. Moreover, two federal judicial decisions had cleared the way for interstate banking by restricting state regulatory authority over interstate branch banking when it is conducted either through a shared-use automatic teller machine or by a "nonbank bank." These developments have dramatically changed the nature of the business of banking, creating an entirely new legislative agenda for states. High on the list of the items that states must now consider are regulatory and tax parity among competing financial institutions; multiple taxation of financial institutions that do business in several states; tax avoidance by out-of-state banks; and out-dated jurisdictional standards.

In 1986, interstate banking became a *fait accompli.* By the end of the year, most states had passed legislation authorizing some form of interstate branch banking. Such legislation removed the state legal barriers that had confined banks to a single state for over a century.

Several forces coalesced in 1986 to bring about this dramatic change in state legislative policy. In previous years, large banks had argued unsuccessfully before state legislatures that interstate branch banking would bring benefits to consumers through increased competition and economies of scale. However, the growing number of bank failures, generally attributed to increased competition in the financial services marketplace and to economic problems in farm and energy states, gave bankers a new and more powerful argument for interstate banking—the instant creation of a large pool of applicants from which to choose a savior for failed and failing banks—and a new ally—state and federal regulators hoping to save their failing banks through mergers with strong banks. The combination proved irresistible.

The judicial branch, too, played a role in dislodging state bans on interstate banking. Two U.S. Circuit Court of Appeals opinions, which interpreted the federal banking laws, paved the way for banks and bank-like entities to engage in de facto interstate branch banking. Federal law is the source of state authority to regulate interstate branch banking by national banks. Federal law also controls the definition of the terms "branch" and "bank." By interpreting those terms narrowly, the opinions limited state authority to regulate interstate branch banking.

In *Independent Bankers Ass'n.* v. *Marine Midland Bank*,[1] the Second Circuit Court of Appeals held that a bank that effected loan and deposit transactions with its customers electronically through a shared-use automatic teller machine (ATM) did not thereby engage in branch banking. According to the court, federal law does not deem an ATM to be a "branch" of a bank if the bank is a mere user, as opposed to an owner, of the machine. In *Florida Dept. of Banking* v. *Board of Governors*,[2] the Eleventh Circuit Court of Appeals held that Florida could not forbid entry to an entity that had a bank charter and accepted deposits in Florida, but did not make commercial loans there (the so-called "nonbank bank") because it was not a "bank" under federal law, which defines a "bank" as an institution that both accepts demand deposits and makes commercial loans.

As a result of these two decisions, banks and bank-like entities can now circumvent state regulatory restrictions on interstate branch banking by delivering their services (1) through electronic devices located across the nation in a form of "branchless banking" or (2) through "nonbank banks," which have separated their deposit-taking activities from their commercial loan activities.

Most states that have addressed the issue of interstate branch banking have done so narrowly. Typically, states have focused only on the immediate task of permitting an out-of-state bank to purchase an existing bank or establish a new bank within their borders. Few have tackled the related state tax issues. The failure of states to address taxation of interstate banking has created problems for both banks and states: for banks there is the specter of multiple taxation, for states there is the danger of tax avoidance by "branchless banks" and "nonbank banks." Defining, analyzing, and solving these state tax problems are part of the unfinished interstate banking agenda.

BACKGROUND

Branch Banking: Statutory Framework for Dual Regulation

The National Bank Act of 1864 provided that the "usual business" of a national bank "shall be transacted at an office or banking house located in the place specified in its organization certificate."[3] In 1924, the U.S. Supreme Court interpreted the act to prohibit national banks from operating branch banks within their home state.[4]

[1] *Independent Bankers Ass'n.* v. *Marine Midland Bank*, 757 F.2d 453 (2nd Cir., 1985); cert. denied, 106 S.Ct. 2926 (1986).

[2] *Florida Dept. of Banking* v. *Board of Governors*, 760 F.2d 1135 (11th Cir., 1985); vacated, 106 S.Ct. 875 (1986); revsd. on remand, 800 F.2d 1534 (1986).

[3] 13 Stat. 101 (1864).

[4] *First Nat'l. Bank* v. *Missouri*, 263 U.S. 640 (1924). In its decision, the Supreme Court held that: (a) national banks can exercise only those powers that are expressly granted them under the National Bank Act or such incidental powers as are necessary to carry on the business for which they are established, and (b) the power to operate a branch bank was neither expressly granted in nor necessarily implied from the National Bank Act.

In 1927, the Congress passed the McFadden Act amending the National Bank Act to allow national banks to establish branch banks within the state in which they were located "if such establishment and operation are . . . expressly authorized to state banks by the law of the state in question."[5] Although the McFadden Act provided for *intrastate* branching, it did not empower national banks to operate *interstate* branches. Nevertheless, the act did not prevent national banks from engaging an interstate activities, provided that those activities were not conducted at a "branch." According to the act, a branch includes any branch bank, office, agency, or place of business at which deposits are received or checks paid or money lent. There is plenty of room within this definition of a branch for an out-of-state national bank to engage in banking and bank-like activity without violating the McFadden Act. For example, a national bank that transacts business in a host state solely through the mail or by telephone has not established a *place* of business in the host state and, therefore, is not operating through a branch.

Several other loopholes in federal laws have allowed banks to engage in further interstate banking activity. For example, although the McFadden Act prevented a bank from directly branching into another state, it did not prohibit the bank from acquiring or establishing a separately chartered and separately capitalized subsidiary bank in another state (indirect branching). The Congress closed this loophole in 1956 with passage of the Bank Holding Company Act (BHCA).[6] The BHCA (and later amendments passed in 1970) bars a bank or bank holding company from owning a *bank subsidiary* in another state, but does not preclude ownership of a *nonbank subsidiary* in another state. According to the Bank Holding Company Act, these nonbank subsidiaries can engage in only those activities which the Federal Reserve Board has determined are "so closely related to banking or managing or controlling banks as to be a proper incident thereto." Pursuant to this authority, the Federal Reserve Board has published an extensive list of permissible activities, which includes mortgage banking, loan production, credit insurance, consumer finance, investment and financial advisory services, the issuance of credit cards, the issuance and sale of travelers' checks, and the operation of industrial banks.

More recently, the U.S. Supreme Court has ruled that neither federal nor state law prohibits banks from expanding across state lines through the use of "nonbank banks." A nonbank bank operates under a bank charter, but is not considered a bank under the BHCA because it either (1) accepts demand deposits or (2) engages in the business of making commercial loans, but not both. Therefore, the entity is not a "bank" within the definition of that term because the BHCA requires that a bank engage in both activities.

Finally, the Douglas Amendment[7] to the McFadden Act permits a bank

[5] 12 U.S.C. sec. 36(c).

[6] 12 U.S.C secs. 1841-1850 (1976).

[7] 12 U.S.C. sec. 1842(d).

or bank holding company to acquire or establish a true bank subsidiary in another state if the laws of that state expressly authorize the acquisition.

State Taxation of Banks: Judicial and Legislative Framework

In 1819, the U.S. Supreme Court issued its momentous decision in *McCulloch* v. *Maryland*.[8] This ruling shaped all state taxes on banks for the next century and a half. In *McCulloch*, the Court struck down a Maryland statute that imposed a tax on bank notes issued by any bank or branch not chartered by Maryland. In a sweeping opinion, Chief Justice John Marshall held unconstitutional all state taxes—other than a real property tax or a tax on bank shares—levied on a governmental instrumentality, such as a national bank. The *McCulloch* Court held that national banks are immune from state taxation unless the Congress specifically authorizes such taxation.

Later, the Congress codified this judicially created immunity doctrine. In 1864, the Congress passed the National Bank Act, which permitted state taxation of national banks only on their real estate and on their shares—the two methods left open by the *McCulloch* decision.[9]

As first announced by the Court, the doctrine of federal immunity applied only to the federal government and the instruments through which it carried on its operations.[10] Inevitably, though, the scope of entities protected from taxation grew. In its heyday, the doctrine protected both state and federal agencies from taxation as entities, and it even protected state and federal officials from taxation as individuals.

The growing tax immunity brought a reaction from the Congress, which gradually narrowed the scope of the judicially created tax immunity of government officials and governmental instrumentalities, including national banks. In 1923 and 1926, the Congress revised its 1864 statute limiting state taxation of national banks to real property taxes and bank share taxes and enacted sec. 5219 to add three new methods by which a state could tax a national bank: (1) by including bank share dividends in the taxable income of a shareholder, (2) by imposing a net income tax, and (3) by levying a franchise tax according to or measured by net income.[11] These statutes permitted a state to tax only those national banks located within its boundaries. Because states drafted their bank tax laws to conform to this location rule, they taxed only their domiciliary banks (i.e., state banks chartered by the home

[8]*McCulloch* v. *Maryland*, 17 U.S. 316 (1819).

[9]Although the constitutional and statutory restrictions applied only to national banks, states applied the same restrictions to state-chartered banks since they were loath to tax their own banks more heavily than they taxed national banks.

[10]A second prong of the federal immunity doctrine holds that a state cannot levy a tax on the income from federal obligations because such a levy is a tax on the power to borrow money on the credit of the U.S. and therefore violates the Borrowing Clause of the Constitution. *Weston* v. *Charleston*, 27 U.S. 465 (1829). Today, this second prong of the federal immunity doctrine is codified in 12 U.S.C. 3124(a). According to that section, "all stocks, bonds, Treasury notes, and other obligations of the United States" are exempt from state or municipal taxation. However, the statute contains an exception for "nondiscriminatory franchise or other nonproperty taxes."

[11]44 Stat. 289 (1926).

state and national banks having their principal office in the home state).

Finally, in 1976, the Congress removed all prior statutory restrictions on state taxation of national banks. Currently, sec. 5219 provides that:

> [f]or the purposes of any tax law enacted under authority of the U.S. or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located.[12]

Thus, the only remaining restriction on state taxation of national banks is that such taxes must not discriminate against national banks. The previous location rule is no longer required. Nevertheless, many states have not amended their bank tax laws to take advantage of this new freedom.

INTERSTATE BANKING: CURRENT STATUS

Today, banks and bank-like entities engage extensively in interstate banking through legislatively sanctioned affiliation with bank subsidiaries located in other states and through judicially sanctioned de facto interstate banking, including the use of ATMs located across the nation and affiliation with nonbank banks.

Branch Banking Legislation

The interstate activity permitted by the new interstate branch banking legislation ranges from unlimited nationwide branch banking to regional reciprocal branch banking and to limited purpose branch banking.

Nine states have passed laws authorizing nationwide branch banking.[13] In these states, any out-of-state bank or bank holding company may establish a bank subsidiary in the host state. Twenty-eight states have passed legislation permitting a bank holding company domiciled in another state within a defined region (usually consisting of several contiguous states) to establish a bank subsidiary within a host state on a reciprocal basis.[14] Typical legislation provides that an out-of-state bank may acquire an in-state bank so long as the other state grants equivalent reciprocal privileges. Finally, thirteen states have passed limited purpose legislation authorizing out-of-state banks to pur-

[12]12 U.S.C sec. 548.

[13]The list and classification of states as cited in this paragraph were compiled by the Conference of State Bank Supervisors in December 1986. According to the system used by the CSBS, some states fall into more than one category. The nine states that permit nationwide branch banking are: Alaska, Arizona, Maine, New York, Oklahoma, South Dakota, Texas, Washington, and West Virginia.

[14]Those states are: California, Kentucky, Louisiana, Rhode Island, Michigan, Nevada, New Jersey, Ohio, Pennsylvania, Utah, Alabama, Connecticut, District of Columbia, Florida, Georgia, Idaho, Illinois, Indiana, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, North Carolina, South Carolina, Tennessee, Virginia, Wisconsin. The first ten of these states have passed regional reciprocal laws with a trigger to nationwide branch banking.

chase failing banks in the host state under certain conditions.[15] Frequently, such limited purpose legislation allows an out-of-state bank to purchase a failing bank only if a domiciliary bank is unwilling or unable to do so.

Nearly every state that has authorized interstate branch banking has done so through the Douglas Amendment to the McFadden Act. According to that amendment, the Federal Reserve Board may not approve an application submitted by a bank or bank holding company to acquire a bank outside the applicant's principal state of operation unless the laws of the state in which the bank is to be acquired or established expressly provide for such entry. Thus, an out-of-state bank or bank holding company may enter a host state only by establishing a separately chartered subsidiary in such state (indirect branching).

To date, only one state permits direct branching. Massachusetts allows direct branching on a reciprocal basis by an out-of-state bank that is domiciled in one of the states within its regional group.

The dual federal/state regulation of the geographic distribution of banks allows states to exert significant control over the spread of interstate branch banking. For example, in 1985 the U.S. Supreme Court upheld a Massachusetts statute that authorized regional, reciprocal branch banking against a Commerce Clause challenge that the legislation discriminated against banks located in the states outside the region defined in the law. The Court held that, with the passage of the Douglas Amendment, the Congress had exempted state regulation of interstate branch banking from the anti-discrimination proscriptions of the Commerce Clause. Accordingly, states may choose freely between lifting their interstate branch banking bans entirely or offering only limited entry to certain out-of-state banks.

Branchless Banking

In January 1986, the New England Federal Savings Bank of Wellesley, Massachusetts opened for business.[16] In less than six months, the bank had received $15 million in deposits. In a robust economy like that of Massachusetts, this would not normally be considered a remarkable achievement. However, what makes this bank unusual is that it has no walk-in place of business. Customers of the New England Federal Savings Bank make their deposits by mail, by telephone, or via automatic teller machines. Within the first six months of operation, the bank had 422 depositors hailing from most of the fifty states. The bank is a full-service bank that makes home mortgage loans and commercial real estate loans; it provides MasterCard, Visa and American Express card services; and it offers individual retirement accounts and Keogh accounts.

Although the New England Federal Savings Bank appears to be the only

[15]These states are: Arizona, Idaho, Kentucky, Louisiana, Minnesota, Nevada, New Mexico, Ohio, Oklahoma, Oregon, Utah, Washington, West Virginia.

[16]"New England Bank Without Walls Depends on US Mail to Bring Deposits Offering Higher Rates," *American Banker*, 23 June 1986, p. 24.

bank so far to offer full-service banking without a walk-in place of business, many banks engage in some form of branchless banking. For example, of the 30,000 depositors of Colonial National Bank of Wilmington, Delaware, only 10,000 come from Wilmington walk-in trade.[17] The remaining 20,000 depositors live in all fifty states and do business by telephone, mail, and nationwide automatic teller machines, and use debit and credit cards and checks. Other banks offer limited or special branchless banking services across state lines. For example, Chemical Bank of New York offers a branchless banking service called "Premium Banking" to residents of Connecticut.[18] The service works as follows: (1) Connecticut customers call a New York toll-free number manned seven days a week by Chemical Bank staff members; (2) customers receive instant access to credit lines; and (3) customers who need cash immediately can make withdrawals at any automated teller machine linked to the New York Cash Exchange.

To date, no state has sought to catalog the activities of branchless banks. Although legislation that attempts to forbid out-of-state banks from offering their services to residents of other states by mail or through electronic means would be constitutionally suspect, a law that merely requires nonresident banks to report the fact and extent of their in-state activities should pass constitutional muster. The failure to pass such legislation is probably due to the low visibility of branchless banks.

Nonbank Banks

According to its legal definition, a nonbank bank is an entity that operates under a bank charter and either accepts federally insured deposits or makes commercial loans, but not both. Frequently, the phrase is more loosely interpreted to encompass nonbank subsidiaries of bank holding companies, such as loan production offices, consumer finance companies, and financial advisory service firms. Nonbank banks are owned by banking organizations and by nonbanking organizations.

Most nonbank banks were established prior to the passage of state legislation authorizing interstate banking. Using the nonbank bank vehicle, banks successfully circumvented state laws that prohibited them from establishing branch banks in other states.

In 1980, the U.S. Supreme Court struck down a Florida statute that prohibited out-of-state banks and bank holding companies from owning an investment advisory service business within the state. The Court found that the statute discriminated against entities operating in interstate commerce in violation of the Commerce Clause. According to the Court, the state could not successfully claim that the statutory discrimination was protected by the Douglas Amendment because that amendment does not apply to nonbank

[17]"TSO Welcomes Long-Distance/Nationwide Customers With System That Could Make Walk-in Banking Passe," *American Banker*, 4 August 1986, backpage.

[18]"Chemical Enters Connecticut Consumer Market with Phone and Mail Premium Banking Service," *American Banker*, 17 December 1985, p. 23.

subsidiaries of out-of-state banks.

In 1986, the Supreme Court refused to give Douglas Amendment protection to nonbank banks. In *Florida Department of Banking* v. *Board of Governors*, the Court held that because a nonbank bank is not a "bank" as defined in the Bank Holding Company Act, Florida could not use the provisions of the Douglas Amendment to restrict the entry of an entity that proposed to take insured deposits within Florida but not make commercial loans there.

These two decisions have drastically curtailed the original broad state control over interstate banking provided by the Douglas Amendment. However, the real culprit is the Congress, not the judiciary; the legislative process has simply failed to keep pace with commercial practice. When the Congress passed the Douglas Amendment, the terms "bank" and "the business of banking" could be defined with certainty. Now, the meaning of both terms is in doubt; yet the Congress has failed to respond.

Unlike the Congress, some states have been both aggressive and creative in dealing with the new financial environment. For example, Connecticut recently passed a new bank regulatory law that affects all banks, savings and loan associations, nonbank corporations that own banks, and the nonbank subsidiaries of the foregoing institutions. In a sharp departure from the federal regulatory definitions, the Connecticut statute defines a "holding company" to include retailers (such as Sears) that own a bank or savings and loan association, and a "bank-business" to include brokerage houses (such as Dean Witter) that provide "deposit services," which include investing a customer's dormant funds in an account with an affiliated bank. According to the Connecticut statute, each of the above entities must obtain permission from the state's commissioner of banking prior to opening any office in Connecticut.

In late 1986, the Court of Appeals for the Second Circuit, in *Sears, Roebuck and Co.* v. *Brown*,[19] upheld the Connecticut statute against a challenge by Sears. Sears argued that the law violated the Commerce and Supremacy clauses of the U.S. Constitution. However, the court found that Connecticut did not improperly discriminate against interstate commerce and that existing federal law did not prevent states from enacting legislation that is more comprehensive than the federal law.

INTERSTATE BANKING: UNFINISHED AGENDAS

Existing state laws governing the taxation of banks originated in the late nineteenth and early twentieth centuries and incorporated the regulatory definitions of banking that existed at that time. As a result, state bank tax laws are grounded on the premise that every bank is located in, and doing business in, a single state. However, the commercial reality is that banks and bank-like entities now transact business freely across state lines.

[19]*Sears, Roebuck and Co.* v. *Brown*, 806 F.2d 339 (2nd Cir., 1986).

State taxes on businesses that operate in, and are taxed by, several states are based on different principles than are taxes on businesses that operate entirely within one state. In the former case, states employ apportionment formulas (source-based taxation) to reduce the risk of multiple taxation; in the latter case, apportionment is not required because only one state can levy an income tax on the business (residence-based taxation).

When banks were located in only one state and when branchless banking across state lines was less prevalent, residence-based taxation did not cause serious problems of multiple taxation. Now, however, states must confront the contradictions inherent in applying a residence-based tax to an interstate business. The increased interstate activity has also created opportunities for tax avoidance through interstate profit shifting among banks and their affiliates located in other states. Finally, the rise of branchless banking has introduced a new form of tax avoidance—that created when an out-of-state bank does business in another state solely by mail or electronic means.

Several decades ago, states faced the first two problems—multiple taxation and tax avoidance through profit shifting among affiliates—in the taxation of manufacturing and mercantile business corporations that transacted business across state lines. The history of state taxation of those corporations is therefore instructive. The third problem—tax avoidance by out-of-state banks doing business in another state solely by mail or ATM—is *sui generis*.

The Problem of Multiple Taxation

In the late nineteenth and early twentieth centuries, large manufacturing and mercantile corporations began expanding their activities outside their states of incorporation. As a result, the following problem of multiple taxation arose.

The domiciliary state, using residence-based taxation, taxed the income earned by the corporation within the state and by its divisions located outside the state. Frequently, another (nondomiciliary) state also taxed the income earned by a division located there; this led to double taxation of that income.[20] To overcome this problem, some states began taxing multijurisdictional corporations on a source basis. That is, states taxed only a fractional share of the corporation's income using an apportionment formula.

The purpose of an apportionment formula is to determine the fraction of a multijurisdictional taxpayer's income that should be attributed to a given state. The formula does this by comparing the taxpayer's in-state income-producing activities with such activities everywhere. Therefore, the particular formula chosen must reflect how and where the taxpayer earns its income: the factors represent how the taxpayer generates its income, and the "situs rules" govern where the income is earned.

[20]Although the U.S. Supreme Court has not squarely so held, it is likely that such taxation is unconstitutional to the extent that it causes double taxation.

At first, there was little uniformity in the factors chosen. Gradually, though, a consensus emerged among the states for the use of a three-factor formula consisting of: property (e.g., plant and machinery), payroll (employees), and receipts (from the sales of goods produced by the plant, machinery, and employees). Thus, most states have agreed that the fraction of income of a manufacturing company that should be attributed to a given state can be measured by the following formula:

$$1/3x \left(\frac{\text{payroll in state}}{\text{payroll in all states}} + \frac{\text{tangible prop. in state}}{\text{tangible prop. in all states}} + \frac{\text{sales in state}}{\text{sales in all states}} \right)$$

Having chosen the formula which represents how the taxpayer generates its income, a state must then adopt rules regulating where the income is earned. These situs rules control what elements shall go into the numerator of the three-factor formula. For example, if employee Z works part-time in state A and part-time in state B, which state should include his or her wages in its numerator for purposes of the payroll factor? Or, if product X is manufactured in state A and sold to a customer in state B, which state should include the receipts from the sale in the numerator of the sales factor? A state's situs rules control these decisions.

Although there is widespread acceptance of the above three factors among the states, there is little agreement on the appropriate situs rules.[21] In 1957, the three-factor formula, consisting of property, payroll, and sales, including detailed situs rules, was codified as a uniform state law in the Uniform Division for Tax Purposes Act (UDITPA). Twenty-three states now use some version of the UDITPA formula. Because even those states using the basic three-factor formula have modified it, some tax overlap remains. Nevertheless, the U.S. Supreme Court has repeatedly upheld divergent state formulas against claims that they create double taxation.[22]

With respect to their bank tax laws, states have just begun to consider apportionment formulas. In so doing, states can be expected to emulate the process that they followed in the case of multijurisdictional manufacturing and mercantile corporations.

Unfortunately, the three-factor formula developed to apportion the income of manufacturing companies cannot be used to apportion the income

[21]Forty-five out of the forty-six states (including the District of Columbia) that levy corporate taxes measured by net income have adopted a three-factor formula consisting of property, payroll, and sales. There is wide variety among the states in how they define and weigh the factors. State situs rules are equally varied. See, J. Hellerstein, *State Taxation, Corporate Income & Franchise* (New York: Warren, Gorham, & Lamont, Inc., 1983), pp. 495-536.

[22]In *Moorman Mfg.* v. *Bair*, 437 U.S. 267 (1978), the Supreme Court upheld an Iowa tax which apportioned the net income of a multijurisdictional corporation using a single (sales) factor formula against a claim that such a formula would cause double taxation.

of financial institutions. Manufacturing companies employ capital (in the form of plant, equipment, and machinery) and labor to produce a product, which is then sold to produce income. The income-producing elements of the business of banking are very different. A bank earns income primarily by soliciting deposits, which it uses to create loans (intangible property) which in turn generate interest and fee income. Thus, in the case of bank income, payroll, receipts, intangible property and deposits are all potential factors.

Given the history of apportionment formulas, it is not surprising that the few states which have revamped their bank tax laws have adopted very different formulas. For example, California uses a variant of the basic three-factor formula (property, payroll, receipts). However, in place of real and tangible property in the property factor, California includes only intangible assets—loans. New York uses a three-factor formula consisting of payroll, receipts, and deposits. Two organizations have proposed uniform rules. The Multistate Tax Commission (MTC) has proposed two regulations; one uses a three-factor formula similar to that of California, the other uses a four-factor formula made up of receipts, (intangible) property, deposits, and payroll. The American Bar Association's proposed federal legislation uses a two-factor formula consisting of payroll and receipts.

The situs rules diverge just as widely. For example, although both the New York and Multistate Tax Commission regulations use a deposits factor, the New York situs rules attribute deposits to the state in which the deposit is "booked" (generally in New York) while the MTC situs rules attribute deposits to the state in which the depositor resides. There is ample legal support for both rules.

In sum, the choice of apportionment formulas and situs rules promises to plague both states and banks for years.

The Problem of Tax Avoidance

States developed the three-factor formula to avoid the problem of multiple taxation that occurred when a single corporation did business through divisions located in more than one state. An entirely different problem arose when multijurisdictional corporations expanded their operations across state lines through separately incorporated subsidiaries. For purposes of a state tax, separate incorporation insulates a subsidiary from its parent: the domiciliary state of the parent corporation cannot tax a subsidiary that is separately incorporated in, and doing business solely in, another state.

Because the law treats parent corporations and their subsidiaries as isolated entities, a group of related corporations doing business across state lines can practice tax avoidance through interstate profit shifting. Consider, for example, the following situation. Corporation A, a manufacturing company, is located in and doing business in state A, a state with a high state income tax rate. Corporation A has a wholly owned subsidiary, corporation B, which is located in state B, a state that does not have an income tax. Corporation A manufactures widgets and corporation B assembles and sells the widgets

throughout the United States, but not in state A. The two companies are clearly integrated economically. In such a situation, it is relatively easy for corporation A to avoid state A's income tax by arranging to have the bulk of the profits from the sale of the widgets fall in state B. Corporation A merely charges corporation B an artificially low price for the widgets, so that it receives little income in state A. Corporation B then sells the widgets at their normal retail price and receives all of the profits in state B, which has no income tax.

To counter this problem, states developed the unitary business principle. According to that principle, the income base subject to apportionment is not limited to the income of the corporation that is doing business within the state (i.e., corporation A in the case of state A in the example above). Instead the base includes the income of all members of the unitary group, which consists of the parent and any of its subsidiaries that are engaged with it in a "functionally integrated" enterprise. Thus, in the example above, the unitary business principle would permit states to apportion the combined income of corporation A and corporation B using the states' regular formula. This method overcomes the problem of profit shifting.

Some corporate taxpayers have criticized the states' use of the unitary business principle, claiming that a clear and economically valid definition of a unitary business is lacking. The U.S. Supreme Court has held that affiliated corporations are unitary and may be included in the combined group if there is a "flow of value" among them.[23] Taxpayers assert that because the method is based upon such a nebulous and indefinite concept, states can and do use the method to require the combination of affiliates that are engaged in entirely unrelated businesses, thereby causing distortions in their tax liability.

Fortunately, the question of unrelated businesses does not arise with banks and bank-like entities. Federal law prohibits banks and bank holding companies from controlling any subsidiaries that are not engaged in activities "incidental to the business of banking" in the case of national banks[24] or "closely related to banking or managing or controlling banks" in the case of bank holding companies.[25] Hence, no bank or bank holding company subsidiary can engage in a business unrelated to that of banking.

The history of tax avoidance by multijurisdictional and multinational business corporations suggests that profit shifting among banks and their bank and nonbank subsidiaries will increase as interstate branch banking grows. States can counter this problem by adopting the unitary business principle.

The Problem of Limited Jurisdiction

Branchless banking creates a new kind of state tax avoidance problem for

[23] *Container Corp. of America* v. *Franchise Tax Board*, 463 U.S. 159 (1983).
[24] 12 U.S.C. 24 (1984).
[25] 12 U.S.C. 1843(a) (1982).

which there is no ready-made solution. Consider, for example, the following common situation. Company A is a credit card subsidiary of a full-service bank. Its only brick-and-mortar place of business is in state A. Company A solicits its credit card customers solely by mail in all fifty states. Through these mail-order operations, company A makes loans to consumers in every state.

Even if we assume that one of these states, state B, has a source-based law, it normally will not tax company A on the interest and fee income it receives from residents of state B because company A does not have a brick-and-mortar presence there. Even with the use of the unitary business principle, state B will not be able to tax its apportioned share of the interest and fee income from company A's credit card subsidiary unless company A has a taxable affiliate located in state B. In order to overcome the tax avoidance problem, states must broaden their jurisdiction rules to allow them to reach out-of-state companies that earn income within their marketplaces. Under current state tax jurisdiction rules, much of the interest and fee income from credit card sales is untaxed by any state. Typically, banks locate their credit card subsidiaries in states that have no income tax, and the states in which the subsidiary does business by mail and electronic means do not assert tax jurisdiction over nonresident companies that have no physical presence there. There appear to be two bases for the restricted jurisdiction rule: (1) the practical difficulties that are involved in discovering which out-of-state banks do business in a state when that business is conducted solely by mail or electronically, and (2) the lack of clear statutory authority to assert jurisdiction over out-of-state banks.

Jurisdiction Rules. According to early theories of jurisdiction, a state could exercise *in personam* judicial jurisdiction[26] over individuals or entities only if they were physically present within the state. In its early decisions, the U.S. Supreme Court held that a state had power to render a judgment against an individual or entity only if it could physically bring them before a court. This power principle barred a suit against a corporation in any state other than its domiciliary state because a corporation was deemed to be "present" in only the state that issued its corporate charter.

In time, the power principle proved to be too restrictive. As the number of corporations doing business in more than one state increased, the U.S. Supreme Court gradually changed its interpretation of the requirements of the due process clause. By the mid-twentieth century, the Court had moved

[26] A state court can render a valid judgment against a nonresident defendant only if the court has jurisdiction over the person (*in personam* jurisdiction) or over the property (*in rem* jurisdiction). To adjudicate an action *in personam* (i.e., an action seeking to impose upon the defendants a duty to do or refrain from doing some specific act or to pay a sum of money), a court must have jurisdiction over the person of the defendant. To adjudicate an action *in rem* (i.e., an action seeking to determine claims to or rights in property even though the claimants are not personally present in the state), a court must have jurisdiction over the *res*. According to the Supreme Court, the minimum contacts required by the Due Process Clause are the same whether the action is *in personam* or *in rem*. *Shaffer* v. *Heitner*, 433 U.S. 186 (1977).

from a power theory of jurisdiction based solely on physical presence to a sophisticated fairness standard based on the "contacts" which the nonresident corporation had with the state asserting jurisdiction.[27] Over a period of forty years, the Court has given content to the term "contacts." In a series of decisions, the Court has held that the necessary contacts are present if the nonresident has either (1) purposefully established a relationship with the forum state;[28] (2) purposefully directed its activities at residents of the forum state;[29] (3) created a continuing contractual obligation with a citizen of the forum state;[30] or (4) deliberately engaged in significant activities within the forum state.[31]

According to the Court, once any of the required contacts is established, a nonresident defendant cannot avoid *in personam* jurisdiction merely because he did not physically enter the state, since "it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a state in which business is conducted." This language, from the recent case of *Burger King* v. *Rudzewicz*, is tailor-made for states that seek to assert jurisdiction over nonresident banks that conduct their interstate activities solely by mail, telephone or other electronic means.

Nevertheless, state courts remain mired in the early jurisdiction concepts of physical presence. While using the modern language of "minimum contacts," these courts have retained a bias for actual physical presence. Indeed, state courts frequently blend the two theories into a two-part jurisdiction test. First, the state must show that the out-of-state business has contacts with the state; then, it must show that the out-of-state business has a physical presence within the state.

As authority for the two-part jurisdiction test, state courts often cite early sales tax decisions of the U.S. Supreme Court. However, the imposition and collection of a sales tax raises problems that do not exist with income taxes. Because a sales tax is imposed and collected at the time of the sale, it is difficult to apportion the tax among several states. Therefore, if more than one state is permitted to tax the sale, the seller will face multiple taxation. The problem is particularly acute in the case of mail-order sales. For this reason, the Supreme Court has required that the seller must be physically present in a state before it can tax an interstate sale. The Supreme Court could not find a fair and workable rule that would prevent multiple taxation of interstate mail-order sales. So, by default, the rule became: because several states could tax an interstate sale, no state could tax the sale.[32] To support this rule, the Court relied upon the Commerce Clause, which prohibits multiple taxation of companies doing business in interstate commerce.

In contrast to sales taxes, income taxes can readily be apportioned among the states in which the income is earned, thereby avoiding the Commerce Clause prohibition against multiple taxation. Since 1918,[33] the Court has routinely upheld, against Commerce Clause challenges, state laws that tax an apportioned share of the income of a multijurisdictional business. Further, since 1939,[34] the Court has consistently held that the Due Process Clause does not prohibit double taxation. Therefore, there is no constitutional obstacle preventing a state from taxing its apportioned share of the income of a bank that conducts its activities within the state by mail or electronically.

Reporting Requirements. Presently, it is difficult for a state to discover which banks conduct activities within the state when the contacts are solely by mail or electronic means. Fortunately, states can solve this problem easily by enacting legislation that requires all nonresident corporations that regularly transact business with its citizens (whether or not they have employees or an office within the state) to file a Notice of Business Activities with the revenue department.

At least one state, New Jersey, has such a statute—although for historical reasons, it specifically exempts financial institutions. According to the New Jersey statute, a nonresident corporation must file a Notice of Business Activities with the state's tax commissioner if (1) it maintains a place of business or maintains personnel (employees, representatives, independent contractors) in the state; (2) it owns or maintains real and/or tangible property in the state; (3) it receives payments in excess of $25,000 from persons residing in the state or from business located in the state; and (4) it derives income from sources within the state.[35] According to the latter two conditions, a nonresident corporation must file the notice even if it does not have a physical presence within New Jersey.

Such a statute should pass constitutional muster in front of the U.S. Supreme Court because it is a narrowly drawn law affecting interstate and intrastate business equally and operates in an area of "profound local concern" such as banking and related financial activities.[36]

[27] *International Shoe Co.* v. *Washington*, 326 U.S. 310 (1945).
[28] *Hanson* v. *Denckla*, 357 U.S. 235 (1958).
[29] *Worldwide Volkswagen Corp.* v. *Woodson*, 444 U.S. 286 (1980).
[30] *McGee* v. *International Life Insurance Co.*, 355 U.S. 220 (1957).
[31] *Burger King Corp.* v. *Rudzewicz*, 105 S.Ct. 2184 (1985).
[32] See, e.g., *J.D. Adams Mfg. Co.* v. *Storen*, 304 U.S. 307 (1938).
[33] *U.S. Glue* v. *Town of Oak Creek*, 247 U.S. 321 (1918).
[34] *Curry* v. *McCanless*, 307 U.S. 357 (1939).
[35] N.J. Stat. Ann. 14A:13-15 through 13-20.
[36] See, *Lewis* v. *BT Investment Managers, Inc.*, 447 U.S. 27, 38 (1980). (The Commerce Clause does not prohibit narrowly drawn state regulatory legislation which affects interstate and intrastate business equally, particularly in an area of "profound local concern" such as banking and related financial activities.) In *Associates Consumer Discount* v. *Bozzarello*, 149 N.J. Super. 358, 373 A.2d 1016 (1977), a nonresident corporation which had no employees and no office in New Jersey was barred from maintaining suit in a New Jersey court because it had not filed a Notice of Business Activities as required by state law. The New Jersey superior court upheld the constitutionality of the statute as an information gathering measure to safeguard the state's revenue and to reduce unfair tax-free competition with businesses that pay taxes to the state. A similar decision by the New Jersey superior court is now on appeal before the state's supreme court. See, *First Family Mtg. Corp.* v. *Durham*, 205 N.J. Super. 251, 500 A.2d 746 (1985); leave to file appeal granted, 511 A.2d 675 (1986).

CONCLUSION

By the end of 1986, nearly every state had passed legislation authorizing some form of interstate branch banking. Also, recent judicial decisions have cleared the way for banks to engage in de facto branch banking in every state through the use of ATMs and affiliated nonbank banks. Yet, in the face of this intense interstate banking activity, states continue to tax banks by using methods that are based upon statutory restrictions and constitutional barriers that are no longer valid and by relying upon regulatory definitions that reflect an antiquated view of the nature and organizational form of banking.

The failure of states to address state taxation of interstate banking has created a situation in which both banks and state coffers suffer: some banks face multiple taxation while others escape state taxation. To solve these problems, states must adopt (1) formulary apportionment of the income of the in-state and out-of-state banks doing business within the state to avoid double taxation of bank income, (2) the unitary business principle to counter tax avoidance through interstate profit shifting by banks, and (3) broader jurisdiction rules to reach those banks that engage in branchless banking within the state.

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U.S. Prosecution of State and Local Officials for Political Corruption: Is the Bureaucracy Out of Control in a High-Stakes Operation Involving the Constitutional System?

Arthur Maass
Harvard University

Perhaps the most serious and disabling federal intrusion of recent years into the independent political status of state and local governments has been actions by the U.S. government to prosecute elected state and local officials and their close associates for local political corruption. In 1986 U.S. Attorneys in New York, Boston, District of Columbia, Pennsylvania, and elsewhere pursued such investigations and prosecutions with unusual vigor. These activities have a recent genesis—since 1974—and they are basically unauthorized, in important respects out of control, and overall questionable in terms of the federal nature of our constitutional system. These findings are supported by data from the Public Integrity Section of the Criminal Division and the Office for U.S. Attorneys, both in the Department of Justice, and by opinions of U.S. courts, legislative histories of bills and statutes, and sources on criminal law and political corruption.

In November 1986 a Working Group on Federalism of the White House Domestic Policy Council issued a "comprehensive report" analyzing the status of federalism in America.[1] The working group was chaired by Assistant Attorney General Charles J. Cooper. The Domestic Policy Council was headed by Cooper's boss, Attorney General Edwin Meese III. The report concluded that:

> The last 200 years have witnessed the evisceration of federalism as a constitutional and political principle for allocating governmental power between the States and Washington. The Founding Fathers' vision of a limited national government of enumerated powers has gradually given way to an expansive, intrusive, and virtually omnipotent national government. States, once the hub of political activity and the very source of our political tradition, have been reduced—in significant part—to administrative units of the national govern-

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[1] "The Status of Federalism: A Report of the Working Group on Federalism of the Domestic Policy Council" (Washington, D.C.: Domestic Policy Council, 1986, Mimeo.).

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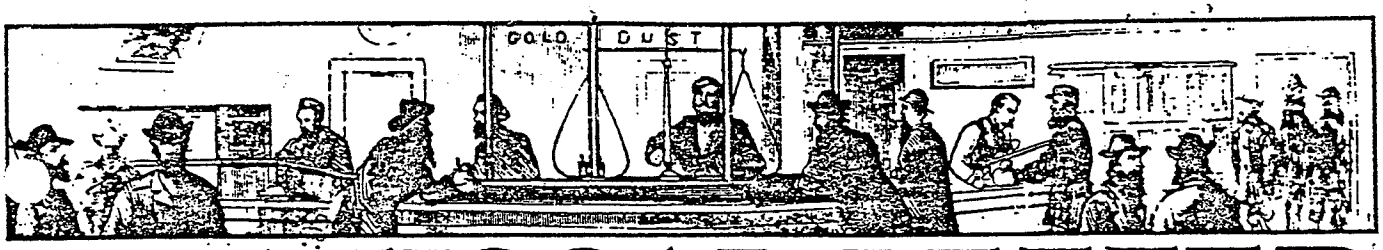

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The Modernization of State Bank Taxes

Sandra McCray, consultant to the
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In no area of state taxation have state legislation and regulation lagged as far behind the changes in federal statutory and constitutional law as in state taxation of national and state banks. For example, about one-third of the states still tax only those banks that have their principal office within their borders. Such residence-based state taxation–i.e. taxation of domiciliary banks only–is a product of a bygone era in which (a) nearly every state banned interstate branch banking, (b) federal statutory law restricted state taxation of national banks, and (c) Supreme Court interpretation of the Constitution prohibited state taxation of interstate commerce. None of these constraints exists today. Moreover, because of recent technological and legal developments and sophisticated marketing techniques, banks can now operate nationwide through the use of automatic teller machines (ATMs), by telephone, and through mail solicitation of deposits and credit card customers.

Another one-third of the states have taken the first step toward modernizing their bank tax laws by providing for apportionment and taxation of the income of out-of-state banks. Unfortunately, however, most of these states are using the Uniform Division of Income for Tax Purposes Act (UDITPA) three factor formula, consisting of sales, real and tangible personal property, and payroll. That formula, which was developed to apportion the income of multistate manufacturing companies, is particularly unsuited for banks. Manufacturing companies earn income by employing capital (in the form of plants, equipment and machinery) and labor to produce a product, which is then sold to produce income. Banks, in contrast, make income by soliciting deposits, which they use to create loans (intangible property) which in turn generate interest and fee income. Banks also earn a significant amount of income from dealings in intangibles other than loans, i.e., securities and money market instruments, and by providing a variety of services.

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Bank Taxes *(conclusion)*

Given the importance of intangibles as an income-producing item for banks, the failure of the UDITPA to include intangible property in its property factor creates distortions in the apportionment of banks' income among states. For example, while most of the real and tangible personal property (those items included in the UDITPA property factor) is located in the domiciliary state of a financial institution, the intangible property of such an institution (loans and deposits) invariably comes from several states. Consequently, an apportionment formula that uses only real and tangible property will benefit the state of commercial domicile at the expense of the market states. If, as is true in the case of the UDITPA, the formula also contains a payroll factor, the balance will be tipped even further in favor of the domiciliary state since most employees will be located there, too.

Further distortions are caused by the failure of states to broaden their tax jurisdiction rules to permit them to tax out-of-state "branchless banks" that conduct activities electronically and by mail. Most states assert tax jurisdiction only over those banks that have a physical location or employees regularly stationed within the taxing state. Thus, out-of-state branchless banks pay no tax to the market states in which they do business, placing local banks at a competitive disadvantage.

Two states, Minnesota and New York, have completely revamped their bank tax laws. Both states have chosen pure source-based income taxation; that is, they apportion the income of both in-state and out-of-state banks. Recognizing the defects of the UDITPA formula, these two states have adopted new formulas specifically tailored to the business of banking. The new laws of New York and Minnesota represent two different approaches to the problem of apportioning the income of multi-jurisdictional banks. The factors chosen by New York are receipts, deposits, and payroll. The New York "situs rules"--rules that govern which state shall be considered the source of the different segments of a bank's income--have a strong domiciliary state bias. For example, according to the New York rules, the situs of income from loans (other than credit card loans) is in New York if the loan is "located in New York." The statutory definition of the phrase "located in New York" makes it clear that in most cases all of the income from loans, wherever orginated, will be deemed to take place in the state in which the lending bank is located. The situs of receipts for services performed by the taxpayer's employees regularly connected with or working out of a New York office is New York if such services are "performed with New York." The regulation deems a service to be performed in New York if the costs of performance are incurred there, regardless of where the services are consumed.

The factors selected by Minnesota--payroll, property, and receipts--are similar to those in the UDITPA formula, but the Minnesota formula includes intangible property in the property factor and excludes real property. The Minnesota situs rules, which have a distinctly market state flavor, differ significantly from the New York rules. According to the Minnesota situs rules, receipts from unsecured commercial loans are deemed to be in Minnesota if the proceeds of the loan are to be applied in the state, and receipts from unsecured consumer loans are deemed to be in Minnesota if the borrower is a resident of Minnesota. The situs of receipts from the performance of services is in Minnesota if the services are consumed in the state, regardless of where the cost of the services is incurred.

Unlike New York, Minnesota has also amended its tax jurisdiction statute. Activities that create jurisdiction to tax in Minnesota include both the traditional "doing business" test, which is based upon the taxpayer's physical presence within the state, and a "regular solicitation" standard, which does not rely on an in-state physical presence. For example, according to the Minnesota law, a financial institution is subject to tax if it regularly solicits business from within the state. "Solicitation" includes: (1) distribution by mail or otherwise of catalogs, periodicals, advertising flyers, or other written solicitations or business to customers in Minnesota; (2) display of advertisements on billboards or other outdoor advertising in Minnesota; (3) advertising in Minnesota newspapers; (4) advertising on Minnesota radio or television.

Both New York and Minnesota have broadened their definition of "bank" to include bank holding company subsidiaries that engage in activities deemed closely related to banking and certain financial institutions that engage in bank-like activities.

Although New York and Minnesota have made commendable progress in their attempts to modernize their bank tax laws, many problems remain. For example, in an interstate environment banks can move their assets (loans) and liabilities (deposits) freely among the states in which they have an affiliate bank. Thus, the state of domicile of a bank that orginates a loan will not necessarily be the state of location of the bank that treats the loan as an asset on its books. The state of domicile of a depositor will not necessarily be the state of location of the bank which holds the deposit as a liability. The geographic separation of assets and liabilities from their source can make it difficult for states to determine which state has the right to tax the interest income from a loan, opening the door for overlapping situs rules and multiple taxation. The trend toward loan securitization, which separates the loan originator from the investor, compounds these problems.

These and other bank-specific issues may make the use of pure source-based taxation unsuitable for banks and financial institutions, requiring states to consider alternative methods of income taxation. The need to do so will become more important as banking corporations increasingly act on the national level.

EXHIBIT K: 38

McCray, Sandra B., "The Massachusetts Bank Tax: Present Realities and Options for the Future" (undated)

THE MASSACHUSETTS BANK TAX: PRESENT REALITIES AND OPTIONS FOR THE FUTURE

by Sandra B. McCray

Draft prepared for the Special Commission on Tax Reform

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IV. SUMMARY

INTRODUCTION AND SCOPE OF STUDY

Nearly every state in the United States taxes banks using methods based upon statutory restrictions and constitutional barriers that are no longer valid and upon regulatory definitions that reflect an antiquated view of the nature and organizational form of banking. The Commonwealth of Massachusetts is no exception to this general rule.

The attempt to apply tax laws containing rules and definitions developed in the late 19th and early 20th centuries to the modern business of banking creates many problems. These problems are often easy to identify, seldom easy to solve. Consider, for example, the definition of a "bank". The Commonwealth has defined a "bank" for purposes of taxation by reference to the regulatory definition of a bank. Accordingly, a "bank" is an entity that accepts insured deposits in Massachusetts. If one accepts the principle that competing entities should be taxed similarly, then one must question whether such a narrow definition of a bank is fair.

Today, unregulated entities such as retailers issue credit cards in competition with bank credit cards, automobile manufacturers provide financing for new cars in competition with

banks, brokerage house offer a variety of cash management programs designed to attract "deposits" in competition with banks, and collateralized loans are increasingly bundled and sold as securities in competition with banks. Yet, currently, most of the above nonbank entities are taxed under the general business corporation tax rather than the bank tax. The structure and rate of the business tax are very different from and are, some argue, more favorable to the taxpayer than the rate and structure of the bank tax.

While all taxpayers, revenue directors and legislators may agree that a good tax system should create tax parity among like entities, few will agree on the exact meaning of tax parity or how it should be achieved. Should the bank tax be amended to match the business corporate tax? Or, should the Commonwealth design an entirely new tax system to cover "financial institutions" defined to include all entities which offer competitive services? And, if Massachusetts chooses the latter course, which of the above entities should be taxed as financial institutions? The answers to such questions involve important legal and policy considerations which must be identified and analyzed.

The study which follows will examine this problem and related issues in depth. The purpose of the study is to identify the major problems with the current bank tax and to present options for reform. Section I reviews the historical development of the Massachusetts' tax on banks. Section II examines the

structure and tax impact of the current bank tax, and evaluates the claim that the tax places an undue and unfair burden on Massachusetts commercial banks vis-a-vis their out-of-state and in-state competitors. Finally, Section III addresses the issue of reform. It describes, analyzes and evaluates alternative methods of taxing the income of banks as well as the likely revenue impact of reform.

I. BACKGROUND: THE HISTORICAL DEVELOPMENT OF THE MASSACHUSETTS TAX ON BANKS

A. Commercial Banks

Massachusetts began taxing commercial banks in 1812. In that year, the legislature passed a statute requiring all incorporated banks to pay a tax of 1% per year on their capital stock. Just seven years later in 1819, the U.S. Supreme Court issued its momentous decision in McCulloch v. Maryland[1] which shaped all state taxes on banks for the next century and a half. In McCulloch, the Court struck down a Maryland statute that imposed a tax on bank notes issued by any bank or branch not chartered by Maryland. In a sweeping opinion, Chief Justice Marshall held unconstitutional all state taxes (other than a real property tax or a tax on bank shares) levied on a governmental instrumentality such as a national bank.

The Court's holding in McCulloch became the basis for the first prong of the federal immunity doctrine which prohibits

state and local governments from taxing federal instrumentalities in the absence of specific Congressional authorization. The second prong of that doctrine, announced by the Court in Weston v. Charleston,[2] holds that state and local governments cannot tax federal obligations without similar Congressional authorization. With the establishment of the national banking system through passage of the National Banking Act in the 1860's, Congress codified these two prongs of the federal immunity doctrine. In the original Act and in later amendments, Congress described the conditions under which national banks could establish branch banks. The amendments set up a complex state and federal scheme to regulate intrastate and interstate banking. This section examines the impact of the two prongs of the federal immunity doctrine and of the dual regulation of branch banking on the evolution of the Massachusetts bank tax.

1. Federal Immunity for National Banks: The Massachusetts Response.

At first the Court applied the doctrine of federal immunity only to the federal government and the instruments through which it carried on its operations. Inevitably though, the scope of entities protected from taxation grew. In its heyday, the doctrine, renamed the intergovernmental immunity doctrine, protected both state and federal agencies from taxation as entities, and it even protected state and federal officials from taxation as individuals.

Although the Supreme Court and Congress have now narrowed the reach of the doctrine, the effects of the previous broad federal immunity linger in most state bank tax statutes. The history of Massachusetts' taxation of commercial banks is a study of one state's response to the restrictive federal legislation passed pursuant to the constitutional powers of the federal government first articulated in McCulloch v. Maryland.

According to the holding in McCulloch, a state could not tax a national bank except by means of a real property tax or a tax on bank shares. Although the constitutional restrictions applied only to national banks, states applied the same restrictions to state-chartered banks since they were loath to tax their own banks more heavily than they taxed national banks.

During the Civil War, Congress strengthened the national banking system by passing the National Bank Act.[3] In that Act, Congress specifically authorized state taxation of national banks by the two methods left open in McCulloch: a tax on their real estate and shares. The Massachusetts legislature responded by providing for state taxation of the shares of a national bank in the cities and towns where the owners of the shares dwelled.[4] Later amendments to the National Bank Act required that national bank shares owned by nonresidents be taxed in the city or town where the bank was located; shares owned by residents remained taxable in the towns where they dwelled.[5] Again, the Massachusetts legislature responded by passing legislation which tracked the language of the federal statute. This method of

taxing bank shares prevailed in Massachusetts until 1923.

But states continued to face problems in taxing banks. As national banks grew in importance, states encountered unexpected obstacles in their attempts to find a valid method of taxing them. Many of these obstacles centered around the meaning of the phrase "other moneyed capital". Section 41 of the National Banking Act prohibited states from taxing national bank shares at a rate greater than the rate they assessed upon "other moneyed capital".[6] After state courts had struggled for some years to find a workable interpretation of that phrase,[7] the Supreme Court finally injected some substance into the term by holding that section 41 prescribed equal treatment of all capital engaged in earning money by dealing in money. Thus, a state could not tax the shares of a national bank at a rate higher than the rate at which it taxed the stock of other corporations which were engaged in the business of banking or the intangible personal property of individuals who were similarly engaged.[8]

Although states attempted to comply with this requirement, in practice, tax discrimination against national banks grew. Individuals competing with national banks in such businesses as lending money, buying and selling bonds, notes and mortgages could and did easily evade state taxes on their intangible personal property. Finding enforcement of their taxes on intangibles impossible, many states switched to an income tax. The Commonwealth was one of those states. In 1916, Massachusetts exempted all intangibles, except national bank shares, from ad

ad valorem taxation and substituted a tax on income at the rate of 6 percent.

But the two different methods of taxing intangibles -- $18 per thousand on national bank shares and 6 percent of net income for all other intangibles -- raised even more complex questions of discrimination. For example, it was thought that a 6% income tax was roughly equivalent to an ad valorem tax of $3 per thousand.[9] Thus, the stock of national banks was taxed at six times the rate imposed on other moneyed capital. Banks soon challenged this system of taxation. In 1921, a bank in Virginia sued the city of Richmond arguing that the state tax unconstitutionally discriminated against it because the ad valorem rate on its shares was effectively higher then the income tax rate on individuals who were engaged in a similar business. The Supreme Court agreed.[10]

Spurred on by the Court's holding in Merchant's National Bank, national banks in Massachusetts sued to recover the back taxes improperly assessed and collected.[11] Finally, Congress stepped in to relieve the bind in which state's found themselves. In 1923 and 1925, Congress revised its early statute limiting state taxation of national banks and enacted sec. 5219 to add three new methods by which a state could tax a national bank: (a) by including bank share dividends in the taxable income of a shareholder, (b) by imposing a net income tax, and (c) by levying a franchise tax according to or measured by net income.[12]

In response to the federal changes, the Massachusetts

legislature adopted an entirely new system of taxation of national banks and trust companies in 1925.[13] The new system included an excise tax on the income of national banks having their principal offices in Massachusetts and on trust companies chartered under state law. The statute provided that the taxable income would be the federal taxable income with certain adjustments. The adjustments required that the net losses of previous years deducted from federal taxable income be added back along with all interest and dividends not included in the federal return, except dividends of Massachusetts corporations. The latter adjustment, which allowed the Commonwealth to tax interest income from U.S. bonds and other federal securities, was put in doubt by the 1929 Supreme Court holding in Macallen Co. v. Massachusetts[14] discussed in the next section. Except for a short period when the latter provision was repealed and except for changes in the definition of net income and in the rate of the tax, Massachusetts has retained its 1925 system of taxing state and national banks.[15]

The federal government, on the other hand, has dramatically changed the statutes governing state taxation of national banks. In 1976, Congress removed all prior statutory restrictions on state taxation of national banks. Currently, sec. 5219, provides that:

> [f]or the purposes of any tax law enacted under authority of the U.S. or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or

other jurisdiction within which its principal office is located.[16]

Thus, the only remaining restriction on state taxation of national banks is that such taxes must not discriminate against national banks.

2. Federal Immunity for U.S. Securities: The Massachusetts Response.

In Weston v. Charleston, the Supreme Court applied the federal immunity doctrine it had announced earlier in McCulloch to strike down a property tax imposed by the City of Charleston, S.C. on stock issued by the Bank of the U.S. and held by an individual. The Court held that the tax violated the Borrowing Clause of the Constitution. Thus, the second prong of the immunity doctrine was born.

In 1862, Congress adopted a legislative exemption from state taxation for "all stocks, bond, and other securities of the U.S. held by individuals, corporations or associations within the U.S. ....",[17] mirroring the apparent absolute prohibition announced in Weston. But this per se ban against state taxation of federal obligations was short lived. In 1868, the Supreme Court upheld a state franchise tax measured by net income including income from federal obligations.[18]

The original 1862 statute, with the judicially-created exception for franchise taxes, remained in effect until 1959. In that year, Congress amended the law to add the judicially-created

exemption for franchise taxes. Currently, sec. 3701 provides:

> All stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations.[19]

Because the Supreme Court had held that a state may tax the income from federal obligations if it used a franchise or excise tax and because the tax passed by the Massachusetts legislature in 1925 was an excise tax measured by net income, it was thought that the tax was valid. This certainty about the validity of the tax dissolved in 1929, however. In Macallen Co. v. Mass.,[20] decided in that year, the Court struck down the state's excise tax on domestic business corporations to the extent that it was measured by income from governmental bonds.

Noting the similarity between the excise tax on business corporations and the excise tax on banks, Massachusetts adopted a new definition of income for purposes of its bank tax.[21] According to this new definition, all income which could not be taxed when received by an individual (e.g. interest income on federal obligations) was exempt from the measure of a bank's income. To compensate for the loss of revenue, the legislature increased the rate of the bank tax.[22]

Without expressly overruling Macallen, the Supreme Court in 1933 abandoned its earlier interpretation of the immunity doctrine and upheld a California excise tax measured by net income, including the income from governmental securities.[23] In that same year, the Massachusetts legislature passed a law reinstating the earlier, all-inclusive definition of income.[24] Since that date, Massachusetts has continued to include income from federal and state obligations in the measure of its bank excise tax.

3. Branch Banking: The Dual Regulatory Scheme and the Massachusetts Response.

The National Bank Act of 1864 provided that the "usual business" of a national bank "shall be transacted at an office or banking house located in the place specified in its organization certificate". According to the Supreme Court's interpretation of the Act, Congress did not thereby license national banks to operate branch banks.[25] Therefore, until Congress amended this section of the National Bank Act in 1927, national banks did not have the power to establish branch banks.

In 1927, Congress passed the McFadden Act amending the National Bank Act to allow national banks to establish branch banks within the state in which they were located "if such establishment and operation are ... expressly authorized to state banks by the law of the state in question ...".[26] The Act did not empower national banks to operate interstate branches.

Although the McFadden Act does not authorize national banks to engage in interstate branching, it does not prohibit them from doing so. According to the Act, a branch includes any branch bank, office, agency, or place of business at which deposits are received or checks paid or money lent. There is plenty of room within this definition of a branch for an out-of-state national bank to engage in banking and bank-like activity without violating the McFadden Act. For example, if a national bank transacts business in a host state through the mail or by telephone, it has not established a place of business in the host state and is not, therefore, operating through a branch.

The interstate branching ban did not terminate all branching activity. For example, there are no federal or state prohibitions against the interstate expansion of banks through nonbank subsidiaries. However, federal law does restrict the activities of these nonbank banks. Section 4 of the Bank Holding Company Act prohibits BHCs from owning or controlling any entity that is not a bank unless the subsidiary's activities fit within one of the categories listed.[27] Most nonbank entities are established as section 4 (c)(8) subsidiaries.[28] According to that section, a BHC may acquire the shares of any company "the activities of which the Board ... has determined are (by order or regulation) so closely related to banking or managing or controlling banks as to be a proper incident thereto ...."[29] Pursuant to this authority, the Federal Reserve Board has promulgated Regulation Y which authorizes a wide variety of

permissible nonbank activities for BHCs including mortgage banking, extension of credit through finance companies, issuance of credit cards, provision of bookkeeping or data processing services, issuance and sale of travelers checks, and operating industrial banks.[30]

Second, banks can expand across state lines through the use of "nonbank banks". According to the provisions of the Bank Holding Company Act, a "bank" is a company which both: (a) accepts demand deposits, and (b) engages in the business of making commercial loans.[31] A nonbank bank is an entity which either accepts demand deposits or makes commercial loans, but not both. Neither state nor federal law prohibits a bank from conducting interstate activities through the establishment of a nonbank bank.[32]

Third, a bank or BHC may acquire a true bank across state lines if the laws of the state in which the banks is to be acquired or established expressly provide for such an entity.

To summarize, branch banking is controlled by both state and federal law. For those banks subject to the McFadden Act (branches of national banks and state banks which are members of the Federal Reserve System) the following rules apply: each state's law will determine whether a national or state bank may engage in branch banking within its borders, and each state's law will determine which activities engaged in by state banks constitute branch banking; however, federal law (the McFadden Act) will determine whether any particular operation engaged in

or facility established by national banks constitutes branch banking.[33] Since the McFadden Act defines only the minimum content of the term "branch", it is the administrative and judicial interpretations which set the parameters of what is a branch. For those entities subject to the Douglas Amendment, the following rules apply: state law will determine whether a bank or bank holding company can acquire a subsidiary bank within a state; however, federal law will determine whether a particular entity acquired by a bank holding company is a "bank".

Historically, the Commonwealth has legislatively restricted intrastate and interstate branch banking. Prior law prohibited Massachusetts banks from operating branch banks (direct branching) across county lines within the state. But, a Massachusetts bank holding company could acquire a separately incorporated and separately chartered bank (indirect branching) across county lines.

State laws also prohibited all interstate branch banking whether direct or indirect. Such laws did not, however, prevent banks from establishing "nonbank" banks in other states.

In the 1980's, the state removed these bans. Now, Massachusetts banks can operate branch banks anywhere in the state. And, in 1982, the Commonwealth passed legislation authorizing regional reciprocal interstate banking. According to this new law, a bank or bank holding company domiciled in Connecticut, Maine, New Hampshire, Rhode Island or Vermont may establish a branch bank or a subsidiary bank in Massachusetts if

(a) it is authorized to do so by the laws under which it is organized, and (b) the laws of the state of domicile of the bank or bank holding company expressly authorize Massachusetts banks to establish (on terms no more restrictive than the Massachusetts law) branch or subsidiary banks in such state.[34]

A. Thrift Institutions[35]

1. 1862-1966: Deposits Tax on State-Chartered Thrifts.

In 1816, the Commonwealth chartered the first thrift institution -- the Provident Savings Bank -- in the United States. But, the state did not tax such entities until 1862. Prior to that year, Massachusetts levied a tax on the deposits in savings banks and assessed the tax directly to the depositors. However, a large portion of the individual deposits was under $500 and, for that reason, not included in returns to assessors. Therefore, these deposits escaped taxation entirely.[36]

To overcome this problem, the state passed a new law in 1862 which required all institutions for savings incorporated under the laws of Massachusetts to pay a tax on the average amount of their deposits. In the years immediately following the passage of this law, the deposits tax faced several legal challenges.

For example, in 1866, the Provident Institution for Savings sought to have the tax declared unconstitutional. Provident argued that because the tax was a property tax which included in its measure deposits invested in federal securities, the tax violated the second prong of the federal immunity doctrine which

held that states could not levy a property tax on obligations of the United States.[37] The U.S. Supreme Court disagreed. According to the Court, the deposits tax was a franchise tax, not a property tax.[38] As such, the tax could include in its measure, deposits invested in federal securities without contravening the Constitution.

With one exception, the state did not significantly alter the base or nature of its tax on thrifts until 1966. In 1881, the state amended its deposits tax to permit thrifts to deduct investments in loans secured by mortgages of Massachusetts real estate taxable in the Commonwealth from their tax base.[39]

2. 1966-1984: Deposits and Income Tax on State-Chartered and Federally-Chartered Thrifts.

Before the Great Depression, chartering of thrifts had developed exclusively as a state activity. Federal chartering began in 1933 as a part of a general relief package designed to provide government support for the distressed mortgage markets.

Like national banks, federal thrift institutions are federal instrumentalities immune from state taxation absent specific Congressional authorization. However, unlike national banks, Congress did not narrowly restrict the methods by which states could tax thrifts. Instead, Congress gave states broad latitude to tax federal associations, requiring only that such taxes be nondiscriminatory. Section 5(h) of the Home Owner's Loan Act of 1933 authorized states to tax federal savings and loan

associations as follows:

> [N]o State ... or local taxing authority shall impose any tax on such association or their franchise, capital, reserves, surplus, loans or income greater than that imposed by such authority on other similar local mutual or cooperative thrift and home financing institutions.[40]

Nevertheless, Massachusetts did not begin taxing federal thrifts until 1966. In that year the state completely revamped its thrift tax by: (a) extending it to federal associations, (b) broadening the deduction for investments in loans secured by real estate to include loans made on property in contiguous states within a radius of fifty miles of the thrift's main office, and (c) adding an income tax component. As enacted in 1966, the Massachusetts statute imposed an excise tax, measured by deposits and income, on both state and federal institutions.

Once again, the tax faced Constitutional challenges. The first challenge came in 1972 when the United States, on behalf of the Federal Home Loan Bank Board sought to have the deposits component of the tax declared unconstitutional because it discriminated against federal savings and loan associations.[41] The discrimination resulted from the different state and federal regulatory requirements imposed on thrifts.

According to Massachusetts law, state-chartered thrifts could invest in out-of-state real estate loans only if the property securing the loan was within a fifty-mile radius of the originating thrift's home office. Federally-chartered thrifts,

on the other hand, could make such loans on property located within one hundred miles of their principal office. Because federal associations made approximately 44 percent of their loans on real property outside the 50-mile area, those associations received a lesser deduction and paid a greater tax. The First Circuit Court of Appeals held that the deposits tax was invalid and unenforceable as applied to federal savings and loan associations.[42] Thereafter, only state-chartered thrifts paid the deposits component of the tax. Federally chartered thrifts remained subject to the income component of the thrift tax.

The U.S. Supreme Court heard a second constitutional challenge to the Massachusetts thrift tax in 1978.[43] Again, the tax was said to be discriminatory because of differing state and federal regulatory requirements. The law allowed thrifts to deduct from their taxable income any additions to the state guaranty fund or to the reserves required by law or state and federal supervisory authorities. First Federal Savings and Loan Association argued that because the reserve requirements for federal associations were lower than those set for state institutions, the deduction for federal associations was smaller than that for state-chartered entities; and, therefore, the tax discriminated against the federal thrifts. The Supreme Court disagreed. Finding the scheme neither unfriendly nor discriminatory on its face, the Supreme Court upheld the income component of the Massachusetts thrift tax as applied to federal savings and loan associations.[44]

In 1982, several mutual associations launched a third attack against the constitutionality of the Massachusetts thrift tax.[45] The savings banks and cooperative banks first argued that the income-based portion of the tax was unreasonable because it did not fairly measure the value of their franchises. In particular, these institutions challenged the Commissioner of Revenue's interpretation of the phrase "operating expenses".

According to G.L. c.63, sec.11 as it existed in 1982, thrifts could deduct all "operating expenses" from their net income tax base. But, the Commissioner of Revenue disallowed deductions for the amounts paid by mutual associations to their depositors/shareholder, finding that these amounts were more like nondeductible dividends than deductible interest payments.[46] The Massachusetts' Supreme Judicial Court upheld the Commissioner's ruling finding that "there is ample support for the Commissioner's position that payments made to depositors are analogous to dividends and thus not deductible as 'operating expenses'".[47]

In a second prong of their suit, the mutual associations argued that because the Commissioner applied the deposits portion of the thrift tax to state-chartered associations but not to federally-chartered institutions, the tax violated the equal protection clause of the federal constitution. The state supreme court upheld the thrift tax against this challenge too. Because of the repeal of the former tax on thrifts, both of these issues are now moot.

3. 1985-Present: Income Tax on all "Banks".

Beginning in 1977, the thrift industry in Massachusetts sought legislation to achieve tax parity with commercial banks. Tax parity bills were introduced in the legislature during the next seven years until finally in 1984 a tax parity bill passed both houses. The Governor signed the bill in January, 1985. Now, the state's thrift tax is a residence-based tax identical in base and rate to the bank tax.

Like commercial banks, thrifts must compete with unregulated entities for business. Also, thrifts are subject to interstate branching restrictions similar to those on commercial banks.[48] Therefore, the discussion which follows applies equally to commercial banks and to thrift institutions.

II. THE CURRENT MASSACHUSETTS BANK TAX

Massachusetts bankers have repeatedly criticized the state's tax on banks and thrifts as fundamentally unfair. They claim that the unfairness includes the following: (1) the bank tax rate is significantly higher than the rate in other states placing Massachusetts bankers at a competitive disadvantage vis-a-vis bankers in other states; (2) the bank tax rate and structure are less favorable than the rate and structure of the Massachusetts tax on general business corporations placing Massachusetts bankers at a competitive disadvantage vis-a-vis their nonbank

competitors within Massachusetts; and, (3) under the current law, Massachusetts cannot effectively tax out-of-state banks. Other critics of the bank tax focus on problems in the calculation of the tax base.

This part of the study describes the current law and evaluates the criticisms by measuring the bank tax scheme against the criteria of a good tax as identified by the Special Commission on Tax Reform. Those criteria are: (1) neutrality, (2) fairness, (3) competitiveness, (4) exportability, (5) cost effectiveness, (6) stability, and (7) simplicity.

A. Overview of Bank Tax

1. Entities Subject to the Tax

G.L. c. 63, secs. 1 and 2 govern taxation of banks in Massachusetts. For purposes of these sections, a "bank" is a commercial bank or thrift which is chartered by the federal government, by the Commonwealth of Massachusetts, or by a foreign country. According to the language of section 1, the Commonwealth cannot tax a bank which is chartered by another state even if the out-of-state bank is doing business in Massachusetts.[49]

In practice, the definition of a bank is limited in another significant way. An entity is not deemed to be a "bank" for purposes of the tax unless it meets the state's regulatory definition of a bank; that is, the entity must accept insured deposits in Massachusetts.

In sum, the following bank and bank-like entities do not pay the Massachusetts bank tax: (a) bank subsidiaries such as loan production offices, credit card subsidiaries, and mortgage banks (because such entities do not meet the regulatory definition of a bank), and (b) banks chartered by other states (because such banks are not included within the statutory definition of a bank). Nonbank bank subsidiaries are subject to the Commonwealth's general business corporation tax.

2. Residence-based Taxation

The bank tax is a residence-based tax; consequently, some banks domiciled in Massachusetts and doing business within and without the state could be subjected to multiple taxation while other banks which are not domiciled in Massachusetts may escape all Massachusetts taxation. The reason for this latter problem is found in the definition of net income.

Federally-chartered and state-chartered banks are taxed on their "net income" at the rate of 12.54%. Chapter 63, section 1 defines net income as the bank's gross income from all sources, without exclusion. This section imposes a residence-based tax on all federally-chartered and state-chartered banks. That is, those banks must pay a tax on all their income whether or not that income is earned from sources within Massachusetts. For example, if a bank which is domiciled in Massachusetts (e.g. a state bank chartered by the Commonwealth or a national bank with headquarters in Massachusetts) does business in one or more other

states, that bank may be taxed by those states on the income it earns from sources within those states. But, the Commonwealth will continue to tax its domiciliary bank on all of its income whether or not it is earned from sources within Massachusetts and whether or not it is subject to tax elsewhere.[50]

The only way a Massachusetts-based bank can escape taxation on all of its income is to conduct its out-of-state business in a state which does not impose a tax on its activities or through a subsidiary separately incorporated in the other state. Conversely, a bank which is domiciled in Connecticut and does business through a branch in Massachusetts escapes taxation in the Commonwealth because the law has no provision for apportioning the income between Massachusetts and Connecticut.

This system of taxation has Constitutional ramifications. Some Supreme Court cases appear to sanction residence-based taxation of corporations which are domiciled in the state imposing the tax; thus, a residence-based tax imposed on a Massachusetts domiciliary bank is at least arguably Constitutional. But, the Court has always prohibited residence-based taxation of nonresident corporations. Because a branch of a federally-chartered bank which is headquartered outside of Massachusetts is considered a nonresident, a state cannot tax that branch on a residence basis; instead, the state must use a source-based tax. Source-based taxation requires the use of an apportionment formula, a method not granted to banks (except banks incorporated in a foreign country) by the statute.

3. The Tax Base

Banks subject to the Massachusetts bank tax must pay a tax at the rate of 12.54% on their net income. "Net income" is defined as:

> [t]he gross income from all sources, without exclusion, for the taxable year, less the deductions, but not credits, allowable under the provisions of the Federal Internal Revenue Code .... Deductions with respect to the following items, however, shall not be allowed:--
>
> (i) dividends received,
>
> (ii) losses sustained in other taxable years, and
>
> (iii) taxes on or measured by income, franchise taxes measured by net income, franchise taxes for the privilege of doing business and capital stock taxes imposed by any state of the United State, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States or any foreign country, or a political subdivision of any of the foregoing.

Except for the above three adjustments, the state's bank tax base "piggybacks" on the federal tax base. Some argue that Massachusetts should partially decouple from the Internal Revenue Code. As an example of the unfairness created by the piggyback, Massachusetts bankers cite IRC section 291 (a) (3). That section disallows all deductions for expenses associated with earning income from tax exempt bonds. Since Massachusetts taxes these

bonds, the reason for the disallowance of expenses at the federal level is not present at the state level. Because the state tax also disallows the same deduction for general business corporations, the issue is primarily one of revenue, not fairness.

As will be seen in Section B, infra, the statutory net income base of banks differs markedly from that of general business corporations.

4. Revenue

According to the Commonwealth's Financial Report, total state revenues in 1984 were $8,382,082,000. Table 1 shows the contribution of each of eight major revenue-producing categories to the total for the years 1975-1984. Taxes represent roughly two thirds of the state's total tax revenue.

Table 2 illustrates state tax revenue by source for the years 1975-1984. It shows that in 1984, banks paid $100,227,000 in state tax -- 1.8% of the state's total tax receipts. Over the 10 year period, bank tax collections increased 152 percent from $39,628,000 to $100,227,000, an average compound growth rate of 11 percent. During that same period, total tax collection increased 171 percent from $2,088,572,000 to $5,659,551,000, an average compound growth rate of 12 percent. Thus, relative to total tax revenues, the contribution of banks has decreased from 1975-1984.

B. Neutrality/Fairness: Structural and Rate Difference within

TABLE 1: STATE REVENUES, 1975 - 1984

COMMONWEALTH OF MASSACHUSETTS
REVENUES BY SOURCE
ALL GOVERNMENTAL FUNDS
For the Fiscal Years Ended June 30, 1975 - 1984
(000's Omitted)

SOURCE	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
TAXES	$2,088,572	$2,652,497	$2,843,043	$3,208,787	$3,521,084	$3,830,970	$4,193,981	$4,637,466	$4,992,353	$5,659,551
FEDERAL REIMBURSEMENTS	$597,830	$785,678	$835,374	$951,787	$1,087,746	$1,114,712	$1,169,148	$1,207,237	$1,254,213	$1,161,263
FEDERAL GRANTS	$351,874	$461,731	$484,196	$618,209	$596,574	$712,738	$687,416	$608,142	$618,306	$639,069
FEDERAL REVENUES SHARING	$64,953	$68,824	$68,133	$88,657	$75,758	$72,729	$36,212	$2,244	$1,546	
FEES, REIMB., SALES, ETC.	$162,959	$200,199	$246,649	$276,526	$307,293	$387,675	$400,252	$455,131	$562,444	$581,243
ASSESSMENTS	$71,361	$81,391	$76,977	$83,718	$90,273	$95,055	$93,622	$100,070	$109,557	$100,004
MOTOR VEHICLE LIC. & REGIS.	$58,685	$55,038	$62,274	$59,167	$65,706	$64,776	$103,102	$110,993	$118,404	$128,257
LOTTERY	$37,581	$44,346	$53,737	$47,074	$52,560	$63,058	$73,842	$85,586	$97,051	$112,695
TOTAL REVENUES	$3,433,815	$4,349,704	$4,670,383	$5,333,925	$5,796,994	$6,341,713	$6,757,575	$7,206,869	$7,753,874	$8,382,082

TABLE 2: STATE TAXES, 1975-1984

COMMONWEALTH OF MASSACHUSETTS
TAX REVENUES BY SOURCE
ALL GOVERNMENTAL FUNDS
For the Fiscal Years Ended June 30, 1975 - 1984
(000;s Omitted)

SOURCE	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
INCOME	$985,616	$1,216,149	$1,191,541	$1,433,577	$1,631,384	$1,860,033	$2,057,945	$2,324,052	$2,472,278	$2,790,067
SALES AND USE	$314,838	$472,491	$594,966	$681,851	$717,710	$745,996	$859,716	$917,362	$1,051,712	$1,248,045
CORPORATIONS	$222,866	$271,145	$324,511	$332,685	$400,640	$438,860	$441,922	$498,002	$506,093	$577,390
MOTOR FUEL	$179,913	$205,667	$214,168	$217,017	$223,739	$212,035	$237,528	$269,297	$250,425	$274,916
CIGARETTE	$85,836	$149,157	$142,759	$142,972	$142,272	$144,018	$148,555	$145,357	$142,912	$169,999
INSURANCE	$74,369	$92,708	$95,314	$103,227	$105,433	$111,517	$114,083	$122,217	$134,890	$134,937
INHERITANCE AND ESTATE	$61,174	$58,707	$71,924	$87,944	$75,312	$78,952	$82,020	$99,355	$111,850	$127,138
ALCOHOLIC BEVERAGES	$64,545	$76,752	$77,084	$79,631	$79,979	$80,631	$84,747	$85,059	$82,709	$83,762
BANKS	$39,628	$37,771	$44,077	$44,913	$55,433	$70,456	$76,505	$70,204	$113,979	$100,227
STATE RACING	$34,984	$34,265	$33,767	$29,831	$28,620	$29,474	$32,268	$33,271	$35,458	$36,828
PUBLIC SERVICE	$6,028	$16,615	$29,438	$26,328	$27,785	$23,068	$17,642	$30,077	$40,482	$52,017
ROOM OCCUPANCE	$9,665	$10,515	$11,050	$13,539	$15,526	$17,831	$22,094	$24,290	$27,510	$32,224
DEEDS	$6,239	$7,252	$8,853	$10,728	$12,415	$12,246	$12,967	$12,492	$13,709	$22,318
BEANO	$1,958	$2,504	$2,764	$3,610	$3,908	$4,357	$4,694	$4,982	$5,277	$5,376
SUNDRY	$913	$799	$827	$934	$928	$1,496	$1,295	$1,449	$3,069	$4,307
TOTAL TAX COLLECTIONS	$2,088,572	$2,652,497	$2,843,043	$3,208,787	$3,521,084	$3,830,970	$4,193,981	$4,637,466	$4,992,353	$5,659,551

Massachusetts

Tax neutrality means that taxes should interfere with decisions of taxpayers to a minimal extent. That is, tax provisions should apply in an even-handed manner to different industries. Fairness requires that all taxpayers bear their "fair share" of the total tax burden. Thus, one can measure the neutrality and fairness of the Massachusetts' bank tax by comparing it to the state's general business corporate tax.

1. Structural Differences

The structure of the two taxes is very different. Like the bank tax, the calculation of net income for the purposes of the general business corporation tax begins with the federal definition of gross income. Thereafter, the bases of the two taxes have little in common. For example, the following state exclusions and deductions from the taxable net income of a business corporation have no counterpart in the bank tax: (a) the exclusion of some dividends from the taxable net income base, (b) a deduction for net operating losses for certain corporations, (c) a deduction for 25 percent of the wages paid to eligible poverty area employees, and (d) a deduction for 50 percent of the contributions of computer equipment and software to any tax-exempt organization in Massachusetts for use in elementary or secondary education.

Other structural differences between the two taxes are more significant. In particular, sections 38 and 32B of the general business tax provide important statutory benefits to general

business corporations that are not granted to banks. First, pursuant to section 38, the business corporation tax is a source-based tax. Both domestic and foreign corporations which have income that is taxable within and without Massachusetts pay tax on only that fraction of their income which is attributable to Massachusetts by a three-factor formula. Thus, no Massachusetts business corporation will be subject to multiple taxation and no foreign business corporation will escape statutory taxation.

Second, according to section 32B two or more business corporations, domestic or foreign, which have filed a federal consolidated return and which have a taxable nexus in Massachusetts may choose to pay tax on their combined net income. Business corporations choosing this option can reduce their Massachusetts tax liability by offsetting the losses of one subsidiary against the income of another.

2. Rate Differences

It is relatively easy to compare the structural differences between the bank and business taxes, to identify the statutory advantages given to business corporations and to conclude that the Massachusetts bank tax structure is not neutral when compared to the structure of the business tax. These structural differences make it impossible to compare the tax rates of the two taxes in the same straightforward manner. Not only do the two tax bases differ, but the business corporation tax is not a straight net income tax. Instead, that tax has two parts, a net income tax component and a property or net worth tax component.

The nominal rate on net income attributable to Massachusetts is 9.54%; the rate on property or net worth is $2.60 per $1000 of property attributable to Massachusetts.

Because of the impossibility of direct rate comparison between the bank tax and the business tax, studies have used indirect methods to calculate the differences in the rates. In a 1984 study by the Executive Office for Administration and Finance, the authors sought to estimate the amount of tax that commercial banks would pay under the structure of the general business tax. Using FDIC operating statistics, the authors projected the aggregate amount of tax that Massachusetts' banks would have paid if they had been subject to the general corporate excise during the years 1980-1982. The projections are only rough approximations since the authors had to use nominal rates and since the bank tax liability was based on FDIC statistics on banks' income tax reserves, figures that typically overstate the liability.

Table 3 displays those projections. The calculations show that, in the aggregate, commercial banks would have paid 17% less state tax under the business corporation excise than they reserved for commercial bank taxes in Massachusetts. This translates into an aggregate tax savings to commercial banks of $10,000,000 per year. Bank tax savings would have been greater under an apportionment formula.

C. Competitiveness: Rate Differentials Across States.

Effect of Taxing Commercial Banks Under the Corporation Income Tax

		80	81	82
1.	Equity	$1,847.7M	$2,030.9M	$2,240.3M
2.	Bank premises, furniture and fixtures	532.0	605.4	686.0
3.	Less: mortgage indebtedness	47.1	47.6	44.8
4.	Net	484.9	557.8	641.2
5.	Net worth [(1)-(4)]	1,362.8	1,473.1	1,599.1
6.	Income before taxes and securities transactions	364.1	411.7	452.5
7.	Bank tax at 12.54% rate (current)	45.66	51.63	56.74
8.	Corporate income tax at 9.50%	34.59	39.11	42.99
9.	Corporate net worth at 0.26%	3.54	3.83	4.16
10.	Total corporate tax	$38.13M	$42.94M	$47.15M
11.	Corporate tax as % of bank tax [(10)/(7)]	84%	83%	83%
12.	Bank tax less corporate tax [(7) - (10)]	$7.5M	$8.7M	$9.6M

Note: Projected bank excise liability (line 7) is taken from FDIC statistics on banks' income tax reserves and is substantially higher than actual collections in 1980-82. Therefore the projected savings (line 12) are also likely overstated.

Source: FDIC Bank Operating Statistics, and Budget Bureau calculations.

Generally the competitiveness of a tax is tested by comparing tax burdens across states. Corporate taxpayers argue that tax rates which are out of line with national averages discourage businesses from locating or expanding their operations within that state. Using the rate comparison method as our guideline, how competitive is the Massachusetts bank tax?

1. Nominal Rates

The nominal rate on the net income of Massachusetts' banks is 12.54%. According to the study conducted by the Executive Office for Administration and Finance, the Massachusetts nominal rate is one of the highest in the nation. Table 4 lists the states and their nominal rates.

However, there are at least two reasons that this nominal rate does not accurately measure the competitiveness of the Massachusetts bank tax. First, many states either do not use an income tax at all or use such a tax only in combination with a deposits, shares or other tax. For these states, the authors of the study calculated equivalent income tax rates using FDIC average income and asset data which may not reflect the true picture in each state. A second and more serious flaw in using nominal rates to measure the competitiveness of the state tax is that such rates do not take into account either the depth of the tax base or the breadth of the administrative enforcement of the law. The latter two variables determine in large part the amount of tax that the taxpayer will actually pay.

2. Effective Rate

TABLE 4

COMPARISON OF NOMINAL STATE TAX RATES: 1984

State	Income only (I) or deposit and other (D) tax base	Rate
New York	I	13.823%
MASSACHUSETTS	I	12.54
Minnesota	I	12.0
Hawaii	I	11.7
Connecticut	I	11.5
California	I	10.9
Nebraska	D	10.27
District of Columbia	I	9.9
New Hampshire	I	9.32
New Jersey	I	9.0
Delaware	I	8.7
Nevada	D	8.08
Rhode Island	I	8.0
Wisconsin	I	7.9
Idaho	I	7.7
Tennessee	D	7.59
Oregon	I	7.5
North Carolina	D	7.27
Alaska	I	7.0
Missouri	I	7.0
North Dakota	I	7.0
Pennsylvania	D	6.82
Mississippi	D	6.59
Arizona	I	6.5
Kansas	I	6.375
Kentucky	D	6.03
Alabama	I	6.0
Arkansas	I	6.0
South Dakota	I	6.0
Florida	D	5.63
Colorado	I	5.0
Iowa	I	5.0
Utah	I	5.0
New Mexico	I	4.8
Virginia	D	4.52
South Carolina	I	4.5
Oklahoma	I	4.0
Maryland	D	3.58
38-state average		7.554%

Note: I (income) states are those with an income tax only, or income plus minor (estimated equivalent rate less than 0.2%) other taxes. D (deposit and other) states have major deposit, share, or other taxes in addition to or in place of income taxes.

The effective tax rate, which measures the amount of tax actually paid, provides a clearer picture of the tax burdens across states. Two Massachusetts studies have compared effective state tax rates on banks. A 1980 study by Peter Merrill calculated taxes paid by banks in twenty (20) states as a percentage of their assets. The study showed that the tax burden in Massachusetts was higher than in any other state in the study. Unfortunately, the Merrill study is unreliable. The authors of the study admit that many states included in the study used a tax basis other than or in addition to net income, and that those states were unable to provide accurate payment data. In some cases, the authors used FDIC data to fill in the gaps; but the FDIC data did not include deposits, share or equity tax collections. For these reasons, the study seriously understated the effective tax burden in many states.

The study conducted by the Executive Office for Administration and Finance compared effective bank tax rates among twenty eight (28) states. In order to improve the reliability of their study, the authors did not include the twenty two (22) non-income tax states. Tables 5 and 6 show the results of their comparisons. Table 5 compares tax burdens among the twenty-eight states using FDIC bank data, FDIC state/local tax data and actual tax collection data from the seven state that were able to provide separate information on bank tax revenues. Over a three-year period -- FY 80-82 -- Massachusetts ranked fifth in average bank tax burden. Massachusetts exceeded the

TABLE 5

	Tax Type I=income B=dep,sh	Actual Taxes	Income Before Taxes ($millions) 1980	1981	1982	Reserve for Income Taxes ($millions) 1980	1981	1982	Tax Burden (Res/Inc.) (percent) 1980	1981	1982	Ave. 1980-82
D.C.	I		95.88	94.77	93.12	13.5	14.8	13.6	14.08	14.77	14.68	14.49
R.I.	I	A	49.91	39.98	47.37	5.5	5.6	5.9	11.05	13.95	12.47	12.49
N.J.	I	A	287.52	343.38	397.41	31.9	35.5	48.5	11.09	10.33	10.19	10.54
Minn.	I		357.38	388.24	408.09	37.7	33.4	36.6	10.55	8.78	9.15	9.49
MASS.	I	A	364.06	411.71	452.48	46.3	32.1	38.4	12.73	7.80	6.72	9.09
Conn.	I		141.79	151.45	113.78	11.5	14.5	10.2	8.11	9.57	8.96	8.88
Ore.	I		131.41	82.93	54.33	9.3	6.5	5.2	7.08	7.84	9.57	8.16
Calif.	I	A	2214.18	1775.58	1317.87	126.1	116.5	157.1	5.69	6.56	11.92	8.06
N.Y.	I	A	4167.17	4497.18	4589.88	271.8	346.8	333.8	6.58	7.69	7.26	7.15
Visc.	I		382.61	299.12	361.79	19.8	28.8	29.5	6.54	6.69	8.15	7.13
Ariz.	I		165.57	165.79	155.98	8.4	9.6	7.9	5.07	5.79	5.07	5.31
N.Dak.	I		76.79	85.39	71.52	3.7	4.1	4.2	4.82	4.88	5.87	5.16
Penn.	D(I)	A	708.87	799.82	855.34	46.6	39.1	33.2	6.57	4.98	3.88	5.12
Idaho	I		69.82	55.56	57.85	3.8	2.6	2.8	5.44	4.68	4.84	4.99
Del.	I	A	44.87	58.86	94.51	2.5	2.2	4.1	5.73	4.36	4.31	4.88
Kansas	I		267.31	285.85	284.83	12.2	13.2	14.5	4.56	4.63	5.11	4.77
Iowa	I		335.69	342.23	276.76	15.8	15.5	13.5	4.47	4.53	4.88	4.63
S.Dak.	I		81.84	83.63	148.49	3.2	3.2	7.9	3.91	3.83	5.32	4.35
Ala.	I		288.41	218.91	215.11	8.2	8.1	9.8	4.89	3.78	4.56	4.12
N.H.	I		75.65	85.35	84.17	4.2	4.7	1.0	5.55	5.51	1.19	4.08
Alaska	I		23.19	41.46	55.28	1.0	1.3	2.5	4.31	3.14	4.53	3.99
Hawaii	I		64.72	54.68	78.62	3.7	1.4	2.6	5.72	2.56	3.68	3.99
Utah	I		91.42	78.48	84.97	2.9	2.5	2.2	3.17	3.19	2.59	2.98
Okla.	I		344.14	426.98	329.48	7.9	8.8	7.7	2.30	2.06	2.34	2.23
Mo.	I		446.66	478.57	428.64	9.2	9.1	9.9	2.06	1.98	2.35	2.18
S.C.	I		116.82	119.65	131.32	1.8	1.5	1.4	1.54	1.25	1.07	1.29
Colo.	I		271.37	314.28	187.78	6.2	6.4	-2.8	2.28	2.04	-1.07	1.09
Ark.	I		123.96	129.46	127.85	8.8	8.4	8.4	8.65	8.31	8.31	8.42
Fla.	D		672.52	618.26	671.68	18.4	15.5	15.2				
Ga.	D		366.36	392.11	353.52	8.9	1.8	8.3				
Ill.	D		1133.74	1192.72	958.97	21.8	17.1	6.4				
Ind.	D		326.46	218.33	188.89	5.5	4.9	3.5				
Ky.	D		275.91	298.48	286.48	8.1	8.1	8.1				
La.	D		482.88	498.97	495.84	8.5	8.1	8.1				
Maine	D		32.37	27.39	35.78	8.2	-8.2	8.2				
Md.	D		181.87	218.86	284.84	18.1	18.4	13.2				
Mich	D		376.11	283.74	334.44	1.5	1.1	1.3				
Miss.	D		137.72	131.88	188.15	8.5	8.5	8.2				
Mont.	D		84.88	77.81	81.63	5.5	4.7	4.8				
N.C.	D		279.91	318.36	387.96	1.3	1.1	1.8				
N.M.	D		32.86	31.95	32.85	8.3	8.3	8.1				
Neb.	D		222.38	239.58	289.39	6.2	6.1	5.8				
Nev.	D		68.68	56.22	48.76	8.8	8.8	8.8				
Ohio	D		628.23	564.58	577.47	8.5	8.1	8.2				
Tenn.	D		249.45	248.13	248.84	7.1	4.5	6.4				
Texas	D		1685.82	2188.28	2825.88	9.3	8.4	8.2				
Va.	D		235.51	269.37	318.82	8.5	8.9	1.1				
Vt.	D		21.67	21.17	26.79	8.4	8.8	8.6				
W.Va.	D											
Wash.	D		238.11	246.35	-93.81	8.7	8.3	8.8				
Wyo.	D		68.88	78.78	69.83	8.8	8.8	8.8				

TABLE 6

Commercial Bank Tax Burden Analysis
FDIC Income and Tax Reserve Data

	Tax Type Insurance Bodeposit etc	Income Before Taxes (millions) 1980	1981	1982	Reserve for Income Taxes (millions) 1980	1981	1982	Tax Burden (Res/Inc.) (percent) 1980	1981	1982	Ave. 1980-82
D.C.	I	93.08	94.77	98.12	13.5	14.0	13.6	14.06	14.77	14.66	14.49
Mass.	I	344.64	411.71	453.68	44.3	33.1	36.4	11.32	10.03	10.63	10.66
Calif.	I	3814.10	1775.58	1817.87	310.3	155.6	183.6	9.36	8.76	10.39	9.51
Minn.	I	387.16	388.34	488.89	37.9	33.8	36.6	10.35	8.76	9.15	9.47
R.I.	I	69.91	39.96	67.37	6.3	6.3	6.3	8.43	10.76	9.88	9.42
N.Y.	I	4167.17	4497.18	4589.88	385.3	491.7	369.6	13.13	10.88	8.78	8.93
Conn.	I	161.79	131.45	113.78	11.5	14.5	48.3	8.11	8.57	8.96	8.38
Ore.	I	181.41	81.92	54.33	9.3	6.5	8.3	7.86	7.84	9.57	8.16
Wisc.	I	883.61	399.13	361.79	19.8	38.8	39.5	6.54	6.69	8.15	7.13
Ariz.	I	165.57	165.79	155.98	8.4	9.6	7.9	5.07	5.79	5.07	5.31
N.Dak.	I	76.79	85.39	71.53	3.7	4.1	4.3	4.83	4.88	5.97	5.16
Idaho	I	69.83	55.56	57.85	5.8	3.4	3.8	8.44	6.48	6.84	6.99
Kansas	I	367.31	385.83	386.53	13.3	15.3	14.5	4.56	4.63	5.11	4.77
Del.	I	66.87	58.66	94.51	3.4	3.1	4.3	5.45	6.19	6.44	6.69
Iowa	I	385.69	341.33	376.76	15.8	15.5	13.5	4.67	4.53	4.88	4.63
N.J.	I	387.53	343.33	397.41	11.1	14.4	11.8	3.86	4.19	3.34	4.53
S.Dak.	I	81.86	83.63	148.69	3.3	3.3	7.9	3.91	3.83	5.83	4.35
Ala.	I	388.41	318.91	313.11	8.3	8.1	9.6	4.89	3.78	4.84	4.13
N.H.	I	75.65	85.35	84.17	4.3	4.7	5.6	5.55	5.51	5.89	4.88
Alaska	I	33.19	41.44	55.38	1.8	1.3	3.5	4.31	3.14	4.53	3.99
Kansas	I	44.72	34.48	78.63	3.7	1.4	3.6	3.73	3.34	3.68	3.99
Utah	I	91.63	78.48	84.97	3.9	3.5	3.3	3.17	3,19	3.89	3.98
Okla.	I	344.14	426.98	339.48	7.9	8.8	7.7	3.98	3.66	3.36	3.35
Mo.	I	466.66	478.57	438.44	9.3	9.1	9.9	3.86	3.98	3.35	3.18
S.C.	I	116.83	119.45	181.33	1.8	1.5	1.4	1.56	1.25	1.07	1.29
Colo.	I	371.39	316.38	187.78	6.3	6.4	-3.8	3.38	3.84	-1.87	1.89
Ark.	I	133.96	139.46	137.85	8.8	8.4	8.4	8.63	8.31	8.31	8.63
Fla.	B	473.53	618.36	471.68	15.4	15.5	15.3				
Ga.	B	366.36	393.11	353.33	8.9	1.8	8.3				
Ill.	B	1133.76	1193.73	958.97	31.8	17.1	4.4				
Ind.	B	336.46	318.33	188.89	5.3	4.9	3.5				
Ky.	B	173.91	198.46	386.48	8.1	8.1	8.1				
La.	B	683.88	698.97	695.84	8.5	8.1	8.1				
Maine	B	33.87	37.39	33.78	8.3	-8.3	8.3				
Md.	B	181.87	318.86	386.84	18.1	18.4	13.3				
Mich	B	376.11	333.76	336.44	1.5	1.1	1.3				
Miss.	B	137.73	131.88	186.15	8.5	8.5	8.3				
Mont.	B	84.88	77.81	81.68	5.5	6.7	6.8				
N.C.	B	379.91	313.36	347.96	1.3	1.1	1.8				
N.M.	B	53.84	51.95	53.85	8.3	8.3	8.1				
Neb.	B	338.38	339.58	389.39	6.3	6.1	5.8				
Nev.	B	48.48	56.33	48.76	8.8	8.8	8.8				
Ohio	B	636.33	566.58	577.47	8.5	8.1	8.3				
Penn.	B	766.67	799.83	855.84	3.6	1.8	8.1				
Tenn.	B	347.45	348.13	346.84	7.1	6.5	6.4				
Texas	B	1685.83	2186.38	2835.88	9.3	8.4	8.5				
Va.	B	333.51	369.37	318.82	8.5	8.9	1.1				
Vt.	B	31.47	31.17	36.79	8.8	8.8	8.4				
W.Va.	B	162.73	185.53	116.16	8.6	8.5	8.3				
Wash.	B	338.11	344.35	-93.81	8.7	8.3	8.8				
Wyo.	B	48.88	78.78	49.33	8.8	4.8	8.8				

	1980	1981	1982
Average Burden			
51 states	5.41	6.77	5.37
Income only (37)	3.78	8.83	5.83
Mass as % of U.S. (37 states)	138.88	134.99	199.88	131.3%

Mass using actual 80-82 tax data.

Mass.	I	344.64	411.71	453.68	44.3	33.1	36.4	12.85	8.04	8.03
Mass as % of U.S. (37)								344.38	97.16	134.38	133.93

Nat'l Ave (37) excluding MT

8.99	8.84	8.83

average by 43% over the three years.

Table 6 compares the tax burdens using straight FDIC data. Here, Massachusetts ranks second among the 28 states. In a variant of the above method, the authors reported the results using actual tax collection data for Massachusetts and FDIC data for all other states. Using this latter method, the Massachusetts tax is 23% above the national average.

The wide spreads reported in these studies in the ranking of the Massachusetts tax burden across states and in the percentage by which the Massachusetts tax varies from the national average testify to the difficulty of pinpointing Massachusetts' place on the tax burden ladder. Nevertheless, it is possible to conclude that the Massachusetts bank tax ranges from 23-43 percent above the national average.

3. Effect on Bank Performance and Activity in Massachusetts

Concluding that the state bank tax is higher than the national average solves only one part of the competitive equation. Next, one must examine the effect of the state tax on bank performance and on bank economic activity within Massachusetts.[51]

The Peter Merrill study briefly investigated the effect of Massachusetts' bank tax on bank performance and economic activity. The study found a negative correlation between bank taxes and growth of bank assets and a positive relationship between assets and job growth. Merrill concluded that the "heavy taxes on Massachusetts banks have restricted the growth of the

banking industry, which is turn has limited the amount of credit the industry could make available for investment in the economic development of the Commonwealth."

On the other hand, the study conducted by the Executive Office for Administration and Finance, using the same data, reached the opposite conclusion -- the states with the most banking activity (the highest concentration of assets) are those with the highest taxes. Moreover, this study found that, in terms of employment growth and profitability, commercial banks in Massachusetts are strong. Table 7 shows that profitability for the state's banks exceeded the national average over the 1980-1982 period (20.1 percent income-to-equity ratio, compared to 16.7 percent nationwide ratio); when adjusted to reflect the relatively higher tax burden imposed in Massachusetts, the average profitability was still three points ahead of the national average.

D. Exportability

Most states seek exportability of taxes in setting their tax policy. They prefer taxes borne by nonresidents to those borne by residents of the state.

Three aspects of the Massachusetts bank tax are particularly relevant to the issue of exportability: the lack of source-based taxation, the narrow definition of a bank, and restricted jurisdiction.

1. Lack of Source-based Taxation

TABLE 7

Commercial Bank Profitability: Mass. vs. the U.S., 1980-1982
($ millions)

	United States				Massachusetts			
	80	81	82		80	81	82	
Assets	$1,855,688	$2,028,980	$2,193,339		$36,205.5	$39,908.3	$44,687.5	
Equity	107,596	118,301	128,833		1,847.7	2,030.9	2,240.3	
Income	19,505	20,230	19,244		364.1	411.7	452.5	
Income/ Equity	18.1%	17.1%	14.9%	3-yr ave 16.7%	19.7%	20.3%	20.2%	3-yr ave 20.1%
Income/ Assets	1.05%	1.0%	0.88%	.95%	1.01%	1.03%	1.01%	1.02%

Source: FDIC Bank Operating Statistics, and Budget Bureau calculations.

As we have noted previously, the statute does not provide for source-based taxation through an apportionment formula. The result is anomalous vis-a-vis the principle of exportability. Banks domiciled in Massachusetts must pay tax on all of their income even if a portion of it is earned by a branch located in, say, Connecticut, and even if Connecticut taxes that portion.[52] And, nondomiciliary banks doing business through a branch located in Massachusetts escape tax entirely.

2. Narrow definition of "Bank"

Certain subsidiaries of out-of-state banks that provide less than full service banking, such as loan production offices, are not taxed as banks because they do not meet the regulatory definition of a bank. Instead, such subsidiaries are taxed as general business corporations. According to data compiled by the Massachusetts Department of Revenue, these subsidiaries typically pay little or no tax.

The tax liability of such bank subsidiaries is calculated by using the apportionment formula for general business corporations. Because that apportionment formula was not intended for use with banks and bank-like entities, it does not include a factor that measures intangible property, the primary means by which banks and bank-like entities (such as loan production offices) earn income. Moreover, the income base of such subsidiaries is likely to be very small. Loans negotiated at a loan production office are "closed" or finalized only at the headquarters office of the out-of-state bank. The local LPO

usually pays a fee to its parent for this service which reduces its Massachusetts income considerably (the parent's income is not taxed by the Commonwealth). This combination of the use of an apportionment formula which does not accurately measure the in-state activity of the subsidiary and an income base which is reduced by management fees paid to the out-of-state parent results in an artificially low tax liability in Massachusetts.

3. Restricted Jurisdiction

The third prong of the exportability issue is more subtle. Today, many out-of-state banks engage in numerous banking activities in all states including Massachusetts and do so without having a brick-and-mortar presence in those states. For example, a large fraction of the credit cards held by residents of all states is issued through the mail by out-of-state banks. These absent, nonresident banks earn interest and fee income from Massachusetts residents who use these cards.[53] Although this income is from Massachusetts sources, it is not taxed by the Commonwealth. The reason for this situation (in addition to the lack of a statutory apportionment formula) is a restricted jurisdictional rule.

Currently , Massachusetts does not tax out-of-state banks which earn income from business that they transact with the state's residents if those out-of-state banks do not have a physical location in Massachusetts. Because of this practice, much Massachusetts-source income goes untaxed. Banks and bank-like entities find it particularly easy to conduct business

across state lines by periodic visits and by mail, telephone, or other electronic means. In addition to the credit card activities, out-of-state banks conduct full-service banking by mail, telephone and automatic teller machines, and solicit loans by sending call officers (representatives) into the state.[54] Out-of-state banks which conduct their in-state activities through the mail, by telephone or through periodic visits are the quintessential nonresidents since they do not own property in Massachusetts and do not employ persons in the state, and do not pay tax to Massachusetts despite the fact that they derive substantial revenue from the state.

E. Other Considerations

1. Cost Effectiveness

Cost effectiveness requires that only those tax incentives that are cost effective in achieving their goals be utilized. In general, the Commonwealth has not provided any specific tax incentives for banks, and so the bank tax cannot be judged against the criteria of this category. Of course, some bank subsidiaries that are taxed as general business corporations may be able to take advantage of one or more of the tax incentives granted to business corporations. But these incentives were not designed for banks or bank-like entities.

2. Stability

Stability refers to the minimization of annual fluctuations over the business cycle. A tax measured by annual net income

does not necessarily provide a stable revenue base; a bank which experiences a net loss will pay virtually no tax. Arguably, a business that experiences a net loss in one or more years should still pay tax because taxes are, at least in part, an exaction for the benefits and protections provided by the state. A corporation operating at a loss continues to receive state benefits and protections similar to those received by profitable businesses.

The bank tax statute does provide for a minimum tax. However, the tax -- in the amount of $288 -- appears to be a token tax rather than an alternative tax assessed according to a benefits principle. Apparently, the Commonwealth has paid heed to considerations other than revenue in setting the minimum tax rate.

3. Simplicity

Simplicity means that there are no unnecessary burdens in terms of both administration and compliance. From the point of view of the Revenue Department, the present bank tax is not burdensome to administer. In general, a residence-based tax is far easier to administer and enforce than a source-based tax which requires the use of an apportionment formula.

Massachusetts bankers, on the other hand, complain that the current system unnecessarily complicates their compliance with the law. As noted previously, a nonbank branch of a Massachusetts bank is taxed under the bank statute while a nonbank <u>subsidiary</u> is taxed under the more favorable general

business tax statute. This system encourages banks to operate their branches as subsidiaries, increasing both the complexity of their corporate structure and their costs. Since this kind of corporate restructuring to take advantage of legal loopholes is a common "tax planning" tool, it would probably occur under any tax structure that the state could devise. Consequently, it is difficult to ascribe the increased complexity in the corporate organization of banks to the current method of taxing banks.

Massachusetts bankers also maintain that their compliance task would be easier if the statute contained provisions for filing a consolidated or combined return. This contention has merit and is covered more fully in section IV.

F. Summary

When tested against the criteria of a "good" tax, the Massachusetts bank tax gets low marks in several areas. The deficiencies in the tax appear to be largely the result of historical forces rather than conscious tax policy decisions. Consider, for example, the external environment existing at the time the tax was drafted: (a) State and federal laws combined to prohibit interstate branching, (b) federal laws restricted the methods by which states could tax national banks, (c) banks were subject to regulatory rate restrictions which limited competition among banks, (d) nonbank corporations did not compete with banks.

Now, consider the situation today: (a) Nearly every state has passed laws permitting some form of interstate branching, (b)

Congress has removed all restrictions on nondiscriminatory state taxation of national banks, (c) Congress has lifted all regulatory rate restrictions, and (d) many nonbank corporations engage in activities in competition with banks.

Most of these changes have occurred since 1976. Yet, the Commonwealth has not significantly revamped the structure of its bank tax since 1925. Therefore, with regard to state taxes, Massachusetts-based banks operate at a disadvantage in today's more competitive environment. The structure of the current tax is neither neutral nor fair when measured against the structure of the tax on general business corporations.

Unlike banks, general business corporations may apportion their income, paying tax on only that amount which is attributable to sources within Massachusetts, and they may file consolidated returns and deduct some dividend income from their Massachusetts taxable income. General business corporations also appear to have a rate advantage over banks, although the magnitude of this advantage is difficult to measure because such corporations must also pay a property tax.

Under the present tax, Massachusetts banks also suffer a rate disadvantage vis-a-vis their interstate competitors. Again, although the magnitude of the rate variance can only be estimated, it appears to range from 23 to 43 percent above the average.

Finally, the Commonwealth's bank tax scores very low in the area of exportability. Indeed, the tax favors out-of-state banks

over in-state banks.

Section III describes and analyzes several options for increasing the neutrality, fairness, competitiveness and exportability of the tax.

III. OPTIONS FOR REFORM

The shortcomings of the present bank tax can be addressed in one of two ways. First, the legislature could amend the bank tax so that it conforms more closely to the tax on general business corporations. This might entail, for example, adding new sections to provide for one or more of the following: apportionment of income, filing of consolidated returns, rate relief, a partial exclusion of dividend income from the tax base, or a partial exclusion of income from state and federal obligations from the tax base. Alternatively, the Commonwealth could choose to rewrite the bank tax completely. The new law might apply, for example, to all competing financial institutions whether or not they are "banks". Like the first option such a new law might provide for apportionment, consolidated returns, rate relief, etc.

This initial decision -- to retain a separate tax on banks or to draft a new tax law for financial institutions -- is revenue neutral. After one determines which entities are subject to the tax, the next step is to design the structure and rate of the tax. It is here that revenue considerations come to the forefront.

This section begins with an analysis of the options for classifying the entities which will be subject to the tax and ends with an analysis of the choices for structural change.

A. Definitions of Financial Institutions for Purposes of Taxation

It is significant that major money-center states which have to date modernized their bank taxes have extended the reach of their new taxes beyond the regulatory definition of a bank. Several considerations dictate this result. Perhaps the most important one is that it is illogical to tax like institutions under different systems. To take an example from the Massachusetts bank tax, why should a loan production office which is a subsidiary of a bank be permitted to apportion its interest and fee income under the general business tax while a bank engaged in the same activity cannot? The solution to this question does not lie in giving banks the same right to apportion their income since the loan production office would remain subject to a different and often more favorable apportionment formula. The answer to the problem is to define "bank" in such a way as to include loan production offices and other such financial institutions under the same tax.

On the other hand, an expanded definition of a bank may increase the complexity of the law unless the statute clearly defines the financial institutions that are subject to the tax. Fortunately, two states have had some experience with an expanded definition of a bank.

1. New York Definition

In 1985, New York completely revised its bank tax to make it similar to the state's tax on general business corporations.

Like Massachusetts, New York had not significantly changed its bank tax law since its enactment in 1926.[55] In its new law, New York has abandoned its previous reliance on the regulatory definition of a bank.

The new law applies to every "banking corporation" that is exercising its franchise or is doing business in New York. A "banking corporation" is defined as:

> (a) any corporation that is organized under the laws of New York, any other state, or country (U.S. or foreign) and that is doing a banking business, or
>
> (b) any corporation the stock of which is 65 percent or more owned or controlled by a bank holding company and that is engaged in a business that can be lawfully conducted by an entity described in (a) above or is engaged in a business that is so closely related to banking or managing or controlling or managing banks as to be a proper incident thereto.

Essentially, then, a banking corporation is one which is either doing a banking business or is a subsidiary of a bank holding company. The law defines a "banking business" as the business that a traditional bank is authorized to do and the business that any other corporation can do which is substantially similar to the business of a traditional bank.

The law makes the the task of revenue authorities and taxpayers easier because it clearly defines which entities are subject to the tax. This is done by regulations which give

specific examples of the kinds of entities which are banking corporations under (a) above and then by referencing the federal regulations that specifically list the subsidiaries of bank holding companies which are banking corporations under (b) above.

On the other hand, the gains in simplicity that arise from the specificity of the law must be weighed against the loss in flexibility. It is obvious that the financial markets are rapidly changing: new methods of financing are being developed and new competitors are appearing. In such an environment, a law which restricts the definition of a financial institution may be quickly outdated.

2. The American Bar Association Definition

The model federal statute proposed by the American Bar Association is an example of a law that contains a definition of a bank which is so restrictive that the entire law appears antiquated even though it is only five years old.

The model law applies only to a "depository" defined as any of the following: (a) a bank whose deposits are insured by the Federal Deposit Insurance Act, (b) an institution whose accounts are insured by the Federal Savings and Loan Insurance Corporation, (c) a thrift which is a member of a Federal home loan bank, (d) any other bank or thrift incorporated or organized under the laws of any state which is engaged in the business of receiving deposits, or (e) any company organized under the laws of a foreign country which maintains a branch or subsidiary in the U.S. and which receives deposits.

Today many non-depository institutions engage in financial activities in competition with banks. In such an environment, a law which limits its tax to depositories will fail to treat like institutions similarly.

3. The California Definition

California's law contains the broadest definition of a bank. The law provides for the apportionment of the income of banks and "financial institutions". Case law defines a financial institution as an entity which receives more than 50 percent of its gross income from the use of its capital in substantial competition with other moneyed capital. Published legal rulings provide examples based on actual situations. This method allows the state maximum flexibility. And, since a taxpayer can request an anonymous legal ruling on its particular situation, there is small loss in certainty.

B. Internal Structure of the Tax

As discussed above, the range of alternative definitions of a bank is very broad. The Commonwealth may decide to (a) define a bank broadly as California does, (b) choose a middle-ground definition of a bank as New York has, or (c) retain its present regulatory-based definition as the ABA model does. None of these threshold choices will limit the available options for structural reform. This section considers five areas of structural reform: the use of an apportionment formula, provisions for the filing of

consolidated or combined reports, changes in the tax base, enforcement considerations, and rate relief.

1. Model Apportionment Formulas: New York, ABA, California

The most compelling argument for the use of an apportionment formula is that such a provision will increase the neutrality, fairness, and exportability of the Massachusetts' bank tax. Although the U.S. Supreme Court has not yet ruled on the issue, an apportionment formula may also be Constitutionally required.

a. New York

The New York law requires all domestic and foreign "banking corporations" doing business in New York to apportion their income according to a three-factor formula: receipts, deposits, and payroll. The receipts factor is the ratio of receipts earned within New York to receipts earned everywhere. It includes: all income from loans, financing leases, rents; service charges, fees and income from bank, credit, travel and entertainment cards; net gains from trading and investment activities; fees from the issuance of letters of credit and traveler's checks; and all income from government bonds and all income from subsidiaries even though a portion of such income is excluded from the tax base. The regulation contains separate "siting" rules for each piece of the above income. The receipts sited to New York make up the numerator; the dominator contains the total receipts from all sources.

The deposits factor is the ratio of the average value of deposits maintained at branches within New York to the average

value of all deposits maintained at branches without New York.

The payroll factor is the ratio of 80 percent of in-state wages, salaries and other personal service compensation to total wages, salaries and other personal service compensation. The numerator of the payroll factor was limited to 80 percent to encourage banks to maintain a large employee base in New York.

The New York law provides for alternative computations of the tax base. The tax liability is the higher of the basic tax or one of the three alternative taxes. Tables 8 & 9 list and briefly describe the four alternatives. The apportionment formula applies only to the first two alternatives. If the taxpayer determines its New York tax liability using the entire net income base, it will calculate its apportionment percentage by adding the three factors together, giving double weight to the receipts and deposits factors, and dividing the result by five. If, on the other hand, the taxpayer uses the alternative entire net income base, it will add the three factors together and divide the result by three. The payroll factor remains the same under either tax base.

Even this brief overview of the New York law testifies to its complexity. The regulations alone cover some 200 pages. Nevertheless, the extensive use of examples in the regulations help to lessen the administrative and compliance burdens.

b. American Bar Association

The ABA model law contains a two-tier two-factor apportionment formula. Since the drafters of the model law

TABLE 8

OVERVIEW OF THE NEW YORK BANK TAX:
ALTERNATIVE BASES

1. Entire net income allocated to the State: 9%

2. Alternative entire net income allocated to the State: 3%

3. Alternative Minimum Tax:

   (a) 1/10 mill per dollar on allocated taxable assets (defined below)

   (b) 1/25 mill per dollar on allocated taxable assets if net worth ratio is less than 5% but greater than or equal to 4% of assets, provided 33% of total assets are in mortgages

   (c) 1/50 mill per dollar on allocated taxable assets if net worth ratio is less than 4% of the average total value of all its assets, provided 33% of total assets are in mortgages

Institutions with outstanding net worth certificates are exempt from this tax.

TABLE 9

DESCRIPTION OF THE ALTERNATIVE BASES

I. ENTIRE NET INCOME

Entire net income means total net income from all sources. It is the same as taxable income reported for U.S. tax purposes.

Additions to U.S. Taxable Income

The additions to be made to U.S. taxable income to derive State entire net income are limited to income from dividends or interest on any kind of shares, stocks, securities or indebtedness received by a corporation organized under the laws of a country other than the United States. The income affected includes income that is:

1. treated as effectively connected with the conduct of a trade or business in the United States pursuant to Section 864 of the Internal Revenue Code of 1954 ('54 Code); even if the income was excluded from the U.S. tax return under a tax treaty provision, or,

2. treated as effectively connected if the income were not excluded from gross income because of '54 Code Section 103.

Deductions from U.S. Taxable Income

The deductions (to the extent not deductible in determining U.S. taxable income) allowed in determining the entire net income have been modified to allow for:

1. Any amount of money or property received from the Federal Deposit Insurance Corporation (FDIC) even if a note is issued in exchange for the funds;

2. Any amount of money or property received from the Federal Savings and Loan Insurance Corporation (FSLIC), even if a note is issued in exchange for the funds;

3. 17% of interest income from subsidiary capital; 60% of dividend income, gains and losses from subsidiary capital; and

4. 22 1/2% of interest income on obligations of the State or its political subdivisions or of the United Stats, other than obligations held for resale in connection with regular trading activities.

The Act provides that the entire net income of an International Banking Facility (IBF) can continue as a deduction in determining the State entire net income. The Act also provides an annual election that allows the taxpayer to forego the deduction from total entire net income and treat the IBF as a branch outside of the State for allocation factor purposes (see below).

In addition, entire net income is computed without regard to the reduction in the basis of property because of any amount of money or other property received from the FDIC or FSLIC, pursuant to '54 Code Section 362.

II. ALTERNATIVE ENTIRE NET INCOME

Alternative entire net income, used under one of the alternative tax methods, means entire net income, as defined above, with the following modifications:

1. No deduction: for 17% of interest income from subsidiary capital; for 60% of dividends, or for gains and losses from subsidiary capital; but

2. Deduction for 22 1/2% of interest income on obligations of the State and its political subdivisions, or of the United States, other than for resale in connection with regular trading activities.

The annual IBF election, i.e., reduction of entire net income or modification of allocation factors, is to be consistently applied for the determination of both the entire net income and the alternative entire net income.

III. ALTERNATIVE MINIMUM TAX

Taxable Assets

This term is defined as the average total value of those assets that are properly reflected on a balance sheet, the income or expenses of which are properly reflected in the computation of alternative entire net income or eligible net income of an IBF. The following are excluded from taxable assets:

1. Money or other property received from or attributed to the FSLIC of FDIC in accordance with Federal National Housing Act (FNHA) 406(f)(1),(2),(3),(4); or

2. Interbank placements up to a maximum amount of $500 million, if 20% or more of a taxpayer's taxable assets are from interbank placements.

Net Worth Ratio

The term net worth ratio means the percentage of net worth to assets where the term net worth and assets are determined under the rules of FNHA Section 406(f)(B)(i).

Mortgages

The term mortgages means all loans secured by real property within or without the State including participation in pools of residential mortgages and loans secured by stock in a cooperative banking corporation. A U.S. government guarantee is not determinative. The average of the mortgages is determined on a quarterly basis.

intended it to apply to all states, they attempted to devise a formula that would prevent the double taxation of bank income that might result from applying an apportionment formula to such widely divergent tax bases as, for example, those based on capital stock, net income, gross income and gross receipts. For this purpose, the drafters included a "pre-apportionment" formula by which a taxpayer would first apply a two-factor formula to a specially defined apportionable base to define the maximum base subject to tax.

Thereafter, the taxpayer would calculate the amount of its taxable income by applying a different two-factor formula to its tax base as regularly defined by state law. The two-factor formula consists of a receipts factor and a payroll factor, defined similarly to the New York factors, but with some differences in the siting rules. The model law contains a "throwout" rule; that is, any receipts and any wages located by the rule in a state without jurisdiction to tax are excluded from both the numerator and the denominator of the respective factors.

c. California

Like New York, California uses a three-factor formula to apportion the income of the financial institutions subject to tax there. The two formulas are very different, however.

The California factors are sales (receipts), property and payroll. The receipts and payroll factor are similar to those factors in the New York and ABA models. The most significant difference in the California rule is the use of the property

factor. That factor is made up of coin and currency located in California and intangible personal property including loans, credit card receivables, and investments in securities. Real property is excluded.

d. Analysis

Assuming that Massachusetts decides to adopt an apportionment formula, how should it assess the merits or the lack thereof of the three formulas discussed?

The purpose of an apportionment formula is to measure what fraction of the income-producing activity of a multijurisdictional taxpayer takes place within a given state. Therefore, the particular factors chosen should reflect in general how the taxpayer generates its income. For example a widely-accepted three-factor formula for manufacturing and mercantile business contains the following factors: property (plant, machinery, etc.), payroll (employees), and receipts (from the sales of goods produced by the plant, machinery and employees). Finally, the formula then spreads the income of the corporate taxpayer among the states which have jurisdiction to tax it by rules which "site" the various components of each of the factors.

Financial institutions make income by lending money (deposits), by investing in federal and state obligations and by providing services. Thus, payroll, receipts, intangible property and deposits are all potential factors.

Some have criticized California's use of an intangible

property factor as improper because it duplicates the receipts factor. These critics have argued that, to the extent that a state wants to give more weight to the receipts factor, it can do so far more simply by double-weighting that factor. However, the two factors are not strictly copies. For example, the "siting" rules are not necessarily the same if a state uses an intangible factor and a receipts factor rather than a double-weighted receipts factor. Consider a loan that is sited in the state (State A) where the loan proceeds are used for the purpose of the property factor, while the interest and fee income is sited in the state (State B) where the lending institution is located for the purpose of the receipts factor. Obviously, the income would be spread differently between States A and B if a double-weighted sales factor were used.

One can level more serious charges against the use of a deposits factor. Unless the Commonwealth decides to retain its current regulatory-based definition of a bank, the deposits factor will not apply to many of the entities subject to its tax and so must be dropped from the formula. But even with a narrow definition of a bank, the deposits factor can cause problems. For example, the drafters of the ABA model law rejected a deposits factor as too difficult to administer and too easy to manipulate.

e. Revenue Effects

The 1984 study conducted by the Executive Office for Administration and Finance found that the Commonwealth would lose

roughly $10,000,000 in tax revenue annually if banks were subject to the same rate and tax base as general business corporations. The authors of the study concluded further that, if banks used combined unitary reporting with formula apportionment of their worldwide income, the revenue loss would be "considerably greater". According to the authors, the amount of tax revenue that Massachusetts would gain from apportioning into the state the income of out-of-state banks would be far less than the amount of income that would be apportioned out.

A 1985 study by Peat, Marwick, Mitchell & Co. corroborates some of the above findings. The Peat, Marwick study found that if banks and thrifts were taxed at the same rate and base as general business corporations, the Commonwealth would lose $11,250,000 annually in tax revenue. The study confirmed that the loss would be greater with the addition of formula apportionment. But, the authors of this study also concluded that the Commonwealth would derive significant tax revenue from out-of-state banks which do business in Massachusetts with the result that "any shortfall in Massachusetts tax revenues will probably be insignificant in the next few years".

According to the study, the additional revenue would come from taxing the interest and fee income earned by out-of-state banks which issue credit cards to Massachusetts residents by mail and the interest and fee income earned by the loan production office subsidiaries of out-of-state banks. Unfortunately, even with the adoption of an apportionment formula similar to the one

currently used by general business corporations, the Commonwealth is unlikely to increase its tax revenues in this manner unless it adopts some new enforcement provisions. We discuss this issue in detail in section 5, infra.

2. Combined or Consolidated Reports

There are three state laws that can serve as models for combined or consolidated reporting. The Commonwealth's general business corporation tax law permits the corporations subject to the tax to file a Massachusetts consolidated report. And, both the New York and California bank tax laws provide for the filing of combined reports.

a. The Massachusetts law

According to G.L. c.63, sec. 32B, two or more domestic or foreign business corporations which have filed a federal consolidated return may choose to be taxed upon their combined net income in Massachusetts. Only those entities which have a separate tax nexus in the state can be included in the Massachusetts combined group.

Bankers argue that the ability of general business corporations to compute their income as a combined group gives such corporations a distinct advantage over bank corporations. In particular, general business corporations can use the losses of one or more subsidiaries to offset the income of other affiliates. And, because section 32B allows the corporations to choose whether or not to file as a combined group, the provision is a significant tax planning tool.

One feature of the Massachusetts law is difficult to administer and should be clarified if the Commonwealth adopts a similar provision for banks. Section 32B is silent as to whether the net income of each of the corporations included in the combined group should apportion their income before combining it or whether the group should first combine their income and then apportion it. The Department of Revenue believes that taxpayers must apportion their income to Massachusetts first and then file as a group. Some taxpayers take the opposite position. The selection can have significant revenue effects.

Consider the following example. Corporations A, B, and C are affiliated corporations which filed a federal consolidated return. Corporation A is a New York company which does 80 percent of its business in New York, 10 percent in Massachusetts and 10 percent in New Jersey. Corporation B does all of its business in New Jersey, and Corporation C does all of its business in Massachusetts. For the tax year at issue, A has a million dollar loss, B has $600,000 in income and C has $500,000 in income. According to the law, Massachusetts can tax only those corporations which are doing business in Massachusetts--corporation A and C.

If taxpayers A and C combine their income before apportionment, the group will have a net loss and will have no tax liability in Massachusetts (-$1,000,000 + $500,000 =-$500,000). If, on the other hand taxpayers A and C apportion their income to Massachusetts first, and then combine it, the

group will show a profit. Corporation A will have a loss of-$100,000 (10% x -$1,000,000 = -$100,000) and corporation B will have a profit of $500,000 (100% x $500,000); their combined net income is $400,000 (-$100,000 + $500,000) which is taxed in Massachusetts.

One can also imagine a situation in which apportioning before combination will result in a net revenue loss. Assume that corporations A, B, and C are affiliated corporations which have filed a federal consolidated return. Corporation A which does 50 percent of its business in Massachusetts has $1,500 of income. Corporation B which does 100 percent of its business in New Jersey has a $1,000 loss. Corporation C which does 100 percent of its business in Massachusetts also has a $1,000 loss. Only corporations A and C can be included in the Massachusetts combined return. If their income is first apportioned to Massachusetts and then combined, the group will have a $250 loss (50% of $1,500 + 100% of -$1,000 = -$250). If, instead, their income is first combined and then apportioned, the group will have $500 of taxable income in Massachusetts ($1,500 + -$1000 = $500). But, in this latter example, the consolidated group, which has the option whether or not to file a Massachusetts combined return, may well choose not to do so while it would certainly choose to file as a combined group in the former example.

It is important to note that combined reporting as defined by section 32B cannot solve the problem of the loss of revenue

which occurs because subsidiaries of out-of-state corporations (such as loan production offices) can reduce their Massachusetts income by paying large management fees to their out-of-state parent. Because such parent corporations do not have a tax nexus in Massachusetts under current law, they cannot be included in the combined group. Both entities may thus escape taxation in Massachusetts although they have each earned income from Massachusetts sources.

b. The New York law

Chapter 298 of the New York bank tax law provides for the filing of combined reports. The New York law differs in several important ways from the Massachusetts law. Most of the differences involve the degree of control given to the state's tax commissioner rather than to the taxpayer.

First, the provisions are mandatory for certain corporations. If one corporation owns or controls 80 percent or more of another corporation or if the corporations are both 80 percent or more owned or controlled by the same interests, the corporations must file on a combined basis. This rule can be ignored only if the taxpayer or the state tax commission can show that the inclusion of one or more of the 80 percent owned corporations fails to reflect properly the tax liability of the entity.

Second, a corporation which does not have a separate tax nexus in New York can be included in the combined group if the tax commissioner deems the inclusion necessary to reflect

properly the tax liability of the group.

Third, the tax commissioner may permit or require corporations which meet a 65 percent or more ownership requirement to file a combined return if he deems it necessary to reflect properly the tax liability of the taxpayer.

c. The California law

California requires corporations engaged in a unitary business to compute their income on a combined basis. Unlike the New York law, corporations which do not have a tax nexus in California but which are engaged in a unitary business with a California-based corporation are <u>automatically</u> included in the combined group.

Assume, for example, that Corporation A is doing business in California and that Corporations B and C are affiliates of A (e.g. the three are more than 50 percent owned by common parent). Assume further that B and C are not doing business in California, but the three corporations are engaged in a unitary business.

Corporation A will include in its apportionable tax base the combined income of the unitary group (A, B, & C). All intercompany sales, dividends and interest are excluded from that base. Then, A will calculate its California taxable income by multiplying the apportionable base by a three-factor formula which is designed to approximate California's share of the income-producing activity of the whole group. Although corporations B & C are not themselves doing business in California, the unitary tie among the corporations satisfies the

nexus requirements of the due process clause.

The most troublesome aspect of the use of the unitary business principle to determine the tax liability of a corporation is the definition of a unitary business -- i.e. which corporations can be included in the combined group. The U.S. Supreme Court has held that affiliated corporations (meeting the more than 50 percent common-ownership test) may be included in the combined report if there is a "flow of value" among them.

Taxpayers complain about the use of a method that is based upon such a nebulous concept as a "flow of value". They argue that because the concept is so indefinite, states can and do use the method to require combination of affiliates that are engaged in entirely unrelated businesses thereby causing distortions in their tax liability.

Fortunately, this problem does not exist with banks and bank-like entities. According to the principles outlined by the U.S. Supreme Court, only those subsidiaries that are engaged in a discrete business enterprise are not part of the unitary group. However, no bank or bank holding company subsidiaries can be excluded from the unitary group as distinct businesses because neither banks nor bank holding companies are permitted to control any subsidiaries that are not engaged in activities "incidental to the business of banking" (national banks)[56] or "closely related to banking or managing or controlling banks" (bank holding companies).[57]

d. Analysis

The Massachusetts law governing consolidated reporting for general business corporations contains a number of flaws which may cause the Commonwealth to lose revenue if it is copied for banks without modification.

In particular, the Commonwealth should consider two modifications: (a) giving more control over the filing of consolidated reports to its tax commissioner as do the law of New York and California, and (b) adding language that requires the inclusion of non-nexus corporations in the combined group either automatically as does the California law or under circumstances in which the inclusion is necessary to reflect properly the group's income as does the New York law.

There are no studies that break out separately the revenue loss that the Commonwealth might suffer from allowing banks and their subsidiaries to combine their income. However, the Peat, Marwick study found that Massachusetts would experience a revenue loss of over $11,000,000 if the state taxed banks under the general business corporation tax. According to the authors of that study, the loss would be far less and eventually negligible if the state used an apportioned tax because it could then reach the income of subsidiaries of out-of-state banks. This conclusion is simply not supportable unless Massachusetts uses a method of combined reporting similar to the New York or California model.

3. The Tax Base

For both banks and general business corporations the calculation of net income begins with federal gross income[58], less the deductions, but not credits, allowable under the provisions of the Federal Internal Revenue Code. Then, the law disallows or restricts certain deductions. For example, neither banks nor general business corporations may deduct taxes paid to other states. The similarity between the two income bases ends here, however.

a. Dividend Income

The most important difference between the two bases involves the treatment of dividend income. Banks may not deduct any dividend income, while general business corporations may deduct all dividend income except that from: (a) companies in which the corporation has less than 15 percent ownership, (b) corporate trusts operating in Massachusetts, and (c) certain domestic international sales corporations.

b. Analysis

The reason for the difference in the treatment of dividend income lies in the history of the two taxes and in the history of state treatment of dividend income. Generally, states have excluded dividend income from the tax base of foreign corporations because they are taxed on a source basis. Until recently, states thought that the due process clause prevented them from taxing, on a source basis, the dividend income of foreign corporations. Prior legal interpretations had held that dividend income was taxable only at the legal or commercial

domicile of the recipient. But, states have typically taxed their domiciliary banks on a residence basis. Thus, the Constitution did not prevent them from including dividends in the tax base.

In its 1980 decision in Mobil Oil Corp. v. Commissioner of Taxes,[59] the U.S. Supreme Court clarified the Constitutional limits on source-based taxation. The Court held that the due process clause does not limit taxation of dividend income to the domiciliary states as had previously been thought. Rather, a state can tax its apportioned share of the unitary income of a corporation transacting business in the state, whether the income is operating income or dividend income.

Banks and their controlled subsidiaries are by definition engaged in a unitary business. Therefore, even if the Commonwealth adopts source-based taxation for banks, it is not Constitutionally required to exclude dividend income from the tax base. Therefore, the choice can be made solely by reference to revenue considerations. Of course, to the extent that the state requires combined reporting, intercompany dividends among unitary affiliates will be excluded in calculating their combined net income.

4. Rate Relief

Legislation lowering the bank tax rate would increase the fairness, neutrality and competitiveness of the bank tax. Presently, that rate is higher than the bank tax rate of other states and the state's general business tax rate.

To achieve parity with general business corporations, the state can either (a) adopt a bank tax which, like the tax on business corporations, contains an income component and a property or net worth component, or (b) choose a straight income tax with a rate differential to offset the loss of the property component.

a. Structure of the Tax

Should the Commonwealth decide to give banks some rate relief, there are several reasons why it should not adopt the property or net worth component of the tax on general businesses.

The property or net worth component of the general business tax originated in the 1930's when many businesses had no income but owed heavy local property taxes. The state took over the taxation of a portion of the property or net worth of these business corporations to grant them tax relief through a lower rate. Because the original tax relief reason for including a property component to the tax no longer exists, it cannot be used to rationalize a similar tax on banks.

Moreover, retention of the property or net worth tax on general business corporations is difficult to justify. The tax is complex and difficult to administer, and the two alternative measures of the tax bases -- property or net worth -- may lead to unequal tax burdens.

If the state's reason for <u>retaining</u> the levy on property or net worth is to insure it a minimum revenue flow, that outcome can be achieved more simply by adopting one or more <u>alternative</u>

taxes similar to the New York law (see Tables 8 & 9).

b. Revenue Effects

As noted previously, two studies indicate that Massachusetts would lose from $10,000,000 to over $11,000,000 in tax revenue if it adopted the rate and structure (but not the apportionment formula) of the general business corporation tax.

5. Enforcement Provisions

Enforcement provisions are an integral part of any revision of the state's bank tax law. We have previously discussed some of the ways in which out-of-state banks operate tax free in Massachusetts. For example, out-of-state banks earn income from Massachusetts sources by issuing credit cards to the state's residents through the mail, by offering full-service banking by phone and other electronic means, and by operating loan production office subsidiaries in state. The Commonwealth can solve these tax-avoidance problems by broadening its jurisdiction rules and/or by adopting combined reporting on the California or New York models.

a. Out-of-State Banks Which Operate without an In-state Brick-and-Mortar Presence.

Currently, the Commonwealth taxes only those banks which have a brick-and-mortar presence in Massachusetts. Because of the state's limited jurisdiction rule and because banks find it particularly easy to transact business without a brick-and-mortar presence, the Commonwealth suffers a revenue loss.

There appear to be two bases for the restricted jurisdiction rule: the practical difficulties in discovering which out-of-state banks operate in Massachusetts, and the lack of clear statutory authority to assert jurisdiction over out-of-state banks. The state can solve these problems by adopting a reporting requirement and by broadening its jurisdiction rule.

New Jersey has a reporting requirement that can serve as a model for Massachusetts. N.J. Stat. Ann. 14A: 13-20(a) requires all foreign corporations that have not received a license to do business in the state or that have not filed a tax return for the year to file a Notice of Business Activities. In general, the Notice must be filed if the corporation receives payments from persons residing in the state or earns income from sources within the state. The failure to file the Notice can result in certain penalties, including the loss of access to the state's courts.

Discovering which out-of-state banks operate in Massachusetts solves only one part of the tax-avoidance problem. To cure the problem and to equalize the tax treatment of in-state and out-of-state banks, Massachusetts can, for example, adopt a statute authorizing taxation of any out-of-state bank which through regular solicitation in the state earns income from transactions with Massachusetts residents. The law would apply to nonresident banks which send "call officers" into the state. The presence of these representatives who act as agents for the nonresident bank creates a clear tax nexus with the state.[60] The statute could apply as well to those banks which solicit within

the state only by mail.[61]

b. Out-of-state Banks Which Operate In-state through subsidiaries.

The second prong of the tax avoidance problem involves those out-of-state banks which operate loan production offices or similar "non-bank" bank entities in Massachusetts. As early as 1933, the Commonwealth recognized and sought to deal with the problem of income shifting from in-state subsidiaries to their out-of-state parents.

For example, the pertinent part of sec. 33 of the general business corporation tax law provides that:

> The net income of a domestic business corporation which is a subsidiary of another corporation or closely affiliated therewith by stock ownership shall be determined by eliminating all payments to the parent corporation or affiliated corporations in excess of fair value, and by including fair compensation to such domestic business corporation for all ... services performed for the parent corporation ....

This law is similar to the federal "arm's length" audit procedure prescribed by IRC sec. 482. It is too cumbersome to be of much use as a cure for tax avoidance problems. Even the federal government with its vastly superior resources is unable to resolve, effectively and timely, disputes over income shifting among related corporations using section 482.

Fortunately, states have other tools with which to tackle

the tax avoidance issue. The Commonwealth could, for example, adopt the method of combined reporting based upon the unitary business principle using either the California or New York model. Also, Massachusetts could include language in an amended jurisdiction statute which would allow it to assert jurisdiction directly over an out-of-state parent because of the activities of its in-state agent. An in-state loan production office that solicits and negotiates loans which are finalized or closed at the parent's home office is acting as agent for the parent in those transactions, thereby creating a tax nexus between the state and the parent.[62]

IV. SUMMARY

The Commonwealth has a variety of ways in which it can increase the neutrality, fairness, competitiveness and exportability of its bank tax. It can adopt an income apportionment scheme based upon the New York or California model or a modified version of the Massachusetts general business corporation laws. The state can add a combined reporting procedure using the laws of the same three states as models. Or, it can reduce the nominal tax rate on banks.

Alternatively, the Commonwealth could choose to make major revisions to its bank tax law by expanding its definition of a bank, by choosing both to restructure its tax along the lines described here and by reducing the rate.

One option -- that of doing nothing -- may not be open to

Massachusetts. Many states have already removed or relaxed their prior bans on interstate branch banking. Some states have already updated their laws to provide for source-based taxation. These developments -- increased interstate branch banking and source-based taxation -- will lead inevitably to multiple taxation of bank income unless all states switch to source-based taxation. Those states that continue to retain residence-based taxation may find their laws struck down.

Therefore, there may be no way for the Commonwealth to avoid some immediate loss of revenue. However, by broadening the definition of a bank and by adopting additional enforcement provisions, the Commonwealth can place itself in a position to recoup these losses in the long run.

NOTES

1. 17 U.S. 316 (1819).

2. 27 U.S. 465 (1829).

3. 13 Stat. 100-118 (1864).

4. See, e.g., Austin v. Aldermen of the City of Boston, 96 Mass. 359 (1867).

5. 15 Stat. 34 (1868).

6. 13 Stat. 112 (1864).

7. See, e.g. Providence Institution for Savings v. City of Boston, 101 Mass. 575 (1869).

8. National Bank of Redemption v. Boston, 125 U.S. 60 (1888); Palmer v. McMahon, 133 U.S. 660 (1890); National Bank of Commerce v. Seattle, 166 U.S. 463 (1897); Providence Institution for Savings v. City of Boston, 173 U.S. 205 (1899).

9. Nichols, Taxation in Massachusetts, 557 (3rd ed. 1938).

10. Merchants National Bank v. Richmond, 256 U.S. 635 (1921).

11. In 1923, the banks compromised their suits and received refunds in the amount of $3,000,000. Nichols, at 559.

12. 44 Stat. 223 (1926).

13. Nichols at 559.

14. 279 U.S. 620 (1929).

15. See,Dane, Taxation of Corporations and Banks -- 1966 Legislation, 52 MASS. L. Q. 41 (1966); Brockelman, et.al., A Year in Massachusetts' Taxation, 60 MASS. L. Q. 377 (1976).

16. 12 U.S.C. sec. 548.

17. 12 Stat. 346 (1862).

18. Society for Sav. v. Coite, 73 U.S. 594 (1868).

19. 12 U.S.C. sec. 3124 (a).

20. 279 U.S. 620 (1929).

21. Nichols, supra, at 560.

22. Id.

23. Pacific Co. v. Johnson, 285 U.S. 480 (1932). In Macallen, the Court had struck down the portion of the Massachusetts' corporate tax that included the income from federal obligations in its measure because the Massachusetts' legislature had amended its earlier law exempting such obligations from the state's tax, an act which the Court said discriminated against the federal obligations. In Pacific, the Court recognized the folly of that position and upheld a similar California tax stating: "We should hesitate to say that any action of the legislature or any purpose disclosed by a state commission could restrict the power of a state ... to authorize a tax which admittedly it could have authorized without them." 285 U.S. at 495.

24. Nichols, supra, at 561.

25. First Natl. Bank v. Missouri, 263 U.S. 640 (1924).

26. 12 U.S.C. sec. 36 (c) (1) (1982).

27. 12 USC 1843 (c) (1982). 12 USC sec.1843 (a) prohibits a Bank Holding Company from acquiring direct or indirect ownership or control of any voting shares of any company which is not a bank. Subsection (c) of sec. 1843 lists certain exemptions from that broad prohibition. A partial list of those exemptions includes: (c)(1) shares held or acquired by a bank in companies engaged in specific activities related to the business of a bank or bank holding company; (c)(2) shares acquired in satisfaction of a debt, provided that the shares are disposed of within two years from the date they were acquired; (c)(4) shares acquired or held in a fiduciary capacity; (c)(5) shares of a kind and amount eligible for investment by a national banking association; (c)(6) shares of any company, provided that such shares do not include more than 5% of the outstanding voting shares of such company; (c)(8) shares of any company the activities of which the Board has determined to be so closely related to banking or controlling banks as to be a proper incident thereto; (c)(9) shares of any company organized under the laws of a foreign country, the greater part of whose business is conducted outside the U.S.; (c)(13) shares of any company which does not do business in the U.S. except as an incident to its international or foreign business.

28. 12 USC 1843 (c) (8) (1982).

29. Id.

30. For a complete current list of approved activities, see 12 CFR 225.4 (1983). The Board permits other activities by order.

31. 12 U.S.C. sec. 1841 (c). The Act applies to both banks and bank holding companies. Because the Bank Holding Company Act defines a Bank Holding Company as any corporation, partnership, business trust, association or similar organization that owns or has control over a bank or another Bank Holding Company, 12 U.S. C. sec. 1841 (a)(1), a bank which proposes to acquire another bank would thereby become a Bank Holding Company. That is, the Act controls all acquisitions of banks by entities which are or would become a Bank Holding Company.

32. On October 6, 1986, the 11th Cir. Court of Appeals reversed its earlier decision (Florida Dep't. of Banking v. Bd. of Governors, 760 F.2d 1135, 1985) which prohibited the U.S. Trust Corporation from converting a Florida-based subsidiary into a nonbank bank. U.S. Trust had appealed the 11th Cir. Court opinion to the U.S. Supreme Court which remanded the case for reconsideration in light of its decision in Federal Reserve Bd. v. Dimension Financial Corp., ******* It is now settled that a bank may establish a nonbank bank in any state without violating federal or state law.

33. See First National Bank v. Dickinson, 396 US 122 (1969).

34. The U.S. Supreme Court upheld the legislation in Northeast Bancorp. v. Bd. of Governors, 105 S.Ct. 2545 (1985).

35. The term "thrift institution" includes state and federal savings banks, cooperative banks, and savings and loan associations.

36. Commonwealth v. People's Five Cents Savings Bank, 87 Mass. 428 (1862).

37. Weston v. Charleston, 27 U.S. 465 (1829).

38. Provident Institution v. Massachusetts, 73 U.S. 611 (1867).

39. St. 1881, c. 304, sec. 8.

40. 12 U.S.C. sec. 1464(h). Although this section is phrased in the negative, courts have uniformly interpreted it as an affirmative grant of taxing authority to states. See e.g. Sooner Federal S & L Ass'n v. Oklahoma Tax Com'n, 662 P.2d 1366 (1982), appeal dismsd., 103 S. Ct. 1760; First Federal Savings & Loan Ass'n v. Johnson, 49 CA.2d 465, 122 P.2d 84 (1942). In Sooner,

the U.S. Supreme Court dismissed the appeal "for want of a substantial federal question". Such a dismissal is a decision on the merits of the case. See, Ohio ex rel. Eaton v. Price, 360 U.S. 246, 247 (1959); Hicks v. Miranda, 422 U.S. 332 (1975); Note, The Insubstantial Federal Question, 62 HARV. L. REV. 488, 489 (1949).

41. United States v. State Tax Commission, 348 F. Supp. 397 (D. Mass., 1972).

42. United States v. State Tax Commission, 481 F.2d 963 (1973).

43. First Federal Savings & Loan Ass'n v. Massachusetts Tax Com'n, 437 U.S. 255 (1978).

44. Id.

45. Andover Savings Bank v. Commissioner of Revenue, 387 Mass. 229 (1982).

46. Stock corporations and mutual associations have different organizational structures. In a stock institution, the shareholders hold the equity of the corporation while the depositors are creditors. A mutual association, on the other hand, does not issue capital stock. Instead, the depositors possess the sole proprietary interest in a mutual. Each depositor holds mutual shares; the number depends on the size of his or her deposit in the association. These shares represent the depositor's interest in the institution. But, the nature of that interest is twofold. A mutual share is a hybrid security--having characteristics of both equity and debt instruments. Thus, the depositor is both an owner and a creditor of the association. The U.S. Supreme Court has determined that, for purposes of the tax-free reorganization provisions of the Internal Revenue Code, a mutual share is more like debt than equity. Paulsen v. Commissioner, 105 S. Ct. 627 (1985).

47. Andover Savings Bank v. Commissioner of Revenue, 387 Mass. 229,238 (1982).

48. The National Bank Act prohibits national banks and bank holding companies from branching interstate unless expressly permitted by state law. There is no similar ban on interstate branching of federally-chartered thrift institutions. However, the Federal Home Loan Bank Board has traditionally pursued a policy of "competitive equality", gearing its approval of branching requests to the prescriptions of the local statutes of the state in which the federal association seeks to branch.

49. In fact, the bank tax definition of a bank is even more restrictive than the regulatory definition of a bank. In 1982, the state amended its regulatory law. Now, a "bank" includes

entities chartered by the states of Connecticut, Maine, New Hampshire, Rhode Island, or Vermont.

50. In the past, this potential for double taxation did not become a reality because federal and state laws restricted state taxation of banks and prohibited interstate branching. Now, this potential for double taxation is more serious; states are beginning to pass legislation updating their old bank tax laws to provide for source-based taxation and removing prior barriers to interstate branching.

51. State taxes appear to play only a small role in the interstate competition to lure businesses. Numerous studies have assessed the effect of state taxes on business location decisions. Most have concluded that state taxes have a negligible effect on such decisions. See, e.g. R. Vaughan, State Taxation and Economic Development, (1979); Advisory Commission on Intergovernmental Relations, Interstate Tax Competition, (1981); R. Schmenner, Making Business Location Decisions, (1982); M. Kieschnick, "Taxes and Growth: Business Incentives and Economic Development" in State Taxation Policy, (ed. M. Barker, 1983).

52. If, however, the Massachusetts based bank does business in another state through the use of a separately incorporated subsidiary, such bank will not be subject to the Massachusetts bank tax.

53. According to an August, 1986 survey conducted by the staff of the American Banker, one-third of the responding banks (77 of the 130 largest banks which received the questionnaire) had at least 30 percent of their card holder accounts outside their home state.

54. Nearly one in ten Americans use banks across state lines. See "Mail and Phone Operations Rev up Banks' Interstate Business", American Banker, at 4 (10-20-85); "Chemical Enters Connecticut Consumer Market with Phone and Mail Premium Banking Service", American Banker, 23-24 (12-17-85).

55. Kaltenborn, Is New York's Bank Tax Ready for the 1990's? 4 J. STATE TAX. 225 (1985).

56. 12 U.S.C. 24 (1984).

57. 12 U.S.C. 1843 (a) (1982).

58. Because the bank tax is a residence-based tax, net income is defined as gross income from all sources; for general business corporations net income is defined simply as gross income.

59. 445 U.S. 425 (1980).

60. Scripto, Inc. v. Carson, 362 U.S. 207 (1960). And see, Hellerstein, State Taxation, 1985 cum. supp. S51-S60.

61. McCray, "State Taxation of Interstate Banking", 21 GA. L. REV. No. 2, (1987) in press.

62. Scripto, supra; The Florida supreme court declined to review a decision by the Florida court of appeals upholding the state's assertion of tax jurisdiction over an absent, nonresident corporation on similar grounds. Western Acceptance v. State, Dept. of Revenue, 472 So.2d 497, rev. denied 486 So.2d 598 (1986).

EXHIBIT K: 39

McCray, Sandra B., "State Taxation of New Banking Procedures", Tax Notes, (June 1990) p. 1129

SPECIAL REPORT

TAX ANALYSTS

STATE TAXATION OF NEW BANKING PROCEDURES

by Sandra B. McCray

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In this article, McCray discusses three new developments in the business of banking and examines their impact on state bank taxes. She believes that unless states update their laws, significant amounts of bank income may escape taxation. Finally, the author describes the new bank tax laws of New York, Minnesota, Indiana, and Tennessee, and evaluates their usefulness as models for other states to follow.

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Recent developments in the business of banking have led many states to re-examine their bank taxes. Some states have commissioned studies of their bank taxes (e.g., Nevada and Arizona), and others have passed new bank tax laws (e.g., New York, Minnesota, Indiana, and Tennessee). These states have recognized that some of these developments, in particular branchless banking, loan securitization, and interjurisdictional funding and booking of loans, can lead to significant amounts of bank income escaping taxation. This article first examines these new developments and the problems that they create for states. Second, the article describes how the new bank tax laws of New York, Minnesota, Indiana, and Tennessee have dealt with problems created by branchless banking, loan securitization, and interjurisdictional loan transactions and evaluates their usefulness as models for other states.

I. NEW DEVELOPMENTS

A. Branchless Banking

An American businessman living in Tokyo recently needed a home mortgage loan for a home that he was purchasing in Chicago. Prior to returning home to the United States this businessman called the Prudential Home Mortgage Company to arrange for a home mortgage loan by phone. Prudential handled the whole transaction, including closing, by means of the telephone call made by the businessman from Tokyo to Chicago.[1]

There are several interesting aspects of this *New York Times* story. One striking aspect is of course that Prudential Home Mortgage, a subsidiary of Prudential Insurance Company, rather than a savings and loan association or a bank, made the home mortgage loan. The blurring of lines among financial institutions is not related, however, to the subject of this article. Another remarkable facet of the story is that the entire transaction, including the closing, was handled by telephone from Tokyo. In fact, Prudential Home conducts its entire business by toll-free telephone, facsimile machine, and computers. In making these home mortgage loans, Prudential is engaging in a form of branchless banking.

[1] *New York Times*, July 1989.

As striking as the *New York Times* story is, it describes only one of the many loan transactions that are routinely handled today by phone, by mail, and through ATMs. Perhaps the best known example of this branchless banking is the bank credit card subsidiary. Typically located in South Dakota, Delaware, or Nevada, the credit card subsidiary solicits credit card applications by mail in all 50 states. According to a recent Federal reserve study, from 1980 to 1987, credit card loans increased by $72 billion with the states of Delaware and South Dakota accounting for 50 percent of the increase. Although a credit card subsidiary is typically located in only one state, it exploits the markets of all states and receives interest and fee income from residents of all states, raising the question of which states have jurisdiction to tax the income from branchless banking activities carried on across state lines. Certainly, the state of domicile of the financial entity has tax jurisdiction. The state of domicile meets all of the due process requirements for nexus. In addition, the market state—the state in which the debtor is located—also has tax jurisdiction over an out-of-state entity that regularly and continuously solicits business with its residents. For example, most states have already concluded that, at least with respect to mail-order retail and insurance sales, the market state also has jurisdiction to tax entities that transact business with their residents.[2] Similarly, an out-of-state bank that regularly and continuously solicits in a state has purposefully availed itself of the state's market and has received benefits and protections from the state.[3] A significant benefit is of course the use of the state's courts in which to enforce its contract with the debtor should he or she fail to pay back the loan made through the use of the credit card.

Two states...have jurisdiction to tax branchless banking activities—the domiciliary...and the market state.

Two states, then, have jurisdiction to tax branchless banking activities—the domiciliary or headquarter state and the market state. If both states do tax the same activity, overlapping taxation will result. For example, let's assume that State A is the state of domicile of Bank A. Bank A engages in commercial lending in several states by sending call officers there. Assume further that State A taxes the interest and fee income earned by Bank A from its interstate commercial lending business according to its apportionment formula which provides that the receipts from interstate commercial loans are located or situated in the state of domicile of the lending bank (headquarter-state situs rules). Thus, according to headquarter-state situs rules, receipts form commercial loans are placed in the numerator of the state of domicile of the lending bank. Assume also that one of the market states taxes the portion of the interest and fee income according to its apportionment formula which provides that the receipts from commercial loans have a situs where (a) the debtor is located, (b) the security property is located, or (c) the loan proceeds are applied (market-state situs rules). Thus, according to market-state situs rules, receipts from commercial loans are placed in the numerator of the state which is providing a market for the business of the lending bank.

Because of the differing situs rules in the two apportionment formulas, the same interest and fee income appears in the numerator of the receipts factors in both states and overlapping taxation results. It is unlikely, however, that a court would find that this overlapping taxation rises to the level of unconstitutional multiple taxation for several reasons. First, the Supreme Court has recognized on several occasions that apportionment formulas provide only rough justice. Moreover, the Supreme Court simply has no principled way to determine which apportionment formula should be favored under the constitution.[4] It is unlikely, therefore, that the Supreme Court would strike down one of these apportionment formulas.

The failure to tax branchless banks places domiciliary banks at a competitive disadvantage....

Despite this potential for overlapping taxation, states should broaden their jurisdiction rules to allow them to assert taxing jurisdiction over out-of-state branchless banks for at least three reasons:

(1) Fairness to the market state. It is simply not fair to allow out-of-state financial entities to transact a branchless banking business within a state without paying their fair share of the tax burden. The out-of-state banks are partaking of the benefits of the market that a state provides and receiving the protections of its business through the judicial system and should therefore pay their fair share;

(2) Tax parity between domiciliary and nondomiciliary banks. The failure to tax branchless banks places domiciliary banks at a competitive disadvantage vis-a-vis out-of-state branchless banks; and

(3) Revenue considerations. It is very easy for banks and retailers to set up subsidiaries in one or two states and conduct a credit card or full lending business in all 50 states by mail, telephone, and ATM, thereby avoiding the taxes of those states that do not have broad jurisdiction rules.

Assuming, then, that market states do adopt broad tax jurisdiction rules to tax out-of-state branchless banks, how can states avoid the overlapping taxation that results from differing apportionment formulas? Several options exist. First, some states, either headquarter states or market states, could voluntarily cede their jurisdiction

[2]Sandra B. McCray, "Overturning *Bellas Hess*: Due Process Considerations," 1985 BYU L. Rev. 265 (1985).

[3]Sandra B. McCray, "State Taxation of Interstate Banking," 21 GA. L. Rev. 283 (1986).

[4]Sandra B. McCray, "Constitutional Issues in State Apportionment of Income: Financial Institutions," 51 ALB. L. Rev. 895 (1987).

over the interest and fee income from these loans to the other states by changing their situs rules. Obviously, the adoption of a uniform apportionment formula, with identical factors and situs rules, would solve the problem of overlapping taxation. A review of the long history of state formulas used to apportion the income of manufacturing and retail businesses shows, however, that state formulas have diverged rather than converged over time. This history suggests that states will be unable to agree upon a uniform formula. Also, given the revenue needs that virtually every state faces today, a voluntary abandonment of tax jurisdiction seems unlikely.

Second, states could adopt the dual system of taxation. According to the dual system, a state taxes its domiciliary banks on all of their income from whatever source derived (and gives a credit for taxes paid to other states) and taxes nondomiciliary banks, including branchless banks, under a single-factor receipts apportionment formula. When an apportionment formula is used *only* in connection with nondomiciliary banks, the interest of both headquarter states and market states coincide. That is, the market state/headquarter state tension exists only when apportionment formulas are used for both domiciliary and nondomiciliary banks. After all, a state is only a headquarter state with regard to its domestic banks. When an apportionment formula is used only for nondomiciliary branchless banks, all states are market states; the market-state/headquarter-state dichotomy disappears, and along with it the overlapping taxation.

B. Securitized Loans

Commentators have called the securitization of bank assets (the pooling and packaging of loans that are then sold to investors without recourse) the most significant financing development of the 1980s.[5] Among the tactical benefits of the securitization of assets are the ability to obtain lower cost funds than through deposits, the ability to expand the funding base of the institution and an improved ability to control reported earnings by taking profit when so desired.

The assets most commonly pooled, bundled, and sold as securities are home mortgage loans, car loans, and credit card loans.

Currently, the assets most commonly pooled, bundled, and sold as securities are home mortgage loans, car loans, and credit card loans. Other, less common arrangements, are the purchase and securitizing of life insurance companies' future premiums and the interest due on insurance company investments and other assets not recognized on the statutory balance sheet. Plans are being developed for the securitization of small business loans.

Loan securitization raises several important issues for states. An understanding of these issues requires an examination of the difference between a traditional loan and a securitized loan. A typical traditional loan will remain on the books of the bank that made the loan until payout—thus, the originator is also the entity that receives the income. In contrast, when a loan is securitized, the unity between the originator of the loan and the recipient of the interest income from the loan is severed. The originator of the loan is the bank, but the recipient of the interest income from the loan is the entity that invested in the security. The dissolution of the relationship between the originator and the investor creates conditions for potentially widespread tax avoidance. Assume for example, that Bank A, which is domiciled in State A, has packaged and sold some of its mortgage loans (secured by homes located in State A) to an out-of-state investor which otherwise has no business relationship with State A. After the sale, State A will lose jurisdiction over the interest income from the loans, even though they are secured by property located in State A. The reason is obvious: no in-state bank owns the loans or the securities that represent the loans.

Typically, state apportionment formulas attribute the interest income from loans either to the state in which the loan originated...or to the state in which the property securing the loan or the debtor is located.

Suppose, now, that Bank B, which is domiciled in State B, purchases the securitized loans from Bank A. State B surely has jurisdiction to tax the income from the securities, but it will apply its apportionment formula to determine how much of the interest income from the securitized loans it can tax. Typically, state apportionment formulas attribute the interest income from loans either to the state in which the loan originated (i.e., the state of domicile of the lending bank) or to the state in which the property securing the loan or the debtor is located. If either of these rules is used to apportion the interest income from the securitized loans held by Bank B in State B, none of the interest income from those instruments will be attributed to State B because (1) Bank B was not the originator of the underlying loans, and (2) neither the property securing the underlying loans nor the debtor is located in State B. Thus, although State B has *jurisdiction* to tax the income from the securitized loans, that jurisdiction is hollow: it produces no revenue for the state. When State B applies its formula to do so, none of the receipts from the securities will be attributed to State B under its apportionment formula. Instead, the interest income from the securitized loans will be apportioned out of State B, even though no other state has jurisdiction to tax that income.

What can be done about this problem of hollow jurisdiction? If the state's bank tax is a pure source-based tax in which a formula is used to apportion the income of both domestic and out-of-state banks, the state can choose one of two potential solutions. First, a state might find a partial solution to the problem by adopting special rules for attributing the interest income from the securitized loans. For example, State B might classify the income from securities as nonbusiness income (by analogy to the rules set out in The Uniform Division of Income for

[5]See, e.g., Ben Weberman, "Securitization Comes of Age," *American Banker*, March 7, 1989, p. 4.

Tax Purposes Act (sometimes called UDITPA) and allocate such income to itself. It is unlikely, however, that a court would uphold such a classification when banks are clearly in the business of investing in securities as well as in the business of making loans. Second, a state might use a throwout rule to assure that the income from securities that is apportioned out but not taxed by any other state does not dilute the income attributable to the state (i.e., income that does not appear in the numerator of any state must be thrown out of the denominator).[6]

Alternatively, a state might solve this hollow jurisdiction problem by adopting a method of taxation other than pure source-based taxation. Because source-based taxes attempt to pinpoint the "source" of income, their operation requires a unity between the originator of the loan and the recipient of the income from the loan. Another option for states is a dual system of taxation, which uses a residence-based tax with a credit for domiciliary banks and a source-based apportioned tax for nondomiciliary banks. Under the dual system, all of the income from securitized loans would be taxed by the state of domicile. No problem of hollow jurisdiction exits.

C. Interjurisdictional (Interstate and International) Loans

> A United States multinational corporation with a South American subsidiary applies for and receives a loan at an Argentinean branch of a U.S. bank. The loan is syndicated out of the London merchant bank subsidiary of the same U.S. bank and funded initially with Eurodollars borrowed from the London merchant bank. The borrowed funds are deposited with the Nassau branch of the same U.S. bank, which funds the Argentinean loan. The Nassau branch, which is located in and managed out of the U.S. bank, booked the loan as an asset of the Nassau branch.[7]

This example of modern banking portrays the international nature of banking, but similar examples exist for interstate loans, which involve several states rather than one state and several foreign countries. The example illustrates the difficulties in determining which state has jurisdiction to tax the receipts and, indeed, the virtual impossibility of finding one source of the earnings from a loan. The new interstate environment creates two sets of problems for states: overlapping taxation and tax avoidance through asset and profit shifting.

Overlapping taxation exists when more than one state deems itself to be the source of the loan. For example, if the above loan were an interstate rather than an international loan, we might ask which state is the source or situs of the loan—the state of domicile of the lending bank, the state where the loan proceeds are to be applied, the state that provides the funds, the state where the debtor is located, or the state where the loan is booked? State source or situs rules currently in effect in various states include the following: a booking rule and/or state of domicile rule (New York), a loan proceeds rule (California), a domicile of the debtor rule (Minnesota). When one interjurisdictional loan is subjected to each of these rules, the receipts from the loan are included in the numerators of each of the state and overlapping taxation results. Equally important is the fact that some of the potential rules—such as the funding and the loan booking rules—are essentially discretionary with the bank, allowing the taxpayer rather than the state to determine where and how much tax to pay.

Overlapping taxation exists when more than one state deems itself to be the source of the loan.

The example illustrates the problems of overlapping tax and tax avoidance that exist when state bank taxes are based entirely upon the necessity of determining the source of the loan. In fact, the example calls into question the viability of using formulary apportionment to source and tax the income from service industries such as banks. Unless one state has the power to tax all of the income form interstate loans, states will face continuing problems of overlapping taxation and tax avoidance. By assuring that one state, the domiciliary state, has the ability to tax all of the income of its domestic banks (from whatever source derived), the dual system avoids the most serious sourcing problems. The income of nondomiciliary branchless banks is sourced by means of a single-factor receipts formula. Because the single-factor receipts formula is the most effective formula for maximizing the revenue flow to the market state from out-of-state branchless banks, its adoption by every state that chooses the dual system is assured.

An understanding of why the single-factor receipts formula is the most revenue-effective formula for nondomiciliary banks requires a brief review of how banks do business across state lines. Most interstate banking occurs through mergers between an out-of-state bank and an in-state bank or through *de novo* entry by a subsidiary of a bank holding company. Interstate banking through either of the above methods will result in an in-state bank (i.e., a bank that is taxed as a domiciliary). A bank that engages in interstate branchless banking (electronically or by mail) in a market state is an out-of-state bank (i.e., a bank that will be taxed as a nondomiciliary). A bank that engages in interstate banking through a *branch* also is an out-of-state bank for purposes of the dual system (i.e., a bank that will be taxed as a nondomiciliary). It is easy to see that it makes sense for the host state to choose a single-factor receipts formula to apportion the income of a branchless bank. By definition, a branchless bank has

[6]A throwback rule, as currently worded in the Uniform Division of Income for Tax Purposes Act—UDITPA, would not work as well as a throwout rule. As currently worded, throwback rules allow states to "throw back" receipts only when the receipts are not *taxable* in another state. Receipts that are *taxable* but *not taxed* are not thrown back. Thus, throwback rules allow the tax avoidance that occurs when taxable entities arrange their affairs so as to take their profits in states or countries that could but do not tax them. Such profit shifting is particularly easy for financial entities. States that choose a throwback rule should bypass the UDITPA language and provide instead that receipts that *are not taxed* in another state shall be thrown back. Further, for either the throwback or throwout rule, a state should require all financial institutions to provide evidence of their tax liability in all other jurisdictions in which they transact business.

[7]Bank officials described a similar such loan in their testimony before an Administrative Law Judge in the case of *First National Bank of Boston v. Commissioner of Revenue*, Commonwealth of Massachusetts Appellate Tax Board Nos. 140012-18, 140099, 161771-772 (1989).

o place of business and no employees in the taxing ate. Even in the case of a nondomiciliary branch bank whether state-chartered, national or foreign), however, a single-factor receipts formula with market state situs rules will generally attribute the most income to the nondomiciliary state. The reasons for the superiority of the single-factor receipts formula are: (1) attribution rules for a (intangible) property factor typically duplicate those for the receipts factor; and (2) the addition of a payroll factor (i.e., a two-factor receipts and payroll formula) would attribute more revenue to the host state than a single factor receipts formula only if the receipts-to-payroll ratio of the branch in the host state is less than the average receipts-to-payroll ratio in the entire corporation.[8] This latter condition would require that the branch earn less revenue per employee than the average of the entire corporation, an unlikely event because the branch would presumably be able to take advantage of many services provided by the home-office employees of its parent corporation rather than hiring separate branch employees to provide such services.

The current interstate environment also creates the conditions for tax avoidance through asset and profit sharing. This problem is particularly acute for the 25 states that have adopted a franchise tax measured by net income. According to Federal law, states must use a franchise tax rather than a direct net income tax if they want to tax the income from Federal securities. Because the income from Federal securities is a major fraction of bank income, the failure to tax such income can result in a significant revenue loss. Moreover, by exempting the ncome from Federal securities from state taxes, states re sending a message to banks that they should invest in Federal securities rather than in loans to businesses and citizens of the state.

Although many would question the wisdom of such a message, nearly half of the states do not use a franchise tax for their banks. In an era of interstate banking, the latter states can become tax havens, where banks from franchise tax states can set up subsidiaries to hold assets, such as Federal securities. States can combat this tax avoidance and protect their franchise taxes by requiring the use of combined unitary reporting. According to the unitary business principle, the income base subject to apportionment is not limited to the income of the bank that is transacting business within the state. Instead, the base includes the income of all members of the unitary group, which consists of the parent and any of its subsidiaries that are engaged with it in a "functionally integrated" enterprise. The use of combined reporting alleviates, therefore, the problem of asset and profit shifting. Combined reporting can be used with both pure source-based taxation and the dual system.

D. Conclusion

New developments in the business of banking have called into question existing state bank tax laws, most of which were enacted long before the advent of branchless banking, loan securitization, and interstate banking. In order to assure that out-of-state branchless banks are taxed similarly to competing in-state banks, states must broaden their tax jurisdiction rules. In order to assure that banks do no avoid state taxes through loan securitization, states must use a throwout rule in connection with their formulary apportionment rules or adopt the dual system of taxation, and in order to assure that banks are not subjected to overlapping taxation, states must either agree on one uniform apportionment formula or adopt the dual system of taxation. Finally, states must use the unitary business principal to protect their revenue base.

To assure that out-of-state branchless banks are taxed similarly to competing in-state banks, states must broaden their tax jurisdiction rules....

II. STATE RESPONSES TO THE NEW DEVELOPMENTS

A. New York

In 1985, New York became the first state to attempt a major overhaul and modernization of its state bank tax. Although the New York tax is a franchise tax, the statute allows banks to deduct 22½ percent of their income from Federal and state securities from the taxable base. New York adopted a pure source-based system. That is, according to the new law both domestic and out-of-state banks calculate their tax liability by means of formulary apportionment. The New York factors are deposits, receipts, and payroll. The numerator of the payroll factor is 80 percent of in-state wages, salaries, and other personal services compensation.[9] The receipts and deposits factors are double-weighted. The situs rules have a strong headquarter-state bias.

Surprisingly, of all the new state laws the New York law pays the least heed to the new developments in banking. First, the New York statute is drafted as if the phenomenon of branchless banking did not exist. For example, the state asserts jurisdiction only over those banking corporations that have a physical location in New York. This omission is puzzling in a state which is the home to Citicorp, whose subsidiaries have the largest volume of credit card assets of any bank holding company, all of

[8]The following calculation illustrates this proposition:

Define R, P, and B as the total receipts, payroll, and apportionable base, respectively, of the entire corporation, and R_b and P_b as the receipts and payroll of the branch in Indiana. If a single-factor formula is employed, the taxable income attributable to Indiana is given by the formula, $T_1 = [R_b/R]B$. If instead Indiana employes a two-factor formula, the taxable income attributable to Indiana is given by the formula

$$T_2 = [1/2]\ [R_b/R + P_b/P]B.$$

It will be advantageous for the market state to use the two-factor formula only if T_2/T_1 is greater than 1, or $[1/2]\ [R_b/R + P_b/P]\ [R/R_b]$ is greater than 1. A little algebra shows that this equation is tantamount to the equation R_b/P_b is less than R/P.

[9]The numerator of the payroll factor was limited to 80 percent to encourage banks to maintain a large employee base in New York. See, Kaltenborn, *Is New York's Bank Tax Ready for the 1990s?* 4 J. State Tax. 225 (1985).

which are located outside New York. As a result of its narrow jurisdiction rules, New York receives none of the interest and fee income paid by its residents to the out-of-state subsidiaries of Citicorp and other nonresident credit card issuers.

Second, the New York bank tax law does not recognize the existence of securitized loans, although the New York banks are among the most active in the nation in purchasing and selling securitized loans. The New York regulations do include a situs rule for trading and investment activities, but the definition of those activities does not appear to encompass securitized loans.[10] The most likely candidate to govern the situs of income from securitized loans is the catch-all rule, which allocates to New York all other business receipts that are earned by the taxpayer in New York state.[11] The law contains neither a throwout or throwback rule.

How does the New York law deal with the problem of overlapping taxation from interstate lending and revenue loss through interstate asset shifting? The strong headquarter-state bias in the New York situs rules can cause overlapping taxation when a New York bank makes a loan into a state like Minnesota that has pure source-based taxation and market-state situs rules. In such a case, however, New York law grants its banks a deduction for taxes paid to Minnesota. The law provides only very weak protection against revenue loss from interstate asset and profit shifting. For example, combined reporting is mandatory only for in-state bank members of the unitary group. Out-of-state banking corporations cannot be included in the group unless the commissioner first finds that a combined report is necessary to reflect properly the income of the New York banking corporation. Such a finding requires, of course, an audit and proof that intercorporate transactions fail to meet an "arm's-length" standard, a lengthy process that often ends in litigation. Thus, the New York franchise tax is easily avoided by setting up a subsidiary in a state without a franchise tax. Other asset and profit shifting can similarly reduce the state's revenues.

Surprisingly, of all the new state laws the New York law pays the least heed to the new developments in banking.

In sum, the New York law fails to address most of the new developments in banking, and is, therefore, of limited use to states seeking a model for their new bank tax laws.

B. Minnesota

Minnesota revised its bank income tax law in 1987 and 1988. Like New York, Minnesota uses formulary apportionment to tax both domestic and nonresident banks. The factors selected by Minnesota are payroll, property (tangible and intangible), and receipts. The three factors are not weighted evenly; instead, the formula apportions income to Minnesota by comparing 70 percent of the receipts in-state to receipts in all states, 15 percent of the property in-state to property in all states, and 15 percent of the payroll in-state to payroll in all states. The Minnesota situs rules have a distinctly market-state flavor.

Unlike the New York law, the Minnesota statute subjects all branchless banks that regularly solicit business with state residents to the state's taxing jurisdiction. Thus, out-of-state banks that regularly (a) distribute by mail or otherwise catalogs, periodicals, advertising flyers, or other written solicitations or business to customers in Minnesota; (b) display advertisements on billboards or other outdoor advertising in Minnesota; (c) advertise in Minnesota newspapers, on Minnesota radio or television; and who receive interest and fee income from Minnesota residents as a result of such solicitation, are taxable in Minnesota. Yet, even with this broad tax jurisdiction rule, the Minnesota tax falls short of achieving tax parity between in-state and out-of-state banks. The state's three-factor formula acts to dilute the income attributed to Minnesota from out-of-state branchless banks because nonresident branchless banks have no real property or payroll in their market states.

The Minnesota law deals with the problem of securitized loans by providing special rules for such loans. For example, the statute apportions receipts from securities, including securitized loans, according to the ratio of the banks's deposits in-state to its deposits in all states. The special rule is, however, an incomplete solution to the problem of tax avoidance in connection with securitized loans because the law does not contain a throwout rule.

The Minnesota law solves half of the twin problems of overlapping taxation and tax avoidance that can occur with interstate banking. On the one hand, the statute uses formularly apportionment with market-state situs rules for both domestic and nonresident banks, thereby creating the conditions for overlapping taxation in the case of loans made to Minnesota customers by banks from states with headquarter-state situs rules. On the other hand, the statute provides for mandatory combined reporting for financial institutions engaged in a unitary business, thereby alleviating the tax avoidance that occurs through interstate asset and profit shifting.

C. Indiana

The 1989 Indiana franchise bank tax law adopts the dual system of taxation. The dual system differs from pure-sourced based taxation in that formulary appointment is used only for out-of-state banks that exploit the state's marketplace. Domestic banks are taxed on all of their income from whatever source derived and given a credit for taxes paid to other states. The conflict between headquarter-state situs rules (like the New York rules) and market-state situs rules (like the Minnesota rules) does not exist under the dual system because the formula with its situs rules is used only for nonresident banks.

Like Minnesota, Indiana subjects all branchless banks that regularly solicit business with state residents to the state's taxing jurisdiction. Because the Indiana law uses a single-factor apportionment formula with market-state situs rules, the state has maximized the amount of income from nonresident branchless banks attributed to it.

The use of the dual system of taxation completely solves the problem of hollow jurisdiction in connection with securitized loans. Rather than apportioning the in-

[10]The statute defines trading and investment activities as foreign exchange transactions, the purchase and sale of options and financial futures, and interbank transfers.

[11]The author was unable to find an answer to the question of how the New York law treats interest income form securitized laons in her conservations with respresentatives of the New York Department of Tax and Finance.

come received by its domestic banks, the Indiana law taxes all of that income and then gives domestic banks a credit for taxes paid to other states.

The Indiana law falls short, however, in failing to provide for combined reporting.[12] As a result, Indiana banks will not be deterred from shifting assets and profits out of state to avoid the state's franchise tax, thereby eroding the state's revenue base.

D. Tennessee

During the 1990 legislative session, the Tennessee legislature passed a new bank tax law, applicable corporate fiscal years ending on or after July 1990. The Tennessee excise tax[13] is considered to be a "nonproperty" tax for purposes of Federal statutory law, thereby allowing the state to include all of the income from Federal securities in the tax base. The Tennessee tax is similar to both the Minnesota and Indiana taxes in that it applies to all out-of-state branchless banks that regularly solicit potential business from customers in Tennessee. Like Minnesota, Tennessee adopted pure source-based taxation, using an apportionment formula for both domiciliary and nondomiciliary banks and combined reporting for all financial institutions that are engaged in a unitary business within and without the state.

The Tennessee statute differs from the Minnesota law in three important respects, however. First, according to Tennessee law, in-state and out-of-state banks must apportion their income using a single-factor receipts formula with market-state situs rules. Second, the Tennessee law contains no special provisions for securitized loans. Third, the law does not apportion the income from Federal securities; instead, all income from such securities is allocated entirely to the state of domicile.

Each of these three provisions can potentially create problems for the state's revenue base. For example, the use of a single-factor receipts formula with market-state situs rules allows a bank that is located in Tennessee but does most or all of its business outside the state to escape most or all state income tax,[14] while subjecting a branchless bank that is located out of state but does business in Tennessee to the state's tax. Such a result deviates from traditional principles of tax law which view income taxes as a *quid pro quo* for the benefits provided by a state to businesses located there.[15] Although it is not possible to predict whether banks are likely to take advantage of state tax haven status offered by the Tennessee law, it should be noted that Nevada has used its lack of a corporate income tax to lure banks and other businesses from sister states. The difference between the Nevada concept and the potential Tennessee scenario is important. In Nevada, the lack of a corporate income tax is viewed as an economic development tool which applies to all corporations. Tennessee, in contrast, uses a three-factor formula for all corporations except financial institutions, singling out and creating a potential advantage for the latter businesses.

Further, both the lack of a special rule for securitized loans and the decision to allocate (rather than apportion) all income from Federal securities may create a significant revenue loss for the state. As described previously, securitization of loans creates a problem of hollow jurisdiction unless a state either provides special rules for securitized loans (Minnesota) or adopts the dual system of taxation (Indiana). Tennessee has chosen to follow neither route. Also, while the failure to apportion the income from Federal securities has some appeal in that a logical situs rule is hard to come by, that failure may encourage banks to move Federal securities to states that do not have a franchise tax in order to enjoy tax-free status there.

E. Conclusion

The 1985 New York bank tax law fails to deal with the tax parity and tax avoidance problems caused by branchless banking, loan securitization, and interstate loans. Few states are likely, therefore, to view the New York law as a model. In contrast, Minnesota has addressed each of these new developments, Indiana has addressed most of them, and Tennessee has addressed one of them fully (branchless banking) and another partially (interstate asset shifting through the use of the unitary business principle, except for Federal securities). Of the two state laws using formulary apportionment for domestic and out-of-state financial institutions, the Minnesota law with its property and payroll factors may bring the state more revenue from domestic banks, while the Tennessee law with its single-factor receipts formula promises to strengthen the state's revenue base from branchless banks. At the same time, however, the Tennessee single-factor receipts formula also creates a potential tax haven for in-state banks that do business outside Tennessee.

The Minnesota and Indiana laws offer the most comprehensive treatment of the problems created by the new environment of financial institutions to date. Both of these state laws have strengths and weaknesses. The Indiana law appears to provide a more complete solution to the problems of branchless banking (by adopting a single-factor receipts formula for out-of-state banks) and loan securitization (by adopting the dual system) than does the Minnesota law, yet the Indiana statute fails to adopt combined reporting. Thus, in the category of protecting the state's revenue base against erosion from interstate asset and profit shifting, the Minnesota law is superior. States seeking models would do well to adopt a bank tax that incorporates the best of the Minnesota and Indiana laws.

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[12]Although the Indiana statute purports to require financial institutions that are engaged in a unitary business to file a combined report (IC 6-5.54), the actual method used negates this requirement. In order to comply with the premises of the unitary business principle, a business filing a combined report must include all of the income of the members of the unitary group (whether or not the members are individually transacting business in the taxing state) in its base, which is then apportioned to the taxing state. The Indiana statute, however, allows financial institutions to apportion their income to the state first and then combine that sum into the taxable base. Obviously, under the Indiana method, nonresident financial institutions which are engaged in a unitary business with an Indiana entity but which are not individually transacting business in Indiana will have no income represented in the taxable base, entirely negating the purpose of the unitary business principle.

[13]Tennessee also imposes a "franchise" tax on domestic and out-of-state banks. The franchise tax is a small tax imposed at the rate of 25 cents per $100 of net worth or of the value of property used in Tennessee, whichever is greater. The former measure will be used for out-of-state banks.

[14]Such business will, of course, be subject to the state's "franchise" tax.

[15]Of course, modern tax principles also include the exploitation of a state's marketplace as one of the benefits supporting the imposition of tax, as well as the customary benefits associated with physical presence.

STATE TAXATION OF NEW BANKING PROCEDURES: A REPLY

To the Editor:

In her article, "State Taxation of New Banking Procedures,"[1] Sandra McCray proclaims that "...states should broaden their jurisdiction rules to allow them to assert taxing jurisdiction over out-of-state branchless banks..."[2] After offering three reasons to support this decree, the author goes on to give her tips for how states can, and *should*, collect more revenue from out-of-state banks without strictly violating the interstate commerce provisions of the U.S. Constitution.[3]

The reasons she gives for why states should broaden their jurisdictions deserve careful scrutiny, because they form whatever basis exists for the remainder of her essay. The three reasons are: 1) fairness to the market state; 2) tax parity between domiciliary and nondomiciliary banks; and 3) revenue consideration.[4] These may be examined in the order they are presented.

Fairness to the market state. According to McCray, "It is simply not fair to allow out-of-state financial entities to transact a branchless business within a state without paying their fair share of the tax burden."[5] Since most *fair* people would agree that it is only *fair* to pay one's *fair* share for anything, the only question that remains is, "What is that *fair* share?" The reader must discern this from the author's only supporting statement.

McCray states, "The out-of-state banks are partaking of the benefits of the market that a state provides and receiving the protection of its business through the judicial system and should therefore pay their *fair* share;"[6] (whatever that is). By this statement, McCray is apparently trying to apply the benefit principle of taxation to out-of-state banks and she managed to identify two benefits. The first benefit is that states provide a "market" to out-of-state banks and this constitutes a benefit to those banks. The second benefit is the protection provided to the foreign banks by the judicial system of the host state.

Does "providing a market" constitute a benefit to a seller? If so, then three highly insidious things are implied. First, this implies that state governments possess something akin to mineral rights (or fishing rights) over their citizenry which may be properly bought and sold independent of the wishes of those citizens. McCray does not quarrel with the fact that foreign banks are providing a service to citizens of the host state by their activities, but to her, the effect on citizens is irrelevant. Taking supply-side economics a little far, McCray forgets about buyers completely, looking only at the fact that banks charge for their services and are better off for having done so. It is not surprising that by looking at only half the transaction, bemusing conclusions follow. In her backward economics, McCray considers it unfair that states do not charge firms for the right to fulfill the demands of their citizens. Presumably, she also finds it unusual that customers do not commonly charge stores for the right to sell them products. After all, the stores are benefitting from the existence of those customers, are they not?

The second problem with allowing states to consider that opening their markets constitutes a benefit to outsiders is that this concept may be applied to buyers as well as sellers. States provide markets not only when they allow the sale of goods and services within their state; they provide a market by allowing the purchase, as well. When New Jersey allows South Dakota banks to sell services in New Jersey, it is providing a market to those South Dakota banks. Likewise, when South Dakota allows New Jersey citizens to purchase services produced there, it is providing a market to those consumers. If the "market" argument justifies the taxing of South Dakota banks by New Jersey, it equally justifies the taxing of New Jersey consumers by South Dakota.

The third insidious notion implied by the "provide a market" phrase is that states provide a benefit by not overtly causing harm. The argument may be stated as follows: 1) State governments have the power to prevent interstate banks from conducting business in their state. 2) If a state were to exercise this power, it would certainly cause harm to out-of-state banks (among others). Therefore, 3) states who choose to not inflict this harm are providing a service which may be taxed under the benefit principal. This is an incredible perversion of the benefit principal. Once again, in McCray's backward economics, state governments are entitled to compensation for injurious actions not taken. By analogy, restaurants are providing an extra service to their patrons by not poisoning them and doctors serve their patients by not inflicting iatrogenic diseases.

The second benefit which out-of-state banks receive is access to the state's judicial system. To place this legitimate application of the benfit principle in perspective, it might help to compare the total cost of the New York State judiciary with the level of revenue received from the current bank tax to see if, in fact, banks are paying their fair share. In fiscal 1989-90, New York State paid $598 million out of the general fund for the operation of the entire state judiciary system.[7] During the same period, the state bank tax generated $565 million[8], or roughly 95 percent of the cost of the state judiciary. Assuming that over 1/20th of New York's court activity is taken up with nonbank matters, such as drug abuse, rape, murder, robbery, prostitution, gambling, divorce, traffic violations, and so on, it can be argued that banks are already paying their fair share of this benefit. Nevertheless, it would be highly instructive if McCray were to estimate the net benefits of state governments to in-state and out-of-state banks so that each can be assessed its "fair share."

Tax parity between domiciliary and nondomiciliary banks. According to McCray, "The failure to tax branchless banks places domiciliary banks at a competitive

[1] *Tax Notes*, June 4, 1990, pp. 1229-1235.
[2] *Ibid.* p. 1230.
[3] The United States Constitution, Article I, Section 10.
[4] McCray (1990) p. 1230.
[5] *Ibid.*
[6] *Ibid.*
[7] New York State Executive Budget 1990-91, p. 584.
[8] *Ibid.* p. A64.

disadvantage *vis-a-vis* out-of-state branchless banks."[9] She provides no support for this statement and, in fact, it would be difficult to do so. The competitive position of a bank, as well as any other firm, is based upon the cost and quality of its factors of production, its proximity to clients able and willing to pay for the products it provides, the number and characteristics of competing firms and products, the services it receives from governments, and the taxes it pays to those governments. By only glancing at the very last of these elements, as McCray does, one cannot say anything intelligent about competitive advantages or disadvantages. While it is true that an out-of-state bank may pay less in host state taxes than a domestic bank relative to some arbitrary measure of business activity, that does not necessarily place it at a competitive advantage. The out-of-state banks do not receive the benefits of the host state on par with banks domiciled in the state. They do not benefit from the state's highway system, its educational system, its health system, and so on as do domestic banks.

Competitive advantage is a complex question best determined by the firms themselves as they search to find their particular niches in the marketplace. To maintain market position and maximize profits, firms must weigh all the elements of competitive position and base their locational decisions upon them. Since McCray only looks at one element, it is no wonder that she finds it "Surprising that of all the new state laws the New York law pays the least heed to the new developments in banking"[10] (i.e., by eschewing her recommendations), yet remains the home to Citicorp and other of the nation's largest banks. Citicorp, by its presence, has apparently decided that New York has not placed it at a competitive disadvantage by ignoring her. Since McCray's suggestions would raise effective taxes on Citibank and others by attacking the transactions of their out-of-state subsidiaries, Citibank's choices, as well as New York's, are quite rational and are hardly cause for amazement.

Revenue considerations. Under this heading, McCray states, "It is very easy for banks and retailers to set up subsidiaries in one or two states and conduct a credit card or full lending business in all 50 states by mail, telephone, and ATM, thereby avoiding the taxes of those states tha do not have broad jurisdiction rules."[11] Perhaps this point belongs properly under the tax parity heading. Note that if state A were to broaden its jurisdictional rules, then the subsidiaries of its domestic banks in those "one or two states" would be taxable by state A, but independent banks or subsidiaries of banks not resident in state A who conduct business from those one or two states would ordinarily not be subject to state A's tax.[12] This would be the case even if both entities provide identical services to identical customers. Although clearly violating principals of tax parity, this branch is ignored by McCray, presumably because it loses no revenue for state A.

Revenue considerations really are the crux of McCray's proclamation that states should broaden their tax jurisdiction. She has tried to craft a method whereby states could export their tax burden to other states with impunity. Although these states may violate the spirit of the interstate commerce clause of the Constitution or its philosophical underpinnings, nevertheless, they do not violate current constitutional interpretations—or rather, McCray's interpretations of those interpretations.

If a state were to adopt McCray's recommendations (none has so far), it would likely collect additional revenue from out-of-state banking entities, and thereby export a portion of its tax burden out-of-state. This does not prove that the state was entitled to this money all along for reasons of fairness, or because of benefits the host state provides. It merely demonstrates a state's ability to exercise market interference over banking within its state.

Revenue considerations really are the crux of McCray's proclamation that states should broaden their tax jurisdiction.

State governments levy taxes to pay for the services they perform. When a state taxes a foreign entity receiving no services, that state is acting as a collective purchasing union. The state is forcing the seller to decide whether it is in his or her best interest to sell products, not only to individuals within the state, but whether to sell to the state as a group of individuals. When purchasing unions exercise market power in this manner, the purchasers as a group, are made better off and sellers are made worse off. Society as a whole is made worse off because fewer transactions take place.[13] This is perhaps why the Constitution prohibits states from laying "imposts of duties on imports or exports..."[14] for these would have similar economic effects.

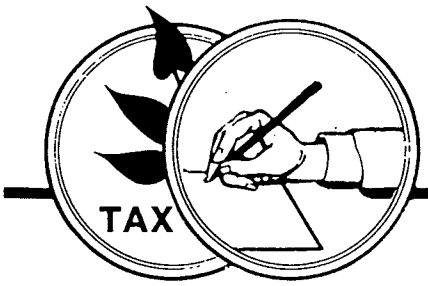
If through savvy legal manipulation someone discovers how to create a state tax scheme which works like a tariff, but safely escapes the constitutional prohibition, McCray may be excused for advocating such a tax in the interest of her home state. She would not be justified in advocating the universal acceptance of such a scheme.

Dr. Roger S. Cohen
New York State Senate
Finance Committee
July 19, 1990

(The author wishes to thank Brien Downes, director of the New York Legislative Tax Study Commission and Marilyn Kaltenborn, New York Department of Taxation and Finance for helpful comments and suggestions.)

[9]McCray 1990, p.1230.
[10]McCray 1990, p.1233.
[11]*Ibid.* p.1230.
[12]An independent would not be subject to tax in state A unless it "regularly and continuously solicits business with its residents." McCray (1990) p. 1230.

[13]See *Microeconomic Theory*, Ferguson and Gould, 4th ed., 1975, chapters 8-12, for a more detailed discussion.
[14]The United States Constitution, Article I, Section 10.



letters to the editor

McCRAY RESPONDS TO COHEN ON STATE BANK TAXES

To the Editor:

Roger Cohen's letter (see *Tax Notes*, July 30, 1990, p. 631) taking issue with my article entitled "State Taxation of New Banking Procedures" (see *Tax Notes*, June 4, 1990, p. 1229) is long on adjectives but short on facts. Three examples will illustrate the problem. First, Cohen suggests that state income taxation of mail-order businesses violates at least the spirit if not the letter of the U.S. Constitution. This is incorrect. In fact, on several occasions the Supreme Court has upheld state income taxes on out-of-state businesses that regularly solicit business within the taxing state (see McCray, "State Taxation of Interstate Banking," 21 GA. L. REV. 283 (1986)). In 1959, recognizing the Supreme Court's position on the legitimacy of such taxation, business lobbyists sought and gained congressional relief in the form of a federal statute (P.L. 86-272) to limit such taxation in connection with the sale of tangible personal property (financial institutions, among others, are not subject to P.L. 86-272).

Second, Cohen asserts that no state has adopted the broad jurisdiction rules that I and other legal scholars and economists have recommended. Incorrect again. In fact, in the very *Tax Notes* article that Cohen criticizes, I discuss four new state bank taxes and note that three of the four states that have modernized their bank tax laws have adopted broad jurisdiction rules. Moreover, more than half of the states have adopted broad jurisdiction rules in connection with their sales taxes on mail-order sellers. (See McCray, "Overturning *Bellas Hess*: Due Process Considerations," 1985 BYU LAW REV. 265).

Finally, Cohen asserts that New York has chosen not to adopt broad jurisdiction rules because it views such taxes as economically inefficient tariffs. Strike three. In fact, New York *has* adopted such rules to reach mail-order insurers and retailers. New York, has, however, exempted from this jurisdiction banks and other financial institutions that mail credit cards to New York residents and receive interest and fee income from them. The state probably did so in response to an actual or perceived risk of out-migration by New York-based financial institutions. In an era in which New York is facing the loss of corporate headquarters and narrowing tax base, this response may be reasonable. Given the state's treatment of mail-order insurers and retailers, however, it is hard to support Cohen's proposition that the New York exemption for banks is rooted in economic or constitutional philosophy.

Very truly yours,

Sandra B. McCray, Esq.
Boulder, Colo.
August 10, 1990

CONGRESSIONAL HEARINGS

UNOFFICIAL TRANSCRIPT OF PENSION SIMPLIFICATION HEARING IS AVAILABLE. Tax Analysts has made available the full text of the unofficial transcript of the August 3 pension simplification hearing before the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service.

Sen. David Pryor, D-Ark., chairman of the subcommittee, accused Treasury of failing to work with Congress in drafting legislation to simplify pension laws. "You've come here to slow down the process," Pryor said, charging Treasury with attempting to "nit-pick" his efforts. Pryor tempered his remarks only by stating that they were not directed personally at Thomas D. Terry, Treasury's Tax Benefits Counsel, who testified at the hearing, but rather at the entire administration. (For prior coverage of the hearing, see *Tax Notes*, August 13, 1990, p. 800.)

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GOVERNMENT OPERATIONS COMMITTEE TO CONSIDER SEQUESTER IMPACT. The House Government Operations Committee intends to consider the impact of sequester on August 28, according to Committee Chairman John Conyers, Jr., D-Mich. In a release highly critical of the Bush and Reagan administrations' budget policies, Conyers said that the committee would be considering the "Truth in Budgeting Reform Act" he introduced on August 2 at the hearing. The time and place of the hearing were not yet available, a committee spokesman said on August 14.

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Madhusudhan, Ranjana G., "Fiscal Federalism Limits the Bank Tax Uniformity Debate", State Tax Notes (August 30, 1993) p. 460-464

state tax notes

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Tax Analysts

Special Report / Viewpoint

Fiscal Federalism Limits the Bank Tax Uniformity Debate

by Ranjana G. Madhusudhan, New Jersey Department of Treasury

Ranjana G. Madhusudhan is a tax analyst with the New Jersey Department of Treasury, Division of Taxation.

The views expressed here are those of the author and do not necessarily reflect the views of the New Jersey Department of Taxation or the Division of Taxation.

The author wishes to thank Henry Coleman and Michael Wasylenko for helpful comments and suggestions.

(For a report on the future of financial institution taxation, see State Tax Notes, Dec. 14, 1992, p. 901. For news and special reports on the proposed MTC regulation for financial institutions, see State Tax Notes, Aug. 31, 1992, p. 297; May 4, 1992, p. 632; and Apr. 20, 1992, p. 551.)

Currently, there is much discussion and debate on the issue of uniformity of state taxation of financial institutions. The Multistate Tax Commission (MTC), state officials, industry representatives, and agencies such as the Federation of Tax Administrators (FTA) are trying to develop a uniform apportionment method for financial institutions.[1] The primary goal is to develop an apportionment formula that will be acceptable to all states, including the money center (or headquarter) and market states. However, given fiscal federalism and the inherently inconsistent goals of market and headquarter states, it would be very difficult to have total uniformity in bank tax laws across states. For instance, headquarter states tend to favor production factors of financial services. The receipts factor is a case in point. A headquarter state would tend to attribute receipts from loans to the location of the bank that processed or provided them. In contrast, a market state would tend to attribute the receipts from loans to the location of the borrower. The ongoing debate over bank tax uniformity needs to shift its attention to more important issues, such as efficiency and simplicity. This paper attempts to refocus the current uniformity debate to the uniform taxation of out-of-state banking institutions.[2]

[1]Douglas (Dec. 25, 1989); Multistate Tax Commission memo dated March 30, 1991; Bucks (April 20, 1992); Hodges and Zammit (April 20, 1992); and Sheppard (May 4, 1992). For details on cited sources, see "References" following this article.

[2]In this analysis, "banking institutions" generally refers to banks and other financial institutions.

Background

The financial services industry in general, and the banking industry in particular, have undergone revolutionary technological and structural changes. These changes have brought about shifts in geographic markets, new financial products, and new suppliers of financial products.[3] Electronic delivery of banking services has given rise to branchless banking across state lines. Interstate banking, which is the most significant of all developments, poses serious challenges for state taxation of banking.

The ongoing debate over bank tax uniformity needs to shift its attention to more important issues, such as efficiency and simplicity. This paper attempts to refocus the current uniformity debate to the uniform taxation of out-of-state banking institutions.

New banking technology enables banks to locate anywhere and engage in interstate banking from their home states.[4] Circumstances that govern the industry have evolved considerably, but tax laws have not. Both evasion and avoidance are encouraged under the existing bank tax laws, which are clearly not equipped to handle the challenges of the changing banking industry.[5] Interstate banking and the onset of nontraditional banking practices and technology are among the forces challenging the existing state banking tax structure. The existing bank taxes are clearly out of sync with modern banking; fundamental reforms are needed.[6] Most state taxes, for instance, do not recognize economic presence and are based on "brick and mortar" or physical presence in the state. "Doing business" conditions clearly need to be aligned with developments taking place in the mode of interstate banking. Taxation

[3]*See* Haraf and Kushneider (1988) for details on the structural changes in the financial services industry.

[4]In this discussion, "home state" refers to the state where a particular bank is chartered and has its headquarters.

[5]Currently, narrow and obsolete rules encourage these problems. Loan production offices are a case in point; rules governing these entities are ambiguous, enabling them to escape state taxation.

[6]For a discussion of major problems with the existing state bank tax systems, particularly those specific to New Jersey, refer to Madhusudhan (1988 and 1992).

of out-of-state banking institutions, particularly the branchless ones, is a significant policy concern.

Different states are responding differently to the new banking environment. New York and Minnesota are among the pioneering states in revision of bank taxes. Recently, Indiana, Tennessee, and West Virginia have also reformed their bank tax laws. The new bank tax laws adopted reflect inherent biases either of a headquarter-state or a market-state approach. Being a financial center state, New York has adopted laws that favor headquarter location there. New York's situs rules favor the origin approach — where was the loan approved and sanctioned? — as opposed to location of the borrower.

The new laws adopted in Indiana, Minnesota, Tennessee, and West Virginia illustrate the other extreme philosophy of a market-state approach. This is clearly reflected in the situs rules and in the fact that "economic presence" of the transaction as opposed to "physical presence" of the bank is recognized as the basis of tax subjectivity in the state. The Indiana and West Virginia laws demonstrate yet another approach — namely, the dual approach to state taxation of banks. Under this system, in-state banks pay taxes on their entire income with provision for credit for taxes paid to other states. Out-of-state banks are taxed using a single-receipts-factor apportionment formula. However, the three alternative models — the headquarter-state approach (New York), the market-state approach (Indiana, Minnesota, Tennessee, and West Virginia), and the dual approach (Indiana and West Virginia) — must be tracked carefully and evaluated against established revenue criteria such as equity, efficiency, and simplicity.[7]

Implications for Tax Uniformity With Fiscal Federalism

Interstate differences in state and local tax systems are an innate feature of American fiscal federalism. State corporate income taxes are a case in point.[8] Five states do not have any corporate income tax.[9] Among the states that levy the corporate income tax, there is wide variation in the tax structure.[10] Some states have a flat rate,[11] some use graduated rates,[12] some have minimum tax requirements,[13] and some have alternative minimum taxes.[14] Several special rates and features also add to the diversity among state corporate income tax systems.[15]

Further, an examination of the existing corporate tax bases and apportionment formulas reveals other dimensions of interstate differences in the U.S. federal system. Although most of the states use taxable federal income as the starting point,[16] the adjusted state taxable income base varies widely due to differences in the additions and subtractions made.[17] The apportionment mechanisms in use also highlight the nonuniformity in the existing structure of state corporate taxes. For instance, even the three-factor Uniform Division of Income for Tax Purposes (UDITPA) formula, which is intended to provide a common framework for allocation and apportionment of interstate income, is not applied in a uniform manner.[18]

Among the states that have adopted the UDITPA formula, some do not allow unitary combination[19] while others do.[20] Of those with unitary combination, some require domestic only[21] or water's edge and some require worldwide combination but permit a water's edge election under certain circumstances.[22] A large number of the states have also modified the three-factor UDITPA formula,[23] usually by double-weighting the sales factor.[24] A few of the UDITPA states have provisions for other formula options.[25]

The above discussion indicates that the structure of corporate income tax varies widely across state lines. This is the case with most other state taxes, including the personal income and sales taxes.[26] Thus, given fiscal federalism, it will be rather difficult to achieve total uniformity in state bank taxes. Total uniformity is not only difficult, but probably not desirable.[27]

It has been noted that in a federal system, economic efficiency points in the direction of a wide scope for decentralized

[7]For an excellent discussion of alternative methods of income taxation of banks, refer to the December 1989 ACIR report. In this report, McCray highlights different models of corporate income taxation, including source-based taxation with formulary apportionment.

[8]*See* ACIR's *Significant Features of Fiscal Federalism* (February 1992), Tables 25 to 27, for details.

[9]These are Nevada, South Dakota, Texas, Washington, and Wyoming.

[10]*See* ACIR's *Significant Features of Fiscal Federalism* and CCH's *State Tax Reporter* for details.

[11]They are Alabama, Arizona, California, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Kansas, Maryland, Massachusetts, Michigan, Minnesota, Montana, New Hampshire, New Jersey, New York, North Carolina, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Utah, Virginia, West Virginia, Wisconsin, and the District of Columbia.

[12]Alaska, Arkansas, Colorado, Hawaii, Iowa, Kentucky, Louisiana, Maine, Mississippi, Missouri, Nebraska, New Mexico, North Dakota, Ohio, and Vermont use graduated tax rates.

[13]Included are Arizona, California, Connecticut, Idaho, Massachusetts, Montana, New Jersey, New York, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Dakota (for financial institutions), Utah, Vermont, and Wisconsin. The flat minimum tax rate ranges from $10 (Oregon) to $800 (California).

[14]California, Florida, Iowa, Minnesota, New York, and Oklahoma are examples of such states. The alternative minimum tax rates range from 3.3 percent (Florida) to 8.5 percent (California).

[15]For instance, there are special rules for financial institutions in many states. Some states also impose surtaxes or surcharges on corporations. Michigan uses a modified value added tax, known as the single business tax, at the rate of 2.35 percent on an adjusted tax base. New York provides a unique example of a state with a rather elaborate fixed-dollar minimum tax rate, which varies according to the taxpayer's gross payroll amount. The rates range from $325 to $1,500 for active corporations and $800 for qualified inactive corporations. There is also a levy of 0.9 mill for every dollar of allocated subsidiary capital.

[16]Alabama, Arkansas, California, Michigan, Mississippi, North Dakota, Utah, and Wisconsin are exceptions.

[17]The disparate provisions for NOL and interest income adjustments are examples.

[18]During 1991, a total of 24 states adopted the Uniform Division of Income for Tax Purposes Act (see ACIR, February 1992, p. 86), or UDITPA.

[19]Alabama, Arkansas, Florida, Massachusetts, Missouri, Pennsylvania, Vermont, West Virginia, Wisconsin, and the District of Columbia do not allow unitary accounting.

[20]Tennessee allows the unitary method for financial institutions only.

[21]Examples of such states are Arizona, Hawaii, Illinois, Kansas, Kentucky, Maine, New Hampshire, New Mexico (optional domestic), North Carolina (domestic at state option), Oklahoma, and Oregon (domestic consolidated).

[22]California, Montana, and North Dakota require worldwide combination but permit a water's edge election under certain conditions.

[23]The UDITPA formula is based on property, payroll, and sales with equal weights.

[24]Arizona, Florida, Illinois, Kentucky, Maine, Massachusetts, Oregon, and Wisconsin are examples of states that double-weight the sales factor.

[25]Colorado, North Carolina, and West Virginia are examples.

[26]In the United States, there is also substantial nonuniformity of local taxes both within and across state lines.

[27]Recall the discussion earlier that despite UDITPA, there is significant nonuniformity in state corporate taxes.

choice in the public sector.[28] Whether interjurisdictional tax and policy competition is good or bad for the federal system remains to be fully resolved.[29] However, there is now a growing realization that competition has the potential to improve public service efficiency and, thereby, government responsiveness to citizen preferences.[30] The new viewpoint suggests that interjurisdictional competition will not always lead to inadequate state and local spending, and may even encourage higher spending. Thus, interjurisdictional competition may be an important regulator of the federal system, with competition yielding a government system in which taxes and policies are brought into line with citizen preferences.[31]

From the discussion above, it appears that states would be likely to structure their own bank taxes in line with their citizen preferences. However, states also are aware of the challenges posed by interstate banking. It is in the interest of states to cooperate to minimize the potential for tax avoidance by banks, particularly under declining fiscal conditions.[32] Interstate competition and cooperation both have a role in a healthy and prosperous federal system, and a certain tension between them may be necessary for the realization of the values of federalism.[33]

Interstate diversity in bank taxes is likely to continue. The recent bank tax reform measures clearly support this argument. States are responding differently to the interstate banking challenge, the crux of the matter being the apportionment of income of multistate banks.[34] It is still too early to discern the pros and cons of these new approaches. In the meantime, states will continue to consider and adopt newer approaches.[35]

Policy Alternatives

The objective is to choose an appropriate formula to apportion the income of multistate banks that provide banking services within and outside the home state. One of the primary goals is to recognize interstate banking and the changing banking industry environment. At this point in time, there is little theoretical or empirical evidence to guide policymakers in selecting apportionment schemes. According to a recent report by the U.S. Advisory Commission on Intergovernmental Relations (ACIR), there is no empirical evidence that suggests that any factor is better than any other or that any combination will produce a better result when used for both headquarter and market states.[36]

The three-factor UDITPA formula currently used by many states is not appropriate for banks.[37] One of the restructuring alternatives for the states is to modify the commonly used three-factor formula, i.e., use a modified multifactor apportionment formula.[38] It is important to recognize, however, that uniformly applying any single apportionment formula would represent a compromise proposal at best.

In general, a multifactor apportionment formula with both supply-side and demand-side factors is a broad-based alternative. Some examples of commonly used apportionment factors are property and payroll (supply side) and receipts (demand side). Several arguments can be made in favor of a multifactor formula. Some of those who have discussed formulary apportionment — who have attempted to look at it through classical lenses — conclude that from a value-theoretic standpoint, both the supply side and the demand side should be included in apportionment formulas.[39] However, the choice of appropriate factors and weights remains somewhat of an open issue.[40]

Using factors that are related both to banking activity and earnings would increase revenue productivity for the state, given other things. For instance, using a three-factor formula to apportion the income of state-based (or "resident") banks would result in a larger tax base for the home state as compared with a single-factor option.[41] Another revenue advantage of a multifactor apportionment alternative is that it enhances the revenue stability of the system. For instance, the loss in tax base due to an increase in receipts out of state would be offset somewhat by supply-side factors. This is because the supply-side factors would tend to increase with increased production of services in-state. A multi-factor formula for banks would be more neutral as similar apportionment is used in the case of multistate general business corporations.

There are policy trade-offs, however. For instance, a multifactor formula with production-oriented factors has the potential to distort equity between state-based and out-of-state banks that provide banking services from outside the state (i.e., the branchless banks). Such a formula would discriminate against in-state banks, which would be subject to relatively higher tax liabilities. This problem of inequity could be partially addressed by changing the factor mix, the factor weights, or both. Many states, for instance, assign a higher weight to the receipts factor.

In contrast, under a single-factor formula based on receipts, the apportionment of income of resident and out-of-state banks would be more equitable. Even though such a formula would be particularly attractive to market states, there would be revenue instability with changes in market and industry conditions.

[28]Oates (1977, p. 14). He also observes that the desire to guarantee adequate service levels in all jurisdictions motivates centrally imposed constraints on local fiscal behavior. A similar view was expressed much earlier by Tiebout (1956).

[29]*See* ACIR (April 1991) report and Kenyon and Kincaid (1991) for an excellent discussion of the subject.

[30]Kenyon and Kincaid (1991, p. 27).

[31]ACIR (April 1991).

[32]Tax avoidance is a serious problem, more so for banks that deal primarily with intangible assets that are flexible across geographic boundaries. New developments in the banking industry, such as asset securitization, create significant tax avoidance potential for multistate banks. Obsolete state bank tax rules — such as those based on the traditional "brick and mortar in-state presence" — also increase tax avoidance opportunities.

[33]ACIR (April 1991, p. iv).

[34]For a summary of new tax legislation, refer to McCray (June 4, 1990).

[35]Currently, there is very little constitutional constraint on the structuring of apportionment formulas by states. According to McCray (July 1987), the Supreme Court will not invalidate a multifactor apportionment formula and factors and situs rules that reasonably represent how and where the particular business earns its income, if the state applies the formula to only those corporations over which it has a tax nexus.

[36]ACIR (December 1989), p. 21.

[37]For instance, it does not include intangible property, which is an essential factor for financial institutions.

[38]Refer to Madhusudhan (1992) for a discussion of issues surrounding the choice of apportionment formulas.

[39]*See* Francis and McGavin (1991, p. 5).

[40]As noted earlier, states have wide latitude in their choice of apportionment formulas (McCray, July 1987, p. 61).

[41]A higher apportioned base under the three-factor formula is because banks headquartered in the state are expected to have most of their property and payroll factors in the home state.

Taking a long view would appear to be a more prudent policy choice.[42]

The main hurdle under the multifactor apportionment alternative would be to get all the states to agree on a uniform formula. States have engaged in formula manipulation to confer benefits on business. They are aware of the underlying political advantage due to its obscurity compared with other methods of business subsidization.[43] Recall again that uniformity attempts through the adoption of the UDITPA formula have failed.

In order to generate a uniform apportionment formula, states would have to agree on all the factors, their definitions, and weights. This is difficult in a fiscally decentralized system. There are bound to be differences between the headquarter and market states. However, regardless of their type, states would not like to give up their powers to design their own state taxes. States would like the autonomy to decide how to tax their resident banks.

A single-factor formula based on receipts would be most appropriate for out-of-state banks.

The taxation of out-of-state banks is, nevertheless, an issue facing all states in the interstate banking era. Thus, the issue of bank tax uniformity needs to be narrowed down to focus primarily on the taxation of out-of-state banks, at least for now. Adopting uniform taxation of out-of-state banks would reduce tax avoidance, which is currently hurting the states.

Uniformity in the Taxation of Out-of-State Banks

A single-factor formula based on receipts would be most appropriate for out-of-state banks. These entities would be subject to tax on the receipts earned in different states. Since the tax subjectivity is on account of receipts earned in a particular state and the services provided are produced outside that state, using factors that are production-oriented (such as property and payroll) would not be appropriate.

A single-factor formula is revenue-productive. Such a formula would tend to generate more revenues from out-of-state banks as compared with any other formula that includes production factors.[44] A single-factor receipts formula scores the highest for simplicity and low compliance and enforcement costs. For instance, tax compliance requirements would be smaller for out-of-state banks under a single-factor receipts formula.[45]

Due to its simplicity, more states would be willing to use a single-factor receipts formula to apportion the income of out-of-state banks. Increased uniformity in the state taxation of financial service providers, in turn, would lower barriers to interstate capital flows and thereby increase the efficiency in the provision of financial services.[46] Banks also may prefer this simple tax design, as more uniformity would tend to reduce the administrative costs of filing their tax returns in various states.

Note that the use of the single-factor formula for out-of-state banks is compatible with both the source-based and residence-based taxation of resident banks. States would, however, need to adopt uniform factor definitions if they also use source-based taxation for resident banks. For instance, the receipts factor must be defined in the same manner for all banks. Consistency in factor definitions would reduce the potential for over- or under-taxation of multistate banks.

But if states use residence-based taxation for state-based banks, they would need to use credits against taxes paid to other states to avoid multiple taxation.[47] In other words, states would retain their autonomy to choose how to tax their resident banks but agree on using the single-factor (receipts) formula to tax out-of-state banks. Administrative issues and enforcement costs are serious policy concerns and are topics for detailed analysis.

Conclusion

In a fiscally decentralized system, there is bound to be wide diversity in state taxes. As such, it is difficult to envision complete uniformity in bank taxes across states. The adoption of UDITPA illustrates the point well. As noted above, many differences still remain in the corporate tax structures among states that have adopted UDITPA.

The promotion of uniformity may be more important from a national perspective.[48] However, nonuniformity in state bank tax laws, particularly in apportionment formulas, is likely to distort equity between in-state and out-of-state banks. Nonuniformity increases the potential for tax avoidance and also multiple taxation for multistate banks.[49] The policy question that must be addressed is: How much uniformity should be targeted within the bounds of fiscal decentralization? There is a need for a practical and realistic approach to the issue of state tax uniformity. The uniformity debate should really focus on the taxation of out-of-state banking institutions.[50] The taxation of out-of-state branchless banking entities is a growing policy concern in most states.[51] It would be relatively easier for states

[42]A market state may evolve into a financial center state. A similar view was expressed by Dan Bucks, executive director of the Multistate Tax Commission, at a recent seminar on state taxation and regulation of banking. *See Tax Notes*, Dec. 25, 1989, p. 1547.

[43]*See* Francis and McGavin (1991, p. 8).

[44]The reason is that out-of-state banks are typically expected to have most of their production factors, such as property and payroll, outside the market state (or in their respective home states).

[45]Out-of-state banks would need to keep track of their receipts in various states, a record probably kept in the regular course of their business.

[46]In a recent study, Neubig (1991) argues that if there is nonuniformity of state tax rules, reduced capital availability would be most likely to occur in market or capital-importing states.

[47]Under a residence-based tax, the entire income of the resident bank is subject to taxation.

[48]*See* ACIR (1975).

[49]Consider the following case as an illustration. Bank Z is based in State A, which uses residence-based taxation (i.e., it taxes the entire income of resident banks). Bank Z earns X percent of its income from State B, which uses source-based taxation, and Y percent in its home state. State A would impose taxes on the entire income of Bank Z, including the X percent earned and taxed in State B. Thus, there would be overtaxation of Bank Z's income. On the other hand, if State A used source-based and State B used residence-based taxation, Bank Z would be undertaxed.

[50]In particular, taxation of out-of-state branchless banking institutions.

[51]Branchless banking is typically conducted by mail, telephone, and various electronic means. The Colonial National Bank of Wilmington, Del., is often cited in the bank tax literature as an illustration of branchless banking.

to agree on adopting uniform rules for taxing out-of-state entities.

Interstate cooperation would benefit all the states. It would help tax compliance by banks and also make the task of enforcement less burdensome at the state level. Several interstate compacts of agreement are already in place in the case of other taxes.[52]

A simple and efficient way to tax out-of-state banks would be to tax them using a single-factor formula based on in-state receipts. It is a simple formula and would minimize tax avoidance by out-of-state banks. Revenue losses currently being experienced by states also would be minimized. Banks should not find it difficult to comply, as they would only have to keep track of their receipts in the market states and would not have to worry about the different state tax laws.[53]

A move toward uniformity would reduce tax-planning opportunities by multistate banks and reduce revenue losses by states.

The adoption by more states of uniform taxation of out-of-state banks would represent a giant step forward in interstate tax uniformity and cooperation.[54] The objective is to maximize uniformity, subject to the constraints of fiscal decentralization. A move toward uniformity would reduce tax-planning opportunities by multistate banks and reduce revenue losses by states. States would retain the autonomy of designing their own bank tax laws for state-based banks. With uniform factor definitions and a system of credits, any potential for multiple taxation would be minimized.[55] Thus, there would be bank tax uniformity to the extent attainable within the limits of fiscal federalism. ☆

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[52]The Interstate Fuel Tax Agreement (IFTA) is an example.

[53]In this context, a market state refers to a state where the bank does business other than the state of its domicile or its home state.

[54]Currently, Tennessee, Indiana, and West Virginia are among the states that tax out-of-state banks using a single-factor receipts formula.

[55]This calls for defining factors uniformly in all states. States would need to work together to find common factor definitions and situs rules. However, they would have the freedom of defining the number of factors and their weights.

EXHIBIT K: 41

Neubig, Thomas S., "The Economic Impacts of New State Taxation of Financial Service Income", Bank Administration Institute - Multistate Taxation Banking Symposium (November 19, 1990)

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THE ECONOMIC IMPACTS OF NEW STATE TAXATION OF FINANCIAL SERVICE INCOME

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for the

Multistate Taxation of Banking Symposium
New York, New York
November 19, 1990

THE ECONOMIC IMPACTS OF NEW STATE TAXATION OF FINANCIAL SERVICE INCOME

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The financial services industry is confronting major differences in how states tax financial institutions with the potential of subjecting their income to multiple state income taxation. Most states tax income earned from financial services performed in the state, while several states now tax income earned from financial services provided to their residents. The economic implications of multiple taxation would affect the availability and cost of financial services for individuals and businesses as well as the efficiency of the U.S. financial capital markets.

1. What does economic theory say about the potential economic effects of multiple state taxation of financial service income?

   - o Reduced capital availability
   - o Higher loan rates and fees
   - o Lower after-tax profits and reduced activity of inter-state lenders
   - o Geographic shifting of financial service production
   - o "Balkanization" of financial services (increased in-state activity)
   - o Additional non-bank lending
   - o Increased compliance and administrative costs

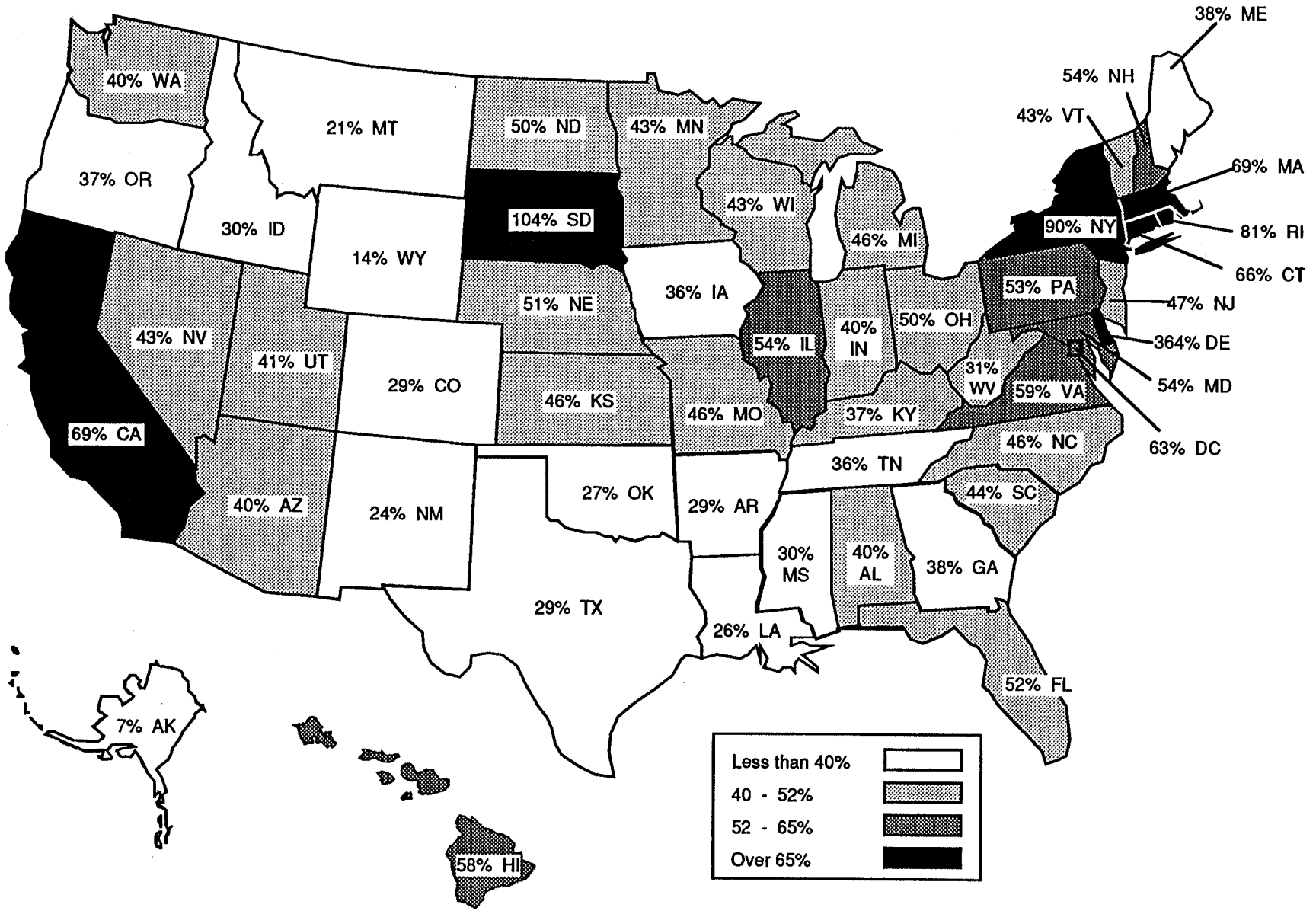
2. Why is the issue important? Is it significant?

   - o Potential costs on:
     - Mortgage borrowers
     - Small businesses
     - State financing costs
     - State economic development efforts
     - National capital markets

3. Which types of individuals, businesses, and states are likely to be affected?

   - o Types of individual customers most likely to be affected
   - o Types of companies that have cross-border primary banking relationships
   - o States that are net capital importers vs. net capital exporters

Figure A. Total In-State Financial Institution Lending as Percentage of Total Private Borrowing in 1989



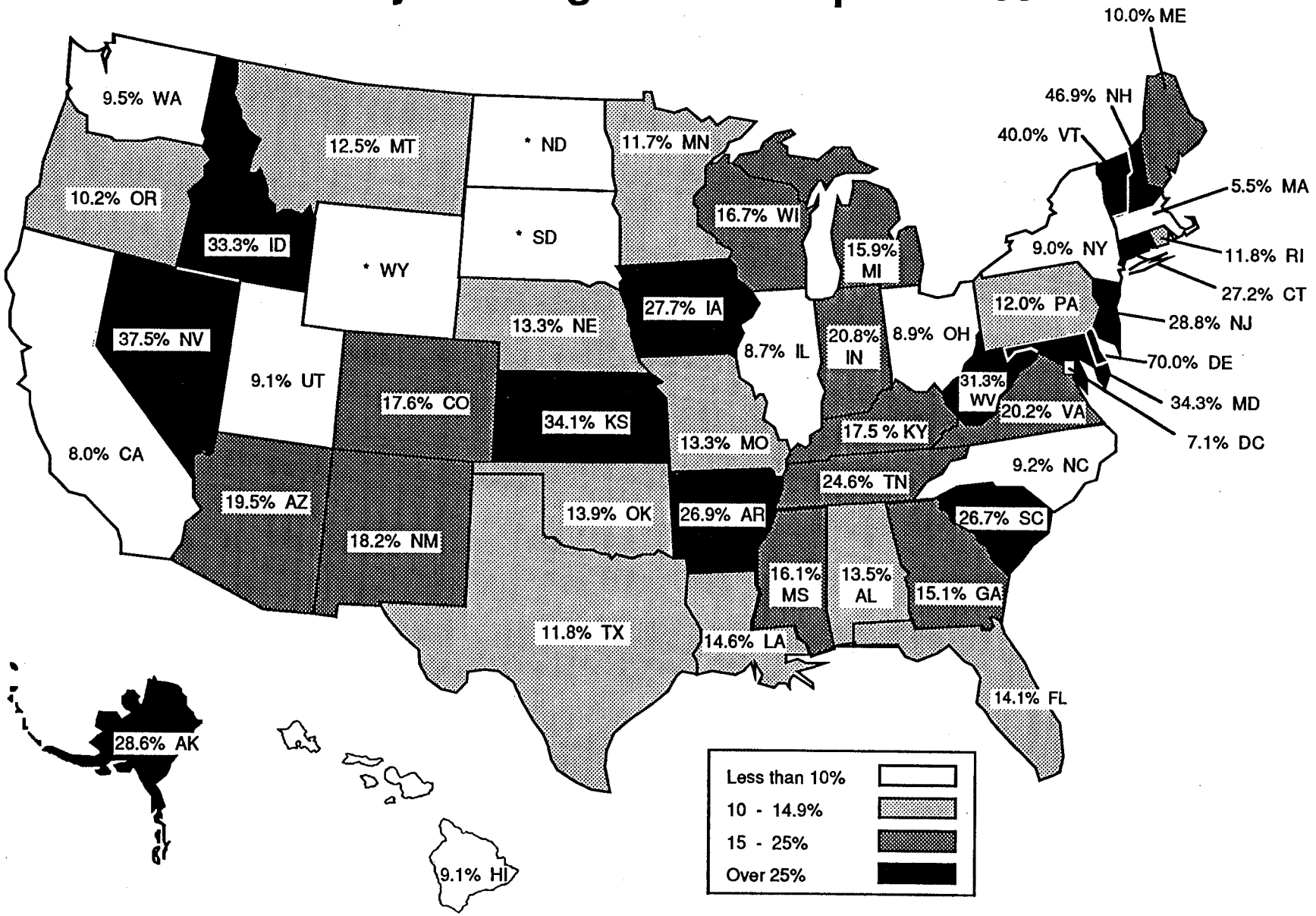
Source: Price Waterhouse estimates.

Price Waterhouse, Washington National Tax Services.

Table A. States Ranked by 1989 Ratio of In-State Financial Institution Lending as Percent of Estimated State Borrowing (Percentages)		
State	In-State FI Lending/ Estimated Borrowing	Rank
Delaware	364	1
South Dakota	104	2
New York	90	3
Rhode Island	81	4
California	69	5
Massachusetts	69	6
Connecticut	66	7
D.C.	63	8
Virginia	59	9
Hawaii	58	10
Illinois	54	11
Maryland	54	12
New Hampshire	54	13
Pennsylvania	53	14
Average for U.S.	52	---
Florida	52	15
Nebraska	51	16
Ohio	50	17
New Jersey	47	18
Kansas	46	19
Missouri	46	20
North Carolina	46	21
Michigan	46	22
South Carolina	44	23
Minnesota	43	24
Vermont	43	25
Nevada	43	26
Wisconsin	43	27
North Dakota	42	28
Utah	41	29
Washington	40	30
Arizona	40	31
Indiana	40	32
Alabama	40	33
Georgia	38	34
Maine	38	35
Kentucky	37	36
Oregon	37	37
Iowa	36	38
Tennessee	36	39
West Virginia	31	40
Mississippi	30	41
Idaho	30	42
Colorado	29	43
Texas	29	44
Arkansas	29	45
Oklahoma	27	46
Lousiana	26	47
New Mexico	24	48
Montana	21	49
Wyoming	14	50
Alaska	7	51

Price Waterhouse, Washington National Tax Services.
Source: Price Waterhouse estimates.

Figure B. Percentage of Firms with Out-of-State Primary Banking Relationships in 1989



* Sample includes fewer than five companies.

Source: Standard & Poors Compumark database. Sample by Price Waterhouse.

Price Waterhouse, Washington National Tax Services.

Table B. Percent of Corporations Reporting an Out-Of-State Primary Banking Relationship by State, 1989

State	Percent of Out-of-State Primary Banking Relationships
Alabama	13.5%
Alaska	28.6
Arizona	19.5
Arkansas	26.9
California	8.0
Colorado	17.6
Connectiuct	27.2
Delaware	70.0
D.C.	7.1
Florida	14.1
Georgia	15.1
Hawaii	9.1
Idaho	33.3
Illinois	8.7
Indiana	20.6
Iowa	27.7
Kansas	34.1
Kentucky	17.5
Louisiana	14.8
Maine	16.0
Maryland	34.3
Massachusetts	5.5
Michigan	15.9
Minnesota	11.7
Mississippi	16.1
Missouri	13.3
Montana	12.5
Nebraska	13.3
Nevada	37.5
New Hampshire	46.9
New Jersey	28.8
New Mexico	18.2
New York	9.0
North Carolina	9.2
North Dakota	*
Ohio	8.9
Oklahoma	13.9
Oregon	10.2
Pennsylvannia	12.0
Rhode Island	11.8
South Carolina	26.7
South Dakota	*
Tennessee	24.6
Texas	11.8
Utah	9.1
Vermont	40.0
Virginia	20.2
Washington	9.5
West Virginia	31.3
Wisconsin	16.7
Wyoming	*
Average for U.S.	14.8%

Price Waterhouse, Washington National Tax Services.

* Less than six corporations reporting a primary banking relationship.

Source: Standard and Poor's Compumark Data Services.
Compiled by Price Waterhouse from a sample of 4601 corporations reporting a primary banking relationship.

EXHIBIT K: 42

New York State Bar Association, Tax Section, Committee on State and Local Taxes, "Revised Preliminary Report on State Taxation of Financial Institutions" (March 31, 1992)

NEW YORK STATE BAR ASSOCIATION
TAX SECTION
COMMITTEE ON STATE AND LOCAL TAXES*

Report on State Taxation of Financial Institutions

I. INTRODUCTION

Recent years have witnessed radical changes in the banking and financial services industry. Deposit-taking and mortgage-lending institutions such as federally-chartered thrifts have opened branches in numerous states, while other financial institutions, such as commercial banks, have continued to expand their home mortgage, commercial lending and consumer credit activities outside the states in which they are domiciled or in which their headquarters are located. In addition, participations in mortgage pools are now frequently sold by the originator to investors of all kinds located throughout the country.

State legislatures, competing for tax revenues, have been taking a hard look at these activities, and are beginning to tax nondomiciliary financial institutions in a much more aggressive fashion.[1] These developments have

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* This report was principally drafted by Henry P. Bubel and Randall K. Short. Helpful comments were contributed by John A. Corry, Haskell Edelstein, Daniel Lavin, James H. Peters, Arthur R. Rosen and Michael Schler.

1 The term "financial institution" as used in this report encompasses, among other entities, commercial banks (generally, depository institutions with broad lending powers for short or intermediate term purposes) and

(footnote continued on next page)

resulted in a current morass with respect to state taxation of financial institutions, one which is largely attributable to the lack of uniformity in the states' respective methodologies for taxing financial institutions. Part of this lack of uniformity is attributable to mere obsolescence: many states' laws governing taxation of financial institutions were enacted before the advent of interstate banking and thus fail to address the particular problems attendant thereto.[2] Other states have no special regimen at all regarding the taxation of financial institutions and instead attempt to apply the same rules to financial institutions as they have traditionally applied to manufacturing companies, with predictably unsatisfactory results.

More recently, however, a number of states have responded to the changing financial landscape and have enacted legislation governing the taxation of nondomiciliary financial institutions. Such legislation has been adopted by

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(footnote continued from previous page)

thrift institutions (including savings and loan associations and savings banks, both of which engage in long-term mortgage lending). For purposes of this report, it does not include other providers of financial services such as insurance companies, securities firms, leasing companies and commercial credit companies.

2 Hodges, Recent Developments in Multistate Taxation of Financial Institutions: A Veritable Revolution, 2 J. of Cal. Tax'n 11, 12 (Fall 1990) (hereinafter referred to as "Hodges"); see generally State Taxation of Banks: Issues and Options, Advisory Commission on Intergovernmental Relations (December 1989).

both "money center states" (those states where major financial institutions are commercially domiciled) and "market states" (those states where customers of financial institutions are more significant than the financial institutions domiciled there). Not surprisingly, the methodologies embodied in the legislation often clash, as they reflect the competing objectives of different states. The Multistate Tax Commission has proposed regulations which purport to reduce this friction, but seem to favor market states and are therefore unlikely to be found acceptable by New York and other money center states.

Various states and industry groups have met in the past, thus far without great success, in attempts to develop a uniform system of taxation of financial institutions which would be acceptable to, and adopted by, both money center states and market states. One of the current efforts includes participation by a small group of states, the Multistate Tax Commission and the Federation of State Administrators. But given the basic differences in self-interest, compromise has thus far proved impossible to achieve.

Arguably, part of the difficulty in achieving a workable compromise stems from the uncertainty surrounding the nexus required for state taxation of nondomiciliaries, and it is therefore quite possible that the anxiously-awaited decision of the Supreme Court in Quill could help remove some

of the impediments to compromise -- if the Court affirms National Bellas Hess in a manner which demands physical presence to establish nexus. But it is also quite likely that Quill will be decided in a manner which permits (or causes) even more states to tax more aggressively.

Regardless of how Quill is decided, the problem of varying apportionment methods will remain for those financial institutions which meet the "new" nexus test in several jurisdictions. In this regard, the Supreme Court recently decided to rehear oral argument in Allied-Signal, in which the Court will determine whether it is constitutional for a state to tax gain recognized by a nondomiciliary corporation attributable to its sale of shares of stock in another corporation which was not engaged in a unitary business with the nondomiciliary corporation. Quite surprisingly, the Court asked the parties to address in supplemental briefs "what constitutional principles should govern state taxation of corporations doing business in several states." The decision in Allied-Signal thus could have a wide impact on the question of the apportionment of income of both financial institutions and other business corporations.

The authors are aware that many of the state tax problems faced by financial institutions are not unique to that industry, so there is a preliminary question as to why the financial institutions industry (if, it is "an" industry at all) should be singled out for special attention by this

association or for special treatment by state legislatures. In the authors' view, the reasons are three: (i) it is often much more difficult to decide whether nexus exists by reason of financial activity; (ii) the variations in apportionment formulas (and the resulting incidence of overapportionment) are far greater than for widget manufacturers, retailers, etc.; and (iii) the fast-changing nature of the financial products bought and sold make planning and compliance much more difficult in this industry. Although the authors are unaware of any published statistics which prove the seriousness of the overapportionment problem, merely reading the relevant statutes and regulations makes it quite clear that financial institutions "operating" in several states which attempt to comply with such authority must be suffering these problems.

This report examines the background of the current difficulties surrounding state taxation of financial institutions and examines some responses to the problems, some of which often have only further muddied the waters. The report addresses possible solutions to the problems which have been considered by various states, industry groups and others, and the legal or practical obstacles to achieving those solutions.

The report concludes that if, like past efforts, these recent efforts do not bear fruit soon, the adoption of federal legislation governing state taxation of financial

institutions, while perhaps not an ideal solution, may present the only practical and effective solution to many of the state tax problems facing financial institutions. As representatives of New York and the other money center states clearly are outnumbered in the Senate, federal intervention does not bode well for our state's fisc. But the greater unknown is whether growth of the state's financial institutions is being hampered by the status quo.

II. CURRENT APPROACHES TO TAXATION OF FINANCIAL INSTITUTIONS

A. The Change From Traditional Banking Activities to Modern Financial Activities

1. **Traditional Banking Activities**. The banking industry in the United States is generally considered to be governed by a "dual banking system" under which lending institutions may be chartered under Federal or state law and are subject to Federal and state regulatory authority, examination and capital requirements. Historically, the dual banking system arose from the competing efforts of the states and the Federal government to control banking activities.[3] National banks (banks created under Federal law) were prohibited from engaging in interstate banking.[4]

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3 See McCulloch v. Maryland, 17 U.S. 316 (upholding the authority of Congress to charter national banks).

4 Hodges, supra note 1, at 12.

The scenario with respect to state taxation of financial institutions prior to the 1970s has been summarized as follows:

> The result of [various federal actions] was that state taxation of banks was narrowly focused on the income-producing activities of banks physically located within their borders (i.e., "domiciliary banks"). Since neither domiciliary banks nor banks located in other states ("nondomiciliary banks") could engage in interstate banking, no need existed for state tax laws to address the taxation of income resulting from multistate banking activities. Apportionment of a bank's income was unnecessary.5

2. **Modern Financial Activities**. In recent years, the interstate activities of banks and financial institutions have increased dramatically. Part of this growth is attributable to technological advancements which have made interstate transactions more feasible and cost-effective.[6] For example, financial institutions have formed credit card subsidiaries which are domiciled in one state, yet service customers in all fifty states, even though the subsidiary might not have a physical presence in states other than its state of domicile.[7] In addition, as the legal and practical obstacles to interstate banking have lessened, financial institutions have become more aggressive in seeking business

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5 Id.

6 Id. at 13.

7 McCray, State Taxation of New Banking Procedures, Tax Notes (June 4, 1990), at 1230 (hereinafter referred to as "McCray").

with borrowers located outside of their states of domicile. Although proposed federal legislation that would have expanded the power of both federal and state chartered banks to cross borders failed to pass in 1991, the Office of Thrift Supervision announced late in December of that year that it would remove the last barriers to nationwide branching for federally-chartered institutions.

B. Common State Approaches to Taxation of Financial Institutions

Many states have done nothing with regard to modifying their method of taxing financial institutions in response to the ever-increasing phenomenon of interstate banking. Thus, in some states, archaic systems, ill-suited to the realities of modern financial activities, remain in place. Other states have addressed the problem more recently, although most often for reasons of self-interest, i.e., to generate tax revenues or to protect financial institutions domiciled in their respective states. The current state approaches to taxation of financial institutions, along with the legal issues underlying such approaches, are discussed below.

1. The Issues of Nexus and Apportionment.

Underlying the consideration of the validity and fairness of any approach to state taxation of financial institutions are two core issues. The first is that of nexus, i.e., whether a state has jurisdiction to tax a financial institution that

engages in transactions with residents of the state or with respect to property in the state but has no physical presence within the state.

The second issue is that of income assignment, i.e., the method by which a state determines the items or the portion of a nondomiciliary's income that will be taxed by that state. Some states use a straight allocation (or "separate accounting") methodology whereby individual items of income are assigned in their entirety to a particular state. More frequently, states have adopted formulary apportionment schemes whereby an entity's income is apportioned to the state according to a formula which looks to the relative activities of the entity within the state and outside the state.

Critical to determinations of income assignment are issues relating to the sourcing of income. A "market state," one in which primarily borrowers and not lenders are located, will in all likelihood seek to source interest income predominantly in the state of residence of the borrower. Conversely, a "headquarters state" or "money center state," in which lenders are located, in all likelihood will seek to source such income predominantly where the loans are administered or where the lender is domiciled.[8]

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8 Id.

2. **Overview of States' Bank Taxation Systems.**

In taxing banks, states use either a franchise tax, a direct net income tax, a bank shares tax, a gross receipts tax or some other form of tax.[9] A survey conducted in 1988 by the Advisory Commission on Intergovernmental Relations found that slightly over half of the states did not tax banks in the same manner as nonfinancial corporations, while slightly less than half of the states taxed banks in the same manner as such corporations. Eighty percent of the states taxed thrifts, such as savings and loan institutions, in the same manner as commercial banks. The survey found that most states did not have statutes that allowed them to tax certain categories of income earned by out-of-state banks that do not have a physical presence in the state, although some states taxed such income by administrative practice.[10]

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9 Kincaid & McCray, A Survey of State Taxation of Interstate Banking, Tax Notes (Nov. 28, 1988), at pp. 981-85 (hereinafter referred to as "Survey").

10 Id. at 984. Based on the following results, the authors of the Survey concluded, not surprisingly, that "the greater the physical presence of an out-of-state bank, the more likely a state is to tax that in-state operation:"

* * *

Categories of Interstate Bank Interest Income
Potentially Subject to State Taxation

Does State Tax...? (Income Category)	Percent of Responding States	
	Yes	No

(footnote continued on next page)

According to the foregoing survey, as of 1988, approximately two-thirds of the states had a statute, regulation or administrative procedure that governed the apportionment of the income of a bank engaged in multistate banking. Many of these states use the three-factor "Massachusetts" formula comprised of property, payroll and receipts factors. The Massachusetts formula was codified in the Uniform Division of Income for Tax Purposes Act ("UDITPA"), which has been adopted, sometimes with minor changes, by many states.

However, "[t]he UDITPA formula is not well suited for apportioning the income of financial institutions because it does not include intangible property, which comprises most of the assets of a financial institution, in the property factor."[11] In fact, financial institutions are expressly

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1.	Interest income from loans to residents in state made by an out-of-state bank which has no office, employees or representatives in state and secured by real property located in state.	24%	76%
2.	Interest income from loans solicited by in-state representatives of out-of-state banks (e.g., call programs).	40%	60%
3.	Interest income from loans solicited at loan production offices located in state but closed at the out-of-state home office of the soliciting bank.	67%	33%

11 Survey, supra note 8, at 985.

excluded from the UDITPA rules.[12] One problem, for example, is that a mortgage loan receivable, which is intangible property, is not usually considered "inventory" for purposes of determining the property factor, with the result that an asset that generates material income is disregarded in assigning that income. Accordingly, some states have modified their bank taxes to exclude the property factor or to alter it to include intangibles.[13]

3. Recent State Approaches to Taxation of Financial Institutions

In an effort to address the inadequacy of previously existing rules, certain states recently have adopted new regimes governing the taxation of financial institutions. Such legislation has been enacted by both "money states" and "market states" in their competition for tax revenues, and not surprisingly, the methodologies embodied in the legislative responses can clash. Certain of the recent responses by state governments are set forth below.

(a) New York. In 1985 New York adopted a modified "money center" approach in enacting a special franchise tax on banks doing business in the state. The

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12 California, however, omitted this exclusion in adopting a modified version of UDITPA; thus, California currently taxes financial corporations through a modified version of the three-factor apportionment formula set forth in UDITPA.

13 Survey, supra note 8, at 985.

regulations include as examples of activities of a corporation which will constitute doing business in New York State: (i) operating a branch in New York State; (ii) operating a loan production office in New York State; and (iii) operating a bona fide office in New York State.[14] A corporation is not deemed to be doing business in New York State if its activities in New York State are limited to such things as: (i) the mere acquisition of one or more security interests in real or personal property in New York State without otherwise doing business; and (ii) the mere acquisition of title to property located in New York State through the foreclosure of a security interest without otherwise doing business.[15]

The New York State apportionment formula for banks is based on three factors: payroll, deposits and receipts.[16] The payroll factor is determined by dividing 80 percent of wages and salaries in the state by total wages and salaries. The deposits factor is determined by dividing New York State deposits by all deposits. The receipts factor is determined by dividing New York State receipts by total receipts from loans, financing leases, rents, service charges, fees and income from bank, credit, travel and entertainment cards; net gains from trading and investment activities; fees from the

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14 20 NYCRR § 16-2.7(c).

15 20 NYCRR § 16-2.7(e).

16 20 NYCRR §§ 19-1 - 19-8.5.

issuance of letters of credit and traveler's checks; and certain other business receipts. The payroll, deposits and receipts factors are then added together, with double weight given to receipts and deposits, and the sum is then divided by five. [17]

Payroll generally is allocated to New York State if the employee to whom the compensation is paid is regularly connected with or working out of an office of the taxpayer within New York State.[18] Deposits are allocated to New York State if they are maintained at branches of the taxpayer within New York State.[19]

The New York State regulations provide even more extensive situs rules for each item of income in the receipts factor. Generally, income is allocated to New York State if it is generated by in-state as opposed to out-of-state business locations. For example, income from loans is located where the greater portion of the income-producing activity related to the loan occurs. To determine where the greater portion of income producing activity occurs, consideration is given to such activities as solicitation, investigation, negotiation, final approval and administration of the loan, with the weight attached to each factor depending upon the

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17 20 NYCRR § 19-2.2.

18 Id. at § 19-5.1.

19 Id. at § 19-7.1.

specific facts.[20] Administration of a loan is the process of managing the account, including bookkeeping, collecting the payments, corresponding with the customer, reporting to management regarding the status of the agreement and proceeding against the borrower in case of default. Such activity is considered located at the office which oversees the activity.[21]

(b) Minnesota. Minnesota followed a "market state" approach in revising its bank income tax law in 1987 and 1988.[22] The law applies to "financial institutions," which include entities engaged in the banking business as well as corporations that derive more than half of their gross income from lending activities in substantial competition with institutions doing a banking business in Minnesota. The approach seeks to impose tax on nondomiciliary financial institutions with no physical presence in the state, but which otherwise have some "economic presence" in the state. This expansive jurisdictional claim, likely to be challenged on constitutional grounds unless blessed by Quill, asserts

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20 Id. at § 19-6.2(c).

21 Id. at § 19-6.2(d)(5). Other situs rules would result in a larger portion of other receipts being located in the state, thus further increasing the receipts factor. Under the situs rules, receipts from the performance of services are earned in New York if the services are performed in New York. Thus, income from servicing on mortgage loans, if the servicing is done in New York, will be allocated to New York.

22 Minn. Stat. Ch. 290.

that a financial institution is doing business in the state even if it merely receives deposits from customers in the state or solicits business in the state. For this purpose, solicitation includes distributing by mail or otherwise written solicitations of business to customers in Minnesota as well as advertising in Minnesota media. A financial institution is rebuttably presumed to be obtaining or regularly soliciting business within the state if it has conducted activities with 20 or more persons within Minnesota during any tax period or if the sum of assets and value of deposits attributable to Minnesota sources exceeds $5 million.

Minnesota apportions a financial institution's income to the state by a three-factor formula of property, payroll, and receipts. Unlike the standard three-factor formula, the receipts factor is weighted 70 percent, and the other two factors are weighted 15 percent each. Moreover, the financial institution formula includes intangible property in the property factor. Most significantly, there are special rules for attributing receipts to Minnesota which generally attribute receipts to the "market" state. Thus, receipts from loans secured by real or tangible personal property in Minnesota are assigned to Minnesota; receipts from unsecured commercial loans are assigned to Minnesota if the proceeds from the loan are to be applied in the state; and receipts from unsecured consumer loans are attributed to Minnesota if the borrower is a resident of Minnesota.

(c) Tennessee. Tennessee also has adopted a "market state" approach.[23] For fiscal years ending on or after July 15, 1990, all corporations or subsidiaries that are engaged in the business of a financial institution in Tennessee are subject to a special corporate income tax. Entities liable for the tax include those that derive more than half their income from one or more of five categories of business: (1) the business of a regulated financial institution, (2) a business substantially similar to that carried on by a Tennessee banking corporation, (3) the making, acquiring, selling, or servicing of loans or extensions of credit, (4) acting as an agent, broker, or adviser in lease transactions that are the economic equivalent of extensions of credit; and (5) credit card operations.

A financial institution is presumed to be doing business in Tennessee if the sum of its assets and deposits attributable to Tennessee sources equals or exceeds $5 million or if it regularly sells products or services to customers in the state, or regularly solicits business from potential customers in the state. A financial institution's income is apportioned to Tennessee by a single-factor receipts formula based on the ratio of receipts attributable to the transaction of business in Tennessee to the total receipts from transacting business in all jurisdictions. The

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23 Tenn. Code Ann. §§ 67-4-801 et seq.

receipts attribution rules generally take a "market" state approach. Thus, receipts from the lease or rental of real or tangible personal property are attributed to Tennessee if the property is located in Tennessee; interest income and other receipts from consumer loans are attributed to Tennessee if the loan is made to a Tennessee resident; interest income and other receipts from commercial loans are attributed to Tennessee if the proceeds from the loan are to be applied in Tennessee and interest income, merchant discount, and other receipts including service charges from financial institution credit card and travel and entertainment card receivables are attributed to Tennessee if the charges are regularly billed there.

(d) Indiana. Indiana has adopted what has been termed a "combined approach." Effective January 1, 1990, Indiana adopted a Financial Institutions Tax ("FIT") that restructures the state's approach to the income taxation of the banking industry.[24] The FIT not only revises the method of taxing financial institutions domiciled in Indiana, it also significantly expands Indiana's taxing jurisdiction over out-of-state financial institutions that derive income from sources in the state.

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24 Ind. Code §§ 6-5.5-1-1 et seq.

The FIT is imposed on corporations "transacting the business of a financial institution in Indiana." The "business of a financial institution" includes bank holding companies and their subsidiaries, regulated financial corporations and their subsidiaries, and any foreign or domestic corporation that engages in the activities that a bank holding company or a regulated financial corporation is authorized to perform. A financial institution is deemed to be transacting business within Indiana (i.e., it is deemed to have nexus with the state for tax purposes) if it engages in any of the following: maintains an office, employee or representative in Indiana; regularly sells products or services of any kind or nature to customers in Indiana; regularly solicits business from potential customers in Indiana; regularly performs services outside Indiana that are consumed in Indiana; regularly engages in transactions with customers in Indiana that involve intangible property; owns or leases real or tangible personal property in Indiana; or regularly solicits and receives deposits from customers in Indiana. A financial institution is rebuttably presumed to be obtaining or regularly soliciting business within the state if it has conducted activities with 20 or more persons within Indiana during any tax period or if the sum of assets and value of deposits attributable to Indiana sources equals at least $5 million.

Financial institutions domiciled in Indiana are taxed on their entire federal taxable income (with Indiana modifications) without apportionment. However, in an effort to avoid multiple taxation, Indiana grants its domiciliary financial institutions a credit against similar taxes paid to other states. Nondomiciliary financial institutions are taxed on an apportioned share of their federal taxable income (with Indiana modifications). The FIT employs a single-factor apportionment formula based on the ratio of the taxpayer's in-state receipts to its total receipts. Receipts are generally attributed to Indiana if the borrower or the market generating the receipts is located in Indiana. Thus, interest and other receipts secured by real or tangible personal property located in Indiana are attributed to Indiana; income from unsecured consumer loans is attributed to Indiana if the borrower is an Indiana resident; and credit card fees and interest are attributed to Indiana if the amounts are regularly billed to Indiana.[25]

4. The Multistate Tax Commission's Proposed Regulations. In May 1990 The Multistate Tax Commission (the "Commission") issued proposed regulations (for potential adoption by Multistate Tax Compact member and non-member

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25 West Virginia has also enacted legislation effective for tax years beginning on or after January 1, 1991, similar to that enacted by Indiana. W. Va. Code § 11-24-7b.

states) providing for a uniform methodology for the allocation and apportionment of income for financial institutions. Like the Indiana, Minnesota, and Tennessee statutes discussed above, the regulations broadly defines the "business of a financial institution" as including the business that a regulated financial corporation is authorized to conduct, the business that is substantially similar to the business that a regulated financial corporation is authorized to conduct and the business that a corporation conducts when more than 50 percent of its gross income derives from lending activities in substantial competition with the business that a regulated financial corporation is authorized to conduct.

With respect to jurisdictional requirements, the proposed regulations would attribute financial institution income only to those states in which it either "exercises its corporate franchise or transacts business." A financial institution is deemed to be exercising its corporate franchise or transacting business in a state if it:

(a) owns, leases or otherwise has an interest in any real or tangible personal property located in the state or maintains an office or other place of business in the state;

(b) makes any direct loan secured by any real or tangible personal property located in the state;

(c) has an employee, representative or independent contractor conducting business activities in its behalf in the state; or,

(d) engages in regular solicitation in the state (whether at a place of business, by travelling

> loan officer or other representative, by mail, by telephone or other electronic means), and the solicitation results in the creation of a depository or direct debtor/creditor relationship with a resident of the state.

A financial institution is rebuttably presumed to be engaged in regular solicitation within a state if, during the tax period, it:

> (i) has entered into direct debtor/creditor relationships with one hundred or more residents of the state;
>
> (ii) has an average during the tax period of ten million dollars ($10,000,000) or more of assets and deposits attributable to sources with the state; or
>
> (iii) has in excess of five hundred thousand dollars ($500,000) in receipts attributable to sources within the state.

The proposed regulations adopt an equally-weighted three-factor formula of property, payroll, and receipts to apportion the income arising from the business of a financial institution. The property factor includes both the taxpayer's real and tangible personal property as well as its intangible property. Intangible property is generally attributed to a state based on the activity of the borrower rather than the lender. Thus, lease financing receivables are attributable to the state if the property is located in the state; assets in the nature of loans that are secured by real or tangible personal property are attributed to the state where the property is located; assets in the nature of unsecured consumer and commercial loans are attributed to the

borrower's state of residence; and credit, travel, and entertainment card receivables are attributed to the state of the borrower's residence.

The attribution rules for the receipts factor, like those for the property factor, generally follow a "market state" approach. Thus, receipts from the lease or rental of real or tangible personal property are assigned to the state where the property is located; interest income and other receipts from assets in the nature of loans secured by real or tangible personal property are assigned to the state where the property is located; interest income and other receipts from unsecured consumer and commercial loans are assigned to the state of the borrower's residence; interest income and other receipts, including service charges and credit, travel, and entertainment card fees, are assigned to the state of the borrower's residence; and merchant discount income from credit card transactions is assigned to the state in which the merchant is located.

The Commission is currently reexamining these proposed regulations, and final regulations, when issued, may adopt approaches to nexus, apportionment and situsing different from those set forth in the proposed regulations as currently drafted.

III. PROBLEMS WITH THE CURRENT APPROACHES

The current lack of uniformity among states' approaches for taxing financial institutions, and the inadequacies of these varying systems, have given rise to numerous problems, as set forth below.

A. Mismatching of Deductions and Income.

Residents of market states who are borrowers on loans from nondomiciliary financial institutions may take a deduction for state income tax purposes for the interest paid to the out-of-state lender. If the state's taxation methodology does not reach interest income earned by a nondomiciliary lender, a shifting of revenue occurs from the borrower's state to the state of domicile of the lender. Of course, such mismatching or shifting of revenue is not unique to financial institutions and may be a necessary result of free trade in a federal structure. It is unlikely, however, that any state has a mechanism for an addback to state income of interest paid to a nondomiciliary lender (although presumably states could enact such a rule).

Another example of mismatching can occur with respect to bad debts. For example, assume a state taxes an out-of-state bank on the basis of a single factor receipts formula and the bank, aside from its business in its home state, makes a single $25 million loan to a customer in that state, for a 5 year term. For the first 3 years, the borrower pays the interest due (no principal payments being

required until the end of the term) which are taxed by the state. In the fourth year, the borrower develops severe financial difficulties and ceases to pay interest. The bank finally determines at the beginning of the fifth year that it can and will collect none of the principal of the loan, and charges it off as a bad debt loss. In the fifth year, of course, the bank has no receipts attributable to the state. Therefore, the state has had the benefit of taxing the bank's compensation for taking the credit risk, but has avoided having to give any tax benefit for the loss actually suffered. That result, of course, mirrors the situation in the bank's headquarters state if it has adopted the same apportionment rules: it taxes none of the revenue, but would suffer the full impact of the bank's bad debt charge-off.

B. The Problems of Double Taxation.

Perhaps the most politically sensitive and economically significant issue is that of double taxation, arising from the varying income apportionment formulas (and accompanying situs rules) used by the states. While the dangers of double or multistate taxation are of concern to manufacturing and most other companies as well, the problems can be even greater for financial institutions because of this greater lack of uniformity among state apportionment formulas. It is fair to conclude that given this lack of uniformity, a financial institution doing business in several

different states may be more likely to be subject to the dangers of double taxation than a manufacturing company.

In addition, many states' systems pose subtleties in the way particular items are measured, sourced, or classified, which makes it difficult to apply general rules and thus increases the likelihood of double taxation. The problem is further complicated for financial institutions because regulatory rules may make it more difficult for a bank to fix or contain the problem.

For example, a financial institution domiciled in a "money center state" may be taxed by that state on all of its income as calculated for federal purposes. If a "market state" imposes a tax on the bank's income deemed derived from residents of the market state (and if neither state allows a credit for tax paid to the other state), double taxation will result.

The ultimate implications of double taxation go even further. Financial institutions might pass on the burden of the double taxation to customers in the form of higher interest rates. Or, nondomiciliary banks might reduce or cease lending to market states. Finally, money center states might seek to retaliate against market states through legislation or other economic methods.

C. Planning and Compliance.

The difficulties of planning and compliance, and the significant costs attendant thereto, are a consequence of

the current morass. A financial institution doing business in numerous states may have to incur substantial costs to develop the expertise to understand and comply with the differing state apportionment methodologies, including the differing definitions and differing allocation factors employed from state to state. The problem is particularly acute for financial institutions because with the proliferation of new financial products, it may be unclear in particular circumstances whether a state's taxing scheme reaches the income generated by those products. The costs of preparing tax returns for numerous states can also be expensive, particularly where the form of the returns will vary greatly from state to state due to the varying apportionment methodologies.

With respect to issues of nexus, financial institutions face even greater uncertainties than manufacturing companies. Particularly in states which have not adopted tax legislation specifically relating to financial institutions, these institutions may not even be able to ascertain whether their activities might subject them to taxation by those states, thus requiring them to file tax returns in those states. Also, financial institutions might have to incur significant costs merely to comply with the market states' system of sourcing income at the residence of the borrower:

> [B]anks have generally never needed to track customers, loans, and income on a destination basis. Most banks consider loans as booked and

> sourced to the state of their commercial domicile, and their increasingly automated and complex internal reporting systems have been created on the basis of origin sourcing. Major financial institutions now count their customers in the hundreds of thousands or millions, with billions of dollars of loans in place. The cost to redesign and modify their systems now to accommodate destination-based reporting for state tax purposes would be quite significant. It may even outweigh the tax paid.[26]

D. Constitutional Considerations.

The various approaches to taxation of financial institutions raise significant constitutional questions as well, in particular relating to the nexus required before a state may tax a nondomiciliary financial institution. For example, with respect to "market state" formulas, even though a financial institution's income may be apportioned to the state based upon the fact that the income derives from a loan

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26 Hodges, Recent Developments in Multistate Taxation of Financial Institutions: A Veritable Revolution, 2 J. of Cal. Tax'n 17, 19 (Winter 1991).

> Difficulties with respect to planning and compliance are even greater for financial institutions which are part of affiliated groups. Certain states might permit or require a particular financial institution to file a combined or consolidated income or franchise tax return with other of its affiliated corporations (whether or not such corporations also constitute financial institutions under that state's definitional regime). Other states might not even permit that same financial institution to file a combined or consolidated return with any of its financial or non-financial affiliates, or might permit or require it to file a combined report only with those of its affiliates which also constitute financial institutions under that state's definitional scheme.

secured by property located in the state, it may be questionable under existing constitutional standards whether the making of a loan secured by property in the state, absent a physical presence in the state of the nondomiciliary financial institution, constitutes sufficient nexus to subject the nondomiciliary financial institution to tax liability.[27] Further, even if a market state's approach to nexus were subsequently determined to be unconstitutional, there may be some chance that nondomiciliary financial institutions which have been paying the tax would not be able to obtain a refund of such taxes.[28]

Major constitutional issues also would arise in connection with selection of a methodology for assigning income to the different states. In particular, the fairness to all states of the apportionment methodology would have to survive constitutional scrutiny.[29]

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27 See National Bellas Hess, Inc. v. Dept. of Revenue, 386 U.S. 573 (1967) (state may not require out-of-state mail order firms to collect and remit state's use tax where firm does not have physical presence in the state).

28 American Trucking Assoc. v. Smith, 110 S. Ct. 2323 (1990); McKesson Corp. v. Division of Alcoholic Beverages and Tobacco, 110 S. Ct. 2338 (1990).

29 One commentator has summarized the constitutional issues as follows:

> The Commerce and Due Process Clauses are the two principal constitutional restraints on the states' power to tax interstate business. Under the Commerce Clause, a tax will pass muster if (1) there is a substantial nexus between the taxpayer and the

(footnote continued on next page)

E. Equity Considerations.

Considerations of equity may also arise with respect to market states which are not taxing nondomiciliary financial institutions:

> Financial institutions and money center states must understand the contribution of the market state or state where the customer is located . . . . For instance, if a financial institution makes home mortgage loans to residents of another state, the institution depends on that state to provide public services and schools that will maintain the value of the homes . . . . Also, the financial institution may depend on the courts of

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(footnote continued from previous page)

> taxing state; (2) the tax is fairly apportioned to the taxpayer's activities in the taxing state; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to the services provided by the state. Under the Due Process Clause, the Court has likewise insisted that there be (1) a minimum connection or nexus between the taxpayer of its activities and the taxing state and (2) a fair relationship between the tax and the taxpayer's activities in the taxing state. As a matter of substance, the nexus and apportionment requirements embodied in the Commerce and Due Process Clauses are indistinguishable, and the Court has so declared.

Hellerstein, Constitutional Limitations on State Taxation of Interstate Banking, p. 2 (footnotes omitted), reprinted in American Bankers Association, Facts and Issues Concerning State Taxation of Commercial Banks (1991).

As one commentator has argued, however, "[t]he Supreme Court has shown great tolerance for differences in state apportionment formulas." McCray, Constitutional Issues in State Income Taxes: Financial Institutions, 51 Albany L. Rev. 895, 928 (1987).

that state to foreclose if the borrowers stop making payments.[30]

IV. PROPOSALS FOR STATE TAXATION OF FINANCIAL INSTITUTIONS

A. Selection of A Universal Model.

It seems clear that to alleviate the problems set forth in this report, there should be a uniform system of taxation of financial institutions governing all states. Such a system should first provide for uniformity with regard to nexus, i.e., defining the minimum contacts which are necessary before a state can subject a nondomiciliary financial institution to its taxing jurisdiction -- and the nexus requirements would have to withstand constitutional scrutiny. And to be conceptually sound, the income assignment methodology must reflect the economic factors responsible for generating the income. Finally, in order to avoid double taxation, the method of apportionment adopted by the states would need to be consistent.

Of course, the difficulties in settling upon a universal model may be virtually insurmountable. It is almost impossible for a state or a financial institution to select one method over another without demonstrating self-interest, parochialism or bias. For example, with regard to nexus, market states can be expected to continue to insist upon the

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30 Remarks of John James, reported in "State Officials Debate Methods of Taxing Financial Institutions," Tax Notes (Dec. 25, 1989), at 1544.

most minimal of nexus requirements, with no physical presence required before jurisdiction to tax could be asserted. With respect to apportionment methods, money states will wish to source interest income at the state of domicile of the financial institution or the state where the loans are administered.

It is extremely difficult to determine what nexus standards and which apportionment formulas might best balance the competing interests in the area. With regard to nexus, a decision must be made as to whether the physical presence of a nondomiciliary financial institution in a state should be required before a state can assert taxing jurisdiction over the financial institution.[31] If physical presence is not required, a different threshold for the minimum contacts which would establish nexus would have to be selected. Such a threshold should embody objective standards, or at least a safe harbor. In this regard, it is debatable whether the Minnesota formula of 20 customers in the state, the Multistate Tax Commission proposal of 100 customers in the state, the

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31 See Quill Corp. v. North Dakota, 470 N.W. 2d 203 (N.D. 1991), cert. granted, 60 U.S.L.W. 3109 (Oct. 7, 1991) (refusing to follow National Bellas Hess, court held that out-of-state mail order seller with no physical presence in North Dakota was required to collect use tax on money order sales to residents of the state); see also Amicus Brief of American Bankers Association submitted in Quill (suggesting that if Supreme Court in Quill abandons physical presence requirement of National Bellas Hess, the Court's holding should be expressly limited to sales and use tax collection requirements).

mere holding of mortgages in a state or foreclosure upon those mortgages, or some greater or lesser threshold or thresholds should be sufficient to confer jurisdiction.

A further issue is that of the method of apportionment, i.e., the factors to be used. As set forth in the introduction to this report, the decision of the Supreme Court in Allied-Signal could have a large impact in this area. Apportionment appears, however, to be the only viable approach to state taxation of financial institutions. The options with respect to apportionment appear to be a single factor approach such as that employed in Indiana, or a multi-factor approach of receipts, property and payroll. The situs of intangibles for purposes of the property factor also would have to be determined. Finally, if a multi-factor approach is selected, a determination would have to be made as to whether the factors would be weighted evenly in the apportionment formula or unevenly, as in Minnesota and New York. For example, having both a property factor and a receipts factor may result in double-counting, to the extent property is defined to include intangibles and the receipts are attributable to those intangibles.

With regard to apportionment, a key issue is that of the sourcing of income. Thus, for example, it must be determined whether interest income from loans should be sourced at the state of domicile of the lending institution, where the loan is administered or booked, where the borrower

resides, where the security for the loan is located, or where the funds are applied.

It may be necessary to gather empirical evidence on such topics as the interstate activities of financial institutions, the incidence and degree of double taxation currently taking place, and the revenue effects of mismatching of deductions and income, before an equitable model can be agreed upon.

In settling upon a uniform model, certain criteria should be observed:

(1) Certainty and clarity: to facilitate planning;

(2) Fairness: taking into consideration the competing interests of and costs to the money states and the market states;

(3) Administration: minimizing the costs of compliance and ensuring financial institutions' ability to comply; and

(4) Revenue considerations/stability: selecting a system that will balance the states' competing needs for tax revenues and that will endure as states switch from being market states to money center states.

B. Obstacles to Change.

The primary difficulty, after selecting a uniform model for apportionment, is ensuring uniform adoption of the

model by all states. This is unlikely, given the overriding competing interests of the states.

The other avenue could be the enactment of federal legislation governing the taxation of interstate financial activities. Congress has previously legislated with regard to the ability of states to tax interstate sales. Public Law 86-272, which does not apply to service providers such as financial institutions, provides that states may not tax out-of-state sellers who sell to residents of the state if the out-of-state seller has no physical presence in the state, and its contacts with the state consist solely of mere solicitation. More specifically, this immunity applies where an out-of-state corporation through its representative solicits orders in a state for sales of tangible personal property, which orders are sent outside the state for approval or rejection and, if approved, are filled by shipment or delivery from a point outside the state. When applied to service industries such as financial services, principles such as those embodied in Public Law 86-272 provide only a partial answer, as they address only the nexus issue and not the apportionment issue.

As stated above, various states and industry groups have met in the past, thus far without great success, in attempts to develop a uniform system of taxation of financial institutions which would be acceptable to both money center states and market states. One of the current efforts includes

the involvement of a small group of states, the Multistate Tax Commission and the Federation of State Administrators.

If the current efforts do not result in concrete progress toward adoption of a uniform model, it may be argued that the adoption of federal legislation governing state taxation of financial institutions, while perhaps not an ideal solution, may present the only effective solution to the current problems.

The possibility of allowing the Federal government to preempt states' ability to tax raises issues of federalism which, it could be argued, implicate the wisdom, although perhaps not the constitutionality, of any legislation to such effect. Nonetheless, given the apparent inability of the states to resolve the problems on their own, it appears that federal legislation may ultimately provide the only solution to the problems surrounding state taxation of financial institutions. As part of the legislative process, Congressional economists might conduct some form of quantitative analysis to determine how and where income is generated (because income is generated by both the market and the institution's operation). A Congressional committee or subcommittee then might develop legislation after analyzing the issues addressed herein, the findings of the Congressional economists, and other issues or data which are relevant to the development of an equitable, economically defensible and

constitutionally sound approach to state taxation of financial institutions.

March 1992

EXHIBIT K: 43

New York State Department of Taxation and Finance, "Franchise Tax on Banking Corporations: Statistical Analysis of 1985 Reform Act" (September 1991)

New York State
Department of
Taxation
and Finance

Franchise Tax on Banking Corporations:

Statistical Analysis of the 1985 Reform Act

September 1991

James W. Wetzler
Commissioner

Office of
Tax Policy Analysis

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Preface

In 1985, the executive and legislative branches of New York State, the government of the City of New York and the state's banking community joined together to reform New York's bank tax. As a result, Chapter 298 of the Laws of 1985 essentially restructured the New York State and New York City taxes for banking corporations.

In December of 1988, a Temporary Commission to Review the Bank Tax submitted a report to the Governor, the Legislature and the Mayor of New York City. At the time that the report was issued, statistical information regarding the reformed bank tax was only available for the 1985 tax year, the first tax year that the reformed law was in effect.

This statistical report, prepared by the Department of Taxation and Finance's Office of Tax Policy Analysis, provides data through the 1987 tax year - the third year of the new law. The report is essentially in the same format as the Commission issued in 1988.

Many of the tables and charts contained in the report provide historical tax statistics by type of bank for the 1981 through the 1987 tax years. This information allows the reader to contrast pre-reform and post-reform statistics. The report also contains historical profiles which summarize changes in the number of taxpayers, allocated income or losses, average tax liability, basis of tax and percentage of the total bank tax paid by each category of bank. Statistical information is also provided regarding the results of some of the more significant changes provided for by Chapter 298 of the Laws of 1985.

I. Introduction

Article 32 of the New York State Tax Law imposes a franchise tax on banking corporations for the privilege of doing business or exercising a corporate franchise in New York. Banks calculate a tax on allocated entire net income, and an alternative minimum tax which is the largest of a tax on allocated assets, a tax on allocated alternative entire net income or $250. A bank's tax liability under Article 32 equals the higher of the tax on allocated entire net income or the alternative minimum tax.

The passage of the 1985 legislation significantly restructured Article 32. The pre-1985 tax on banking corporations included, as does current law, a tax on entire net income. Prior to 1985, the alternative minimum tax was different for savings banks and savings and loan associations and for all other banking corporations, including commercial banks. For savings banks and savings and loan institutions, the alternative tax was either a tax based on interest or dividends credited to depositors or shareholders or $250. For all other banking corporations, the alternative tax was either a tax based on issued capital stock or $250. A bank's tax liability was the higher of the tax on entire net income or the alternative minimum tax.

A. Intent of Reform

The 1985 legislation reforming New York's bank tax was intended to:

- tax banks more like general business corporations;
- make the treatment among and between commercial banks and thrifts similar;
- make the calculation of the tax more predictable and less likely to be adjusted upon audit; and
- maintain New York City as a financial center.

It was not a goal of the legislation to increase or decrease the tax revenues received from the existing population of banks. However, it was recognized that the legislation would result in an increase in the number of banking corporations subject to the tax. To achieve these goals the legislation:

- reduced the rate of the tax measured by entire net income from 12 percent to 9 percent;

- provided three alternative taxes for banking corporations: a tax measured by assets with varying rates depending on the taxpayer's net-worth-to-assets ratio and the percentage of its loans secured by certain types of mortgages, a tax measured by alternative entire net income imposed at the rate of three percent, or a fixed minimum tax of $250;

- provided formula allocation as the method of determining the portion of entire net income, alternative entire net income and assets attributable to business done in New York State (formula allocation is the method used by general business corporations);

- imposed a tax on non-New York banking corporations doing business in this State;

- provided that where a group of affiliated corporations computes its tax on one return, the tax shall be computed on a combined basis (the method used by general business corporations) rather than on a consolidated basis; (see Appendix 1)

- provided tax relief to certain banking corporations which receive federal assistance; and

- substantially conformed the Administrative Code of the City of New York to these changes.

Chapter 298 took effect with respect to taxable years beginning on or after January 1, 1985. However, all the amendments, except for those which related to savings banks and savings and loan associations and to the alternative minimum tax measured by assets were scheduled to sunset for taxable years beginning on or after January 1, 1990. Chapter 553 of the Laws of 1989 extended the sunset date of the provisions until December 31 of 1991.

II. Descriptions of Data and Terms

Section III, "Summary of Statistics" and Section IV, "Tax Statistics by Type of Bank," provide comparisons of tax return data for the tax years 1981 through 1987. In addition, Section IV contains statistical information regarding some of the more notable changes provided for by the 1985 legislation. Tables 1 through 6 and Charts 1 through 35 contain the historical information. The report presents information for five separate categories of banks and for all banks. Tables 7 through 10 and Charts 36 through 44 contain statistics regarding specific 1985 changes. The report provides details by type of bank wherever possible. To assist readers in interpreting the data, definitions of many of the terms as used in the charts are provided below.

A. Definitions

Data Base - All tax statistics provided in this report are based solely on data as contained on bank tax returns. The report does not adjust the return data for audit results. In the State fiscal years 1985-86 through 1990-91 audit revenue, on average, accounted for more than 36 percent of total Article 32 collections. If these audit collections were included in the data, the results could appear significantly different.

Currently, the Department of Taxation and Finance is in the process of completing its audit program on pre-reform bank tax returns. In addition, audits of several large Article 32 taxpayers for post-reform years have been undertaken. However, given the early stage of the post-reform audit program, this report cannot provide information regarding pre and post-reform audit results.

The statistics do not reflect the Metropolitan Commuter Transportation District (MCTD) surcharge paid by banks doing business within the MCTD region. Also, because the data is from tax years through 1987 the statistics do not reflect the effect of the 2.5 percent surcharge imposed in the 1989 tax year or the 15 percent surcharge imposed in the 1990 tax year.

Confidentiality - Confidentiality laws prohibit the disclosure of statistics that would reveal the identity, either directly or indirectly, of a particular taxpayer. Where confidentiality rules preclude disclosure the table describes the statistic as "not disclosable". Generally, the statistical tabulations cannot include cells

containing data from less than three taxpayers. However, in certain circumstances statistics for cells containing more than three observations cannot be provided because that would allow calculation of data that is not disclosable. Most commonly this applies to "total" figures where only one observation in the group is not disclosable.

Filing Entity/Bank - For purposes of statistical presentation, the report considers each consolidated or combined group or a bank filing separately as a single filing entity. This report refers to each filing entity as a single bank.

Clearinghouse Banks - The clearinghouse banks referred to throughout this report are Bankers Trust Company, Bank of New York, Chase Manhattan Bank, N.A., Chemical Bank, Citibank, N.A., European American Bank, Irving Trust Company, Morgan Guaranty Trust Company of New York, Manufacturers Hanover Trust Company, Marine Midland Bank, N.A., National Westminster Bank USA, and United States Trust Company of New York.

Foreign Banks - Foreign banks, as identified on Department of Taxation and Finance records, are commercial banks that are headquartered outside of the United States or its possessions.

Commercial Banks - Commercial banks, as referred to throughout the report, are all non-thrift institutions that are neither clearinghouse nor foreign banks.

Thrifts - The term "thrifts" describes both savings banks and savings and loan associations.

Consolidated/Combined Groups - 1984 statistics reflect the number of consolidated groups. Statistics for 1985, 1986 and 1987 reflect the number of combined groups. The total number of corporations in either the consolidated or the combined group includes the parent corporation and all related corporations included in the parents' state tax return. (see Appendix 1)

Alternative Tax Bases - Capital stock was the alternative tax base for clearinghouse, foreign, and commercial banks through the 1984 tax year. For thrifts, the base of the alternative tax, through the 1984 tax year, was interest or dividends credited to depositors or shareholders. Beginning in the 1985 tax year two alternative tax bases, taxable assets and alternative entire net income, apply to all types of banking corporations. This report aggregates tax liabilities under these two alternative bases.

Tax Liability - Tax liability statistics, throughout the report, refer to tax after credits as reported on Article 32 tax returns.

Federal Taxable Income/Entire Net Income - Federal taxable income (federal gross income minus allowable deductions) is the starting point in the calculation of New York income. Entire net income (ENI) refers to a bank's federal taxable income adjusted for New York modifications (additions and subtractions) before the New York portion is determined through separate accounting (pre-1985) or formula apportionment (1985 and later). Unfortunately, a large number of banks failed to provide complete income information on state tax returns filed through the 1984 tax year. Federal taxable income and entire net income statistics from that period are, therefore, unavailable from Department of Taxation and Finance records. This lack of data makes it impossible to provide statistics regarding trends in federal taxable income, the effect of New York modifications or comparisons of the results of separate accounting and formula apportionment.

Allocated Entire Net Income (ENI) - Allocated ENI refers to the New York portion of ENI. Allocated ENI, through the 1984 tax year, refers to the amount of ENI attributable to New York as determined by separate accounting (or in some cases, by a gross income apportionment formula). Allocated ENI from the 1985 and later tax years refers to the amount of ENI attributable to New York through formula apportionment.

International Banking Facilities (IBF) - Since 1981, Article 32 has provided banking corporations with special tax treatment for their New York international banking facilities (IBFs). An IBF is a set of asset and liability accounts segregated on the books and records of a depository institution, United States branch or agency of a foreign bank, or an Edge or Agreement Corporation that includes only international banking facility time deposits and international banking facility extensions of credit. IBF statistics provided in Table 10 reflect modifications to federal taxable income for IBF activities. These modifications may be either the subtraction of IBF income or the addition of IBF losses. Beginning in the 1985 tax year banks were allowed to elect to treat IBF activities as if they were doing business outside New York in calculating their income allocation percentage. As noted in the footnote to Table 9, the number of banks that used the IBF election in the 1985, 1986 and 1987 tax years was 67, 93, and 111, respectively.

Formula Apportionment/Allocation Percentage - For corporations doing business within and without the State, formula apportionment is used to determine the portion of the tax base (i.e., entire net income, alternative entire net income and assets) attributable to New York. The tax base allocable to New York is calculated by multiplying the unallocated base by an allocation percentage. This percentage is based on the ratio of receipts, deposits and payroll earned or paid in New York to those earned or paid everywhere.

Deduction for 60 Percent of Dividend Income, Gains or Losses from Subsidiary Capital - The 1985 legislation provided that in computing New York entire net income banks are allowed to deduct 60 percent of dividend income, gains and losses from subsidiary capital. The amount of this deduction and its distribution by type of bank are depicted in Table 10 and Charts 37 and 38.

Deduction for 17 Percent of Interest Income from Subsidiary Capital - The 1985 legislation provided that in computing New York entire net income banks are allowed to deduct 17 percent of interest income from subsidiary capital. The amount of this deduction and its distribution by type of bank are depicted in Table 10 and Charts 39 and 40.

Deduction for 22.5 Percent of Interest from Certain Government Obligations - The 1985 legislation provided for a deduction for 22.5 percent of interest income on New York or United States obligations, other than obligations held for resale in connection with regular trading activities. The amount of this deduction and its distribution by type of bank are depicted in Table 10 and Charts 41 and 42.

III. Summary of Statistics

A. Factors Affecting Statistics

Two types of factors contributed to the year to year changes depicted in the statistical tables and charts contained in this section. Factors such as changes in the state or national economies, competition within the financial services industry, the formation or dissolution of banks are all "external factors" which occurred independent of changes in the tax law. The other major factor that affected the statistics depicted in this section was the reform of the tax structure provided for by the 1985 legislation.

Fifteen separate changes provided for by the 1985 legislation may have significantly affected the statistics reported in this section. Those changes are:

- A change in the definition of banking corporations
- A change in the definition of subsidiaries to be included in the returns of an affiliated group
- A change providing that a group of affiliated corporations compute its' tax on a combined basis (previously a group of affiliated corporations computed its' tax on a consolidated basis; savings banks and savings and loan associations were not allowed to file on a combined or consolidated basis)
- Changes in the definition of entire net income including:
  - introduction of a new deduction for 17 percent of interest income from subsidiary capital
  - introduction of a new deduction for 60 percent of dividend income and gains or losses from subsidiary capital
  - introduction of a new deduction for 22.5 percent of interest income from obligations of New York State or its political subdivisions or of the United States Government

- introduction of a new deduction for the amount of cash or assistance received from the FDIC or FSLIC pursuant to the Garn - St. Germain Depository Institutions Act of 1982.

- Introduction of formula allocation for determining the portion of income or alternative tax base attributable to New York State (previously the amount of income or alternative tax base attributable to New York State was determined through separate accounting)

- Elimination of the alternative tax measured by capital stock

- Elimination of the alternative tax based on interest or dividends

- Introduction of an alternative tax on the amount of alternative entire net income allocated to New York State

- Introduction of an alternative tax on the amount of taxable assets allocated to New York State

- Introduction of an election to treat an international banking facility as if it were located outside of New York State when computing its entire net income allocation percentage

- No attempt is made in this report to quantify the effect of each individual change. Rather, the report directs readers to the statistics reported herein that may indicate some of the results of the changes.

B. Overview of Statistics

Number of Banks

The 1985 legislation changed the definition of taxpayers subject to Article 32. Prior to the enactment of Chapter 298, the franchise tax on banking corporations applied only to banks doing a banking business in New York. By amending the definitions of "banking corporation" and "doing a banking business," the 1985 legislation expanded the taxable universe of Article 32 taxpayers by imposing the franchise tax on out-of-state corporations doing business in New York while doing a banking business anywhere. As a result,

out-of-state banks with nonbank offices (i.e., loan production or branch offices) in New York are currently subject to the bank tax.

Between 1981 and 1987, the number of banks subject to Article 32 grew 39 percent from 582 banks to 806 banks. Overall, most of the growth was attributable to foreign banks and commercial banks. The number of thrift institutions, in contrast, has decreased over the six year period.

The increase of 137 taxpayers between the 1984 and the 1985 tax years actually represents a net change resulting from the loss of 64 taxpayers that filed under Article 32 in 1984 but not in 1985 and the addition of 201 taxpayers that filed under Article 32 in 1985 but not in the previous year.

The 1984 tax liability of the 64 banks that did not file under Article 32 in the 1985 tax year was $7.6 million. The 1985 tax liability of the 201 banks not filing under Article 32 in the 1984 tax year was $9.6 million. The net increase in Article 32 revenues attributable to the change in the number of taxpayers was, therefore, approximately $2.0 million or 4 percent of the difference between total 1984 and 1985 bank tax revenues.

Number of Combined Filers

Chapter 298 of the Laws of 1985 provided for changes in the definition of subsidiaries to be included in an affiliated group. Prior to the enactment of the 1985 legislation, certain 80 percent or more owned subsidiaries were categorized as banking corporations if they were principally engaged in business that might lawfully be conducted by a commercial bank. Chapter 298 increased the number of subsidiaries that can be classified as banking corporations in two ways. First, the 80 percent ownership test was reduced to a 60 percent test. In addition, the 1985 legislation provided that most subsidiaries of thrifts may be classified as banking corporations if principally engaged in certain types of business.

In addition, the legislation provided that a group of affiliated corporations compute its tax on a combined basis (previously a group of affiliated corporations computed its' tax on a consolidated basis). Also, prior to 1985, savings banks and savings and loan associations were not allowed to file on a combined or consolidated basis.

In the 1984 tax year, there were 41 consolidated returns. By the 1987 tax year, there were 151 taxpayers filing on a combined basis. Thrifts, which prior to 1985 could not file on a consolidated or combined basis, accounted for 65 of the 104 additional combined returns. No foreign banks filed on a consolidated basis in 1984 or a combined basis in 1985. By 1987, 7 foreign banks were filing combined returns.

Tax Liability

The tax liability figures contained in this report are "as reported" on original tax returns. They do not reflect adjustments made on audit. As noted in Section II, in the State fiscal years 1985-86 through 1990-91 audit revenue, on average, accounted for more than 36 percent of bank tax collections. From 1981 through 1985 total tax liability under Article 32 has ranged from a high of $189.9 million in the 1981 tax year to a low of $128.9 million in the 1984 tax year. Total tax liability in the first year under the new bank tax (1985) totaled $180.6 million. In the 1986 and 1987 tax years, total tax liability increased to $253.7 million and $285.9 million respectively.

Through the 1985 tax year, the total tax liabilities of the clearinghouse and foreign banks mirrored that of the industry as a whole, starting from a high point in 1981, falling off from 1982 through 1984 and rising again in 1985. Between the 1985 and 1986 tax years the tax liability of the clearinghouse banks decreased by less than $1 million followed by an increase of more than $16 million in the 1987 tax year. The tax liability of foreign banks has risen steadily since 1984.

The total tax liability of commercial banks remained steady from 1981 through 1985. The tax liability of the group then rose 30 percent in the 1986 tax year and remained essentially unchanged in the 1987 tax year. To a lesser extent, the tax liabilities of savings banks also followed the pattern of all banks from 1981 through 1985. Savings banks experienced a significant increase in total tax liability in the 1986 tax year followed by another increase between 1986 and 1987. Savings and loan associations experienced a steady decrease in tax liability over the five year period from 1981 through 1985. Like savings banks, savings and loan associations experienced a significant increase in total tax liability between the 1985 and 1986 tax year. The total liability of savings and loan associations remained virtually unchanged between the 1986 and the 1987 tax years.

Percentage of Total Tax

With a few exceptions, the distribution of total bank tax liability among types of banks remained fairly steady from 1981 through 1985. Both clearinghouse banks and commercial banks in 1985 paid nearly the same portion of the total bank tax that they paid in the 1981 tax year. Between the 1985 and 1987 tax years, the portion of bank tax paid by clearinghouse banks dropped from 36.6 percent to 28.5 percent. The tax liabilities of foreign banks over the 1981-87 period grew from 13.5 percent of the total bank tax in 1981 to 22 percent in 1987. The tax liability of savings banks, as a percentage of the total bank tax, dropped steadily from 1981 through 1984, followed by a steady rise through the 1985, 1986 and 1987 tax years. The portion of bank tax paid by the savings and loan industry dropped steadily from 1981 through 1985. Like savings banks, savings and loan associations experienced a steady increase in the portion of total bank paid between the 1985 and the 1987 tax years.

Average Tax Liability

In the 1985 tax year, the average tax liability of each category of bank was less than in the 1981 tax year. Between 1985 and 1987, each category of bank experienced an increase in their average tax liability with the most significant increase occurring in the thrift categories.

Basis of Tax

The change in the basis of the alternative tax was among the most significant of the changes provided for by the 1985 legislation. Prior to the legislation the alternative tax base for clearinghouse, foreign and commercial banks was capital stock. For thrifts, the base of the alternative tax, through the 1984 tax year, was interest or dividends credited to depositors or shareholders. Beginning in the 1985 tax years, two alternative tax bases, taxable assets and alternative entire net income were introduced. These alternative bases now apply to all types of banking corporations.

Overall, there has been a steady decrease in the percentage of bank tax liability attributable to alternative based taxes. In 1981, Article 32 taxpayers paid $63.9 million in taxes based on capital stock or interest and dividends.

That alternative based liability represented over 33 percent of the total tax liability under the bank tax. In 1987, Article 32 taxpayers paid a total of $28.5 million in alternative based taxes. Those alternative based taxes represented only 10 percent of the total 1987 tax liability.

Contrary to the overall trend, clearinghouse banks, foreign banks and commercial banks have all exhibited a movement toward alternative based tax liabilities. Of these groups, the most notable change is among foreign banks which, as a group, experienced a sharp rise in alternative based tax liability between 1984 and 1985. Between 1985 and 1987, the trend continued with the alternative based liability of foreign banks increasing by 34.3 percent.

The overall trend toward income based taxes, therefore, seems to be attributable to savings banks and savings and loan institutions. In 1981 nearly all of the tax liability of savings banks and savings and loan institutions was from taxes based on interest or dividends. From 1985 through 1987, nearly all of the tax liability of the institutions in these groups was based on income.

Table 8 provides a detailed analysis of alternative based tax liability in the tax years 1983 through 1987. The table isolates the alternative based tax liability of banks that had positive allocated entire net income. These statistics are helpful in identifying shifts between the income base and alternative bases before and after the introduction of the new alternative bases in 1985. By limiting the statistics to those banks that had positive income, banks that experienced losses (which would pay an alternative tax regardless of the base or rate of that tax) are removed from consideration.

Overall, between 1983 and 1985, the total alternative tax based liability and the portion of banks paying on that base that had positive entire net income remained relatively steady. Between 1985 and 1986, the percentage of such banks dropped from 28.4 percent of all alternative based taxpayers to 18.6 percent. In 1987 the percentage rose again to 23.8 percent. Across categories of banks however, there were significant changes between 1984 and 1985, the year that the new alternative tax bases were introduced. Among savings banks and savings and loan associations the number of banks with positive income that paid on an alternative basis dropped from 18 to 3 and from 14 to 3 respectively. Through the 1987 tax year, the number of such banks continued to decline overall. Conversely, throughout the three remain-

ing categories of banks (clearinghouse, commercial and foreign) there were increases in the number of banks with positive income that paid alternative based taxes. Between the 1985 and 1987 tax years, the number of foreign and commercial banks with positive entire net income that paid alternative based taxes increased while the number of such banks in the clearinghouse category declined slightly.

Rate of Asset Based Tax

The 1985 legislation provided for rates of one-tenth, one twenty-fifth or one-fiftieth of a mill to be applied to the asset base. The rate of the asset based tax is determined by the taxpayer's net-worth to assets ratio and the percentage of its loans secured by certain types of mortgages. Virtually all banks that paid taxes based on assets in the 1985 through 1987 tax years paid based on the highest rate of one-tenth of a mill.

Alternative Entire Net Income Base

The 1985 legislation introduced a new alternative tax based on "alternative entire net income" (entire net income with certain deductions added back and taxed at a rate of 3 percent). In the 1985 tax year, 17 banks based their taxes on the alternative income base. In both the 1986 and 1987 tax years, 7 banks based their taxes on the alternative entire net income base. Between 1986 and 1987, the total tax liability of banks paying on the alternative entire net income base decreased slightly from $1.2 million to $743,840. In the 1987 tax year the tax liability of banks paying on the alternative entire net income base represented less than three-tenths of 1 percent of the total bank tax liability.

Allocated Entire Net Income/Loss Statistics

Overall, the number of banks experiencing New York losses grew slightly from 1983 to 1984 then decreased steadily through 1986. Between 1986 and 1987, the amount of allocated losses grew slightly. The number of banks reporting positive allocated entire net income grew slightly between 1983 and 1984 followed by a significant rise in the number of banks reporting positive allocated entire net income in 1985. Between 1985 and 1987, 76 additional banks reported positive allocated income.

With the exception of a very slight decrease in positive entire net income between 1983 and 1984, the trend in the amount of income or losses seems to indicate a significant rise in New York income between 1984 and 1987 and a significant overall decrease in the amount of allocated losses in that same time period. The overall trend of steady increases in positive allocated entire net income held true for all classifications of banks through the 1986 tax year. In the 1987 tax year allocated income decreased slightly for all categories except the clearinghouse banks.

Generally the trend, for most categories of banks, since 1984 has been toward reductions in allocated losses. However, commercial banks did not conform to this trend, experiencing an overall increase in New York losses between 1984 and 1987

Entire Net Income Allocation Percentage

One of the more significant changes provided for by the 1985 legislation was the introduction of formula apportionment. Prior to 1985, entire net income was attributed to New York State based on separate accounting or gross to gross apportionment. The formula introduced in 1985 provides that a banking corporation's income allocation percentage is comprised of the discounted proportion of total wages, salaries and other employee renumeration which have been paid to New York based employees (with the exception of general executive officers), the proportion of the bank's total receipts attributable to New York activities (double weighted) and the proportion of total deposits maintained in New York State (double weighted).

Overall, in the 1985 tax year, 43.1 percent of entire net income was attributable to New York using the income apportionment formula introduced by the 1985 legislation. In the 1987 tax year, the average income allocation percentage increased slightly to 47.3 percent.

In the 1985 tax year, savings and loan associations allocated the highest portion of entire net income to New York State (98.2 percent). In the 1987 tax year, the income allocation percentage of the savings and loan category dropped to 84.9 percent. In 1985, foreign banks and savings banks each allocated about 62 percent of entire net income to New York State. In 1987,

the average income allocation percentage of foreign banks dropped to 55.2 percent while the average income allocation percentage for savings banks rose to 84.2 percent. The average allocation percentage for clearinghouse banks dropped slightly between 1985 and 1987 from 56.1 percent to 51 percent. Commercial banks, as a group, continued to allocate the lowest portion of their entire net income to New York under formula apportionment (16.2 percent in 1985, 18.0 percent in 1986 and 22.3 percent in 1987).

Statistics regarding the average income allocation percentage by type of bank are provided in Table 7 and Chart 36.

Special Deductions

The 1985 legislation provided that in calculating entire net income banking corporations are allowed to subtract three new deductions. Those deductions are: a deduction for 60 percent of dividend income, gains and losses for subsidiary capital, a deduction for 17 percent of interest income from subsidiary capital and a deduction for 22.5 percent of interest income from certain government obligations.

Deduction for 60 Percent of Dividend Income and Gains or Losses from Subsidiary Capital - Among all taxpayers the deduction for 60 percent of dividend income and gains or losses from subsidiary capital, provided for by the 1985 legislation, was claimed by 30 banks in 1985. The number of banks claiming the deduction increased slightly between 1985 and 1987. The total amount of the deduction rose from $203.5 million in 1985 to nearly $1.2 billion in the 1986 tax year. The total amount of the deduction then decreased to $584.7 million in 1987. In 1987, 60 percent of the deduction was claimed by banks in the clearinghouse category. Commercial banks claimed 33 percent of the deduction.

Deduction for 17 Percent of Interest Income from Subsidiary Capital - Among all taxpayers, the deduction for 17 percent of interest income from subsidiary capital was claimed by 31 banks in 1985. The total amount of the deduction for those banks was $221.8 million. In the 1986 tax year, claims for this deduction by 28 taxpayers totalled $821.7 million. The number of taxpayers claiming the deduction decreased to 25 in 1987, and the amount of the deduction dropped by 44 percent. In 1987, 84 percent of the deduction was claimed by banks in the clearinghouse category.

Deduction for 22 1/2 Percent of Interest Income on New York and United States Obligations - The deduction for 22 1/2 percent of interest income on New York or United States obligations has, by far, been the most widely used of the new deductions. The deduction was claimed by 346 taxpayers in 1985 and 402 taxpayers in 1987. The total amount of the deduction for these banks was $923.2 million in 1985 and $857 million in 1987. 43 percent of the 1987 amount was claimed by banks in the commercial category. 31 percent was claimed by clearinghouse banks and 14 percent was claimed by banks in the thrift category. Foreign banks accounted for 12 percent of the deduction.

Statistics regarding the use of special deductions are provided in Table 10 and Charts 37 through 44.

Income Modification or Allocation Adjustment for International Banking Facility (IBF) Activities

Since 1981, Article 32 has provided banking corporations with special tax treatment for their New York international banking facilities. In addition, the 1985 legislation allowed banks an election to treat IBF activities as if they were doing business outside New York in calculating their income allocation percentage.

From 1982 through 1985, the number of banks making an adjustment to federal taxable income for IBF activities (subtraction of IBF income or addition of IBF losses) decreased. In contrast, the total amount of the adjustments rose from $1.3 billion in 1982 to nearly $2.0 billion in 1985. While most of the decrease in the number of banks making the adjustment was attributable to foreign banks, the bulk of the increase in the total amount of such adjustments was split between clearinghouse banks and foreign banks, which had respective increases in the amount of the deduction of $686.7 million and $213.4 million over the four year period.

Since 1985, the number of banks deducting IBF income has dropped steadily as has the amount of the deductions. Between 1985 and 1986 the total amount of the IBF deduction dropped 22 percent followed by a 38 percent drop between the 1986 and 1987 tax years. Most of the decrease in the IBF deduction is attributable to the increased use of the allocation election provided for by the 1985 legislation. In 1985, the first year of the election, 67 banks elected to use the allocation benefit. By the 1987 tax year the number of banks electing to use the allocation method grew to 111.

Statistics regarding the use of the IBF deduction and the allocation election are provided in Table 9.

IV. Tax Statistics By Type of Bank

This chapter contains historical tax statistics by type of bank for the 1981 through the 1987 tax years. Summaries of changes in the number of taxpayers, allocated income or losses, average tax liability, basis of tax and percentage of the total bank tax paid are provided for each category of bank. (Tables 1-6 and charts 1-35) This chapter also provides tables and charts regarding some of the more notable features of the 1985 reform. (Tables 7-10 and charts 36-44)

Clearinghouse Banks

The number of clearinghouse banks remained constant from 1981 through 1987. The portion of bank tax paid by clearinghouse banks decreased overall from 36.3 percent in the 1981 tax year to 28.5 percent in the 1987 tax year.

Following a 34 percent decrease from 1981 through 1984, total tax liability of clearinghouse banks increased by 80 percent between 1984 and 1987. The amount of tax liability attributable to alternative based taxes increased from $1.4 million in the 1981 tax year to nearly $8 million in the 1987 tax year. Alternative based liability peaked at $12.1 million in the 1985 tax year. Between 1981 and 1984 income based liability decreased from $67.5 million to $40.5 million. It then rose steadily to $73.5 million in the 1987 tax year.

From 1983 through 1987, the majority of taxpayers reported positive allocated entire net income, with the total amount increasing from $448.6 million to $946.3 million. Negative allocated entire net income decreased from $329.9 million to $149.1 million during the same period.

TABLE 1

HISTORICAL PROFILE OF CLEARINGHOUSE BANKS 1981-1987

NUMBER OF TAXPAYERS AND TOTAL TAX LIABILITY

TAX YEAR	NUMBER OF FILING ENTITIES	NUMBER FILING SEPARATELY	NUMBER FILING ON COMBINED OR CONSOLIDATED BASIS	TOTAL TAX LIABILITY OF CLEARINGHOUSE BANKS	PERCENT OF BANK TAX PAID BY CLEARINGHOUSE BANKS	AVERAGE TAX LIABILITY OF CLEARINGHOUSE BANKS
1981	12	UNAVAILABLE	UNAVAILABLE	$68,970,103	36.3%	$5,747,509
1982	12	UNAVAILABLE	UNAVAILABLE	41,480,020	31.0%	3,456,668
1983	12	UNAVAILABLE	UNAVAILABLE	52,679,431	36.8%	4,389,953
1984	12	0	12	45,535,745	35.3%	3,794,645
1985	12	0	12	66,093,357	36.6%	5,507,780
1986	12	0	12	65,543,217	25.8%	5,461,934
1987	12	0	12	81,438,578	28.5%	6,786,548

DISTRIBUTION OF TAX LIABILITY BY BASIS OF TAX

	INCOME BASE		ALTERNATIVE BASE		MINIMUM TAX	
TAX YEAR	NUMBER PAYING ON INCOME BASE	INCOME BASED LIABILITY	NUMBER PAYING ON ALTERNATIVE BASE	ALTERNATIVE BASED LIABILITY	NUMBER PAYING MINIMUM TAX	MINIMUM TAX BASED LIABILITY
1981	9	$67,525,974	3	$1,444,129	0	$0
1982	7	36,662,984	5	4,817,036	0	0
1983	9	49,186,000	3	3,493,431	0	0
1984	7	40,510,487	5	5,025,258	0	0
1985	6	54,017,814	6	12,075,543	0	0
1986	6	58,806,506	6 *	6,736,711	NOT DISCLOSABLE	NOT DISCLOSABLE
1987	8	73,445,132	4	7,993,446	0	0

INCOME STATISTICS

	POSITIVE ALLOCATED ENI		NEGATIVE ALLOCATED ENI		NET ALLOCATED ENI	
TAX YEAR	CORPS WITH POSITIVE ALLOCATED ENI	TOTAL POSITIVE ALLOCATED ENI ($ THOUSANDS)	CORPS WITH NEGATIVE ALLOCATED ENI	TOTAL NEGATIVE ALLOCATED ENI ($ THOUSANDS)	NET ALLOCATED ENI ($ THOUSANDS)	CHANGE FROM PREVIOUS YEAR ($ THOUSANDS)
1981	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE
1982	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE
1983	NOT DISCLOSABLE	448,602	NOT DISCLOSABLE	(143,594)	305,008	UNAVAILABLE
1984	8	423,210	4	(329,919)	93,291	(211,717)
1985	9	683,293	3	(127,341)	555,952	462,661
1986	NOT DISCLOSABLE	767,905	NOT DISCLOSABLE	(93,337)	674,568	118,616
1987	9	946,317	3	(149,064)	797,253	122,685

* In order to maintain confidentiality, minimum tax filers have been aggregated with alternative based taxpayers for the 1986 tax year.

Source: New York State Department of Taxation & Finance, Office of Tax Policy Analysis

CHART 1

NUMBER OF CLEARINGHOUSE BANKS
1981 - 1987

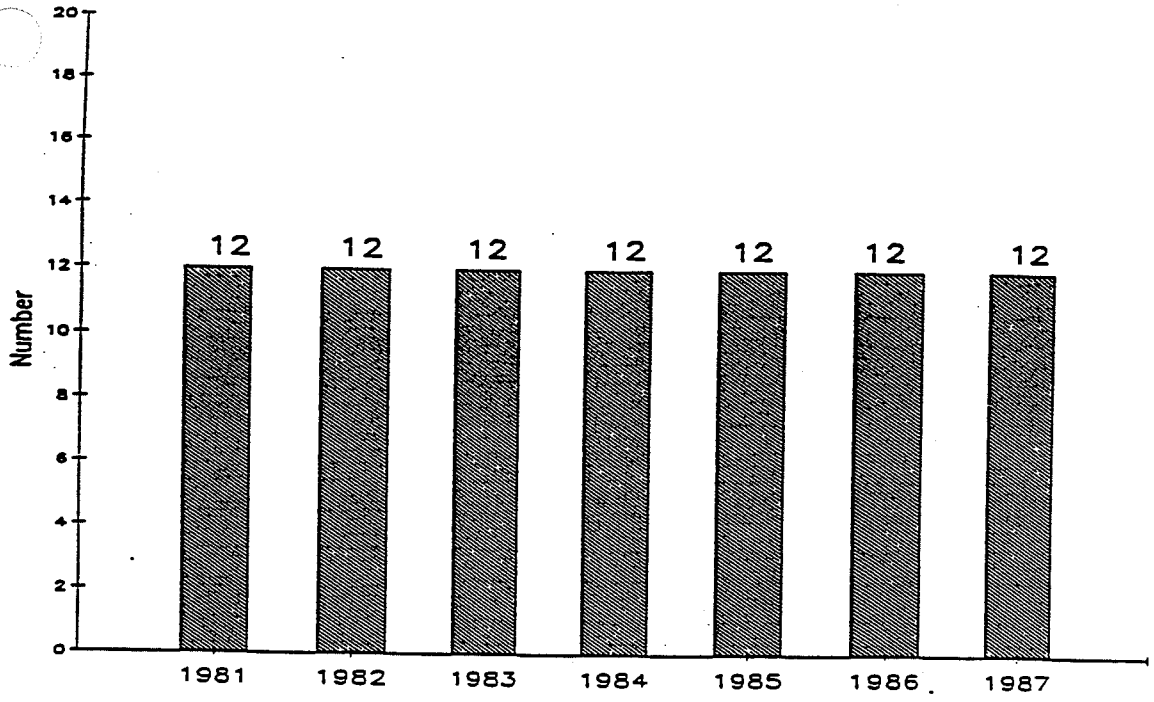


CHART 2

NUMBER OF BANKS REPORTING NEW YORK INCOME
& NUMBER REPORTING NEW YORK LOSSES
1983 - 1987
CLEARINGHOUSE BANKS

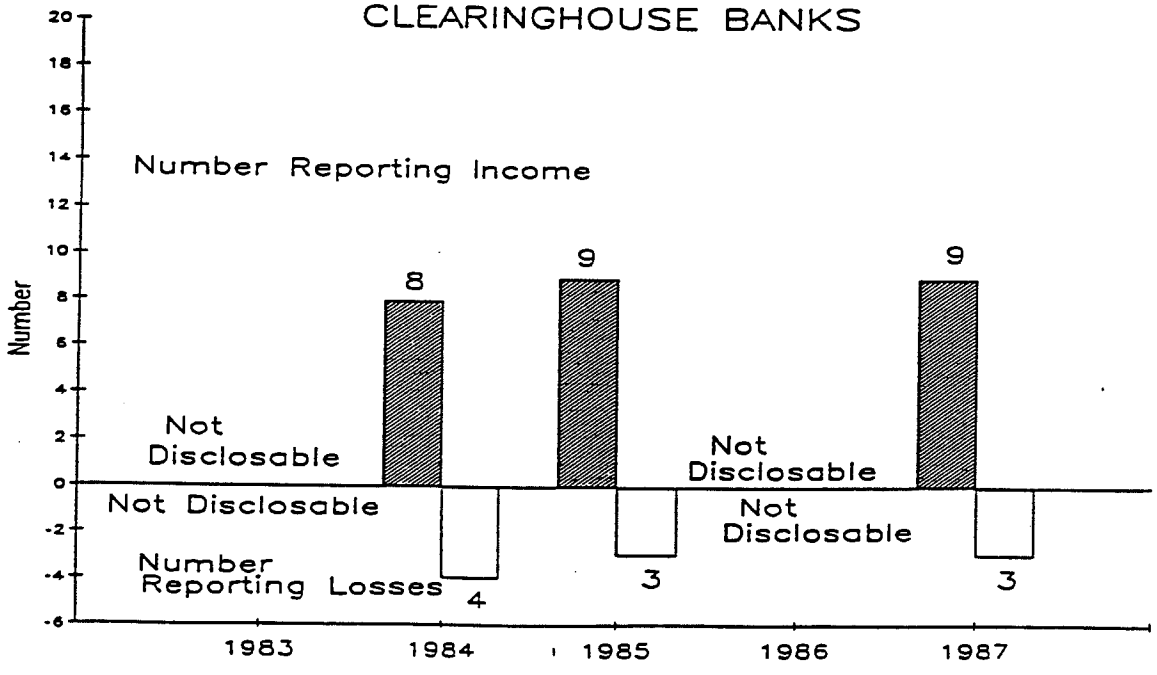


CHART 3

ALLOCATED NEW YORK ENTIRE NET INCOME OR LOSSES
1983 - 1987
CLEARINGHOUSE BANKS

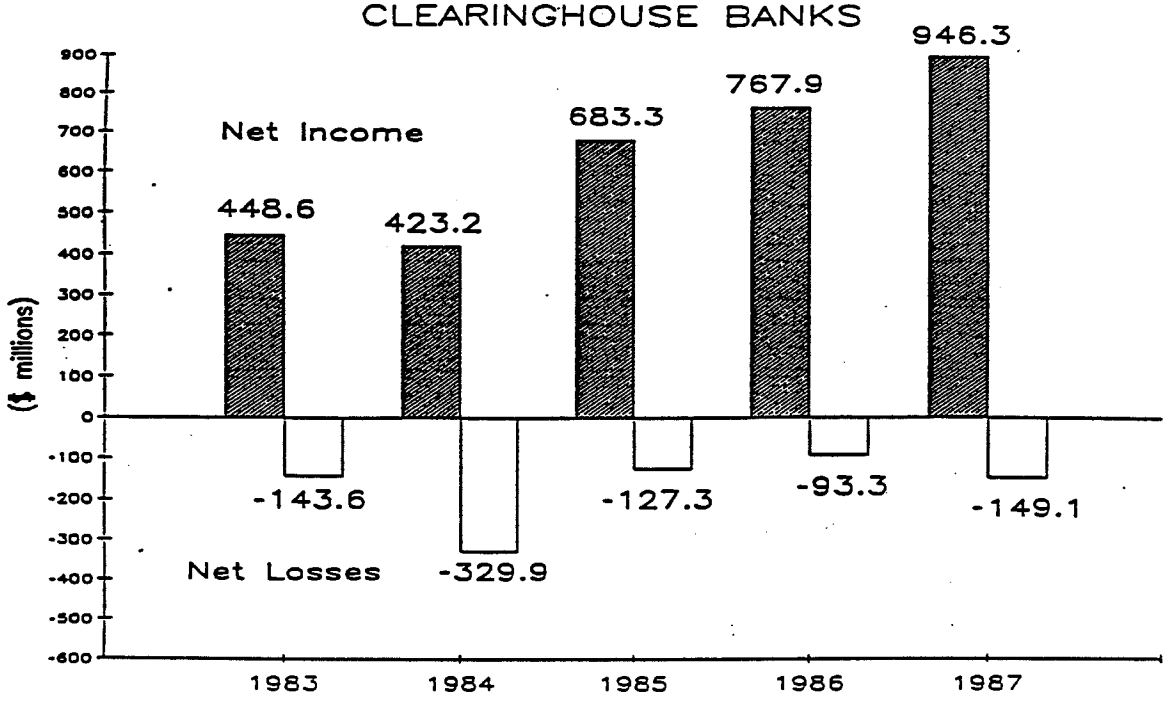


CHART 4

AVERAGE TAX LIABILITY AND TOTAL TAX LIABILITY
1981 - 1987
CLEARINGHOUSE BANKS

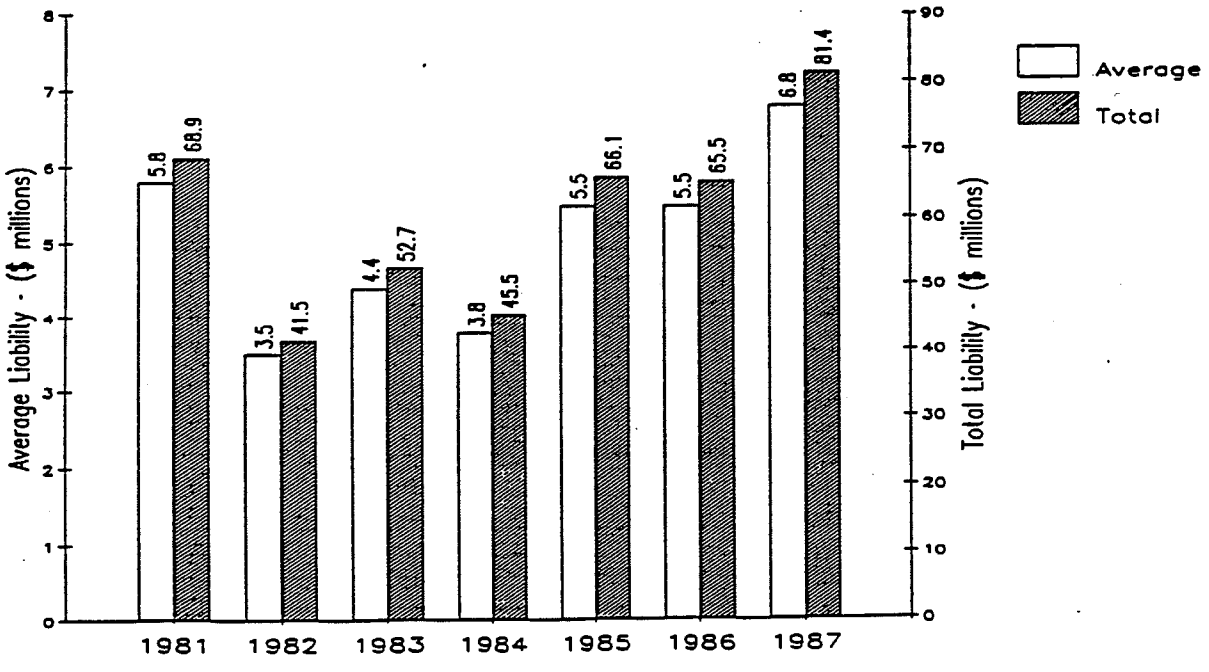


CHART 5

PERCENTAGE OF TAX LIABILITY BY BASIS OF TAX
1981 - 1987
CLEARINGHOUSE BANKS

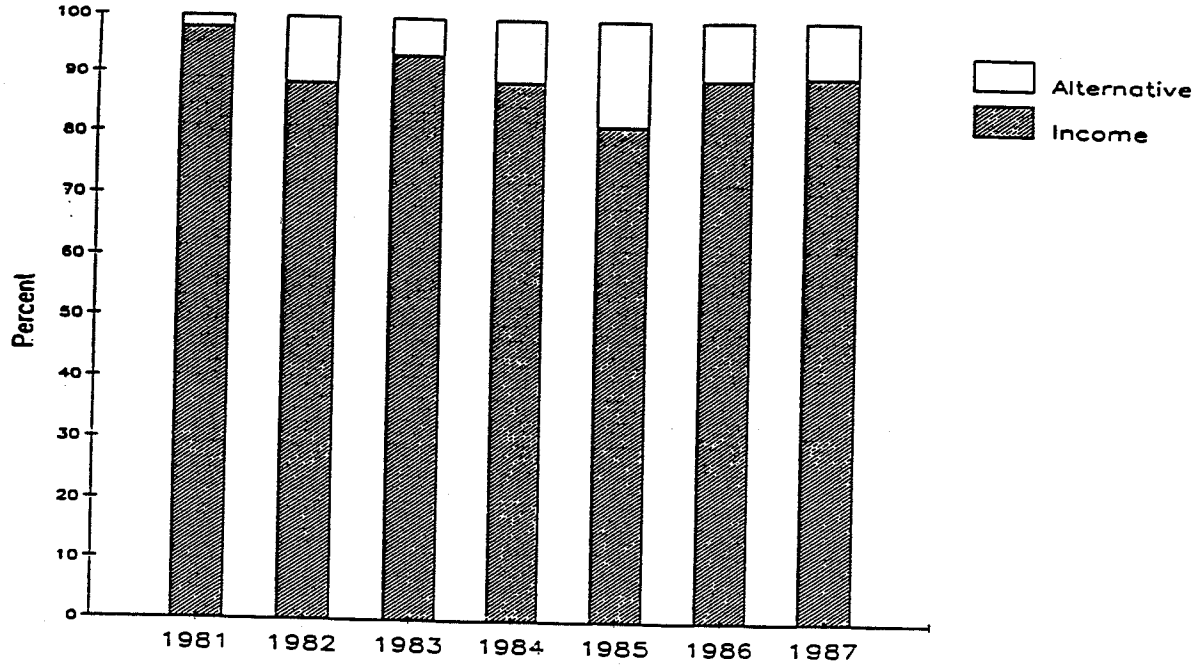
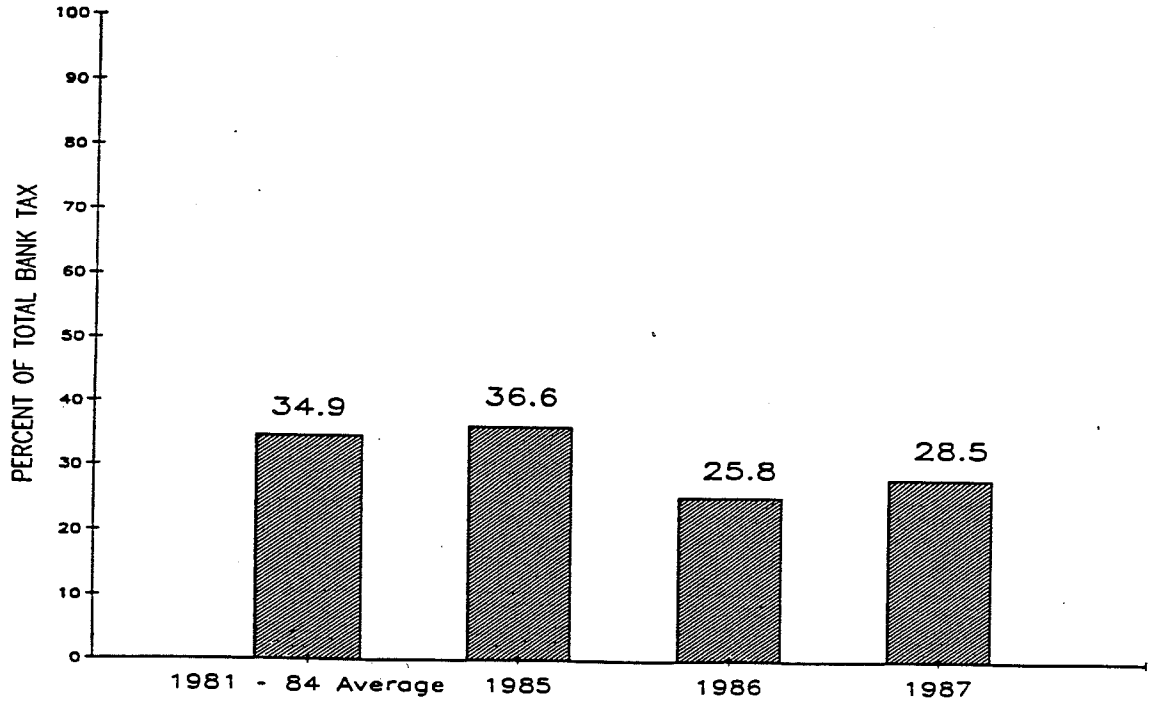


CHART 6

PERCENTAGE OF TOTAL BANK TAX PAID
BY CLEARINGHOUSE BANKS



Foreign Banks

From 1981 through 1987 the number of foreign banks increased from 161 to 317. The portion of the total bank tax paid by foreign banks increased steadily from 13.5 percent in the 1981 tax year to 22 percent in the 1987 tax year.

Between 1981 and 1984 the total tax liability of foreign banks decreased from $25.7 million to $20.7 million. From 1985 through 1987 total tax liability increased by 68 percent to $62.9 million. The portion of total tax liability attributable to the alternative base remained steady from 1981 through 1984. Alternative based liability rose sharply from $2 million to $12.5 million between 1984 and 1985. In 1987 it continued to increase to $16.8 million. Income based liability decreased from $24.1 million to $18.7 million between 1981 and 1984. It then increased sharply to $46 million in the 1987 tax year.

Positive allocated entire net income rose from $229.6 million in 1983 to $545.1 million in 1987. During that period the number of banks reporting positive income increased from 58 to 98. In the 1983 tax year, 119 taxpayers reported allocated losses of $469.4 million. By 1987, 219 taxpayers reported $545.6 million in allocated losses.

TABLE 2

HISTORICAL PROFILE OF FOREIGN BANKS 1981-1987

NUMBER OF TAXPAYERS AND TOTAL TAX LIABILITY

TAX YEAR	NUMBER OF FILING ENTITIES	NUMBER FILING SEPARATELY	NUMBER FILING ON COMBINED OR CONSOLIDATED BASIS	TOTAL TAX LIABILITY OF FOREIGN BANKS	PERCENT OF BANK TAX PAID BY FOREIGN BANKS	AVERAGE TAX LIABILITY OF FOREIGN BANKS
1981	161	UNAVAILABLE	UNAVAILABLE	$25,675,172	13.5%	$159,473
1982	168	UNAVAILABLE	UNAVAILABLE	18,216,950	13.6%	108,434
1983	178	UNAVAILABLE	UNAVAILABLE	26,348,461	18.4%	148,025
1984	202	202	0	20,740,437	16.1%	102,675
1985	264	264	0	37,335,768	20.7%	141,423
1986	282	277	5	57,205,490	22.6%	202,856
1987	317	310	7	62,845,546	22.0%	198,251

DISTRIBUTION OF TAX LIABILITY BY BASIS OF TAX

	INCOME BASE		ALTERNATIVE BASE		MINIMUM TAX	
TAX YEAR	NUMBER PAYING ON INCOME BASE	INCOME BASED LIABILITY	NUMBER PAYING ON ALTERNATIVE BASE	ALTERNATIVE BASED LIABILITY	NUMBER PAYING MINIMUM TAX	MINIMUM TAX BASED LIABILITY
1981	55	$24,121,288	106	$1,553,884	0	$0
1982	56	16,717,279	112	1,499,671	0	0
1983	55	25,127,593	123	1,220,868	0	0
1984	59	18,690,647	143 *	2,049,790	NOT DISCLOSABLE	NOT DISCLOSABLE
1985	60	24,820,743	161	12,504,275	43	10,750
1986	74	47,486,114	144	9,703,376	64	16,000
1987	75	46,034,043	169	16,793,253	73	18,250

INCOME STATISTICS

	POSITIVE ALLOCATED ENI		NEGATIVE ALLOCATED ENI		NET ALLOCATED ENI	
TAX YEAR	CORPS WITH POSITIVE ALLOCATED ENI	TOTAL POSITIVE ALLOCATED ENI ($ THOUSANDS)	CORPS WITH NEGATIVE ALLOCATED ENI	TOTAL NEGATIVE ALLOCATED ENI ($ THOUSANDS)	NET ALLOCATED ENI ($ THOUSANDS)	CHANGE FROM PREVIOUS YEAR
1981	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE
1982	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE
1983	58	229,549	119	(469,399)	(239,850)	UNAVAILABLE
1984	61	170,976	140	(635,299)	(464,323)	(224,473)
1985	78	307,773	186	(642,088)	(334,315)	130,008
1986	93	561,463	189	(442,286)	119,177	453,819
1987	98	545,130	219	(545,598)	(468)	(118,707)

* In order to maintain confidentiality, minimum tax filers have been aggregated with alternative based taxpayers for the 1984 tax year.

Source: New York State Department of Taxation & Finance, Office of Tax Policy Analysis

CHART 7

NUMBER OF FOREIGN BANKS

1981 - 1987

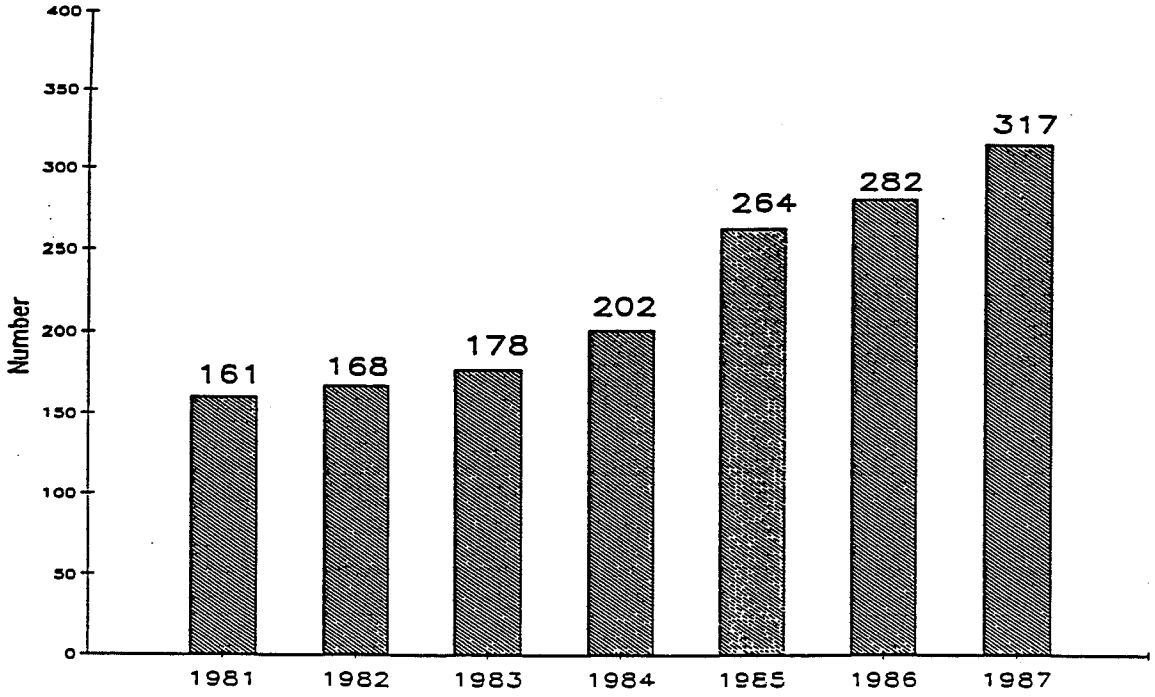


CHART 8

NUMBER OF BANKS REPORTING NEW YORK INCOME & NUMBER REPORTING NEW YORK LOSSES

1983 -1987

FOREIGN BANKS

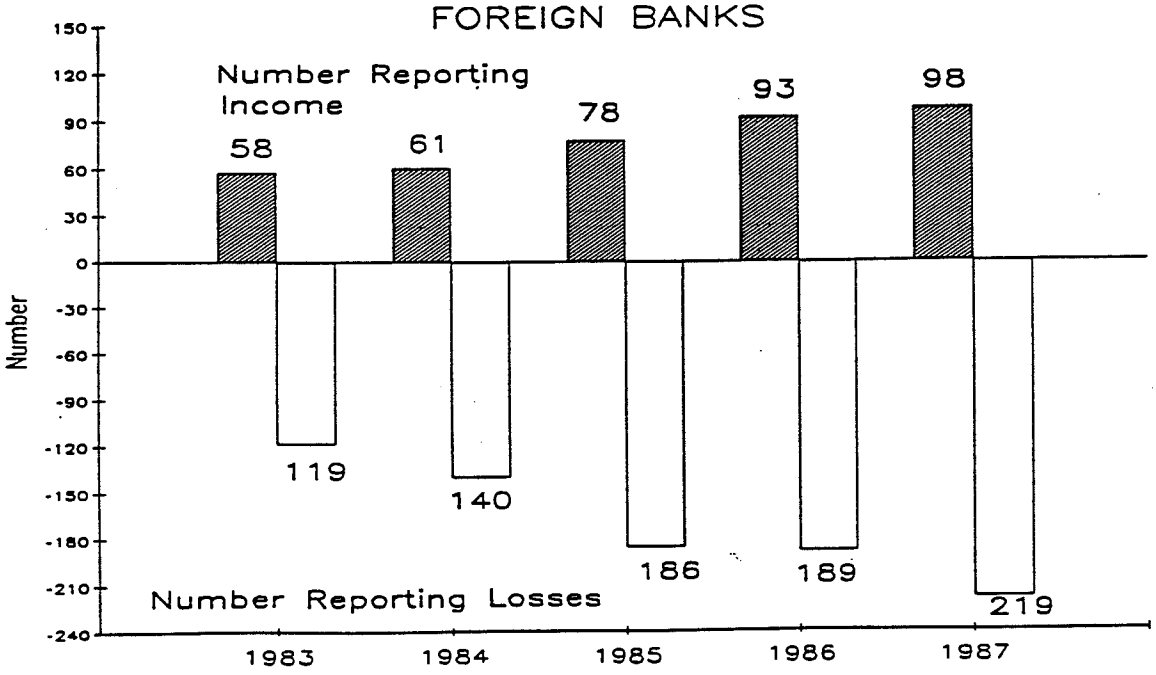


CHART 9

ALLOCATED NEW YORK ENTIRE NET INCOME OR LOSSES
1983 - 1987
FOREIGN BANKS

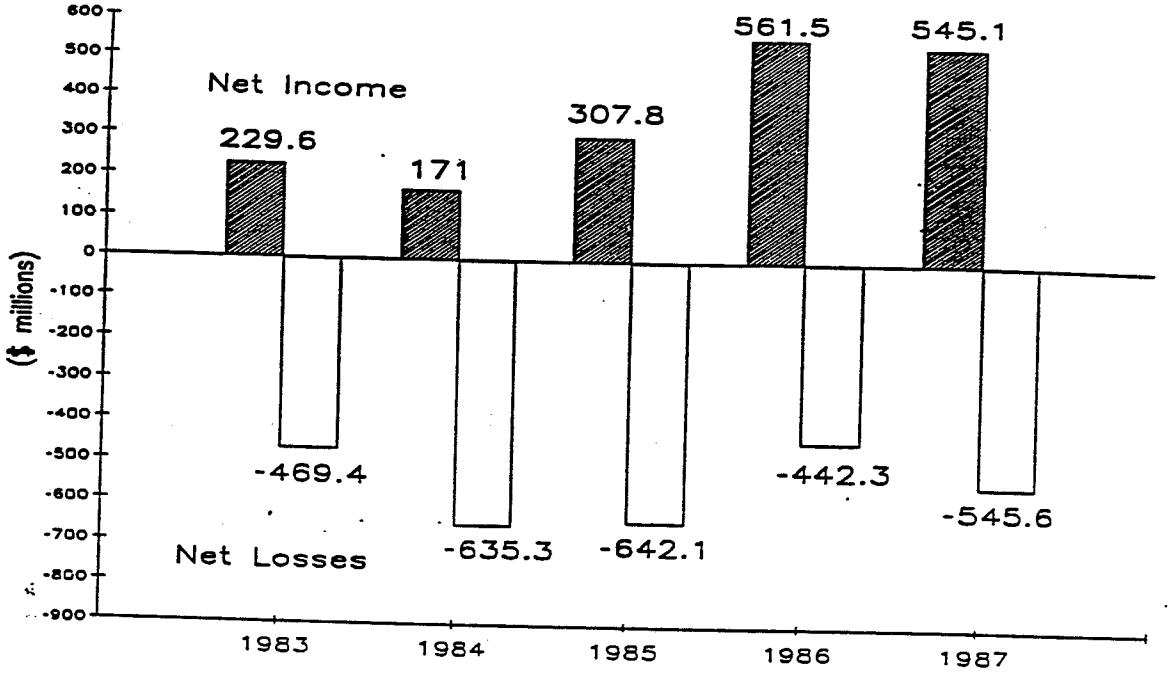


CHART 10

AVERAGE TAX LIABILITY AND TOTAL TAX LIABILITY
1981 - 1987
FOREIGN BANKS

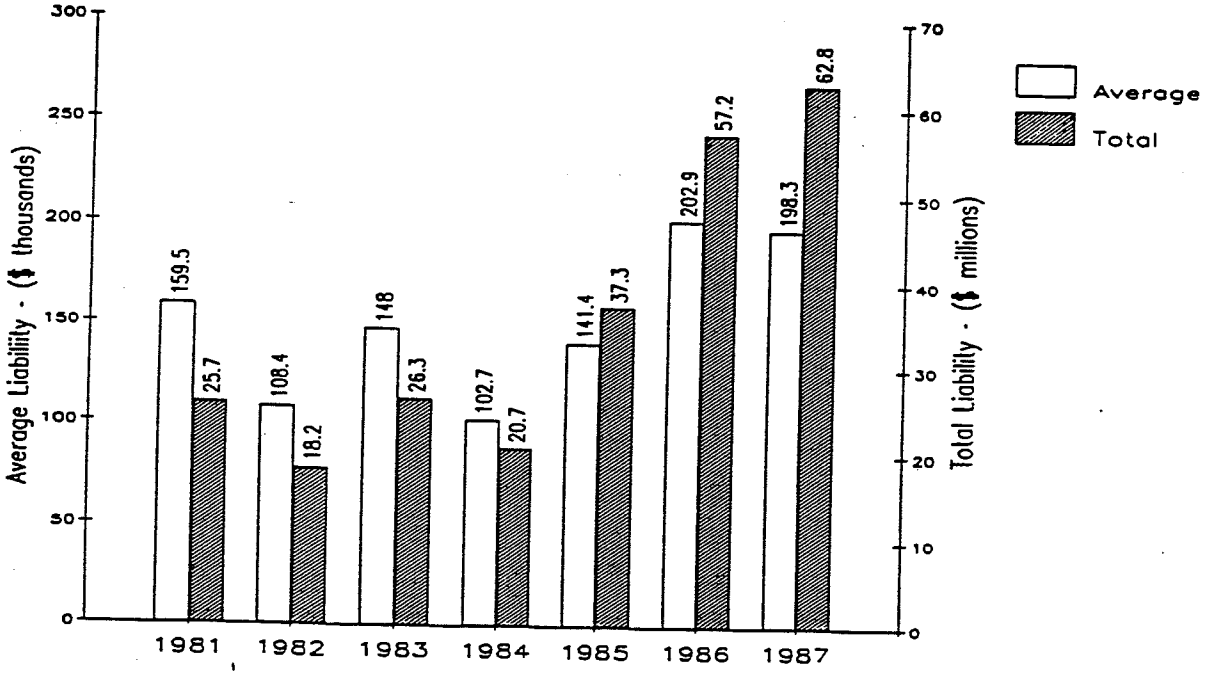


CHART 11

PERCENTAGE OF TAX LIABILITY BY BASIS OF TAX
1981 - 1987
FOREIGN BANKS

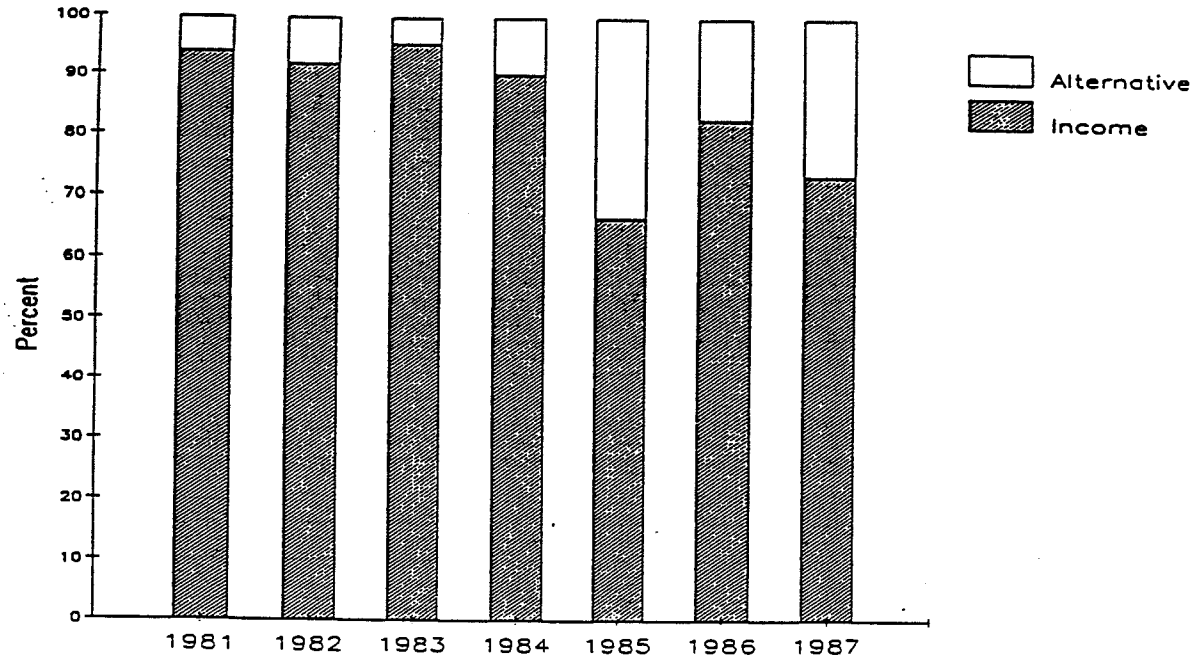
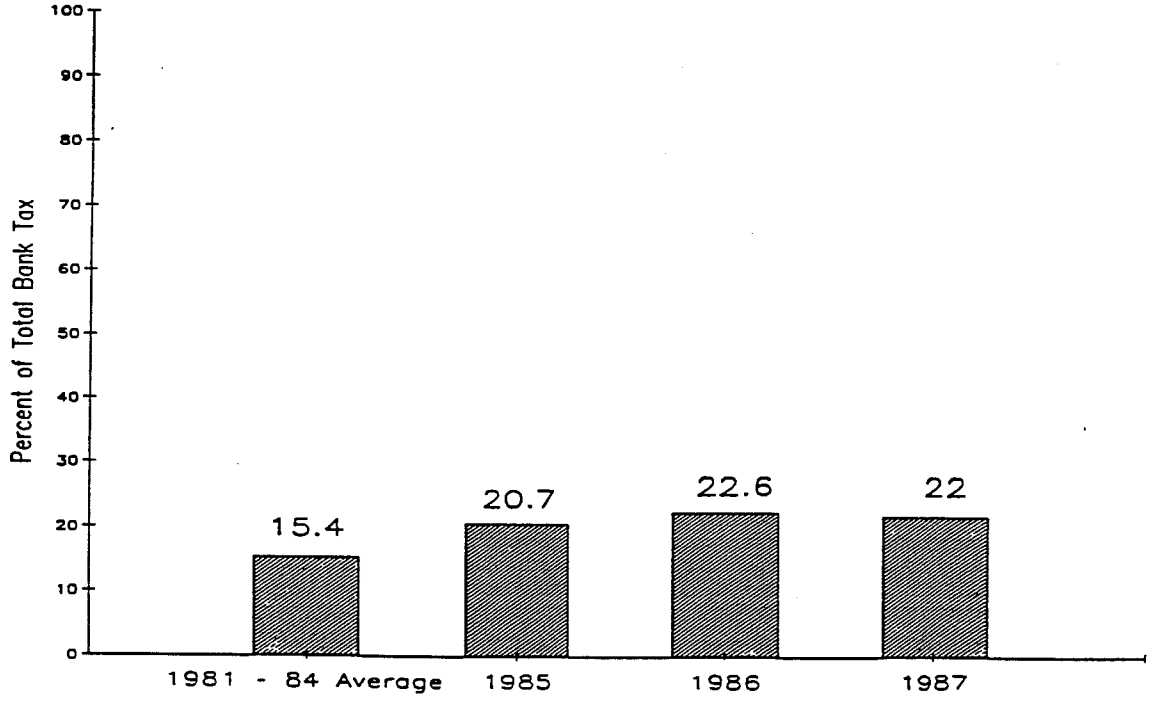


CHART 12

PERCENTAGE OF TOTAL BANK TAX PAID
BY FOREIGN BANKS



Commercial Banks

The number of commercial banks increased from 187 to 310 between the 1981 and 1987 tax years. The portion of bank tax paid by commercial banks peaked at 26.9 percent in 1984 and decreased to 15.8 percent in 1987.

The total tax liability of commercial banks remained steady from 1981 through 1985. This amount increased by 30 percent between the 1985 and 1987 tax years to nearly $45 million. Income based tax liability remained steady from 1981 through 1984. After declining slightly between 1984 and 1985, income based liability increased to $41.7 million in the 1987 tax year. Alternative based tax liability increased sharply from $669,900 in 1984 to $2.7 million in 1985. It then increased to $3.3 million in 1987.

Total positive allocated entire net income increased steadily from $305.7 million in 1983 to $558.5 million in 1987. During the same period, allocated losses increased overall from $106.3 million to $165.2 million respectively.

TABLE 3

HISTORICAL PROFILE OF COMMERCIAL BANKS 1981-1987

NUMBER OF TAXPAYERS AND TOTAL TAX LIABILITY

TAX YEAR	NUMBER OF FILING ENTITIES	NUMBER FILING SEPARATELY	NUMBER FILING ON COMBINED OR CONSOLIDATED BASIS	TOTAL TAX LIABILITY OF COMMERCIAL BANKS	PERCENT OF BANK TAX PAID BY COMMERCIAL BANKS	AVERAGE TAX LIABILITY OF COMMERCIAL BANKS
1981	187	UNAVAILABLE	UNAVAILABLE	$34,351,777	18.1%	$183,699
1982	186	UNAVAILABLE	UNAVAILABLE	35,436,661	26.5%	190,520
1983	190	UNAVAILABLE	UNAVAILABLE	34,789,695	24.3%	183,104
1984	192	163	29	34,700,988	26.9%	180,734
1985	271	198	73	34,017,468	18.8%	125,526
1986	326	263	63	44,317,751	17.5%	135,944
1987	310	245	65	44,991,470	15.8%	145,133

DISTRIBUTION OF TAX LIABILITY BY BASIS OF TAX

	INCOME BASE		ALTERNATIVE BASE		MINIMUM TAX	
TAX YEAR	NUMBER PAYING ON INCOME BASE	INCOME BASED LIABILITY	NUMBER PAYING ON ALTERNATIVE BASE	ALTERNATIVE BASED LIABILITY	NUMBER PAYING MINIMUM TAX	MINIMUM TAX BASED LIABILITY
1981	171	$34,150,774	12	$200,003	4	$1,000
1982	156	34,867,803	30 *	568,858	NOT DISCLOSABLE	NOT DISCLOSABLE
1983	151	34,184,654	34	603,791	5	1,250
1984	154	34,030,338	35	669,900	3	750
1985	172	31,300,403	49	2,704,565	50	12,500
1986	207	42,079,489	54	2,222,012	65	16,250
1987	209	41,667,858	55	3,312,112	46	11,500

INCOME STATISTICS

	POSITIVE ALLOCATED ENI		NEGATIVE ALLOCATED ENI		NET ALLOCATED ENI	
TAX YEAR	CORPS WITH POSITIVE ALLOCATED ENI	TOTAL POSITIVE ALLOCATED ENI ($ THOUSANDS)	CORPS WITH NEGATIVE ALLOCATED ENI	TOTAL NEGATIVE ALLOCATED ENI ($ THOUSANDS)	NET ALLOCATED ENI ($ THOUSANDS)	CHANGE FROM PREVIOUS YEAR
1981	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE
1982	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE
1983	155	305,745	33	(106,332)	199,413	UNAVAILABLE
1984	162	315,383	30	(64,276)	251,107	51,694
1985	192	408,074	79	(79,448)	328,626	77,519
1986	224	560,622	102	(109,068)	451,554	122,928
1987	231	558,525	79	(165,215)	393,310	(58,244)

* In order to maintain confidentiality, minimum tax filers have been aggregated with alternative based taxpayers for the 1982 tax year.

Source: New York State Department of Taxation & Finance, Office of Tax Policy Analysis

CHART 13

NUMBER OF COMMERCIAL BANKS

1981 - 1987

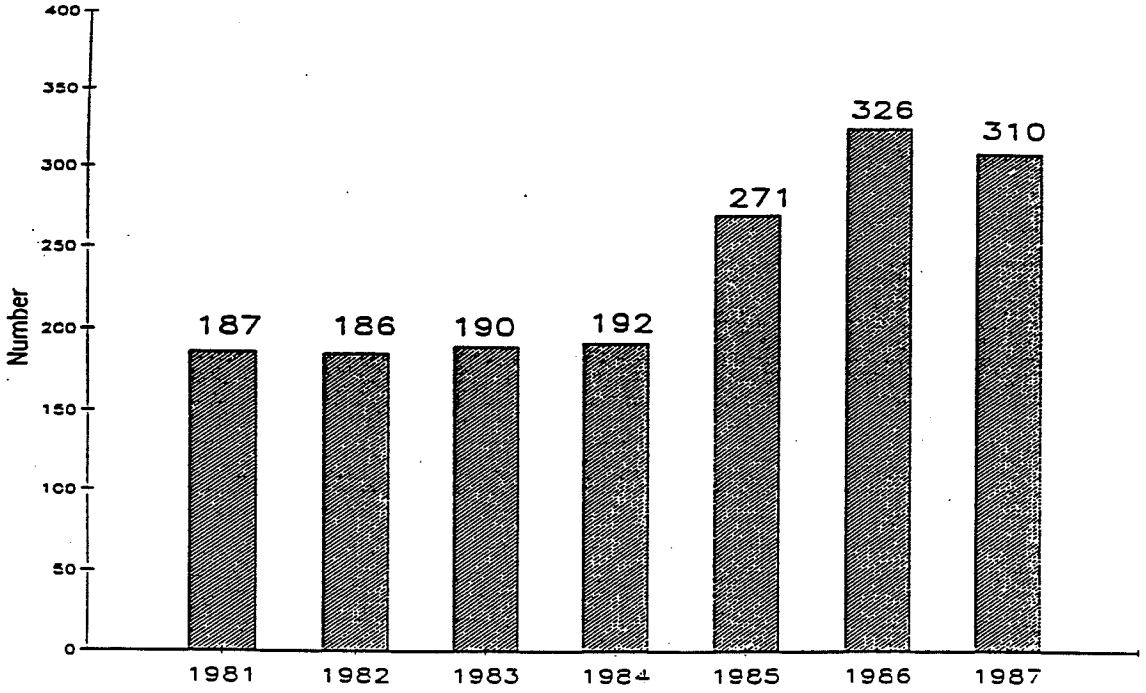


CHART 14

NUMBER OF BANKS REPORTING NEW YORK INCOME

& NUMBER REPORTING NEW YORK LOSSES

1983 - 1987

COMMERCIAL BANKS

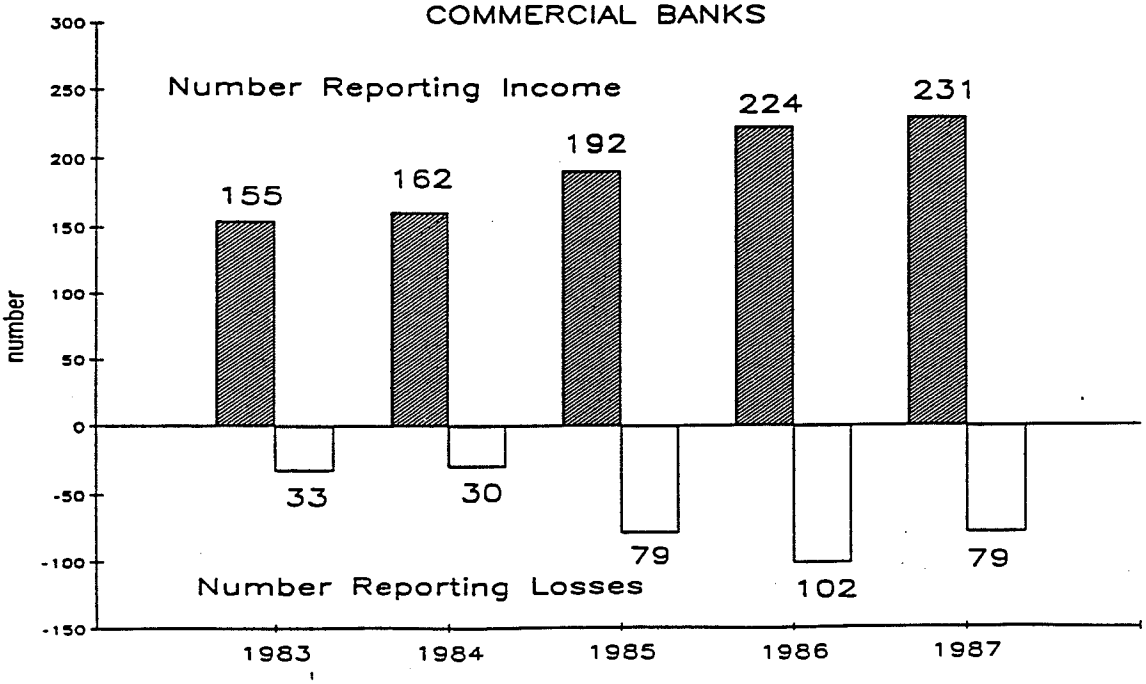


CHART 15

ALLOCATED NEW YORK ENTIRE NET INCOME OR LOSSES
1983 - 1987
COMMERCIAL BANKS

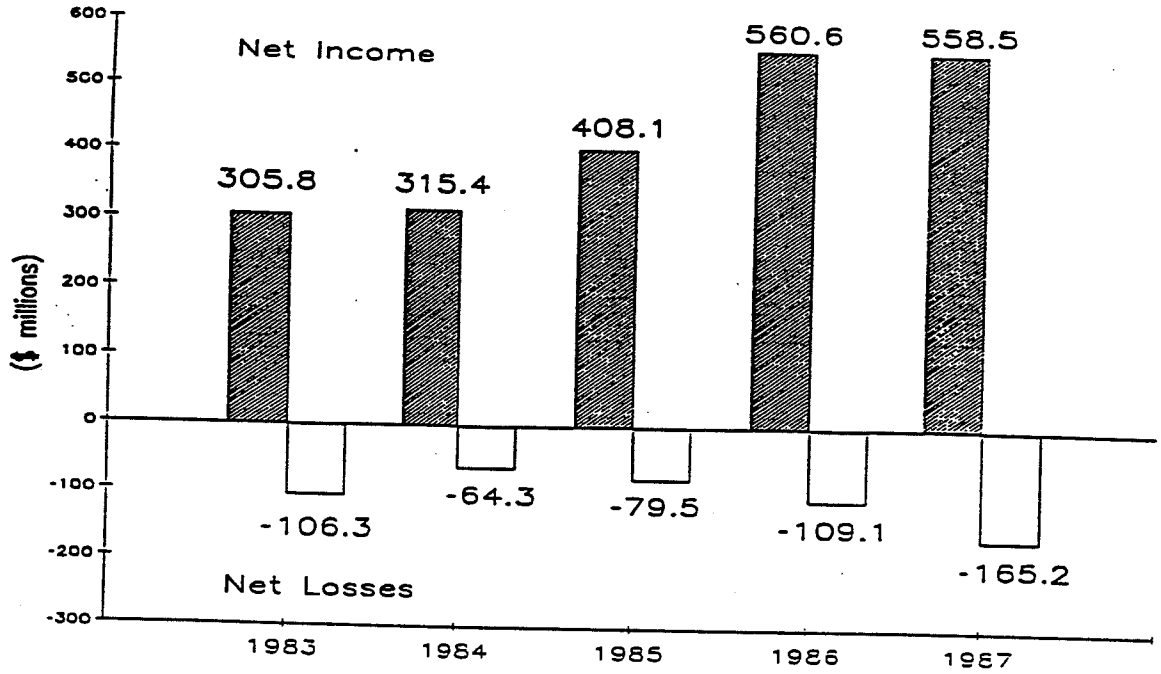


CHART 16

AVERAGE TAX LIABILITY AND TOTAL TAX LIABILITY
1981 - 1987
COMMERCIAL BANKS

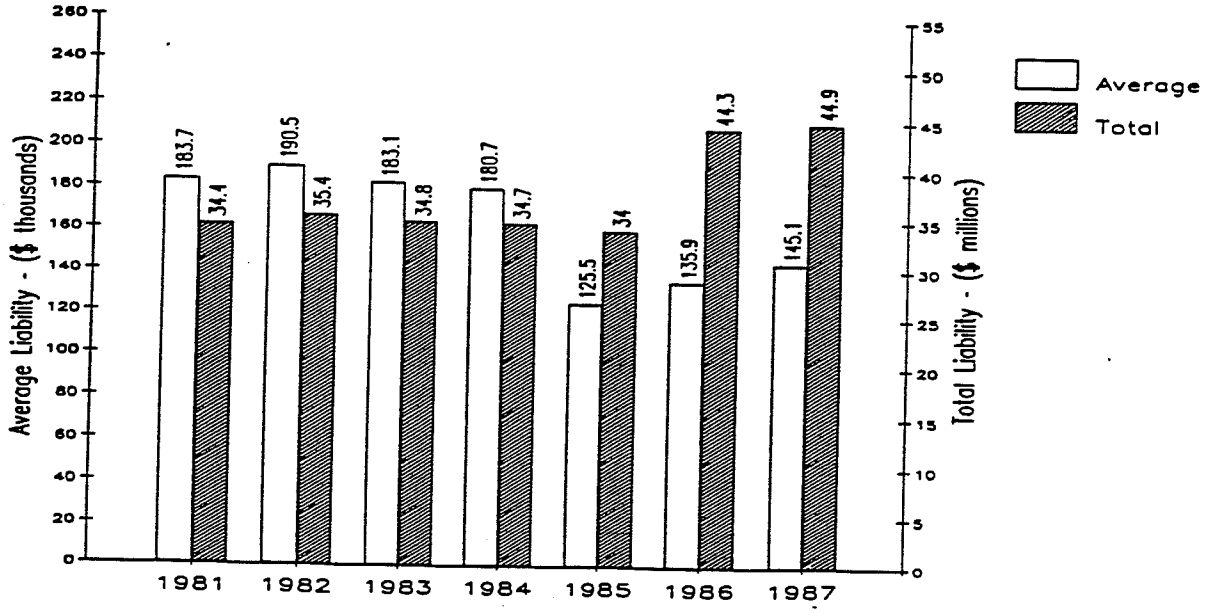


CHART 17

PERCENTAGE OF TAX LIABILITY BY BASIS OF TAX
1981 - 1987
COMMERCIAL BANKS

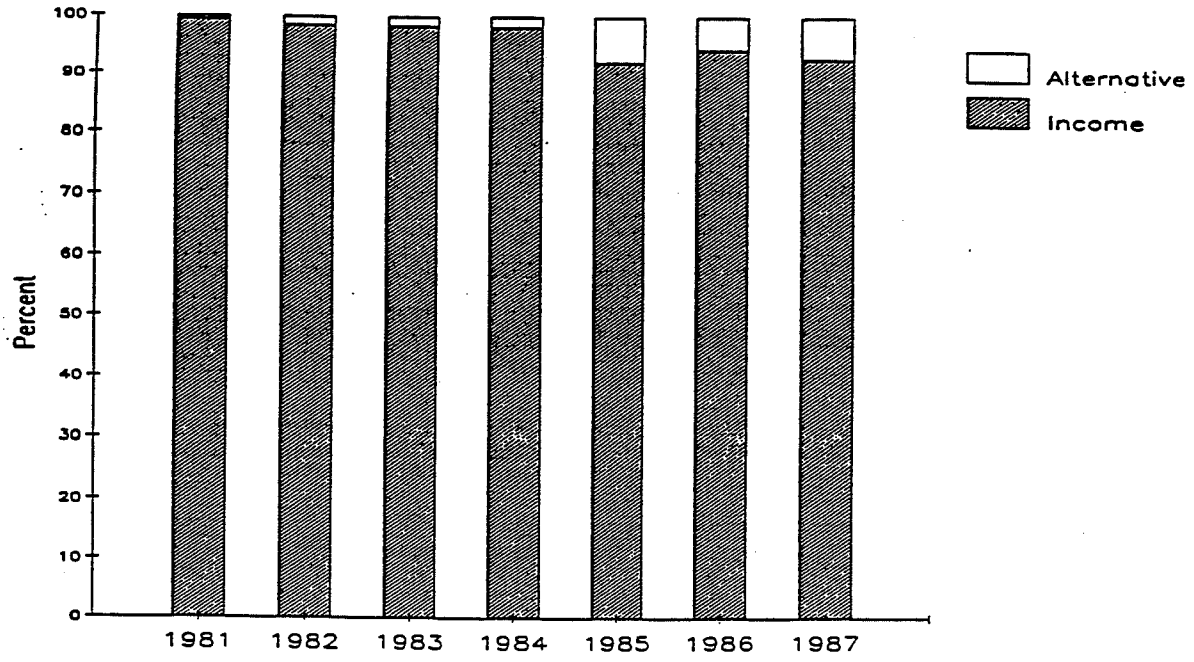
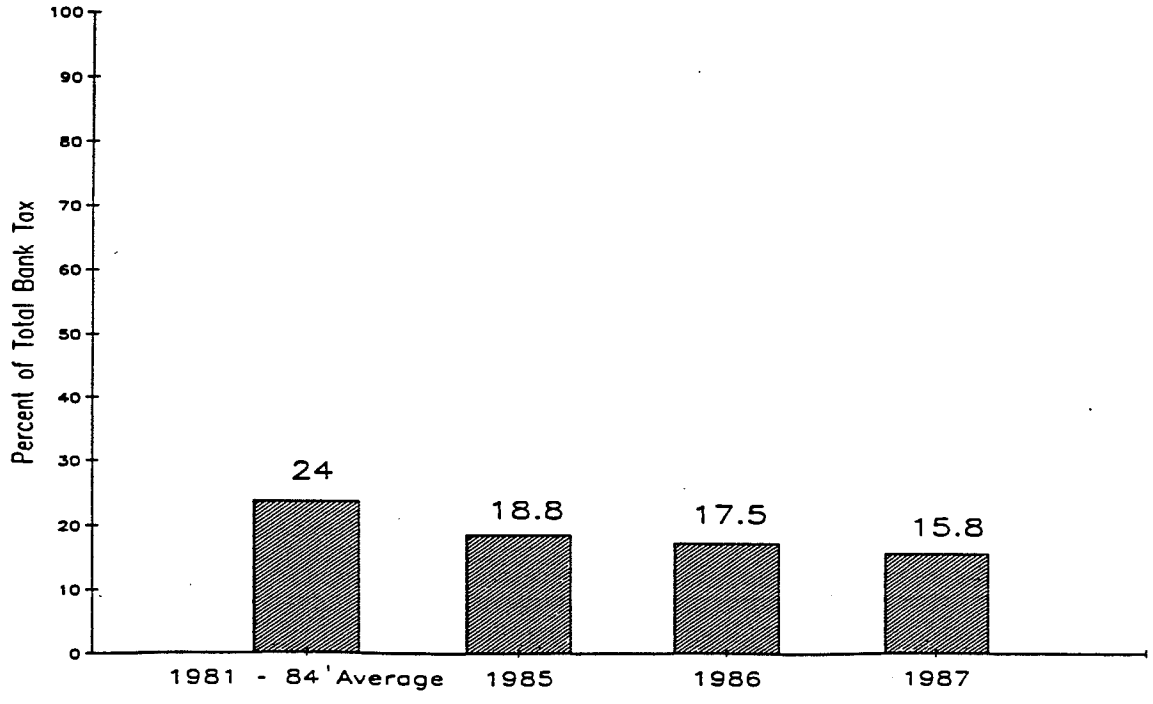


CHART 18

PERCENTAGE OF TOTAL BANK TAX PAID
BY COMMERCIAL BANKS



Savings Banks

The number of savings banks decreased overall from 111 in 1981 to 99 in 1987. The portion of bank tax paid by savings banks decreased from 25.7 percent to 17.3 percent between 1981 and 1984. It then increased steadily to 28.1 percent in the 1987 tax year.

The total tax liability of savings banks decreased steadily between 1981 and 1984. This trend reversed from 1984 through 1987 when total tax liability increased from $22.3 million to $80.5 million. Between 1981 and 1987 there was a converse pattern between income and alternative based tax liabilities. The most significant shift in these liabilities occurred between 1984 and 1985. Income based liability increased from $5.3 million to $36.4 million while alternative based liability decreased from $17 million to $335,831.

Between 1983 and 1987, total positive allocated entire net income increased from $87.2 million to $1.1 billion. Allocated losses peaked at $1.3 billion in the 1984 tax year and decreased to $54.3 million in the 1987 tax year.

TABLE 4

HISTORICAL PROFILE OF SAVINGS BANKS 1981-1987

NUMBER OF TAXPAYERS AND TOTAL TAX LIABILITY

TAX YEAR	NUMBER OF FILING ENTITIES	NUMBER FILING SEPARATELY	NUMBER FILING ON COMBINED OR CONSOLIDATED BASIS	TOTAL TAX LIABILITY OF SAVINGS BANKS	PERCENT OF BANK TAX PAID BY SAVINGS BANKS	AVERAGE TAX LIABILITY OF SAVINGS BANKS
1981	111	111	NOT ALLOWED	$48,772,268	25.7%	$439,390
1982	95	95	NOT ALLOWED	31,161,914	23.3%	328,020
1983	99	99	NOT ALLOWED	24,116,847	16.9%	243,605
1984	96	96	NOT ALLOWED	22,298,566	17.3%	232,277
1985	100	57	43	36,704,910	20.3%	367,049
1986	102	53	49	70,002,818	27.6%	686,302
1987	99	47	52	80,487,004	28.1%	813,000

DISTRIBUTION OF TAX LIABILITY BY BASIS OF TAX

	INCOME BASE		ALTERNATIVE BASE		MINIMUM TAX	
TAX YEAR	NUMBER PAYING ON INCOME BASE	INCOME BASED LIABILITY	NUMBER PAYING ON ALTERNATIVE BASE	ALTERNATIVE BASED LIABILITY	NUMBER PAYING MINIMUM TAX	MINIMUM TAX BASED LIABILITY
1981	NOT DISCLOSABLE	NOT DISCLOSABLE	111 *	$48,772,268	0	$0
1982	6	4,190,224	86	26,970,940	3	750
1983	21	6,413,868	59	17,698,229	19	4,750
1984	26	5,294,546	53	16,999,770	17	4,250
1985	67	36,362,079	5	335,831	28	7,000
1986	87	69,906,780	15 *	96,038	NOT DISCLOSABLE	NOT DISCLOSABLE
1987	87	80,069,944	12 *	417,060	NOT DISCLOSABLE	NOT DISCLOSABLE

INCOME STATISTICS

	POSITIVE ALLOCATED ENI		NEGATIVE ALLOCATED ENI		NET ALLOCATED ENI	
TAX YEAR	CORPS WITH POSITIVE ALLOCATED ENI	TOTAL POSITIVE ALLOCATED ENI ($ THOUSANDS)	CORPS WITH NEGATIVE ALLOCATED ENI	TOTAL NEGATIVE ALLOCATED ENI ($ THOUSANDS)	NET ALLOCATED ENI ($ THOUSANDS)	CHANGE FROM PREVIOUS YEAR ($ THOUSANDS)
1981	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE
1982	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE
1983	44	87,229	52	(601,778)	(514,549)	UNAVAILABLE
1984	47	104,198	47	(1,268,616)	(1,164,418)	(649,869)
1985	78	542,558	22	(188,044)	354,514	1,518,932
1986	95	1,134,356	7	(127,792)	1,006,564	652,050
1987	93	1,056,403	6	(54,291)	1,002,112	(4,453)

* In order to maintain confidentiality, income based filers have been aggregated with alternative based taxpayers for the 1981 tax year and minimum tax filers have been aggregated with alternative based taxpayers for the 1986 and 1987 tax years.

Source: New York State Department of Taxation & Finance, Office of Tax Policy Analysis

CHART 19
NUMBER OF SAVINGS BANKS
1981 - 1987

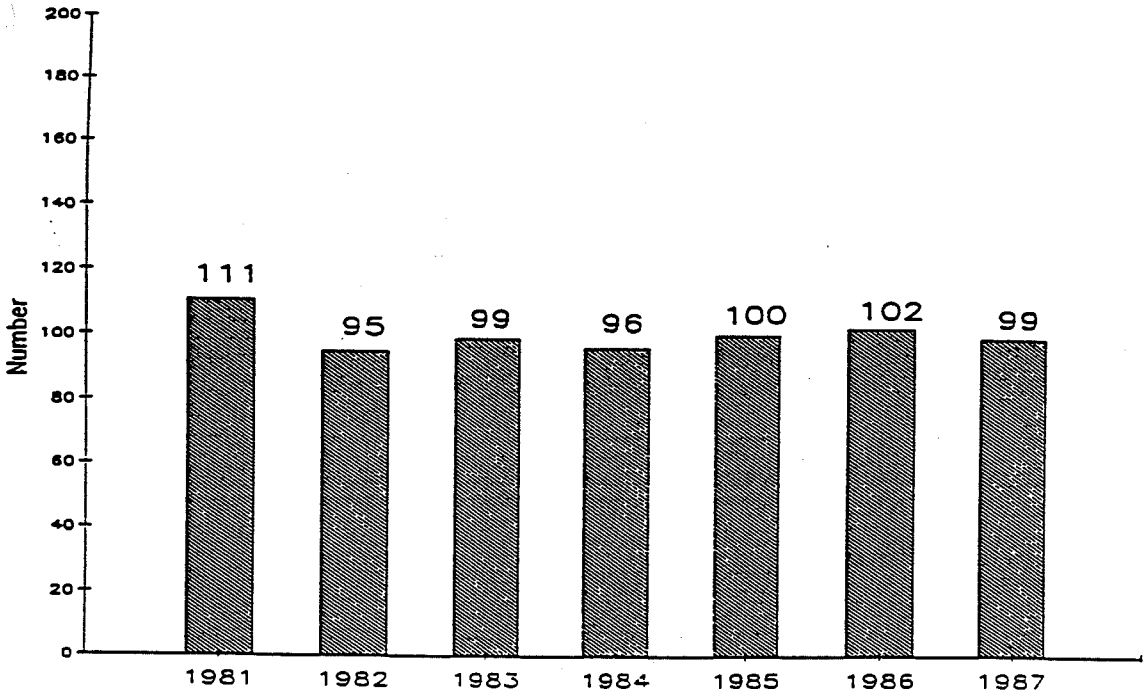


CHART 20
NUMBER OF BANKS REPORTING NEW YORK INCOME
& NUMBER REPORTING NEW YORK LOSSES
1983 - 1987
SAVINGS BANKS

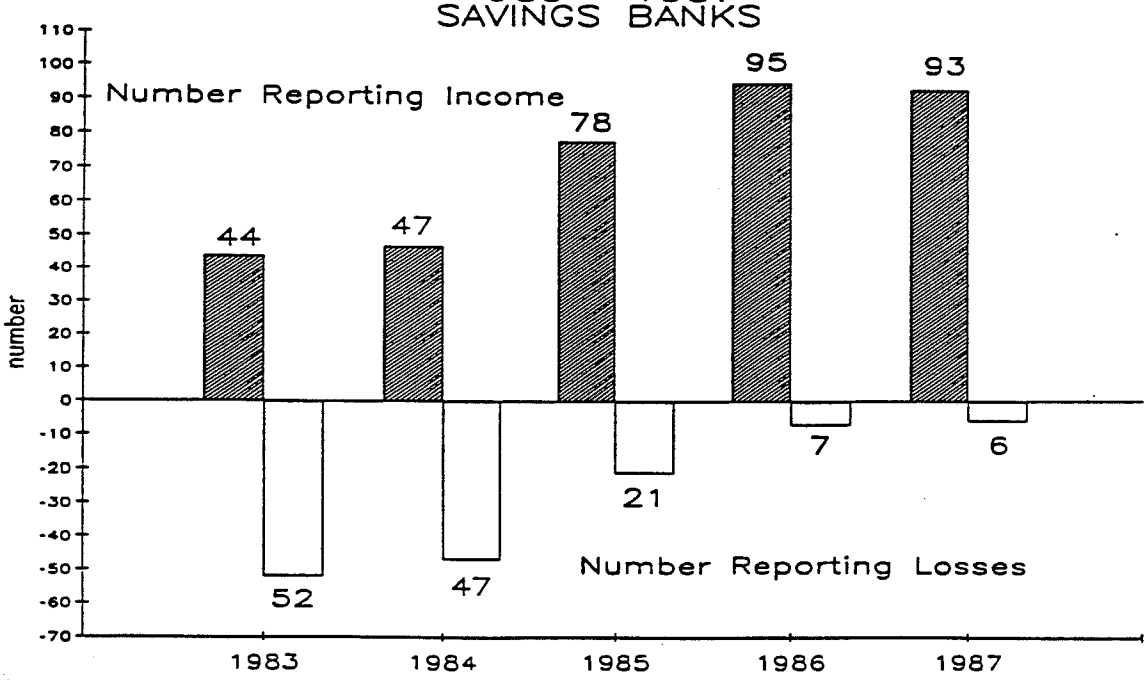


CHART 21

ALLOCATED NEW YORK ENTIRE NET INCOME OR LOSSES
1983 - 1987
SAVINGS BANKS

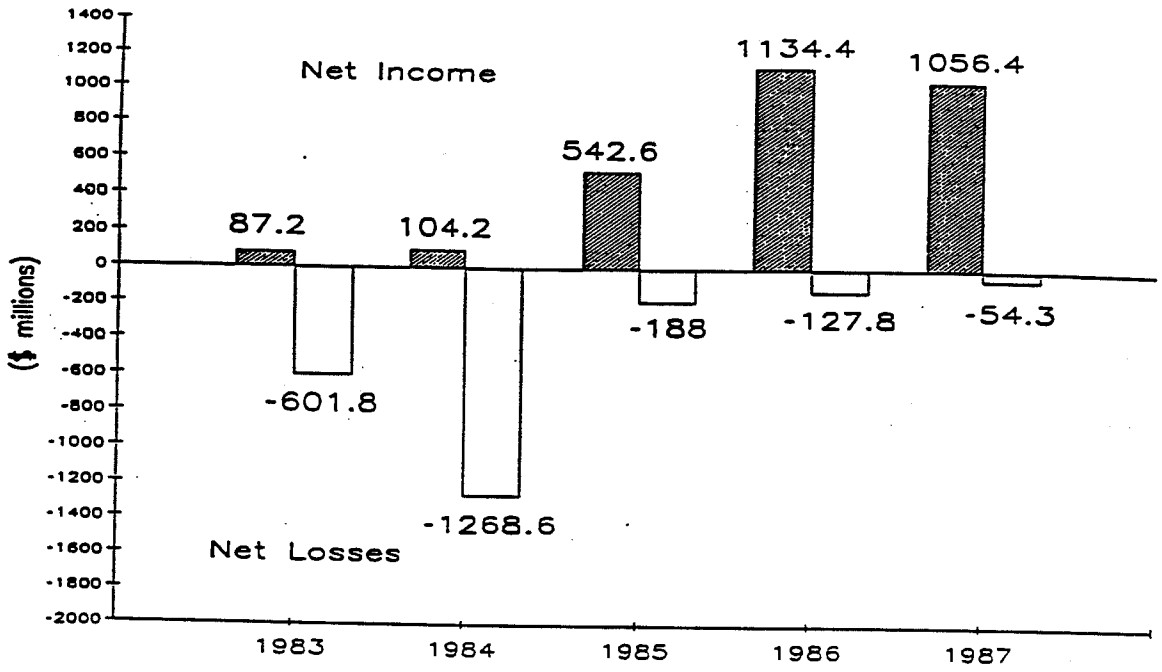


CHART 22

AVERAGE TAX LIABILITY AND TOTAL TAX LIABILITY
1981 - 1987
SAVINGS BANKS

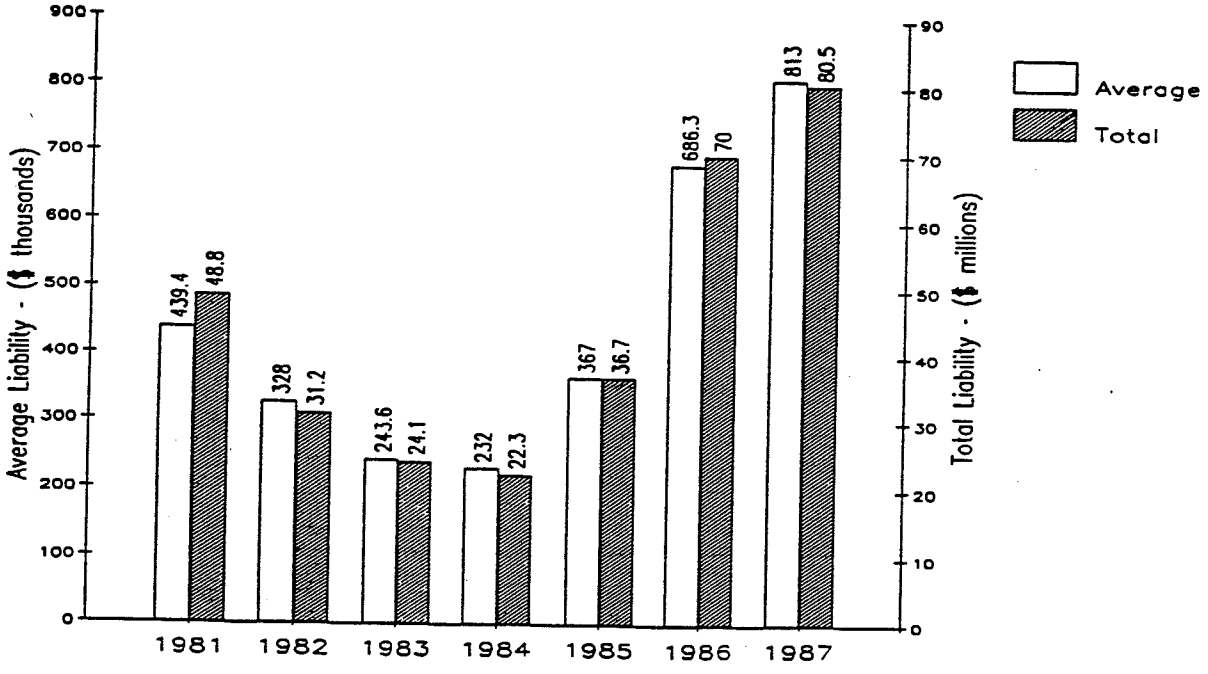


CHART 23

PERCENTAGE OF TAX LIABILITY BY BASIS OF TAX
1981 - 1987
SAVINGS BANKS

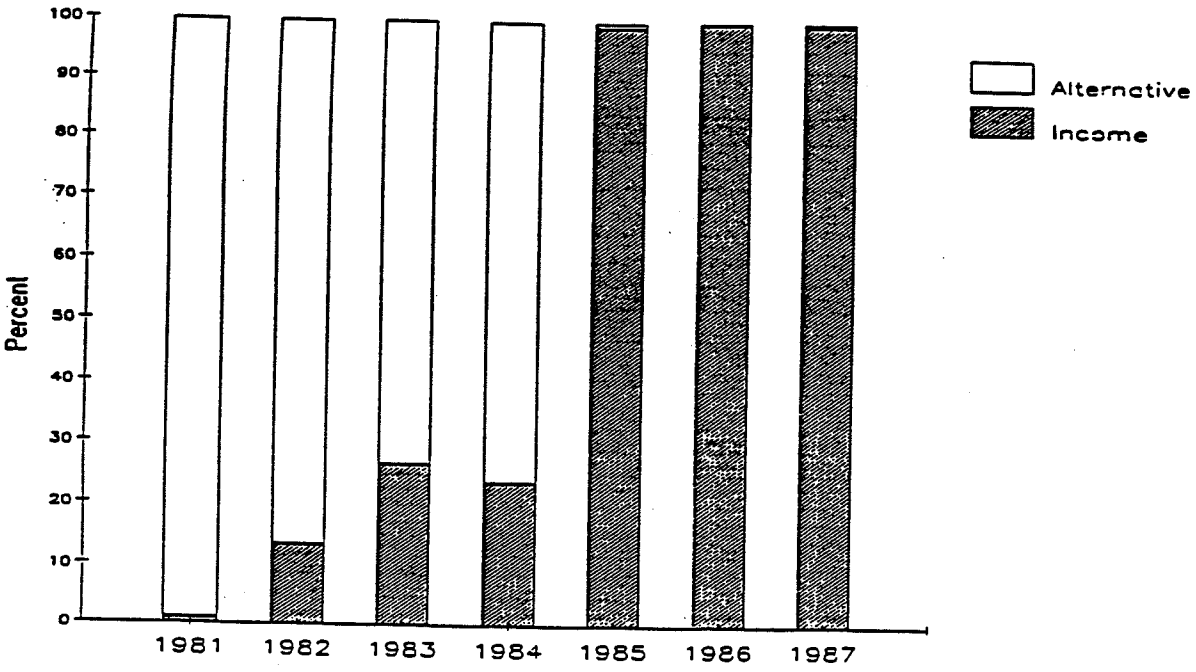
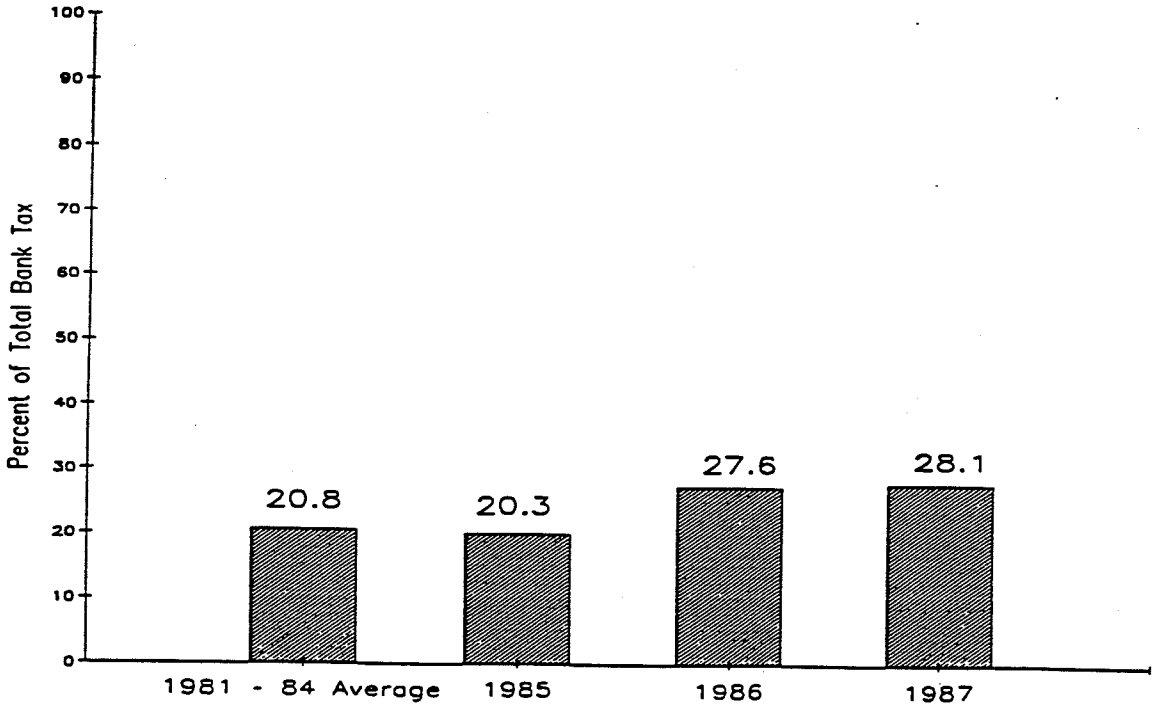


CHART 24

PERCENTAGE OF TOTAL BANK TAX PAID
BY SAVINGS BANKS



Savings and Loan Associations

The number of savings and loan associations filing under Article 32 decreased steadily from 111 in the 1981 tax year to 68 in the 1987 tax year. The portion of bank tax paid by savings and loan associations decreased overall from 6.4 percent in the 1981 tax year to 5.7 percent in the 1987 tax year.

The total tax liability of savings and loan associations decreased steadily between 1981 and 1984. This trend changed between 1984 and 1987, with total tax liability increasing from $5.7 million to $16.2 million. This shift was due to an increase in income based liability from $3.5 million in 1984 to nearly $16.2 million in 1987. The number of taxpayers paying on the income base increased from 4 in 1981 to 57 in 1987.

The most significant shift in allocated income and losses occurred between 1984 and 1985. Reported allocated income increased from $41.1 million to $108.1 million during that period. Reported allocated losses decreased from $211.5 million in 1984 to $89.5 million in 1985.

TABLE 5

HISTORICAL PROFILE OF SAVINGS AND LOAN ASSOCIATIONS 1981-1987

NUMBER OF TAXPAYERS AND TOTAL TAX LIABILITY

TAX YEAR	NUMBER OF FILING ENTITIES	NUMBER FILING SEPARATELY	NUMBER FILING ON COMBINED OR CONSOLIDATED BASIS	TOTAL TAX LIABILITY OF SAVINGS AND LOANS	PERCENT OF BANK TAX PAID BY SAVINGS/LOAN ASSOCIATIONS	AVERAGE TAX LIABILITY OF SAVINGS/LOAN ASSOCIATIONS
1981	111	111	NOT ALLOWED	$12,195,079	6.4%	$109,866
1982	99	99	NOT ALLOWED	7,612,094	5.7%	76,890
1983	81	81	NOT ALLOWED	5,045,097	3.5%	62,285
1984	79	79	NOT ALLOWED	5,702,025	4.4%	72,178
1985	71	61	10	6,491,506	3.6%	91,430
1986	66	50	16	16,613,183	6.5%	251,714
1987	68	53	15	16,168,827	5.7%	237,777

DISTRIBUTION OF TAX LIABILITY BY BASIS OF TAX

	INCOME BASE		ALTERNATIVE BASE		MINIMUM TAX	
TAX YEAR	NUMBER PAYING ON INCOME BASE	INCOME BASED LIABILITY	NUMBER PAYING ON ALTERNATIVE BASE	ALTERNATIVE BASED LIABILITY	NUMBER PAYING MINIMUM TAX	MINIMUM TAX BASED LIABILITY
1981	4	$257,602	107	$11,937,477	0	$0
1982	6	653,258	93 *	6,958,836	NOT DISCLOSABLE	NOT DISCLOSABLE
1983	27	3,219,005	40	1,822,592	14	3,500
1984	23	3,486,699	41	2,211,576	15	3,750
1985	45	6,459,192	6	27,314	20	5,000
1986	54	16,522,781	4	88,402	8	2,000
1987	57	16,152,660	5	14,667	6	1,500

INCOME STATISTICS

	POSITIVE ALLOCATED ENI		NEGATIVE ALLOCATED ENI		NET ALLOCATED ENI	
TAX YEAR	CORPS WITH POSITIVE ALLOCATED ENI	TOTAL POSITIVE ALLOCATED ENI ($ THOUSANDS)	CORPS WITH NEGATIVE ALLOCATED ENI	TOTAL NEGATIVE ALLOCATED ENI ($ THOUSANDS)	NET ALLOCATED ENI ($ THOUSANDS)	CHANGE FROM PREVIOUS YEAR
1981	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE
1982	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE
1983	44	38,244	35	(317,932)	(279,688)	UNAVAILABLE
1984	40	41,122	39	(211,532)	(170,410)	109,278
1985	56	108,061	15	(89,518)	18,543	188,953
1986	61	245,261	5	(25,721)	219,540	202,429
1987	58	204,359	10	(15,804)	188,555	(13,874)

* In order to maintain confidentiality, minimum tax filers have been aggregated with alternative based taxpayers for the 1982 tax year.

Source: New York State Department of Taxation & Finance, Office of Tax Policy Analysis

CHART 25

NUMBER OF SAVINGS AND LOAN ASSOCIATIONS
1981 - 1987

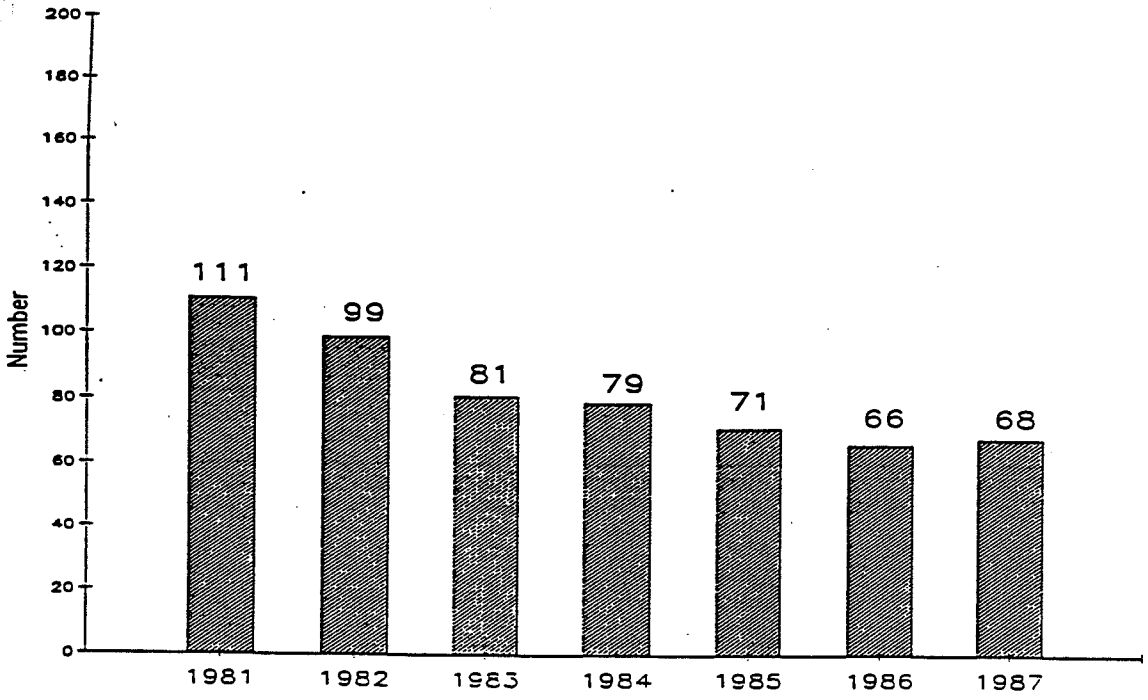


CHART 26

NUMBER OF BANKS REPORTING NEW YORK INCOME
& NUMBER REPORTING NEW YORK LOSSES
1983 - 1987
SAVINGS AND LOAN ASSOCIATIONS

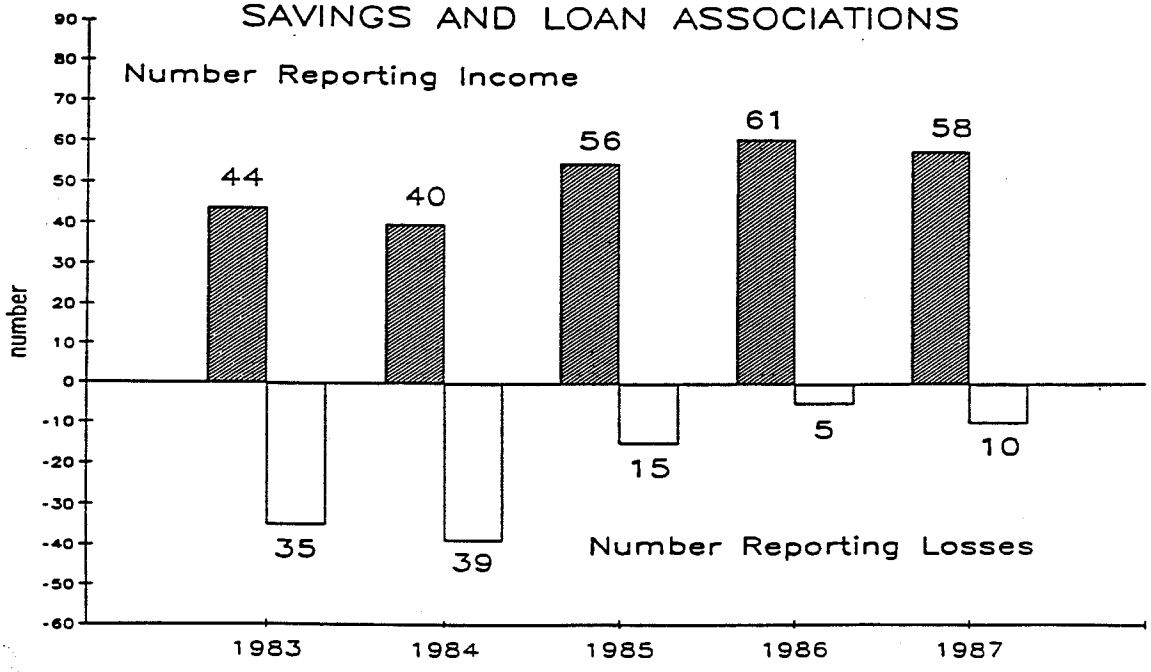


CHART 27

ALLOCATED NEW YORK ENTIRE NET INCOME OR LOSSES
1983 - 1987
SAVINGS AND LOAN ASSOCIATIONS

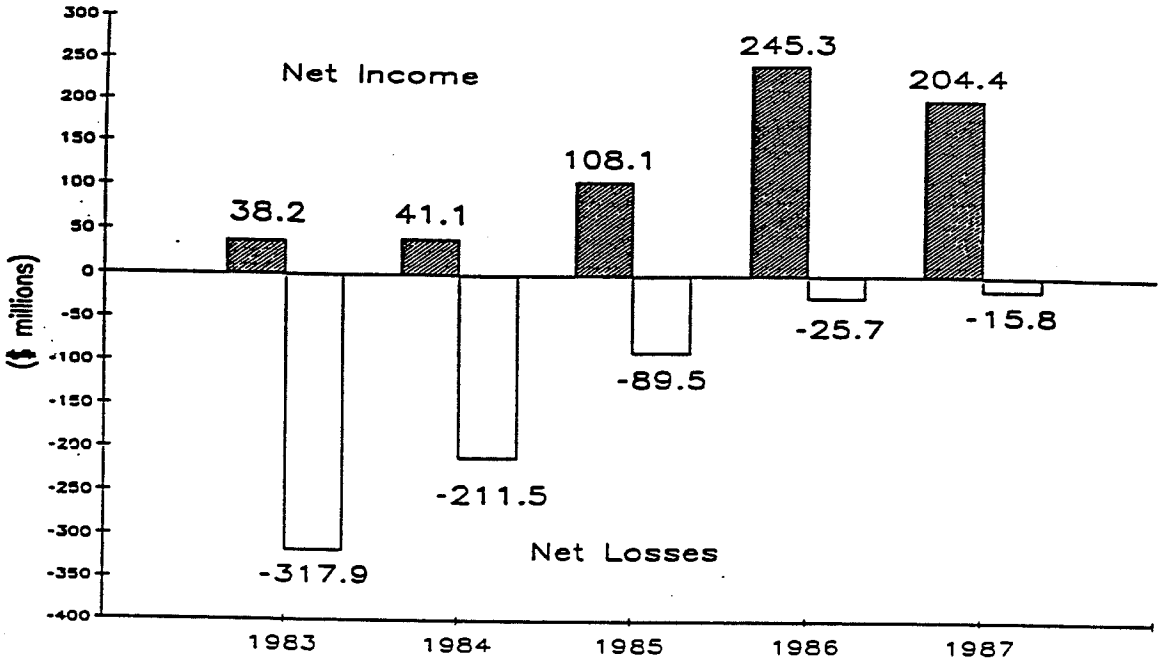


CHART 28

AVERAGE TAX LIABILITY AND TOTAL TAX LIABILITY
1981 - 1987
SAVINGS AND LOAN ASSOCIATIONS

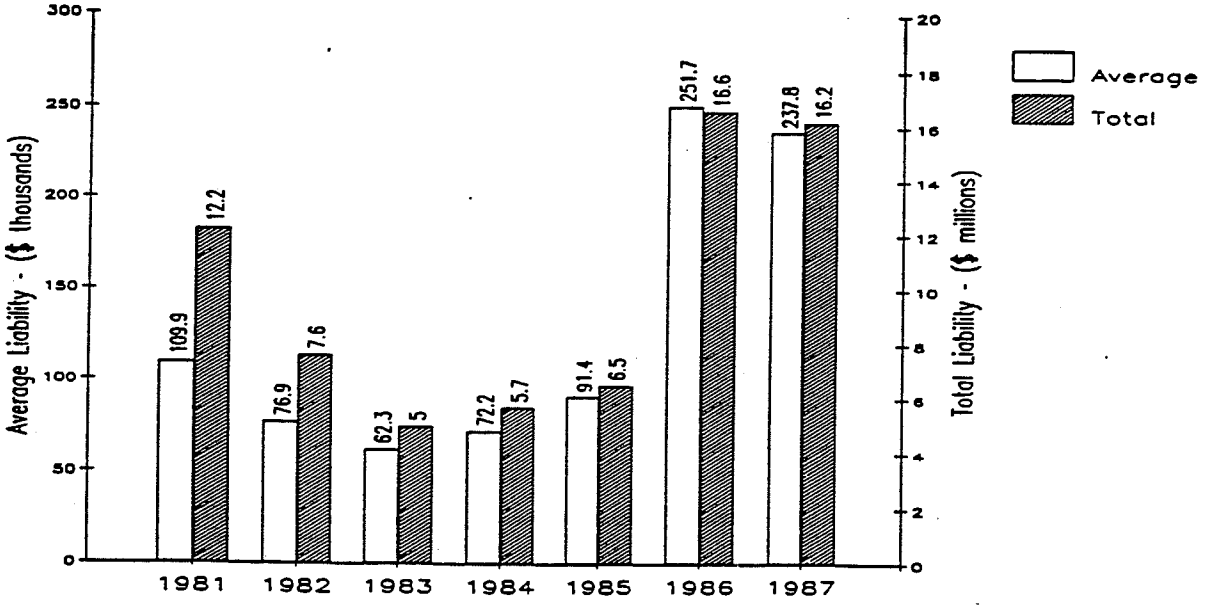


CHART 29

PERCENTAGE OF LIABILITY BY BASIS OF TAX
1981 - 1987
SAVINGS AND LOAN ASSOCIATIONS

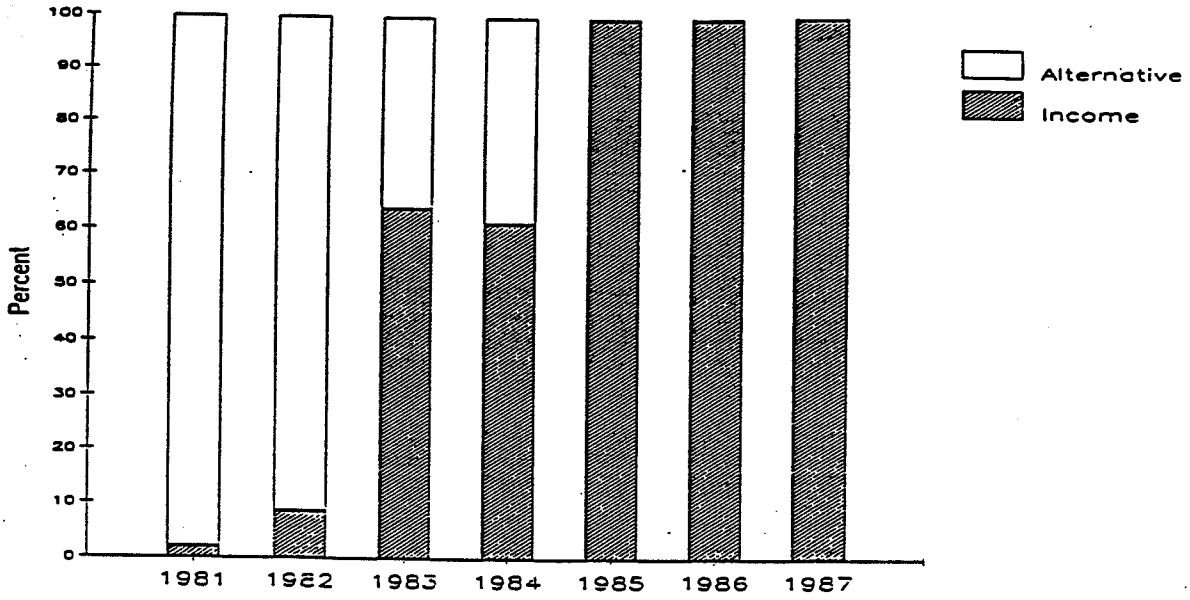
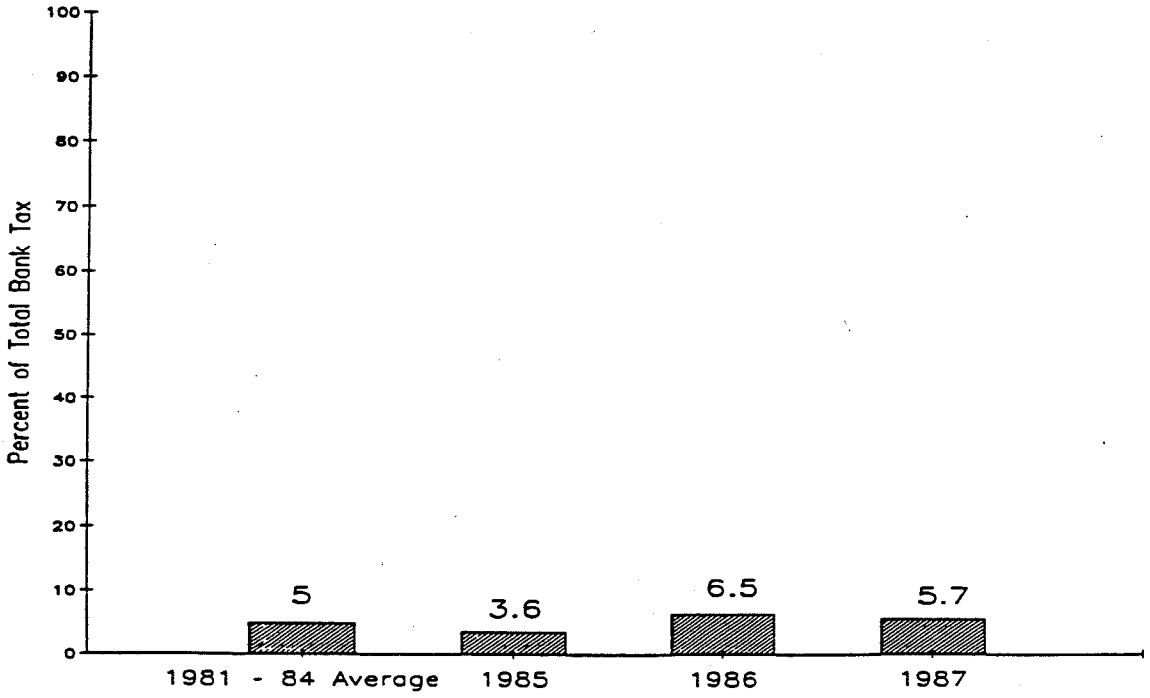


CHART 30

PERCENTAGE OF TOTAL BANK TAX PAID
BY SAVINGS AND LOAN ASSOCIATIONS



All Banks

The total number of Article 32 taxpayers increased from 582 to 806 between 1981 and 1987

Following an overall decrease in the total tax liability of Article 32 taxpayers, liability rose from $129 million in 1984 to $285.9 million in 1987. From 1981 through 1987 there was a converse trend between the number and liability of taxpayers paying on the income base and those paying on alternative tax bases. During this period, income based liability increased from $126 million to $257.4 million while alternative based liability decreased from $63.9 million to $28.5 million.

Positive allocated income increased sharply from $1.1 billion in the 1983 tax year to $3.3 billion in the 1987 tax year. During that period the number of taxpayers reporting positive income increased from 301 to 489. The number of taxpayers reporting allocated losses increased from 239 to 317 in the seven year period. However, reported allocated losses decreased from $1.6 billion in the 1983 tax year to nearly $930 million in the 1987 tax year.

TABLE 6

HISTORICAL PROFILE OF ALL BANKS 1981-1987

NUMBER OF TAXPAYERS AND TOTAL TAX LIABILITY

TAX YEAR	NUMBER OF FILING ENTITIES	NUMBER FILING SEPARATELY	NUMBER FILING ON COMBINED OR CONSOLIDATED BASIS	TOTAL TAX LIABILITY OF ALL BANKS	PERCENT OF BANK TAX PAID BY ALL BANKS	AVERAGE TAX LIABILITY OF ALL BANKS
1981	582	UNAVAILABLE	UNAVAILABLE	$189,964,399	100.0%	$326,399
1982	560	UNAVAILABLE	UNAVAILABLE	133,907,639	100.0%	239,121
1983	560	UNAVAILABLE	UNAVAILABLE	142,979,531	100.0%	255,321
1984	581	540	41	128,977,761	100.0%	221,993
1985	718	580	138	180,643,009	100.0%	251,592
1986	788	643	145	253,682,459	100.0%	321,932
1987	806	655	151	285,931,425	100.0%	354,754

DISTRIBUTION OF TAX LIABILITY BY BASIS OF TAX

	INCOME BASE		ALTERNATIVE BASE		MINIMUM TAX	
TAX YEAR	NUMBER PAYING ON INCOME BASE	INCOME BASED LIABILITY	NUMBER PAYING ON ALTERNATIVE BASE	ALTERNATIVE BASED LIABILITY	NUMBER PAYING MINIMUM TAX	MINIMUM TAX BASED LIABILITY
1981	240	$126,055,638	339 *	$63,907,761	4	$1,000
1982	231	93,091,548	326 *	40,815,341	3	$750
1983	263	118,131,120	259	24,838,911	38	$9,500
1984	269	102,012,717	277 *	26,956,294	35	$8,750
1985	350	152,960,231	227	27,647,528	141	$35,250
1986	428	234,801,670	223 *	18,846,539	137	$34,250
1987	436	257,369,637	245 *	28,530,538	125	$31,250

INCOME STATISTICS

	POSITIVE ALLOCATED ENI		NEGATIVE ALLOCATED ENI		NET ALLOCATED ENI	
TAX YEAR	CORPS WITH POSITIVE ALLOCATED ENI	TOTAL POSITIVE ALLOCATED ENI ($ THOUSANDS)	CORPS WITH NEGATIVE ALLOCATED ENI ($ THOUSANDS)	TOTAL NEGATIVE ALLOCATED ENI ($ THOUSANDS)	NET ALLOCATED ENI ($ THOUSANDS)	CHANGE FROM PREVIOUS YEAR
1981	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE
1982	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE	UNAVAILABLE
1983	301	1,109,369	239	(1,639,035)	(529,666)	UNAVAILABLE
1984	318	1,054,889	260	(2,509,642)	(1,454,753)	(925,087)
1985	413	2,049,759	305	(1,126,766)	922,993	2,377,746
1986	473	3,269,607	303	(798,204)	2,471,403	1,548,410
1987	489	3,310,734	317	(929,972)	2,380,762	(90,641)

* In order to maintain confidentiality, some income based tax filers have been aggregated with alternative based taxpayers for the 1981 tax year and some minimum tax filers have been aggregated with alternative based taxpayers for the 1982, 1984, 1986 and 1987 tax years.

Source: New York State Department of Taxation & Finance, Office of Tax Policy Analysis

CHART 31

TOTAL NUMBER OF BANKS

1981 - 1987

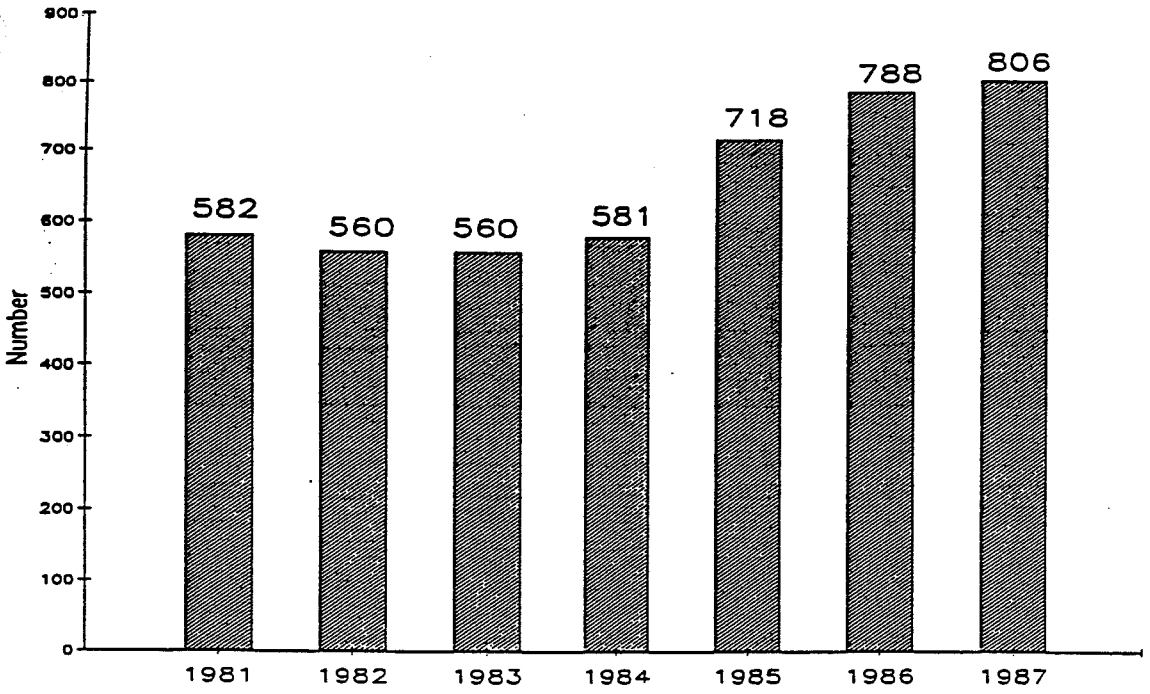


CHART 32

NUMBER OF BANKS REPORTING NEW YORK INCOME

& NUMBER REPORTING NEW YORK LOSSES

1983 - 1987

ALL BANKS

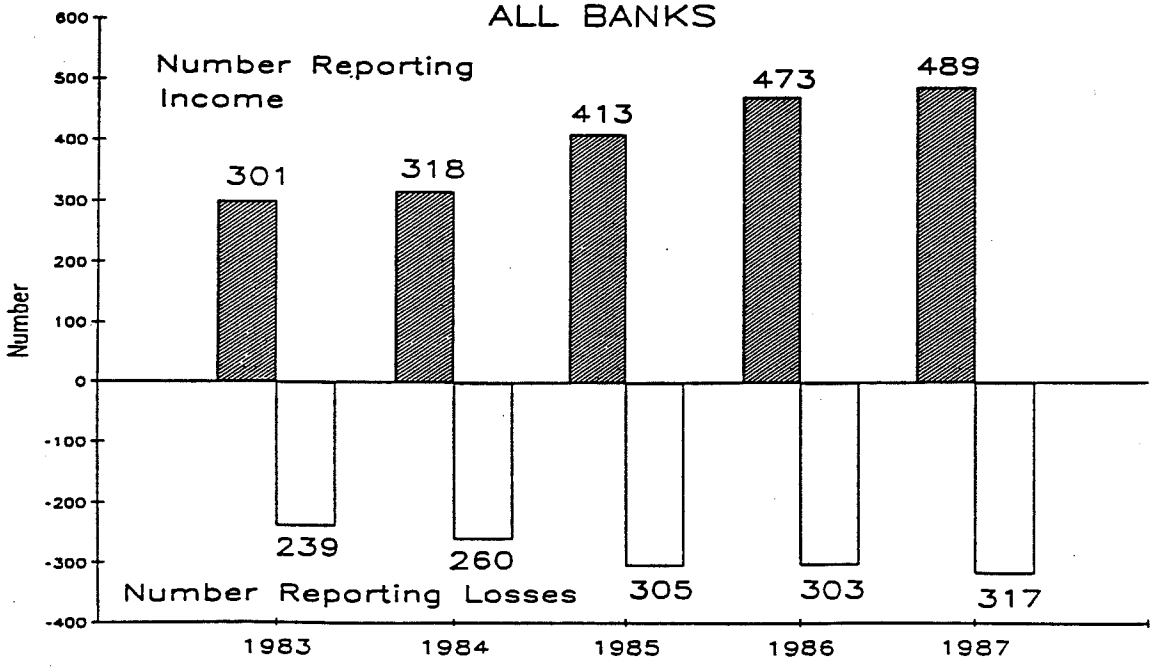


CHART 33

ALLOCATED NEW YORK ENTIRE NET INCOME OR LOSSES
1983 - 1987
ALL BANKS

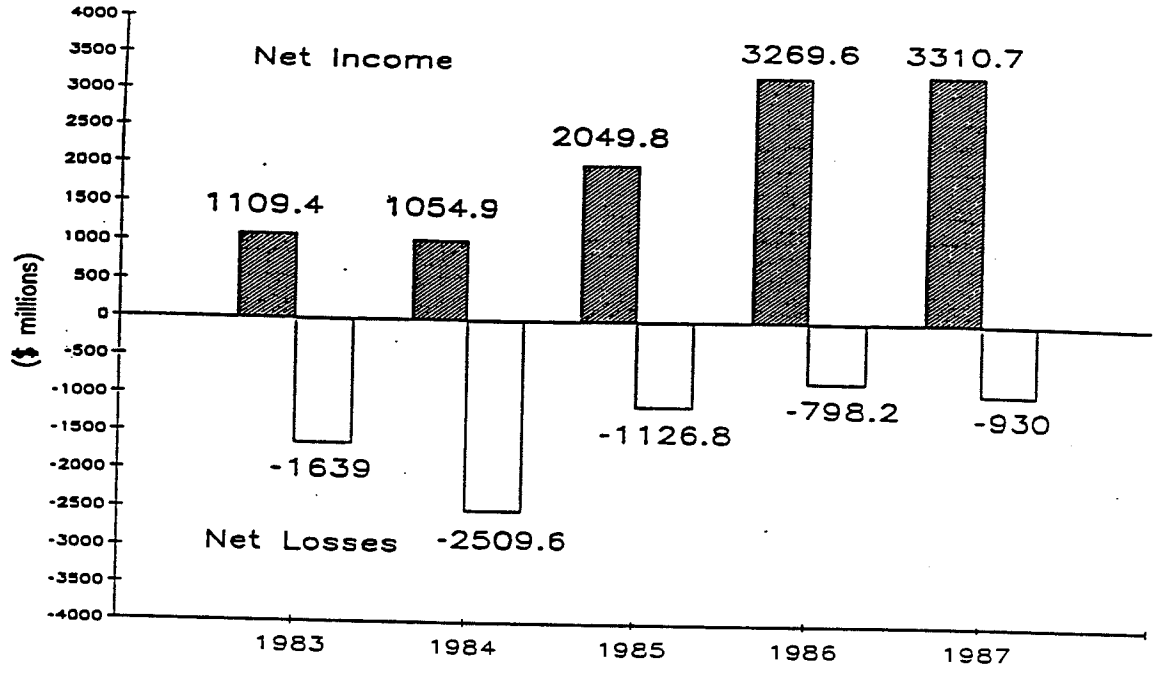


CHART 34

AVERAGE TAX LIABILITY AND TOTAL TAX LIABILITY
1981 - 1987
ALL BANKS

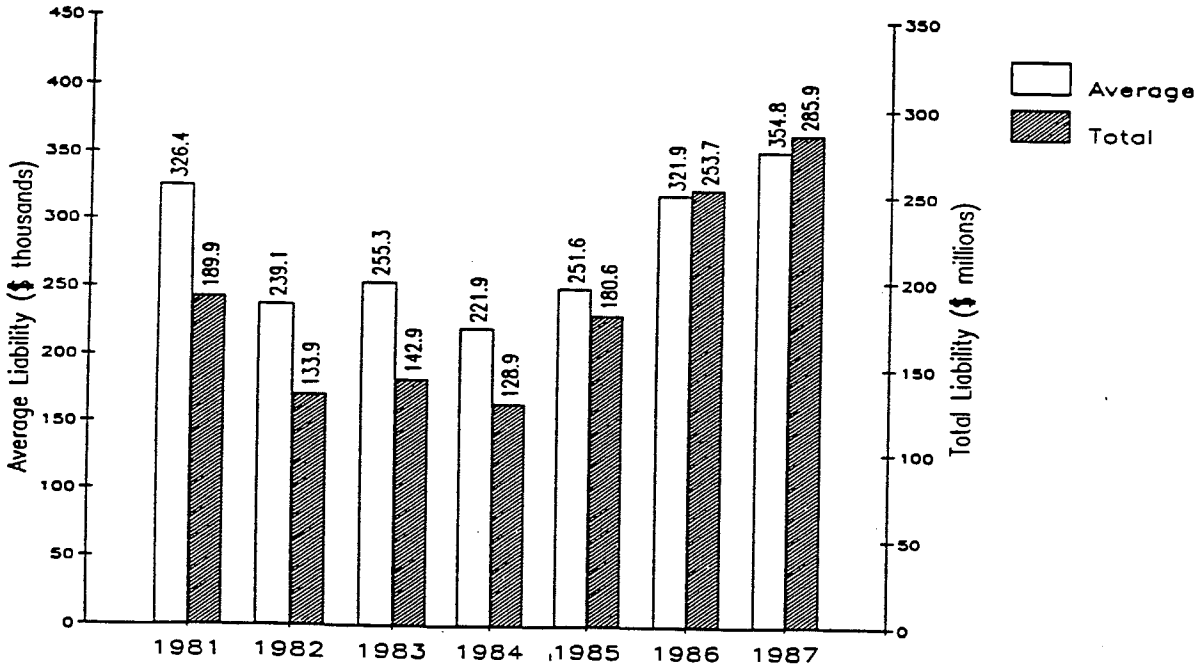
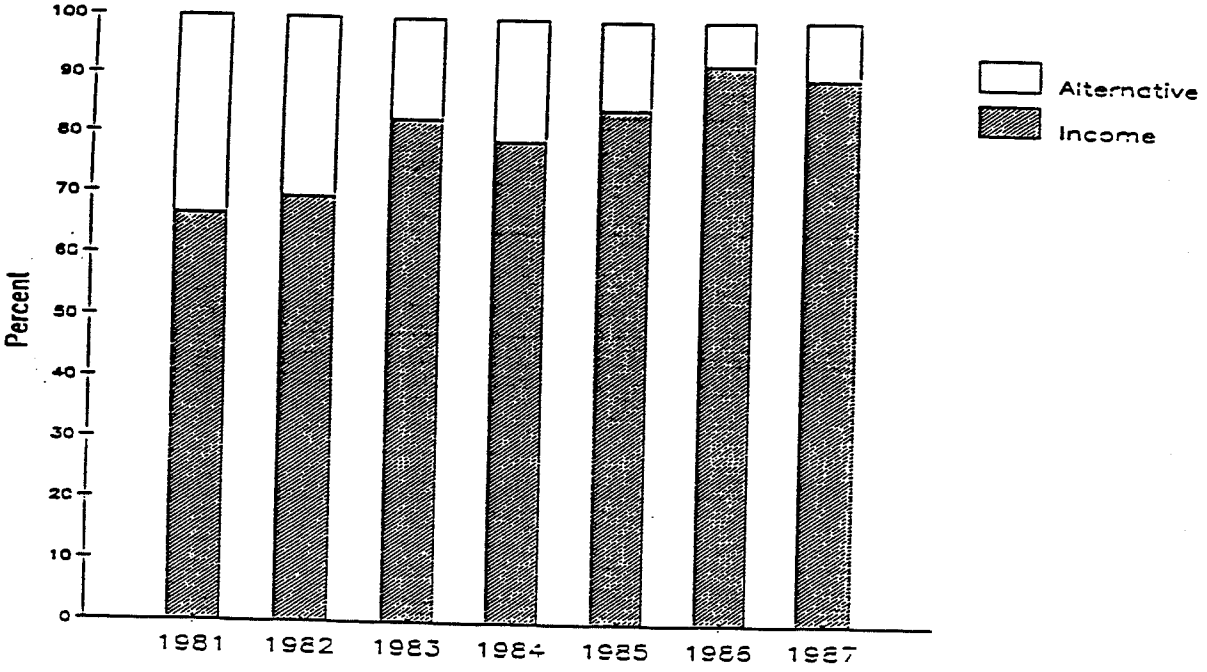


CHART 35

PERCENTAGE OF LIABILITY BY BASIS OF TAX
1981 - 1987
ALL BANKS



Features of 1985 Reform

Tables 7-10 and charts 36 through 44 provide information regarding the results of some of the more significant changes provided for by the 1985 legislation. An overview of these changes and a discussion of their results is provided in Section III, Summary of Statistics.

TABLE 7

AVERAGE ENTIRE NET INCOME ALLOCATION PERCENTAGE-1987

	NUMBER OF BANKS WITH NEGATIVE ALLOCATED INCOME	TOTAL NEGATIVE ENTIRE NET INCOME ($ THOUSANDS)	TOTAL NEGATIVE ALLOCATED ENTIRE NET INCOME ($ THOUSANDS)	NUMBER OF BANKS WITH POSITIVE ALLOCATED INCOME	TOTAL POSITIVE ENTIRE NET INCOME ($ THOUSANDS)	TOTAL POSITIVE ALLOCATED ENTIRE NET INCOME ($ THOUSANDS)	AVERAGE ENTIRE NET INCOME ALLOCATION PERCENTAGE
CLEARINGHOUSE	3	(203,129)	(149,064)	9	1,944,162	946,317	51.0%
FOREIGN	219	(968,167)	(545,598)	98	1,008,790	545,130	55.2%
COMMERCIAL	79	(423,622)	(165,215)	231	2,825,111	558,525	22.3%
SAVINGS	6	(60,308)	(54,291)	93	1,258,104	1,056,403	84.2%
SAVINGS/LOAN	10	(46,673)	(15,804)	58	212,767	204,359	84.9%
ALL BANKS	317	(1,724,249)	(929,972)	489	7,248,934	3,310,734	47.3%

Source: New York State Department of Taxation & Finance, Office of Tax Policy Analysis

CHART 36

AVERAGE ENTIRE NET INCOME ALLOCATION PERCENTAGE
1987

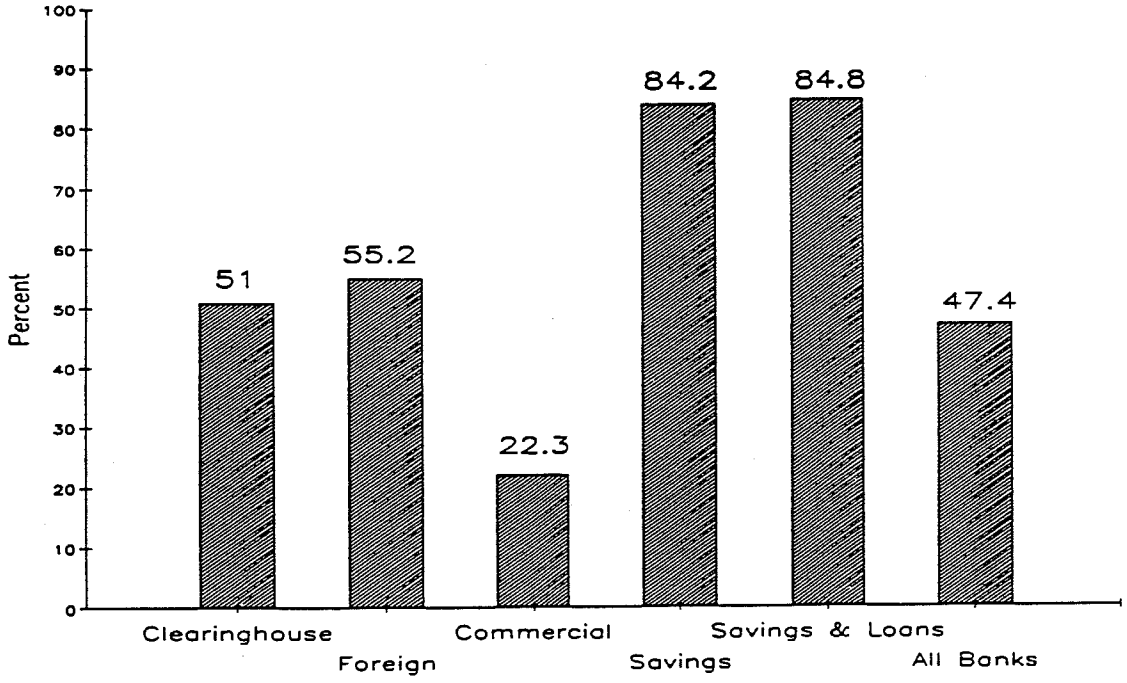


TABLE 8

BANKS WITH POSITIVE ALLOCATED ENTIRE NET INCOME AND PAYING ON ALTERNATIVE BASE 1983-1987

	NUMBER OF BANKS PAYING ALTERNATIVE BASED TAX	NUMBER OF BANKS PAYING ALTERNATIVE BASED TAX WITH POSITIVE ALLOCATED INCOME	PERCENT OF BANKS PAYING ALTERNATIVE BASED TAX WITH POSITIVE ALLOCATED INCOME	TOTAL ALTERNATIVE BASED TAX LIABILITY	TAX LIABILITY OF BANKS PAYING ALTERNATIVE BASED TAX WITH POSITIVE ALLOCATED INCOME	PERCENT OF TOTAL ALTERNATIVE BASED TAXES PAID BY BANKS WITH POSITIVE ALLOCATED INCOME
CLEARINGHOUSE						
1983	3	NOT DISCLOSABLE	NOT DISCLOSABLE	$3,493,431	NOT DISCLOSABLE	NOT DISCLOSABLE
1984	5	NOT DISCLOSABLE	NOT DISCLOSABLE	5,025,258	NOT DISCLOSABLE	NOT DISCLOSABLE
1985	6	3	50.0%	12,075,543	3,870,240	32.1%
1986	4	NOT DISCLOSABLE	NOT DISCLOSABLE	6,736,711 *	990,195	14.7%
1987	4	NOT DISCLOSABLE	NOT DISCLOSABLE	7,993,446	214,480	2.7%
FOREIGN						
1983	123	3	2.4%	$1,220,868	51,063	4.2%
1984	141	NOT DISCLOSABLE	NOT DISCLOSABLE	2,049,790 *	NOT DISCLOSABLE	NOT DISCLOSABLE
1985	161	17	10.6%	12,504,275	3,089,614	24.7%
1986	144	19	13.2%	9,703,376	1,771,190	18.3%
1987	169	23	13.6%	16,793,253	5,426,130	32.3%
COMMERCIAL						
1983	34	3	8.8%	$603,791	$8,367	1.4%
1984	35	6	17.1%	669,900	465,621	69.5%
1985	49	11	22.4%	2,704,565	636,648	23.5%
1986	54	8	14.8%	2,222,012	652,656	29.4%
1987	55	13	23.6%	3,312,112	1,032,574	31.2%
SAVINGS						
1983	59	22	37.3%	$17,698,229	$5,447,364	30.8%
1984	53	18	34.0%	16,999,770	4,702,931	27.7%
1985	5	3	60.0%	335,831	242,683	72.3%
1986	15	0	0.0%	96,038 *	0	0.0%
1987	12	NOT DISCLOSABLE	NOT DISCLOSABLE	417,060 *	111,429	26.7%
SAVINGS AND LOAN						
1983	40	15	37.5%	$1,822,592	$605,118	33.2%
1984	41	14	34.1%	2,211,576	409,249	18.5%
1985	6	3	50.0%	27,314	16,877	61.8%
1986	4	NOT DISCLOSABLE	NOT DISCLOSABLE	88,402	87,461	98.9%
1987	5	0	0.0%	14,667	0	0.0%
ALL BANKS						
1983	259	43	16.6%	$24,838,911	$6,111,912	24.6%
1984	275	38	13.8%	26,956,294 *	5,577,801	20.7%
1985	227	37	16.3%	27,647,528	7,856,062	28.4%
1986	221	27	12.2%	18,846,539 *	3,501,502	18.6%
1987	245	36	14.7%	28,530,538 *	6,784,613	23.8%

* In order to maintain confidentiality, minimum tax filers have been aggregated with alternative based taxpayers for the 1984, 1986 and 1987 tax years.

Source: New York State Department of Taxation & Finance, Office of Tax Policy Analysis

TABLE 9

BANKS MAKING MODIFICATIONS TO INCOME FOR INTERNATIONAL BANKING FACILITY ACTIVITIES(1)

	NUMBER OF BANKS USING IBF INCOME MODIFICATION	NUMBER OF BANKS USING IBF SUBTRACTION	AMOUNT OF IBF SUBTRACTION ($ THOUSANDS)	NUMBER OF BANKS ADDING IBF LOSSES TO INCOME	AMOUNT OF IBF LOSSES ADDED TO INCOME ($ THOUSANDS)	TOTAL AMOUNT OF REDUCTIONS IN ENI FROM IBF MODIFICATIONS ($ THOUSANDS)
CLEARINGHOUSE						
1982	10	10	885,664	0	0	885,664
1983	11	11	1,077,990	0	0	1,077,990
1984	9	9	1,277,031	0	0	1,277,031
1985	12	11	1,358,858	0	0	1,358,858
1986	10	10	1,033,016	0	0	1,033,016
1987	10	NOT DISCLOSABLE	504,315	NOT DISCLOSABLE	(88,518)	592,893
FOREIGN						
1982	100	76	314,601	24	(56,905)	371,506
1983	121	96	387,824	25	(25,028)	412,852
1984	138	96	584,516	42	(50,856)	635,372
1985	94	73	506,161	21	(78,831)	584,992
1986	97	72	422,716	25	(39,642)	462,358
1987	74	46	288,206	28	(53,930)	342,136
COMMERCIAL						
1982	15	12	50,117	3	(860)	50,977
1983	19	NOT DISCLOSABLE	57,906	NOT DISCLOSABLE	(209)	58,115
1984	18	NOT DISCLOSABLE	68,338	NOT DISCLOSABLE	(194)	68,532
1985	14	NOT DISCLOSABLE	54,856	NOT DISCLOSABLE	(5,607)	60,463
1986	20	16	67,010	4	(2,175)	69,185
1987	12	5	8,927	7	(21,059)	29,986
SAVINGS						
1982	0	0	0	0	0	0
1983	0	0	0	0	0	0
1984	0	0	0	0	0	0
1985	0	0	0	0	0	0
1986	0	0	0	0	0	0
1987	0	0	0	0	0	0
SAVINGS/LOAN						
1982	0	0	0	0	0	0
1983	0	0	0	0	0	0
1984	0	0	0	0	0	0
1985	0	0	0	0	0	0
1986	0	0	0	0	0	0
1987	0	0	0	0	0	0
ALL BANKS						
1982	125	98	1,250,382	27	(57,765)	1,308,147
1983	151	NOT DISCLOSABLE	1,523,720	NOT DISCLOSABLE	(25,237)	1,548,957
1984	165	NOT DISCLOSABLE	1,929,885	NOT DISCLOSABLE	(51,050)	1,980,935
1985	120	NOT DISCLOSABLE	1,919,875	NOT DISCLOSABLE	(84,438)	2,004,313
1986	128	99	1,522,742	29	(41,817)	1,564,559
1987	96	NOT DISCLOSABLE	801,448	NOT DISCLOSABLE	(163,507)	964,955

(1) In addition, in the 1985, 1986 and 1987 tax years, 67, 93 and 111 banks respectively elected to use the IBF formula allocation method.

Source: New York State Department of Taxation & Finance, Office of Tax Policy Analysis

TABLE 10

CLAIMS FOR "SPECIAL DEDUCTIONS" BY TYPE OF BANK
1985 - 1987

	DEDUCTION FOR 60% OF DIVIDEND INCOME		DEDUCTION FOR 17% OF SUBSIDIARY INTEREST		DEDUCTION FOR 22.5% OF INTEREST ON GOV'T. OBLIGATIONS	
	NUMBER OF BANKS CLAIMING DEDUCTION	AMOUNT OF DEDUCTION ($ THOUSANDS)	NUMBER OF BANKS CLAIMING DEDUCTION	AMOUNT OF DEDUCTION ($ THOUSANDS)	NUMBER OF BANKS CLAIMING DEDUCTION	AMOUNT OF DEDUCTION ($ THOUSANDS)
CLEARINGHOUSE						
1985	6	135,881	8	195,803	12	329,302
1986	7	664,439	7	253,549	11	272,967
1987	8	349,245	8	389,874	12	269,375
FOREIGN						
1985	3	6,459	0	0	56	75,883
1986	NOT DISCLOSABLE	570	0	0	66	92,971
1987	NOT DISCLOSABLE	112	0	0	91	101,789
COMMERCIAL						
1985	15	58,657	12	20,477	154	403,957
1986	16	472,000	11	563,106	178	407,791
1987	15	195,150	8	73,730	163	363,824
THRIFTS						
1985	6	2,528	11	5,559	124	114,066
1986	9	19,517	10	5,079	140	118,041
1987	8	40,226	9	982	136	122,032
ALL BANKS						
1985	30	203,525	31	221,839	346	923,208
1986	NOT DISCLOSABLE	1,156,526	28	821,734	395	891,770
1987	NOT DISCLOSABLE	584,733	25	464,586	402	857,020

Source: New York State Department of Taxation & Finance, Office of Tax Policy Analysis

CHART 37

AMOUNT OF DEDUCTION FOR 60% OF DIVIDEND INCOME AND GAINS/LOSSES FROM SUBSIDIARY CAPITAL 1985 - 1987

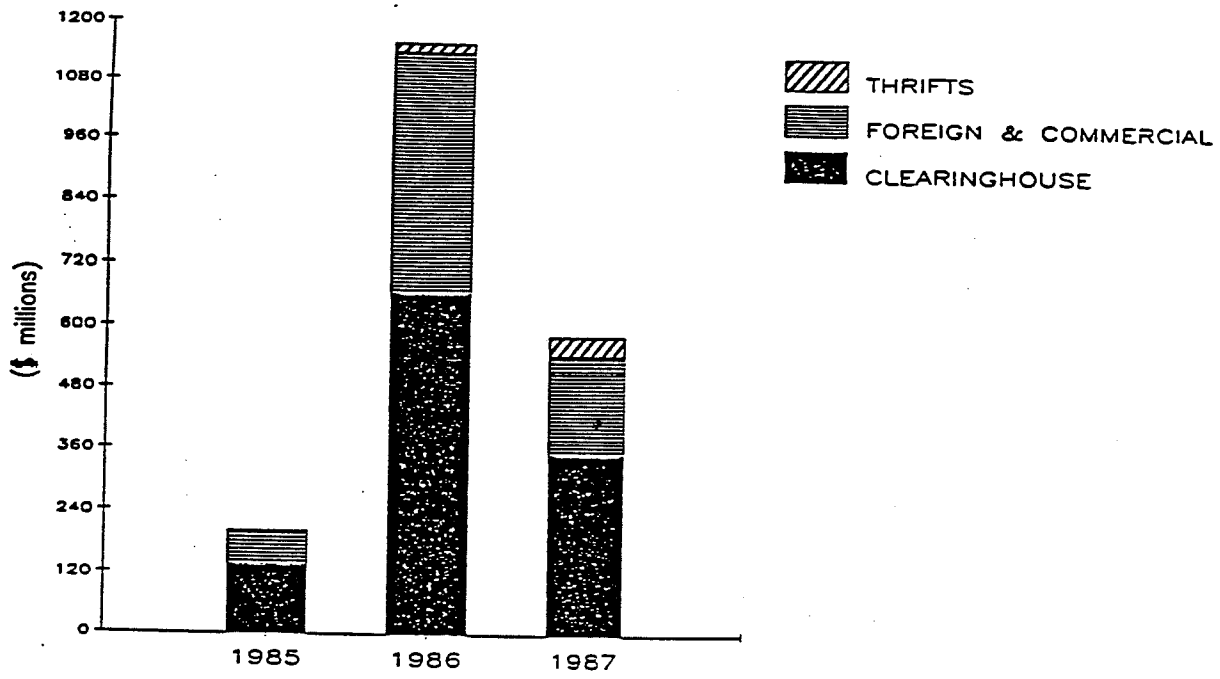


CHART 38

DISTRIBUTION OF 60% DEDUCTION BY TYPE OF BANK 1985 - 1987

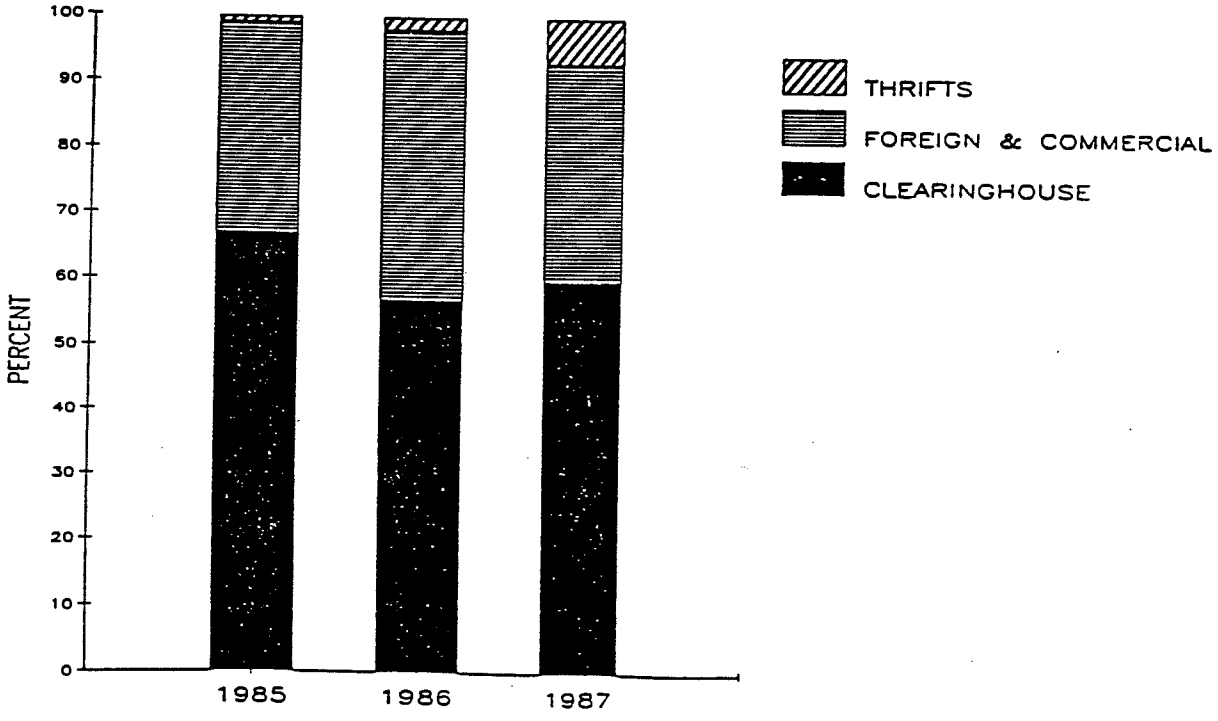


CHART 39

AMOUNT OF DEDUCTION FOR 17% OF INTEREST INCOME FROM SUBSIDIARY CAPITAL 1985 - 1987

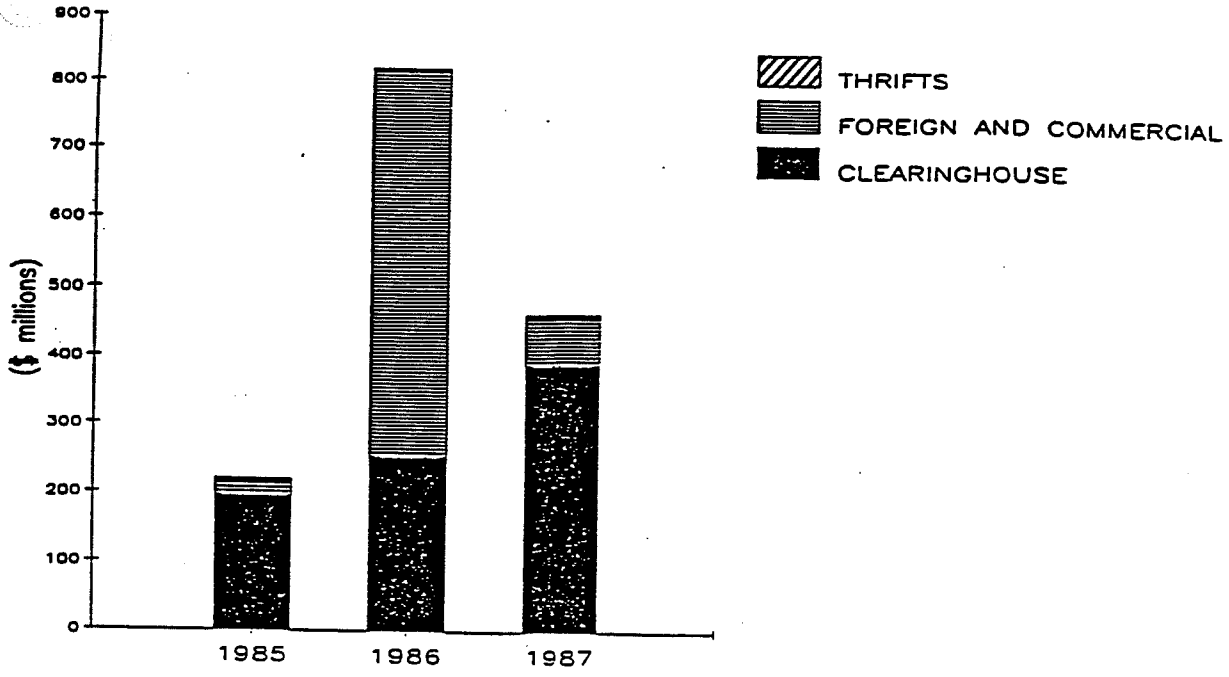


CHART 40

DISTRIBUTION OF 17% DEDUCTION BY TYPE OF BANK 1985 - 1987

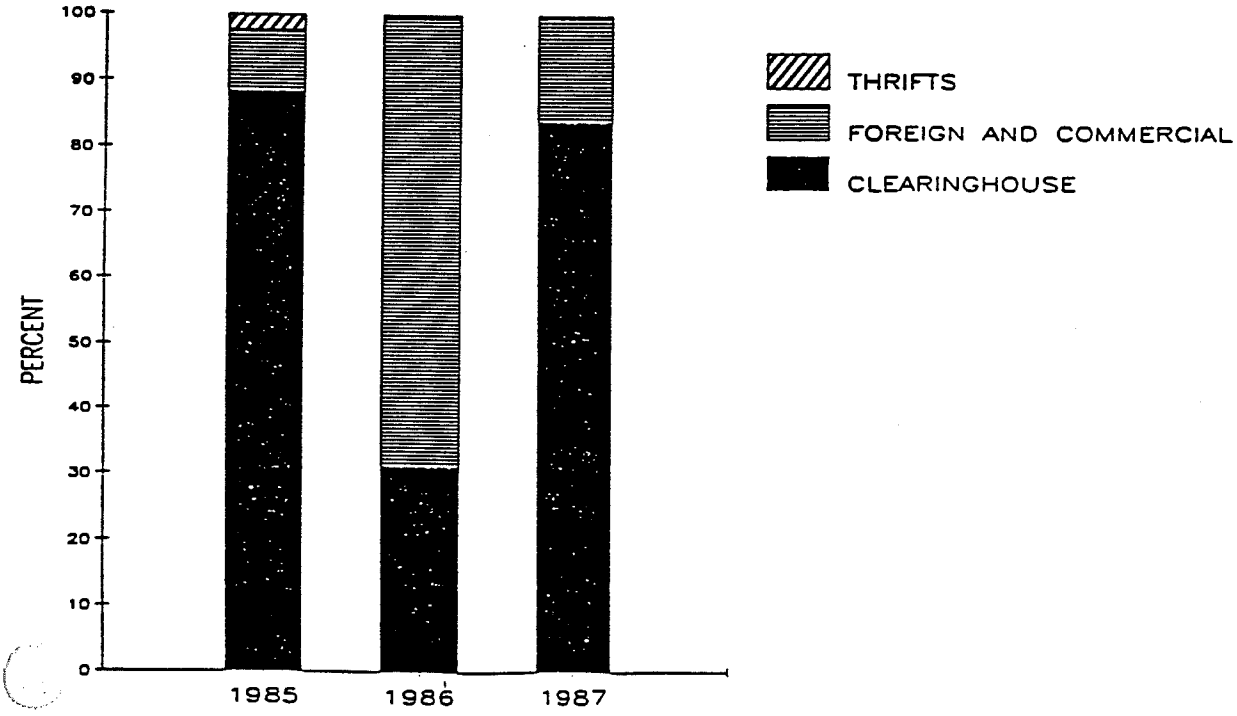


CHART 41

AMOUNT OF DEDUCTION FOR 22.5% OF INTEREST INCOME ON NEW YORK AND FEDERAL OBLIGATIONS 1985- 1987

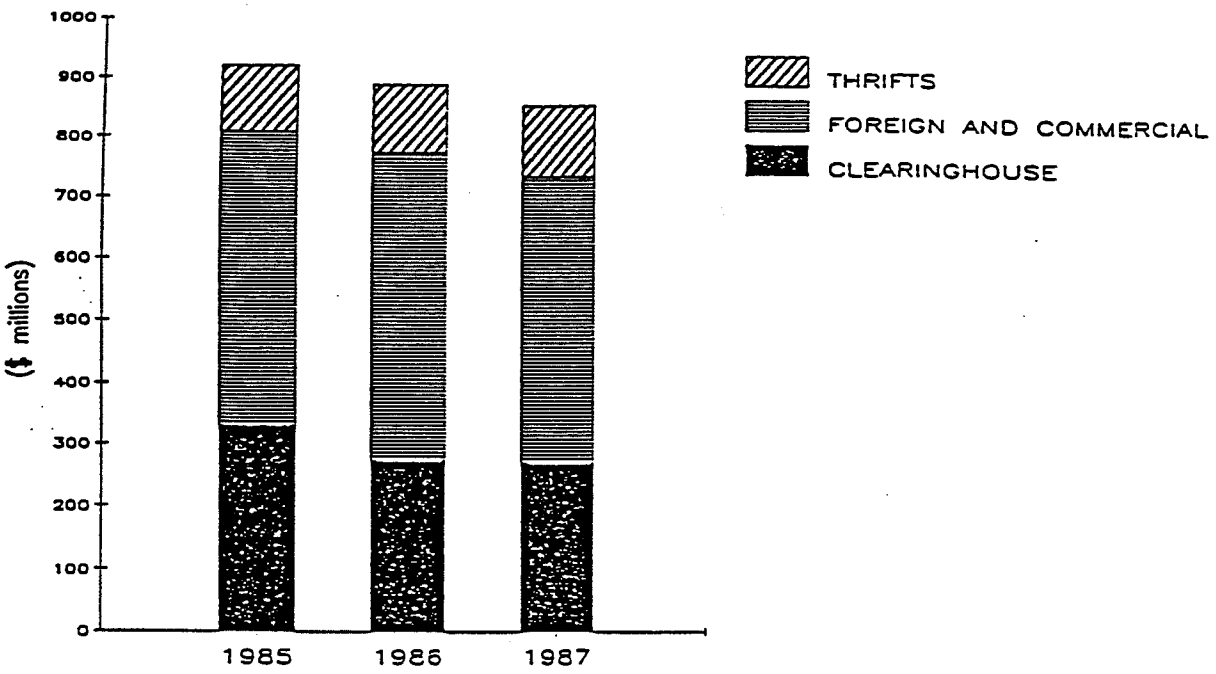


CHART 42

DISTRIBUTION OF 22.5% DEDUCTION BY TYPE OF BANK 1985 - 1987

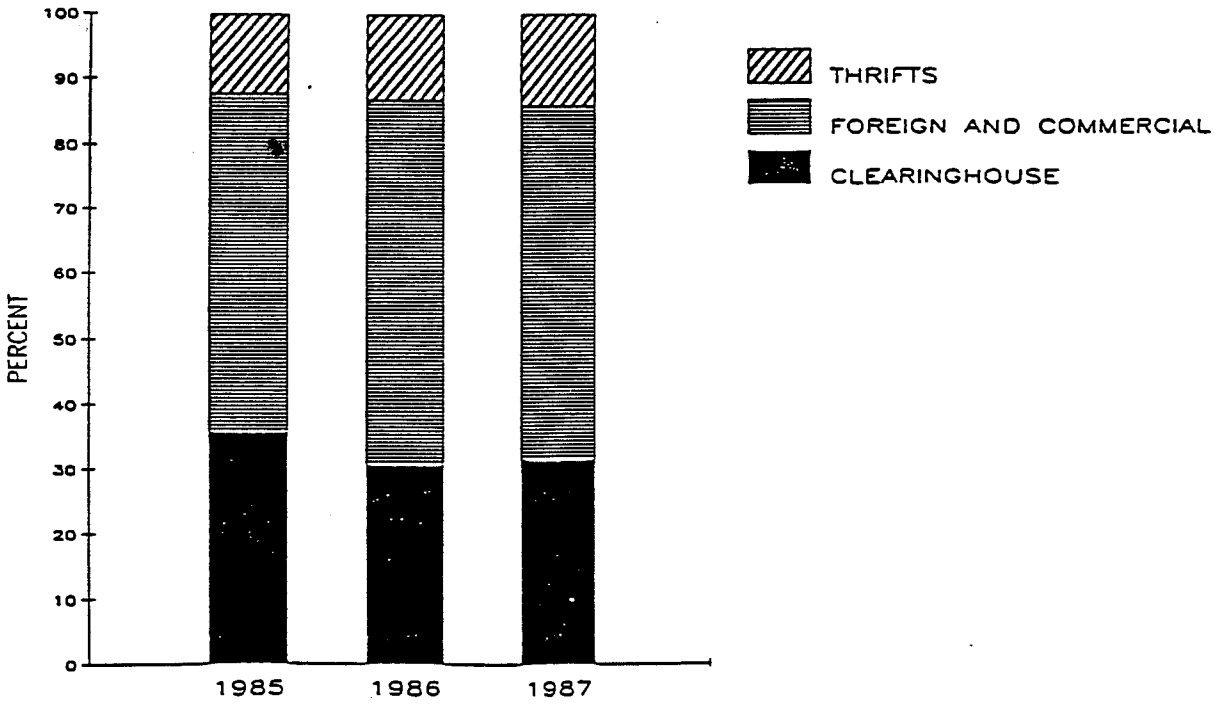


CHART 43

TOTAL AMOUNT OF "SPECIAL DEDUCTIONS"
1985 - 1987

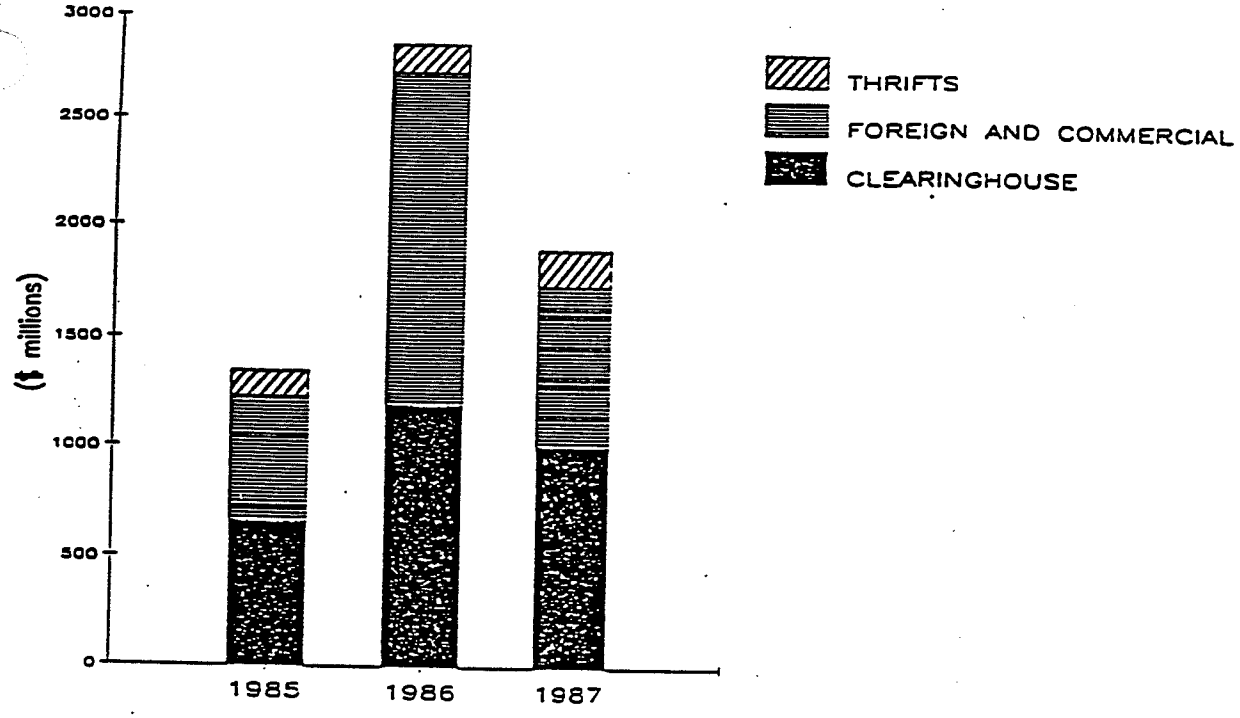
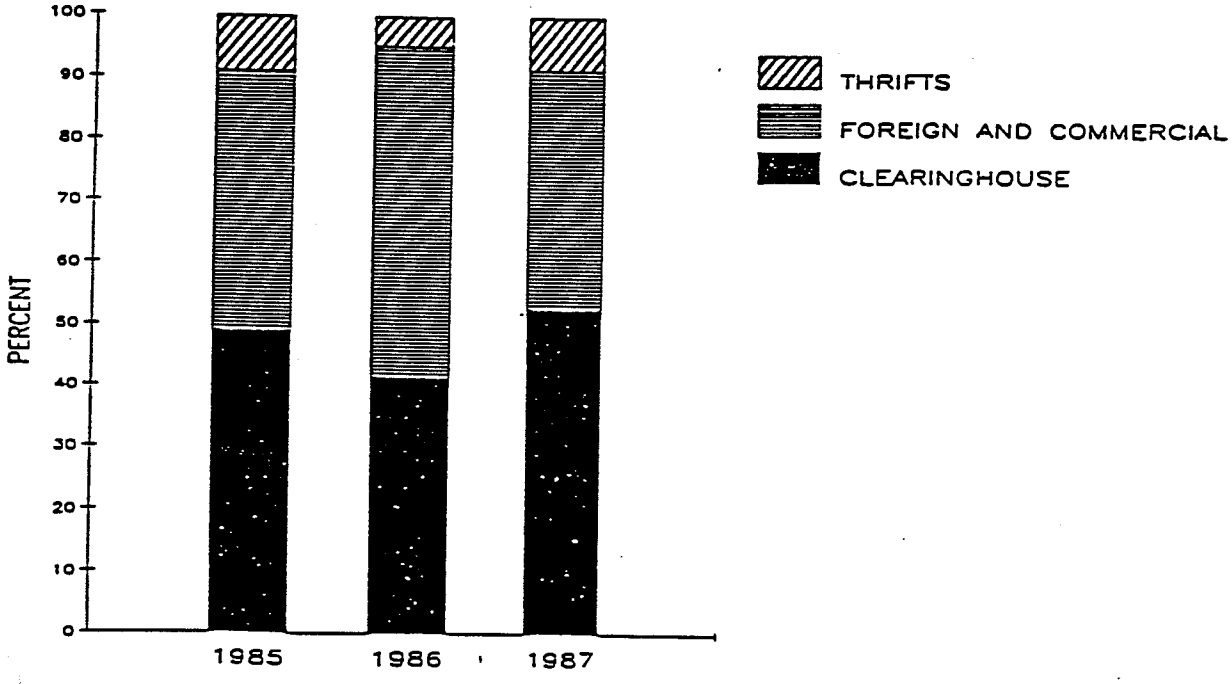


CHART 44

DISTRIBUTION OF CLAIMS FOR "SPECIAL DEDUCTIONS" BY TYPE OF BANK
1985 - 1987



Appendix A: Consolidated and Combined Filing

Generally, under the consolidated approach, each corporation calculated its own entire net income (or loss) and determined the portion of such income (or loss) allocable to business done in New York. In calculating entire net income (or loss), a corporation did not include any dividends it received from other members of the consolidated group. The allocated entire net income (or loss) of all the corporations in the group were added together to determine the consolidated allocated entire net income (or loss) of the group.

Generally, under the combined approach, each corporation is treated essentially as a division of a single corporation. The group computes a combined entire net income (or loss) and a combined income allocation percentage. In computing combined entire net income (or loss) and the combined income allocation percentage, all intercorporate transactions are eliminated. Combined entire net income (or loss) is multiplied by the combined income allocation percentage to arrive at allocated combined entire net income (or loss).

EXHIBIT K: 44

Papke, James A., "The Taxation of Indiana Savings and Loan Institutions: The Case for Competitive Equality" (Outline dated June 21, 1988)

THE TAXATION OF INDIANA SAVINGS AND LOAN INSTITUTIONS: THE CASE FOR COMPETITIVE EQUALITY

Outline of Remarks

by

Dr. James A. Papke
Professor of Economics and Public Finance
and
Director
Center for Tax Policy Studies
Purdue University

Ninety-Sixth Annual Convention of the
Indiana League of Savings Institutions, Inc.,
21 June 1988, Lexington, Kentucky

Supplemented Table 4

ANNUAL WEIGHTED ASSET GROWTH IN CONTIGUOUS STATES

1975-1986
(Dollar amounts in millions)

	Change in Assets	% of Change in Contiguous States	Annual Growth Rate	Annual % of Change x Rate
INDIANA	$ 6,364		6.46	
Illinois	39,962	39.14	9.00	3.52
Kentucky	3,796	3.72	7.01	.26
Michigan	25,064	24.55	12.27	3.01
Ohio	33,268	32.59	8.32	2.71
United States (trillions)	8,322		12.05	
Annual growth in contiguous states (weighted average)				9.50
Difference in annual growth rate:				
United States		12.05		
Contiguous States (weighted average)			9.50	
INDIANA		6.46	6.46	
DIFFERENCE		5.59	3.04	

Source: S&L: Savings and Loan Source Book and FDIC Bank Operating Statistics; Credit Unions: Credit Union National Association, Inc.,; Insured Commercial Banks: FDIC

PREPARED BY: Indiana League from and attached to Papke Study.

I. Rapidly shifting economic and market forces, combined with changes in federal and state laws and regulations have made obsolete the Indiana differential tax treatment among different types of financial institutions and between financial institutions and nonfinancial institutions. Existing statutory tax burden differentials are unfair to the thrift industry and costly for consumers of its services. Failure to harmonize tax rules to accommodate changing economic circumstances will only increase the costs already imposed on Indiana and its economy by the present labyrinth of outdated tax provisions. The increasing disparity between the imperatives of economic forces and the current tax environment explains the origin and the need for the League-sponsored study of the comparative taxation of Indiana savings and loan institutions.

II. The Indiana financial services industry employs more than 107,000 people, including some 43,000 in thrift and other depository institutions. In recent years, the lines between the various types of financial institutions have blurred to the point where what was once a series of discrete industry segments (commercial banks, savings and loan associations, credit unions, insurance companies, security brokers, and the like) is now emerging on one financial services industry. The industry plays an important role in the channeling of savings from individuals, corporations, and public and non-profit organizations into capital formation and productive investments. Employment and income in this sector of the

State's economy have been languishing, despite substantial national growth.

A. The annual employment growth rate of Indiana S&Ls, for example, was 3 percent over the last decade in contrast to an 8.4 percent growth rate for the U.S. as a whole (see attached Table 1). Further, Indiana S&L assets grew at 6.5 percent annual rate compared to 12.1 percent nationally (Table 2).

B. This growth disparity reflects a variety of forces, but an increasingly significant factor which should command the State's attention is the rising competition from other states, particularly neighboring states, seeking to attract the employment and capital potential of this high-growth industry.

1. Over the last decade, average annual employment in S&Ls among the states contiguous to Indiana grew at a combined 5.83 percent rate compared to Indiana's 3.0 percent. The growth rate for Michigan (7.04 percent) was twice as great as that for Indiana (Table 3).

2. The Indiana growth rate in assets for the same period also lagged behind all neighboring states (Table 4).

III. Much of the current structure of the Indiana tax law as it relates to depository institutions was formulated in the 1930s, when traditional public policy limited each type of institution to specific areas, products, and services; but, these boundaries have disappeared and have given way to greater regionalization and nationalization and, in some cases, internationalization of

product markets. Financial institutions are engaged in ever more broadly-based competition for consumer assets, with major combinations of different types of financial and nonfinancial enterprises. The emergence of "financial supermarkets," offering a full line of financial products (banking, brokerage, insurance, real estate, mutual fund, and investment banking services) is now a reality.

A. These changes are driven by economic and market forces, including consumer preferences, competition, technological progress in communications and computer applications, and the regulatory environment.

B. It should be policy of the State of Indiana to foster its compelling economic interest in the financial services industry. The industry should be allowed to evolve at the pace and in the direction dictated by the demands of the competitive marketplace, unimpeded by obsolete tax rules. It is inequitable and inefficient for the State to impose dissemilar tax treatment on similarly situated institutions and thereby inhibit the ability of one segment of the industry to compete on a "level playing field" with other segments of the same industry. The first principle of sound taxation should be the equal treatment of equals; that is, competing financial institutions should be taxed in essentially the same manner, and financial institutions should, in general, be taxed no more heavily, or more lightly, than non-financial institutions.

IV. There are four compelling arguments for a re-examination and restructuring of Indiana's system of S&L taxation. First, it results in tax differentiation among financial institutions and between financial and non-financial enterprises that is logically insupportable. Differences in form rather than substance are permitted to determine tax liabilities. Second, it bears little or no relation to the profitability of the thrift industry, and, in fact, imposes direct penalties upon the expansion and progress of the industry. Third, Indiana S&Ls are subject to much higher taxation than their counterparts in the immediately neighboring states and in the U.S. as a whole. Unfavorable tax comparisons present impediments to economic expansion and opportunities for tax avoidance. Finally, the present State tax structure is unnecessarily complicated and relatively costly to administer. Amble evidence and documentation create a persuasive case for significant revision in the tax treatment of Indiana S&Ls in the interest of serving the public interest.

A. According to the report (Indiana's Current Taxing Policy of Its Financial Institutions) prepared for the Commission on State Tax and Financing Policy in October 1987, the effective gross income tax rate (tax liability expressed as a percentage of income) of S&Ls was consistently more than three and four times that of state-chartered banks and as much as eighty times greater than that of state credit unions for comparable years. And, this is in "good" years. In "bad" years (e.g. 1981 and 1982), Indiana S&Ls paid substantial gross income

taxes in the face of large operating losses. Moreover, the effective tax rate imposed on S&Ls exceeds, in every year, the rate imposed on Indiana non-financial enterprises by the combination Adjusted Gross Income and Supplemental Net Income Taxes. In short, the Indiana S&Ls are more heavily taxed by the State than all other industries operating in the State. Stated alternatively, the State of Indiana is selling the same "package" of public services to the business sector, but is consistently charging S&Ls substantially more; the State appears to be pursuing a policy of price discrimination without product differentiation.

B. The evidence of substantial overtaxation of S&Ls provided by the State agency is supported by the 1987 tax survey of League members. With data from reporting Indiana S&Ls, which account for over 90 percent of all S&L assets, the average effective gross income tax rate for the 1980-1986 period was 33 percent. For three of these years (1981-84), reporting S&Ls recorded net losses and still paid $34.8 million in State gross income taxes. The tax amounted to $3,418 per employee, or $239 thousand per year for the average institution employing 70 people.

C. FSLIC data also disclose an average return on assets over the last eight years of less than one percent and a corresponding effective tax rate of 30 percent (Table 5).

D. Indiana occupies the undisputed first place (i.e., at the top of the tax burden scale) among the states in the imposition of State taxes on its S&Ls (see Table 6). For example, if the

State of Illinois tax system were applied to a representative Indiana S&L, its tax liabilities in 1986 would have amounted to only 26 percent of the Indiana tax payment. Stated alternatively, the typical Indiana S&L would have experienced a $141 thousand reduction in tax liabilities if the Illinois taxing provisions were applicable in Indiana.

1. Indiana's S&L tax structure generates the highest tax burdens when compared to the four competitive contiguous states of Illinois, Kentucky, Michigan, and Ohio.

2. In recent comparative tax burden studies conducted in Kentucky and Ohio, specific references were made to the disproportionate tax costs the State of Indiana places on its S&Ls. Outside of Indiana, the State has the "image" of a high thrift institution tax location and an adverse "climate" for domestic thrift institution growth and development.

3. The State must weigh carefully the counter-productive impact which substantial differential tax treatment can impose on an industry no longer regarded as "captive". The imposition of competitive tax inequalities on what might be mistakenly perceived to be "captive" thrift institutions will prompt capital for these institutions to migrate to tax-favored industries or to states with less onerous tax laws.

V. Why should the State rely on a bad tax structure when preferred alternatives are available? A preoccupation with questions of

"revenue replacement" alone, without reference to the broader economic and competitive implications of current tax policy, ignores the employment and tax revenue potential offered by a viable financial service's industry.

Table 1

EMPLOYMENT TRENDS: BANKING, INSURANCE AND SECURITIES INDUSTRY

1975-1986

	Change in Employment		Annual Growth Rate	
	IN	US	IN	US
Banking:				
Commercial Banks and Stock Savings Banks	7,437	447,908	2.36	3.12
Savings and Loan Associations	1,242	221,694	3.00	8.40
Insurance	5,128	189,302	1.71	1.47
Security Brokers and Dealers	1,261	172,543	8.37	7.60
Total/Finance, Insurance and Real Estate	19,390	1,892,026	1.82	3.39

Source: U.S. Bureau of the Census, County Business Patterns and Bureau of Labor Statistics, Employment and Wages: Annual Averages various years.

Table 2

ASSET TRENDS: DEPOSITORY INSTITUTIONS

1975-1986

	Change in Assets		Annual Growth Rate	
	IN (millions)	US (trillions)	IN	US
Banking:				
Insured Commercial Banks	$27,556.4	$1,635.6	7.83	9.56
Savings and Loans	$ 6,364.0	$ 832.2	6.46	12.05
Credit Unions	$ 3,268.8	$ 129.2	14.60	14.65

Source: S&L: Savings and Loan Source Book and FDIC Bank Operating Statistics; Credit Unions: Credit Union National Association, Inc.; Insured Commercial Banks: FDIC

1/ U.S. data are for 1975-1985

Table 3

EMPLOYMENT TRENDS: SAVINGS AND LOAN INSTITUTIONS
INDIANA, CONTIGUOUS STATES, AND THE U.S.

1975-1986

	Change in Employment	Annual Growth Rate
INDIANA	1,242	3.00
Illinois	9,880	5.37
Kentucky	1,241	5.62
Michigan	5,002	7.04
Ohio	8,560	5.32
United States	221,694	8.40

Source: U.S. Bureau of the Census, County Business Patterns and Bureau of Labor Statistics, Employment and Wages: Annual Averages various years.

Table 4

ASSET TRENDS: SAVINGS AND LOAN INSTITUTIONS
INDIANA, CONTIGUOUS STATES, AND THE U.S.

1975-1986
(Dollar amounts in millions)

	Change in Assets	Annual Growth Rate
INDIANA	$ 6,364	6.46
Illinois	39,962	9.00
Kentucky	3,796	7.01
Michigan	25,064	12.27
Ohio	33,268	8.32
United States (trillions)	$ 8,322	12.05

Source: S&L: Savings and Loan Source Book and FDIC Bank Operating Statistics; Credit Unions: Credit Union National Association, Inc.; Insured Commercial Banks: FDIC

Table 5

SUMMARY OF FINANCIAL RELATIONSHIPS OF INDIANA REPRESENTATIVE SAVINGS AND LOAN ASSOCIATION

1979-1986

Year	Income/ Revenue	Income/ Assets	Tax Payments (1000)	Effective Tax Rate (T/Y)
1986	10.7%	1.1%	$ 190.8	15.4%
1985	7.2	0.8	165.1	20.2
1984	2.4	0.2	134.8	54.5
1983	(1.6)	(0.2)	119.5	-
1982	(14.1)	(1.5)	112.9	-
1981	(10.3)	(1.0)	104.9	-
1980	3.2	0.3	92.6	45.2
1979	12.1	1.1	101.8	14.7

- Negative income (losses) recorded for 1981 ($800.4), 1982 ($1,226.0), and 1983 ($148.6).

Source: FSLIC, Combined Financial Statistics, selected years.

Table 6

INTERSTATE TAX BURDEN COMPARISON: STATE TAXES PAID BY REPRESENTATIVE INDIANA SAVINGS AND LOAN INSTITUTION TO INDIANA AND TAXES THAT WOULD HAVE BEEN PAID ON THE SAME BUSINESS UNDER THE TAX STATUTES OF THE FORTY-NINE OTHER STATES, 1986

State	Alternative Tax Liabilities (1)	Rank (2)	Relative Position (IN = 100) (3)	Liability Effect of Tax Substitution (4)
Alabama	$ 74,460	22	39.09	$ -116,367
Alaska	86,870	17	45.59	-103,957
Arizona	130,305	7	68.36	- 60,522
Arkansas	74,460	22	39.09	-116,367
California	143,956	5	75.55	- 46,871
Colorado	62,050	26	32.58	-128,777
Connecticut	142,715	6	74.87	- 48,112
Delaware	107,967	9	56.66	- 82,860
Florida	68,255	23	35.83	-122,572
Georgia	103,400	10	54.25	- 87,427
Hawaii	145,197	4	76.18	- 45,630
Idaho	95,557	15	50.16	- 95,270
Illinois*	49,640	32	26.02	-141,187
INDIANA	190,827	1	100.00	---
Iowa	62,050	27	32.52	-128,777
Kansas	28,485	34	14.95	-162,342
Kentucky*	102,822	11	53.93	- 88,005
Louisiana	-0-	36	-	-190,827
Maine	66,483	24	34.89	-124,344
Maryland	52,168	30	27.39	-138,659
Massachusetts	155,621	2	81.64	- 35,206
Michigan*	50,455	31	26.44	-140,372
Minnesota	147,424	3	77.33	- 43,407
Mississippi	76,400	21	39.19	-114,427
Missouri	86,870	17	45.59	-103,957
Montana	83,767	18	43,97	-107,060
Nebraska	82,768	20	43.44	-108,059
Nevada	-0-	36	-	-190,827
New Hampshire	101,705	12	53.30	- 89,122
New Jersey	37,230	33	19.53	-153,597
New Mexico	59,568	28	31.27	-131,259
New York	11,690	8	58.60	- 79,137
North Carolina	83,160	19	43.63	-107,667
North Dakota	86,870	17	45.59	-103,957

Table 6 (Cont'd)

State	Alternative Tax Liabilities (1)	Rank (2)	Relative Position (IN = 100) (3)	Liability Effect of Tax Substitution (4)
Ohio*	$ 86,865	17	45.59	$ -103,962
Oklahoma	62,050	26	32.58	-128,777
Oregon	93,075	16	48.85	- 97,752
Pennsylvania	142,715	6	74.87	- 48,112
Rhode Island	99,280	13	52.10	- 91,547
South Carolina	99,280	13	52.10	- 91,547
South Dakota	74,460	22	39.09	-116,367
Tennessee	74,460	22	39.09	-116,367
Texas	-0-	36	-	-190,827
Utah	62,050	26	32.58	-128,777
Vermont	23,287	35	12.22	-167,540
Virginia	74,460	22	39.09	-116,367
Washington	62,385	25	32.74	-128,442
West Virginia	55,003	29	28.86	-135,824
Wisconsin	98,039	14	51.42	- 92,788
Wyoming	-0-	36	-	-190,827

Source: Computed from data provided in Combined Financial Statements, 1986, FSLIC - Insured Institutions, Balance Sheet and Income and Expense Statement, Federal Home Loan Bank Board; Source Book Statistics of Income, Corporation Income Tax Returns, U. S. Department of the Treasury, Internal Revenue Service, Washington, D. C.; State Tax Guide, 1987, Commerce Clearing House, Inc.; and Research Department, U. S. League of Savings Institutions.

Notes: Because of identical tax liability computations and rankings, the lowest tax states (Louisiana, Nevada, Texas, and Wyoming) are all ranked thirty-six.

* Denotes states contiguous to Indiana.

EXHIBIT K: 45

Ressino, Anthony G. and Hannah, Mark R., "Should Indiana Change How It Taxes Financial Institutions?", Hoosier Banker, (November 1988)

Joe LOFTUS

Should Indiana change how it taxes financial institutions?

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Taxation of Indiana financial institutions has generally gone unchanged since 1933. Yet the financial-services industry has undergone significant changes in recent years — changes caused by deregulation and increased interstate activity. These changes, combined with several years of intense lobbying efforts by the thrift industry to change the tax structure, has some members of the State Commission on Tax and Financing Policy studying whether to recommend to the 1988 Indiana General Assembly changes in how financial institutions are taxed.

These commission members want to establish a more simplified and equitable tax structure that applies to all segments of the financial-services industry. To achieve this structure, we may see a franchise tax that uses federal net taxable income as a base; eliminates the current gross-income tax, supplemental net-income tax, and bank and S&L tax (intangibles taxes); and subjects banks to the personal-property tax.

However, any new financial-institutions tax will be successful only if the new legislation adequately addresses the following issues:

- *Revenue distribution:* State and local governments will have to be convinced that their revenues will not change significantly.
- *Sharing of the tax burden:* Industry groups will have to be convinced that the legislation provides for equitable taxation.

Following is a review of the current financial-institutions tax structure, a look at why a new tax strategy is being proposed, and some of the effects of such proposed changes. The information was derived for an Indiana Bankers Association study conducted by the financial institutions department of Geo. S. Olive & Co., Indianapolis.

Financial-institution taxation in the United States

Primarily three types of taxes are levied on banks at the state level across the country. A general understanding of these taxes and of the system currently used by the state of Indiana can offer a clearer picture as to why some are proposing a change in Indiana's tax structure.

Gross-income tax. A gross-income tax provides a relatively steady income stream to the state's general fund which can help a state in its fiscal planning. The basic argument against the gross tax is that it does not reflect an institution's current operating condition. A bank operating with a return on assets of 1 percent would incur approximately the same tax liability as if the bank's net income were zero. Indiana is one of the few states that still use gross-income tax.

Net-income tax or a franchise tax based on net income. A net-income tax addresses the basic argument against a gross-income tax. As an institution's operating results fluctuate, so does its tax liability. The state would have a relatively steady income stream that reflects overall business conditions.

The major problem facing a state government utilizing a net-income tax for banks is that the U.S. Constitution requires that interest income from obligations of the U.S. government not be taxable by states. This deduction alone would allow banks to pay little, if any, net-income tax. Michigan has offset this effect by adding back an amount which is meant to approximate the expenses associated with generating interest income from government obligations. A franchise tax measured by net income imposed by a state for the privilege of doing business within the state can include the income from federal obligations. A net-income tax or a franchise tax based on net income for banks is used by more than 40 states and appears to be a fair tax if appropriate adjustments are made to net income.

Excise (intangibles) tax. An excise (intangibles) tax on deposits and/or capital is similar to a gross tax in that it provides a relatively steady income stream to the state. This tax also has drawbacks similar to the gross tax, since fluctuations in net income do not correspond directly with the excise-tax base.

Application to Indiana. Currently, Indiana uses all three primary types of taxes that are levied on banks at the state level. The reporting tends to be cumbersome in Indiana compared to other states because all three are used, and the excise (intangibles) and gross tax interplay with one another. (National banks pay excise (intangibles) tax first and offset these payments against gross-tax liability, while the opposite is true for state banks). Also, since excise- (intangibles) tax payments go to the bank's respective county, and gross-tax payments go to the general fund, inequities in the distribution of tax revenue exist among counties, depending on the mix of state and national banks.

The excise- (intangibles) tax rate in Indiana (0.25 percent) is substantially higher than the average rate of other states. Therefore, even if the gross-income tax were eliminated, the tax burden of a bank would most likely not change. The supplemental net-income tax rarely affects banks, as Indiana allows a deduction from state taxable income of interest from U.S. government obligations without any type of adjustment for related expenses.

Taxation of financial institutions in Indiana

Five major taxes currently apply to Indiana banks, savings and loan associations, and credit unions. All three types of institutions are exempt from the adjusted gross-income tax. In addition to the five major taxes, financial institutions are subject to the state unemployment insurance tax and to the sales and use tax.

Corporate gross-income tax (GIT). The corporate gross-income tax applies to all financial institutions except federal credit unions. The current rate is 1.20 percent. The tax is applied to gross receipts such as interest, dividends, commissions, etc., and is received through most types of business transactions executed within the state, with revenues going to the state's general fund. The main receipts which are exempt from this tax are out-of-state business receipts and interest earned on obligations of the U.S. government and of the state of Indiana.

State banks make quarterly gross-tax deposits and are allowed to credit their gross-tax payments against their monthly bank (intangibles) tax liability. If the gross credits exceed the bank (intangibles) tax liability in a given year, then excess credits can be carried back or forward up to 36 months.

Normally, state banks use all of their gross-tax credits in a given year and pay

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Indiana taxes

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some additional bank (intangibles) tax to their respective counties. National banks offset their monthly bank (intangibles) taxes paid against their gross-tax liability, which usually eliminates any gross-tax liability. Savings and loans are allowed to use gross- and property-tax credits against their savings and loan association tax; however, excess credits are lost quarterly.

In an economic downturn, the gross-receipts tax could actually cause or increase an operating loss. The corporate gross tax cannot be legally apportioned, so the state currently receives little income from multistate or multinational financial transactions. The gross receipts tax was scheduled to decline 0.05 percent per year until expiring after December 31, 2009. Recently, however, a moratorium has been put on the tax, freezing the rate at 1.20 percent.

Supplemental net income tax (SNIT). The supplemental net income tax applies to banks and savings and loan associations with a current rate of 4.50 percent, with revenues going to the state general fund.

The tax is applied to net federal taxable income with the following modifications:

1) Add all state income taxes, all real estate and personal property taxes, and charitable contributions;

2) Subtract Indiana net operating loss, interest earned on obligations of the U.S. government, and the greater of gross or adjusted gross income tax liability.

Banks usually do not pay any SNIT due to the deduction of interest earned on obligations of the U.S. government.

Bank (intangibles) tax. The bank tax is an excise (intangibles) tax which applies to private or savings banks, state or nationally chartered banks, and trust companies.

The tax rate is a flat 0.25 percent, with revenues going to respective counties. The tax base is the value of the capital accounts and the deposit accounts, less the assessed value of all real estate owned, public deposits, deposits of charitable organizations, deposits of qualified pension and retirement plans, non-resident deposits, float, obligations of the U.S. government that are exempt from taxation, and exempt Indiana state and municipal obligations.

Banks pay taxes on real property but not on personal property.

Savings and loan association tax (S&L tax). This is an excise (intangibles) tax which applies to any savings and loan association. The tax rate is a flat 0.14 percent, with revenues going to respective counties. The tax base is the value of the capital accounts and the deposit accounts, less the assessed value of all real estate owned, public deposits, deposits of charitable organizations, non-resident deposits, float, obligations of U.S. government that are exempt from taxation, and exempt Indiana state and municipal obligations.

Local property tax. Banks pay taxes on real property but not on personal property. The assessed value is used as a deduction against the bank (intangibles) tax base. Savings and loan associations and credit unions pay real estate- and personal-property taxes. Savings and loan associations are allowed to take personal-property taxes as a credit against their S&L tax. They also take the assessed value as a deduction against the S&L tax. Each financial institution is subject to the property-tax rate determined for its particular taxing district. Property-tax revenues are distributed to all local units of government.

Neighboring state tax laws

The IBA study included an analysis of the tax structures of four states surrounding Indiana. To achieve comparative results, an average balance sheet and income statement were tabulated using statewide totals divided by the number of banks in Indiana. All significant items in the various state's tax codes were taken into account.

The study determined that a representative Indiana bank had average assets of $143,500,000 for 1987. The weighted-average percentage of gross and intangible taxes to assets for a sample of 43 Indiana banks was calculated to be 0.133 percent for 1987. This percentage, applied to the average assets of $143,500,000, resulted in an estimated gross and intangible tax liability of $191,000 for the representative Indiana bank.

Since no two banks are alike, an estimated 1987 tax liability under the different state tax structures was computed for each of the 43 Indiana banks to supplement the results obtained from using a theoretical bank.

Illinois: The two principal taxes which are imposed on banks in Illinois are the net replacement tax and the net income tax, with respective rates of 2.5 and 4 percent. All revenues from these taxes go towards the state's general fund.

The tax base for both of these taxes is primarily federal taxable income, plus state, municipal, and other interest income excluded in arriving at federal taxable income, less interest income on U.S. government obligations included in federal taxable income.

The tax under Illinois tax law for the representative Indiana bank would be approximately 15 percent of the tax under Indiana law. Each bank in the sample of 43 banks would pay less tax under Illinois law than under Indiana law.

Kentucky: The principal tax upon banks in Kentucky is the share tax, with a rate of 95 cents per $100 of taxable fair-cash value. Revenues from this tax go into the state's general fund.

The basis for the tax is the taxable fair-cash value of the shares, which is defined as the fair-cash value of the shares (approximates book net worth) reduced by the influence of tax-exempt U.S. government obligations.

Counties and cities also levy a share

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Indiana taxes

(continued from page 8)

tax (intangibles tax) of 0.01 percent of bank deposits.

The tax under Kentucky tax law for the representative Indiana bank would be approximately 50 percent of the tax that would be paid under Indiana law.

Ohio: Banks in Ohio are subject to the Franchise Tax with a rate of 1.5 percent on net worth. Revenues from this tax go primarily to respective counties.

The tax under Ohio tax law for the representative Indiana bank would be approximately 80 percent of the tax that would be paid under Indiana law. In the sample of 43 banks, 22 banks would pay less tax and 21 banks would pay more tax under Ohio law.

Michigan: The two principal taxes which are imposed on banks in Michigan are the single business tax and the intangibles tax, with respective rates of 2.35 and 0.02 percent. All revenues from these taxes go toward the state's general fund.

The tax base for the single business tax is primarily *federal* taxable income, plus salaries and employee benefits, depreciation, and out-of-state municipal income, less interest income from federal obligations reduced by expenses (total expenses net of salaries and employee benefits and depreciation) incurred in generating non-taxable state interest income.

The tax base for the intangibles tax is monies on hand or in transit and deposits in banks.

The tax under Michigan tax law for the representative Indiana bank would be approximately 50 percent of the tax that would be paid under Indiana law. Each bank in the sample of 43 banks would pay less tax under Michigan law than under Indiana law.

The authors

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Geo S. Olive & Co., Indianapolis, is an associate member of the Indiana Bankers Association.

Tax proposed by the Indiana League of Savings Institutions

The Indiana League of Savings Institutions has proposed an excise tax that, when considered in this study, showed various outcomes for the sample banks.

This proposed excise tax would replace the current gross income tax, adjusted gross income tax, supplemental net income tax, and bank and S&L tax (intangibles tax). The proposed rate would be 8.25 percent. Banks would become subject to personal-property taxes. Revenues from this tax would be split evenly between the state's general fund and respective counties.

The tax base for this proposed tax is primarily federal taxable income plus state and municipal interest income.

The tax under this proposed tax legislation for the representative Indiana bank would be approximately 76 percent of the tax that is paid under current Indiana law. In the sample of 43 banks, 33 banks would pay less tax, and 10 banks would pay more tax under the proposed financial institutions tax. No computation of the additional property tax that would have to be paid was made.

Impact on interstate activity

State taxation of the financial industry is one of the current issues facing state legislators nationwide. Legislators are examining numerous factors to deal with this complex issue. These factors include:

- General shifting of tax collection from federal to state levels,
- Relaxed governmental constraints relating to the due process and commerce clauses of the U.S. Constitution, and
- Increasing interstate activity and the changing market for financial services.

Indiana currently does not have a tax structure for financial institutions which directly addresses interstate activity. Prior to the recent surge of interstate activity, both through mergers and acquisitions and through the impact of increased marketing of financial services through electronic means, financial institutions traditionally did little business without state situs. Thus, Indiana did not have a pressing need to draft legislation dealing with interstate financial activities.

Now Indiana is faced with considering state taxation to address interstate activity. On the one hand, Indiana can tax all activity which it is entitled to tax. However, this taxation could have a negative impact on economic development in terms of businesses relocating or establishing here. The decision should only be made after a cost/benefit study is performed. Until Congress establishes uniform jurisdictional rules and apportionment standards, this complex area may not be adequately resolved.

The foregoing discussion has been presented as an aid to Indiana bankers and other interested parties to be used to assess any proposed change in financial-institutions taxation. It is easy to say that we are all interested in a simplified and equitable taxing scheme. However, simplification and equality may come at a higher cost to some institutions than to others.

The Indiana Bankers Association is currently monitoring the progress of the commission and the state as it addresses the issue of change, and would welcome thoughts and comments on the subject.

History of bank taxation: A summary

king system in the Indiana egan in 1814 with the char- two banks, Madison and s, by territorial legislation. came the first state banks of following Indiana's admis- the Union in 1816. The Constitution at that time lim- ie incorporation of banks to ite banks and their branches. ion of state banks at this time ted of a property tax on real es- nd a tax on bank stock.

1-1837

ne bank in Vincennes dissolved 1821, with the bank in Madison owing in 1824. After the disap- arance of the only state banks in diana, banking needs were provid- l by the Cincinnati and Louisville ranches of the Second Bank of the Jnited States.

This system proved sufficient for the next few years; however, by the early 1830s, it became evident that Indiana needed more banks to serv- ice its growing population. In 1834, the state's General Assembly char- tered the Second (New) State Bank. The new system provided for one central bank and for 10 branches lo- cated throughout the state. The state made only half of the bank stock available to the public. The special tax for these banks was computed at 12.5 cents per non-state-owned share and was used for Indiana schools. In 1837, the taxation of these banks was widened to include the regular state tax on shares, but the total payment could not exceed a rate of 1 percent per share.

1852

The Free Bank Law of 1852 opened banking ownership com- pletely to the public. This law result- ed in the formation of approximately 80 banks in less than two years. At this time, the Third State Bank was chartered, although the state was not a shareholder.

1864-1923

Congress passed the National Bank Act of 1864, which imposed comprehensive restrictions on state and local taxation of national banks. Congress allowed national banks to be taxed on their shares of stock and real estate, but taxes, if imposed, could not favor state banks over na- tional banks. However, in 1865, Con- gress enacted a 10-percent tax on the notes issued by state banks, which essentially ended the existence of state-chartered banks. The 1920s saw more Congressional changes. After 1923, states were allowed to tax ei- ther the shares or the net income of national banks. In 1926, another change allowed states the right to tax dividends on bank stock to individual shareholders, if a net income tax were also in place.

1933

The General Assembly enacted several changes to the way banks were taxed in Indiana. Since the state could not pass a law taxing na- tional banks directly on intangibles, the General Assembly passed a law which taxed the shareholder or de- positor. The law provided that each bank pay a flat rate of 0.25 percent on behalf of its depositors, with the option of assuming the tax or de- ducting it from the depositor's ac- counts. The law also ended the taxa- tion of bank shares to individuals at general property-tax rates. The new law also provided that banks not pay a general property tax except on its real estate. The gross-receipts tax was also added but affected only state banks, as federal law prohibited a gross receipts tax on national banks. The initial rate of the gross tax was 1 percent.

1963-present

The General Assembly added a 2- percent adjusted gross-income tax which affected brokerages, bank holding companies, and credit insti- tutions, with banks being exempt. In 1971, Indiana added the gross- receipts tax to include national banks, since Congress had removed all taxing restrictions on national banks in 1969 as long as national banks were taxed on a basis compa- rable to other banks. Nevertheless, Indiana continued to exempt banks from personal-property tax. Legisla- tion in 1973 raised the adjusted gross-income tax rate to 3 percent, and also added a supplemental net- income tax to all financial institu- tions except credit unions. Beginning in 1973, the gross-receipts tax was to be gradually decreased to zero by 2009. In 1983, the expiration date was extended to after December 31, 2009. In 1987, the 2009 expiration date was repealed and the rates were frozen at 1.2 percent for the high rate and at 0.3 percent for the low rate effective January 1, 1987.

In 1973, the Indiana Department of Revenue conducted what was considered to be its first extensive audits of bank tax returns since the enactment of the bank (intangibles) tax in 1933. Because the Bank (In- tangibles) Tax Act was considered sketchy in certain key areas and be- cause little official guidance in calcu- lating the bank (intangibles) tax liabil- ity had been provided, it was not sur- prising that numerous issues were raised by the department in its audits of the bank tax returns. Several posi- tions taken by the department were vigorously opposed by the banks. As a result of meetings between repre- sentatives of the Indiana Bankers Association and the department to address these issues, S.B. 229 was en- acted in 1975 that restructured the bank (intangibles) tax.

New legislation in 1978 called for the annual reduction in the sav- ings and loan excise tax. The rate was reduced to 0.20 percent in 1978, to 0.17 percent in 1979, and to its current rate of 0.14 percent in 1980.

This information has been condensed from the 1982 report on State Taxation of Financial Institutions prepared for the Commission on State Tax and Financing Policy by Beth I. Schiffli and Scott S. Floyd.

EXHIBIT K: 46

Ruempler, Henry and Ames, Joanne, "Multiple State Taxation: Will Your Bank Be Hit by Out-of-State Levies?", Vol. 9, No. 18, Banking Expansion Reporter, p. 1 (September 17, 1990)

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Multiple State Taxation: Will Your Bank Be Hit By Out-of-State Levies?

By Henry Ruempler and Joanne Ames

The proposed Multistate Tax Commission (MTC) regulations and similar formulations enacted in Minnesota (1987), Indiana (1989) and Tennessee (1990) embody what we refer to as the market state approach for taxation of income of financial institutions, including out-of-state banks. The introduction of the market state approach, whereby the bank would be subject to income tax in the state where the borrower uses the funds, raises serious issues of unfair and undesirable additional tax and tax-related burdens on the financial services industry. The industry was protected against this burden until the expiration of Public Law 93-100, which permitted only domiciliary states to tax banks based on income. Financial institutions should be entitled to the same consistent and commonly accepted "doing business" standard as retailers and manufacturers have under Public Law 86-272.

While the banking industry is now waking up to the risks presented by the market state tax approach, the states have only looked at these taxes as a potential revenue benefit. What has not been recognized is that market state taxation will not

Continued on page 11

Mr. Ruempler is Director, Tax and Accounting, at the American Bankers Association. Ms. Ames is Tax Regulation Counsel at the ABA.

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Multiple State Taxation

Continued from page 1

only impose an unfair tax on financial institutions, but it will have a detrimental economic effect on the states and their residents. The tax will affect bank lending into those states, denying consumers and business borrowers access to needed funds at a fair market rate of interest. Moreover, the market state scheme imposes enormous compliance costs on the banking industry and the state governments.

The principal objections which the banking industry should raise against market state taxation are that it:

- Fails to provide any mechanism to prevent multiple taxation of the income due to inconsistent rules regarding jurisdiction and apportionment.
- Constitutes a barrier to the interstate flow of funds which will hurt *borrowers* by raising the cost and reducing the availability of credit and hurt *lenders* by increasing portfolio risk and financial market instability.
- Imposes enormous compliance costs on the taxpayer and audit costs on the state which exceed, in virtually all cases, the amount of tax due to the state.

Nexus/Multiple Taxation

Since 1940, the U.S. Supreme Court has used the term "nexus" as a shorthand for a requirement that state taxes be based on a minimum level of contact to survive constitutional scrutiny under the Commerce Clause and the Due Process Clause. The minimum contacts question has a unique application to banking. Banks have long sought removal of state law prohibitions against branching or acquiring offices beyond their home state. Even today, after years of progress, only 11 states permit nonreciprocal nationwide banking (but not interstate branching), while the remaining 39 strictly limit the banks ability to enter their markets. Many larger banks have aggressively sought to expand into new states; in some cases, exercising the federal exception for acquiring failing institutions as the price for market entry. Thus, the "market exploitation" and "branchless banking" arguments which are used to justify low nexus standards for market state taxation are absurd on their face. How can a bank exploit a market when it cannot legally open an office in that state? Close customer contact gives local banks an enormous marketing advantage over out-of-state institutions which attempt to compete by mail. Branchless banking may be cheaper for some high volume banking services, but it is no substitute for dealing with customers face to face. Moreover, retailers and manufacturers advertise and solicit business across state lines without a physical presence or regular employee contact, *but that does not make them subject to state income tax.*

Banks should not be singled out for special or discriminatory tax treatment compared to general corporations.

Banks should not be singled out for special or discriminatory tax treatment compared to general corporations. General corporations are protected by Public Law 86-272 from taxability based on customer location even though they have employees in the state soliciting orders from local customers. Public Law 86-272 is a minimum nexus standard that Congress has imposed (pursuant to its Commerce Clause powers) for the imposition of state taxes on income from the sale of tangible personal property. The financial industry enjoys no such legislative protection. This lack of a defined system of multistate taxation, in contrast to that enjoyed by general corporations, greatly magnifies the variations in determining local income and the resultant tax overlap. Such state taxation is thus disproportionate and unfairly cripples the ability of financial institutions to provide services in interstate commerce.

Generally, commercial banks pay state taxes on all of their income under existing state tax systems. Home states either tax 100 percent of the income of local banks or provide that their income otherwise apportionable to states where the banks are not taxable is reassigned or "thrown back" to the home state. In this circumstance, it is evident that the conversion of state tax systems to the market state approach is totally unnecessary to prevent any portion of bank income from escaping state taxation. On the contrary, for the reasons described below, the market state approach promotes double taxation.

The market state approach raises the issue of double taxation because it does not address taxation in the domicile state. The fact that the same dollars can be used in the numerator (for apportionment purposes) and the factors of the numerator can be varied by each state consequently results in double taxation. Such overlapping of taxation is in conflict with the Commerce Clause-based doctrine of multiple taxation which was first enunciated in *Western Live Stock v. Bureau of Revenue,* 303 U.S. 250 (1938). The Supreme Court in *Japan Line Ltd. v. County of Los Angeles,* 441 U.S. 434, 446 (1979) stated: "It is a common-place of constitutional jurisprudence that multiple taxation may well be

offensive to the Commerce Clause." Since the Supreme Court has not consigned the multiple taxation doctrine to the scrap heap of Commerce Clause jurisprudence, market state taxation raises a serious constitutional question regarding double taxation.

Furthermore, the fact that each state is able to select a method of determining taxable income in a way that maximizes revenue consistent with its own regional attributes is further proof that multiple taxation is inevitable under the market state approach. Although the MTC regulations have a three factor equally weighted standard, Tennessee and Indiana already have adopted a 100 percent receipts factor and Minnesota uses a 70 percent receipts factor. As a result, retaliatory taxes and a breakdown in interstate tax information sharing may result as residence-based and market-based states come into conflict.

Economic Impact

Until recently, there has been no economic analysis of the market state taxation of out-of-state banks, and no consideration of the economic risks of this new form of taxation on consumer access to low-cost bank credit across state lines. Now, Professor William J. Hunter, Marquette University, Milwaukee, Wisconsin, has formulated an initial conclusion that the full cost of this tax to a state and its residents may far outweigh the benefits brought to the state through higher tax revenue. (See unpublished paper, *An Economic Analysis of the Market State Approach for the Taxation of Income Earned by Out-of-State Banks).* The economic consequences arising from state taxation which are likely to occur are:

- Reduction of credit availability for consumers in the market state.
- Reduction of credit for economic development in the market state.
- Higher interest costs for borrowers able to get credit.
- Curtailment of the flow of federal funds to commercial banks in the market states.
- Instability in financial markets in the market state.
- Longer local economic downturns resulting from more limited access to out-of-state lending.
- Excessive compliance costs on out-of-state lenders.
- Burdens on secondary market transactions.

The economic theory, according to Professor Hunter, is quite simple: the higher costs for out-of-state banks to provide credit will force these lending institutions to curtail, or in many cases completely eliminate lending to the market state. This means that the total credit available in-state is less than otherwise and the remaining credit will be more costly—if available *at all* for borrowers of low and moderate incomes.

While there is no empirical data to conclusively demonstrate the magnitude of these economic risks, both economic theory and experience with other restraints on the interstate flow of funds indicate that the risk could be, in Professor Hunter's words, "substantial." One useful analogy which Professor Hunter uses to illustrate the risk involves state usury laws. The literature on usury statues confirms that financial institutions consistently respond to state-imposed reductions in their rates of return. The conclusion is that banks will have to either raise the rates of interest to borrowers in the market states or curtail their lending significantly. The impact of this curtailment of credit will be felt most heavily on low and middle-income borrowers—those that already face difficulties obtaining credit on reasonable terms.

Another serious aspect of the imposition of market state taxation will be evident in its effect on the secondary market for loans such as mortgage-backed securities.

Another serious aspect of the imposition of market state taxation will be evident in its effect on the secondary market for loans such as mortgage-backed securities. This risk has been identified by Minnesota and Indiana when these states amended their statutes to exclude, from taxation, income earned by banks from the purchase of instruments in the secondary market which are secured by property in Minnesota or Indiana, respectively. Tennessee seems to be unclear about the application of its statute to such transactions. In a recent letter to the Tennessee Bankers Association, dated July 17, 1990, the Commissioner of Revenue indicated that these instruments "represent an asset in the nature of a loan as contemplated by the Act and, therefore, subject to tax notwithstanding their classification as a security for federal and state securities law purposes." Thus, a financial institution which holds a Federal National Mortgage Association-guaranteed mortgage-backed security collateralized by Tennessee mortgages may be subject to the Tennessee tax. Banks which are considering purchasing these securities will either select alternative investments or demand a premium to cover the cost of the

Tennessee tax. Those actions illustrate the costs to Tennessee borrowers if the state bases its tax on the holding of secondary instruments.

Professor Hunter identified another major consequence of the trade barrier for credit caused by market state taxation—financial market instability. Among the many risks faced by banks, there is the risk due to major economic factors outside the bank's control. For example, business failures tend to rise during periods of economic recessions. If a bank's portfolio is not diversified geographically, it faces greater risk of failure. The market state-based tax will likely force greater concentration of financial markets when out-of-state banks opt for lending to states without the tax. Local banks which lend in the taxing state will hold a loan portfolio which is more sensitive to local economic factors and the benefits of diversification will be lost.

The local economy may suffer another way from the adoption of market state taxation. When a region is attempting to recover from a recession in the economic cycle, it may need more funds than are readily available from local lenders. While the slack might normally be covered through a free-market flow of funds from healthy areas of the country, that process will be inhibited by out-of-state lenders' unwillingness to bear the cost of market state taxation.

Administrative Cost of Compliance

The market state tax approach will be very costly to implement for both the taxpayer and tax collector. The taxpayer will incur substantial additional direct costs in many areas of the bank—lending, systems, finance and administration. For the tax collector, these proposals will be difficult to administer and enforce. It will involve substantial effort and added costs to identify the universe of taxpayers, to predict total revenues for state budget consideration, and to audit those out-of-state taxpayers accurately and fairly.

The most obvious compliance burden on banks stems from the low nexus standard. Under the MTC proposal, for example, a bank would be subject to tax in the market state if it had 100 customers in the state or total assets and deposits in the state of $10 million. Commercial banks will find themselves subject to taxation in states where they have no regular contacts and are not permitted to open an office. Since 9,000 of the nation's banks are small businesses which do not have in-house tax counsel, these banks will be unaware of the state tax laws where they are not permitted to engage in banking, thereby facing possible penalties and interest for failure to file tax returns. Even in those cases where the bank is aware of its tax exposure, the cost of calculating income based on state rules, filing the tax returns and estimated payments, and tracking further changes in the law will be excessive.

Commercial banks will find themselves subject to taxation in states where they have no regular contacts and are not permitted to open an office.

The market state approach attributes income to the customer location, thereby compounding the compliance burden. The facts necessary to determine the institution's local taxable income (e.g., where the customer is "located"; where the services are "consumed") is often known only to the customer and may be virtually unattainable. Even when the facts can be obtained, they can change from year to year, and as such, it will be difficult to program this information on existing computer systems. This difficulty is compounded by variations in each state's customer location rules. The administrative cost of compliance is not only expensive and requires significant lead time (no other area of the organization requires data collected in this fashion), but is an ongoing compounding process. Since each state can have (and has) different rules, the administrative burden escalates as the interrelationships between states present more and more potential combinations. The threshold of contacts giving rise to the taxability is so low under the MTC's proposal (i.e., 100 credit card customers, regardless of income level earned from those accounts, or just one $10 million corporate loan) and the diversity/complexity of the new tax systems in Minnesota, Indiana and Tennessee demonstrate clearly that the compliance costs actually exceed the total tax due. ABA member banks of all sizes that have considered the impact of either Minnesota, Tennessee or Indiana legislation upon their institutions calculate that the administrative compliance costs exceed the tax due by 250 percent or more.

The complexity of the receipts-sourcing rules for each and every type of receipt is critical. A typical regional bank has approximately eight loan application systems that would require extensive programming under the proposed regulations and operational overhead. Many bank application systems are monthly systems rather than annual systems. Typically, institutions have hundreds of categories for interest and non-interest income on its general ledger. These numerous categories of interest and non-interest income are necessary for various regulatory, shareholder and management reporting

analyses but are not geared to a state sourcing concept. The numerous application systems coupled with the huge volume of categories of book income and monthly cycles of application systems create enormous compliance responsibilities for each transaction with the attendant programming costs for each system to assimilate and aggregate the tax data for all the accounts.

It will be more costly for the state to hire, train and ship off revenue agents to determine the perceived out-of-state bank tax liability than the actual amount of tax due.

Another complication in the market state taxation is shown by the fact that the property factor under the MTC proposal would include intangibles. The use of intangibles in a property factor has somewhat the same administrative burdens as attempting to source all receipts. Most multi-state taxpayers are familiar with the rules and sourcing for tangible property. Intangible sourcing would produce factors similar to a receipts factor under the MTC proposal. The impact is, in essence, a double weighted receipts factor, which ignores where the services are performed (an important aspect of *any* service business). In addition, the MTC proposed rule for the sourcing of intangibles appears inconsistent with existing statutory and judicial interpretations of situs for intangibles and could be in conflict with existing state laws for taxation of intangibles.

All of these taxpayer filing problems are mirrored by corresponding state taxing audit problems. It will be more costly for the state to hire, train and ship off revenue agents to determine the perceived out-of-state bank tax liability than the actual amount of tax due. The banking industry experience with Minnesota audits is limited, but the extensive questionnaires used by the state auditors to determine if all of the banks activities have been reported are very complex. Frankly, the Tennessee statute may be unauditable. Both administratively and monetarily, therefore, the burden rests upon the states to enforce their laws when the out-of-state banks have no physical presence upon which the state can seize.

Conclusion

The prospect for market state taxation of banks is bleak in the short run. States legislators have not examined the economic issue and, therefore, perceive this tax as an easy source of revenue from taxpayers that do not vote. The MTC is pushing ahead with its proposal and shows no sign of stopping the process. While the MTC may adapt its proposal to answer some of the industry's concerns, including possibly raising the threshold for taxability, its rules will only apply to some 20-odd states, and then only if the MTC member states adopt the proposal without modification. There still will not be national uniformity based on the MTC approach. Finally, Congress has thus far been reluctant to restrict the states' ability to raise revenue, especially now that so many federal-state programs have been cut out of the federal budget. Yet, Congress may perceive the lack of uniformity in the taxation of financial institutions now in the same way as it perceived the treatment of retailers and manufacturers prior to the enactment of Public Law 86-272. The burden is upon the banking industry to make its case effectively and often until the weight of the problem is recognized and the states and/or the federal government responds.

EXHIBIT K: 47

Sicora, Jerome J., "State Taxation and Regulation of Banking - Minnesota Approach" (undated outline)

STATE TAXATION AND REGULATION OF BANKING
MINNESOTA APPROACH

JEROME J. SICORA

A. Minnesota rules prior to 1987 amendments. (Sales factor for three-factor formula.)

1. Interest from loans were attributed to the office where the customer applied for the loan.

2. Credit card interest or service charges were attributed to the residence of the holder.

3. Credit card merchant discount was attributed to the merchant's location.

5. The property factor only included tangible property.

6. There was no statute defining jurisdiction to tax.

B. 1987-1988 amendments. (As part of a wholesale change in the way corporations are taxed under the Minnesota franchise tax, Minnesota changed the way that financial institutions apportion income and enacted a statute defining jurisdiction to tax (nexus).

1. Jurisdiction to tax where bank has no physical presence in the state, but has economic presence.

   a. The out-state bank must have transactions (includes deposits) with 20 or more Minnesota customers in any tax year and the value of its assets and deposits in the state must exceed $5,000,000.

2. If these limitations are exceeded, the bank is presumed to be subject to Minnesota tax.

3. Secondary market exclusion. Banks acquiring Minnesota assets in the so called "secondary market" are not subject to tax, if that is the only activity in Minnesota.

4. Apportionment.

   a. Formula

      1) Sales, payroll, and property.

      2) Sales are weighted 70 percent payroll 15 percent and property 15 percent.

   b. Overview. Three significant changes.

      1) Intangible property was included in the property factor.

      2) Income from intangibles is included in the sales or receipts factor.

      3) Receipts from business operations are assigned to Minnesota on what may be called a consumption basis. Interest from secured loans is assigned to the state in which the security is located. Interest from

unsecured consumer loans is assigned to Minnesota if the borrower is a resident of Minnesota. Interest from unsecured commercial loans is attributed to the state in which the proceeds are applied.

4) The intangible property giving rise to income or receipts is attributed in state or out-state in the same way as the receipts.

5) Investment receipts are attributed on the basis of deposits from Minnesota to total deposits, except receipt from Minnesota governmental securities which are all attributed to Minnesota.

6) Fees are attributed to the state in which the services for which fees are paid are consumed.

C. Underlying policy consideration for changes.

1. Out-state banks will be required to pay tax in Minnesota.

2. Minnesota domiciled banks will pay less tax.

3. In the three-factor formula, the sales or receipts factor is used to offset or counter balance payroll and property. Assigning interest from loans to an office does not accomplish the offset.

D. Problems encountered.

1. As originally drafted, the law would have subjected both the primary market and the secondary market to Minnesota jurisdiction to tax.

2. Because banks must borrow money to lend money, banks are not able to make traditional loans and hold them to maturity.

3. Solution is to create loans that banks can transfer to others. (Secondary market.)

4. Minnesota banks were concerned that if the secondary market was taxed by Minnesota,the availability of the secondary market would seriously diminish.

5. As noted before, interest income from unsecured commercial loans is generally attributed to the place where the proceeds are applied.

   a. If the place of application of the proceeds cannot be determined, then the interest is assigned to the office of the borrower where the application for the loan is made in the regular course of business.

   b. If the place of application of the proceeds and the office of the borrower cannot be determined, the interest is thrown out.

C

ADVISORY
COMMISSION ON INTERGOVERNMENTAL RELATIONS
WASHINGTON, D.C. 20575

January 27, 1989

Mr. William W. Wiles
Secretary of the Board
The Federal Reserve Board
20th & Constitution Avenue, N.W.
Washington, DC 20551

Dear Mr. Wiles:

On behalf of the members of the U.S. Advisory Commission on Intergovernmental Relations, I wish to submit for the record the attached statement relating to the proposal to rescind the Federal Reserve Board's existing rule in Regulation Y permitting bank holding companies to establish or acquire nonbank companies engaged in activities that may be conducted by the parent bank.

Sincerely,

Robert B. Hawkins, Jr.
Chairman

Attachment

cc: Robert L. Clark
Comptroller of the Currency

STATEMENT OF THE ADVISORY COMMISSION ON
INTERGOVERNMENTAL RELATIONS
BEFORE THE FEDERAL RESERVE BOARD

RELATING TO REGULATION Y; DOCKET NO. R-0652

Robert B. Hawkins, Jr.
Chairman

Interest of the Commission

The Advisory Commission on Intergovernmental Relations (ACIR) is an independent bipartisan commission created by Congress in 1959 to monitor the operation of the American federal system and to recommend improvements. The Commission is composed of 26 members -- 6 members of Congress, 3 members of the federal executive branch, 4 governors, 4 mayors, 3 state legislators, 3 elected county officials, and 3 private citizens. As a part of its long-range effort to improve federal-state-local cooperation and to achieve balance, equity and efficiency in the federal system, the Commission investigates and formulates policy recommendations on specific intergovernmental issues.

The Commission's interest in the proposal by the Federal Reserve Board arises from its recent investigation of and report on the dual banking system. In its September, 1988 report entitled State Regulation of Banks in an Era of Deregulation, the Commission examined the history of and present strength of the dual banking system. As a result of its investigation, the Commission found that the dual banking system has served the

nation well for more than a century by (1) permitting experimentation and innovation in both banking activity and governmental regulation of banking, (2) encouraging competition between federal and state regulators, (3) combatting regulatory ossification and preventing regulatory capture, and (4) allowing states to tailor banking regulation to state and local needs.

The report examined proposed federal legislation that would have preempted state legislative and regulatory authority over the new activities of state banks by requiring that new powers, such as insurance, securities and real estate, be conducted only in an affiliate of a bank holding company and only after approval by the Federal Reserve Board. The Commission concluded that the proposed preemptive federal legislation would dampen innovation and further erode the balance of power in the federal system. Accordingly, the Commission recommended that Congress not enact legislation that would preempt state regulatory authority over state bank activities in the fields of insurance, real estate, and securities. Because the current proposal of the Federal Reserve Board would have a substantially similar effect, the ACIR wishes to comment on the Board's proposal to preempt state legislative and regulatory authority over the activities of state bank subsidiaries.

The Proposal of the Federal Reserve Board

On November 30, 1988, the Federal Reserve Board issued for public comment a proposal to rescind the Board's existing rule in

Regulation Y, which acknowledges the right of states to determine the activities that a state bank may engage in through subsidiaries. According to existing Regulation Y, state banks that are owned by bank holding companies can acquire, without Board approval, subsidiary companies that are engaged in activities permitted under state law, even if such activities are not permitted under federal law. The Board's proposed rule would remove the deferral to state law and, instead, broadly preempt state law by requiring bank holding companies to obtain approval from the Board before their state banks could acquire or retain control of nonbank subsidiaries. Approximately 65 percent of the nation's state-chartered banks are owned by bank holding companies. Under the Board's proposal, therefore, federal law rather than state law would govern the activities of the subsidiaries of some 65 percent of all state banks.

In addition to the above specific preemptive effect, the Board's proposal signals the advent of an even broader national encroachment upon state powers. On the one hand, the Board maintains that its proposed rule change will not affect the dual banking system because states will still be free to decide what powers a bank may engage in within the bank itself. On the other hand, the Board acknowledges that the proposed rule change will further "a fundamental policy objective of bank regulation in the powers area," which objective requires that all new bank activities take place "in a subsidiary of a holding company

rather than in a holding company bank or in a subsidiary of a bank."

Stated Reason for the Board's Action

According to the Board, at the time it adopted its existing rule in Regulation Y recognizing state authority over the activities of bank subsidiaries, the powers that states granted to bank subsidiaries were limited: no evidence existed that banks were "evading" the restrictions on bank activities contained in the Bank Holding Company Act (BHCA), and no conflict existed between the scope of activities permitted for bank holding companies under the BHCA and those permitted to bank subsidiaries under state laws. Now, however, such circumstances, according to the Board, are no longer operative.

ACIR finds the logic of the Board's position to be problematic in several respects. First, the Board appears to argue that its existing rule contains an implied condition, namely, that the Board will not preempt state powers so long as state legislatures do not exercise their right to determine the proper scope of activities of state bank subsidiaries by granting their banks powers, but will preempt state powers when states decide to exercise their authority as provided for in the existing rule.

Second, the use of the words "evading" or "evasion" by the Board to describe the recent state banking legislation assumes that state legislators and regulators, by granting state bank subsidiaries new powers, had somehow acted unlawfully, when in

fact the actions of state authorities were entirely within the spirit as well as the letter of the law.

Third, the state/federal regulatory diversity and tension, cited by the Board as the problem necessitating preemption, constitutes the very the heart of the dual banking system. On many occasions in the century and a half of dual regulation, states have taken advantage of their exemptions from federal law to offer state banks powers forbidden national banks or bank holding companies. On other occasions, the Comptroller has taken the lead in expanding the powers of national banks. To the extent that the Board now finds that such state/federal regulatory tension is an excuse for preemption, its action signals the demise of the dual banking system.

Furthermore, the Board does not demonstrate that there are problems in the dual banking system of sufficient severity or nationwide scope to justify national preemption. Instead, the Board appears to be moving to preempt potentially innovative and economically beneficial activity in a period of state experimentation.

Legal Authority

As authority for its proposed action, the Board cites Section 4(a) of the BHCA. That section prohibits a bank holding company from acquiring direct or indirect ownership or control of any voting shares of any company that is not a bank. According to the Board, "by encompassing indirect as well as direct

ownership interests, [section 4] of the Act prohibits a holding company bank as well as the holding company itself from owning more than 5 percent of the voting shares of any company engaged in impermissible nonbank activities ...."

The position of the Board in this regard is somewhat anomalous. First, it admits to not having power over "improper activities" when conducted in the bank directly, but proposes to assert control over the same activities when conducted in a bank subsidiary. Second, section 7 of the Act provides:

> **Reservation of Rights to the States.** The enactment of this chapter shall not be construed as preventing any State from exercising such powers and jurisdiction which it now has or may hereafter have with respect to banks, bank holding companies and subsidiaries thereof.

The Board interprets this section to give the states "concurrent jurisdiction" over banks and bank holding companies and then interprets the word "concurrent" to assign to the states the role of supervising state bank compliance with the dictates of federal law, thereby removing all substance from the phrase "concurrent jurisdiction." This interpretation effectively repeals the language of section 7 that specifically reserves an independent role for the states in governing state banks and their subsidiaries. The recent decision of the D.C. Court of Appeals upon petition for rehearing in the AMBAC case suggests that the

court will not lightly upset the historic independent role of the Comptroller of the Currency and the states in bank regulation.

The Need to Preserve a Safe and Sound Banking System

In its proposal, the Board states that its proposed action will further the goal of preserving a safe and sound banking system. In order to assure the competitive vitality of banks, the Board believes that it is necessary for banks to expand their activities and that the safety of the system requires that they do so in affiliates of bank holding companies, rather than in bank subsidiaries.

Widespread agreement exists for the Board's position on the need for banks to expand their activities. In fact, several state legislatures and regulators have taken the lead by granting their state banks the power to engage in insurance activities, real estate activities, and securities activities. Less agreement exists, however, for the Board's position on the need for such expansion to take place in bank holding company affiliates. For example, after reviewing all possible structures that a bank or bank holding company could establish for its expanded activities, the U.S. General Accounting Office concluded that "one cannot say that one structure insulates the bank while another does not."

Indeed, little evidence exists to support the view of the Board that the safety and soundness of the bank system requires that these new bank powers be exercised only in an affiliate of a

bank holding company rather than in a bank subsidiary. To the contrary, the Board's reliance on its "source of strength" doctrine, by which the Board requires a bank holding company to provide financial aid to its problem banks, may be misplaced. For example, some commentators believe that the Board's "source of strength" doctrine creates an illusion that the Board will take responsibility for assuring the financial strength of companies that own banks and the nonbank subsidiaries of those companies. Others, citing the failure of the Board to compel the Hawkeye bank holding company to provide funds to a wholly owned insolvent bank, point to the complete lack of any statutory authority for the "source of strength" doctrine and the consequent inability of the Board to use the doctrine to assure that a bank holding company will come to the aid of its problem banks.

The ACIR shares the Board's concern for the safety and soundness of the nation's banking system. The Commission does not believe, however, that a safe and sound bank system requires the Board to preempt state law in the proposed manner.

Preemption of State Law through Regulatory Action

The statutory section cited by the Board as legal authority for its proposed action is murky at best. While section 4(a) does prohibit a bank holding company from acquiring direct or indirect ownership or control of any voting shares of any company that is not a bank, section 7 contains a reservation of rights to

the states assuring a continued independent role for the states. Nothing in the Bank Holding Company Act indicates that Congress had intended, by enacting the BHCA, to remove the historic power of states to regulate the activities of their state banks.

The Board's proposal to interpret federal law so as to withdraw state control over state banks violates the basic precepts of federalism. In Garcia v. San Antonio Metropolitan Transit Authority (1985), the U.S. Supreme Court observed that the federal political process was designed "in large part to protect the States from overreaching by Congress." According to the Court, the structure of the federal government allows states to protect their sovereign interests by exercising their influence before Congress. When a federal regulatory agency interprets an ambiguous law so as to preempt state powers in the absence of a clear Congressional directive--indeed, contrary to recent Congressional action--the premise of the Garcia majority is undermined, and the viability of the federal system is threatened. In effect, the Board proposes to preempt what the Congress declined to preempt during the last session. As the four dissenting justices in Garcia warned, "[T]he administration and enforcement of federal laws and regulations necessarily are largely in the hands of staff and civil service employees. These employees may have little or no knowledge of the States and localities that will be affected by the statutes and regulations for which they are responsible. In any case, they hardly are as

accessible and responsive as those who occupy analogous positions in state and local governments."

Conclusion

For the above reasons, the Advisory Commission on Intergovernmental Relations encourages the Federal Reserve Board to reconsider its proposal to preempt state laws governing the activities of the subsidiaries of state-chartered banks that are owned by bank holding companies and to consider retaining its existing rule, both for the vitality of the dual banking system and for the vitality of the federal system.

D

A Commission Report

State Regulation of Banks in an Era of Deregulation

Advisory Commission on Intergovernmental Relations

A-110
September 1988

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A Commission Report

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Preface

In recent years a combination of innovations in the private delivery of financial services and federal and state regulatory rulings have dramatically changed the structure of the U.S. banking sector:

- New forms of financial institutions, such as the "nonbank bank," have emerged, creating issues of how such entities should be treated for regulatory and tax purposes.
- During 1985 and 1986, most states relaxed or removed prior legislative bans on interstate banking, a development that radically altered the manner in which banks do business.
- Federal regulators have permitted banks to underwrite and deal in certain securities, thereby raising issues of whether and how to separate more risky activities from traditional bank activities of lending and deposit taking.
- Several states are experimenting with regulatory innovations and are granting powers to state banks that allow them to offer new products and services, such as securities and insurance brokerage and underwriting.

These developments have led to the creation of a wide variety of new products and services that not only promote increased competition and efficiency within the financial sector but also add to the diversity and accessibility of consumer financial services. At the same time, however, these developments create new problems of taxation and interstate jurisdictional and regulatory conflicts. They also raise issues of equal treatment among similar types of business activities and of the safety and soundness of banks and other financial institutions.

The purpose of this report is to examine the key intergovernmental regulatory issues that arise as a result of the changing economic and institutional structure of the banking and financial services industry. In order to accomplish this objective, the report is divided into three parts.

The report begins with a review of the history of bank regulation, thereby providing an important background and context for understanding the present structure of the financial industry and the reasons for establishing the current system of dual banking whereby the states and the federal government share in the responsibility for regulating banks and other financial business activities.

The study then proceeds to an analysis of the current issues of bank regulation. This part is divided into two sections. A first section presents a discussion of the purpose and scope of bank regulation—the division of responsibility among regulators, areas of jurisdictional overlap, and efforts to improve regulatory coordination. Next, a closer look is taken at the

effects of deregulation on the operation of the dual banking system. This discussion includes an explanation of the intergovernmental issues relating to the growth of interstate banking and the new banking powers relating to securities underwriting, insurance, and real estate investment activities that have been granted by some state regulators.

The final section of the report then explains and evaluates pending congressional and federal regulatory proposals to preempt state controls over the new powers of banks by granting sole regulatory and supervisory control over such powers to the Federal Reserve Board.

As a result of this study, the Commission reaches several findings with respect to the intergovernmental status of bank regulation in the U.S. and concludes that not only has the dual banking system generally led to a system whereby the goals of institutional stability and soundness are responsibly balanced with the need to encourage innovation and experimentation in the provision of financial services, but also that recent proposals for a greater concentration of regulatory authority by the federal government poses significant risks of stagnation and of a further erosion of the balance of power in the federal system.

Accordingly, with respect to legislation now pending in Congress that would restrict state regulatory authority over the insurance and securities activities of state-chartered banks, the Commission recommends that the Congress refrain from enacting preemptive legislation that would further regulate an already heavily regulated industry.

Robert B. Hawkins, Jr.
Chairman

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Introduction

States have exhibited remarkable resilience in their regulation of banks over the years. In 1781, states took the lead in regulation by requiring banks to receive a state charter. In 1791, the federal government, using state law as a model, chartered a national bank, the First Bank of the United States. In 1816 Congress granted a 20-year charter to the Second Bank of the United States. Never popular with the public, the life spans of the First and Second Banks of the United States were short. Therefore, state banks dominate the early history of banking in this country.

In 1864 and 1865, Congress enacted two laws in an attempt to create a single national banking system. First, it passed the *National Currency Act*. Like the state laws on which it was modeled, this Act created a uniform system under which private persons could apply for and receive a national bank charter from the Comptroller of the Currency. Second, Congress levied a 10 percent tax on all state bank notes. These actions caused many state banks to change from a state to a national charter; they did not, however, have the intended effect of eliminating all state banks. States adapted to the federal legislation by offering expanded powers to banks in order to entice them into seeking a state rather than a national charter. Banks adapted by ceasing to issue the heavily taxed bank notes to borrowers and setting up deposit accounts instead. The years 1864 and 1865, therefore, mark the birth of the dual banking system: in those years, state and federal chartering of banks became a reality, and the regulatory competition between the two chartering authorities began.

From the beginning, banking has been plagued with problems of mismanagement and fraud on the part of bank owners and carelessness and inexperience on the part of regulatory authorities. Outbreaks of bank "panics" have occurred often in U.S. history. With each new bank panic and crash, Congress first formed a committee to study the problem and eventually added another layer of federal regulation. In this way, Congress created the Federal Reserve System and the Federal Deposit Insurance Corporation. For the most part, Congress has allowed state banks to avoid much of the added federal regulation. For example, the *Federal Reserve Act* made state bank membership in and regulation by the Federal Reserve Board optional. By choosing not to become members of the Federal Reserve System, state banks could escape regulation by the Federal Reserve Board. The *Glass-Steagall Act*, which prohibits banks from engaging in securities underwriting, excludes from its provisions state banks that are not members of the Federal Reserve System.

On many occasions, states have taken advantage of these exemptions from federal law by offering state banks powers often forbidden to national banks. The Comptroller of the Currency has typically re-

sponded to the state/federal imbalance by seeking similar new powers for national banks. On other occasions, the Comptroller has taken the lead in expanding bank powers by interpreting the *National Bank Act* to allow national banks to act as insurance agents, to engage in personal property leasing, and to offer discount securities brokerage services. This regulatory diversity and tension, which is at the heart of the dual banking system, is credited with encouraging innovation, increasing competition, and preventing economic concentration; at the same time, it is faulted with creating a competition in laxity.

Thus, the dual banking system has been fostered by: (1) Congressional restraint, in refraining from preempting state regulation of banking and allowing state banks to retain a degree of independence from federal regulatory authority; and (2) state adaptation to changing conditions in banking. As this report illustrates, however, the future of the dual banking system is uncertain. Recent congressional legislation and federal regulatory actions would broadly preempt state control of all new bank activities, including securities, insurance and real estate, and transfer this control to the Federal Reserve Board. Yet, it is the dual banking system with its regulatory diversity and tension that has made it possible for banks to offer these new services in the first place. By impairing the future functioning of the system, the proposed federal legislation and regulation may signal the demise of the dual banking system and with it the innovation, competition, and avoidance of concentration that it has promoted.

The purpose of this report is to examine and evaluate the key intergovernmental regulatory issues that arise as a result of the changing economic and institutional structure of the financial services industry. The report begins with a review of the history of bank regulation and the development of the dual banking system, and then analyzes the current issues of bank regulation and the nature and scope of legislation that is pending in the Congress that would restrict regulatory authority over the insurance and securities activities of state-chartered banks.

Recommendation*

The Commission finds that the nation's dual banking system has many benefits for citizens, states, and local communities. That system has been conducive to state experimentation, banking innovation, regulatory competition, and vitality in both banking regulation and banking activity. Further concentration of regulatory authority by the federal government in an already heavily regulated industry poses risks of stagnation and of a further erosion of the balance of power in the federal system. Although there are problems in the nation's banking system, currently proposed measures for federal preemption do not address those problems. Many state regulators have used their authority responsibly in extending new powers pertaining to insurance, real estate, and securities to their state banks.

The Commission recommends, therefore, that the Congress not enact proposed legislation and that the Federal Reserve Board not promulgate proposed rules that would substantially preempt state regulatory authority over state nonmember bank activities in the fields of insurance, real estate, and securities.

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*Mayor Donald M. Fraser introduced the following dissent:

I dissent from the recommendation that Congress not enact proposed legislation that would preempt state regulatory authority over state banks in the fields of insurance and securities. I believe that federal preemption of "new" bank powers, such as securities underwriting, is appropriate because such activities should take place in a subsidiary of a bank holding company and not in a bank or a direct subsidiary of a bank.

In my view, the bank holding company approach has two advantages. First, the holding company mechanism provides maximum legal separation between the bank and its securities affiliate because there is no direct ownership link between a bank and its affiliates. It is less likely, therefore, that a bank would be held liable for the actions of a securities affiliate than it would for the actions of a direct bank subsidiary. Second, the holding company structure will help to promote competitive equality among the institutions engaged in securities underwriting. If securities activities are conducted directly within a bank or in a subsidiary of a bank, they are likely to receive a benefit from the direct association with the federal safety net because of increased public confidence in securities offerings made by insured banks. The use of the bank holding company structure would help to create a level playing field by minimizing both the public confidence advantage of a bank subsidiary and the competitive edge a bank might have in raising funds in the capital markets because of its association with the federal safety net.

Findings

1. Principal Objectives of Bank Regulation

The principal public policy objectives of bank and bank holding company regulation have generally been understood to include the following: (1) protection of depositors and consumers; (2) protection of bank safety and soundness; (3) enhancement of competition; (4) avoidance of undue concentration in the banking industry; and (5) promotion of efficient credit allocation. Responsibility for achieving these objectives is vested in four principal regulatory actors: state banking supervisors, the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation.

2. Dual Banking System: The Traditional Approach to Regulation

The nation's dual banking system—by which banks and banking activities are regulated by both the states and the federal government—has served the nation well for more than a century. Dual banking, moreover, conforms to the principles of federalism because regulatory authority is shared by the states and the federal government. Currently, four categories of banks exist: (1) state member banks (state banks that have chosen to become members of the Federal Reserve System and are therefore regulated by the states and the Federal Reserve Board), (2) state nonmember banks (state banks that have not chosen to become Federal Reserve members and are regulated by the states and the FDIC), (3) national banks (regulated by the Comptroller of the Currency and the Federal Reserve Board), and (4) bank holding companies (regulated by the Board and by some states). All state banks are subject to federal regulatory override, either by the Federal Reserve Board or the FDIC. The balance presently struck by Congress gives due regard for the rights of states and for the legitimate interest of the federal government in the protection of the federal deposit insurance fund.

3. Experimentation, Innovation, and Competition

The dual banking system has permitted considerable experimentation and innovation in both banking activity and governmental regulation of banking. Regulatory diversity has given banks opportunities to experiment with new services and to initiate innovations in response to changing conditions. The ability of new and existing banks to choose the set of laws and administrators under which they will operate is another important feature of the dual banking system. Congressional restraint in preempting state authority has given states opportunities to experiment and to innovate, and to tailor banking regulation to state and local needs. In turn, there have been many instances where the federal government has adopted regulatory innovations developed by states.

Dual banking has also encouraged competition between federal and state regulators and, thereby, competition within the banking industry as well. Such competition reduces the ability of industry representatives to capture regulatory authorities.

4. Proposed Federal Preemption

Although federal officials rarely criticize the principle of dual banking regulation, they have initiated a process of piecemeal preemption of state authority. Proposed federal legislation, which has recently passed the Senate, and proposed rules by the Federal Reserve Board would substantially preempt state regulatory authority over state banks and banking activities in the fields of insurance, real estate and securities. Yet, there is no evidence that the current federal oversight of these activities of state banks (by the FDIC or the Board) is not sufficient. The Chairman of the FDIC, moreover, has stated that further federal preemption of state authority in these areas is not necessary. Many state regulators have exercised their powers responsibly in these fields, and those states which have allowed their banks to diversify their portfolios have helped their banks to compete better in today's complex financial markets. There are problems in the national banking system and in some state banking systems, but the proposed legislation and rules do not address those problems.

5. Dangers of Increased Federal Preemption

Banking is already a heavily regulated industry. Dual banking regulation, however, alleviates some of the problems that can arise from government regulation. Further concentration of regulatory authority in the hands of the federal government, especially in the absence of a clear need for preemption, poses the risk of undermining the vitality present in the existing dual banking system. Proposed legislation and rules would add another layer of federal regulation on state-chartered banks and thereby imperil the future existence of state banks. Given the tremendous changes occurring in banking today, the dual system has allowed states to engage in a great deal of experimentation with regard to interstate banking, bank services for consumers, and bank activities in insurance, real estate, and securities. In some cases, states have also moved out ahead of the federal government to create uniformity, coordination, and cooperation in such matters as information sharing and bank examinations. Conflicts over regulation frequently arise, moreover, not between state and federal regulators but among federal regulators. Thus, an increase in federal regulation through further preemption of state authority is not likely to reduce conflicts among regulators, but may dampen the innovation occurring under the dual banking system and will further erode the position of the states in the federal system.

1

Regulation of Banks: Historical Context

BIRTH OF THE DUAL BANKING SYSTEM

The role of the states in the United States banking system is unique among industrialized nations. That role is usually described by reference to the dual banking system, the deceptively simple phrase used to describe the complex web of state and federal laws that control banking. Historically, the dual banking system referred simply to the power of both state and federal governments to charter and supervise banks. A key principle of the dual banking system today is that the rights of the two governments should be approximately equal in chartering banks and in regulating and examining the banks that they charter. Jealously guarded by states today as an integral part of the United States federal system of government, the dual banking system began accidentally.

Commentators identify the Bank of North America as the first bank, in the modern sense, in North America.[1] Prophetically, the bank was a product of both federal and state law. Originally established in 1781 under a charter granted by the Continental Congress, the Bank of North America obtained a second charter in 1782 from the state of Pennsylvania when doubt arose as to the validity of the federal charter.[2]

Soon thereafter other states began to charter banks. In 1784, the Massachusetts legislature granted a charter to the Bank of Massachusetts; in 1790, Maryland chartered the Bank of Maryland; and in 1791, New York incorporated the Bank of New York. By 1816, 246 state-chartered banks existed.[3] State legislatures granted these early charters to individual banks by special act.[4] Each charter could therefore contain restrictions and grants of power specific to only one bank. Some generalizations are possible, however. For example, most charters permitted banks to issue notes, receive deposits, make loans, and provide services to the chartering government. Typical restrictions included prohibitions against trading in goods and against owning real estate other than that needed and used to house bank activities or acquired as loan collateral.

Most early state-chartered banks confined their lending activities to short-term loans. Banks made their short-term loans by giving borrowers bank notes rather than deposits as is the present practice. The borrower could redeem the bank notes in hard currency from the bank's capital or sedentary deposits to pay his debts. Frequently, borrowers used the bank notes as currency, giving the notes to their creditors in payment of their debts rather than redeeming them. Creditors, in turn, could either redeem the notes or use them in payment of their own debts.[5] Sometimes the holders presented their notes for redemption in hard currency while the loans on which the notes were based were still outstanding. This

practice dangerously depleted the banks' reserves and often caused insolvency. Banks sought to avoid this fate by preventing redemption of the notes. Banks accomplished this by placing their notes in circulation far from the point of redemption or by persuading note holders not to redeem them.[6]

Several factors contributed to the specialization in short-term loans. For example, early banking theory was heavily influenced by the "real bills" doctrine and by English law. The real bills doctrine, developed by Adam Smith, held that banks could preserve their liquidity only by confining their activity to short-term, self-liquidating loans to finance the conversion of raw materials into goods and their transportation to market. According to this theory, banks that made longer loans would face the risk of insufficient funds to lend during periods of increased economic activity and to satisfy demands of depositors for hard currency.[7] Another important factor in the early specialization of banks in short-term lending involved the belief, inherited from English Parliamentary law, that a separation between banking and commerce was necessary to restrain banks from monopolizing commerce as well as banking.

These two factors—the real bills doctrine and the fear of economic concentration—led banks and some state legislatures to define the business of banking narrowly. Yet, securities underwriting, especially of federal and state government bonds, was deemed a permissible activity even under the restricted definition of the business of banking.[8] Alongside this narrow view of the proper business of a sound bank existed another, competing view. Some states issued bank charters that permitted or required banks to hold stock in other companies, to combine insurance and banking, and to establish and/or manage transportation systems and utilities.[9]

The idea of a national bank, held in abeyance after skepticism arose over the validity of the federal charter granted to the Bank of North America by the Continental Congress, was renewed on the adoption of the Constitution. Alexander Hamilton, long a proponent of national banking, became the first Secretary of the Treasury of the new republic. Under Hamilton's patronage, and over the objections of both Secretary of State Thomas Jefferson and Attorney General Edmund Randolph who deemed the creation of a national bank unconstitutional, Congress granted a 20-year charter to the First Bank of the United States in 1791.[10]

In 1811 the First Bank of the United States faced another challenge to its existence. Upon application for a renewal of its charter, opponents of the bank argued that a grant of a corporate charter was an attribute of sovereignty that could exist only by express power. Because the Constitution was silent regarding the authority of Congress to incorporate a bank, no such power could be implied. This time, the opponents won and Congress refused to renew the bank's charter.

A mere five years later, however, Congress granted a 20-year charter to the Second Bank of the United States.[11] The turnabout came as the country faced extraordinary demands on its financial resources caused by the War of 1812 and the beginning of commercial farming and manufacturing. Although these developments created an urgent need for an orderly banking and currency system, state banks were profiting from the increased borrowing and were in no mood to provide stability through the use of hard currency. Because Congress believed it did not have constitutional power to regulate state banks, it chose to bring order to the nation's banking system by establishing its own competing bank.[12]

This bank fared little better than did many state banks, however. Indeed, it fell prey to the same forces—lack of understanding of commercial banking and lack of competent management—that had undermined the stability of the state bank system. Equally important, farmers and small businessmen, opposed to the tight credit policies of the bank, accused it of exercising monopolistic privilege. Popular reaction against the Second Bank of the United States grew. In 1832 President Jackson vetoed the legislation renewing the Second Bank's charter, which was due to lapse in 1836. Realizing that the tide had turned against him, the president of the Second Bank of the United States, Nicholas Biddle, became reckless. From 1835 to mid-1836, when it ceased doing business as a national bank and became a state-chartered bank, the Bank of the United States increased its securities holdings from $4 million to more than $20 million. Lacking adequate liquidity to support the immense increase in its assets, the bank borrowed from abroad. Then, when its foreign sources of liquidity dried up, the bank suspended all payments in hard currency.

Meanwhile, conditions in state-chartered banks were also ripe for a general bank crisis. The aggregate value of the state bank notes in circulation had risen from $61 million in 1830 to $149 million in 1837.[13] The crisis hit on May 10, 1837. All the banks then in operation suspended payment in specie. Some historians maintain that Biddle had masterminded the general suspension, which he could do because of the greater size of U.S. Bank (now operating as the U.S. Bank of Pennsylvania) relative to other state banks, and because the U.S. Bank held a significant number of the notes issued by other state banks.[14]

The so-called free banking era began in 1838. In that year New York passed its Free Banking Act, which standardized the bank chartering process by setting uniform minimum capital and regulatory standards for all chartered banks.[15] The New York

law was a reaction to the specific problems that led to crisis of 1837 and to the general public outcry against monopolistic banking. Under the new law, New York granted a charter to any bank that deposited with the state comptroller U.S. bonds, state bonds, or real estate bonds and mortgages. In exchange, the bank received an equivalent amount of bank notes for circulation. Because many blamed the crash of 1837 on the mixing of commercial and investment banking, the New York act prohibited its chartered banks from investing and trading in securities.[16]

Other states soon followed the New York lead by passing similar free banking laws and increasing their supervision of banks. Despite the reforms, state banks continued to fail at a high rate. In fact, between 1840 and 1847 the number of state banks actually declined. Unfortunately, the volume of bank notes in circulation did not decrease proportionately to the bank failures. Instead, the notes issued by defunct banks continued to circulate along with the notes of viable banks. By 1862, 7,000 different kinds of notes issued by 1,600 different banks were in circulation. Another 5,000 counterfeit notes circulated along with the legitimate notes.[17]

Once again the banking system was in disarray. Commercial transactions stalled as uncertainty grew over the worth of the notes in circulation. Creditors who were willing to accept bank notes in payment of debts demanded that the notes be discounted. Notes issued by the stronger banks of New England were accepted at par, those of New York banks were subject to a 10 percent discount, and notes from banks west of the Appalachians were at a 50 percent discount. Popular reaction against banks increased. Iowa outlawed banks from 1846 to 1857; in 1845 the Texas constitution banned banks completely.[18] Other states responded to the public outcry by instituting bank examinations designed to increase their safety and soundness.[19]

Spurred into action by the need to finance the Civil War and the need for a uniform currency, Congress passed the *National Currency Act* in 1864.[20] The *National Currency Act*, renamed the *National Bank Act* in 1874, and hereafter referred to as the *National Bank Act*, established national banks and gave them authority to issue bank notes secured by government bonds. Congress intended that this act would hasten the passing of state banking. When it became evident that state banks would not die easily, Congress passed a 10 percent tax on state bank notes in order to pressure state banks to convert to national charters.[21] Although the number of state banks dwindled from 1,466 in 1863 to 247 in 1868,[22] the tax did not have the hoped-for effect of causing the end of state-chartered banks. State banks adapted to the federal tax on their notes by discontinuing the use of notes and initiating the use of deposits and checks. With this classic industry response to government regulation, the dual banking system was born.

EVOLUTION OF BANK REGULATION

Five themes have dominated bank regulation in the United States: (1) federal/state regulatory competition, (2) multiple regulation and supervision of banks, (3) separation of commercial and investment banking, (4) restrictions on interstate banking, and (5) fear of monopolistic control in the banking system.[23] The first of these themes originated as a corollary to the dual banking system, the second and third arose largely from a series of crises in the banking system, and the fourth and fifth spring from a deeply rooted fear of economic concentration.

The Dual Bank System and State/Federal Regulatory Competition

Regulatory competition between national and state-chartered banks began with the passage of the *National Bank Act*. Consider, for example, the following difference in state/federal charter requirements. Like the New York Free Banking Act on which it was based, the *National Bank Act* required national banks to keep a large portion of their capital in securities on deposit with the Comptroller of the Currency. Unlike the New York law however, the federal act dictated that national banks deposit only federal securities. In exchange, the national bank received notes equal to 90 percent of the value of the deposited bonds.[24] While these stringent requirements enabled the U.S. government to guarantee the payment in full of national bank notes, they also artificially restricted the expansion of national banks by tying their expansion to the supply of Treasury securities rather than to the needs of business. For example, when the federal government reduced its level of outstanding debt, as it did after the Civil War, the supply of Treasury securities fell, causing a contraction in national bank note circulation.

State bank charter laws also required banks to pledge securities against their bank notes with the state comptroller. The state legislation, however, was far less restrictive than were the national laws. For example, state banks were not restricted in the kinds of securities they could deposit, and their note issues were not limited to 90 percent of the market value of the deposited securities.[25] Consequently, state banks could expand more freely than national banks. State banks had other advantages over national banks. For example, Congress limited the lending activities of national banks to commercial credit, whereas many state laws allowed banks to make mortgage loans. Some state laws permitted branch banking, while the *National Bank Act* prohibited this practice.[26]

The advantages of a state charter were not lost on national banks. During the period from 1863 to 1900, the state banking system underwent a remarkable revitalization as national banks converted to state charters. By 1900 state banks had edged out national banks in both numbers (5,000 state banks to 3,790 national banks) and in deposits (state banks holding 55 percent of all deposits).[27] The potential threat that these charter conversions posed to the national bank system was, in turn, not lost on Congress. In 1913 Congress authorized national banks to engage in real estate lending. Thus began the state/federal regulatory competition that has, over the years, been scorned as a competition in laxity and praised as a model of regulatory excellence.[28]

For several decades after the Civil War, the business of securities underwriting flourished as railroads issued bonds to finance construction of lines across the West.[29] Because many state laws allowed banks and/or trust companies to underwrite securities, state banks and state incorporated trust companies participated in the underwriting of these issues. National banks, on the other hand, were excluded from this lucrative business by regulatory and judicial prohibitions against securities underwriting.[30] Very soon, however, national banks circumvented this inequity by engaging in securities activities through state bank and trust company affiliates.[31] Later, they persuaded the Comptroller of the Currency to relax his prior ban on securities activities and finally induced Congress to "level the playing field." The *McFadden Act* of 1927 enabled national banks to underwrite those securities that the Comptroller of the Currency approved.[32]

The Bank Panic of 1907 and the Establishment of the Federal Reserve System

From 1863 to 1913, regulation and supervision of national and state banks was entrusted to the Comptroller of the Currency and state bank superintendents, respectively. The banking panic of 1907 resulted in the addition of another layer of federal regulation in the form of the Federal Reserve Board. Two-hundred-forty-six banks failed during the 1907 crash.[33] The origin of the crash is generally attributed to speculation in railroad and copper stocks by individuals and large New York banks and trust companies.[34] When the price of copper stocks declined, panic set in and depositors rushed to withdraw their cash. Banks and trust companies, operating on desperately small reserves, were unable to meet the demands of depositors and closed.[35]

The 1907 panic precipitated the establishment in 1908 of the National Monetary Commission, which was charged with the responsibility of analyzing the crash of 1907. This commission focused its attention on the problems of insufficient reserves and the inelasticity of the currency. Its recommendations included the establishment of a central bank controlled by private bankers.[36] In 1913, the Pujo Committee was formed to investigate the so-called money trust. The Pujo Committee found numerous abuses and illegalities in the use of securities affiliates by banks and advocated the separation of commercial and investment banking. Congress eventually adopted elements of both studies.

First, Congress established a central bank with its passage of the *Federal Reserve Act* in 1913.[37] The act established 12 regional Federal Reserve Banks that operated under the under the general supervision of a Federal Reserve Board located in Washington, DC. According to the provisions of the act, every national bank had to become a member of the Federal Reserve System and to submit to regulation by the board. State banks could become members of the system on a voluntary basis.[38] For the first time, state banks (which chose to become members of the Federal Reserve System) became subject to federal regulation and supervision. The act obliged state member banks to meet the same capital requirements as national banks and the same limitations with regard to payment of unearned dividends and withdrawal or impairment of capital.[39] Another bank panic would occur before the recommendations of the Pujo Committee concerning the separation of commercial and investment banking would become law.

The Great Depression and the Separation of Commercial Banking from Investment Banking

Although speculation in securities by banks had been identified as a cause of several of the early bank panics, and although the Pujo Commission Report[40] had concluded that national banks could not legally purchase and sell equity securities, national banks continued to expand their securities activities through affiliates. National bank affiliates originated and distributed a wide variety of securities, including those of foreign governments, cities, states, and foreign business corporations.[41]

As the volume of this activity increased, a great number of abuses arose. One category of abuse involved the mixing of commercial and investment banking functions. For example, unsuccessful sales of securities issues by their affiliates induced some banks to make excessive loans to their securities affiliates or to purchase securities from their affiliates for bank fiduciary accounts. Conversely, a bank loan to a company which later failed was often propped up through the purchase and sale of the company's stock through the affiliate.[42]

These and similar abuses went virtually unchecked. Prior to the stock market crash of 1929 and the bank reform of 1933, federal law was silent with regard to the use of securities affiliates by national

banks. Federal law neither authorized nor prohibited the use of such affiliates. Unlike state bank superintendents, the Comptroller of the Currency did not even have legal authority to examine the securities affiliates of national banks. Following the stock market crash, Congress began investigations into the activities of securities affiliates. Although all the witnesses agreed on the need for regulation of securities affiliates, they differed sharply on the need to ban such affiliates. Senator Glass, the chairman of the subcommittee conducting the investigations, favored the abolition of all securities affiliates. Others favored government regulation of the securities activities of banks. During the course of the congressional hearings, 5,844 banks failed.[43] The numerous bank closings were often accompanied by indictments of bank officials for fraud and forgery. As the financial position of banks continued to deteriorate, 18 states declared bank holidays and 7 states placed restrictions on withdrawals. When President Roosevelt declared the national bank holiday on March 5, 1933, opposition to the Glass bill evaporated, and the *Banking Act* of 1933 became law.

The 1933 act (1) established a Federal Deposit Insurance Corporation; (2) required separation of securities affiliates from commercial banks and their holding companies; (3) prohibited interest on demand deposits; and (4) permitted intrastate branch banking for national banks if and to the extent that state law granted branching to state banks. The Federal Deposit Insurance Corporation (FDIC), which insured bank deposits up to $2,500, was modeled in part on earlier state deposit insurance schemes.[44] With the establishment of the FDIC, Congress subjected state nonmember banks to federal regulation for the first time and placed a third level of federal regulation on national banks.

The portion of the bill that dealt with securities, popularly known as the *Glass-Steagall Act*, created a wall between commercial and investment banking. Sections 16 and 20 banned both national and state member banks from underwriting corporate equity and debt securities and from affiliating with entities that were principally engaged in such activities. Section 21 prohibited any entity engaged in securities underwriting from taking deposits. Unlike the ban in section 20, section 21 did not prohibit affiliation between such entities. Section 32 prevented personnel interlocks between member banks and securities underwriters.[45] The *Glass-Steagall Act* exempted state nonmember banks from its provisions, an important exclusion that states are exploiting today.[46]

FEAR OF MONOPOLISTIC CONTROL IN THE BANKING SYSTEM AND THE RESTRICTIONS AGAINST INTERSTATE BANKING

Early in the history of state banking, most states either prohibited or limited intrastate branch banking. States justified their restrictions on branching as necessary to prevent undue concentration in the banking system. Branch banking, it was thought, would cause the death of small independent banks, thereby hindering the development of the west. Opponents of branching argued that branch banks would secure the "easiest obtainable and most desirable business . . . leaving the unit banks to take care of the enterprises of the town which have not already reached a condition of independence," thereby causing the collapse of independent banking.[47] The loss, in turn, of these small unit banks would be catastrophic to the nation since "the rapid economic development of America had been largely due to the policy of the pioneering unit banks which recognized the principle of service."[48]

The *National Bank Act*, which provided that the usual business of a national bank shall be transacted at an office or banking house located in the place specified in its organization certificate, did not displace these state-imposed geographic restrictions. Shortly after the passage of the act, the Comptroller of the Currency interpreted its provisions as forbidding national banks to operate branches. Succeeding Comptrollers followed this precedent.[49] No such ban prevented state banks from branching intrastate, and many did so as states gradually relaxed their laws. Congress took a small step toward remedying this imbalance by amending the *National Bank Act* in 1927. The amendment, popularly known as the *McFadden Act*, permitted national banks to operate branches within the state in which their home office city is located, if and to the extent that state law allowed state banks branching power.

If federal law outlawed branch banking, it did not stop national banks from operating nationwide through a system of joint ownership of separately chartered banks. Typically, the joint ownership took one of two forms: (1) chain banking, which united several banks through common ownership and directors; and (2) group banking, which united banks through the formation of a parent holding company.

During the 1920s, group banking gradually replaced chain banking as the dominant device for linking banks nationwide.[50] The number of bank holding companies declined during the early 1930s, but then they grew virtually unchecked until 1956.[51] In that year, Congress passed the *Bank Holding Company Act*,[52] which prohibited interstate banking through subsidiary banks. According to one section of the Act, the Board of Governors of the Federal Reserve must approve all bank acquisitions by a bank or a bank holding company. Another section, popularly known as the Douglas amendment,[53] provides that the Board of Governors cannot approve the acquisition of a subsidiary bank outside the holding company's principal state of operation unless the laws of the

state in which the bank is to be acquired or established expressly allow such entry. The 1956 act applied only to multibank holding companies, but in 1970 Congress amended the act to extend its provisions to one-bank holding companies.

ENDNOTES

[1] Paul Studenski and Herman Krooss, *Financial History of the United States*, 2nd ed. (New York: McGraw-Hill, 1963), p. 31; Benjamin Klebaner, *Commercial Banking in the United States: A History* (New York: Dryden Press, Holt, Rinehart & Winston, 1974), p. 2.

[2] Bray Hammond, *Banks and Politics in America From the Revolution to the Civil War* (Princeton: Princeton University Press, 1957), pp. 48-52.

[3] Klebaner, p. 7.

[4] Edward L. Symons, "The 'Business of Banking' in Historical Perspective," 51 *George Washington Law Review* (1983): 676.

[5] John Kenneth Galbraith, *Money: Whence It Came, Where It Went* (Boston: Houghton Mifflin, 1975), p. 20.

[6] Studenski and Krooss, pp. 73-74.

[7] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 287, 5th ed. (1930); Robert Litan, *What Should Banks Do?* (Washington, DC: The Brookings Institution, 1987) p. 14 .

[8] Litan, pp. 14-15.

[9] Symons, pp. 688-89.

[10] Studenski and Krooss, pp. 60-61.

[11] John J. Knox, *A History of Banking in the U.S.* (New York: Augustus M. Kelley, 1966, reprint of 1900 ed.), p. 75.

[12] Stephen J. Friedman and Connie M. Friesen, "A New Paradigm for Financial Regulation: Getting from Here to There," 43 *Maryland Law Review* (1984): 413.

[13] Knox, p. 76.

[14] Ibid. For a complete recounting of the events that led to the bank crisis of 1837, see Hammond.

[15] Howard Hackley, "Our Baffling Banking System," 52 *Virginia Law Review* (1966): 570.

[16] Litan, p. 17; Klebaner, p. 95.

[17] Galbraith, p. 88.

[18] Hackley, p. 574.

[19] Klebaner, pp. 40-44.

[20] 13 Stat. 112 (1864).

[21] Studenski and Krooss, pp. 154-55.

[22] Litan, p. 21.

[23] Friedman and Friesen, p. 416.

[24] Studenski and Krooss, p. 155.

[25] Ibid., p. 114.

[26] Ibid., p. 178.

[27] Litan, p. 22.

[28] Kenneth Scott, "The Dual Banking System: A Model of Competition in Regulation," 30 *Stanford Law Review* (1977): 1.

[29] Litan, p. 22.

[30] *First Nat'l Bank of Charlotte v. Nat'l Exchange Bank*, 92 U.S. 122 (1875); Friedman and Friesen.

[31] W. Nelson Peach, *The Securities Affiliates of National Banks* (Baltimore: Johns Hopkins University Press, 1941), p. 53.

[32] 44 Stat. 1224, 1227 (1927); Peach, pp. 40-42.

[33] Galbraith, p. 111.

[34] Studenski and Krooss, p. 253.

[35] Ibid., pp. 253-54.

[36] Ibid. p. 255.

[37] 38 Stat. 251.

[38] 38 Stat. 259.

[39] Ibid.

[40] Report of the Committee Appointed Pursuant to House Resolutions 429 and 504 to Investigate the Concentration and Control of Money and Credit, 1913.

[41] Peach, p. 104: Historians differ on the causes of the numerous bank failures preceding and during the Great Depression. No attempt is made here either to evaluate those differences or to make an independent analysis of the causes. This section merely describes those events that led to the passage of the *Glass-Steagall* bill, without judging the wisdom of Congress in doing so.

[42] Ibid.

[43] Ibid, p. 156.

[44] Hackley, p. 577.

[45] Litan, p. 27.

[46] The *Competitive Equality Banking Act* of 1987 (P.L. 100-86) contained provisions that temporarily extended the prohibitions of the *Glass-Steagall Act* to FDIC-insured state nonmember banks. The temporary extension expired March 1, 1988.

[47] Statement of Comptroller of the Currency Dawes in 1924, quoted in Klebaner, p. 126.

[47] Ibid.

[49] Ibid., p. 59.

[50] Klebaner, p. 60.

[51] Ibid., pp. 127, 159.

[52] 70 Stat. 133 (1956). Codified at 12 USC 1841-50 (1982).

[53] 12 USC sec. 1842(d) (1982).

2

Current Issues in Bank Regulation: The Future of the Dual Banking System

PURPOSE AND SCOPE OF BANK REGULATION

The public policy objectives of bank and bank holding company regulation include the following: (1) protection of bank safety and soundness; (2) enhancement of competition; (3) avoidance of undue concentration; (4) protection of consumers and depositors; and (5) promotion of efficient credit allocation.[1] Traditional bank regulation seeks to implement these goals through the use of statutory provisions and regulatory guidelines designed for that purpose. Yet, many regulatory provisions do not fall neatly into one of the five categories. Instead, some can be justified under two or more categories, and others appear to further one goal while frustrating another. A review of some bank regulatory provisions illustrates the overlap and contradictions.

State and federal entry controls, such as the requirements of a charter, minimum capitalization, and deposit insurance fall within the category of preservation of safety and soundness. In practice, however, chartering requirements (particularly the omnipresent statutory provision directing the chartering authority to consider whether another bank is needed in the community in which the applicant bank proposes to locate) have been used to protect the monopoly franchise of existing banks, frustrating the pro-competitive objective of category two.

Portfolio regulation is another method by which governments control the safety and soundness of banks. Under this subheading belong investment standards, reserve requirements, and single borrower limits. Federal laws and most state laws permit banks to purchase government obligations but ban the purchase of corporate equities. Legislators have deemed the degree of risk in dealing in common stocks inimical to bank soundness. For similar reasons, state and federal laws restrict bank investment in real estate. Both of these limitations, however, are also thought to further the objective of avoiding undue concentration of economic resources (category 3). Single borrower limits, by which states restrict the magnitude of loans that a bank can make to any one borrower to a specified percentage of the bank's capital, have the effect of lowering risk by promoting portfolio diversification. Single borrower limits are also credit allocation devices (category 5).

Legislators have addressed category 2 concerns (the enhancement of competition) by imposing restrictions on the establishment of branches, requiring regulatory approval of bank mergers and holding company acquisitions. In practice, however, regulators can and do use each of these provisions as devices to control economic concentration.

Among the regulatory tools that are intended to protect borrowers and depositors are deposit insur-

ance, usury laws (legal ceilings on loan interest rates), disclosure requirements and anti-discrimination provisions. Again, many of these provisions serve a dual purpose, and others have unintended consequences. Deposit insurance safeguards consumer savings, but it is also the primary vehicle for the prevention of bank runs, a category 1 concern. Bankers argue that usury ceilings have credit allocation consequences, e.g., by allocating credit away from states that have strict usury laws.

None of the specific regulatory provisions crosses all five categories. No one of the four regulators—state bank superintendents, the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation—oversees all of these regulatory provisions.

Division of Responsibility among Regulators

The legislation that empowers each of the four bank regulators and delineates their tasks suffers from the same defects as do all laws. The language is frequently imprecise; later amendments often contradict the original law with which they must coexist; and over time new grants of power create duplication and overlapping jurisdiction. Regulators and bankers are quick to take advantage of these flaws.

The original dual bank regulatory scheme was relatively simple. It divided regulatory power between the two chartering authorities. According to the early scheme, state authorities chartered, regulated, supervised, and examined all state-chartered banks. The Comptroller of the Currency (OCC) had identical privileges with respect to nationally chartered banks. State law dominated in the area of branching, however.

Gradually, this simple system became more complex as Congress reacted to the various bank panics and crises by adding new layers of federal regulation. The *Federal Reserve Act* of 1913 gave the Federal Reserve Board (Board) some control over "member banks." For example, the act required member banks—all national banks and those state banks that voluntarily became members of the Federal Reserve System—to maintain reserves against their deposits. Also, state member banks became subject to the same capital requirements as national banks and to the same restrictions with respect to purchasing or lending on their own stock and payment of unearned dividends.

The *Banking Act* of 1933 added another layer of federal regulation with the creation of the Federal Deposit Insurance Corporation (FDIC). Although established primarily as an insurance agency, Congress gave the FDIC significant power over state "nonmember banks"—state banks that had not chosen to become members of the Federal Reserve System. One provision of the act required all state-chartered banks that wished to have their deposits insured by the FDIC to apply to that agency for insurance. With the creation of the FDIC, federal law as well as state law controlled entry into the state banking system. New state banks seeking charters applied first to the state banking authorities and then to the FDIC for approval, whereas national banks received insurance automatically on being granted a national charter. In return for federal insurance of their deposits, state nonmember banks submitted to federal regulation for the first time. The FDIC's regulatory control over state nonmember banks has grown significantly since 1933. For example, all bank mergers resulting in an insured state nonmember bank and all new branches of insured nonmember banks must be approved by the FDIC. Today, insured nonmember state banks are the largest class of federally regulated banks, comprising about 90 percent of the nearly 10,000 state banks.

Congress added a final layer of federal regulation in 1956 with the passage of the *Bank Holding Company Act* (*BHCA*). Actually, the *Banking Act* of 1933 had previously given the board some power to regulate bank holding companies. Because the 1933 act covered only bank holding companies that owned a Federal Reserve member bank, it created an incentive for national banks to convert to state charters in order to escape holding company regulation by becoming nonmember banks. The *BHCA* closed this gap by subjecting all bank holding companies to the authority of the Federal Reserve Board.[2] According to the act, a bank holding company, defined as an organization that owns 25 percent or more of the stock of a bank, must obtain the approval of the Federal Reserve Board before formation.

Given the heavy federal overlay on state bank regulation, it is no longer possible to classify bank regulation within the dual banking system along state/federal lines. To understand bank regulation today, one must first identify in which of four categories a particular bank belongs: (1) state member banks (regulated by states and the Board); (2) state nonmember banks (regulated by states and the FDIC); (3) national banks, (regulated by the OCC and the Board), and (4) bank holding companies (regulated by the Board and by some states).

Jurisdictional Overlap: Areas of Conflict

The diffusion of power among regulators can serve a salutary purpose, such as preventing industry representatives from capturing their regulators. It can also create interagency conflicts and turf battles. In some areas of bank regulation, interagency strife has arisen among the three federal regulators, involving the states only peripherally. In other areas, federal regulators have tangled directly with state

authorities by challenging state authority to regulate state-chartered banks.

Turf battles among the federal regulators are endemic to the system. Legislation delineating the respective powers of the three agencies is necessarily general; the regulators flesh out the law by interpreting its meaning and application to specific situations through regulations, interpretative guidelines, and policy statements. Over the years the conflicts between the OCC and the Federal Reserve Board have dominated the clashes among the federal regulators. In the mid 1960s their interagency disputes became headline news.[3] Congress documented their disagreements in subcommittee hearings on bills to consolidate federal bank supervisory functions.[4]

Typically, the disputes have involved differing interpretations of the law, each agency interpreting the law so as to increase its regulatory power. Consider, for example, the following conflicting interpretations of a federal funds transaction—a transaction in which a member bank whose reserves on deposit with its Federal Reserve bank are deficient will "buy" reserves from another member bank that has excess reserves on deposit with its Federal Reserve bank. In 1963, the OCC ruled that a federal funds transaction was neither a borrowing by the purchasing bank nor a loan by the selling bank for purposes of the statutory limit on loans and borrowings by national banks. The Board, however, ruled that federal funds transactions constitute loans and borrowings for purposes of the limitation on loans by member banks to their affiliates, a section of the law administered by the Board.

A similar "turf" battle occurred in a dispute over which of the two regulators would control the conditions under which a national bank could "accept"—i.e., guarantee payment of—drafts or bills of exchange that grow out of the importation or exportation of goods, the domestic shipment of goods, and/or the storage of certain goods covered by a warehouse receipt. The Board asserted control over the acceptance powers of national banks pursuant to a provision of the *Federal Reserve Act* that limited the amount that a member bank may "accept" for any one person as well as the aggregate amount of all such acceptances.[5] The OCC ruled that national banks were not subject to such limitations, basing this ruling on the *National Bank Act*. The making of acceptances, the Comptroller contended, was an "essential part of banking"; as such, it was within the "incidental" powers granted all national banks and not subject to any limitations in the *Federal Reserve Act*.[6]

More recently, the *Wall Street Journal* has reported the observations of a participant in a meeting among the three federal regulators and Vice President Bush as follows: "The yelling, bickering, and wild accusation were so heated that Vice President George Bush finally gave them all a blistering for their backbiting and bureaucratic rivalries."[7] Among the issues that divided the federal regulators were the following: (1) loans to other countries (the Board encouraging banks to continue lending to Third World countries, the FDIC and the OCC taking a more restrictive view of such loans); (2) nonbank banks (the Board refusing to approve applications for nonbank banks while the OCC frequently approved them); (3) capital requirements (the Board allowing banks to include goodwill and other intangibles in the calculation of their required capital, while the OCC and FDIC require banks to deduct goodwill and other intangibles from capital).

Similar examples of past disputes abound, and comparable conflicts exist today. One current battle among the federal regulators—whether the Board has the power to regulate the subsidiaries of all banks (including nonmember banks) that are members of a bank holding company—significantly affects the dual banking system. The dispute involves an interpretation of the provisions of the *Bank Holding Company Act*. The operative provisions of that act are found in section 3, which governs the acquisition of banks by a bank holding company;[8] section 4, which controls the nonbanking activities of a bank holding company and its nonbanking subsidiaries;[9] and section 7, which contains a provision to reserve powers to the states.[10]

Federal (the OCC and the FDIC) and state authorities argue that the history of the *Bank Holding Company Act* indicates that Congress intended to restrict the Board's power under that act to bank holding companies and their nonbank subsidiaries. Legal commentators agree that the act does not give the board authority to regulate the activities of banks themselves.[11] That power remains with the primary regulators of the banks: the OCC and the state banking supervisors. The Board cannot, under this view, order a bank to divest itself of an "improper" subsidiary because the Board lacks power to limit the activities of banks. State regulators cite these arguments and also point to section 7 of the *BHCA* as authority for their position. That section provides:

> **Reservation of Rights to the States.** The enactment of this chapter shall not be construed as preventing any State from exercising such powers and jurisdiction which it now has or may hereafter have with respect to banks, bank holding companies and subsidiaries thereof.

The Board has taken an opposing position. The Board admits that it cannot regulate the direct activities of state banks that are members of a bank holding company, but claims that it has the authority to regulate *subsidiaries* of all banks that are part of a bank

holding company system through section 4 of the *BHCA*. The specific language relied on by the Board prohibits a bank holding company from "acquiring direct or indirect ownership or control of any voting shares of any company which is not a bank. . . . " According to the Board, "by encompassing indirect as well as direct ownership interests, [section 4] of the Act prohibits a holding company bank as well as the holding company itself from owning more than 5 percent of the voting shares of any company engaged in impermissible nonbank activities. . . . "[12] The position of the board in this regard is somewhat anomalous: it admits to not having power over "improper activities" when conducted in the bank, but asserts control over the same activities when they are conducted in a bank subsidiary. Nevertheless, in a recent decision, the D.C. Circuit Court of Appeals agreed with the board, ruling that the BHCA gives the board authority to restrict the activities of subsidiaries of national banks that are owned by a bank holding company.[13]

No similar disputes exist among state regulators. This lack of conflict cannot be attributed, however, to the enlightened attitude of state regulators. It is, rather, a product of restrictive laws. Until recently, state and federal laws prohibited interstate banking and limited the activities of banks. These laws confined banks to one state, thereby escaping conflicts among regulators in different states; the laws also created a separation between the business of banking and that of other regulated entities, thereby avoiding jurisdictional disputes among regulators in the same state. Deregulation has removed many of these former restrictions. Based on the federal experience, one cannot rule out the possibility of conflicts among state regulators in the future.

Jurisdictional Overlap: Efforts at Coordination

Congress established the Federal Financial Institutions Examination Council (Council) in 1979 to "promote consistency in federal examinations and progressive and vigilant supervision."[14] The five-member council consists of the Comptroller of the Currency, the chairman of the FDIC, a member of the Board of Governors of the Federal Reserve System appointed by the chairman of the Board, the chairman of the Federal Home Loan Bank Board, and the chairman of the National Credit Union Administration. States are represented as nonvoting members of an advisory council.

To implement the general statutory mandate, Congress set forth three specific goals for the council: (1) to prescribe uniform principles, standards, and report forms for federal examinations of financial institutions by the five regulators represented on the council, (2) to develop uniform reporting systems for federally supervised financial institutions, their holding companies and their nonfinancial subsidiaries, and (3) to conduct schools for examiners employed by the five agencies.

These goals have proved elusive. For example, in 1985, the council approved a Uniform Report of Examination for commercial banks. Only the Federal Reserve implemented the new report, and in 1987 the council rescinded its earlier action approving the uniform report.[15] Nine years after it was created, the council is still unable to agree on a uniform report of examination. Although the council conducts a school for examiners pursuant to goal (3), the agencies involved view the council's training program as peripheral to their own individual bank examiner schools. Consequently, the council's schools have contributed little toward uniformity in the training of bank examiners. It is evident that the council has made scant progress toward realizing the goals of its empowering legislation. Cooperative efforts among state and federal regulators have fared better. The council has approved a General Policy for Sharing Confidential Information with State Banking and Thrift Regulatory Agencies.[16]

Although they are novices at the supervision and examination of banks across state lines, many state bank regulators have made admirable progress in creating uniformity and coordination of bank examinations with their counterparts in other states. No statutory organization, analogous to the federal council, exists to mandate uniformity in state bank regulatory practices. Nevertheless, the Conference of State Bank Supervisors (CSBS) has sometimes played a similar role in providing support for state efforts toward uniformity and cooperation.

Formed in 1902, the CSBS is a professional organization governed by a 12-member board composed of state bank supervisors and an advisory council made up of state-chartered bankers. The organization provides training (introductory through advanced) for state bank examiners and seminars for bank department supervisory personnel and attorneys throughout the nation. In 1987, CSBS conducted 25 schools and seminars for over one thousand students. The training programs have helped to create uniform standards in state bank examinations across the country.

The CSBS also conducts an accreditation program for state banking departments. Accreditation is a rigorous process, beginning with a self-evaluation conducted according to a set of criteria developed by CSBS, proceeding to an on-site evaluation and report thereof under the direction of the CSBS Performance Standards Committee, and a review by the organization's Audit Committee. Thirteen state banking departments have achieved accreditation, and others have begun the process.

Regional cooperation, discussed in the following section, is a new phenomenon, which arose as a result of bank deregulation.

EFFECTS OF DEREGULATION ON THE DUAL BANKING SYSTEM

Many times in the long history of dual banking in the United States, Congress has considered proposals to reform the system, which has been described as "baffling,"[17] "confusing," "inconsistent," "duplicative," and "a curse."[18] The reform movements have usually focused on abolishing state-chartered banks, although, as noted previously, much of the inconsistency and duplication in the system arises from turf battles among federal regulators, not from disagreements between state and federal regulators.[19] In recent years, however, regulatory reform through the elimination of state banks is rarely discussed. Indeed, the dual banking system has achieved the status of scripture.

If congressional regulatory reformers are unlikely to suggest today the outright abolition of the dual banking system, they are prone to propose or acquiesce in the erosion of the system through piecemeal preemption of state banking powers. The dual banking system may face peril from the states, too. As banks extend their operations interstate and expand the kinds of services that they can offer, state legislatures will have to pass laws and appropriate funds to enable bank departments to meet the challenge of an increasingly sophisticated industry, and state bank superintendents across the nation will have to work together to meet the regulatory and supervisory challenges brought on by their new powers.

THE STRENGTHS OF THE DUAL BANKING SYSTEM

Supporters and critics of the dual banking system both agree that the ability of new and existing banks to choose the set of laws and administrators under which they will operate is the heart of the dual banking system. Supporters deem this aspect of the system a boon to banks and consumers. The regulatory diversity is said to encourage innovation, increase competition, prevent economic concentration, and operate as an "escape valve from arbitrary or discriminatory chartering and regulatory policies at either the state or federal level...."[20] Critics characterize the system as one that fosters a competition in laxity that may result in a regulatory race to the bottom.

Whichever way one views the dual banking system (and the view may change depending on the particular time of observation), there is no doubt that the system has fostered competition among state and national banks; in so doing, it has changed the way that banking is conducted. Many of the changes in banking have begun at the state level; indeed, states have used the dual banking system to perform their historic role as laboratories for experimentation. On numerous occasions in the past, state experiments have provided models for federal bank legislation, including the *National Bank Act*, the establishment of the FDIC, the federal provisions for bank examinations, the use of checking accounts, and NOW accounts, and the payment of interest on deposits.[21] As described below, the experimentation continues today.

The dual banking system also allows states to control the kind of banking structure they will have within their boundaries. For example, by controlling the conditions for entry of an out-of-state bank and delimiting its in-state activities, a state can tailor its banking system to its particular needs. Finally, because citizens have greater access to state legislators and regulators, the dual banking system allows consumers of bank services (borrowers and depositors) to have a greater voice in the kinds of services that banks will provide. These aspects of the system are fragile. All such state powers can be preempted by congressional action. Ultimately, without congressional restraint, the dual banking system will not survive.

INTERSTATE BANKING

Since the inception of the dual banking system, states have controlled the interstate branching activities of banks and bank holding companies through the *McFadden* and the *Bank Holding Company Acts*, respectively. A state can exercise regulatory control over banks that are members of an out-of-state bank holding company by enacting laws that permit such banks to enter only if the parent bank holding company applies for and receives permission from the host state. Entry through a bank holding company gives a state maximum control over the bank. The vast majority of state laws that allow interstate branch banking do so through the bank holding company mechanism. One state, Massachusetts, allows direct branch banking. A legislative grant of entry through direct branching prevents the host state from exercising control over the branch, even if it is a state bank branch. The chartering state remains the primary regulator and supervisor of the branch.

In the late 1970s states began passing legislation permitting interstate banking. Some states passed legislation that provided for "regional reciprocal interstate banking." According to these laws, an out-of-state bank holding company can acquire a host-state bank only if (1) the principal place of business of the holding company is in one of the states named (usually in a contiguous area), and (2) the other state accords equivalent reciprocal privileges to banks of the host state.[22] Forty-four states allow some form of interstate banking. Twenty-eight states have passed re-

gional reciprocal interstate banking laws, and 16 states allow nationwide interstate banking.[23]

In addition, some states require the parent bank holding company to meet the credit and deposit needs of low and moderate income and minority residents, to meet the credit needs of small business in the community served, and to show that it has complied with the federal *Community Reinvestment Act*.[24] Other states require that the entering bank or its parent bank holding company must provide "net new funds" to the state.[25]

Regional reciprocal interstate banking laws have spawned a host of agreements among states and among the different regulators within states. Michigan, Georgia, Virginia, and California have been particularly active in these areas. For example, Michigan has entered into information-sharing agreements with the states in its statutory reciprocal interstate banking group.[26] The agreement between Michigan and Illinois is representative. According to that agreement, the Michigan Financial Institutions Bureau agrees to share with the Illinois Commissioner of Banks examination reports and other pertinent information on Michigan state banks controlled by a bank holding company that seeks to acquire an Illinois bank or bank holding company. The Illinois commissioner has made a reciprocal agreement with the Michigan Financial Institutions Bureau. Michigan has also entered into an agreement for the sharing of information with the Federal Reserve Board, the OCC and the FDIC. Within Michigan, the Financial Institutions Bureau has signed reciprocal information sharing agreements with the state's revenue commissioner and the Michigan State Police.

Examination coordination among regulators is also a key component of effective bank supervision. The Michigan bank supervisor, the state supervisors within Michigan's regional group and the three federal regulators cooperate closely in their examinations of bank holding companies and their affiliates that are located in one or more of the states within the reciprocal region. Typically, the federal and state regulators coordinate their examinations of the state and national banks that are a part of the bank holding company system; in such cases, the examinations of each member of the holding company and the holding company itself will take place simultaneously.[27] The joint examinations and information sharing allows all four regulators to learn promptly of a problem arising in a bank holding company or one of its banks (national or state, member or nonmember) and to discover whether the problem has spread to other banks within the holding company system. At the conclusion of the examinations, each regulator issues a separate examination report for each bank examined, and copies are distributed to all other participating regulators.[28]

The southeastern regional reciprocal group[29] has a similar information sharing and examination coordination plan in place. Georgia and Virginia have been leaders in this region. The procedures used in these states are similar to those in the Michigan plan in that they call for information sharing among the states in the reciprocal group and coordination of examinations among the states, the FDIC, the OCC and the board. Both Georgia and Virginia have given their bank supervisors broader regulatory authority than exists in Michigan, however. In Georgia and Virginia, the superintendents have legislative power to examine bank holding companies.[30]

Bank supervisors in both states maintain that the additional powers allow them to perform their duties with greater care.[31] Not only do the policies set at the holding company level affect the stability of the banks themselves, but the financial condition of the holding company itself also can have a direct impact on the safety and soundness of its banks. The problems in the bank holding company of Continental Illinois are cited as examples of both propositions. Georgia regulators add that their policies with regard to the frequency of examination of holding companies are more strict than the policies of the Board. For that reason, the Georgia department can spot and act on problems at the bank holding company level more quickly than the Board. In Georgia, state bank regulators handle the examinations of 95 percent of the state's bank holding companies.[32]

The Virginia commissioner notes that the broader power to examine the entire system enables the department to serve banks better, too. Instead of a piecemeal approach to bank examination, the Virginia department is able to provide a comprehensive report on the effect that the policies of the holding company are having on the entire system. The Virginia approach has been very beneficial to the dual banking system. For example, in 1977, 40 percent of all bank assets in Virginia were held by state banks, and in 1986 that percentage increased to 60 percent.[33] Control over the bank holding company also provides an effective regulatory tool in that the state bank supervisor can monitor the acquisitions of the bank holding company and require divestiture of a subsidiary in the case of serious infractions of the law.

Recently, the California Superintendent of Banks drafted a policy statement setting forth certain basic principles of regulatory cooperation for the regulation of interstate banking. Signed by 12 western states,[34] the document calls for officials of each signatory state to meet during the fourth quarter of each year to schedule and coordinate examinations, requires each state to accept the work performed by other signatory states as part of its supervision of interstate banking entities, and encourages signatory

states to seek any needed statutory authority to allow them to share information.[35]

One state, Connecticut, has experimented with creating a level regulatory playing field among competing industries through its statutory control over holding companies. In 1983 the Connecticut legislature established a "Commission to Study Legislation to Limit the Conduct of Business in Connecticut by Subsidiaries of Banking Holding Companies and the Impact of Non-Depository Institutions on Traditional Banking Activities." The commission found that the "greatest amount of activity in the financial services industry came in recent years . . . through the emergence of far-flung networks of outlets that organizations such as Sears, Merrill Lynch, Shearson/American Express . . . created to compete on a local level with services that banks traditionally provided."[36]

As a result of the commission's report, the Connecticut legislature passed legislation requiring all banks and savings and loan associations, corporations that own one or more banks or savings and loans, and the nonbanking subsidiaries of such corporations to obtain permission from the commissioner of banking prior to engaging in a "banking business" in an office in Connecticut. The statute defined a banking business as including the following activities: receiving deposits, paying checks, lending money, and any other activity determined by the banking commissioner to be so closely related to banking as to be a proper incident thereto. In 1984, the Connecticut commissioner found that several activities of Dean Witter, a Sears securities subsidiary, fell within the terms of the statute. Specifically, Dean Witter was involved in receiving deposits by brokering certificates of deposit for various financial institutions and by offering a "sweep account," by which a customer might elect to have the free funds in his account automatically invested in an account in one of Sears Savings Banks.

Sears and Dean Witter challenged the Connecticut law, contending that it violated the Commerce and Supremacy Clauses of the U.S. Constitution. The U.S. district court upheld the law, a decision that was upheld by the 2nd Circuit Court of Appeals.[37] Sears chose not to appeal the case further.

GRANTS OF NEW POWERS TO STATE-CHARTERED BANKS: SECURITIES UNDERWRITING, INSURANCE ACTIVITIES, AND REAL ESTATE INVESTMENT

At present, many states are actively experimenting with granting banks the power to engage in activities previously forbidden to them, such as securities and insurance brokerage and underwriting, and real estate investment and development. Banks have pushed for these new powers, arguing that allowing them to offer these new products and services will benefit everyone: consumers, who will enjoy reduced prices as a result of the increased competition; businesses, which will enjoy improved access to capital markets; state and local governments, which will likely pay lower interest rates on issues of municipal revenue bonds; banks, which will become more efficient and profitable through diversification and economies of scope; and the FDIC, which will face less exposure as banks become stronger.

As noted, the 1933 *Glass-Steagall Act* created a wall separating banking and securities activities. Sections 16 and 20 of the *Glass-Steagall Act* prohibit federally chartered and state-chartered member banks from purchasing, dealing in, or underwriting nongovernment securities for their own account (sec. 16) and from affiliating with any corporation engaged principally in the prohibited activities (sec. 20). Section 21 of the act forbids the *same entity* from both engaging in securities activities and receiving deposits. The *Glass-Steagall* prohibitions do not apply to two kinds of entities: state nonmember banks and securities firms that own nonbank banks.[38]

The exemption for state nonmember banks was intentional; Congress did not believe that it had the constitutional authority to regulate state-chartered banks, a view that is discredited today.[39] Consequently, the securities activities of state nonmember banks are governed solely by state law and the FDIC. All state nonmember banks are subject to an FDIC rule that requires them to conduct securities activities in a "bona fide subsidiary."[40]

The FDIC rule defines a bona fide subsidiary as one that is adequately capitalized and physically separate in its operation. It must maintain separate corporate records and have separate employees who are compensated by the subsidiary. The subsidiary must conduct business pursuant to independent policies and procedures, and obey certain "fire wall" provisions designed to prevent risky financial activities from endangering the traditional banking operations of making loans and receiving deposits.[41] The rule limits the securities subsidiary's underwriting activities to investment quality debt and equity issues and mutual funds. The FDIC does not require state nonmember banks to form a bank holding company prior to engaging in securities activities.

Today, 23 states allow their state-chartered banks to engage in various securities activities.[42] New York has taken the lead among the states in aggressively seeking new securities powers for its state banks. In December 1986, New York's Superintendent of Banks issued an interpretation of the state's mini *Glass-Steagall Act*. Like the federal law, the New York *Glass-Steagall Act* prohibits affiliations between a bank and a securities subsidiary that is "engaged

principally" in underwriting securities. According to the superintendent's interpretation of the phrase "engaged principally," a state bank can affiliate with a securities firm if the firm's "impermissible" (i.e., forbidden under the state's mini *Glass-Steagall Act*) securities underwriting activities constitute less than 25 percent of its total securities underwriting activities.[43]

Recently, the New York superintendent has sought a limited repeal of the state's mini *Glass-Steagall Act*. The proposed legislation would allow securities affiliates of state banks to underwrite and deal in mutual funds, municipal revenue bonds, investment grade corporate bonds, commercial paper, and asset-backed securities.[44] The proposal contains a number of "fire wall" restrictions. For example, a bank could contribute no more than 10 percent of its capital, through loans or investments, to a securities affiliate (the aggregate limit is 20 percent). Other restrictions would (1) require disclosures to customers that securities subsidiary obligations are neither insured by the FDIC nor backed by the parent bank, (2) forbid loans to customers for the purchase of securities from the bank subsidiary for the underwriting period and 30 days thereafter, and (3) prohibit the securities subsidiary from selling securities to the bank or its trust accounts during the above period.[45]

States have also relaxed their prior prohibitions against engaging in insurance activities, such as acting as an insurance agent or broker or underwriting insurance policies. Thirteen states now allow banks to underwrite insurance and/or act as an insurance agent or broker.[46] Other state laws mirror the federal prohibitions against bank involvement in insurance.

According to the Garn-St.Germain *Depository Institutions Act* of 1982, insurance is not deemed a service "closely related to banking"; therefore, bank holding companies subject to the regulatory control of the board are banned from engaging in such activities. Exceptions to the general prohibition allow banks to sell general insurance in towns with populations of less than 5,000 and small bank holding companies (those with less than $50 million in assets) to sell insurance anywhere. Also, under the act, banks can sell credit-life, accident and health, and involuntary unemployment insurance, as well as property insurance on collateral that secures loans of $10,000.

Some states have long considered insurance to be a permissible activity for banks either without restrictions or with limited restrictions. For example, the North Carolina banking code never contained provisions forcing a separation between banking and commerce. The 54 state nonmember banks in North Carolina are free to invest in a variety of commercial businesses, including insurance underwriting and brokerage, subject to the approval of the bank commissioner. Approval is granted if the commissioner finds that the activity is consistent with the continued safety and soundness of the bank (e.g., the bank has sufficient capital, earnings, and liquidity and is well managed). Once approval is received, the bank may conduct the approved activities within the bank or in a subsidiary, according to its business judgment. Presently, two banks are engaged in general insurance underwriting; one in the bank directly, the other in a bank subsidiary. Three banks act as general insurance brokers.[47]

Indiana law has allowed banks to act as agents or brokers for property and casualty insurance since 1933. Indiana banks can choose to offer these services either directly in the bank or through a bank subsidiary.[48] Currently, about 50 nonmember banks act as insurance agents or brokers, and 15 of those sell insurance out of state.[49]

Until recently, most state laws prohibited banks from investing in real estate. A typical state statute would limit a bank's investment in real estate to that needed and used for its home office. Approximately 25 states have eased those restrictions and now permit state banks to invest in and develop real estate and/or act as a real estate broker, subject to certain limitations.[50] Virtually all of these states have imposed investment limitations on the real estate powers of their banks. For example, California law permits its banks to invest in, purchase, develop, manage, and sell real property, but limits that authority to (1) 10 percent of the bank's assets if the activities are conducted in a bank subsidiary, or (2) the amount of the bank's capital if the real estate activities are conducted in the bank directly.[51]

Some states tie the aggregate amount of funds that a bank may invest in real estate to the bank's performance in meeting the community's credit needs. For example, the state of Washington limits the total amount of funds that a bank may invest in real estate to 2 percent of its capital, surplus, and undivided profits. The percentage can be increased, however, if the bank has received a high score in meeting its community's credit needs. Washington law lists several factors to be considered in assessing the bank's record of performance, including: (1) the institution's participation in governmentally insured or subsidized loan programs for housing, small businesses, or small farms; (2) the geographic distribution of the institution's credit extensions, credit applications, and credit denials; (3) evidence of prohibited discriminatory or other illegal credit practices; and (4) the institution's participation, including investments, in local community development projects. A bank that receives a community reinvestment score of "1" (excellent performance) can increase its aggregate investment in real estate to 10 percent; a score of "2" (good performance) enables a bank to increase its real estate investment to 8 percent, and so on.[52]

ENDNOTES

[1] Peter D. Saba, "Regulation of State Nonmember Insured Banks' Securities Activities: A Model for the Repeal of *Glass-Steagall*," 23 *Harvard Journal of Legislation* (1986): 211, quoting Paul Volcker in "How the Financial System Can Best Be Shaped to Meet the Needs of the American People, Financial Deregulation: Hearings Before the House Committee on Banking, Finance and Urban Affairs, 98th Cong., 2d Sess. 1680 (1984).

[2] The 1956 *Bank Holding Company Act* (and the Douglas Amendment thereto) applied only to multibank holding companies. In 1970, the act was amended to bring one-bank holding companies under the supervision of the Federal Reserve Board and to subject them to the geographical restrictions of the Douglas Amendment.

[3] See, for example, *Business Week*, January 4, 1964, p. 21; *Washington Post*, January 3, 1964, sec. A, p. 14, col. 1; *New York Herald Tribune*, March 23, 1965, p. 31, cols. 2-5; p. 32, col. 1.

[4] Hearings Before the Subcommittee on Bank Supervision and Insurance of the House Committee on Banking and Currency and the House Committee on Banking and Currency on H.R. 107 and H.R. 6885 with Respect to the Consolidation of Bank Examining and Supervisory Functions (1965).

[5] 12 U.S.C. sec. 372 (1964).

[6] Hackley, "Our Baffling Banking System" 52 *Virginia Law Review* (1966): 599, 616.

[7] *Wall Street Journal*, January 23, 1985, p.1

[8] 12 U.S.C sec. 1842 (1982).

[9] Ibid., sec. 1843.

[10] Ibid., sec. 1846.

[11] Carter Golembe & H. Holland, "Expansion Possibilities for Nonmember Banks," *Banking Expansion Report*, 10, January 15, 1982; Saba, pp. 225-26.

[12] 50 *Federal Register*, p. 4522, n. 3 (1985) (emphasis in original).

[13] *American Insurance Assoc.* v. *Clarke*, D.C. Civil No. 85-1489, decided August 23, 1988.

[14] Federal Financial Institutions Examination Council, *1987 Annual Report*.

[15] Ibid. p. 4.

[16] The FDIC has contributed significantly toward federal/state cooperation and coordination. For example, many states presently use examination report forms provided by that agency; in 1987, 474 state examiners attended training courses at the FDIC training center and an additional 120 participated in courses held at field locations; and the agency allows states direct access to its computer database.

[17] Hackley, p. 15.

[18] Hearings on the Operation of the National and Federal Reserve Banking System Before the Senate Committee on Banking and Currency, 72d Cong., 1st Sess., part II, p. 395 (1932), quoted in Scott, p. 1. For a list of quotes, see generally, Scott, ibid.

[19] Some legal commentators have argued for unification at the federal level while retaining state regulation and supervision of state banks. See, e.g., J. L. Robertson, "Federal Regulation of Banking: A Plea for Unification" 31 *Law & Contemporary Problems* (1966): 673.

[20] W. Brown, *The Dual Banking System in the United States* (Washington, DC: American Bankers Association, 1968): pp. 59, 64.

[21] National banks, too, have actively experimented with new powers. For example, beginning in 1961, Comptroller of the Currency James J. Saxon, issued a series of rulings in which he interpreted the *National Bank Act* to allow national banks to expand their powers in order to improve their competitive position. Comptroller Saxon authorized national banks to engage in the insurance, personal property leasing, and data processing businesses; to operate travel agencies; to engage in branch banking via courier services; and to engage in securities activities, such as revenue bond underwriting. Some of the Comptroller's rulings were struck down by the courts. See, Dunn, "Expansion of National Bank Powers: Regulatory and Judicial Precedent Under the *National Bank Act*, *Glass-Steagall Act*, and *Bank Holding Company Act*" 36 *Southwestern Law Journal* (1982): 765.

[22] The U.S. Supreme Court has upheld the constitutionality of such laws. *Northeast Bancorp* v. *Board of Governors*, 472 U.S. 159 (1984).

[23] Twelve of the 28 regional reciprocal state laws have a trigger date to nationwide interstate banking. See Conference of State Bank Supervisors, *State of the State Banking System* (1988).

[24] As of mid-1987, the following states had such laws: District of Columbia, Illinois, Indiana, Maine, Maryland, Michigan, Minnesota, Nevada, New Hampshire, New York, Pennsylvania, Utah, Vermont, Washington, West Virginia, and Wyoming. See *Legislative Sourcebook on Financial Deregulation* (Washington, DC: National Center for Policy Alternatives, Public Capital Series, 1988), p. 113.

[25] Ibid. The states that have such requirements include Illinois, Maine, Minnesota, New Hampshire, and Vermont.

[26] The members of the group include Illinois, Indiana, Ohio, Wisconsin, and Minnesota.

[27] According to a representative of the Michigan Financial Institutions Bureau, the need for such cooperation became evident with the failure of Penn Square Bank. Penn Square, an Oklahoma bank, sold loan participations to larger banks in several states. Michigan National Bank was one of the purchasers of Penn Square loan participations, which it then distributed among several other Michigan banks in its holding company system, including several state-chartered banks. As the Penn Square loans began to go bad, the four regulators (the Federal Reserve Board, the Comptroller, the FDIC and State Supervisor) had little contact with each other even though all banks in the Michigan National Bank holding company system were affected. As a result, some inconsistency occurred in regulatory classification of the loans. The new policy of simultaneous examinations and information sharing would avoid such problems. Phone conversation with Don Mann, Director, Bank and Trust Division, Michigan Financial Institutions Bureau, April 21, 1988.

[28] Ibid.

[29] The southeastern regional reciprocal group includes: Georgia, Virginia, Maryland, North and South Carolina, Florida, Tennessee, Alabama, Kentucky, Mississippi, Washington DC, and Louisiana.

[30] Sixteen other states have passed similar legislation. See, Conference of State Bank Supervisors, *State of the State Banking System.*

[31] Phone conversations with John Kline, Deputy Commissioner for Bank Supervision, Georgia, May 3, 1988, and with Sidney Bailey, Commissioner of Financial Institutions, Virginia, April 20, 1988.

[32] Phone conversation with John Kline, May 3, 1988.

[33]Phone conversation with Sidney Bailey, April 20, 1988.

[34]Those states are Alaska, Arizona, California, Idaho, Montana, Nevada, New Mexico, Oregon, Texas, Utah, Washington, and Wyoming.

[35]From documents provided by John R. Paulus, California Deputy Superintendent of Banks.

[36]Report to the General Assembly of the State of Connecticut of the Findings and Recommendations of the Commission to Study Legislation to Limit the Conduct of Business in Connecticut by Subsidiaries of Banking Holding Companies and the Impact of NonDepository Institutions on Traditional Banking Activities, 5-7, 10-11 (January 5, 1983).

[37]*Sears Roebuck and Co.*, v. *Brown*, 806 F2d 399 (2nd Cir.1986).

[38]A nonbank bank is an entity that either accepts deposits or engages in the business of making commercial loans, but not both. Formerly, such an entity was not a "bank" for purposes of the *BHCA*, which defined a bank as an entity that does both. Congress closed the nonbank bank loophole in the *Competitive Equality Banking Act* of 1987 (P.L. 100-86), by redefining a bank as an institution that is insured by the FDIC. About 170 nonbank banks established prior to March 5, 1982, are protected in part by the grandfather clause in the Act. Securities firms that are affiliated with a nonbank bank are not subject to the prohibitions of the *Glass-Steagall Act*. First, they do not come within section 21 because that section only bans a securities firm from directly taking deposits; it does not prohibit deposit taking if it is done through a subsidiary or affiliate. Second, the use of a nonbank bank allows the securities firm to avoid regulatory oversight by the board.

[39]Saba.

[40]12 *Code of Federal Regulations*, sec. 337.4(b)(1)(ii) (1985).

[41]For a complete list of the required provisions, see 12 *Code of Federal Regulations*, sec. 337.4(a)(2)(i)-(ix).

[42]Fourteen states allow banks to engage in some securities underwriting and 17 allow securities brokerage. Some states allow both. See Conference of State Bank Supervisors, *State of the State Banking System*.

[43]"NY Ruling to Pressure Congress," *American Banker*, January 2, 1987, p. 1.

[44]"NY Regulator Prepares Draft Bill Allowing Banks in Securities," *American Banker*, March 10, 1988, p. 16.

[45]Ibid.

[46]Conference of State Bank Supervisors, *State of the State Banking System*. Three of these states allow insurance underwriting and 13 permit banks to own or operate an insurance agency.

[47]Phone conversation with William Graham, North Carolina Commissioner of Banks, May 16, 1988.

[48]Phone conversation with Jim Cooper, Administrative Assistant, Indiana Department of Financial Institutions, May 17, 1988.

[49]Phone conversation with William King, President of the Indiana Bankers Association, May 17, 1988.

[50]Conference of State Bank Supervisors, *State of the State Banking System*. Twenty-five states allow banks to engage in real estate development and six allow them to act as a real estate broker.

[51]As of December 31, 1987, the total investment of California state chartered banks in real estate development amounted to one-half percent of total state bank assets. Data supplied by John R. Paulus, California Deputy Superintendent of Banks.

[52]*Washington Revenue Code Annotated*, sec. 30.60.010; 30.04.212 (1986). The Washington law is modeled after a 1984 New York law.

3

Federal Activity and Proposed Preemption

ISSUES OF PENDING LEGISLATION

Historically, the relaxation of regulatory restraints over bank activities at the state level has spurred similar changes at the federal level. This action/reaction regulatory response is central to the dual banking system. It continues today.

States began to remove their prior geographic barriers and restraints on bank products and services in the late 1970s. In the mid 1980s, congressional committee hearings and federal agency reports on expanded bank powers mushroomed, and culminated in proposed legislation and agency rules. The future shape of bank powers and bank regulation as sculpted by proposed federal legislation and regulations sharply curtails state control over banking.

The issue at the heart of the state/federal tension is the form in which banks shall be allowed to exercise their new powers. Bank regulators agree that the regulatory goals of safety and soundness dictate that certain securities activities, such as underwriting commercial paper, investment grade corporate bonds and asset-backed securities, which are subject to SEC requirements, should be conducted in an entity separate from the bank.[1] Most regulators would add insurance underwriting to the list of activities that should be physically separated from the bank.

As noted, the FDIC has issued a rule that requires state nonmember banks to conduct their securities activities in a bona fide bank subsidiary. Similar FDIC rules on insurance and real estate subsidiaries stalled when a turf dispute arose between the FDIC and the board.[2] The FDIC rules do not change the balance of power between state and federal regulation. As is the case now, (1) state law controls whether a state nonmember bank can engage in securities activities; (2) if the state bank engages in securities activities pursuant to state law, it can do so only in a separate bank subsidiary; and (3) two regulators, the FDIC and the appropriate state superintendent will supervise the bank, the board has no authority over either the bank or its securities subsidiary.[3] The balance struck by Congress under the current scheme gives due regard for the rights of states and the interest of the federal government in the protection of the federal deposit insurance fund.

Under proposed federal legislation, however, the board would have the sole authority over the securities activities of banks. The 1988 Proxmire-Garn bill (S.1886) would substantially repeal the *Glass-Steagall Act*. Passed in the Senate by a vote of 94-2, S. 1886 permits banks to underwrite and sell a broad range of securities through affiliates owned by federally regulated bank holding companies. Like the proposed New York State law, S. 1886 contains fire wall limitations on loans and other interaffiliate transactions between banks and their securities affiliates to

prevent risky investment activities from endangering federally insured bank deposits.

Unlike the FDIC rule that requires state nonmember banks to house their securities activities in a separate subsidiary but allows states to permit or prohibit such activities in the first instance, the Proxmire-Garn bill would broadly preempt state control over the securities activities of state nonmember banks.

S.1886 entirely removes such state control and adds a third layer of regulation on state nonmember banks. Under the bill, all banks (national, state member, and state nonmember) can engage in securities activities only if (1) they do so through a bank holding company, (2) they receive approval from the Board to engage in such activities, (3) they become subject to the Board's regulatory and supervisory authority. Thus, states that have determined that certain securities activities are permissible for their banks, subject to certain restrictions, will no longer be allowed to sanction those activities. Conversely, other states that have found securities activities too risky for their banks will no longer be permitted to ban such activity. S. 1886 denies states the right to prohibit securities activities if they are conducted by a state bank that has received the Board's approval.

The usual justification that is offered for the broad preemption of state authority over nonmember banks is that the federal deposit insurance fund will be put at risk if a bank's securities activities are not conducted in an affiliate of a bank holding company, rather than in the bank directly or in a subsidiary of the bank.

This statement implies that (1) all securities activities are more risky than traditional bank activities, and (2) the insulation between banking and securities activities necessary to protect the federal deposit insurance fund can be accomplished only through the use of a bank holding company, rather than through a bank subsidiary.

Few regulators have agreed with the first point. Economists, too, make risk-based distinctions among various securities products. For example, one economist, Anthony Saunders, has measured the degree of risk between corporate bonds (which banks cannot underwrite because of the *Glass-Steagall Act* and which would be permitted by S. 1886 only in an affiliate of a bank holding company) and general obligation municipal bonds (which banks are allowed to underwrite directly within the bank).[4] According to Saunders, the fluctuations in yields of corporate bonds were lower between January 1978 and March 1983 than were the fluctuations in yields of the general obligation municipal bonds.[5] Robert Litan, in his recent book *What Should Banks Do?*, makes the point that:

> . . . considered in isolation, underwriting securities involves less risk than extending and holding loans. In a typical securities offering, the underwriter bears the risk of loss for only a few days, whereas a commercial bank bears the risk of a loan default until the loan is repaid. In addition, by definition, the underwriter deals in assets that are liquid and readily traded; despite the progressive securitization of commercial bank balance sheets, most bank loans remain illiquid because they are specific to the borrower.[6]

The second point raises two subissues: how to control the potential conflicts of interest and cross-subsidization that may arise as a result of banks entering into securities activities, whether through a bank holding company affiliate or a bank subsidiary (the "fire wall" problem); and how to ensure that banks do not become legally liable for debts incurred by their securities activities whether conducted through a bank holding company affiliate or a bank subsidiary (the "piercing the corporate veil" problem).

S. 1886 contains numerous fire wall provisions that are designed to insulate a bank from the activities of its securities affiliate, including prohibitions against extending credit to its securities affiliate, purchasing for its own account the financial assets of a securities affiliate, and extending credit to an issuer of securities underwritten by the securities affiliate for the purpose of paying the principal of those securities or interest or dividends on those securities. Identical provisions can be put in place for banks and their securities subsidiaries.[7] Indeed, in the insurance industry, such fire wall provisions between insurance companies and their subsidiaries have been in place for many years.[8] As noted previously, the New York State bank superintendent has proposed similar fire wall provisions for state banks that engage in securities activities through subsidiaries.

By placing securities activities in a separate corporate entity, whether it be an affiliate of a bank holding company or a bank subsidiary, a bank can take advantage of the legal principle of limited liability. That principle holds that every corporation is a legal entity distinct and separate from its shareholders; accordingly, a bank would not be legally liable for the debts or actions of its subsidiary or affiliate.

Samuel Chase, an expert in the area of the application of the principle of limited liability to banks, has noted that unless banks ignore or abuse the principle, courts will not breach the separateness of the corpo-

rations.[9] Typical abuses that may cause a court to "pierce the corporate veil" and hold a bank liable for the debts of its subsidiary or affiliate include: (1) misleading representations and actions (i.e., a bank represents that it stands behind a subsidiary or an affiliate and a third party relies on the representation to his detriment); (2) illegitimate activities or purposes; (3) failure to observe corporate distinctions; and (4) inadequate capitalization of the subsidiary or affiliate.[10] In the above four circumstances in which a court may pierce the corporate veil, courts make no distinction between an affiliate and a subsidiary except in the fourth circumstance. It is less likely that a bank would be held liable for the debts of an undercapitalized securities affiliate than it would be for the debts of an undercapitalized subsidiary. Thus, the use of a undercapitalized subsidiary may create more risk of piercing the corporate veil than would the use of an undercapitalized affiliate.

There is some reason to believe that the use of a bank holding company affiliate under the current practice of the Board and the FDIC will weaken the legal insulation of banks from the losses and debts of their bank holding company securities affiliates. According to Chase, several current policies of federal regulators undermine the insulation between a bank and its affiliate. For example, the Federal Reserve Board's prescription of capital adequacy standards for bank holding companies, which are nearly identical with those required for banks, sends an "unmistakable signal to the private markets that the government assumes an important measure of responsibility for the financial soundness of entire bank holding companies as opposed to banks."[11] The board's "source of strength" doctrine, by which the board requires a bank holding company to provide financial aid to its problem banks, "reinforces the impression that the Federal Reserve takes responsibility for assuring the financial strength of companies that own banks and nonbank subsidiaries of those companies."[12]

Some commentators note that both managers and customers of bank holding company banks view such institutions as integrated entities.[13] This fact has led at least one legal scholar to disagree with Chase's legal analysis. Philip Blumberg has concluded that the "piercing" doctrine, which is based on a separate entity theory, is gradually being replaced by an "enterprise" approach. The latter approach requires an analysis of the underlying economic realities of the relationships between units in order to determine whether a common enterprise exists.[14] A finding of the existence of a common enterprise would allow a court to treat the holding company and its affiliates as one entity without the need to pierce the corporate veil. Blumberg notes, however, that in the vast majority of cases, courts apply the separate entity theory.

Another scholar, Robert Litan, favors the holding company mechanism for reasons unrelated to legal theories. Litan cites three advantages of the holding company approach. First, the use of a holding company structure would end the disparity between the activities open to bank holding companies and those open to state banks. Second, the holding company organization would be more likely to prevent deposit insurance from subsidizing nonbanking activities;[15] and third, the use of the holding company mechanism would vest agencies at the federal level with all responsibility for supervising the transactions and affiliations between nonbank and bank activities.[16]

After reviewing all possible structures that a bank or bank holding company could establish for its expanded activities, the U.S. General Accounting Office concluded that "one cannot say that one structure insulates the bank while another does not."[17] The GAO report also noted the disadvantages to banks associated with the use of a bank holding company structure, such as additional administrative cost, delays in obtaining regulatory approvals, loss of the benefits of product diversification and loss of economies of scope. The latter two disadvantages are particularly important because the advantages promised as a result of permitting banks to engage in securities activities were to come from product diversification and economies of scope.

In sum, while there is some evidence to support the case for all securities activities to be conducted in an affiliate of a bank holding company rather than in an independent bank subsidiary in order to protect the federal deposit insurance fund, that evidence is rebutted by the dominant legal theory of corporate separateness and by the Board's own policies, such as its "source of strength" doctrine and capital adequacy guidelines for bank holding companies. Conversely, there is much evidence that the use of a bank holding company affiliate as the vehicle for expanded powers will decrease the promised benefits of the additional powers.[18]

The Proxmire-Garn proposal would also preempt state laws that govern the insurance activities of banks. S. 1886 prohibits all bank holding company banks and bank subsidiaries from providing insurance as principal, agent, or broker. The bill makes an exception for a state bank that is a member of a bank holding company. Such a bank or its subsidiary can sell insurance as an agent or broker if (1) the bank is located in the same state in which the operations of the bank holding company parent are principally conducted; (2) the activities are authorized by the state; and (3) the insurance is sold only to residents of that state or to companies headquartered in the state. The bill flatly prohibits national banks from engaging in most insurance activities. Thus, the pro-

posed law not only prevents state banks from competing in the large interstate insurance market but also creates a statutory imbalance in the powers permitted state banks and those granted to national banks.

As currently drafted, the Proxmire bill preempts state laws only with respect to the securities and insurance activities of banks, yet it may become a model for future federal regulation of all new bank activities. The Federal Reserve Board recognizes this fact. In testimony before the Senate Committee on Banking, Housing and Urban Affairs, Federal Reserve Chairman Greenspan noted that S. 1886 is "precedent setting because it establishes a framework that can be tested and, if it proves adequate as we expect it will, should serve as a foundation on which to build more generally for the future."

In fact, the Board has attempted to preempt state control over the real estate activities of state banks in much the same way that the Proxmire bill does with regard to securities. In January 1987, the Board published its proposed rules on the permissibility of real estate investment activities for bank holding companies. The Board's proposal would preempt state laws governing the real estate activities of state banks by prohibiting state banks that are members of bank holding companies from engaging in such activities through bank subsidiaries unless and until they meet the regulatory and supervisory limitations set by the Board. The Board's proposed real estate rule is still pending.[19]

As evidence of the need for greater federal control, proponents of federal preemption point to the growing crisis in the savings and loan industry. These advocates maintain that the problems in the thrift industry can be traced to state legislators and regulators who removed all prior restrictions on the investments of state-chartered thrifts, allowing them to speculate without restraint. The resulting failures and liquidations have cost the Federal Savings and Loan Insurance Corporation (FSLIC) billions of dollars and have left that fund bankrupt.

Financial institution analysts portray a more complex picture of what went wrong with the thrift industry, however. Most analysts agree that the industry's problems began more than a decade ago and that blame for its woes must be shared by Congress, federal and state regulators, and the industry itself. A recent story in the *New York Times* quoted in the Congressional Record summarizes the assignment of culpability as follows:

> Federal regulators, who frequently bowed to political pressure from an industry known for its powerful grass-roots lobbying, have come under fire for deregulating the thrift industry piecemeal and granting too much leeway in accounting practices. The [Federal Home Loan] Bank Board, the industry's primary regulator, is criticized for being too close to the thrift units it regulated, and for responding with inadequate resources and ill-trained examiners when the situation began to unravel.
>
> And the industry . . . was unable to cope with the high interest rates that sprang from the late 1970s and spurred deregulation. Many executives lacked expertise to compete in the new world of finance. Several states—particularly Florida, Texas, and California, trying to protect the interests of their state-chartered savings and loans—passed their own . . . sweeping deregulatory provisions.
>
> In 1984, [Congress] failed to support the Bank Board and the Federal Deposit Insurance Corporation in attempting to stop money brokers from placing large sums of insured deposits at risk-taking thrifts and banks.[20]

The enormous losses that the thrift industry has borne and continues to bear are sobering. Few would argue, however, that state regulators are the primary culprits and that wholesale preemption of state laws is the cure.

CONCLUSION

The dual banking system has allowed states to carry out their historic mission as laboratories for experiments. Many of the regulatory tools and bank products in common use today were first introduced at the state bank level. States are continuing to perform this role today. State legislators and regulators are involved in a variety of activities from removing or relaxing prior bans on interstate banking and coordinating bank examinations with their counterparts across state lines and within the federal system, to designing systems under which banks can safely offer new products and services, to creating a legislative scheme under which banks and bank-like institutions and products compete on a level regulatory field.

When conducted with due regard for the safety and soundness of the banking system, these state experiments further the regulatory goals of enhancement of competition, avoidance of undue concentration, protection of consumers and depositors, and promotion of efficient credit allocation. The first two goals in particular will suffer if Congress and federal

regulators require that new bank products and services be conducted only under the umbrella of a bank holding company, since new bank products and services will be conducted primarily by the bigger bank holding companies.

Despite its continuing vitality, the dual banking system is fragile. Its survival depends on state legislators who will have to pass laws and appropriate funds to enable state banking departments to meet the challenge of an increasingly sophisticated industry, and on state bank supervisors, who will have to work together to meet the regulatory and supervisory challenges that the new powers bring.

Ultimately, however, without congressional restraint, the dual banking system will not survive. Pending congressional and federal regulatory proposals would broadly preempt state control over the new powers of banks, granting sole regulatory and supervisory control over such powers to the Federal Reserve Board. State banks could avoid such control only by refraining from engaging in new activities or from offering new products, an action that may in itself drain the vitality from the dual banking system and hasten its demise.

ENDNOTES

[1]Some state regulators believe that banks should be allowed to conduct certain securities powers directly. Included among the securities powers deemed permissible activities by a bank are: underwriting U.S. Treasury obligations, state and local general obligation bonds, municipal revenue bonds, and mutual funds registered with the SEC. Statement of Jill M. Considine, New York State Superintendent of Banks, before the New York State Senate Banks Committee, March 8, 1988.

[2]In December 1987, the FDIC rule on insurance and real estate was formally withdrawn, based on the amount of time that had elapsed since the proposal was published for comment and the lack of substantial evidence regarding the degree of risk to the insurance fund. The staff is currently reevaluating the issue. Information provided by Robert F. Miailovich, Associate Director, Division of Bank Supervision, FDIC.

[3]As noted previously, a dispute currently exists as to whether a securities, real estate, or insurance subsidiary of a state nonmember bank that belongs to a bank holding company is subject to further regulation by the Federal Reserve Board. The board has attempted to assert its power over such activities by refusing to approve bank holding company acquisitions of banks that engage in such activities either directly or through a subsidiary. According to the board, banks that are members of a bank holding company cannot engage in securities underwriting, real estate, and/or insurance because they are impermissible activities under the *BHCA*.

[4]Anthony Saunders, "Bank Safety and Soundness and the Risks of Corporate Securities Activities," in Ingo Walter, ed., *Deregulating Wall Street* (New York: John Wiley and Sons).

[5]Ibid., p. 174.

[6]Litan, p. 89.

[7]Firewalls can also be put in place to insulate traditional bank activities from securities activities conducted within the bank itself. For example, life insurance companies have for years maintained separate accounts for certain customers that cannot be commingled with their general assets. See "Corporate Separateness as a Tool of Bank Regulation," Samuel Chase & Company. Study prepared for the Economic Advisory Committee of the American Bankers Association (1983), p. 22.

[8]Samuel Chase and D. Waage, "Corporate Separateness as a Tool of Bank Regulation," prepared for the Economic Advisory Committee of the American Bankers Association (1983), p. 26.

[9]Ibid., pp. 9-12. Samuel Chase, "Insulating Banks from Risks Run by Nonbank Affiliates," prepared for the American Bankers Association (1987), pp. 12-15.

[10]Ibid.

[11]Ibid., p. 30.

[12]Ibid., p. 31.

[13]Litan, p. 104.

[14]Blumberg, *The Law of Corporate Groups* (1985).

[15]Litan recognizes, however, that the holding company mechanism will not necessarily prevent banks from assisting their nonbanking affiliates if the affiliates face financial trouble, and that even in a holding company system banks can induce their parent holding companies to assume risks in diversifying their activities. Litan, pp. 146, 104.

[16]Ibid., pp. 147-48.

[17]U.S. General Accounting Office, *Bank Powers: Insulating Banks from the Potential Risks of Expanded Activities*, (Washington DC: U.S. General Accounting Office, 1987).

[18]See, e.g., Litan, p. 147, and GAO, *Bank Powers*.

[19]See "Regulations Regarding Real Estate Investment and Development Activities of Subsidiaries of Holding Company Banks" 52 *Federal Register* 213, November 4, 1987, p. 42301.

[20]Nathaniel Nash, "The Industry Owes Its Troubles to Congress, Regulators—and Itself," *New York Times*, June 12, 1988.

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EXHIBIT K: 48

Strauss, Robert P., "An Evaluation of Alternative Approaches to State Taxation of Financial Institutions" (Paper presented to NCSL-MTC-ACIR Conference) (December 13, 1990)

An Evaluation of Alternative Approaches to State Taxation of Financial Institutions

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A Paper Presented to the NCSL-MTC-ACIR Conference on State Taxation of Financial Institutions, December 13, 1989

31 October 1990

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1. Introduction

This conference reflects a long-standing interest by the intergovernmental community in the tax and regulatory treatment of financial institutions. Ever since the Uniform Division for Income Tax Purposes Act excepted "financial organizations" from the standard "three factor formula" in 1957, the states have applied a myriad of apportionment formulae and definitions to the income of multi-state financial institutions.[1] Moreover, because of federal deregulation of traditional depository institutions and the increased access of depository institutions to state markets through state enactment of inter-state banking statutes, financial institutions (and the market for their services) continue to go through profound changes. These changes in the state regulatory and tax environments which financial institutions face come at a time when world markets for financial services have become relatively commonplace, and extremely competitive.[2] As a consequence, there is a general need for care on the part of states when they move to refashion their tax treatment of financial institutions. On the one hand, the Constitution, federal law, and various court decisions have provided the states with significant latitude in their taxation of financial institutions court decisions on how they may tax financial institutions. On the other hand, significant heterogeneity among the states can adversely affect the entire sector vis a vis foreign treatment of their financial institutions.

Earlier papers in this volume have described and argued for various approaches to the tax treatment of financial institutions which reflect, in part, these new economic and regulatory realities. The goal of this paper is to evaluate these competing methods for state taxation of financial institutions, and to make a balanced recommendation for what the states in unison might wish to move toward as a realistic solution to a long-standing problem. To that end, the paper:

1. states the principles of good state taxation of business;

2. puts the taxation of financial institutions within this more general context of the proper state taxation of business; and,

3. evaluates the varying state tax instruments and methods applied to financial institutions.

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[1]See Pierce[1957] for the first statement of the exception, and ACIR(1989), especially Tables 7-9 which demonstrate the heterogeneity in tax treatment of banks.

[2]For a discussion of the implications of such global change on state-local institutions, see Ebel and Marks[1990], Rivlin[1990] and Strauss[1990].

In order to accomplish this, it is worthwhile to make some preliminary remarks about the financial services industry, and the evolution of its taxation at the federal level over the last decade. With this in hand, we may then consider an appropriate normative framework for state taxation of business, and evaluate the approaches currently being practiced among the states. Also, I report the implications for the tax base of different apportionment schemes in Washington State that resulted from work done for the Washington State Department of Revenue several years ago.[3]

The organization of the paper is as follows:

Section 2 briefly describes the evolution of the US financial services industry over the past decade, and the changing federal tax treatment it has faced.

Section 3 lays out a general framework for evaluating state business taxes, and then discusses briefly the major issues which arise in the state taxation of business. We shall see that all of the discussion at this conference really revolves around the issue of how the sales factor in the apportionment formula should be measured. Section 4 describes the three competing methods to geographically attribute income of multi-state financial institutions; Section 5 evaluates them in relation to the criteria in Section 2.

Section 6 relates empirical studies of financial institutions; and, Section 7 concludes.

By way of summary, I reach the conclusion that the uniform tax treatment of various types of business should be the highest priority in the design of state business tax policy, because it assures the least amount of economic discrimination, and generally simplifies administration and compliance. To achieve this, application of the standard three factor formula to the multistate activity of financial institutions makes the most sense. Measuring sales on a destination basis, in conformity with the current UDIPTA formula would complete a modest redesign, and put all businesses on the same footing. Given the poor economic condition of many financial institutions, this simplification of rules will not lead to adverse revenues because it is likely that the financial services sector, at least commercial banks and savings and loans, will not be paying much in the way of income taxes for the foreseeable future.

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[3] See Symons and Strauss[1987].

2. Aspects of the U.S. Financial Services Industry

2.1. Fragmentation of Financial Services Industry

[4] Since the early 1970's, the market for financial services has undergone several structural changes. Overall, employment has grown strongly during this period, from 1 million employees in 1970 to 1.6 million in 1988, or at a rate of about 2.5% per year. The first structural change of note is the widespread growth in the bank holding company as an organizational form; this has been the vehicle through which inter-state banking has occurred. In 1980, there were only 121 bank holding companies, while in 1987 there were 6,503. The number of banking offices represented by holding companies has accordingly grown: from 4,155 in 1970 to 50,678 in 1987.

As savings and loan institutions were permitted to provide most of the financial services of commercial banks and competition increased in that sector, the number of savings and loan institutions fell: from 6,162 in 1970 to 3,639 in 1988. Undoubtedly the numbers will continue to diminish as the shakeout in the S&L industry continues in the 1990's.

The number of commercial banks has remained relatively constant at 14,434 in 1980 and 13,139 in 1988; however, the number of commercial branch banks essentially doubled during this period: from 22,967 in 1970 to 47,216 in 1988.

While our financial markets have been going through a reorganization due to phased deregulation, the relative importance of large US commercial banks among their world counterparts has fallen, especially in terms of their share of world deposits. In 1970, of the top 500 banks world-wide, the US contained 185 (or 37%) which had 33% of total deposits. In 1988, the US contained only 107 of the top 500 banks worldwide (or 21.4%), and these represented only 10.4 % of top 500 deposits. This relative decline in US deposits has been a source of concern to many observers of capital markets for it may suggest a declining ability of our commercial banking sector to provide domestic capital. Some have suggested that the pace of deregulation and consolidation of commercial banking should be increased. This would permit gains in efficiency from economies of scale, lower capital costs and improved services to consumer and business borrowers.

While large US commercial banks have declined in relative importance world-wide, other sources of domestic capital from non-bank financial institutions have become available. For example, the 1970's witnessed the creation of money market funds as an alternative to traditional depository forms of

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[4] Data for this section are drawn from the Statistical Abstract of the US, selected years.

secure savings. In 1970 such instruments did not exist, while in 1988 there was $265 billion invested in such instruments, or about 9% of the assets of traditional commercial banks. Non-bank financial assets were 18% of total assets of all financial institutions in 1970, and were 24% in 1986.

Representatives of traditional depository institutions have repeatedly argued that they are increasingly forced to compete for deposits and lending opportunities against other sources of monied capital which are free from state and federal regulation. In the retail lending area, large retailers offer credit which competes directly with the loan operations of commercial banks and savings institutions.

2.2. The Evolving Federal Tax Treatment of Depository Institutions

With respect to the tax treatment of commercial banks, it is widely recognized that they enjoyed very favorable federal tax treatment up until the Tax Reform Act of 1986. For example, Marovelli [1986] estimates that the average effective domestic tax rate for 15 publicly traded commercial banks, between 1980 and 1984 was .27%; this is well below the effective tax rates for many other industries which average 10-15%.

The major source of this favorable federal tax treatment was the allowable deduction from gross income, in the computation of federal taxable income, of a *percentage* of outstanding loans as a bad debt reserve irrespective of actual bad debt experience.

In 1965 commercial banks were permitted to deduct 2.4% of loans outstanding as a bad debt reserve deduction, e.g. as a normal cost of doing business. To the extent that the spread between the interest costs of deposits plus the costs of doing business and the rate of return earned on various types of loans was less than 2.4%, commercial banks were essentially tax-free for federal tax purposes. The Tax Reform Act of 1969 reduced this percentage for the period 1969-76 to 1.8%. Between 1976 and 1981 the percentage was 1.2%. In 1982, the percentage was .6% which persisted until the Tax Reform Act of 1986.[5]

Some of the tax benefit of this bad debt deduction was reduced by other federal tax provisions. In particular, the extent of the deduction was reduced by 15 to 20% (that is, only 80 or 85% of the 1.2% of outstanding loans was allowed as a deduction) by the Congress, and the allowable deduction was added to the base of the minimum tax. In the 1980's the scaling of the deduction varied from 20 to 15%. The 1982 Act scaled back the 20% to 15%; however, the Deficit Reduction Act of 1984 took the 15% to 20%.

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[5]See Joint Committee on Taxation[1985b].

Finally, the 1986 Reform Act repealed the .6% deduction for banks with assets over $500 million.[6] It was estimated that elimination of the bad debt reserve deduction would, over 1987-91, raise $5 billion in additional federal taxes.

Savings and loan institutions historically were permitted to deduct 40% of their net operating income as bad debt reserves, irrespective of actual bad debt experience. To the extent that such deductions created net operating losses, the losses could be carried backward and forward just as any other business loss. Again, the 1986 Act eliminated the 40% bad debt reserve deduction.

3. Some General Remarks on the State Taxation of Business

Here we briefly review the goals of a good state tax system in order to evaluate alternative methods of state taxation of business and financial institutions.[7]

3.1. Goals of A Good State Tax System and the State Taxation of Business

There are four general principles of state taxation of business that lead to a desirable state business tax system:

1. A good state tax system should achieve socially articulated distributional objectives;
2. A good state tax system should be economically neutral and not alter consumer and business choices unintentionally in the process of raising revenues;
3. A good state tax system should be simple, certain, inexpensive for the taxpayer to comply with, and easy and economical for the tax collector to administer; and,
4. A good state tax system should raise sufficient revenues to finance socially desired public services.[8]

These four principles have practical implications for the design of a state business tax structure that warrant discussion. First, with respect to achieving vertical equity (the tax treatment of firms with differing abilities to pay), it is evident that its achievement will be difficult because varying a tax rate

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[6]See Joint Committee on Taxation(1987), pp. 549-557

[7]This discussion is drawn in main from Strauss[1986].

[8]There is a fifth goal that warrants statement, the proper matching of the type of tax with the the type of local service being provided, when considering local taxation. However, since this discussion relates only to state taxation of business, the implications of this fifth principle will not be elaborated on here.

on business will create an incentive for businesses to subdivide-- a form of organizational change which is not available to individuals or families in response to a progressive tax rate structure. To avoid this sort of undesirable subdivision, it follows that business taxes on any base should be *proportional*, e.g. the *rate* of tax should not vary with the size of the base.

Second, given that one accepts the proposition that state business tax rates should be proportional, the remaining equity issue is horizontal equity: the tax treatment of equals. Here, achieving horizontal equity implies that the observed effective tax rate among firms, subjected to the same measurement of tax base, should be the same.

Third, achieving economic neutrality argues for ensuring that the tax wedge facing firms that compete with each other, in state and out of state in the same, local market, should be the same. If the observed pattern of effective tax rates is the same across firms, then the efficiency goal is being served. This economic neutrality goal requires, for example, that the taxation of traditional depository institutions and non-bank financial institutions be the same since they compete with each other for monied capital.

It follows as a corollary of this third principle that income should not be taxed more than once, or not at all unless such pyramiding of tax rates or tax exemption serve some identifiable and broadly agreed upon purposes.

Fourth, the revenue adequacy principle has a practical implication for the relation of corporate to personal tax rates and the taxation of dividend income at the personal level. Corporate source income, since 1986, is now subject to a real double taxation at the corporate and individual levels. There is thus a need to construct personal and corporate tax rates in tandem. To the extent that corporate tax rates are substantially above personal tax rates, one creates an incentive for either the reorganization of the corporation to the integrated form of a Subchapter-S corporation, or the disincorporation of the corporation to a sole proprietorship.[9] Both federal and state tax rates, as currently in place, work in tandem in moving firms toward the single tax solution. To the extent corporations move to Subchapter-S or sole proprietorship status, both federal and state revenues become at risk, since the double-taxation of corporate source income is reduced to a single taxation at the individual level, and typically the individual rates are less than the corporate (and combined corporate-individual) rates.

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[9]It should also be pointed out that there other reasons to maintain a two-tier [corporate-personal] structure even if it is not tax-advantageous. The corporate form provides shareholders limited liability and perpetuity of interests at the corporate level.

3.2. General Geographic Attribution Rules of State Income Taxes for Mercantile Corporations

The evolution of state taxation of multi-state activities of general, mercantile corporations has been chronicled in a number of outstanding treatises[10]. It will be useful, however, to state symbolically the general apportionment approach taken under the Uniform Division for Income Tax Purposes Act (UDIPTA) developed some years ago. We may then juxtapose these general rules against various approaches discussed in this conference for the taxation of financial institutions.

The UDITPA formula provides that the taxes payable to the i'th state of a multistate mercantile corporation's profits, Π, shall be computed as:

$$T_i = t_i * \Pi * (1/3)[\ \Sigma\ \{W_i/\Sigma W + P_i/\Sigma P + S_i/\Sigma S)\ \}\ ] \qquad (1)$$

where:

T_i is the taxes attributable to the i 'th state.
t_i is the tax rate in the i'th state.
Π is the overall, multistate profits of the firm
W_i is the payroll in the 'th state.
ΣW is the sum of all payrolls
P_i is the property in the i'th state
ΣP is the sum of all property
S_i is the sum of sales in the i'th state on a *destination* basis.
ΣS is the sum of all sales on a *destination* basis.

UDITPA contains detailed definitions of how one measures payroll, property, and sales within and across states where a multi-state company is active, and the Multi-State Tax Commission has further elaborated on what should be contained in the numerators and denominators for various types of economic activity. Recall that financial organizations are excepted from (1), although ACIR(1989) reports that 23 states tax banks as general businesses[11], and 12 states used the UDITPA formula, *per se*. Thus, many states have devised their own sets of rules which elaborate or vary, in some cases considerably, from the simple statement of (1).

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[10] See, for example, Hellerstein(1983), for an over-view of the evolution of state corporate income taxes, and Pomp(1987) for a discussion of New York's reforms of its business tax structure.

[11] ACIR[1989], Table 3, p. 36. Note that none of the money center states, e.g. New York, Illinois, Delaware etc. tax commercial banks as they do general businesses.

4. The Geographic Attribution Options under Discussion

Any state business tax must deal not only with the issue of the geographic attribution of activities, but also the nature of the initial tax base, and the nature of the filing unit. As has been pointed out by a number of analysts[12], the states may impose a tax on the interest income of federal securities either through a non-discriminatory franchise tax that taxes all traditionally exempt interest, or through a proportional scheme which was determined to be acceptable under *Bartow*.

Also, it is reasonably clear as a result of *Container* that the states are relatively unencumbered in the sort of filing unit to which they may attach income taxes. That is, they have significant latitude in taxing separate, combined, consolidated, or unitary entities of domestic corporations.

Given that the apportionment issue is the most widely discussed issue with respect to financial institutions, I will not delve into the wisdom or desirability for states to pursue exempt interest, or pursuing one type of entity vrs another. These issues are sufficiently complex to require a separate discussion.

Thus we now turn to the principles of a good state business tax system, and the relationship of these principles to the three approaches to the taxation of financial institutions as discussed earlier in this volume. In particular, we shall examine them in relation to the goals of economic neutrality, revenue adequacy, and administrative ease.

The three approaches are:

1. The Money Center Approach (New York, California).--the attribution to the state of commercial domicile those transactions reflected in the sales factor to the "home state" or state of origin in order to apportion the income arising from multi-state activities[13];

2. The Credit Approach (Indiana).--the provision to out-of-state financial institutions of a credit against their domestic liability within Indiana[14] ;

3. The Mercantile Approach(Minnesota).--application of the destination principle for various bank activities in the sales factor[15].

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[12]See Symons and Strauss(1987), and McCray(1989), among others.

[13]See Commissioner Wetzler's paper in this volume.

[14]See Representative Kiely's paper and Sandra McCray's paper in this volume.

[15]See Commissioner James' paper in this volume.

Another approach, forwarded by Levinson[1981], argues for apportionment solely on the basis of loans and/or deposits. The argument here is that loans/deposits are the primary input into the production function of financial institutions, and their location indicates the source of income to them. Levinson notes[16] that better than 80% of total liabilities of commercial banks are attributable to deposits, and interest expenses, the major cost factor in commercial banking, are more than 80% attributable to the cost of financing such deposits. As we shall see, the New York approach follows this line of economic reasoning.

5. An Evaluation of the Approaches in Minnesota, New York and Indiana

5.1. Economic Neutrality: Avoiding Double/Under Taxation

The simplest form of economic neutrality requires, in the context of (1) above, that the sum of each state's share of a multistate corporation's profits equal 1.0. Double or multiple taxation will occur if the sum of the percentages in (1) exceed 1.0. To the extent that the states vary, e.g. use different formulae, in their treatment of a company's multistate profits, there exists a risk that such multiple taxation can occur. Conversely, there also exists a risk that if the states pursue divergent attribution rules, they may wind of up taxing less than 100% of such profits.

An example will make this more clear.

Suppose two states, A and B, have the same tax rate, t, and suppose that state A used (1), while state B, the only other state in which a firm does business, uses a single factor formula based on sales. It is easy to see, were both states to use (1), that the total taxes of the firm imposed by A and B would be t Π. If, on the other hand both states do not use (1), but have different rules, then the sum of taxes in A and B need not equal t Π, and over- or under-taxation can occur. To see this first result, let us state the result from application of (1) for A and B:

$$t\Pi = t * \Pi * (1/3)[\ \Sigma\ \{W_A/\Sigma\ W + P_A/\Sigma\ P + S_A/\Sigma S)\ \}\ ] +$$

$$t * \Pi * (1/3)[\ \Sigma\ \{W_B/\Sigma\ W + P_B/\Sigma\ P + S_B/\Sigma S)\ \}\ ] \qquad (2)$$

Now, let state B instead use a single factor formula based on sales:

$$T_b = \pi\ t * \{\ S_B/\Sigma S)\ \} \qquad (3)$$

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[16] ibid, p. 454.

If (3) is greater than $t * \Pi * (1/3)[\ \Sigma\ \{W_B/\Sigma\ W + P_B/\Sigma\ P + S_B/\Sigma S)\ \}\ ]$, it follows that we have multiple taxation. This will occur as long as $\{W_B/\Sigma W + P_B/\Sigma P\}/2 < S_B/\Sigma S)$. That is, if the firm in state B has a sales fraction that is greater than the average of its payroll and property fractions, the total tax imposed will be greater than $t * \Pi$. If the reverse is true, then less than 100% of Π will be taxed at rate t, and under-taxation will accordingly occur.

It should be emphasized that under-taxation can occur in the financial services industry for other reasons as well. Financial activity, because it can move electronically and almost effortlessly, can occur in different geographic areas in response to differences in tax rates, the absence of an income tax, e.g. creating the possibility of so-called "nowhere income, " or in response to differences in definitions among the states as to what constitutes situs or nexus.

For example, if one were to use a destination basis in the measure of loan activity in the sales factor of (1) above, but determine the location of the loan on the basis of where the loan is *booked*, one would be creating substantial incentives for aggressive tax planning. Financial institutions would simply develop loan production offices in low tax rate or no-tax rate states, or in pleasant, but foreign places such as Vancouver or Toronto, in Canada. Contrast this approach to measuring loan activity based on where the borrower *resides*. This second approach would eliminate significant tax planning opportunities.

To a large extent the risk of multiple or under taxation can be mitigated by the adoption of a standard formula by all states. However, while this may provide non-discriminatory treatment to business, it may not provide particular states with revenues which they consider fair and equitable. States sometimes seek to redress such perceived inequities by simply varying the definitions of factors in (1). For example, if some states use sales measured on a destination basis, and others use sales measured on an origin basis, it follows that the same difficulty and economic discrimination can arise. If a state that has little payroll and property of a firm uses a destination principle in measuring sales, while the state where the firm is domiciled uses an origin principle in measuring sales, it is easy to see how multiple taxation can occur.

Since much of the debate among the states is between money-center states, which desire to use an origin principle for measuring sales, and market states, which desire to use a destination principle for measuring sales, it is of value to expand the notation in (1) for the different possible types of transactions which a firm may have. In particular, let us denote a firm's sales *from* state i *to* state j as S_{IJ}.

In the case of states A and B, there are four logical possible ways that a firm may make sales:

from A to B, from B to A, from A to A, and from B to B. The last two cases are simply establishments of a multistate firm doing in-state business in state A and B respectively. It follows that the sum of all of the firm's sales, ΣS, is:

$$\Sigma S = S_{AB} + S_{BA} + S_{AA} + S_{BB} \quad (4)$$

Now, destination-based apportionment, as generally required by UDITPA, for state A involves using $S_{BA} + S_{AA}$ in the numerator of (1), while origin-based apportionment for state A involves using $S_{AB} + S_{AA}$ in the numerator of (1) to apportion with. Note that in both cases the *denominator* of the sales factor remains the same, e.g. (4) above.

We may now restate the UDITPA rule for general, multistate mercantile corporations which are subject to tax in state A as:

$$T_A = t_A * \Pi * (1/3)[\Sigma \{W_A/\Sigma W + P_A/\Sigma P + (S_{BA} + S_{AA})/\Sigma S) \}] \quad (5)$$

Minnesota's approach to the taxation of financial institutions is:

$$T_A = t_A * \Pi * [.15 * W_A/\Sigma W + .15 * P_A/\Sigma P + .7 * (S_{BA} + S_{AA})/\Sigma S)] \quad (6)$$

New York's general, money center or origin based approach then is for state A:

$$T_A = t_A * \Pi * (1/5)[\Sigma \{.8 * W_A/\Sigma W + 2 *(R_A/\Sigma R) + 2 * ((D_{AB} + S_{AA})/\Sigma D) \}] \quad (7)$$

where:

R is receipts from interest income, other income from loans and leases, rents, interest from bank, credit, travel, entertainment, service charges, receipts from discounts, investment and trading income
D is deposits located within New York

Indiana's credit approach may be stated, for financial institutions domiciled in Indiana, as:

$$T_A = t_A * \Pi - C \quad (8)$$

where:

C = a credit for state taxes paid by domestic financial institutions to other states

and for foreign institutions. Indiana's credit approach is:

$$T_A = t_A * \Pi * [S_{BA} + S_{AA})/\Sigma S] \quad (9)$$

Several aspects of (5). (6). (7). and (8)-(9) are evident vis a vis the issue of economic neutrality. First. only the Minnesota approach is consistent with the geographic attribution of general. mercantile corporations: however. Minnesota does not give equal weight to the three factors in the formula. So. compared to the tax treatment of general mercantile corporations in other states. Minnesota's formula is different. If all the states adopted Minnesota's formula *and* adopted Minnesota's weights for the three factors. the risk of multiple or under-taxation of financial institutions would disappear. However. because the weights are different than 1/3 each, the risk of multiple taxation remains vis a vis firms taxed under a pure UDITPA formula.

Since New York and Indiana follow different formulae than Minnesota, it follows that financial institutions facing the New York or Indiana approaches to apportionment will necessarily be facing other than 100% taxation of Π vis a vis the Minnesota approach. If all the states adopted the New York approach. then the risk of multiple or under-taxation would disappear. but the geographic attribution of revenues would readily favor New York.

Second. non-bank financial institutions such as Sears. GE Credit etc. can be competing under tax burdens from (5). in some states. with financial institutions that face (6). (7). and (8)-(9). Since (5) by itself does not entail a risk of double-taxation. and only a few states appear to be "money center states"[17]. it follows that the principal risk which financial institutions face to the extent they are in fact profitable. especially in New York. the largest money center state. could be the risk of double taxation rather than under-taxation.

For firms that do business in Minnesota, financial and non-financial institutions will be facing the same apportionment rules. albeit with other than equally weighted factors as compared with other states.

Third. it is evident that New York's double-weighting of deposits and assets are designed. especially in view of the sourcing definitions. to bring income back into New York. The explicit reduction in the numerator of the payroll factor essentially discounts New York employee's wages presumably in recognition of the unusually high cost of living in New York City.

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[17] See the discussion in the next section on revenue implications and estimates of which states are money center states.

Fourth, it is evident that the Indiana approach, by not including payroll or property for foreign firms, like Iowa's general single factor formula, is attempting to bring the profits of foreign firms into Indiana, and creates a risk of double taxation.

5.2. Revenue Considerations 1: Origin vrs Destination

Whether or not the simultaneous application of the various formulae to multi-state financial institutions creates a significant risk of multiple taxation depends in good measure on which states use which geographic attribution rules in relation to their financial institutions.

Unfortunately, there is no readily available data on bank loans across the states in terms of origin and destination by state, thus indirect methods must be used to shed some light on the implications of different sourcing rules. In this section we make some national estimates of what such sourcing rules might entail, and in the next section we examine the implications of different sourcing rules for Washington State.

One way to estimate the extent to which any state is a "money center" as contrasted to "market" state is to examine for 1969 and 1989, each state's population in comparison to its commercial bank assets and deposits.[18] If a state's share of US commercial bank assets or deposits is *greater* than its share of US population, then we may call the state a "money center" state as contrasted to the reverse situation. The economic logic of such reasoning is fairly straight forward, and simply presumes that if the relative capitalization of the commercial banks is greater than the relative population of the state vis a vis the US capitalization or US population, then the state will be a net lender outside its boundaries.

Table 5-1 shows these calculations for 1969 and 1989. Several things are immediately apparent from this analysis: 1] in 1969, New York commercial banks dominated the US market. Then, New York had 11.59% *more* of all US commercial banks assets than its share of the US population. Only Illinois with 1.69% *more* in commercial bank assets than population was comparable. By 1989, however, New York's dominance had diminished dramatically, and its share of commercial bank assets was only 6.22% larger than its population share. Note that by 1989 Delaware, Illinois, Florida and South Dakota displayed significant concentrations of commercial bank assets vis a vis their population size. These data probably reflect the movement of significant credit card activities out of New York to South Dakota and Delaware.

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[18] These are readily available data.

The same general pattern emerges if one compares the state share of bank *deposits* with state population shares. Again, New York's dominant position has declined from 1969 to 1989, and a few other states such as Massachusetts and Texas became money center states in the 1980's.[19]

The tables indicate that an origin based sourcing rule will potentially benefit relatively few states. Moreover, the benefit of such sourcing rules has been declining over the last 20 years as commercial banking activity has become more dispersed.

5.3. Revenue Considerations 2: State Bad Debt Reserve Rules and NOL's

A common complaint against the money center approach by market states is that it concentrates tax revenues from financial institutions in relatively few states. Whether or not this in fact occurs depends on whether or not such institutions are in fact taxable in the money center states. It is instructive to note that when the Congress eliminated the bad debt deduction in the Tax Reform Act of 1986 which would have the effect of making commercial banks more taxable in the long run once their net operating loss carryforwards had been exhausted and the banks became economically profitable, New York did not follow suit. A phone survey of several money center states (New York, Delaware, and Pennsylvania) indicates that as of 1990 they all retained the pre-1986 bad debt deduction which the Congress eliminated in the 1986 Tax Reform Act. Moreover, since virtually all states which tax financial institutions on an income base accord at least net operating loss carryforward, the prospect of origin-based taxation leading to no-where income appears substantial.

5.4. Administrative Considerations

Uniformity across the states in their formulary treatment of financial institutions should in principle ease the administrative burdens for tax collectors as well as taxpayers. Whether or not one uses an origin or destination principle, a multistate firm must keep records of where transactions occur, and be able to demonstrate under audit where taxable events took place.

Payroll and tangible property are relatively easy to measure and do not cause administrative difficulties for either tax collector or taxpayer. However, a number of papers in this volume have argued that application of the destination principle for the numerator of the sales factor is not administratively feasible[20]. In the era of high speed computing, direct marketing, and pay-by-phone,

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[19] It should be noted that using state personal income instead of population for the same period does not change the essential conclusions of this analysis.

[20] See the papers by Commissioner James Wetzler of New York State, and Haskel Edelstein of Citicorp.

Table 5-1: Ranking of States: 1969 and 1989 by Difference between % Share of US Commercial Bank Assets and % Share of Population

State	1969 % Assets - % Pop	1989 % Assets - % Pop
New York	11.59%	6.22%
Delaware	-0.01	1.83
Massachusetts	-0.35	1.08
Illinois	1.69	0.83
South Dakota	-0.02	0.51
Florida	-0.51	0.44
D.C.	0.19	0.29
Nevada	-0.01	0.19
Texas	-0.27	0.19
Rhode Island	-0.12	0.09
Pennsylvania	0.13	0.09
Connecticut	-0.46	0.02
Minnesota	0.02	0.02
Hawaii	-0.07	0.02
New Hampshire	-0.17%	-0.01%
Vermont	-0.05	-0.02
Alaska	-0.04	-0.02
Arizona	-0.17	-0.04
North Dakota	-0.02	-0.04
Wyoming	a/	-0.04
Nebraska	a/	-0.07
Montana	-0.03	-0.1
Virginia	-0.73	-0.11
Idaho	-0.09	-0.13
Maryland	-0.84	-0.14
Kansas	-0.15	-0.15
New Mexico	-0.21	-0.18
Utah	-0.16	-0.19
Iowa	-0.07	-0.19
North Carolina	-1.13	-0.2
Georgia	-0.75	-0.2
Maine	-0.24	-0.21
Missouri	0.09	-0.21
Kentucky	-0.55	-0.24
New Jersey	-0.57	-0.25
West Virginia	-0.35	-0.26
Colorado	-0.17	-0.29
Arkansas	-0.4	-0.32
Oklahoma	-0.2	-0.36
Mississippi	-0.55	-0.4
Oregon	-0.18	-0.41
Tennessee	-0.52	-0.42
Indiana	-0.33	-0.48
Alabama	-0.79	-0.48
Louisiana	-0.58	-0.52
Washington	-0.54	-0.53
Wisconsin	-0.2	-0.58
South Carolina	-0.87	-0.59
California	0.57	-0.96
Ohio	-0.77	-1.24
Michigan	-0.04	-1.26

a/ Difference less than .01%
Source: calculations by author, data from Statistical Abstract of US

Table 5-2: Ranking of States: 1969 and 1989 by Difference between % Share of US Commercial Bank Deposits and % Share of Population

State	1969 % Deposit - % Pop	1989 % Deposit - % Pop
New York	9.41%	4.41%
Delaware	0.01	0.86
Florida	-0.31	0.78
Massachusetts	-0.53	0.78
Texas	-0.08	0.74
Illinois	1.67	0.62
D.C.	0.22	0.29
Hawaii	-0.06	0.11
South Dakota	0.01	0.11
Minnesota	0.09	0.04
Arizona	-0.12	0.03
Rhode Island	-0.14	0.02
Nevada	a/	0.01
New Hampshire	-0.17%	a/
Nebraska	0.05	a/
Vermont	-0.04	a/
Alaska	-0.03	-0.01
North Dakota	a/	-0.01
Wyoming	0.01	-0.01
Pennsylvania	0.15	-0.02
Missouri	0.2	-0.03
Kansas	-0.08	-0.03
Connecticut	-0.43	-0.04
Virginia	-0.65	-0.07
Montana	a/	-0.07
New Jersey	-0.39	-0.08
Iowa	0.04	-0.08
Idaho	-0.07	-0.11
California	0.39	-0.13
New Mexico	-0.19	-0.15
Maryland	-0.79	-0.16
Utah	-0.14	-0.19
West Virginia	-0.33	-0.19
Kentucky	-0.47	-0.2
Maine	-0.23	-0.2
Georgia	-0.77	-0.21
Colorado	-0.14	-0.22
Arkansas	-0.35	-0.22
Oklahoma	-0.15	-0.23
Tennessee	-0.45	-0.3
Mississippi	-0.51	-0.32
North Carolina	-1.09	-0.35
Louisiana	-0.51	-0.37
Indiana	-0.2	-0.38
Oregon	-0.15	-0.39
Washington	-0.5	-0.43
Alabama	-0.73	-0.44
Wisconsin	-0.09	-0.46
South Carolina	-0.84	-0.61
Michigan	0.08	-0.95
Ohio	-0.63	-1.16

a/ Less than .01% difference
Source: calculations by author, data from Statistical Abstract of US

this is difficult to accept, for it is tantamount to an assertion that commercial banks do not know where to send credit-card bills, mortgage statements, etc. in the ordinary conduct of their business. Protestations by depository institutions that information on the location of deposits is also unavailable seem equally strained. Commercial banks would seem to have to know where their depositors reside because their depositors demand confirmation of their transactions with them in the ordinary course of business.

It may well be that commercial banks do not want to comply with a destination principle of tax reporting with respect to deposits or receipts of various sorts, because they may have to write a bit of software to tabulate their administrative records differently; however, it is difficult if not impossible to believe that commercial banks and/or their service bureaus, do not know where borrowers and depositors reside.

6. Taxbases of Washington State Financial Institutions under Different Apportionment Rules

In 1986-7, the author was engaged by the Washington State Department of Revenue to construct a series of tax simulation models in contemplation of a possible adverse ruling by the U.S. Supreme Court in *National Can vrs. the Washington State Department of Revenue* which could have endangered as much as 40% of the state's budget in 1987-8.[21]

In the course of the analysis of various business tax alternatives to the state's historical reliance on business gross receipts taxes, the issue of how to tax financial institutions arose. Given that Washington had earlier encouraged multistate banking into Washington, the issue was of some importance. To that end, the Department of Revenue in conjunction with the Washington State Bankers Association conducted an in-depth survey of various measures of activities of financial institutions inside and outside Washington State. The response to the survey was excellent, and all large, domestic and foreign depository institutions participated in the project.

Several general findings derived from the resulting analysis[22]. First, calculation of the effective tax

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[21] As is generally known, National Can Corporation, et al, or Tyler-PipeIndustries as it is sometimes called, was decided in favor of the plaintiffs on June 23, 1987; however, the financial implications to Washington State, after the legislature passed various prospective corrections, and the Washington State Supreme Court held in favor of the State with regard to payment of back taxes, were quite modest.

[22] See Symons and Strauss[1987] for a full discussion of the impact of various income, balance sheet, and value-added taxes in comparison to the Business and Occupation Tax.

rate of the historical gross receipts tax, vis a vis book income, revealed rather high effective tax rates compared to other sectors of the economy. This was consistent with the general view by financial institutions that the gross receipts tax applied to them, as contrasted with a net income tax, taxed them at significantly higher tax rates. Second, application of virtually any income tax and a wide variety of 3 and 4 factor formulas led to lower effective tax rates more in line with those faced by general, mercantile corporations.

Since data were collected on the face value of loans *booked* in Washington State vis a vis loans booked everywhere, as well as similar data on deposits and interest income, it is of interest to contrast the impact of various *single* factor apportionment formulas on the apportionment of broadly defined income. Note that data on payroll and real property were also collected.

Table 6-1 below shows that a deposits-only formula would apportion the least amount of multistate income to Washington State, while, surprisingly, a formula based just on real property would apportion the most income to Washington State. However, in no event is the difference between the lower and upper bound more than 11%---a surprisingly small amount of variation.

Table 6-1: Impact of Apportioning 1984 Income of Selected Financial Institutions in Washington State by Various Single Factors

Factor	1984 Income in Washington State
Apportionment based on Payroll	$148,006,262
Apportionment based on Real Property	$155,736,874
Apportionment based on Face Value of Loans	$152,436,016
Apportionment based on Deposits	$140,606,130
Apportionment based on Interest Income	$144,903,869

Source: unpublished analysis of 1987 study of Washington State financial institutions;Center for Public Financial Management, Carnegie-Mellon University

The relatively slight variation in the use of very different apportionment fractions suggests that revenue gains from using what may initially be perceived as advantageous apportionment concepts may be modest. In turn, this suggests that the revenue costs of uniformity, e.g. using the general UDITPA formula in (5) to most states may be rather modest.

7. Conclusions

This evaluation of the various methods of taxing financial institutions leads to a number of general conclusions.

First, the risk of double-taxation is eliminated if the states use the same apportionment formula, regardless of what it is. If tax rates are the same across the states, financial institutions which engage in multistate activities will compete with each other on the same tax basis.

Second, vis a vis competition from non-bank financial institutions, the adoption of the standard UDITPA formula will put financial and non-financial institutions on the same basis, and again allow them to compete with each other on the same tax basis.

Third, at least in this author's view, use of the destination principle as contrasted with the origin principle for the definition of various portions of the sales factor seems workable, and administrable. We may look to Minnesota for some early confirmatory experience in that regard.

Fourth, the continued adoption by some states of very generous bad debt reserve rules that the Congress eliminated in 1986 means that commercial banks and savings and loans will continue to have low or negative incomes as measured by state tax accounting rules. Irrespective of this, it seems reasonable to expect that historical net operating losses generated by pre-1986 rules and serious economic difficulties in the early 1990's will mean that traditional depository financial institutions will not be making heavy tax payments to the states.

Fifth, over time, differences between market and money center states seem to be diminishing with the result that geographic concentration of deposits and assets of commercial banks is diminishing. This suggests that uniform reliance by the states on the general, three factor formula, using the destination principle, may not create substantial revenue problems. Moreover, an examination of Washington State data indicates rather little variation in the impact of using payroll and real property in comparison to a number of origin-based factors.

In summary, a wise and prudent business tax policy toward financial institutions at the state level would entail moving to the standard three factor formula. Various streams of intangible income can be included in the receipts or sales factor, and can be measured on a destination basis. Such a policy will treat non-bank and traditional depository institutions on the same basis, and simplify tax administration for the tax collector. Increased uniformity in state business seems most important in this new era of international competition and increasing homogeneity of fiscal institutions overseas.

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Characteristcs of Banks by State, 1986

State	Total Bank Assets (Thousands)	Total Bank Assets Rank	Total Bank Income (Thousands)	State & Local Income & Franchise Taxes as a Percent of Total Bank Income	Percent of Assets in Banks with Assets Greater than $300 Millions(1)	Percent of Assets in Banks with Inter-national Branches
AL	28,940,746	26	322,437	4.8	63.4	0.2
AK	5,020,619	49	(61,283)	-0.2	77.6	0.0
AZ	27,638,582	27	174,628	8.7	82.9	9.3
AR	17,955,364	32	97,735	1.0	22.8	0.0
CA	250,679,004	2	633,938	30.1	21.8	66.8
CO	25,638,505	28	92,264	-0.5	36.7	0.0
CT	32,783,728	22	280,561	14.2	84.8	0.0
DE	24,879,677	29	372,655	5.9	71.1	24.7
DC	14,528,114	38	116,723	7.5	65.6	28.8
FL	102,296,233	6	755,538	4.5	76.6	1.9
GA	50,197,133	15	520,839	0.8	64.4	0.0
HI	10,629,792	41	93,221	7.6	59.6	30.7
ID	7,063,620	46	28,105	-0.3	82.7	0.0
IL	141,705,971	4	1,123,843	2.3	17.3	36.0
IN	48,625,319	16	382,882	0.4	42.8	8.3
IA	30,056,994	24	107,864	15.5	18.8	0.0
KS	24,566,183	30	135,551	8.7	19.0	0.0
KY	33,104,489	21	313,168	0.1	43.8	0.0
LA	36,898,084	20	(80,591)	-0.1	54.9	0.0
ME	6,103,237	48	63,526	1.1	80.6	0.0
MD	37,556,978	19	280,374	8.4	68.9	12.1
MA	70,062,368	9	591,407	18.0	42.9	47.2
MI	75,964,885	8	607,977	0.9	47.3	20.4
MN	54,281,222	12	384,037	8.3	21.8	28.9
MS	17,880,949	33	165,675	0.2	37.7	16.6
MO	52,370,954	13	405,655	2.0	51.4	0.0
MT	7,251,361	44	(2,025)	-89.8	10.1	0.0
NE	16,633,477	36	77,859	3.3	30.3	0.0
NV	8,991,197	43	104,765	0.3	92.7	0.0
NH	7,188,846	45	79,584	1.4	45.7	0.0
NJ	68,190,730	10	657,309	8.7	87.3	0.0
NM	9,868,035	42	62,503	-0.2	38.9	0.0
NY	415,984,020	1	4,180,846	10.4	17.3	80.0
NC	55,635,613	11	620,467	2.0	69.6	23.5
ND	6,932,095	47	29,492	10.5	0.0	0.0
OH	86,512,032	7	902,723	0.1	68.8	9.3
OK	29,158,542	25	(228,976)	0.9	27.1	0.0
OR	18,889,051	31	131,841	8.7	87.6	0.0
PA	129,729,238	5	1,093,112	0.3	37.5	45.7
RI	11,241,291	39	102,138	6.0	39.3	52.6
SC	17,047,373	35	135,561	4.1	77.9	0.0

Characteristcs of Banks by State, 1986

State	Total Bank Assets (Thousands)	Total Bank Assets Rank	Total Bank Income (Thousands)	State & Local Income & Franchise Taxes as a Percent of Total Bank Income	Percent of Assets in Banks with Assets Greater than $300 Millions(1)	Percent of Assets in Banks with Inter-national Branches
SD	17,357,199	34	236,410	8.3	74.8	0.0
TN	38,746,591	18	350,722	7.7	61.0	0.0
TX	200,530,121	3	(981,797)	-0.4	29.1	20.3
UT	11,058,376	40	39,484	0.7	79.0	0.0
VT	4,651,567	50	44,408	0.0	66.7	0.0
VA	50,989,311	14	514,156	0.7	74.6	6.8
WA	31,434,690	23	208,179	0.2	34.3	53.2
WV	14,866,317	37	159,446	0.1	14.8	0.0
WI	40,506,590	17	354,949	10.4	21.6	9.5
WY	4,380,073	51	(18,611)	0.0	0.0	0.0

Source: Calculated from FDIC, Call and Income Report tape for 1986.

Note:
(1) Do not have international branches.

Source: Data compiled by William F. Fox, Economic Research, University of Tennessee.

STATE TAXATION OF BANKS

	Corporate Income Tax Rate	Franchise Tax Rate	Share Tax Rate	Apportion Bank Tax Liability	Franchise Tax Based on Income	Interest from Government Securities Taxable	
						Federal	State & Local
AL	0.0	6.0	0.0	Y	Y	Y	Y
AK (1)	9.4	0.0	0.0	Y	N/A	N	Y
AZ (k,1)	10.5	0.0	0.0	Y	N/A	N	Y
AR (1)	6.0	0.27	0.0	Y	N	N	N
CA	0.0	10.644	0.0	Y	Y	Y	Y
CO (1)	6.0	0.0	0.0	N	N/A	N	N
CT (h)	0.0	11.5	0.0	Y	Y	Y	Y
DE (1)	0.0	8.7	0.0	N	Y	Y	Y
DC (k)	0.0	10.5	0.0	Y	Y	N	Y
FL (c)	0.0	5.5	0.2	Y	Y	Y	Y
GA (d,k)	6.0	.0	0.0	Y	N	N	Y
HI	0.0	11.7	0.0	N	Y	Y	Y
ID (k)	7.7	0.0	0.0	Y	N/A	N	Y
IL	6.5	0.0	0.0	Y	N/A	N	Y
IN (d)	3.4	0.0	0.25	Y	N/A	N	N
IA	0.0	5.0	0.0	N	Y	Y	Y
KS	0.0	6.375	0.0	Y	Y	Y	Y
KY	0.0	0.0	0.95	N	N/A	N	Y
LA	0.0	0.0	0.0	N	N/A	N	N
ME (a)	0.0	1.0	0.015	Y	Y	Y	Y
MD	0.0	7.0	0.0	Y	Y	Y	Y
MA	0.0	12.54	0.0	N	Y	Y	Y
MI (j)	0.0	0.0	0.0	Y	N/A	N	Y
MN	0.0	9.5	0.0	Y	Y	Y	Y
MS (f,1)	5.0	0.25	0.0	N	N	N	N
MO	0.0	7.0	0.0	N	Y	Y	Y
MT	0.0	6.75	0.0	Y	Y	Y	Y
NE	0.0	0.0	0.0004	N	N/A	N	N
NV	0.0	0.0	0.0	N	N/A	N	N
NH	8.0	1.0	0.0	N	N	N	N
NJ (a)	0.0	9.0	0.2	Y	Y	Y	Y
NM (b,d,1)	7.6	0.0	0.0	Y	N/A	N	N
NY	0.0	9.0	0.0	Y	Y	Y	Y
NC	7.0	0.15	0.0	Y	N	Y	Y
ND	0.0	10.5	0.0	Y	Y	Y	Y
OH	0.0	1.5	0.0	Y	N	Y	Y
OK	5.0	0.125	0.0	Y	N	Y	Y
OR	7.75	0.0	0.0	Y	N/A	N	N
PA	0.0	0.0	1.075	N	N/A	N	Y
RI	8.0	0.00025	0.000695	N	N	N	N
SC	0.0	4.5	0.0	N	Y	Y	Y
SD	0.0	6.0	0.0	Y	Y	Y	Y
TN	6.0	0.25	0.0	Y	N	Y	Y
TX	0.0	0.525	0.0	N	N	N	N
UT (g)	0.0	5.0	0.0	Y	Y	Y	Y
VT	0.0	0.00024	0.0	N	N	N	N

STATE TAXATION OF BANKS

	Corporate Income Tax Rate	Franchise Tax Rate	Share Tax Rate	Apportion Bank Tax Liability	Franchise Tax Based on Income	Interest from Government Securities Taxable	
						Federal	State & Local
VA	0.0	1.0	0.0	N	N	Y	Y
WA (e,k)	0.0	0.0	1.5	Y	N/A	N	Y
WV	9.45	0.75	0.0	Y	N	N	N
WI	0.0	7.9	0.0	Y	Y	Y	Y
WY	0.0	0.0	0.0	N	N/A	N	N

NOTES:

N/A Not applicable.

a. The share tax is a franchise tax levied on assets.
b. Levies a $50 franchise tax.
c. Levies an intangible property tax.
d. Levies a gross receipts tax.
e. The share tax is the business and occupation tax.
f. Levies a share tax, but it is a credit against the personal property tax.
g. Has a supplemental income tax.
h. Minimum tax is levied in the event no income is earned.
i. The gross receipts tax is a credit against the income tax.
j. Levies the Single Business Tax.
k. Not all state and local government interest is taxable.
l. This is the highest marginal tax rate levied on income.

Source: Data compiled by William F. Fox, Center for Business and Economic Research, University of Tennessee

State Bank Taxation and the Rise of Interstate Banking: A Survey of States

John Kincaid and Sandra B. McCray

Tremendous changes are occurring in the U.S. banking system. One of the changes has been the rise of interstate banking. Bank holding companies and banks are branching out into other states by (1) locating subsidiary banks throughout the nation and (2) soliciting deposits and offering loans to customers across the country by mail and through electronic means in a form of "branchless banking." A person living at one end of the country can now do most or all banking through mail and electronic transfers with a bank located at the other end of the country. Increasingly, in fact, citizens do business, directly and indirectly, with many banks, both in state and out of state.

Interstate banking poses a number of tax and regulatory challenges to the states. Forty-six states have enacted interstate banking laws as a first response to these challenges (see Table 1). The ACIR has been conducting research on state taxation and regulation of banks and will issue its first report, entitled *State Regulation of Banks in an Era of Deregulation*, in October 1988. The second phase of the research involves an examination of the principal issues and options in state taxation of banks.

The challenges faced by states include: (1) the adoption of jurisdiction rules that create tax parity between domiciliary banks (i.e., banks that are chartered by or are headquartered in one's own state); and nondomiciliary banks (i.e., banks that are chartered by or are headquartered in another state but conduct business in one's own state) and (2) the search for an apportionment formula for taxation that reflects how and where multistate banks earn income.

Basically, the spread of interstate banking poses three tax problems for the states: (1) the in-state activities of nondomiciliary banks may escape taxation, thus putting domiciliary banks at a competitive disadvantage, (2) state taxation of nondomiciliary branchless banks may result in double taxation, thus putting out-of-state banks at a competitive disadvantage, and (3) the use of differing and conflicting formulas by states to apportion bank income can create administrative burdens and overlapping taxation. Accordingly, interstate banking is causing states to reexamine their bank taxes and, in some cases, to experiment with new tax formulas. New York and Minnesota, for example, recently enacted changes in their bank tax laws.

The ACIR has undertaken a study of state taxation of banks in order to examine the issues involved in the taxation of interstate banking and the options available to states. One element of this research was a survey of existing state tax practices, the summary results of which are reported here.

In April 1988 a questionnaire was mailed to bank-tax administrators in all 50 states and the District of Columbia. A follow-up mailing was made to states that did not respond to the first mailing. This survey was conducted jointly with the Federation of Tax Administrators, which FTA provided close cooperation and valuable support, especially in handling the mailings of the questionnaire. Usable responses were received from 49 states plus the District of Columbia.

State Taxes Levied on Banks

The most widely used bank tax is a franchise tax, levied by 69 percent of the responding states and the District of Columbia. The popularity of the franchise tax is due largely to two factors.

First, a franchise tax has significant revenue advantages for states. According to federal law, states cannot include the value of or income from federal obligations in their tax base unless they adopt a "nondiscriminatory franchise or other nonproperty tax." Because federal obligations ordinarily comprise a large fraction of a bank's assets and income, failure to use a franchise tax for banks can be costly for states.

Table 1

State Interstate Banking Laws and Effective Dates

Nationwide[1]	Regional[2] Reciprocity Required/ Trigger to Nationwide	Regional[3] Reciprocity Required	States without Interstate Banking
Alaska 7/82	California 7/87	Alabama 7/87	Hawaii
Arizona 10/86[6]	Colorado 7/88[8 8]	Arkansas 1/89[9]	Iowa
Idaho 1/88	Delaware 1/88	Connecticut 6/83[5]	Kansas
Kentucky 1/86[4]	Illinois 7/86	District of Columbia 11/85	Montana
Maine 1/78[5]	Indiana 1/87	Florida 7/85	North Dakota
New Jersey 1/88[4 5]	Louisiana 7/87[10]	Georgia 7/85	
New Mexico 1/90[6]	Michigan 1/86[5]	Maryland 7/85	
New York 6/82[4 5]	Nebraska 1/90	Massachusetts 7/83[5]	
Oklahoma 7/87	Nevada 7/85[6 8]	Minnesota 7/86	
Rhode Island 1/88[4 5]	Ohio 10/85[5]	Mississippi 7/88	
South Dakota 2/88[4 5]	Oregon 7/86[7]	Missouri 8/86	
Texas 1/87[6]	Pennsylvania 8/86[5]	New Hampshire 9/87[5]	
Utah 1/88	Vermont 1/88[5]	North Carolina 1/85	
Washington 7/87[4]		South Carolina 7/86	
West Virginia 1/88		Tennessee 7/85	
Wyoming 5/87		Virginia 7/85	
		Wisconsin 1/87	

Source: Conference of State Bank Supervisors, August 1988.

[1]Any out-of-state bank holding company can acquire an existing and/or new (de novo) host-state bank.

[2]An out-of-state bank holding company can acquire a host-state bank only if (1) the principal place of business of the holding company is in one of the states named in the host state's statute, and (2) the other state accords equivalent reciprocal privileges to the banks of the host state. After a certain date, set forth in the statute, any out-of-state bank holding company can acquire an existing and/or new (de novo) host-state bank.

[3]An out-of-state bank holding company can acquire a host-state bank only if (1) the principal place of business of the holding company is in one of the states named in the host state's statute, and (2) the other state accords equivalent reciprocal privileges to the banks of the host state.

[4]Reciprocity requirement.

[5]De novo entry permitted.

[6]De novo entry permitted after specified time period—Arizona (6/30/92), Colorado (7/1/93), Nevada (7/1/90), New Mexico (7/1/92), and Texas (9/1/2001).

[7]Oregon law has no reciprocity requirement.

[8]States which drop reciprocity requirement after trigger—Colorado and Nevada.

[9]Effective date 1/89, unless determined otherwise according to statutory specifications.

[10]After 7/1/94, an out-of-state bank holding company may open any new bank or acquire a nonestablished LA bank if the acquirer has an established LA bank.

Second, the use of a franchise tax for banks tends to increase the neutrality and fairness of a state's tax system. States that choose a direct net income tax for banks, for example, must exempt the value of and/or income from federal obligations from their bank tax base. This exemption can cover from 10 to 60 percent of a bank's income. By contrast, federal obligations typically constitute an insignificant percentage of the assets and income of nonbank corporations. Therefore, unless states offer a comparable reduction in the tax base of competing nonbank institutions, the use of a direct net income tax will generally favor banks over nonbank corporations.

Of the 35 states that reported using the franchise tax, 20 states (61 percent) measure the tax by a bank's net income. In addition to, or instead of, a franchise tax, 19 of the responding states (38 percent) levy a direct net income tax, 7 (14 percent) impose a bank shares tax, 4 (8 percent) levy a gross receipts tax, and 6 (12 percent) impose another type of tax on banks. Judicial interpretations of the U.S. Constitution probably account for the use of a direct net income tax alone or in conjunction with a franchise tax. According to its interpretations of the commerce clause in the early part of this century, the U.S. Supreme Court ruled that states could not tax businesses operating in interstate commerce by means of a franchise tax, but they could do so with an apportioned direct net income tax. The court's rulings led many states to adopt either a straight, direct, net income tax or a system by which the in-state business of banks was subject to a franchise tax while their interstate business was subject to a direct net income tax.

Interestingly, there are regional differences in bank tax practices. Fully 81 percent of the responding states in

the South, 73 percent in the Northeast, and 70 percent in the Midwest levy a franchise tax as opposed to only 42 percent of the states in the West.[1] In contrast, 54 percent of the responding states in the West and 41 percent in the South levy a net income tax, as opposed to only 22 percent of the states in the Northeast and 18 percent of the states in the Midwest. No northeastern state reported using a gross receipts tax, although this tax is used by one midwestern, one southern, and two western states. None of the responding states in the West reported using a bank shares tax, which is levied by 33 percent of the eastern states, 9 percent of the midwestern states, and 18 percent of the southern states. Although these percentages do not directly reveal it, the total number of states using a bank shares tax has been dwindling in recent years.

The bank shares tax was more widely used prior to 1983 because an 1864 federal law restricted state taxation of national banks to a real property and/or bank shares tax. The 1983 Supreme Court decision in *American Bank & Trust Co.* v. *Dallas County*, however, hastened the demise of the bank shares tax by severely limiting its revenue-raising capability. In its ruling, the court struck down a Texas bank shares tax because the tax, which the court found to be a property tax, included the value of federal obligations in its base in violation of federal statutory law. Currently, only seven states use a bank shares tax, and at least two of those states are reviewing that tax for possible changes.

Another finding from the survey is that in taxing banks, 32 states (64 percent) include the value of, or income from, state obligations (e.g., bonds), and 25 states (50 percent) include the value of, or income from, federal obligations. Federal law prohibits a state from including the value of, or income from, federal obligations in the measure of its tax unless it uses a *nondiscriminatory* franchise (or other nonproperty) tax. A state franchise tax is deemed discriminatory and in violation of federal law if it includes the value of or income from federal obligations in the base while exempting the value of or income from its own state or municipal obligations. Thus, every state that taxes federal obligations must also tax its own state obligations. Because states are usually loathe to tax the obligations of their own government while exempting those of the federal government, the federal law has the effect of creating a partial tax parity among state and federal obligations. No federal statute or judicial decision prohibits a state from taxing the income from the obligations of other states while exempting the income from its own obligations, however. This fact apparently accounts for the finding that more states tax state obligations than tax federal obligations; the state obligations being taxed are those of other states.

[1]Regions were defined in accordance with official Census categories: Northeast—Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut, New York, New Jersey, and Pennsylvania; Midwest—Ohio, Indiana, Illinois, Michigan, Wisconsin, Iowa, Missouri, Nebraska, Kansas, Minnesota, North Dakota, and South Dakota; South—Delaware, Maryland, Virginia, West Virginia, North Carolina, South Carolina, Georgia, Florida, Kentucky, Tennessee, Alabama, Mississippi, Arkansas, Texas, Oklahoma, and Louisiana; West—Montana, Wyoming, Colorado, Utah, Idaho, Arizona, Nevada, New Mexico, California, Oregon, Washington, Alaska, and Hawaii.

Banks Versus Other Firms

Twenty-seven of the responding states (54 percent) do not tax banks in the same manner as they tax general (nonfinancial) business corporations. The remaining 23 states (46 percent) do tax general business corporations in the same manner as banks. The use of an industry-specific bank tax by most states appears to be the result of two historical forces. First, until 1976, federal law restricted the methods by which states could tax national banks. Second, until the 1980s, most banks occupied a narrow niche in the business of financial intermediation. The business of banking was confined to soliciting deposits and making short-term commercial and consumer loans. Today, however, federal law provides that states are free to tax banks in any manner they choose, as long as the tax does not discriminate against national banks. Also, banks now engage in a wider variety of business activities, such as securities, insurance and real estate, thus competing directly with nonbank entities in these areas. The number of states that question the continued use of an industry-specific bank tax in this new competitive environment may well increase in the near future.

Again there are regional differences. Fully 77 percent of the states in the West and 53 percent in the South tax banks in the same manner as they do other business corporations. Only 20 percent of the states in the East and 25 percent in the Midwest reported doing so.

Forty of the states (80 percent) tax savings and loan institutions in the same manner as banks. Here there are no marked regional differences, although slightly fewer states in the South (67 percent) tax savings and loan institutions in the same manner as banks.

State Constitutional Limits

In the vast majority of states, there are no constitutional limits on state taxation of banks. Forty-six (96 percent) of the responding states reported no constitutional limits on state taxation of domestic banks and savings and loan institutions. The two responding states with such limits are located in the South and West.

Except for three states—one each in the Midwest, South, and West—45 of the responding states (94 percent) have no constitutional limits on state taxation of out-of-state banks or savings and loan institutions. Similarly, except for one state in the South and three in the West, 44 of the responding states (92 percent) have no constitutional limits on state taxation of income from state or municipal obligations.

Taxation of Interstate Bank Income

The survey results presented in Table 2 indicate that, with one exception, most states do not have statutes that permit them to tax major categories of income earned by out-of-state banks that do not have a physical presence in the state. Nevertheless, some states report that they do tax such income by administrative practice. Generally, the

greater the physical presence of an out-of-state bank, the more likely a state is to tax that in-state operation.

The fact that large numbers of states do not tax a fraction of the income of out-of-state banks that conduct their in-state activities without a physical presence (i.e., banks that conduct their business solely by mail or through electronic means) is due primarily to past judicial interpretations of the commerce clause. According to its interpretation of the commerce clause in the early part of this century, the U.S. Supreme Court invalidated all state taxes on multistate corporations, holding that such taxes created multiple taxation and thereby burdened interstate commerce. Gradually, however, the court changed its interpretation of the commerce clause. If the multistate corporation had an office in the taxing state, the court often upheld the state's tax against a commerce clause challenge, finding that the tax fell on a local business rather than on interstate commerce. Later, the court found the existence of an in-state employee to be sufficient to sustain a state's tax. Still later, the court announced a general rule allowing states to tax an apportioned share of the income of a nondomiciliary corporation. The court found that the use of an apportionment formula solved the problem of multiple taxation.

Some observers argue, however, that a remaining impediment to state taxation of interstate business can be found in the Supreme Court's 1967 decision, *National Bellas Hess* v. *Department of Revenue of the State of Illinois*, which prohibits *unapportioned* state *sales* taxes on mail-order sellers. Other observers maintain that this decision does not apply to apportioned net income taxes, and that, therefore, states are free to broaden their tax jurisdiction rules as interstate branchless banking becomes more prevalent.

There are also some regional differences in state taxation of interstate bank income. Generally, states in the Midwest more often tax interstate bank income than do states in other regions. For Category 1 in Table 2, the Midwest at 50 percent is well ahead of other regions (20 percent in the South, 10 percent in the Northeast, and 9 percent in the West). For Category 2, the West at 39 percent is ahead of other regions (27 percent in the Midwest, 17 percent in the South, and 10 percent in the Northeast). For Category 3, the Midwest at 50 percent is again ahead of other regions (20 percent in the South, 18 percent in the West, and 10 percent in the Northeast). Similarly, a larger percentage of states in the Midwest (60 percent) tax the interest income in Category 4 than do states in the West (42 percent), South (43 percent), and Northeast (20 percent). For Category 5, however, the Midwest and the South are tied at 80 percent, although the West (70 percent) is close behind, but far ahead of the Northeast (30 percent). In all categories, except Category 1, the Northeast has the smallest percentage of states taxing interstate bank interest income.

The results displayed in Table 2 also point up the problem of equity in interstate bank taxation. The ACIR does not advocate increased bank taxation or a particular bank tax policy, but it should be noted that states that do not assert tax jurisdiction over the kinds of interstate bank income listed in Table 2 need to examine whether they are placing their domiciliary banks at a competitive disadvantage. At the same time, a state that bases its taxation on the entire net income of its domiciliary banks needs to determine whether other states are taxing the out-state-portions of that same income, thereby subjecting domiciliary banks to double taxation.

Licensing Out-of-State Bank Operations

The survey results displayed in Table 3 show that most states are not active in registering or licensing the loan and

Table 2

Categories of Interstate Bank Income Potentially Subject to State Taxation

Does state tax . . . ? (income category)	Percent of Responding States Yes	No	Leading Tax Region*
1. Interest income from loans made by an out-of-state bank which has no office, employees or representatives in state to a resident of the state and secured by personal property located in state.	22	78	Midwest 50
2. Interest income from credit cards issued to state residents by an out-of-state bank which has no office or employees in state.	21	79	West 39
3. Interest income from loans to residents in state made by an out-of-state bank which has no office, employees or representatives in state and secured by real property located in state.	24	76	Midwest 50
4. Interest income from loans solicited by in-state representatives of out-of-state banks (e.g., call programs).	40	60	Midwest 60
5. Interest income from loans solicited at loan production offices located in state but closed at the out-of-state home office of the soliciting bank.	67	33	Midwest & South 80

*Region with highest proportion of states reporting a tax on each category of interstate bank income. Table shows name of region and percentage of states in the region levying a tax.

Table 3

State Registration or Licensing of Out-of-State Bank Operations

Does state license . . . ? (business activity)	Percent of Responding States Yes	No	Leading Region*
1. Require the agent or representative of an out-of-state bank who solicits loans or deposits in state to register or apply for a license.	21	79	West 40
2. Require an out-of-state bank which solicits loans or deposits in state through an agent or representative to register or apply for a license.	38	62	West 44
3. Require an out-of-state bank which solicits loans or deposits in state through a loan production office to register or apply for a license.	54	46	West 80

*Region with highest proportion of states reporting a requirement in each category. Table shows name of region and percentage of states in the region imposing the requirement.

deposit activities of out-of-state banks. Only where an out-of-state bank operates a loan production office do more than half of the states require registration or a license. Again there are regional differences. States in the West are more active in registering or licensing out-of-state banking operations than are states in other regions. In Category 1, 31 percent of southern states, 10 percent of midwestern states, and none of the responding northeastern states require a license. Requirements are imposed in Category 2 by 38 percent of the states in the South, 40 percent in the Midwest, and 25 percent in the Northeast. In Category 3, requirements are imposed by 60 percent of midwestern states, 38 percent of southern states, and 25 percent of northeastern states. Thus, as in the taxation of interstate bank income (Table 2), fewer states in the Northeast than in other regions require registration or licensing of out-of-state bank activity.

Tax Apportionment Formulas

Thirty-two (64 percent) of the responding states said that they have a statute, regulation, or administrative procedure that governs the apportionment of the income (or other tax measure used) of a multistate bank. Of the 32 states that use an apportionment formula, 11 (or 22 percent of the 50 states) have adopted the three-factor "Massachusetts" formula consisting of property, payroll, and sales.

The Massachusetts three-factor formula was developed to apportion the income of multistate manufacturing companies and was later codified (with some modifications) in the Uniform Division of Income for Tax Purposes Act (UDITPA). However, the UDITPA formula specifically excludes financial institutions from its provisions. The formula is not well suited for apportioning the income of financial institutions because it does not include intangible property, which comprises most of the assets of a financial institution, in the property factor. For this reason, the states that have recently revamped their bank taxes have either dropped the property factor entirely or have changed the make-up of the property factor to include intangibles.

No commonality exists among the 21 states that use an apportionment formula other than the UDITPA. The lack of uniformity among state apportionment formulas can lead to overlapping taxation of bank income because state formulas that assign particular pieces of interstate bank income to specific states are likely to clash.

Future Plans

In terms of the immediate future, 30 states (60 percent) responding to the survey have no plans to change the formula currently used to apportion the income of banks for tax purposes. The remaining 16 states (32 percent) expect changes to be made in their formula. (Eight percent did not answer this question.)

Similarly, 34 of the responding states (68 percent) indicated no plans to broaden state jurisdictional rules in order to tax the income that out-of-state banks receive from banking transactions with in-state residents solely by mail or through electronic means. Again, 8 percent did not respond to this question, leaving 12 states (24 percent) with reported plans to broaden jurisdictional rules.

Conclusion

The results of the ACIR/FTA survey show that a number of states are beginning to meet the tax challenges posed by interstate banking. For example, 10 states reported that they have broadened their tax jurisdiction rules to allow them to tax the in-state activities of out-of-state branchless banks, thereby creating greater tax parity between in-state and out-of-state banks. Nevertheless, much remains to be done. For example, states have made scant progress toward finding a uniform rule to apportion the income of multistate banks. The states have, however, entered a period of experimentation that may lead to the identification of the most effective method for taxing banks in the new world of interstate banking—a method that would promote uniformity among state bank taxes and equity for in-state and out-of-state banks.

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STATE TAXATION OF BANKS: ISSUES AND OPTIONS

A Study Prepared for the
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[*SEE EXHIBIT K: 2 FOR THIS STUDY*]

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Should Massachusetts Reform Its Bank Tax?

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The Massachusetts state legislature is currently considering a bill that would dramatically alter the Commonwealth's bank tax. The proposed reforms are more sweeping than any enacted since the tax was introduced in 1925. The problems they address are present throughout the nation and have already led New York and Minnesota to overhaul their bank taxes.

The bill, known as H. 6028,[1] addresses at least two flaws in Massachusetts' bank tax. First, the tax distorts the allocation of economic resources between banking and other industries in Massachusetts, especially those industries that provide financial services. Second, it imposes significantly different tax liabilities on banks earning identical incomes within the Commonwealth, even though the banks benefit similarly from services provided by the Commonwealth's state, county, and municipal governments.

This article explains how the Commonwealth's bank tax creates these two problems, discusses why they are causing so much concern, and evaluates the extent to which the reforms proposed in H. 6028 would solve them. The article finds that the legislation would mitigate both problems, although at the cost of complicating the tax. Furthermore, by enacting the legislation, the Commonwealth might motivate other states to reform their bank taxes along similar lines.

I. The Massachusetts Bank Tax in Brief

Massachusetts taxes the net income of banks, banking associations, trust companies, and savings and loan associations at a statutory rate of 12.54 percent. Its definition of taxable bank income, broader than the federal government's, includes such federally excluded items as intercorporate dividends and interest on state and local governmental obligations. It treats each separately incorporated bank as a distinct taxable

entity, even if affiliated with a bank holding company. For example, the Commonwealth treats the Bank of Cape Cod in Falmouth, Massachusetts and the Union National Bank in Lowell, Massachusetts as separately taxable entities, although they are both affiliates of the Bank of New England Corporation, the Boston-based bank holding company.

The Commonwealth taxes banks according to the "residence" principle. It taxes all of the income, wherever earned, of its "resident" or "domiciliary" banks, that is, banks whose principal office, or "headquarters," is located within its territory.[2] Thus, the First National Bank of Boston pays tax to the Commonwealth on the income generated by its activities throughout the country and around the world, not just by its activities within Massachusetts. However, the Commonwealth exempts from taxation all income earned by "nondomiciliary" banks. For example, Morgan Guaranty and Trust Company, domiciled in New York, pays no income tax to the Commonwealth, even though it transacts business within its borders.

A bank affiliated with a bank holding company is domiciled where its headquarters is located, not where the headquarters of its parent bank holding company is located.[3] For example, Casco-Northern Bank of Maine, Inc., headquartered in Portland, Maine, is not subject to the Commonwealth's bank tax, even though it is affiliated with the Boston-based Bank of Boston Corporation.[4] On the other hand, Arlington Trust Company, headquartered in Lawrence, Massachusetts, is taxed by the Commonwealth, even though the bank is affiliated with the Hartford National Corporation of Hartford, Connecticut.

The Commonwealth's Taxation of Banks Compared to Its Taxation of Other Corporations

Massachusetts taxes the net income of corporations other than banks (nonbank corporations) at a statutory rate of 9.5 percent, more than 3 percentage points lower than that applied to bank income. It subjects them to an additional tax on their tangible personal property located in Massachusetts at a rate of $2.60 per $1,000 of value. Corporations whose tangible personal property is a small fraction of their total assets in the Commonwealth (including most nonbank financial corporations) pay a tax on their net worth instead, also at $2.60 per $1,000 of value. The Commonwealth also grants nonbank corporations tax preferences not accorded to banks, such as an exclusion for most intercorporate dividends, the right to carry forward losses incurred during the first five years of their operation, and tax credits for locating facilities and hiring residents in urban poverty areas.

Several other states also tax the income of banks at a different rate than the income of nonbank corporations. This practice began primarily as a response to federal restrictions on state taxation of nationally chartered banks. From 1923 until 1973, federal law forbade states to tax the income of nationally chartered banks at a rate higher than that applied to state-chartered banks and nonbank corporations.[5] Like many other states, Massachusetts interpreted this requirement to mean that the burden[6] of all state and local taxes on national banks should be no higher than that of all state and local taxes on other corporations. Consequently, the Commonwealth adjusted its statutory tax rate on bank income each year in order to keep the overall tax burden on banks equal to that on other businesses (Helmberger 1960).

During the same 50-year period, federal law prohibited states from applying certain taxes to national banks, such as sales taxes on materials, supplies, and equipment; excise taxes; and documentary and stamp taxes.[7] Although not required by federal law, states generally refrained from levying these taxes on state banks, too (McCray 1987, Welch 1934). Furthermore, as noted above, banks have never been subject to the Commonwealth's tangible personal property/net worth tax. Consequently, each year the Commonwealth set a statutory tax rate on banks higher than that applicable to nonbank corporations. It halted annual adjustments to its bank tax rate in 1976.[8] The statutory tax rates on bank income, nonbank corporate income, tangible personal property, and net worth have not changed since.

Like all other states except Georgia, Massachusetts taxes nonbank corporations operating within its territory according to the source principle, not the residence principle (Commerce Clearing House 1988). In other words, it requires them to pay tax only on that portion of their income earned or "sourced" within the Commonwealth. The Commonwealth uses a formula to determine its fair share of a nonbank corporation's taxable income based on its shares of the corporation's tangible property, payroll, and receipts. Thus, Digital Equipment Corporation, which operates facilities in several states, pays tax only on that fraction of its income apportioned to Massachusetts.

Why Most States Tax Banks According to the Residence Principle

Like Massachusetts, most states tax bank income according to the residence principle. While several states have a formula for apportioning bank income—suggesting taxation by the source principle—almost all of them apply their formulas in a manner that permits them to tax all of the income of their domiciliary banks but none of the income of nondomiciliary banks transacting business within their territory. A few states, such as New York, Florida, South Dakota, and California, do indeed practice source taxation of bank income to a limited extent (Multistate Tax Commission 1986, Commerce Clearing House 1988). Minnesota, the only state currently engaging in this practice intensively, has been doing so only since 1987.[9]

Source taxation is likely to spread over the next several years.

Until 1976, federal law effectively forbade the states to tax the income of national banks according to the source principle.[10] Since then states have been reluctant to embrace the principle because they have doubted their constitutional authority to tax the income of nondomiciliary banks. Under the Constitution's "due process" clause, a state may tax only those firms whose contacts with it exceed a minimum threshold. When that threshold is exceeded, the state is said to have "nexus" with the firm.

Given current federal and state restrictions, banks have practically no branches outside their state of domicile.[11] Their contacts with out-of-state customers are limited to personal visits, mailings, and telecommunications. Many states doubt that they can establish nexus with a nondomiciliary bank conducting in-state business solely through these channels.

However, some prominent legal scholars have argued that in many cases a state may tax the income of a bank lacking a branch within its territory without violating due process (McCray 1986, Hellerstein 1972). These opinions helped persuade Minnesota to begin taxing the income of banks according to the source principle. Moreover, as explained in Section III, once one state converts to source taxation, other states have an incentive to follow suit. Source taxation is therefore likely to spread over the next several years.

II. Problems with the Massachusetts Bank Tax

The Massachusetts bank tax violates at least two normative standards of taxation: inter-industry neutrality and equity according to the benefit principle.

Inter-Industry Neutrality

A neutral tax does not distort private decisions governing the allocation of economic resources among industries. In a competitive economy without distortions, these decisions produce an inter-industry allocative pattern that maximizes the total value of production. The more a tax distorts this pattern, the less the value of the output that the economy will obtain from its supply of scarce resources, that is, the less efficiently it will operate.

Without distortions such as those introduced by taxation, competitive private economic decision-makers tend to allocate resources among industries so as to obtain the highest available rate of return. As an illustration, suppose that Massachusetts had no taxes whatsoever and the marginal rate of return obtainable in its banking industry were higher than that obtainable in its other industries. Capital, and perhaps labor as well, would flow from other industries into the banking industry. The total value of the economy's output of goods and services would rise because each unit of reallocated capital and labor would be put to a more profitable use.

The marginal rate of return in banking would eventually fall as the supply of banking services rose relative to demand. The marginal rate of return in other industries would rise as supply fell relative to demand. The flow of labor and capital into banking would stop when marginal rates of return were equal across all industries. Since further reallocation would not increase the economy's total value of production, inter-industry allocative efficiency would be maximized.

Suppose that after this reallocation had occurred the Commonwealth imposed a tax on bank income but not on other income. Owners of banks would try to shift part of the burden of the tax to their customers in the form of higher prices.[12] However, the owners would have to bear some of the tax's burden them-

selves and, consequently, their marginal rate of return would decline relative to that enjoyed by the owners of other businesses. Labor and capital would flow out of banking until the after-tax marginal rate of return rose to equal the marginal rate in other industries. The allocation of resources between banking and other industries in the Commonwealth would be deflected from its most efficient pattern. Too few resources would be devoted to banking and too many to the production of goods and other services.

In recent years, the Commonwealth's banks have become especially concerned about the inter-industry neutrality of the bank tax because they have faced increasing competition from nondepository financial institutions (nondepositories). Examples of nondepositories include insurance companies, investment banks, mortgage banks, and consumer finance companies. Competition between banks and nondepositories began to intensify during the late 1970s and early 1980s, when interest rate ceilings prevented banks from offering depositors high market rates.

In recent years, the Commonwealth's banks have faced increasing competition from nondepository financial institutions.

Unencumbered by interest rate ceilings and other banking regulations, nondepositories were able to offer investments, such as shares of money market mutual funds, comparable in liquidity to savings instruments offered by banks but providing market yields. Nondepositories also began to offer services, such as check writing and credit cards, long considered to be the exclusive province of banks. Deregulation of banking has broadened the competitive interface between the two types of institutions. Ceilings on bank interest rates have been lifted, and banks have obtained the authority to engage in activities formerly limited to nonbank financial companies, such as leasing, transacting in futures markets, and the provision of certain computer services.[13]

In evaluating how a tax affects the ability of industries to compete with one another, economists analyze its impact on inter-industry differences in marginal tax rates. If a tax increases the marginal tax rate of an industry relative to those of other industries, it weakens the industry's ability to compete and therefore diminishes inter-industry allocative efficiency. Economists generally use the "representative firm" approach to conduct such an analysis. They create a sample of hypothetical firms—or, even better, select a sample of actual firms—representative of an industry. They assume that each firm embarks on a new project—for example, the establishment of an additional factory, warehouse, or branch office—and then compute the tax burden on the income generated by the project. By changing assumptions concerning tax rules, economists explore how alternative rules narrow or widen inter-industry differences in this rate. Such analyses have been performed at both the national and state levels.[14]

Table 1 presents an analysis, based on a crude version of the representative firm approach, of the average annual marginal tax rates faced by both the Commonwealth's banks and its nondepository credit institutions in 1983 and 1984 under current Massachusetts law. The table compares a fictitious representative bank with a fictitious representative nondepository credit institution. The bank (column 1) is representative of all banks reporting net income on federal corporate income tax returns filed in 1983 or 1984. All of these profitable banks were added together to form one huge hypothetical parent bank. The representative bank is a miniature of this hypothetical parent. The same method was used to construct the representative nondepository credit institution, depicted in column 2. The method provides an estimate of the average state tax burden in each industry. Each industry's average tax burden is used as a proxy for its marginal tax rate.[15] A detailed description of the method is provided in the appendix.

The tax burdens reported in the table (row 15) take into account only the Commonwealth's bank tax, nonbank corporate income tax, and tax on nonbank corporate net worth. It is assumed that the total burdens of other taxes on the two compared firms are equal. Consequently, the difference between the tax burdens of the two firms reported in the table is assumed also to reveal the difference between their total tax burdens. These are reasonable assumptions. Since the production technologies of the two industries are similar, the burdens of their property taxes and sales taxes on their inputs are probably also similar. Under the Tax Reform Act of 1986, the federal tax treatment of the two industries is also similar.

Even though the nondepository is subject to the net worth tax, its tax burden (10.4 percent) is 2.1 per-

Table 1

A Comparison of the Massachusetts Tax Burden of a Representative Bank with That of a Representative Nondepository Credit Institution in 1983 and 1984

	Bank (1)	Nondepository Credit Institution (2)
1. Net income before federal, state, and local taxes	$10,000,000	$10,000,000
2. Federal taxable income	4,126,164	5,243,960
3. − Deduction for dividends permitted under Massachusetts law	not permitted	955,461
4. + Federal deduction for dividends received	205,872	282,468
5. + Federal deduction for net loss carryovers	1,528,035	1,317,165
6. + Federal deduction for taxes paid	1,611,673	2,192,532
7. + Federal exclusion for interest on state and local governmental obligations	2,479,560	618,802
8. Equals: Estimated Massachusetts taxable income	9,951,303	8,699,466
9. Estimated Massachusetts income tax	1,247,893	826,449
10. Net worth	n.a.	109,695,012
11. − Property taxable at local level	n.a.	26,063,083
12. + Mortgage indebtedness	n.a.	407,933
13. Equals: Estimated taxable net worth	n.a.	84,039,862
14. Estimated net worth tax	n.a.	218,504
15. Total Massachusetts income and net worth taxes as a percent of net income (tax burden) [(row 9 + row 14)/row 1)] × 100	12.5%	10.4%

n.a.: not applicable.

Note: See appendix for methodological details.

Sources: Author's calculations and U.S. Internal Revenue Service, *Corporation Source Book, Statistics of Income*, 1983 and 1984.

centage points lower than that borne by the bank (12.5 percent). These results suggest that the Commonwealth's banks are currently at a tax disadvantage vis-à-vis their nondepository competitors.

Fairness According to the Benefit Principle

Because Massachusetts taxes bank income according to the residence principle, it imposes different income taxes on banks earning identical incomes within its territory. It imposes no tax on nondomiciliary banks and taxes all the income of its domiciliary banks, including that earned in other states.[16] These differences in tax treatment are unfair in the sense that banks earning similar incomes within the Commonwealth benefit to a similar degree from the services provided by its state and local governments. Nondomiciliary banks use state and local services similar to those used by domiciliary banks. If a nondomiciliary bank has a loan production office in the Commonwealth, the office's property is protected from fire, theft, and vandalism. The bank's employees use roads and ride public transportation. The bank may petition state courts to enforce contracts signed by borrowers situated within the Commonwealth. Furthermore, the bank benefits indirectly from a wide variety of state and local services that enable the Commonwealth's economy to function properly.

By similar reasoning, the Commonwealth should impose the same tax liability on two domiciliary banks earning identical incomes within its territory, even if one of them earns additional income out-of-state. To the extent that a bank conducts business in other states, it benefits from public services provided by the governments of those states, not the Commonwealth's. Under the residence principle, the Commonwealth violates this norm by taxing all the income of domiciliary banks, wherever earned.

The inequities of residence taxation would be more palatable to Massachusetts bankers if all states taxed bank income at the same rate. All banks domiciled in states practicing residence taxation (most states taxing bank income do) would pay tax on all their income, wherever earned, to their state of domicile at the common rate. Consequently, banks domi-

ciled in these states would compete on an equal tax footing, even if according to the benefit principle they still paid taxes on some of their income to the wrong state government.

However, Massachusetts' statutory tax rate on bank income is the highest among the states. Fourteen states do not tax the income of banks. Thirty states have a statutory tax rate on bank income at least 3 percentage points lower than the Commonwealth's and 12 of the 30 have a rate at least 6 percentage points lower.[17] (See table 2.) By adhering to the residence principle, the Commonwealth ensures that its domiciliary banks face its high tax rate wherever they transact business and that other banks never face it. The Commonwealth's domiciliary banks are concerned that this tax disadvantage is causing them to lose business to their nondomiciliary competitors.[18]

The prospect of more widespread source taxation of bank income has further sensitized Massachusetts bankers to the inequities of residence taxation. By adhering to the residence principle, the Commonwealth puts its domiciliary banks at an especially severe tax disadvantage in competing in their home state with rivals domiciled in states practicing source taxation. When one of these rival banks makes a loan to a Massachusetts borrower, the Commonwealth taxes none of the resulting income because the bank is not domiciled within its territory. The rival bank's state of domicile taxes only the portion of the bank's income earned within that state's borders, as indicated by its apportionment formula. The remaining portion escapes taxation by both states.

When a bank domiciled in Massachusetts extends a loan to a borrower situated in a state practicing source taxation, the Commonwealth taxes the resulting income in full. The part of this income earned within the borrowing state's territory is also taxed by the borrower's state, as determined by its apportionment formula. Because the Commonwealth gives the bank no credit for taxes paid to the borrower's state, the bank is subject to double taxation.

Increasing competition from out-of-state banks has deepened the concern of Massachusetts bankers about their current tax disadvantage and their potentially greater tax disadvantage should source taxation become more prevalent. Innovations in data processing and telecommunications have permitted banks to expand their interstate operations. They now use computerized mailings, automated teller machines, and other sophisticated equipment to take deposits, clear checks, service credit card accounts, and provide a wide variety of other financial services across state lines (McCray 1986, Hellerstein 1972). As the volume and variety of interstate banking activity have increased, so has competition between Massachusetts' domiciliary and nondomiciliary banks.

Table 2
Statutory Tax Rates on Bank Income, by State, as of Taxable Year 1988

State	Tax Rate	Rank
MASSACHUSETTS	12.54	1
Hawaii	11.7	2
Connecticut	11.5	3
Arizona	10.5	4
Nebraska	10.27	5
District of Columbia	10.25	6
California	9.6	7
Minnesota	9.5	8
New Jersey	9.0	9
New York[a]	9.0	9
Delaware	8.7	11
Nevada	8.08	12
New Hampshire	8.0	13
Rhode Island	8.0	13
Wisconsin	7.9	15
Idaho	7.7	16
New Mexico	7.6	17
Tennessee	7.59	18
Oregon	7.5	19
North Carolina	7.27	20
Alaska	7.0	21
Missouri	7.0	21
North Dakota	7.0	21
Pennsylvania	6.82	24
Mississippi	6.59	25
Kansas	6.375	26
Alabama	6.0	27
Arkansas	6.0	27
South Dakota	6.0	27
Florida	5.63	30
Colorado	5.5	31
Iowa	5.0	32
Oklahoma	5.0	32
Utah	5.0	34
Virginia	4.52	35
South Carolina	4.5	36
Maryland	3.58	37

[a] New York City also taxes the income of banks domiciled within its borders at a statutory rate of 9.0 percent. Banks may deduct their city tax against their state taxable income.

Note: Georgia, Illinois, Indiana, Kentucky, Louisiana, Maine, Michigan, Montana, Ohio, Texas, Vermont, Washington, West Virginia, and Wyoming impose major deposit, share, or other taxes on banks in place of income taxes.

Source: Commerce Clearing House, *State Tax Guide*, 1988.

The Difficulty of "Arm's Length" Pricing

Affiliates of bank holding companies provide each other with a variety of services. For example, the lead bank of a bank holding company sometimes advises its affiliates on the management of their loan portfolios. The lead bank charges "fees" for its services that appear as receipts on its books and as costs on the books of its affiliates.

In order to enforce the bank tax, the Commonwealth's tax auditors must have some means of verifying the reasonableness of the prices of such inter-affiliate transactions. Otherwise, the allocation of income reported by a bank holding company between affiliates domiciled within and without Massachusetts might be incorrect. As a result, Massachusetts-based affiliates might pay a different amount of tax to the Commonwealth than their unaffiliated counterparts earning identical income within its territory.

The geographic allocation of the incomes of multistate bank holding companies is difficult to verify.

Tax auditors have limited means of evaluating the reasonableness of the prices of inter-affiliate transactions. As guidelines, most use the prices of "arm's length" transactions—comparable transactions occurring between independent firms. The usefulness of these guidelines is limited because comparable transactions among independents are often hard to find. In some cases, the affiliates of bank holding companies are so interdependent that tax officials are unable to isolate and quantify the contribution of each affiliate to the company's profits.

Partially because the geographic allocation of the incomes of multistate bank holding companies is so difficult to verify, the Massachusetts Bankers Association has been cautious in supporting further relaxation of the Commonwealth's restraints on interstate banking. Currently, the Commonwealth allows a bank holding company headquartered in another New England state to acquire or establish separately incorporated affiliates within Massachusetts if that state grants Massachusetts bank holding companies the same privilege. Legislation currently pending before the Massachusetts state legislature would give the Commonwealth authority to enter into such reciprocal agreements with any state in the nation.[19] The Association is concerned that, if the legislation were enacted, the Commonwealth's Department of Revenue might lack the resources needed to enforce arm's length pricing. As a result, the Massachusetts taxable income of some banks controlled by out-of-state bank holding companies might be understated.[20]

III. The Effects of the Proposed Reforms

H. 6028 would reform the Commonwealth's bank tax in four ways. First, it would broaden the types of financial institutions subject to the tax to include corporations "principally carrying on the business of a financial institution." The expanded definition would include most investment banks; nondepository credit institutions, both unaffiliated and affiliated with bank holding companies; and other financial institutions whose lending activities bring them into "substantial competition with a bank." These financial institutions would no longer be subject to the general corporate income tax or net worth tax.

Second, the proposed law would lower the bank tax's statutory tax rate from 12.54 percent to 10.5 percent effective in 1989. The Commonwealth would be able to levy higher tax rates in years 1989 through 1993 if growth in bank tax revenues fell below a specified minimum. Under no condition could the Commonwealth impose a tax rate on bank income higher than 12.54 percent.

Third, under H. 6028 the Commonwealth would tax the income of multistate banks according to the source principle rather than the residence principle. The Commonwealth would identify and tax all bank income earned within its territory, whether by domiciliary or nondomiciliary banks. It would apportion the income of all multistate financial corporations taxable under its reformed bank tax according to a formula based on its shares of each financial corporation's total payroll and receipts. According to the formula, the Commonwealth's share of a multistate financial corporation's nationwide taxable income would equal:

$$\tfrac{1}{2} \times \left[\frac{\text{Payroll in Massachusetts}}{\text{Payroll worldwide}} + \frac{\text{Receipts on business in Massachusetts}}{\text{Receipts on business worldwide}} \right]$$

Unlike the formula used to apportion the income of multistate nonbank corporations, this proposed

formula contains no property factor. This omission is appropriate because the property factor used in the formula to apportion nonbank income excludes intangible assets, such as stocks, bonds, and notes. These assets are excluded because their geographic location is so difficult to pinpoint. The resulting distortions in the geographic division of multistate corporations' tax bases are mild as long as intangibles account for a small fraction of their income. This condition clearly does not hold in the case of multistate financial corporations since intangibles account for the vast bulk of their capital.[21]

Fourth, the proposed law would give the Commissioner of the Commonwealth's Department of Revenue authority to require affiliates of bank holding companies doing business in Massachusetts to file tax returns based on combined unitary accounting.[22] Under this requirement, the "apportionable entity" of these affiliates would be their whole parent company. Consequently, the denominators of the payroll and receipts factors in the apportionment formula would equal the worldwide payroll and receipts, respectively, of the parent company. In order to compute its Massachusetts income, each affiliate would multiply the apportionment formula by its parent company's worldwide income.

H. 6028 would put banks and many other financial institutions on a more competitive tax footing by subjecting all of them to the same tax. By narrowing the gap between the bank tax rate and the tax rate on the income of nonfinancial corporations, the bill would probably put financial and nonfinancial corporations on a more competitive tax footing, too. As recommended below, this goal would best be achieved by eliminating the tangible personal property/net worth tax now levied on most nonbank corporations and subjecting all corporations to the same statutory tax rate.

Taxing multistate banks according to the source principle rather than the residence principle would improve the equity of the bank tax. Domiciliary banks would no longer pay taxes to Massachusetts on income earned outside its borders, and banks domiciled outside the Commonwealth in states taxing by source would no longer earn tax-free income within Massachusetts. A bank's Massachusetts tax liability would be a function of its Massachusetts income, not its state of domicile or its worldwide income. As a result, its Massachusetts tax bill would bear a closer relationship to the value of the public services it enjoys from the Commonwealth's state, county, and municipal governments.

By granting the Department of Revenue the right to require combined unitary accounting, the proposed law would eliminate the need for the Department to verify the reported prices of transactions among affiliates of bank holding companies. Under combined unitary accounting, the income of a Massachusetts-based affiliate, as stated on its books, would be irrelevant to the computation of its income for state tax purposes. Consequently, the Department would no longer have to engage in the contentious practice of "arm's length" pricing.

H. 6028 would complicate the bank tax for both taxpayers and tax enforcers. The bill contains specific rules for determining when the Commonwealth has the authority to tax a nondomiciliary bank and for implementing its proposed apportionment formula. Enforcement of these rules would inevitably compel the Commonwealth to impose greater reporting and recordkeeping requirements on banks and give rise to litigation in circumstances where the rules are ambiguous.

For example, under the bill the Commonwealth would have the authority to impose the bank tax on "any bank or other taxable financial institution transacting business with 20 or more Massachusetts residents or with $5,000,000 or more of assets attributable to sources within [the Commonwealth]" (H. 6028, sec. 1.1). In order to determine which nonresident banks exceeded this threshold, the Commonwealth might have to require all of them doing business in Massachusetts to register with its Department of Revenue and report regularly on the nature and scope of their in-state activities. As another example, the bill stipulates that, for the purpose of apportioning a bank's receipts between Massachusetts and other states, "receipts from the lease or rental of real or tangible property shall be located where the property is located" (H. 6028, sec. 1.3). Disputes will inevitably arise over the location of such mobile, frequently leased assets as aircraft and railroad cars.

While the complexity that the bill would create is undesirable, it is an unavoidable cost of improved equity. If multistate banks are to bear their fair share of Massachusetts' tax burden, the Commonwealth must determine how much income each of them earns within its borders. It needs formulas and rules, even though imperfect and complicated, to make these determinations.

By converting to the source taxation of bank income, the Commonwealth would give its domiciliary banks a tax advantage over its nondomiciliary rivals subject to residence-based taxation. The states in

which these rival banks are domiciled could eliminate this advantage by converting to source taxation themselves. If enacted, H. 6028 might therefore motivate other states, especially states that domicile banks competing with the Commonwealth's domiciliary banks, to reform their bank taxes, too.

Under the bill, a bank domiciled in Massachusetts could extend loans to borrowers in a state practicing residence taxation without paying tax to that state on the resulting income. The Commonwealth would tax only that portion of this income earned within its borders, as determined by its apportionment formula. By contrast, if a bank domiciled in the borrowers' state extended the loan, the resulting income would be taxed in full.

A bank domiciled in a state practicing residence taxation would be taxed twice on the income it earned on loans extended to Massachusetts borrowers. The income would be taxed in full by its state of domicile. That part of the income apportioned to Massachusetts would also be taxed by the Commonwealth.[23] If a Massachusetts bank extended the loan instead, the resulting income would be taxed only by the Commonwealth.

Banks domiciled outside of the Commonwealth but competing with its domiciliary banks might pressure their state governments to convert to source taxation. If these governments did convert, they would put their banks at a tax advantage vis-à-vis banks domiciled in states still practicing residence taxation, engendering pressure for further conversions. A chain reaction might ensue, culminating in universal source taxation. While this chain reaction ran its course, the nation's multistate banks would experience double taxation in some cases, and undertaxation in other cases, by state governments.

IV. Policy Recommendations

The reforms proposed in H. 6028 generally have merit. However, the Commonwealth could further narrow disparities between the marginal tax rate of banking and those of other industries by eliminating the tangible property/net worth tax and taxing the income of all corporations, both bank and nonbank, at the same statutory rate. Furthermore, whatever rules for apportioning bank income the Commonwealth ultimately adopts, it should coordinate them with those formulated by other states opting for source taxation.

The rationale for the tangible property/net worth tax is no longer valid. It originated during the Great Depression, when many businesses were having difficulty paying their local property taxes. The Commonwealth took over the taxation of tangible personal property, whose value is especially difficult to assess, taxed it at a low rate, and shared the resulting revenue with its municipalities (Henderson 1987, McCray 1987). In this manner, the Commonwealth provided businesses with some tax relief while defusing a contentious issue dividing taxpayers and municipal officials.

If source taxation becomes more widespread, the Commonwealth could significantly lower the costs of complying with its bank tax by coordinating its apportionment rules with those of other states. Ideally, these rules should be uniform across all states. Lack of uniformity would not only complicate tax compliance but could lead to inadvertent multiple taxation. For example, H. 6028 (section 1.2) stipulates that interest receipts from credit card loans should be apportioned to the state in which the credit cardholder resides. Suppose that Rhode Island began to apportion bank income and assigned such receipts to the domiciliary state of the bank issuing the credit cards. A bank domiciled in Rhode Island would pay taxes to both Massachusetts and Rhode Island on income generated by its credit card operations within the Commonwealth.

States have managed to coordinate their rules for apportioning the income of nonfinancial corporations through such agreements as the Multistate Tax Compact and the Uniform Division of Income for Tax Purposes Act.[24] The federal government could offer states greater assistance in enforcing their bank taxes as an inducement to reach similar agreements on coordinated source taxation of bank income.

Whether or not H. 6028 is ultimately enacted, the state taxation of banks is becoming an increasingly salient issue. More and more states are reevaluating their bank taxes in light of the changing structure, technology, and regulatory environment of financial service industries. In the interests of equity and interindustry allocative efficiency, these reevaluations should lead to greater integration of bank and nonbank income taxation and more widespread source taxation of bank income based on combined unitary accounting.

Appendix

The Derivation of the Numbers in Text Table 1

The values of the variables for the hypothetical bank presented in text table 1 were chosen in the following manner: 1) average annual aggregate values of these variables were obtained for all banks reporting net income on their federal corporate income tax returns in 1983 and 1984; 2) the ratio of the average annual aggregate value for each variable to average annual aggregate pre-tax net income was computed; 3) the representative bank's net pre-tax income was assumed to equal $10 million; 4) it was assumed that the ratio of the bank's value for each variable to the bank's net pre-tax income was the same as the ratio of the average annual aggregate industry value for the variable to average annual aggregate industry net income. For example, the ratio of the aggregate industry federal deduction for taxes paid to aggregate industry net pre-tax income in 1984 was 0.1615084. The comparable ratio for 1983 was 0.1608261. The simple average of these two ratios is 0.1611673. Consequently, the federal deduction for taxes paid by the representative bank is 0.1611673 x $10 million, or $1,611,673 (line 6, column 1 of text table 1). The same method was used to select the characteristics of the hypothetical credit agency facility.

Aggregate values of most variables for the corporations reporting net income in each industry were obtained from the U.S. Internal Revenue Service, *Corporation Source Book, Statistics of Income*, 1983 and 1984. For the purpose of constructing the hypothetical examples in text table 1, banks were considered to include the following minor industry categories used by the Internal Revenue Service: mutual savings banks, banks other than mutual savings banks, and savings and loan associations. Credit agencies were considered to include the following industrial categories: personal credit institutions; business credit institutions; and other credit institutions, finance not allocable.

The manner in which the variables in text table 1 were constructed from variables reported in the *Corporation Source Book* is explained in the table at the bottom of the page.

In determining their Massachusetts taxable income, the Commonwealth's corporate income taxpayers start with their federal taxable income, before the federal deductions for dividends received and net loss carryovers. All dividends received are excludable from Massachusetts taxable corporate income except: 1) dividends from ownership of shares in a corporate trust engaged in business in the Commonwealth; 2) dividends resulting from deemed or actual distributions (except actual distributions of previously taxed income) from a domestic international sales corporation that is not wholly-owned; and 3) dividends from any class of stock if the corporation owns less than 15 percent of the voting stock of the payer corporation. The percentage of dividends received by profitable nondepository credit institutions falling into these three categories is small. Consequently, 90 percent of these dividends were assumed to be deductible from state taxable income.

While Massachusetts' nonbank corporate income taxpayers generally are not permitted to carry over losses from

Line Number	Variable in Text Table 1	Line Number[a]	Variable(s) from Corporation Source Book
1	Net income before foreign, federal, state, and local taxes	63 52	Total receipts minus Total deductions plus Deduction for taxes paid
2	Federal taxable income	74	Income subject to tax, total
3	Deduction for dividends permitted under Massachusetts law	42 0.9 × 43	[Dividend receipts, domestic corporations, plus Dividend receipts, foreign corporations]
4	Federal deduction for dividends received	70	Dividends received deduction
5	Federal deduction for net loss carryovers	71	Net operating loss deduction
6	Federal deduction for taxes paid	51	Deduction for taxes paid
7	Federal exclusion for interest on state and local governmental obligations	35	0.97 × interest receipts on government obligations, state and local
10	Net worth	27 28 29 30 31	Capital stock, plus Paid-in or capital surplus, plus Retained earnings, appropriated, plus Retained earnings, unappropriated, minus Cost of Treasury stock
11	Property taxable at the local level	16 12	Land, plus Depreciable assets
12	Mortgage indebtedness	2	.001 × Total assets

[a] Refers to line number in table in *Corporation Source Book*.

previous taxable years, they may carry over losses generated during the first five years of their existence. Since these loss carryover deductions have minor revenue effects, it was assumed that the representative nondepository had no such deductions. Banks are not permitted such deductions.

The Commonwealth requires both banks and nonbank corporations to include in their Massachusetts taxable income federally excludable interest on state and local governmental obligations and federally deductible taxes paid to other governments. It was assumed that 97 percent of interest on such obligations, whether received by banks or nondepository credit institutions, is tax exempt. (This assumption is based on conversations with investment bankers.)

Other minor deductions and credits available to nonbank corporations were not taken into account in text table 1.

Nonbank corporations subject to the net worth tax are permitted to deduct the value of all tangible property subject to local property taxation. The value of the deduction was set equal to the value of the nondepository's land plus depreciable assets. This assumption biases upward the estimate of the deduction's value, and therefore biases downward the estimate of taxable net worth, because some depreciable assets are not taxed at the local level. However, the results of the analysis are not sensitive to changes in this assumption.

Nonbank corporations must add any mortgage indebtedness on their deductible property to their taxable net worth. Although the *Corporate Source Book* provides no data on the mortgage indebtedness of profitable nondepository credit institutions, the Federal Deposit Insurance Corporation (FDIC) tabulates total mortgage indebtedness, as well as many other statistics, for FDIC-insured banks in Massachusetts. It was assumed that the ratio of mortgage indebtedness on property deductible at the local level to total assets for the representative nondepository credit institution was the same as the comparable ratio for all profitable FDIC-insured Massachusetts banks in 1983. This ratio was 0.001.

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[1] Commonwealth of Massachusetts, House Bill No. 6028, June 29, 1988. For an alternative proposal for reforming Massachusetts' bank tax, see McCray 1988.

[2] *Massachusetts General Laws*, Ch. 63, Secs. 1 and 2. More precisely, a national bank is domiciled in the state "where its operations of discount and deposit" are carried on, as indicated on its organization certificate filed with the U.S. Comptroller of the Currency. See 12 *United States Code, Annotated*, Para. 22. A state bank is domiciled in the state that holds its corporate charter, usually also the state in which its principal office is located.

[3] The principal office of a bank holding company is usually located in the state that holds its corporate charter. All bank holding companies are state-chartered, even if some or all of their affiliates are nationally chartered banks.

[4] However, fees received by Bank of Boston, Incorporated from Casco-Northern for services rendered are taken into account in the computation of the bank holding company's taxable income in Massachusetts. Dividends paid to Bank of Boston, Incorporated by Casco-Northern are not taxed by the Commonwealth because, like most bank holding companies doing business in the Commonwealth, Bank of Boston, Incorporated is subject to the 9.5 percent income tax applicable to most nonbank Massachusetts corporate income taxpayers. (See discussions in this section and the appendix for further details concerning this tax.) Under this tax, dividends received by corporations from affiliates are tax exempt. By contrast, all dividends received by the First National Bank of Boston, or any other bank domiciled in Massachusetts, are taxed by the Commonwealth.

Bank holding companies, as well as other corporations engaged exclusively in "buying, selling, dealing in, or holding securities, and not as brokers," are taxed on their gross income, that is, on their receipts gross of the costs of doing business. (The 12.54 percent tax on banks and the 9.5 percent tax on most nonbank corporations are imposed on income net of the costs of doing business, or net income.) The rate of tax on gross income varies, depending on the classification of the corporation for federal income tax purposes (*Massachusetts General Laws*, Ch. 63, Sec. 38B).

[5] The federal law imposing this requirement was the Act of March 4, 1923, Chs. 2, 67, 42 Stat. 1499–1500. The law that removed this requirement was the State Taxation of Depositories Act, P.L. 91–156, December 24, 1969.

[6] Throughout this article, a taxpayer's tax "burden" refers to the ratio of its tax liability to its profits.

[7] Act of March 4, 1923, Chs. 2, 67, 42 Stat. 1499–1500.

[8] Ch. 684, *Acts and Resolves of Massachusetts*, 1975. The Commonwealth halted these annual adjustments because it was felt that the gap between the statutory tax rate on bank income and that on the income of nonbank corporations should not widen further. Telephone interview with The Honorable Robert H. McClain, Undersecretary of Administration and Finance of the Commonwealth of Massachusetts, June 27, 1988.

[9] *Minnesota Statutes, Annotated*, Para. 290.01, 290.15, 290.191. For a clear discussion of Minnesota's apportionment rules, see McCray (forthcoming).

[10] The federal government forbade states to impose certain taxes, including income taxes, on nondomiciliary banks (Act of March 4, 1923, Chs. 2, 6, 42 Stat. 1499–1500). The law that removed this restriction was the State Taxation of Depositories Act, P.L. 94–422, 1975.

[11] Under the McFadden Act of 1927, nationally chartered banks are forbidden to branch across state lines. The Act gives the states the right to determine whether nondomiciliary state-chartered banks may establish branches within their territory. See Syron 1984, p. 9.

Massachusetts is the only state permitting nondomiciliary state-chartered banks to establish full-service branches within its borders. However, it grants this right only to banks domiciled in states that grant Massachusetts state-chartered domiciliary banks the same privilege. No states have reciprocated to date.

The only two types of offices that bank firms currently operate outside of their state of residence are loan production offices and branches of Edge Act Corporations. Loan production offices are branches whose sole function is to solicit and negotiate loans, which are then finalized at the bank's headquarters. Edge Act Corporations are banks specializing in international lending. The issue of whether an automated teller mechanism (ATM) is a branch for legal purposes is still unresolved by the courts. See McCray 1986, pp. 298–314.

However, many bank holding companies own separately incorporated subsidiaries, both bank and nonbank, in states outside

their headquarters state. Each of these subsidiaries is a separate taxable entity. Nonbank subsidiaries of bank holding companies often own branches in more than one state.

[12] They could also attempt to shift part of the tax's burden to employees in the form of lower wages, although in the process they could drive labor out of banking into other industries.

[13] The federal laws most responsible for blurring the lines of demarcation between banks and nonbank financial corporations are the Depository Institutions Deregulation and Monetary Control Act of 1980, P.L. 96–221, and the Garn-St Germain Depository Institutions Act of 1982, P.L. 97–320.

[14] At the national level, see Fullerton, Henderson, and Mackie (1987) and Gravelle (1982). At the state level, see State of New York Legislative Commission on the Modernization and Simplification of Tax Administration and Tax Law (1984); DeSeve and Vasquez (1977); Papke and Papke (1986); Special Commission Relative to the Competitiveness of the Massachusetts Tax System in the Development of a Tax Reform Program for the Commonwealth (1987).

[15] In practice, the industry's average tax burden may differ from its marginal tax rate. However, in equilibrium the two are theoretically equal.

Suppose that the industry's average tax burden does differ from its marginal tax rate. How it is likely to differ depends on how the balance sheet of a typical nondepository changes when it expands. If by expanding it increases the ratio of its net worth to income, its average tax burden underestimates its marginal tax rate. The conclusion drawn from table 1, that nondepositories face a lower marginal tax rate than banks, may therefore be invalid. However, there is no compelling reason to believe that expansion increases the net worth-to-income ratio of a typical nondepository. If the opposite is the case, table 1 underestimates the Commonwealth's discrimination against banks at the margin.

[16] Keep in mind the distinction made in this article between a "bank" and a "bank holding company." Even though Massachusetts exempts nondomiciliary banks from income taxation, it does not exempt separately incorporated domiciliary affiliates of bank holding companies merely because the companies' headquarters are located in another state. Similarly, the Commonwealth does not tax the income of separately incorporated nondomiciliary affiliates of Massachusetts-based bank holding companies. All bank holding company affiliates are separate taxable entities.

[17] Whether Massachusetts' bank tax burden is also the highest among the states is difficult to determine because most states do not keep track of the net pre-tax income of their taxable banks. According to a study performed by the Commonwealth's Executive Office for Administration and Finance (1984), the Commonwealth's average annual effective bank tax rate for 1980, 1981, and 1982 was either the fifth highest or the second highest, depending on the data used, among the 28 states (including the District of Columbia) taxing bank income during each of these three years.

[18] See letter from Massachusetts Bankers Association, Inc. to The Honorable John W. Olver, Senate Chairman, Joint Committee on Taxation, Massachusetts General Court, December 4, 1985. (The Massachusetts General Court is the Commonwealth's state legislature.) Whether their concern is justified is uncertain. Many factors other than differences in state income tax burdens are far more important in determining the extent to which a bank successfully penetrates out-of-state markets. For example, the banks that compete most successfully outside their state of domicile are generally the nation's largest banks enjoying the advantages of goodwill, economies of scale, and specialized banking expertise. Whether they enjoy a state tax advantage or state tax disadvantage vis-à-vis their competitors in out-of-state markets is unlikely to have much bearing on their success.

[19] Massachusetts' current interstate banking law can be found at *General Laws of Massachusetts*, Ch. 167, Sec. 39. For the proposed revisions to this law, see Commonwealth of Massachusetts, House Bill No. 5865, June 7, 1988.

[20] Telephone interview with David E. Floreen, Vice President, Government Relations, Massachusetts Bankers Association, Inc., June 17, 1988.

[21] See McCray (1987), p. 56, and American Bar Association (1984), pp. 54–56.

[22] For further background on the issue of combined unitary accounting, see Tannenwald (1984); McLure (1984); and Henderson (1987).

[23] However, if a bank holding company headquartered outside the Commonwealth were to instruct an affiliate domiciled in the Commonwealth to make a loan to a Massachusetts borrower, the resulting income would be taxed only by the Commonwealth. If a Massachusetts-based bank holding company were to instruct an affiliate domiciled in another state to make a loan to a borrower situated in that state, that state, and only that state, would tax the resulting income.

[24] For background on the Multistate Tax Compact, see U.S. Congress, Senate, Committee on Banking, Housing, and Urban Affairs (1975), pp. 343–348. The Uniform Division of Income for Tax Purposes Act (UDITPA) is a model law, not a law actually passed by Congress, formulated and approved by the National Conference of Commissioners on Uniform State Laws in 1957. The law is concerned entirely with interstate division-of-base procedures.

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Shifting Property Tax Burdens in Massachusetts

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Property taxes have long been virtually the only tax source for local governments in Massachusetts. Because cities and towns rely so heavily on the property tax to support a full range of local services, including schools, property tax burdens in the state are well above the national average. In per capita terms, property taxes in Massachusetts were the second highest in the nation and 84 percent above the national average in fiscal year 1980.[1] At least partly in response to taxpayer perceptions that taxes were too high, the property tax system in Massachusetts has undergone a number of radical changes in this decade, including implementation of a stringent property tax limitation measure (Proposition 2½), universal adoption of full-value assessment, and authorization for cities and towns to tax nonresidential property at higher rates than residential.

This article considers the effects of these changes on both the overall property tax burden in Massachusetts and the distribution of property taxes between residential and nonresidential taxpayers. It finds that effective property tax rates have fallen substantially, with a strong economy augmenting the effects of explicit changes in the tax system. Moreover, while it was initially feared that these changes, on net, would increase the residential share of taxes, statewide the share of property taxes falling on residential property has risen only slightly.

Part I of the article summarizes the major changes in property tax institutions and the economic environment that occurred in the decade. Part II documents the substantial decline in property tax rates that resulted from Prop 2½ and the strong real estate market. Part III examines changes in the share of property taxes borne by residential property. By classifying its tax rate and taxing nonresidential property at a higher rate than residential, a city or town can alter both the tax rates faced by different classes of property and the share of the levy paid by each class.[2] Part IV of the paper analyzes this local decision to classify the property tax rate. The final section offers some conclusions.

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Tracy, William L., (Indiana Department of Revenue), "The Indiana Financial Institutions Tax" (April 1991)

ATTACHMENT 14

The Indiana Financial Institutions Tax

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For presentation to

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I. Introduction

In 1989, the Indiana Legislature added a new Article to Indiana's Code (IC 6-5.5) which provides a franchise tax measured by net income for corporations transacting the business of a financial institution in the State of Indiana. The new law is effective for taxable years that begin after December 31, 1989. The tax is imposed at a rate of eight and one-half percent (8.5%).

II. New Nexus Rules

This new law extends Indiana's tax jurisdiction to both resident and nonresident financial institutions and to any other corporate entity that transacts the business of a financial institution in Indiana, regardless of the domicile of such entity. In fact, this new law adopts an economic presence method for determining the jurisdictional basis for taxing nonresidents who conduct the business of a financial institution in Indiana.

III. The Business of a Financial Institutions

Two categories of activities constitute the "business of a financial institution" for purposes of the franchise tax. The first category encompasses the activities of traditional financial institutions [IC 6-5.5-1-17-(d)(1)]. The second category includes any corporation which derives 80% of its income from making loans and extending credit.

If a transaction is treated as a lease for federal income tax purposes, the leasing transaction is not the economic equivalent of extending credit for purposes of the 80% test [IC 6-5.5-1-17(d)(2)(B)]. However, for purposes of the 80% test, extending credit not only includes credit card operations, but, pursuant to the 1990 amendments, also includes debit card operations, charge card operations and similar businesses [IC 6-5.5-1-17(d)(2)(C)].

IV. Taxpayers

The term "taxpayer" includes regulated financial institutions, their holding companies and the subsidiaries of either, as well as any other corporation (including entities taxed as a corporation under the Internal Revenue Code) organized under the laws of the United States, Indiana, another taxing jurisdiction or a foreign government, which is carrying on the business of a financial institution [IC 6-5.5-1-17(a)].

Taxpayers are differentiated on the basis of their resident or nonresident status. A resident taxpayer is a taxpayer which is commercially domiciled in Indiana and transacts the business of a financial institution in this State. If a taxpayer is a resident taxpayer, all income received by the taxpayer is automatically attributable to Indiana and such income is subject to the financial institutions tax.

A nonresident taxpayer is a taxpayer which is not commercially domiciled in Indiana but transacts the business of a financial institution in this State [IC 6-5.5-1-4]. Chapter 3 of IC 6-5.5 establishes the rules for determining when the activities of nonresident corporations constitute transacting business in Indiana. A taxpayer is transacting business in Indiana for purposes of the franchise tax when it satisfies any of the following eight tests:

(1) maintain an office in Indiana;
(2) has an employee, representative, or independent contractor conducting business in Indiana;
(3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;
(4) regularly solicits business from potential customers in Indiana;
(5) regularly performs services outside Indiana that are consumed within Indiana;
(6) regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana;
(7) owns or leases tangible personal or real property located in Indiana; or
(8) regularly solicits and receives deposits from customers in Indiana.

Only a portion of a nonresident taxpayer's income is subject to the tax. The statute employs a single factor receipts formula to determine the percentage of the nonresident taxpayer's income which is taxable. The single factor receipts formula is derived by dividing the gross receipts attributable to transacting business in Indiana by the taxpayer's total receipts from transacting business in all taxing jurisdictions.

V. Exemptions and Exclusions

Four specific types of corporations are exempted from the franchise tax:

(1) Insurance companies subject to the tax under IC 27-1-18-2 or IC 6-2.1;
(2) International banking facilities (as defined in Regulation D of the Board of Governors of the Federal Reserve System;
(3) Any corporation that is exempt from income from tax under Section 1363 of the Internal Revenue Code; and
(4) not-for-profit corporations [IC 6-5.5-2-7].

An exclusion is also provided for those financial institutions whose Indiana activities are limited to certain activities [IC 6-5.5-3-8(5)]. These activities include owning an interest in the following types of property, including those activities within Indiana that are reasonably required to evaluate and complete the acquisition or disposition of the property, the servicing of the property or the income from the property, the collection of income from the property, or the acquisition or liquidation of collateral relating to the property:

(A) An interest in a real estate mortgage investment conduit, a real estate investment trust, or a regulated investment company (as those terms are defined in the Internal Revenue Code).

(B) An interest in a loan-backed security representing ownership or participation in a pool of promissory notes or certificates of interest that provide for payments in relation to payments or reasonable projections of payments on the notes or certificates.

(C) An interest in a loan or other asset in which the interest is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.

(D) An interest in the right to service or collect income from a loan or other asset from which interest on the loan or other asset is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.

(E) An amount held in an escrow or a trust account with respect to property described in this subdivision.

VI. Method of Filing Returns

The statute permits taxpayers to report on a separate or a combined basis. However, members of a unitary group must file collectively on one combined return. Also, there isn't any provision for filing consolidated returns.

A taxpayer is allowed to file a separate return only in those instances where the taxpayer is not a member of a unitary group as defined in IC 6-5.5-1-18. If the taxpayer is a member of a unitary group, combined reporting is mandatory. However, if the taxpayer determines that its Indiana income is not accurately reflected by the filing of a combined return, then the taxpayer may petition the Department by indicating on its annual return, that the return is a separate return made by a member of a unitary group. Such petition is subject to approval by the Department [IC 6-5.5-5-1(b)].

If a combined return is warranted, each taxpayer which is a member of a unitary group is obligated to file a combined return which includes all operations of the unitary business, but the unitary group should collectively file one return (IC 6-5.5-5-2, IC 6-5.5-6-1). The statute requires that the combined return include the adjusted gross income of all members of the group (IC 6-5.5-5-2). The statute provides an exclusion for the income of corporations or other entities organized in foreign countries, except a federal or State branch of a foreign bank or its subsidiary which transacts business in Indiana (IC 6-5.5-5-2). In other words, combined reporting is on a water's edge basis.

The term "unitary business" is defined as business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution [IC 6-5.5-1-18(a)]. The term may be applied within a single entity or between multiple entities and without regard to whether each entity is a corporation, a partnership or a trust.

The term "unitary group" is defined as those entities that are engaged in a unitary business transacted wholly or partially within Indiana [IC 6-5.5-1-18(a)]. Unity is presumed if there is unity of ownership, operation, or unity of use as evidence by centralized management, centralized purchasing, advertising, accounting, or other controlled interaction among entitles that are members of the unitary group as defined in IC 6-5.5-1-18(a).

Unity of ownership exists for a corporation if it is a member of a group of two or more business entities, 50% of whose

voting stock is owned by a common owner or owners or by one or more of the member corporations of the group [IC 6-5.5-1-18(c)].

VII. The Tax Base

Except for credit unions and investment companies, adjusted gross income is defined as Federal taxable income under Section 63 of the Internal Revenue Code, with nine modifications (IC 6-5.5-1-2). Probably the most important modification is the addback of interest from state and local government obligations which are exempt from Federal income tax under Section 103 of the Internal Revenue Code. This modification causes the interest from all government obligations (Federal, state and local) to be included in the tax base.

For resident taxpayers, deductions for net operating losses and net capital losses are allowed from adjusted gross income to arrive at taxable income (IC 6-5.5-2-1). No apportionment is made for income attributable to out-of-state sources (IC 6-5.5-2-2).

For nonresident taxpayers, adjusted gross income is narrowed to apportioned income by the use of a single factor apportionment formula based on the attribution of the taxpayer's receipts pursuant to IC 6-5.5-4. Apportioned income is the percentage of the taxpayer's total receipts attributed to Indiana. Deductions for net operating losses and net capital losses are then allowed from apportioned income to arrive at taxable income for nonresident taxpayers.

VIII. Credits

Because of the nonapportionment of receipts for a resident taxpayer, a credit is provided to avoid double taxation (IC 6-5.5-2-5. This credit is equal to the lesser of (1) the amount of tax actually paid to another state on the same receipts or (2) the amount of tax due by multiplying the Indiana tax rate times the lesser of (a) the taxpayer's adjusted gross income that is subject to taxation by another state or (b) the taxpayer's adjusted gross income that would be attributable to another state using Indiana's rules for attributing receipts.

A tax actually paid to another state includes a direct net income tax; a franchise or other tax measured by net income; a tax based on deposits, investment capital or shares, net worth or capital, or a combination of these tax bases; or any other tax that is imposed instead of an income tax. However, the credit will not be allowed until the Indiana Department of Revenue receives satisfactory proof of the payment of taxes to another state (IC 6-5.5-2-5.3).

A credit is also provided in a more limited manner for nonresident taxpayers (IC 6-5.5-2-6). The credit only applies to receipts from loans and loan transactions that are attributable to another state under its laws and attributable to Indiana under IC 6-5.5-4. Also, the principal amount of each loan or loan transaction must be for two million dollars ($2,000,000) or more. The credit is the lesser of (1) the amount of tax actually paid on the loan receipts to another state or (2) the tax due under IC 6-5.5 on the same loan receipts. The Indiana credit is then reduced by the amount of any credit allowable by the taxpayer's domiciliary state in arriving at the tax due that state.

The nonresident taxpayer is also provided an alternative to calculating the credit. If the tax payable to the taxpayer's domiciliary state for any loans or loan transactions is equal to or greater than the tax due Indiana on the same transactions, then the nonresident taxpayer may exclude the receipts from such transactions in calculating the tax due to Indiana. However, the nonresident taxpayer must include in the return an estimate of the total of those receipts [IC 6-5.5-2-6(e)].

IX. Attribution Rules

The rules for attributing the receipts of a nonresident to Indiana for purposes of the single factor apportionment formula are quite detailed (IC 6-5.5-4). The following receipts are attributed to Indiana.

1. Lease an rental receipts from tangible property located in Indiana.

2. Receipts from loan secured by tangible property located in Indiana.

3. Receipts from installment sales contracts that deal with tangible property located in Indiana.

4. Receipts from unsecured consumer loans if the loan is made to an Indiana resident.

5. Receipts from unsecured commercial loans if the proceeds of the loan are to be applied in Indiana, or if the application of the proceeds cannot be determined, if the business applied for the loan in Indiana.

6. Receipts from letters of credit, acceptance of drafts, and other devices for assuring or guaranteeing loans or credit pursuant to the same rules for attributing receipts from commercial loans.

7. Receipts from credit cards, if the charges and fees are regularly billed to Indiana.

8. Receipts from the sale of an asset if the income from that asset would be attributable to Indiana.

9. Receipts from the performance of services to the extent that the benefits of such services are consumed in Indiana.

10. Receipts from the issuance of traveler's checks, money orders and savings bonds if they are purchased in Indiana.

11. Receipts from investments in securities issued by an Indiana governmental entity.

A taxpayer's receipts from its portion of a participation loan will be attributed in the same manner as other loans. The nonbusiness income of a taxpayer will be allocated to its commercial domicile. Any other receipts not specifically mentioned will be attributed to Indiana in the same manner that aggregate receipts are attributed to Indiana.

Two final comments should be made about the attribution of receipts to Indiana: (1) if the taxpayer's activities create tax nexus with Indiana, then even those receipts from activities not sufficient by themselves to create tax nexus will be subject to the attribution rules; and (2) the receipts from transactions entered into prior to 1990 will be included in determining apportionable income.

X. Business Activity Report

For each taxable year, a corporation that carries on any business activity or owns or maintains any property in Indiana must file a business activity report with the Indiana Department of Revenue (IC 6-8.1-6-6). The report is due the fifteenth day of the fourth month following the end of the corporation's taxable year. However, a corporation is not required to file the business activity report for a taxable year if: (1) it filed for that year an adjusted gross income tax return or a financial institutions tax return, (2) it obtained during that year written authority from the state to conduct business in Indiana, or (3) it is exempt from taxation under the adjusted gross income tax statutes and the financial institutions tax statutes.

Until a report is filed in compliance with the law, a corporation may not pursue in Indiana courts any claim that arose under Indiana law during that taxable year or any claim on a contract executed before or during that taxable year that is enforceable under Indiana law. However, a court may allow the claim to be pursued if the corporation shows that it was not required to file the report, or it has since filed the report, or

it has filed a tax return for the year in question, or it provides security in an amount sufficient to cover all tax liabilities that may be due. Also, the failure of a co-participator in a participation loan to file a business activity report does not prevent any other corporation from enforcing the loan documents in their entirety in an Indiana court.

TITLE 45 DEPARTMENT OF STATE REVENUE

LSA Document #90-119(F)

DIGEST

Adds 45 IAC 17 concerning taxation of financial institutions. Effective 30 days after filing with the secretary of state.

45 IAC 17

SECTION 1. 45 IAC 17 IS ADDED TO READ AS FOLLOWS:

ARTICLE 17. TAXATION OF FINANCIAL INSTITUTIONS

Rule 1. Definitions

45 IAC 17-1-1 Applicability
Authority: IC 6-5.5-9-1
Affected: IC 6-5.5

Sec. 1. Unless otherwise defined, all terms used in this article shall have the same meaning as those terms are defined in IC 6-5.5. *(Department of State Revenue; 45 IAC 17-1-1; filed Jan 22, 1991, 4:55 p.m.)*

Rule 2. Taxpayer

45 IAC 17-2-1 Financial Institutions Tax (FIT)
Authority: IC 6-5.5-9-1
Affected: IC 6-5.5-1-17; IC 6-5.5-2-8

Sec. 1. (a) The Financial Institutions Tax (FIT) is intended to tax both traditional financial institutions (such as banks and savings and loans, etc.), that are transacting business within Indiana, as well as other types of businesses that are deemed to be transacting the business of a financial institution in Indiana.

(b) The FIT is a franchise tax imposed upon a corporation that:
(1) is transacting the business of a financial institution in Indiana;
(2) is a partner in a partnership that is transacting the business of a financial institution in Indiana; or
(3) is the grantor and beneficiary of a trust that is transacting the business of a financial institution in Indiana.
(Department of State Revenue; 45 IAC 17-2-1; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-2-2 "Corporation" defined
Authority: IC 6-5.5-9-1
Affected: IC 6-5.5-1-17

Sec. 2. As used in section 1 of this rule, "corpo ation" means an entity that is:
(1) a corporation (as defined in Internal Revent Code Section 7701(a)(3)) for federal income ta purposes, or any other entity taxed as a corpor tion under the Internal Revenue Code; and
(2) organized under the law of the United State this state, any other taxing jurisdiction, or a fo eign government.
(Department of State Revenue; 45 IAC 17-2-2; filed Ja 22, 1991, 4:55 p.m.)

45 IAC 17-2-3 Financial institutions
Authority: IC 6-5.5-9-1
Affected: IC 6-5.5

Sec. 3. (a) The "business of a financial institu tion" means the activities of a holding company, regulated financial corporation, or a subsidiary c either that each is authorized to perform unde federal or state law, including the activities authc rized by regulation or order of the Federal Reserv Board for such a subsidiary under Section (4)(C)(8 of the Bank Holding Company Act of 1956 (12 U.S.C 1843(C)(8)).

(b) For purposes of the FIT, a "holding company means a corporation which is registered under th Federal Bank Holding Company Act of 1956, or reg istered as a savings and loan holding company othe than a diversified savings and loan holding compan (as defined in Section 408(a)(1)(F) of the Federa National Housing Act (12 U.S.C. 1730(a)(1)(F)).

(c) For purposes of the FIT, a "regulated finan cial corporation" means:
(1) an institution, the deposits, shares, o accounts of which are insured under the Federa Deposit Insurance Act, or by the Federal Saving and Loan Insurance Corporation;
(2) an institution that is a member of a Federa Home Loan Bank;
(3) any other bank or thrift institution incorpo rated or organized under the laws of a state that i engaged in the business of receiving deposits. (The terms "bank", "thrift institution", and "deposits" shall have the same meaning as used in the title article, chapter, section, or administrative rule under which the corporation is chartered or regulated.);
(4) a credit union incorporated and organized under the laws of this state;
(5) a production credit association organized under 12 U.S.C. 2071;
(6) a corporation organized under 12 U.S.C. 611 through 12 U.S.C. 631 (an Edge Act corporation); or

(7) a federal or state agency or branch of a foreign bank (as defined in 12 U.S.C. 3101).

(d) For purposes of the FIT, a "subsidiary" of a holding company or a regulated financial corporation means:

(1) a corporation which has fifty percent (50%) or more of its voting stock owned by another legal entity; or

(2) an entity other than a corporation that is taxed as a corporation under the Internal Revenue Code and has fifty percent (50%) or more of its net worth owned by another legal entity.

(Department of State Revenue; 45 IAC 17-2-3; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-2-4 Other corporations

Authority: IC 6-5.5-9-1

Affected: IC 6-5.5

Sec. 4. (a) The tax is also imposed upon any corporation if the corporation is organized under the laws of the United States, this state, another taxing jurisdiction, or a foreign government and the corporation is carrying on the business of a financial institution within Indiana.

(b) The corporation is deemed to be conducting the business of a financial institution and therefore subject to the FIT if eighty percent (80%) or more of the corporation's gross income during the taxable year is derived from the following activities:

(1) Extending credit. (Refer to subsection (e) below.)

(2) Leasing that is the economic equivalent of extending credit.

(3) Credit card operations.

(c) As used in this section, "gross income" includes the income derived from activities which are performed by corporations primarily (as defined by the eighty percent (80%) text) engaged in the business of extending credit. Gross income includes income from the following:

(1) Interest.

(2) Fees.

(3) Penalties.

(4) A market discount or other type of discount.

(5) Rental income.

(6) The gain on a sale of intangible or other property evidencing a loan or extension of credit.

(7) Dividends or other income received as a means of furthering any of the three (3) activities listed in subsection (b).

(d) Extraordinary income is excluded from gross income for purposes of satisfying the eighty percent (80%) test. Extraordinary income includes income which is unusual, infrequent, nonrecurring, and unrelated to the extension of credit.

(e) For purposes of satisfying the eighty percent (80%) test, corporations which are in the business of a financial institution must be conducting the activities of extending credit, leasing that is the economic equivalent of the extension of credit, or credit card operations, as follows:

(1) Making, acquiring, selling, or servicing loans or extensions of credit. For the purpose of this subdivision, loans and extensions of credit include 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; and any other transactions with a comparable economic effect. The following are examples of extending credit:

(A) A corporation is a manufacturer of widgets. In 19x9, the corporation received one million dollars ($1,000,000) in gross income from the sale of widgets. In selling such widgets, the corporation makes available an installment obligation plan whereby its customers buy widgets over an extended period of time. In 19x9, the corporation received one hundred thousand dollars ($100,000) in interest and fees from such installment obligations. Because only ten percent (10%) of the corporation's total receipts from all sources is derived from extending credit, the corporation is not considered a taxpayer for purposes of the FIT.

(B) Corporation A is primarily engaged in the business of a collection agency. Various other corporations enter into contracts with Corporation A for purposes of having delinquent loan monies collected. Corporation A does not originate or acquire the loans. Corporation A receives income from the various corporations based upon the percentage of payments collected. Corporation A is not a taxpayer for purposes of the FIT. Although one hundred percent (100%) of Corporation A's income is from servicing loans, Corporation A is not extending credit.

(2) Leasing or acting as an agent, broker, or advisor, in connection with leasing real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes. If the lease is the economic equivalent of the extension of credit, and the lease is not treated as a

lease for federal income tax purposes, the income derived from the lease is included in gross income for purposes of satisfying the eighty percent (80%) test whether the corporation is leasing its own real or personal property or is the lessor of real or personal property owned by another.

(3) Operating a credit card, debit card, charge card, or similar business. If eighty percent (80%) of a corporation's total gross income is derived from:

(A) extending credit;

(B) leasing; or

(C) credit card operations;

the corporation is subject to the FIT.

(See 45 IAC 17-4-4 concerning taxation of corporations which are partners in a partnership and corporations which are grantors and beneficiaries of a trust.) *(Department of State Revenue; 45 IAC 17-2-4; filed Jan 22, 1991, 4:55 p.m.)*

45 IAC 17-2-5 Exemptions

Authority: IC 6-5.5-9-1

Affected: IC 6-2.1; IC 6-3-8; IC 6-5; IC 6-5.5-2-7; IC 6-5.5-9-4; IC 27-1-18-2

Sec. 5. (a) Generally, any taxpayer which is taxable under the FIT (IC 6-5.5) is exempt from the following:

(1) Indiana's gross income tax (IC 6-2.1).

(2) Adjusted gross income tax (IC 6-3).

(3) Supplemental net income tax (IC 6-3-8).

(4) Bank tax (IC 6-5-10).

(5) Savings and loan tax (IC 6-5-11).

(6) Production credit association tax (IC 6-5-12).

However, in the case of a partnership with a corporate partner, transacting the business of a financial institution, only the income subject to FIT shall be exempt from the above listed taxes. (See 45 IAC 17-4-4 regarding the tax liability for corporate partners of a partnership which is doing the business of a financial institution.) NOTE: The exemptions provided for the taxes listed in subdivisions (1) through (3) do not apply to a taxpayer to the extent the taxpayer is acting in a fiduciary capacity.

(b) Four (4) types of corporations are exempt from the FIT as follows:

(1) Insurance companies subject to tax under IC 27-1-18-2 or IC 6-2.1.

(2) International banking facilities, as defined in Regulation D of the Board of Governors of the Federal Reserve System.

(3) Subchapter S corporations, as defined in Section 1363 of the Internal Revenue Code.

(4) Any corporation which is exempt from taxation under the Internal Revenue Code except for the corporation's unrelated business income.

(Department of State Revenue; 45 IAC 17-2-5; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-2-6 Transacting business within Indiana

Authority: IC 6-5.5-9-1

Affected: IC 6-5.5-3; IC 22-4-2

Sec. 6. (a) A taxpayer is transacting business within Indiana if the taxpayer has activities which include any of the following:

(1) Maintains an office in Indiana by establishing a regular, continuous, and fixed place of business in this state.

(2)(A) Has an employee, representative, or independent contractor conducting business in Indiana evidenced by such persons regularly acting on behalf of the taxpayer in furthering the business of a financial institution, as defined in section 3 of this rule;

(B) both the office from which such person's activities are directed or controlled is located in Indiana and the majority of such person's services are conducted on behalf of the taxpayer in this state; or

(C) a contribution to the Indiana employment security fund is required under IC 22-4-2 with respect to compensation paid to the employee.

(3) Owns or leases to customers real or tangible personal property if the property is physically situated in this state. Mobile tangible personal property is deemed to be located in Indiana if:

(A) such property is operated entirely in Indiana or is only occasionally operated outside this state; or

(B) the principal base of operations from which the property is sent out is in Indiana or there is no principal base of operations and Indiana is the commercial domicile of the lessee or other user of the property.

(4) Regularly solicits business from potential customers in Indiana.

(5) Regularly solicits and receives deposits from Indiana customers in Indiana. Deposits are attributed to this state if they are deposits made by this state or residents, political subdivisions, or agencies and instrumentalities of this state regardless of whether the deposits are accepted or maintained by the taxpayer at locations within Indiana.

(6) Regularly sells products or services of any kind or nature to Indiana customers in Indiana that receive the product or service in Indiana.

(7) Regularly performs services outside Indiana

that are consumed within Indiana.

(8) Regularly engages in transactions with Indiana customers that involve intangible property, including loans, but not property described in section 7 of this rule and result in receipts flowing to the taxpayer from within Indiana.

(b) For purposes of this article, "regularly", when applied to any business activity, depends on the number of transactions, and with respect to any transaction, its size and complexity and whether it involves one (1) act or a series of activities to be performed over a substantial time period, and the extent to which any transaction or transactions involve the protection by the laws, government, or public institutions of the state of Indiana. The following are examples:

(1) A corporation which operates a credit card or charge card business and executes a contract with cardholders enforceable in Indiana which is evidenced by one (1) or more of the following: billed to cardholders in Indiana, providing interest on any amount due until paid, providing a card which operates as a form of money for purchasing material and services in Indiana, or establishes contracts with the Indiana vendors.

(2) A regulated financial corporation receiving deposits and making loans in Indiana, operated through mail, telephone, or automated terminals in Indiana with computer generated or other record keeping and billing outside Indiana.

(3) A regulated financial corporation providing an Indiana based corporation with a line of credit with complex credit requirements and supervision.

(4) A construction loan in Indiana requiring many draws and substantial inspection and certification over a period of time in Indiana.

(Department of State Revenue; 45 IAC 17-2-6; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-2-7 Exemptions; certain activities

Authority: IC 6-5.5-9-1

Affected: IC 6-5.5-3-8; IC 6-5.5-4

Sec. 7. A taxpayer is not considered to be transacting business in Indiana for the purposes of the FIT if the only activities of the taxpayer in Indiana are, or are in connection with, any of the following:

(1) Maintaining or defending an action or suit.

(2) Filing, modifying, renewing, extending, or transferring a mortgage, deed of trust, or security interest.

(3) Acquiring, foreclosing, or otherwise conveying property in Indiana as a result of a default under the terms of a mortgage, deed of trust, or other security instrument relating to the property.

(4) Selling tangible personal property, if taxation is precluded by 15 U.S.C. 381 through 15 U.S.C. 384.

(5) Owning an interest in the following types of property even though activities are conducted within Indiana that are reasonably required to evaluate and complete the acquisition or disposition of the property, the servicing of the property or the income from the property, the collection of income from the property, or the acquisition or liquidation of collateral relating to the property:

(A) An interest in a real estate mortgage investment conduit, a real estate investment trust, or a regulated investment company (as those terms are defined in the Internal Revenue Code).

(B) An interest in a loan backed security representing ownership or participation in a pool of promissory notes or certificates of interest that provide for payments in relation to payments or reasonable projections of payments on the notes or certificates.

(C) An interest in a loan or other asset from which the interest is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.

(D) An interest in the right to service or collect income from a loan or other asset from which interest on the loan or other asset is attributed in IC 6-5.5-4-4 through IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.

(E) An amount held in an escrow or a trust account with respect to property described in this subdivision.

(6) Acting:

(A) as an executor of an estate;

(B) as a trustee of a benefit plan;

(C) as a trustee of an employees' pension, profit sharing, or other retirement plan;

(D) as a trustee of a testamentary or inter vivos trust or corporate indenture; or

(E) in any other fiduciary capacity, including holding title to real property in Indiana.

(Department of State Revenue; 45 IAC 17-2-7; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-2-8 "Soliciting business" defined

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5-3-1

Sec. 8. A taxpayer is not required to be physically present within Indiana to be soliciting business. Soliciting business includes, but is not limited to, the following:

(1) The distribution, by mail or otherwise, of catalogs, periodicals, advertising flyers, or other written solicitations of business to potential customers in Indiana, without regard to the state from where the distribution originated or where the materials were prepared.

(2) Display of advertisements on billboards or other outdoor advertising in this state.

(3) Advertisements in newspapers published in this state.

(4) Advertisements in trade journals or other periodicals, the circulation of which is primarily within this state.

(5) Advertisements in an Indiana edition of a national or regional publication or a limited regional edition of which this state is included as part of a broader regional or national publication, and which are not placed in other geographically defined editions of the same issue of the same publication.

(6) Advertisements in regional or national publications in an edition which is not by its contents geographically targeted to Indiana, but which is sold over the counter in Indiana or by subscription to Indiana residents.

(7) Advertisements broadcast on a radio or television station which are received by Indiana residents.

(8) Any other solicitation by telegraph, telephone, computer data base, cable, optic, microwave, or other communication system.

(Department of State Revenue; 45 IAC 17-2-8; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-2-9 Regularly soliciting business; presumption

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5-3-4

Sec. 9. A taxpayer is presumed, subject to rebuttal, to regularly solicit business within Indiana during a taxable year if at any time during the taxable year, the sum of the taxpayer's assets, including the assets arising from loan transactions, and the absolute value of the taxpayer's deposits attributable to Indiana, equal at least five million dollars ($5,000,000), or if the taxpayer does any of the following during the taxable year:

(1) Sells products or services of any kind or nature to twenty (20) or more Indiana customers who receive the product or service in Indiana.

(2) Solicits business from twenty (20) or more potential Indiana customers.

(3) Performs services outside Indiana that are consumed within Indiana by twenty (20) or more customers.

(4) Engages in transactions with twenty (20) or more Indiana customers that involve intangible property, including loans, but not property described in section 7 of this rule and result in receipts flowing to the corporation from such customers within Indiana.

However, if a taxpayer is presumed to be regularly soliciting business in Indiana, but its total activities in Indiana fall within the exempt activities identified in section 7 of this rule, the taxpayer is not subject to the FIT. *(Department of State Revenue; 45 IAC 17-2-9; filed Jan 22, 1991, 4:55 p.m.)*

Rule 3. Computation of Tax

45 IAC 17-3-1 Adjusted gross income

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5-1-2

Sec. 1. For corporations other than credit unions or investment companies, "adjusted gross income" means taxable income as defined in Section 63 of the Internal Revenue Code, adjusted as follows:

(1) Add an amount equal to a deduction allowed or allowable under Section 166 (Bad Debt), Section 585 (Reserve for Bad Debt), or Section 593 (Reserve for Bad Debt) of the Internal Revenue Code.

(2) Add an amount equal to a deduction allowed or allowable under Section 170 (Charitable Contributions) of the Internal Revenue Code.

(3) Add an amount equal to a deduction or deductions allowed or allowable under Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by a state of the United States or for taxes on property levied by a state or a subdivision of a state of the United States. (This provision requires the add back of taxes on property (real and tangible personal) levied at the local level, and taxes on property levied at the state level, e.g., Indiana's motor vehicle excise tax).

(4) Add the amount of interest excluded under Section 103 (Interest on State and Local Bonds) of the Internal Revenue Code or under any other federal law, minus the associated expenses disallowed in the computation of taxable income under Section 265 (Expenses and Interest Relat-

ing to Tax-Exempt Income) of the Internal Revenue Code.

(5) Add an amount equal to the deduction allowed under Section 172 (Net Operating Loss Deduction) or Section 1212 (Capital Loss Carrybacks and Carryovers) of the Internal Revenue Code for net operating losses or net capital losses.

(6) Subtract income that the United States Constitution or any statute of the United States prohibits from being used to measure the FIT, imposed by IC 6-5.5. Although United States obligations are not subject to income taxation as provided under federal law, United States obligations are not preempted by federal law from franchise taxes. See 15 U.S.C. 3124(a). Therefore, United States obligations are not subtracted from federal taxable income for purposes of the FIT.

(7) Subtract income that is derived from sources outside the United States, as defined by the Internal Revenue Code.

(8) Subtract an amount equal to a debt or portion of a debt that becomes worthless during the taxable year within the meaning of Section 166(a) (Wholly or Partially Worthless Debts) of the Internal Revenue Code.

(9) Subtract an amount equal to any bad debt reserves that are included in federal taxable income because of accounting method changes required by Section 585(c)(3)(A) of the Internal Revenue Code.

(Department of State Revenue; 45 IAC 17-3-1; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-3-2 Methods of reporting

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5-5-1; IC 6-5.5-6-1

Sec. 2. (a) Consolidated reporting is not permitted for purposes of the FIT. Separate or combined reporting are the only methods of reporting which are allowed.

(b) A taxpayer shall file a separate return when the taxpayer is not a member of a unitary group. If the taxpayer is a member of a unitary group as defined in section 5 of this rule, combined reporting is mandatory, unless IC 6-5.5-5-1(b) is applicable.

(Department of State Revenue; 45 IAC 17-3-2; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-3-3 Calculating the FIT liability for resident taxpayers filing a separate return

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5-2-1; IC 6-5.5-2-2

Sec. 3. (a) A resident taxpayer is a corporation that is transacting business within Indiana under 45 IAC 17-2-6, and is commercially domiciled in this state.

(b) Generally, the FIT liability before allowable credits for a resident taxpayer that is not a member of a unitary group is determined as follows:

STEP ONE: Calculate adjusted gross income as defined under section 1 of this rule. NOTE: Adjusted gross income includes the taxpayer's adjusted gross income from whatever source derived; therefore, adjusted gross income includes income from all taxing jurisdictions and without regard to the type of activity which produced such income. The adjusted gross income is not apportioned.

STEP TWO: Subtract from STEP ONE deductible net operating losses incurred in taxable years beginning after December 31, 1989. NOTE: A net operating loss for any taxable year is a net operating loss carryover to each of the fifteen (15) taxable years that follow the taxable year in which the loss occurred or until exhausted, whichever occurs first.

STEP THREE: Subtract from the result of STEP TWO an amount equal to net capital losses not to exceed the taxpayer's net capital gains that were incurred for taxable years beginning after December 31, 1989, to the extent that such net capital losses were added back in determining adjusted gross income. NOTE: Capital losses unused during the taxable year may be carried forward to each of the five (5) succeeding taxable years or until exhausted, whichever occurs first. However, net capital losses carried forward can only be deducted to the extent of net capital gains.

STEP FOUR: Multiply the result of STEP THREE by the FIT rate.

(Department of State Revenue; 45 IAC 17-3-3; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-3-4 Calculating the FIT liability for the nonresident taxpayer filing a separate return

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5-2-1; IC 6-5.5-2-3

Sec. 4. (a) A nonresident taxpayer is a corporation which is transacting business in Indiana under 45 IAC 17-2-6 and has its commercial domicile in a taxing jurisdiction outside Indiana.

(b) Generally, the FIT liability before allowable credits for a nonresident taxpayer which is not a member of a unitary group is determined as follows:

STEP ONE: Calculate adjusted gross income as

defined under section 1 of this rule. NOTE: Adjusted gross income includes the taxpayer's adjusted gross income from whatever source derived. The adjusted gross income is then apportioned. The adjusted gross income for the taxable year is multiplied by the quotient of:

(A) the taxpayer's total receipts attributed to transacting business in Indiana as determined under section 10 of this rule; divided by

(B) the taxpayer's total receipts from transacting business in all taxing jurisdictions.

STEP TWO: Subtract from STEP ONE deductible Indiana net operating losses incurred in taxable years beginning after December 31, 1989. When calculating the Indiana portion of the net operating losses, use the apportionment percentage used for the taxable year of the loss. NOTE: A net operating loss for any taxable year is a net operating loss carryover to each of the fifteen (15) taxable years that follow the taxable year in which the loss occurred or until exhausted, whichever occurs first.

STEP THREE: Subtract from the result in STEP TWO an amount equal to any capital loss carry forward for taxable years beginning after December 31, 1989, multiplied by the apportionment percentage used for the applicable loss year plus any capital loss incurred during the taxable year multiplied by the current year's apportionment percentage. The amount of losses available to be deducted are limited to the extent of the current year's apportioned capital gains. NOTE: Capital losses unused during the taxable year may be carried forward to each of the five (5) succeeding taxable years or until exhausted, whichever occurs first.

STEP FOUR: Multiply the result of STEP THREE by the FIT rate.

(Department of State Revenue; 45 IAC 17-3-4; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-3-5 Unitary

Authority: IC 6-5.5-9-1

Affected: IC 6-2.1-2-11; IC 6-5.5-1-18; IC 6-5.5-5-1

Sec. 5. (a) A designated taxpayer who is a member of a unitary group shall file a combined return covering all the operations of the unitary business and including all taxpayer members of the unitary group.

(b) A corporation must be a taxpayer as defined under 45 IAC 17-2 in order to be a member of a unitary group for purposes of the FIT.

(c) A "unitary business" means business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually, or as a group, in transacting the business of a financial institution. Unity of ownership exists when a corporation is a member of a group of two (2) or more entities and more than fifty percent (50%) of the voting stock of each member of the group is directly or indirectly owned by:

(1) a common owner or common owners, either corporate or noncorporate; or

(2) one (1) or more of the member corporations of the group. Example 1, Corporation A owns eighty percent (80%) of Subsidiary B. Subsidiary B owns sixty percent (60%) of Subsidiary C. Corporation A directly owns eighty percent (80%) of Subsidiary B and indirectly owns forty-eight percent (48%) of Subsidiary C. There is unity of ownership between Corporation A and Subsidiary B because Corporation A directly owns more than fifty percent (50%) of Subsidiary B. There is unity of ownership between Subsidiary B and Subsidiary C because Subsidiary B directly owns more than fifty percent (50%) of Subsidiary C. Although Corporation A indirectly owns only forty-eight percent (48%) of Subsidiary C, there is unity of ownership between Corporation A and Subsidiary B and Subsidiary C because Subsidiary B is a member corporation of the group and directly owns more than fifty percent (50%) of Subsidiary C. Example 2, Corporation A owns one hundred percent (100%) of Corporations B and C. Corporations B and C each owns thirty percent (30%) of Corporation D. Although no single corporation owns more than fifty percent (50%) of Corporation D, the unitary group owns sixty percent (60%) of Corporation D. Therefore Corporation D is a member of the unitary group.

Unity is presumed whenever there is unity of ownership, operation, and use evidenced by centralized management or executive force, centralized purchasing, advertising, accounting, or other controlled interaction among entities that are members of a unitary group.

(d) A unitary group for purposes of the FIT is composed of those taxpayer members that are engaged in a unitary business transacted wholly or partially within Indiana. Therefore, if one (1) member of a unitary group is conducting the business of a financial institution in Indiana, then all members of the unitary group engaged in a unitary business must file a combined return, even if some of the members are not transacting business in Indiana. The following are examples of unitary groups:

(1) A parent corporation is a taxpayer and commercially domiciled in Indiana. Parent owns fifty-

five percent (55%) of Subsidiary A which is a taxpayer and commercially domiciled in Indiana. Parent also owns fifty-five percent (55%) of Subsidiary B which transacts the business of a financial institution and is commercially domiciled outside the state of Indiana. Subsidiary B does not extend credit in Indiana. Assume that the parent and Subsidiary A and Subsidiary B are engaged in a unitary business. The combined return must include the respective adjusted gross income of the parent and both subsidiaries.

(2) A parent corporation owns more than fifty percent (50%) of five (5) subsidiaries. Three (3) of the corporations are conducting the business of a financial institution. Two (2) of the corporations derive one hundred percent (100%) of their income from manufacturing. For purposes of the FIT, the three (3) corporations conducting the business of a financial institution are a unitary group and must file a combined return. The two (2) corporations which are manufacturers are neither subject to the FIT nor a member of the unitary group.

(3) Assume the same facts as stated in subdivision (2). The parent corporation derives sixty percent (60%) of its income from the three (3) subsidiaries which are financial institutions and forty percent (40%) from its subsidiaries' manufacturing operations. If the parent is not a taxpayer for purposes of the FIT, the parent would not be a member of the unitary group for purposes of the FIT. (In the event the parent is a taxpayer under the Gross Income Tax Act (IC 6-2.1-2-11), the parent would exclude income attributable to the members of the group subject to the franchise tax.) However, if the parent satisfies the eighty percent (80%) test because eighty percent (80%) or more of its gross income is derived from the business of a financial institution (either from the parent's financial activities alone or in conjunction with the income stream from the financial subsidiaries), the parent would be included as a member of the unitary group.

(Department of State Revenue; 45 IAC 17-3-5; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-3-6 Calculating the FIT liability for taxpayers filing a combined return

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5-2-4; IC 6-5.5-5-2

Sec. 6. Generally, the FIT liability before allowable credits for a taxpayer filing a combined return for a unitary group is determined as follows:

STEP ONE: Eliminate all income and deductions from transactions between entities that are included in the unitary group.

STEP TWO: Calculate the unitary group's adjusted gross income which consists of:

(A) all of the adjusted gross income of the resident taxpayer members of the unitary group; plus

(B) the adjusted gross income of all nonresident taxpayer members of the unitary group for the taxable year multiplied by the quotient of:

(i) the receipts of the nonresident taxpayer members of the unitary group attributable to transacting business in Indiana, as determined under section 10 of this rule; divided by

(ii) the receipts of the nonresident taxpayer members of the unitary group from transacting business in all taxing jurisdictions, as determined under section 10 of this rule.

The above calculation does not permit each member to separately calculate its own Indiana adjusted gross income.

STEP THREE: Subtract from the result in STEP TWO an amount equal to the unitary group's net operating losses attributed to Indiana that were incurred in taxable years beginning after December 31, 1989. The amount of the net operating loss deduction shall be computed similar to STEP TWO above for the tax year in which the net operating loss occurred. The unitary group's net operating loss deduction consists of:

(A) all of the adjusted gross income of the resident taxpayer members of the unitary group for the loss year; plus

(B) all of the adjusted gross income of all nonresident taxpayer members of the unitary group for the loss year multiplied by the quotient of:

(i) the receipts during the loss year of the nonresident taxpayer members of the unitary group attributable to transacting business in Indiana, as determined under section 10 of this rule; divided by

(ii) the receipts during the loss year of the nonresident taxpayer members of the unitary group from transacting business in all taxing jurisdictions.

STEP FOUR: Subtract from the result in STEP THREE an amount equal to the unitary group's capital loss carry forward for taxable years beginning after December 31, 1989, and the capital loss for the current taxable year which is attributable to Indiana. The amount of losses available to be deducted are limited to the extent of the current year's capital gains attributed to Indiana. (Note: Capital losses unused during the taxable year may be carried forward to each of the five (5) succeeding taxable years or until exhausted, whichever

occurs first.) The current year's capital gains attributed to Indiana is determined by the sum of the capital gains of the resident members plus the capital gains attributed to Indiana for the nonresident members. The unitary group's capital losses attributed to Indiana for the current taxable year must be multiplied by the capital loss ratio. The capital loss ratio is determined by the sum of Indiana's resident member's total receipts plus nonresident member's receipts attributed to Indiana divided by the unitary group's total receipts derived from all taxing jurisdictions. The unitary group's capital loss carry forward attributed to Indiana for taxable years beginning after December 31, 1989, must be multiplied by the capital loss ratio used for the respective loss year. The capital loss ratio is determined by the sum of Indiana's resident member's total receipts plus nonresident member's receipts attributed to Indiana divided by the unitary group's total receipts derived from all taxing jurisdictions.

STEP FIVE: Multiply the result in STEP FOUR by the FIT rate.

(Department of State Revenue; 45 IAC 17-3-6; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-3-7 Credits for taxes paid to other states

Authority: IC 6-5.5-9-1

Affected: IC 6-5.5

Sec. 7. (a) A resident taxpayer or a resident member of a unitary group is entitled to a credit against the FIT.

(b) To claim a credit for creditable taxes paid to other taxing jurisdictions, the resident taxpayer must provide the department with a schedule which lists the separate taxing jurisdictions and the respective amounts paid.

(c) As used in this section, "creditable tax" means a tax imposed by a taxing jurisdiction and based on any of the following:

(1) Net income.
(2) Franchise.
(3) Deposits.
(4) Investment capital.
(5) Shares.
(6) Net worth or capital.
(7) A combination of these tax bases.
(8) Any other tax that is imposed instead of an income tax.

(d) Taxes paid to political subdivisions of a state are not creditable taxes.

(e) The credit equals the lesser of any of the following:

(1) The amount of creditable tax actually paid by the resident taxpayer or member to any other taxing jurisdiction on the resident taxpayer's or member's adjusted gross income.
(2) The amount of creditable tax calculated on the taxpayer's adjusted gross income that is subject to taxation by the other taxing jurisdiction using Indiana's tax rate.
(3) The amount of creditable tax calculated on the taxpayer's adjusted gross income that is attributable to the other taxing jurisdictions under the rules for attributing gross receipts under section 10 of this rule using Indiana's tax rate.

(Department of State Revenue; 45 IAC 17-3-7; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-3-8 Credits for certain nonresident taxpayers

Authority: IC 6-5.5-9-1

Affected: IC 6-5.5-2; IC 6-5.5-4

Sec. 8. (a) A nonresident taxpayer filing separately or a combined return is entitled to a credit against its FIT liability in the amount of direct net income tax, a franchise tax, or other tax measured by net income that is due for a taxable year to the nonresident taxpayer's domiciliary state if:

(1) the receipt of interest or other income from a loan or loan transaction is attributed both to the taxpayer's domiciliary state under that state's laws and also to Indiana under IC 6-5.5-4; and
(2) the principal amount of the loan is at least two million dollars ($2,000,000).

(b) The credit is available only in regard to loans which are in a principal amount of two million dollars ($2,000,000) or more as expressed in the loan document. There may be instances when a corporation extends many loans but only some of the loans meet the two million dollar ($2,000,000) qualifying limit. To determine the amount of tax attributable to the qualified loans, divide the receipts attributable to the qualified loans by the total receipts and multiply that fraction expressed as a percentage by the amount of the FIT due.

(c) The amount of the credit is equal to the lesser of the actual taxes paid to the domiciliary state for the loan transaction or the amount due to Indiana on the loan transaction.

(d) If the nonresident taxpayer's domiciliary state grants a credit for taxes paid to other states, the credit available for the purposes of Indiana's FIT is the net tax paid to the domiciliary state. The credit granted by Indiana's FIT must be reduced by the

amount of credit granted by the taxpayer's domiciliary state.

(e) Rather than applying the credit, if the domiciliary state's method of calculating the tax base is similar to Indiana's method, but the domiciliary state's tax rate is higher than Indiana's tax rate, the nonresident corporation has the option of excluding the receipts attributable to Indiana from the numerator and denominator of the apportionment formula. However, the taxpayer must include in the return an estimate of the total of those receipts.

(f) The following are examples of credits for certain nonresident taxpayers:

(1) A nonresident taxpayer makes a two million dollar ($2,000,000) loan and the receipts from the loan are attributable to both Indiana and the taxpayer's domiciliary state. The domiciliary state grants a credit for taxes due to the state of Indiana. Assume both Indiana and the domiciliary state have the same tax rate. If the nonresident corporation owes taxes to Indiana in the amount of five thousand dollars ($5,000) and the domiciliary state grants a credit for such five thousand dollars ($5,000), then the tax liability to Indiana is five thousand dollars ($5,000), and the amount of the Indiana credit is zero (0).

(2) A nonresident taxpayer makes a two million dollar ($2,000,000) loan and the receipts from the loan are attributable to both Indiana and the taxpayer's domiciliary state. The domiciliary state grants a credit for taxes due to the state of Indiana. If the nonresident taxpayer owes taxes to Indiana in the amount of four thousand dollars ($4,000) and the taxpayer owes its domiciliary state a five thousand dollar ($5,000) tax liability, the domiciliary state would grant a credit only to the extent of the four thousand dollar ($4,000) tax due. The amount of Indiana's potential credit granted is reduced by four thousand dollar [*sic.*] ($4,000). Therefore, zero (0) credit is available to be used against the taxpayer's Indiana four thousand dollar ($4,000) tax liability.

(3) A nonresident taxpayer makes a two million dollar ($2,000,000) loan and the receipts from the loan are attributable to both Indiana and the taxpayer's domiciliary state. The domiciliary state does not grant a credit for taxes due to the state of Indiana. If the nonresident taxpayer owes taxes to Indiana in the amount of five thousand dollars ($5,000) and the taxpayer owes a three thousand dollar ($3,000) tax liability to its domiciliary state, the five thousand dollar ($5,000) Indiana tax liability would be reduced by three thousand dollars ($3,000).

(Department of State Revenue; 45 IAC 17-3-8; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-3-9 Other credits that can be applied against the FIT

Authority: IC 6-5.5-9-1
Affected: IC 6-3-3-10; IC 6-3.1; IC 6-5.5

Sec. 9. The following credits are available to be taken for purposes of reducing a corporation's FIT liability:

(1) Enterprise zone employment expense credit (IC 6-3-3-10).
(2) Teacher's summer employment credit (IC 6-3.1-2).
(3) Donation of high technology equipment for schools credit (IC 6-3.1-3).
(4) Investment credit (IC 6-3.1-5).
(5) Enterprise zone loan interest credit (IC 6-3.1-7).
(6) Neighborhood assistance credit (IC 6-3.1-9).
(7) Industrial recovery tax credit (IC 6-3.1-11).
(8) Drug and alcohol abuse prevention credit (IC 6-3.1-12).

(Department of State Revenue; 45 IAC 17-3-9; filed Jan 22, 1991, 4:55 p.m.)

45 IAC 17-3-10 Attributing receipts for nonresident taxpayers and nonresident members of a unitary group

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5-1-10; IC 6-5.5-4

Sec. 10. (a) As used in this article, the following definitions apply:

(1) "Receipts" includes all gross income as defined in Section 61 of the Internal Revenue Code. However, upon the disposition of assets such as securities and money market transactions, when derived from transactions and activities in the regular course of the taxpayer's trade or business, receipts are limited to the gain (as defined in Section 1001 of the Internal Revenue Code) that is recognized upon the disposition.

(2) "Money market instruments" means federal funds sold and securities purchased under agreements to resell, commercial paper, banker's acceptances, and purchased certificates of deposit and similar instruments.

(3) "Securities" means United States Treasury securities, obligations of United States government agencies and corporations, obligations of state and political subdivisions, corporate stock and other securities, participation in securities backed by mortgages held by United States or

state government agencies, loans backed securities and similar investments.

(b) Attribution of receipts shall be as follows:
(1) Receipts from the lease or rental of real or tangible personal property must be attributed to Indiana if the property is located in Indiana.
(2) Receipts from the sale of an asset, tangible or intangible, must be apportioned in the manner that the income from the asset would be apportioned under this article.
(3) Receipts from the performance of fiduciary and other services must be attributed to the state in which the benefits of the services are consumed. If the benefits are consumed in more than one (1) state, the receipts from those benefits must be apportioned to Indiana on a pro rata basis according to the portion of the benefits consumed in Indiana.
(4) Receipts from the issuance of traveler's checks, money orders, or United States savings bonds must be attributed to the state in which the traveler's checks, money orders, or bonds are purchased.
(5) Receipts from investments of a financial institution in securities of this state and its political subdivisions, agencies, and instrumentalities must be attributed to Indiana. "Political subdivision" means a county, township, city, town, separate municipal corporation, special taxing district, or school corporation. "State agency" means a board, commission, department, division, bureau, committee, authority, military body, college, university, or other instrumentality of this state, but does not include a political subdivision or an instrumentality of a political subdivision.
(6) Interest income and other receipts from assets in the nature of loans or installment sales contracts that are primarily secured by or deal with real or tangible personal property must be attributed to Indiana if the security or sale property is located in Indiana.
(7) Interest income and other receipts from consumer loans not secured by real or tangible personal property must be attributed to Indiana if the loan is made to a resident of Indiana.
(8) Interest income and other receipts from commercial loans and installment obligations not secured by real or tangible personal property must be attributed to Indiana if the proceeds of the loan are to be applied in Indiana. If it cannot be determined where the funds are to be applied, the income and receipts are attributed to the state in which the business applied for the loan. As used in this section, "applied for" means initial inquiry (including customer assistance in preparing the loan application) or submission of a completed loan application, whichever occurs first.
(9) Interest income, merchant discount, and other receipts including service charges from financial institution credit card and travel and entertainment credit card receivables and credit cardholders' fees must be attributed to the state to which the card charges and fees are regularly billed.
(10) Interest income and other receipts from a participating financial institution's portion of participation loans must be attributed under this article. A participation loan is a loan in which more than one (1) lender is a creditor to a common borrower.
(11) Fee income and other receipts from letters of credit, acceptance of drafts, and other devices for assuring or guaranteeing loans of credit must be apportioned in the same manner as interest income and other receipts from commercial loans are apportioned.
(12) Any other receipts of gross income not specfically attributable to Indiana or to another taxing jurisdiction applying this subsection, shall be attributed to Indiana in the same proportion that aggregate receipts are attributed to Indiana under subdivisions 1 through 11.

(c) If a taxpayer has adjusted gross income from a trade or business subject to apportionment under this section and in addition has income not connected with that trade or business, the unconnected income must be allocated to its commercial domicile and therefore will not be included in either the numerator or denominator for purposes of determining the apportionment percentage. Intangible property is employed in a trade or business if the owner of the property holds it as a means of furthering the trade or business. Income from such intangible property is considered to be connected with the trade or business and is subject to apportionment. *(Department of State Revenue; 45 IAC 17-3-10; filed Jan 22, 1991, 4:55 p.m.)*

Rule 4. Other Taxpayers

45 IAC 17-4-1 Resident state chartered credit unions

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5; IC 28-7-1-24

Sec. 1. (a) State chartered credit unions incorporated in Indiana are subject to the FIT. (See 45 IAC 7-2.) For purposes of computing the adjusted gross income of the credit union, adjusted gross income

equals the total transfers to undivided earnings, minus dividends for that taxable year after statutory reserves are set aside under IC 28-7-1-24. In other words, adjusted gross income can be defined as net transfers to undivided earnings. No other deductions are permitted.

(b) A resident taxpayer's income is not apportioned to other states. Therefore, the taxpayer's adjusted gross income equals all of the taxpayer's adjusted gross income from whatever source derived.

(c) For purposes of computing the FIT liability, the adjusted gross income of the credit union is multiplied by the FIT rate.

(d) A copy of the Year End Call Report submitted to the National Credit Union Association must be included when filing the annual tax return. *(Department of State Revenue; 45 IAC 17-4-1; filed Jan 22, 1991, 4:55 p.m.)*

45 IAC 17-4-2 Nonresident state chartered credit unions

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5; IC 28-7-1-24

Sec. 2. (a) Credit unions chartered in a state other than Indiana may be subject to the FIT under 45 IAC 17-2. For purposes of computing the adjusted gross income of the nonresident credit union, adjusted gross income is the total transfers to undivided earnings, minus dividends for the taxable year after statutory reserves are set aside under IC 28-7-1-24. In other words, adjusted gross income can be defined as net transfers to undivided earnings. No other deductions are permitted.

(b) For purposes of determining the statutory reserves under IC 28-7-1-24(e), the Indiana department of financial institutions may revise the statutory reserve requirement. The Indiana department of financial institutions has promulgated rules which allow the statutory reserves for Indiana purposes to coincide with the Federal Credit Union Act (12 U.S.C. 1762). Therefore, a nonresident state chartered credit union may determine its statutory reserves for purposes of the FIT by applying the reserve requirements of the Federal Credit Union Act.

(c) For purposes of computing the FIT liability, the adjusted gross income must be apportioned by dividing the total receipts attributable to transacting business in Indiana by the total receipts from transacting business in all taxing jurisdictions. This quotient, expressed as a percentage, is multiplied by the total adjusted gross income to arrive at the apportioned adjusted gross income which is multiplied by the FIT rate. *(Department of State Revenue; 45 IAC 17-4-2; filed Jan 22, 1991, 4:55 p.m.)*

45 IAC 17-4-3 Federally chartered credit unions; exemption

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5

Sec. 3. Federal law prohibits the state taxation of federally chartered credit unions under the Federal Credit Union Act (12 U.S.C. 1768). *(Department of State Revenue; 45 IAC 17-4-3; filed Jan 22, 1991, 4:55 p.m.)*

45 IAC 17-4-4 Partnerships or trusts

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5-2-8

Sec. 4. (a) Neither partnerships nor trust entities are subject to the FIT. However, partnerships with a corporate partner, and trusts which have a corporate grantor and beneficiary which are conducting the business of a financial institution, are required to file annual information returns. The information returns must be filed on a schedule provided by the department. The partnership or trust must calculate the tax liability as if the partnership or trust were a taxpayer for purposes of the FIT.

(b) If a partnership or trust that is commercially domiciled in Indiana is transacting the business of a financial institution in Indiana, and the partners or grantors and beneficiaries are nonresident corporations, the partnership or trust is responsible to withhold and remit the nonresident corporation's tax liability on its apportioned income if the nonresident corporation is otherwise not a taxpayer for purposes of the FIT. The apportioned income attributable to the corporate partner is the same percentage as its distributive share. The corporate partner which is a resident or nonresident and otherwise subject to the FIT is responsible for the FIT in accordance with the corporate partner's percentage share of the partnership or trust's adjusted gross income or apportioned income.

(c) If a resident corporate partner is otherwise not subject to the FIT, the corporate partner must pay the FIT liability attributable to its partnership income. The income attributed to the corporate partner's share which has been taxed under IC 6-5.5 would not be included in the income calculation for purposes of any other taxes under 45 IAC 17-2-5. For example, a nonresident partnership is conducting the business of a financial institution both within and without Indiana. Assume Corporation A owns

sixty percent (60%) of the partnership and Corporation B owns forty percent (40%) of the partnership. Further assume that eighty percent (80%) of the partnership's receipts are attributable to Indiana and twenty percent (20%) of the partnership's receipts are attributable to other states. Corporation A's distributive share of income is forty-eight percent (48%) (sixty percent (60%) multiplied by eighty percent (80%)) of the total adjusted gross income. Corporation B's distributive share is thirty-two percent (32%) (forty percent (40%) multiplied by eighty percent (80%)) of the total adjusted gross income for purposes of attributing income to the corporate partners. *(Department of State Revenue; 45 IAC 17-4-4; filed Jan 22, 1991, 4:55 p.m.)*

45 IAC 17-4-5 Investment companies

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5-1-2

Sec. 5. (a) For purposes of the FIT, an "investment company" means a person, copartnership, association, or corporation, whether domestic or foreign, that:

(1) is registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.); and

(2) solicits or receives a payment and issues in exchange for such payment an investment contract as evidenced by:

(A) a so-called bond;
(B) a share;
(C) a coupon;
(D) a certificate of membership;
(E) an agreement;
(F) a pretended agreement; or
(G) another evidence of obligation;

entitling the holder to anything of value at some future date, if the gross payments to the holder equal at least fifty percent (50%) of the sum of the company's gross payments on all investment contracts plus the company's gross income from all other sources, except dividends from subsidiaries, for the taxable year.

The term "gross payments" means the amount received during the taxable year on outstanding investment contracts, plus interest and dividends earned on those contracts. The interest and dividends earned on investment contracts are determined by prorating the total dividends and interest for the taxable year in question in the same proportion that certificate reserves, as defined by the Investment Company Act of 1940, are to total assets.

(b) To qualify as a taxpayer, the investment company must satisfy the eighty percent (80%) test under 45 IAC 17-2. Regardless of whether or not a corporation meets the definition of an investment company, a corporation which makes investments may be a taxpayer if the eighty percent (80%) test is satisfied.

(c) In the case of an investment company, adjusted gross income means the company's federal taxable income multiplied by the quotient of:

(1) the aggregate of the gross payments collected by the company during the taxable year from old and new business upon investment contracts issued by the company and held by residents of Indiana; divided by

(2) the total amount of gross payments collected during the taxable year by the company from the business upon investment contracts issued by the company and held by persons residing within Indiana and elsewhere.

(Department of State Revenue; 45 IAC 17-4-5; filed Jan 22, 1991, 4:55 p.m.)

Rule 5. Reporting

45 IAC 17-5-1 Required reporting

Authority: IC 6-5.5-9-1
Affected: IC 6-5.5; IC 6-8.1-6-2

Sec. 1. (a) Annual returns are required to be filed with the department by every taxpayer subject to the FIT, including any taxpayer which has a loss for that taxable year. A unitary group is required to file only one (1) return covering all members of the unitary group. A schedule of all members of the unitary group must be attached to the annual return. A copy of the taxpayer's federal income tax return which has been filed with the Internal Revenue Service for the same taxable year must accompany the Indiana annual return.

(b) The annual return must be filed with the department on or before the fifteenth day of the fourth month following the close of the taxable year. The department will recognize an extension of time which has been granted by the Internal Revenue Service, provided that such extension of time can be verified through the Internal Revenue Service, and a copy of the federal application for extension of time is attached to the Indiana annual return.

(c) If an additional extension period is needed for purposes of filing Indiana's annual return, and such time exceeds the federal extension period granted, the taxpayer is required to file a petition for a separate Indiana extension of time in accordance with IC 6-8.1-6-2.

(d) Each taxpayer shall report and submit a quarterly estimated tax payment to the department

equal to twenty-five percent (25%) of the taxpayer's total estimated tax liability for the taxable year. The quarterly estimated payment is due on or before the last day of the month following the close of each quarter of the taxable year.

(e) Failure to make quarterly estimated payments at least equal to:

(1) twenty percent (20%) of the final tax liability for the taxable year; or

(2) twenty-five percent (25%) of the final tax liability for the taxpayer's previous taxable year;

will result in a ten percent (10%) penalty imposed upon the difference between the actual amount paid and the amount required to be paid for each quarter.

(Department of State Revenue; 45 IAC 17-5-1; filed Jan 22, 1991, 4:55 p.m.)

EXHIBIT K: 51

Vosburg, Thomas, "State Taxation of Banks and Financial Institutions: Results of Recent Surveys" (Multistate Tax Commission)(June 1986)

STATE TAXATION OF BANKS AND FINANCIAL INSTITUTIONS:

RESULTS OF RECENT SURVEYS

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INTRODUCTION

The Multistate Tax Commission conducted this study in order to evaluate the degree to which uniformity exists among state tax laws regarding banks and financial corporations as well as to assess the extent to which states are taking full advantage of the taxing powers available to them regarding these institutions. Deregulation brought on significant changes in the banking industry allowing banks to become more diversified in the services they offer and the manner and place in which they conduct business. Also, several federal restrictions on states' powers to tax banks have been lifted in recent years. Both of these factors combine to warrant a re-examination of state taxation of financial institutions.

The MTC staff conducted two surveys to gather the information contained in this report. The first survey, conducted in December of 1985 and January 1986, addressed the type of taxes states employ to tax banks, how these taxes are measured and to what degree states tax non-branch interstate banking activity. The second survey, conducted in April and May of 1986, examined state statutory restrictions on state jurisdiction to tax bank income earned through non-branch interstate banking activity. Finally, information regarding current interstate banking laws was obtained from the Conference of State Bank Supervisors.

Section 1 of this report contains an overview of the general issues under investigation and a brief summary of survey results. Section 2 provides a presentation of the jurisdiction survey. Appendices A through K contain detailed tabulations of the state responses to the bank tax survey while Appendices L though P list the open-ended responses comments given by states in the jurisdiction survey. Appendix Q contains copies of both questionnaires employed in the study.

SECTION 1: BANK TAX SURVEY RESULTS

General Issues in Taxation of Financial Corporations

In theory, states should strive to adopt a tax system that is simple, efficient and fairly uniform with other state tax codes. Uniformity and simplicity ease the administrative burdens of both the taxpayer and the state. As demands on states' revenues increase, efficient taxation of the states' tax bases is of increasing importance. Considerable progress can yet be made toward these ends in regard to state taxation of banks.

Banks differ from non-financial corporations in a number of ways. In the past Congress has severely restricted state taxation of national banks. For example, until 1926, the National Bank Act restricted state taxation of banks to property tax and shares tax. Congress then allowed states to impose net income and franchise taxes on banks. Finally, in 1976, Congress effectively removed all statutory restrictions on state taxation of national banks, requiring only that they be treated the same as state banks.

Also, unlike other corporations, banks have historically been restricted from branching into other states. As a result, many state's bank tax laws were not drafted with an eye on income produced from interstate commerce, as are general corporation tax codes.

About half of the states tax banks and non-financial corporations in the same way. Table 1 lists these states as well as those that tax banks differently from non-financial corporations. See Appendix E for states' comments discussing the differences in how they treat financials and non-financial corporations.

Table 1
States Taxing Banks in the Same Manner as Non-Financial Corporations

Response	No. of States	States
Do Tax Non-Financials & Banks the Same Way	23	AK, AZ, AR, CO, CT, FL, ID, IL, MI, MN, MS, MT, NE, NH, NJ, NC, OR, TN, TX, UT, WA, WI, WY
Do Not Tax Non-Financials & Banks the Same Way	28	AL, CA, DC, DE, HI, GA, IN, IA, KS, KY, IA, ME, MD, MA, MO, NV, MN, NY, ND, OH, OK, PA, RI, SC, SD, VT, VA, WV

Types of Tax Used by States to Tax Banks

Banks generate a significant portion of their income from government obligations and securities. Efficient taxation of these institutions dictates utilization of a tax that can reach such income. Federal law prohibits taxation of federal obligations except by means of a franchise tax.

Of the different taxes states typically employ to tax banks, the franchise tax is the most widely used. Thirty four of the responding states utilize a franchise tax, while 17 do not. A net income tax is the second most common tax, being employed by 18 of the responding states. Eight states utilize a bank shares tax, and six states administer a gross receipts tax. Other types of taxes are employed by eight states. Table 2 displays the states using each type of tax. See Appendix A for states' comments describing the "other" taxes employed.

Table 2
States Utilizing Alternative Taxes on Banks

Type of Tax	No. of States	States
Franchise Tax	34	AL, AK, AR, CA, CT, DC, DE, FL, GA, HI, ID, IA, KS, ME, MD, MA, MN[1], MO, MS, MT, NH, NJ, NY, NC, OH, OK, SC, SD, TN, TX, UT, VT, VA, WI
Net Income Tax	18	AK, AZ, AR, CO, GA, IL, IW, MO, MS, NE, NH, NM, NC, ND, OK, OR, TN, WI
Bank Shares Tax	8	IN, KY, LA, MS, NV, NH, PA, RI
Gross Receipts Tax	6	AZ, GA, IN, MN, WA, WV
Other	5	AL[2], MI[3], NH[4], NJ[5], ND[2]

Notes: [1] The tax is called an excise tax, but has been construed to be the same as a franchise tax by Minnesota courts.
[2] Privilege tax measured by income.
[3] Single business tax, intangible tax.
[4] Tax on interest paid to depositors.
[5] Savings institution tax.

Sixteen of the responding states utilized more than one type of tax on banks. Of these, the most common practice is to combine a franchise tax with one or more other taxes. Seven states utilize both a franchise tax and a net income tax to tax banks, while five combine a franchise tax with the net income tax, bank shares, gross receipts or other taxes. Four states combine a net income tax with a tax other than a franchise tax. Table 3 displays the states utilizing more than one tax on banks as well as the combination employed.

Table 3
States Using More Than One Type of Tax to Tax Banks

Combination of Tax	No. of States	States
Franchise Tax & Net Income Tax	7	AK, AR, MO, NC, OK, TN, WI
Franchise Tax & Other Tax(es)	5	AL[1], GA[3], MS[3], NH[5], NJ[6]
Net Income Tax & Other Tax(es)	4	AZ[2], IN[4], MN[7], ND[1]

Notes: [1] Privilege tax measured by net income.
[2] Net income and gross receipts tax.
[3] Net income and bank shares tax.
[4] Bank shares and gross receipts taxes.

[5] Net income, banks shares and interest paid to customers taxes.
[6] Savings institution tax.
[7] Gross receipts tax.

There are a variety of methods available to states for applying their franchise taxes. When measured by net income, the franchise tax performs basically as a net income tax, yet allows the state to reach income derived from government securities. However, of the 34 states utilizing a franchise tax on banks, only 20 choose to measure that tax by net income. See Table 4 for a list of these states. See Appendix B for states' comments discussing other franchise tax measures employed.

Table 4
States Measuring Franchise Taxes by Net Income

Measurement of Tax	No. of States	States
Measured by Net Income	20	CA, CT, DC, FL, HI, ID, IA, KS, ME, MD, MA, MN, MO, MT, NJ, NY, SC, SD, UT, WI
Not Measured by Net Income	12	AL, AK, AR, DE, GA, MS, NC, OH, OK, TX, VT, VA
No Response	2	NH, TN

Taxation of Federal and State Obligations

While states do have the power to reach income generated by federal and state obligations, not all choose to take advantage of it. Although federal law no longer restricts states from taxing government obligations, several states have laws or constitutional provisions that limit their own ability to tax such income.

Twenty-seven of the responding states include the value of federal and state obligations in the measure of their tax on banks. All of these states, except North Dakota and Oregon, utilize a franchise tax. (North Dakota employs a privilege tax based on net income, basically a franchise tax, while Oregon utilizes a corporate excise tax measured by net income.)

Six states utilize a franchise tax, but do not include the value of federal and state obligations in the measure of the tax (Arkansas, Idaho, Mississippi, Texas, Virginia, and Vermont). Table 5 lists states that include the value of federal and state and local securities in the measure of the tax they impose on banks.

Table 5
States Including the Value of Federal and State Obligations
in the Measure of the Tax They Impose on Banks

Response	No. of States	States
Value of Federal & State Obligations Included	27	AL, CA, CT, DC, DE, FL, HI, IA, KS, ME, MD, MA, MN, MO, MT, NJ, NY, NC, ND, OH, OK, OR, SC, SD, TN, UT, WI
Value of Federal & State Obligations Not Included	21	AK, AR, CO, ID, IL, IN, KY, MI, MS, NE, NV, NH, NM, PA, RI, TX, VT, VA, WA, WV, WY
No Response	3	AZ, GA, LA

Only one state (California) reported that it has constitutional restrictions on the manner in which it taxes banks and savings and loan institutions. Considerably more states, however, place constitutional restrictions on the taxation of income derived from federal and state obligations. Fourteen states place some type of constitutional restrictions on the taxation of such income.

Interstate Banking

Congress has delegated the power to restrict or to permit both intrastate and interstate branch banking to the states. The McFadden Act of 1927 opened the door to intrastate branching by national banks, if such an activity was allowed by the state. In regard to interstate branching, the Bank Holding Company Act disallows bank holding companies from opening banks in another state unless such activity is expressly permitted by that state.

Restrictions on intrastate branching vary from state to state. Many states impose geographic restrictions on intrastate branching, limiting branches to the county in which the bank's home office is located. Others allow more general state-wide branching, though many prohibit the opening of a branch in a city where the principal office of a bank is already located.

According to information obtained from the Conference of State Bank Supervisors, as of April 1986, 35 states had adopted legislation allowing some type of interstate banking, although restrictions placed on such activities vary from state-to-state. Eighteen states employ regional reciprocity agreements; these agreements allow entry into a state by holding companies only from states within a specified region that also reciprocate with such entry privileges. Oregon's law limits such activity to a region, but does not require reciprocity. Seven states allow entry from a holding company domiciled anywhere in the nation. Seven other states have regional reciprocity laws with built in trigger dates for opening the state up to nationwide entry. Table 6 displays the states that maintain each of these types of law.

Eleven states allow entry of an out-of-state holding company in order to help stabilize a failing bank. Four states have provisions grandfathering in banks that were in operation prior to the McFadden Act. Six states provided for entry of banks with limited charter powers. Table 6 also displays the states that employ each of these types of statutes.

Table 6
Entry into Home State by Out-of-State Financial Institutions
Through Bank Holding Companies* (April 1986)

Type of Law	Number of States	States
Nationwide	7	AK[2], AZ[2], ME, NY[1], SD[3], WA[1,2], WV[1,2]
Regional	1	OR[2,7]
Regional Reciprocity/ Trigger to Nationwide	7	KY[2,4], RI, MI[2], NV[2,7], NJ, OH, UT[2,7]
Regional Reciprocity	18	AL[2], CT, DC[2], FL[2], GA[2], ID[2,4], IL[2,4], IN[2,4], MD, MA, MN[2,4], MS[2,10], NC[2], SC[2], TN[2], VA[2], WI[2]
Emergency Entry/ Problem Banks	11	ID[8], KY, MD[9], MD, NV, NM, OH, OR[8], UT, WA, WV
Grandfathered[6]	4	FL, IL, IA, NE
Limited Charter Powers	6	DE, DC, MD, NE, NV, VA

*Data for domestic banks and bank holding companies.

Notes:
[1] Reciprocity requirement.
[2] De novo entry no authorized, Arizona and Nevada de novo entry authorized after specified time period.
[3] For a single existing state bank and may not expand the banks activities thereafter.
[4] Continuous state reciprocity.
[5] Savings banks.
[6] By state law.
[7] Oregon has no reciprocity requirement; Nevada and Utah have no requirement after trigger.
[8] Acquisition by states within the region.
[9] Troubled savings and loans may be acquired by out-of-state bank holding companies and converted to banks (1985).
[10] Law does not authorize multibank holding companies.

Table 7 displays the states listed as comprising the region within which interstate banking may take place in the statutes of each state employing a regional type of interstate banking law.

Table 7
Regional Interstate Banking Laws: States Comprising Regions
April 1986

State with Regional Statute	Number of States Listed in Statute	States Listed in Statute
Alabama	13	AR, FL, GA, KY, LA, MD, MS, NC, SC, TN, VA, WV, DC
Connecticut	6	CT, ME, MA, NH, RI, VT
Dist. of Columbia	12	AL, DC, FL, GA, LA, MD, MS, NC, SC, TN, VA, WV
Florida	13	AL, AR, DC, FL, GA, LA, MD, MS, NC, SC, TN, VA, WV
Georgia	10	AL, FL, GA, KY, LA, MS, NC, SC, TN, VA
Idaho	7	ID, MT, NV, OR, UT, WA, WY
Illinois	7	IL, IN, IA, KY, MI, MO, WI
Indiana	5	IL, IN, KY, MI, OH
Kentucky*	7	IL, IN, MO, OH, TN, VA, WV
Maryland (7/1/85)	5	DC, DE, MD, VA, WV
(After 7/1/87)	15	AL, AR, DC, DE, FL, GA, LA, MD, MS, NC, PA, SC, TN, VA, WV
Massachusetts	6	CT, ME, MA, NH, RI, VT
Michigan	6	IL, IN, MI, MN, OH, WI
Minnesota	5	IA, MN, ND, SD, WI
Mississippi (7/1/88)	5	AL, AR, LA, MS, TN
(After 7/1/90)	14	AL, AR, FL, GA, KY, LA, MS, MO, NC, SC, TN, TX, VA, WV
Nevada	12	AK, AZ, CO, HI, ID, MT, NM, NV, OR, UT, WA, WY
New Jersey	15	DC, DE, IL, IN, KY, MD, MI, MO, NJ, OH, PA, TN, WA, WV, WI
North Carolina	14	AL, AR, DC, FL, GA, KY, LA, MD, MS, NC, SC, TN, VA, WV
Ohio	14	DC, DE, IL, IN, KY, MD, MI, MO, NJ, OH, PA, TN, VA, WI, DC

Table 7 (Continued)

State with Regional Statute	Number of States Listed in Statute	States Listed in Statute
Oregon	9	AK, AZ, CA, HI, ID, NV, OR, UT, WA
Rhode Island	6	CT, ME, MA, NH, RI, VT
South Carolina	14	AL, AR, DC, FL, GA, KY, LA, MS, MO, NC, SC, VA, WV
Tennessee	14	AL, AR, DC, FL, GA, KY, LA, MD, MS, MO, NC, SC, VA, WV
Utah	12	AK, AZ, CO, HI, ID, MT, NV, NM, OR, UT, WA, WY
Virginia	14	AL, AR, DC, FL, GA, KY, LA, MD, MS, NC, SC, TN, VA, WV
Wisconsin	8	IL, IN, IA, MI, MN, MO, OH

State Taxation of Interstate Income Producing Activities of Out-of-State Banks

The banking industry has evolved in many ways that allow banks to engage in interstate income producing activities without opening formal branches, thus avoiding restrictions placed on branch banking by state and federal laws. These activities include soliciting loans in various ways such as through loan production offices, in-state representatives of out-of-state banks (call programs), issuing credit cards by mail from an out-of-state office and conducting general banking activities from out-of-state solely by mail and telephone. As banks engage in business in states where they do not have a physical presence, questions arise regarding what type of activities establish a sufficient connection, or nexus, between the state and the out-of-state bank to allow state taxation of the bank.

States have responded in varying degrees to revising their tax laws as courts further clarify these nexus issues. As a result, considerable divergence exists regarding how activities of out-of-state banks are taxed from state to state.

No states presently collect tax on income produced from credit cards issued to state residents by out-of-state banks. However, five states (Arkansas, Colorado, Iowa, Minnesota, and New Mexico) indicated they felt such income was taxable, but were not collecting these revenues due to administrative constraints.

About one quarter of the states felt that an in-state representative of an out-of-state bank provides sufficient nexus to tax. Thirteen of the responding states taxed income produced in this manner.

Many more states tax out-of-state banks operating loan production offices in state. These operations generally involve loans solicited from an office in state, but closed at the home office of the out-of-state bank. Twenty-seven of the responding states taxed income produced by those activities.

Fewer states consider the mere use of personal or real property located within the state as security for a loan made by an out-of-state bank which has no office, employees, or representatives in the state as a sufficient nexus to tax such a bank. Eleven states tax income from loans secured by personal property within the state. Twelve states tax income produced by loans secured by in state real property. Table 8 lists the number and percent of states taxing these activities.

Table 8
States Taxing Non-Branch Interstate
Income Producing Activities of Out-of-State Banks

Activity	Number of States	States
Credit Card Income	0	
Loans Solicited by Call Programs or Representatives	13	AL, AZ, AR, DC, KS, LA, ME, MT, NM, NY, NC, OR, SD
Loan Production Offices	27	AL, AK, AZ, AR, CA, CO, DC, KS, IA, ME, MD, MN, MO, MT, NE, NH, NJ, NY, NC, OK, OR, RI, SC, SD, UT, VA, WA
Loans Secured by Personal Property	11	CO, DC, HI, KS, ME, MN, MT, NE, NJ, NM, OR
Loans Secured by Real Property	12	CO, DC, FL, HI, KS, ME, MN, MT, NE, NJ, NM, OR

Registration of Non-Branch Interstate Bank Activity

A necessary prerequisite to states taxing non-branch interstate branch activity is the states registration of such activity. States differ in the degree to which they require out-of-state banks engaged in these interstate non-branch activities to register or obtain a license.

Out-of-state banks soliciting loans or deposits through loan production offices are required to register or apply for a license in 23 states. License or registration requirements are imposed on out-of-state banks utilizing an agent or representative in 14 states. Twelve states require such agents or representatives themselves to register or be licensed. Table 9 displays the number of states registering banks involved in these activities. See Appendices H, I and J for states' comments regarding registration requirements.

Table 9
States Registering Non-Branch Interstate Bank Activity

Activity	No. of States	States
Banks with Loan Production Offices	23	AL, AK, CA, GA, HI, IL, IN, KS[1], KY, ME, MD, MS, MT, NM, NY, OK, RI, SC, SD, TX, VA, WA, WI
Banks with In-State Agents or Reps.	14	CA, GA, HI, ID, IL, KS[1], MD, NY, OK, OR, SD, TX, VA, WI
Agents or Reps. of Out-of-State Banks	12	AL, CA, GA, HI, ID, IL, KS[1], KY, MD, NY, OK, RI

Note: [1] If bank charges higher rates.

SECTION 2: STATE BANK TAX JURISDICTION SURVEY RESULTS

Results of State Bank Tax Jurisdiction Survey

This section presents results of a survey conducted by the MTC in the spring of 1986 regarding statutory restrictions on state jurisdiction to tax bank income earned from interstate activities. The MTC's uniformity committee is working toward promulgating uniform rules for the apportionment of such bank income. To accomplish this task, the commission must determine whether there are any state jurisdictional barriers to taxation of interstate bank income.

Currently, banks carry on their interstate activities in a variety of ways including the following:

a) Interstate branching (where permitted by state laws).

b) Interstate "nonbank" bank subsidiaries.

c) Nationwide automatic teller machines (ATMs) which serve customers nationwide.

d) Travelling representatives who solicit loans in several states (call officers).

e) Solicitation and issuance of credit cards nationwide.

f) Interstate mail and telephone banking.

The latter two methods do not require the out of state bank to have a physical presence in the host state. Therefore, an out-of-state bank can engage in significant banking activities in a state in which it has no physical presence.

In April of 1986, the MTC staff mailed questionnaires to state tax administrators of all 50 states and the District of Columbia asking if their

state's laws contained any jurisdictional provisions which would restrict that states taxation of interstate bank income. Forty states have responded to date. The questionnaire also asked how states are presently apportioning bank income, and whether any special rules or regulations had been passed regarding the same. The following tables present the results of the survey, and the attached appendices contain listings of the open-ended comments given by the states in response to certain questions.

Restrictions on State Jurisdiction to Tax Interstate Bank Activity

While the majority of states responding to the questionnaire indicated that they had no such statutory restrictions on their jurisdiction to tax out-of-state banks, a significant number of states are restricted in some way. Twenty-four states, or about two thirds of the responding states, indicated that their jurisdiction to tax such bank activity was limited only by the commerce and due process clauses of the U.S. Constitution. Twelve states indicated that they are limited by statute to taxing only banks with a physical location in the state. A few states can tax only banks with a duly authorized branch within the state. Thirteen states indicated their jurisdiction to tax banks was limited in other ways. See Tables 10, 11, 12, and 13 for these figures. Appendices L and M list states comments discussing their other jurisdictional constraints.

Table 10
States Which Are Limited in Their Jurisdiction To Tax Out-of-State Banks Only by the Due Process and Commerce Clauses of the U.S. Constitution

Response	No. of States	States
Only Due Process & Commerce Clause Limitations	24	AZ, CO, DC, FL, GA, HI, IL, IN, ME, MI, MN, MS, MT, NE, NJ, NM, NC, ND, OR, SC, TN, TX, UT, WI
Other Limitations	14	AL, IA, KS, LA, MD, MA, MO, NY, OH, PA, SD, VT, VA, WA
No response	13	AK, AR, CA, CT, DE, ID, KY, NV, NH, OK, RI, WV, WY

Table 11
States Limited by State Law to Taxing Only Banks Which Have a Physical Location Within the State

Response	No. of States	States
Must have physical location to tax.	12	AL, IN, IA, MD, MO, MS, NE, ND, PA, TX, UT, VT
May tax banks without physical location.	26	AZ, CO, DC, FL, GA, HI, IL, KS, IA, ME, MA, MI, MN, MT, NJ, NM, NY, OH, OR, SC, SD, TN, VA, WA, WI, WV
No response	12	AK, AR, CA, CT, DE, ID, KY, NV, NH, OK, RI, WY

Table 12
States Limited By Law To Taxing Only Banks With A Duly Authorized Branch Within The State

Response	No. of States	States
Must have a branch to tax.	4	MO, TX, UT, VT
May tax without branch.	30	AL, AZ, CO, DC, FL, GA, HI, IL, IA, KS, IA, ME, MD, MA, MI, MN, MS, MT, NE, NJ, NM, NY, OH, OR, SC, SD, TN, VA, WA, WI
No response	15	AK, AR, CA, CT, DE, KY, NV, NH, NC, ND, OK, PA, RI, WV, WY

Table 13
States Which By Statute Have Other Limitations On Their Jurisdiction to Tax Bank Income

Response	No. of States	States
Jurisdiction is limited in other ways.	13	FL, HI, ID, IN, IA, ME, MD, MA, NJ, OH, SD, VT, VA
Jurisdiction is not limited in other ways.	22	AL, AZ, CO, DC, GA, IL, KS, IA, MI, MN, MO, MT, NE, NM, NY, OR, SC, TN, TX, UT, WA, WI
No response	15	AK, AR, CA, CT, DE, KY, NV, NH, NC, ND, OK, PA, RI, WV, WY

About half of the responding states reported that they have jurisdictional provisions governing financial institutions other than banks. See Table 14 for a listing of these states. Appendix N list states' comments discussing these problems.

Table 14
States With Laws Containing Jurisdictional Provisions Governing Financial Institutions Other Than Banks

Response	No. of States	States
Have provisions governing other financial institutions	19	AL, DC, ID, IN, IA, LA, ME, MA, MO, MS, NE, ND, OR, PA, SD, TN, VA, WI, WV
Do not have provisions governing other financial institutions	20	AZ, CO, FL, GA, HI, IL, KS, MD, MI, MN, MT, NJ, NM, NC, OH, SC, TX, UT, VT, WA
No response	12	AK, AR, CA, CT, DE, KY, NV, NH, NY, OK, RI, WY

State Apportionment of Bank and Financial Institution Income

Approximately 3/4 of the states responding said that they do apportion bank income, and almost all responded that the apportion they income of financial organizations other than banks. Tables 15 and 16 indicate which states apportion these types of income.

However, while most states do apportion such income, only a third have passed special rules or regulations regarding these industries. See Tables 17 and 18 for these figures.

Table 15
States Using An Apportionment Formula To Tax The Income of Banks

Response	No. of States	States
Apportionment formula for banks.	29	AL, AZ, CO, DC, FL, GA, HI, ID, IL, IN, KS, IA, ME, MD, MI, MN, MT, NE, NJ, NM, NY, NC, OR, SD, TN, TX, UT, WA, WI
No apportionment formula for banks.	9	IA, MA, MO, MS, OH, PA, SC, VT, VA
No response	13	AK, AR, CA, CT, DE, KY, ND, NV, NH, OK, RI, WV, WY

Table 16
States Using An Apportionment Formula To Tax The Income of Financial Institutions

Response	No. of States	States
Have apportionment formula for financial institutions	35	AL, AZ, CO, DC, FL, GA, HI, ID, IL, IN, IA, KS, LA, ME, MD, MA, MI, MN, MO, MT, NE, NJ, NM, NC, ND, OR, SC, SD, TN, TX, UT, VT, VA, WA, WI
Do not have apportionment formula for financial institutions	3	MS, OH, PA
No response	13	AK, AR, CA, CT, DE, KY, NV, NH, NY, OK, RI, WV, WY

Table 17
States That Have Proposed or Passed Rules or Regulations Governing the Apportionment of Income of Banks

Response	No. of States	States
Have passed rules or regulations	10	AL, DC, FL, MN, NY, OR, SD, TN, WA, WI
Have not passed rules or regulations	27	AZ, CO, GA, HI, ID, IL, IN, IA, KS, LA, MD, MA, MI, MO, MS, MT, NE, NM, NC, NJ, OH, PA, SC, TX, UT, VT, VA
No response	13	AK, AR, CA, CT, DE, KY, NE, NV, NH, OK, RI, WV, WY

Table 18
States That Have Proposed or Passed Rules or Regulations Governing the Apportionment of Income of Financial Institutions

Response	No. of States	States
Have passed rules or regulations	10	AL, DC, FL, ND, OR, SD, TN, VA, WA, WI
Have not passed rules or regulations	27	AZ, CO, GA, HI, ID, IL, IN, IA, KS, LA, MD, MA, MI, MN, MO, MS, MT, NE, NJ, NM, NC, OH, PA, SC, TX, UT, VT
No response	13	AK, AR, CA, CT, DE, KY, NE, NV, NH, OK, RI, WV, WY

About 1/3 of the responding states apportion interstate bank income using the UDITPA three-factor formula. Two thirds of the states apportioning such income utilize other methods. Table 19 lists the states apportioning such income by use of the UDITPA formula. Appendix P summarizes the explanations given by the states regarding what other methods are employed in apportioning bank and financial institution income.

Table 19
States Utilizing the UDITPA Three-Factor Formula or Other Methods to Apportion Bank Income

Method Used	No. of States	States
UDITPA 3-factor formula	13	AZ, CO[1], ID, IN, KS, LA[2], ME, MT, NE, NM, SD[3], TX, UT
Other methods	26	AL, CO[1], DC, FL, GA, HI, IL, IN, IA, LA[2], MD, MA, MI, MN, MO, MS, NC, ND, NJ, NY, SC, TN, VT, VA, WA, WI
No response	14	AK, AR, CA, CT, DE, KY, NV, NH, OH, OK, PA, RI, WV, WY

Note: [1] Colorado gives all taxpayers a choice of using either the UDITPA three-factor formula or its own two-factor formula.
[2] Louisiana taxpayers deriving income primarily through loans use a two-factor (payroll, loan volume) formula. Other financials use the UDITPA formula.
[3] South Dakota provides for the modification or rejection of the UDITPA formula.

APPENDICES

The following appendices list the open-ended comments given by states to the questions asked in each questionnaire. Appendices A through K cover questions asked in the Bank Tax Survey. Appendices L through P relate to the Bank Jurisdiction Survey. Appendix Q contains copies of both questionnaires used in the study.

APPENDIX A: TAXES USED BY STATES TO TAX BANKS

1. How does your state tax banks?

   a. Franchise Tax?

      Yes: AL, AK, AR, CA, CT, DC, DE, FL, GA, HI, ID, IA, KS, ME, MD, MA, MN, MO, MS, MT, NH, NJ, NY, NC, OH, OK, SC, SD, TN, TX, UT, VT, VA, WI

      No: AZ, CO, IL, IW, KY, LA, MI, NE, NV, NM, ND, OR, PA, RI, WA

   b. Net Income Tax?

      Yes: AK, AZ, AR, CO, GA, IL, IN, MO, MS, NE, NH, NM, NC, ND, OK, OR, TN, WI

      No: AL, CA, CT, DC, DE, FL, HI, ID, IA, KS, KY, LA, ME, MD, MA, MI, MN, MT, NV, NJ, NY, OH, PA, RI, SC, SD, TX, UT, VT, VA, WA, WV, WY

   c. Bank Shares Tax?

      Yes: IN, KY, LA, NV, NH, PA, RI

      No: AL, AK, AZ, AR, CA, CO, CT, DC, DE, FL, GA, HI, ID, IL, IA, KS, ME, MD, MA, MI, MN, MO, MT, NE, NJ, NM, NY, NC, ND, OH, OK, OR, SC, SD, TN, TX, UT, VT, VA, WA, WI, WV, WY

   d. Gross Receipts Tax?

      Yes: AZ, GA, IN, NM, WV

      No: AL, AK, AR, CA, CO, CT, DC, DE, FL, HI, ID, IL, IA, KS, KY, LA, ME, MD, MA, MI, MN, MO, MS, MT, NE, NV, NH, NJ, NY, NC, ND, OH, OK, OR, PA, RI, SC, SD, TN, TX, UT, VT, VA, WA, WI, WY

   e. Other, please specify:

Alabama: Privilege tax measured by net income.

Kentucky: Banks are exempt from Franchise (License) Tax.

Louisiana: Ad valorem.

Michigan: Single business tax, intangible tax.

Minnesota: The tax is called an excise tax, but this has been construed to be the same as a franchise tax by Minnesota courts.

Missouri: Income tax is fully creditable against Bank Franchise Tax.

New Hampshire: Tax on interest paid to depositors; 1% of interest paid with a $10,000 deduction.

New Jersey: Corporation Income Tax NJSA 54:10E-1 et seq. Savings Institution Tax NJSA 54:10D-1 et seq. Note: Except Building & Loan Associations, Savings & Loan Associations, and Savings banks.

North Dakota: Privilege tax based on income.

Oregon: (1) Oregon has both a Corporation Income Tax and a Corporation Excise Tax (measured by net income).

APPENDIX B: MEASUREMENT OF FRANCHISE TAX

2. If your state uses a franchise tax, how is that tax measured?

a. By Net Income?

Yes: CA, CT, DC, FL, HI, ID, IA, KS, ME, MD, MA, MN, MO, MT, NJ, NY, SC, SD, UT, WI

No: AL, AK, AR, DE, GA, MS, NH, NC, OH, OK, TN, TX, VT, VA

Not Appropriate: AZ, CO, IL, IA, KY, IA, MI, NE, NV, NM, ND, OR, PA, RI, WA, WV, WY

b. Other (please specify)

Alabama: Capital employed at $3.00 per $1,000.00.

Alaska: Flat fee

Arkansas: Issued and outstanding stock.

Connecticut: Banks must compute the Connecticut tax liability on the net income base and an additional tax base and pay the larger of the two or the minimum tax of $100.00.

Delaware: Taxable income.

Maine: Assets tax.

New Hampshire: Based on capitalization.

New Jersey: The Corporation Business Tax Act (NJSA 54:10A-1 et seq. is a franchise tax consisting of two parts, one measured by entire net income and one measured by entire net worth. However, the part measured by entire net worth is currently being phased out.

New York: Net income is only one of four alternative measures. Other tax bases are: assets, alternative entire net income and a minimum tax of $250.00.

North Carolina: Net worth or value of tangible property.

Ohio: Net worth.

Oklahoma: Value of capital employed.

Rhode Island: Authorized capital.

Tennesse: Greater of the net worth or the real intangible property.

Texas: Tax on surplus and capital.

Vermont: Gross deposits.

Virginia: Net capital as defined by statute.

APPENDIX C: INCLUSION OF VALUE OF FEDERAL AND STATE OBLIGATIONS IN MEASURE OF TAX

3. Does your state include the value of, or income from federal and state obligations (bonds, etc.) in the measure of the tax?

Yes: AL, CA, CT, DC, DE, FL, HI, IA, KS, ME, MD, MA, MN, MO, MT, NJ, NY, NC, ND, OH, OK, OR, SC, SD, TN, UT, WI

No: AK, AR, CO, ID, IL, IW, KY, MI, MS, NE, NV, NH, NM, PA, RI, TX, VT, VA, WA, WV

No Response: GA, MS, WV, WY

APPENDIX D: USE OF TWO-TIER SYSTEM TO TAX BANKS

4. a. Does your state use a two-tier system to tax banks?

Yes: AR, CA, ME, NV

No: AL, AK, AZ, CO, CT, DC, DE, FL, HI, ID, IL, IN, IA, KS, KY, LA, MD, MA, MI, MN, MO, MT, NE, NH, NJ, NM, NY, NC, ND, OH, OK, OR, PA, RI, SC, SD, TN, TX, UT, VT, VA, WI, WY

b. Does your state use a two-tier system to tax banks? If your answer is yes, please explain the nature of your two-tier tax.

Arkansas: Franchise tax is three-tier based upon dollars of assets.

California: "Two-tier" is not fully descriptive. California imposes a higher franchise tax on financials than on generals to compensate for the exemption of financials from local personal property and business taxes. The incremental increase is determined by a statistical sampling of such local taxes paid be general corporations.

Maine: (1) .005 x net book income
(2) .0004 x assets per book

Nevada: (1) A bank shares tax and (2) an ad valorem property tax on any real property owned by the banks. A real property valuation is deducted from the bank shares valuation. See Exhibit 1 - NRS 367.

APPENDIX E: DIFFERENCES IN STATE TAXATION OF FINANCIAL AND NON-FINANCIAL CORPORATIONS

5. a. Does your state tax general (non-financial) business corporations in the same manner as it taxes banks?

Yes: AK, AZ, AR, CO, CT, FL, ID, IL, MI, MN, MS, MT, NE, NH, NJ, NC, OR, TN, TX, UT, WA, WI, WY

No: AL, CA, DC, DE, HI, GA, IN, IA, KS, KY, LA, ME, MD, MA, MO, NV, NM, NY, ND, OH, OK, PA, RI, SC, SD, VT, VA, WV

b. If your anser is no, please explain the differences.

Alabama: General business corporations are subject to a direct net income tax under Sec. 40-18-31. (Alabama employs a franchise tax on banks.)

Alaska: (Answer was "yes" to 5.a.) Exception: Corporations involved in the production and transportation of oil and gas must file an oil and gas corporate tax return.

California: The measuring base, "income", is the same for financials and other corporations. Multijurisdictional taxpayers apportion income between jurisdictions on a three-factor formula. Contrary to apportionment for general corporations, the formula used for financials includes intangibles in the property factor. In addition, financials are taxed at a higher rate than general corporations. See response to question 4.

Delaware: Corporation rate 8.7%. Bank franchise 8.7% on first $20,000,000 taxable income; 6.7% next $5,000,000; 4.7% next $5,000,000; 2.7% over $30,000,000.

Hawaii: Banks are subject to a franchise tax which is in lieu of a privilege tax (general, excise tax) and a net income tax.

Illinois: In the case of financial institutions income is apportioned by using a single-factor formula rather than the standard three-factor formula.

Indiana: General business corporations are subject to an adjusted gross income tax; banks are subject to a bank shares tax.

Iowa: General corporations pay an income tax with a deduction for 50% of federal income and a progressive rate of 6 to 12%. Banks and saving and loans pay a franchise tax without a deduction for federal income tax at a 5% rate.

Kansas: General business corporations are subject to an income tax. (Kansas employs a franchise tax on banks.)

Kentucky: Banks are exempt from income and license taxes. General business corporations are taxed by taxable income and capital employed. (Kentucky employs a bank shares tax on banks.)

Louisiana: General business corporations are subject to income and franchise taxes, but not subject to a share tax. Banks subject to the share tax are exempt from income and franchise tax.

Maine: Net income tax based on federal taxable income. (Maine employs a franchise tax on banks.)

Maryland: All property of financial and non-financial institutions is taxed in the same manner. However, personal property of the bank used in the banking operation is exempt. Corporations are subject to the State Income Tax of 7% of net income. Financial institutions pay a franchise tax instead of income tax.

Massachusetts: Business corporations are taxed under an excise measured by both property and net income. The tax rate for property is $2.60 per $1,000. The rate for net income is 9.5%. Business corporations are subject to apportionment. Banks (with a principal office in Massachusetts) are taxed under a franchise tax measured by net income at a rate of 12.54%. They are not subject to apportionment.

Nevada: See Navada constitution Art. 8, 2. No corporate income tax in the State of Nevada. (Nevada employs a bank shares tax on banks.)

New Mexico: General business corporations pay a franchise tax. A special deduction is allowed under gross receipts tax for "charges made in connection with the origination, making or assumption of a loan or from charges made for handling loan payments".

New York: The rate on net income is lower for banking corporations. There are differences in what constitutes net income and other alternative measures of tax are different.

North Dakota: Tax rates are different. U.S. interest is taxable on the bank tax return.

Ohio: General corporations are subject to two alternative bases of the Ohio corporate franchise tax.

Oklahoma: Bank's income is modified by not taxing U.S. or Oklahoma obligation interest and a reduction of expense equal to 50% of the income excluded.

Pennsylvania: General business cororations are subject to corporate net income tax and the foreign franchise-capital stock tax. Banks are subject to the bank shares.

Rhode Island: Corporations are subject to a tax based on et worth in addition to income and franchise. Banks are subject to income and franchise only.

South Dakota: South Dakota does not have a general corporate income tax. (South Dakota employs a franchise tax on banks.)

Virginia: Non-financial corporations are taxed on net income. (Virginia employs a franchise tax on banks.)

Vermont: Non-banks are subject to corporate income tax on Vermont income.

APPENDIX F: CONSTITUTIONAL RESTRICTIONS ON STATE TAXATION OF BANKS AND SAVINGS AND LOAN INSTITUTIONS

6. a. Does your state constitution place any restrictions on state taxation of banks or savings and loan institutions?

Yes: CA, NV

No: AL, AK, AZ, AR, CO, CT, DC, DE, FL, HI, ID, IL, IW, IA, KS, KY, LA, ME, MD, MA, MI, MN, MO, MS, MT, NE, NH, NJ, NM, NY, NC, ND, OH, OK, OR, PA, SC, SD, TN, WO, UT, VT, VA, WA, WI, WV

No Response: GA, RI, WY

b. If yes, please explain those restrictions.

Alaska: (Answer to 6.a. was "no".) Exception: Foreign banks - see AS 06.10.D10.

California: Banks are constitutionally exempt from taxes other than a tax measured by net income, real property taxes and motor vehicle tax and license fees (Article 13, Sec. 16). Statutory law (Sec. 23182, Rev. and Tax. Code) currently extends such protections to other financial institutions.

Nevada: See Nevada constitution Art. 10, 1. (allows for the use of a bank shares tax, isn't really a restriction).

APPENDIX G: CONSTITUTIONAL RESTRICTIONS PLACED ON STATE TAXATION OF INCOME FROM STATE OR MUNICIPAL OBLIGATIONS

7. a. Does your state constitution place any restrictions on state taxation of income from state or municipal obligations?

Yes: AK, AZ, CA, DC, IN, KY, MS, NE, NV, NM, OH, OR, TN, WV

No: AL, AR, CO, CT, DE, FL, HI, ID, IL, IA, KS, LA, ME, MD, MA, MI, MN, MO, MT, NH, NJ, NY, NC, ND, OK, PA, SC, SD, TX, UT, VT, VA, WA, WI

No Response: GA, RI, WY

b. If yes, what are these restrictions?

Alaska: The are wholly tax-exempt (IRC adopted).

Arizona: The Court of Appeals of Arizona, in Continental Bank v. Arizona Department of Revenue, 131 Ariz. 6 (1981) has interpreted Art 9. Section 2 of Arizona Constitution to exempt from taxation income arising from state, municipal and city bonds.

California: Interest on bonds issued by the state or a local government in the state is exempt from taxes "on income". This restriction does not apply to franchise taxes, which are "measured by income".

District of Columbia: The district may not tax its own obligations.

Indiana: Exempt from all state taxes.

Kentucky: Income from bonds issued by Kentucky and its political subdivisions is not taxable.

Mississippi: State and municipal obligations are exempted from income reported.

Nebraska: Under Nebraska law, income from state or municipal obligations is not subject to tax.

Nevada: See Nevada constitution Art. 10, Sec. 1. No state income tax in the state of Nevada.

New Mexico: Income from state or municipal obligations is exempt from taxation.

North Carolina: (Answer to 7.a. was "no".) Income from North Carolina (state and municipals within state) obligations specifically exempt from income tax.

Oregon: Under the Personal Income Tax and Corporation "Income" tax, interest from Oregon obligations is not taxable. Under the corporation "Excise" tax, the income is included in the net income upon which the tax is measured.

Ohio: Income from certain state obligations is exempt.

Tennessee: No income tax on state or municipal obligations.

APPENDIX H: STATE TAXATION OF INTERSTATE INCOME PRODUCING ACTIVITIES OF OUT-OF-STATE BANKS

10. Does your state currently tax any of the following interstate income producing activities of out-of-state banks?

a. Interest income from credit cards issued to your state residents by an out-of-state bank which also has no office or employees in your state (e.g. issuance of card through the mail)?

Yes:

No: AL, AK, AZ, AR, CA, CO, CT, DC, DE, FL, GA, HI, ID, IL, IN, IA, KS, KY, LA, ME, MD, MA, MI, MN, MO, MS, MT, NE, NV, NH, NJ, NM, NY, NC, ND, OH, OK, OR, PA, RI, SC, SD, TN, TX, UT, VT, VA, WA, WI, WV, WY

b. Interest income from loans solicited by in-state representatives of out-of-state banks (call programs)?

Yes: AL, AZ, AR, DC, KS, LA, ME, MT, NM, NY, NC, OR, SD

No: AK, CA, CO, CT, DE, FL, GA, HI, ID, IL, IN, IA, KY, MD, MA, MN, MO, MS, NE, NV, NH, ND, OH, OK, PA, RI, SC, TN, TX, UT, VT, VA, WA, WV, WY

c. Interest income from loans solicited at loan production offices located in your state but closed at the out-of-state home office of the soliciting bank?

Yes: AL, AK, AZ, AR, CA, CO, DC, KS, LA, ME, MD, MN, MO, MT, NE, NH, NJ, NY, NC, OK, OR, RI, SC, SD, UT, VA, WA

No: CT, DE, FL, GA, HI, ID, IL, IW, IIA, KY, MA, MS, NV, ND, OH, PA, TN, TX, VT, WV, WY

No Response: MI, WI

d. Interest income from loans made by an out-of-state bank which has no office, employees or representatives in your state to a resident of your state and <u>secured by personal property located in your state</u>?

Yes: CO, DC, FL, HI, KS, ME, MN, MT, NE, NJ, NM, OR

No: AL, AK, AZ, AR, CA, CT, DE, IL, IN, IA, KY, LA, MD, MA, MI, MO, MS, NV, NH, NY, NC, ND, OH, OK, PA, RI, SC, SD, TN, TX, UT, VT, VA, WA, WI, WV, WY

No Response: GA

e. Interest income from loans made by an out-of-state bank which has no office, employees or representatives in your state to a resident of your state and secured by real property located in your state?

Yes: CO, DC, FL, HI, KS, ME, MN, MT, NE, NJ, NM, OR

No: AL, AK, AZ, AR, CA, CT, DC, DE, IL, IN, IA, KY, LA, MD, MA, MI, MO, MS, NV, NH, NY, NC, ND, OH, OK, PA, RI, SC, SD, TN, TX, UT, VT, VA, WA, WI, WV, WY

APPENDIX I: REGISTRATION OF OUT-OF-STATE BANKS WITH LOAN PRODUCTION OFFICES IN-STATE

11. Does your state require an out-of-state bank which solicits loans or deposits in your state through a loan production office to register or apply for a license?

Yes: AL, AK, CA, GA, HI, IL, IN, KS (For higher rates), KY, ME, MD, MS, MT, NM, NY, OK, RI, SC, SD, TX, VA, WA, WI

No: AZ, AR, CO, CT, DC, FL, ID, IA, KS (for normal rates), LA, MA, MI, MN, NE, NV, NH, NJ, NC, ND, OH, OR, PA, TN, UT, VT, WY

No Response: MO, WV

Not Appropriate: DE (Loan Production Offices prohibited)

Alabama: Any corporation doing business in Alabama must register with the Secretary of State and file a franchise tax return. If corporation does not register, all contracts are null and void if seeking relief in court.

Alaska: Must file a statement with the Department of Commerce. If soliciting deposits, must comply with the Alaska Banking Codes.

Delaware: Loan production offices prohibited.

Hawaii: Subject to the requirements outlined in Chapter 403, HRS.

Indiana: Must register as a foreign corporation with Secretary of State Office.

Illinois: See attached "Foreign Bank Representative Office Act". Ill. Rev. Stat. Ch. 17, Para. 2851-2856.

Kansas: (Answer was neither "yes" nor "no".) Deposits can be solicited or held by an out-of-state bank. A Kansas charter must be obtained. An out-of-state bank can extend loans without obtaining a license. Lenders must obtain a license in order to charge higher rates of interest. (KSA 16a-2-401, 16a-2-301 et. seq.) For the license to charge higher rates, see KSA 16a-2-302.

Kentucky: KRS 287.820

Montana: Sales, finance and consumer loans are regulated, requiring registration with financial division, Department of Commerce. Real estate loans are not regulated. Banks can solicit deposits directly.

New Mexico: Must notify the state and comply with specific regulation, but are not required to be licensed.

New York: Supervisory policy CB-121.

Rhode Island: If only lending must obtain a loan license.

(1) 19-25 Small Loan Business
(2) 19-25.2 Secondary Loan Business
(3) 19-25.3 General Lenders License
If interstate branch, refer to 19-30-10.

12. Does your state require an out-of-state bank which solicits loans or deposits in your state through an agent or representative to register or apply for a license?

Yes: CA, GA, HI, ID, IL, KS (for higher rates), MD, NY, OK, OR, SD, TX, VA, WI

No: AL, AK, AZ, AR, CO, CT, DC, DE, FL, IW, IA, KS (for normal rates), KY, LA, ME, MA, MI, MN, MT, NE, NV, NH, NJ, NM, NC, ND, OH, PA, RI, SC, TN, UT, VT, WA, WY

No Response: MO, WV

Idaho: Must be licensed as a bank. (26-1201, Idaho Code)

New York: Supervisor policy CB-121 attached.

Rhode Island: No, as long as agent or representative is licensed.

APPENDIX K: REGISTRATION OF AGENTS AND REPRESENTATIVES OF OUT-OF-STATE BANKS

13. Does your state require the agent or representatives of an out-of-state bank who solicits loans or deposits in your state to register or apply for a license?

Yes: AL, CA, GA, HI, ID, IL, KS (for higher rates), KY, MD, NY, OK, RI

No: AK, AZ, AR, CO, CT, DC, DE, FL, IW, IA, KS (for normal rates), LA, ME, MA, MI, MN, MS, MT, NE, NV, NH, NJ, NM, NC, ND, OH, OR, PA, SC, SD, TN, TX, UT, VT, VA, WA, WI, WY

No Response: MO, WV

Alabama: The agent is required to buy an occupational license as agent-broker.

Idaho: Must be licensed as a bank. (26-1201, Idaho Code)

Nevada: See NRS 659.115 and NRS 673.270. Note: As of 11/18/85 American Bank of Commerce, et. al. has filed suit against the State of Nevada concerning the constitutionality of the Nevada Bank shares tax.

New York: Supervisor policy CB-121.

Rhode Island: If only lending must obtain a loan license.

(1) 19-25 Small Loan Business
(2) 19-25.2 Secondary Loan Business
(3) 19-25.3 General Lenders License

APPENDIX L: OTHER WAYS STATE LAWS LIMIT STATES' JURISDICTIONS TO TAX BANK INCOME

QUESTION A.1c

State	States' Comments
Alaska	AS 43.20.031(d) exempted banks from taxation under the Alaska Net Income Tax Act. AS 43.70.030(b) taxed banks under the Alaska Business License Act. Both AS 43.20.031(d) and AS 43.70.030(b) have been repealed for years after 1983. Banks are now taxed under the Alaska Net Income Tax Act.
Florida	See S.220.69,F.S. Provides limited exemption. (See Appendix N.)
Hawaii	Section 241-4,HRS (section discusses measure and rate of tax, apportionment method).
Idaho	Sec. 63-3023A, Idaho Code - This section specifies certain activities which <u>may not</u> be considered business situs for taxation: a) Creating, acquiring or purchasing loans, or any interest in them. b) Collecting and servicing loans in any manner, making credit investigations and physical appraisals of real or personal property securing loans. c) Soliciting of applications of loans which are sent outside this state for approval; and d) filing of security interests, maintaining or defining any action or suit; holding, selling assigning transferring, collecting or enforcing any loans, for closing or other disposition thereof, including acquiring title to property securing such loans by foreclosure.
Indiana	Domestic and foreign banks with Indiana locations are exempt from the Indiana adjusted gross income tax. Indiana employs a bank shares tax.
Iowa	National banks must have a principal office within the state. Iowa prohibits interstate branch banking.
Massachusetts	Massachusetts cannot tax banks as a regular corporation because regular corporations cannot be organized to do banking business.

State	States' Comments
Montana	Montana has no special provisions relating to the "how to tax". Each bank is required to be separately incorporated and on a very limited basis is allowed to use AIMs. For out-of-state banks "engaged in business" in Montana or "deriving income from activities within Montana", we have Section 18 UDITPA language to work with.
Nebraska	Sec LB 774 1 (4) (a) and (4) (b). Defines financial institutions as those chartered or qualified to do business in Nebraska or those that maintain a permanent place of business and actively solicit deposits from residents, or those that utilize the office or place of business of an affiliate to solicit loans from residents.
New Jersey	N.J.S.A. 17.9A-331 Exempt Transactions. Foreign banks may conduct the following exempt transactions in New Jersey without becoming taxable in the state. 1) Acquiring loans through an in-state banking institution. 2) Securing such loans with property in-state. 3) Holding, leasing, mortgaging, contracting with respect to, or conveying, in-state property acquired through foreclosure of a loan acquired through an in-state banking institution or through business transactions conducted outside the state.
Tennessee	Only to the extent T.C.A. Sec. 67-2-1201 and 45-2-1202 define "doing business in Tennessee" and exempt certain activities from the excise tax.
Vermont	Banks are subject to a tax based on gross deposits. Vermont cannot impose a tax on a banks net earnings. 32 USA 5836.
Virginia	Virginia imposes a franchise tax on net capital. The Franchise tax is imposed upon taxpayers organized as banks in Virginia. The tax is imposed upon banks organized under the authority of the United States and doing business or having an office in Virginia or charter designating it's principal office in Virginia.
Wisconsin	Rule 2.49 provides a special formula for apportioning the net income of financial organizations including banks. (See response to Question 3.b. below.)
Washington	There is no limitation specifically to banks. If services are performed for Washington customers from both within and without the state apportionment of income is required.

APPENDIX M: ADDITIONAL JURISDICTIONAL RESTRICTIONS REGARDING BANK INCOME

QUESTION 2.a.b.

State	States' Comments
Dist. of Columbia	Income derived from sale of intangible personal property in D.C. by a financial institution not carrying on or engaging in a trade or business within D.C. shall not be considered income from D.C. sources. D.C. Code Sec. 47-1810.1.
Florida	Exemption of certain out-of-state banks. S.220.69 F.S. (Foreign banks that do not allocate or apportion income to Florida for purposes of their returns to their home state are not required to file in Florida,. Applies to foreign banks that are taxed on 100 percent of their Florida based income by their home state.)
Georgia	Georgia presently allows a deduction for international banking facility income and banking income from persons or entities located outside the U.S. 48-7-21(b)(1)(B).
Indiana	No statute exists to restrict taxation; however, restrictions exist by omission of statutes which allow us to tax income of out-of-state banks derived in Indiana.
Iowa	State charted banks can only be taxed to the extent that the bank is chartered by Iowa. (422.61(1) and 524.103(19)
Louisiana	R.S. 12:302 K+L (Acts not considered transacting business: (Financial organizations generally: 1) acquiring or making loans, 2) maintaining depositing or pledge-holder agreements with in-state bank, 3) making, collecting and servicing such loans through Louisiana concerns engaged in the business of servicing loans, 4) acquiring immovable property securing such loans under foreclosure, 5) inspecting or appraising immovable property as direct or indirect securing for such loans, mortgages and mortgage rates, 6) owning, modify, renewing, extending, transferring, or foreclosing on such loans, mortgages or mortgage notes.
Maine	Income is allocated and apportioned. M.R.S.A., T-36 Sec. 5206-B, sub-Sec. 3, chapter 821.
Maryland	Must be "doing business" in the state as defined. (Foreclosing mortgages is not considered doing business. Lending money without physical presence is not considered doing business either.)

APPENDIX M (Continued)

State	States' Comments
Mississippi	The bank has to be "doing business" in Mississippi the same as any other corporation, but currently we do not allow interstate banking.
South Dakota	(1) Taxpayer must have an office in South Dakota or the services provided or, (2) transactions must occur in this state or the bank has employees in South Dakota and those employees transacted financial business in this state. SDLL 10-43-22.1-25.7.
Virginia	(1) Virginia cannot tax any bank under the bank franchise tax statutes unless they have received a certification of authority from the State Corporation Commission to do business in Virginia as a bank (6.1-13). (2) Out-of-state banks loaning money into Virginia and who subsequently foreclose on such property may be subject to corporate income tax to the extent property is held in Virginia and the bank has income from Virginia sources (58.1-400) (58.1-401).
Washington	See WAC 458-20-146. Income from engaging in financial businesses is subject to the business and occupation tax under the classification service and other activities.

APPENDIX N: JURISDICTIONAL PROVISIONS GOVERNING FINANCIAL INSTITUTIONS OTHER THAN BANKS

QUESTION 3.a,b.

State	States' Comments
Alaska	06.10.040 A.S. See cite for definitions of "foreign bank". ("Foreign banks" means lending organizations with principal office in another state. Foreign banks are allowed to make loans, receive security for loans, service or collect loans and enter into purchasing contracts necessary or appropriate to the foregoing activities without becoming liable for taxation.)
Dist. of Columbia	DC Code Sec. 47-1801.4 (25). Definition of financial institution includes savings and loans and any company, a substantial part of the business of which consists of receiving deposits, making loans and exercising powers similar to those permitted to banks.
Florida	Jurisdictional limitations may be implied by a lack of specific inclusion of items in specified numerators of apportionment fractions. S.214.71(3)(b),F.S.
Idaho	Sec. 63-3023A, Idaho Code. (See question A.1.C., Appendix M.)
Indiana	Building and loans, credit unions, savings banks, private banks, and small loan companies organized in reorganized under laws of Indiana. 28-1-1-3(a)
Iowa	Iowa's taxing jurisdiction over out-of-state savings and loan associations is limited only by the due process and commerce clauses of the U.S. Constitution. 422.60 and 422.61.
Louisiana	(See question 2.a,b., Appendix N.) R.S. 12:302K+L
Maine	Taxable entities include federally chartered financial institutions, service corporation or subsidiary, and financial institution holding companies. Title 36 M.R.S.A. Sec. 5206-5 sub-sec. -4.
Massachusetts	M.G.C. Ch. 63, S.39, S.30 P.2, (Sections extend Massachusetts jurisdiction to tax all foreign corporations "doing business" within Massachusetts, and do not exclude financial organizations from definition of foreign corporation.)
Mississippi	Must be "doing business" in Mississippi.

Nebraska	LB 774 1(4) defines which financial institutions are included.
Oregon	State and federal credit unions may be exempt from the corporate tax ORS.080(12).
South Dakota	Same as provisions governing banks, SDCL 10-43.
Texas	Exemptions for savings and loans, and credit unions from the tax Texas tax code Sec. 171.054 171.077.
Virginia	Virginia imposes the corporation income tax on corporations not qualifying as banks in Virginia. Savings and loans have special statutory modifications as do financial corporations. Credit unions are specifically exempt. Savings & Loans; Sec. 58.10-403 Financial Corporations; Sec. 58.1-418 Credit Unions; title 6.1, chapter 4
Washington	All financial institutions are treated the same whether they are banks or otherwise. Federally chartered credit unions are exempt of retail sales tax on purchases. All credit unions are exempt of business tax. WAC 458-20-146
West Virginia	Business and occupation tax applies to banks and any other financial businesses. W. Va. Code Sec. 11-13-2K.
Wisconsin	Banks are included in the definition of financial organizations, so these provisions are the same as for banks. s.71.07(2)(d) WS.

APPENDIX O: RULES AND REGULATIONS PROPOSED OR PASSED BY STATES REGARDING INTERSTATE BANK INCOME

QUESTION B.2a

State	States' Comments
Alaska	See 15 AAC 20.600-680 and 15 AAC 20.920. (Specifies that financials must use property, payroll and sales to apportion income.)
Florida	See Rule 12C1-1.11(1)(a), F.A.C. which relates to income from loans secured by mortgages on real estate located in this state (such activity is considered as conducting business for tax purposes).
Indiana	Banks are taxed on the same apportionment formula as all other corporations subject to Indiana Gross Income Tax Laws.
Minnesota	See Unitary Business taxation 8019.0300 supb.8 defines how unitary banks businesses must file a combined report. See Appendix Q.
Nebraska	See LB 774. Franchise tax is based on the average deposits of the financial institution (includes banks). Apportionment is by a deposit factor, limited by payroll and property factors. LB 774 Sec. 5 (1)(2).
North Dakota	N.D.A.C. Rule 81-03-09.1.01 (Industries excluded from UDITPA employ a property, payroll and sales formula, with property double weighted).
South Dakota	ARSD64; 26:02:07-10. (Allows for consolidated returns, exclusion of factors from the three-factor formula and the use of separate accounting.)
Texas	Rule 3.403, 3.411, 3.393 (These rules apply to all foreign corporations.)
Washington	WAC 458-20-194 (refers to the application of the business and occupation tax to foreign corporations).

APPENDIX P: OTHER, NON-UDITPA, APPORTIONMENT METHODS EMPLOYED BY STATES IN APPORTIONING BANK INCOME

QUESTION 3.b.

State	States' Comments
Colorado	Colorado apportions bank income the same as general corporation's income, using either the UDITPA three-factor formula or a two-factor (revenue and property) formula.
Georgia	Georgia presently uses a one-factor formula based upon the taxable situs of intangible property. Sec. 48-7-31(d)(1).
Florida	See S.214.71,FS for the three-factor formula generally used including special sales fraction rules for "financial organizations. S.220.15 F.S. modifies S.214.71, FS (sales of a financial organizations including but not limited to banks and saving institutions, investment companies, real estate investment trusts and brokerage companies, shall be in this state if derived from: 1. Fees, commissions or other compensation for financial services rendered in this state. 2. Gross profits from trading securities managed within this state. 3. Interest and dividends managed within the state. 4. Interest charged to customers at places of business within this state for carrying debit balances of margin accounts, without deduction of any costs incurred in carrying such accounts. 5. Any other gross income resulting from the operation as a financial organization within this state.
Hawaii	Section 241-4(b)(4)HRS. Income shall be determined by allocation and separate accounting. Losses from property owned outside the state and from other sources outside the state shall not be deducted. Reserves shall be allocated to the State by the application of a fraction, the numerator of which consists of the gross income included in determining the "entire net income from all sources" and the denominator of which consists in the gross income similarly ascertained but without regard to whether from sources within or without the state.
Iowa	Currently only one production credit association has activity outside the state sufficient to require apportionment. Apportionment is based upon loan volume from Iowa offices to total loan value.

Louisiana	Specific allocation and apportionment formulas for banks and financial institutions are not provided in our statutes. Taxpayers allocate and apportion income as provided in RS 47:242 through 245. Taxpayers deriving income primarily from making loans use the apportionment formula in R.S. 47:245E (this is a two-factor formula using a payroll factor and a loan volume factor).
Maryland.	A ratio of gross receipts is derived from business done in Maryland to gross receipts from all sources.
Massachusetts	Massachusetts uses its own three-factor formula.
Michigan	One factor formula: Michigan gross business/total gross business. M.S.A. 208.65.
Minnesota	Under Minnesota law, banks cannot use UDITPA. (Minnesota statutes 290.171, art IV.2.) If a bank is part of a unitary group that files a return on the basis of a combined report, the bank uses a three-factor formula of either an arithmetic average of property, payroll and gross receipts or a formula in which property is weighted 15%, payroll 15%, and gross receipts 70%, which ever produces the least taxable income (MS 290.19 sub d.1(2). Insurance companies apportion income on the basis of gross premiums collected from business within this state to total gross premiums (M.S. 290.35). Investment companies apportion income on the basis of gross payments on investment contracts received from Minnesota residents to total gross payments on such contracts (MS 290.36).
Missouri	Special single sales factor.
Mississippi	Direct and separate accounting.
New Jersey	Three-factor Massachusetts formula without provision for throwout or throwback with respect to nowhere receipts.
New York	New York apportions bank income by a three-factor formula consisting of receipts, payroll and deposits.
North Carolina	North Carolina utilizes a single sales factor for apportion bank income. This is basically the sales factor of the UDITPA formula.
South Dakota	South Dakota provides for modification or rejection of the UDITPA formula.

Virgina	Virginia imposes a special one-factor formula for financial corporations based on costs-of-performance in Virginia over cost-of-performance everywhere. Section 58.1-418. Banks are taxed on net capital under the Bank Franchise Tax.
Washington	Washington apportions such income based on costs of doing business within Washington as compared to costs of doing business all over.

APPENDIX Q: SURVEY QUESTIONNAIRES

This Appendix contains a copy of both the Bank Tax Survey questionnaire and the Bank Tax Jurisdiction questionnaire sent to Tax Administrators to gather information for this study.