

**EXHIBIT J: 20:**

**Letter from James H. Paige, III  
(Secretary, West Virginia Department of Taxation and Revenue)  
(January 15, 1992)**



STATE OF WEST VIRGINIA  
DEPARTMENT OF TAX AND REVENUE  
Charleston 25305

COPY

GASTON CAPERTON  
GOVERNOR

JAMES H. PAIGE III  
SECRETARY

January 15, 1992

Sharon G. Bias  
Acting Commissioner  
Division of Banking  
Building 3, Room 311  
Charleston, WV 25305

Re: Questions And Answers On Taxation Of Out-Of-State  
Financial Organizations Pursuant To Senate Bill 632  
Legal Log 91-311

Dear Sharon,

This letter is in response to your letter of November 21, 1991 requesting answers to nine questions pertaining to how out-of-state financial organizations would be taxed under the business franchise tax and corporation net income tax subsequent to enactment of Senate Bill 632 (1991).

Those questions and our responses to each question are as follows.

QUESTION 1:

Explain when nexus would be created under this new tax law. Specifically, is nexus created if loans are outstanding each year at a certain amount or must a financial institution make NEW loans in a certain amount each year to be required to apportion their income to West Virginia?

RESPONSE TO QUESTION 1:

Senate Bill 632 (1991) requires out-of-state financial organizations with business activities within this State to apportion their capital and their business income using a single apportionment factor (gross receipts) rather than the three factor apportionment formula generally used for business franchise tax and corporation net income tax purposes. Nexus would exist when the financial organization has sufficient minimum contacts with West Virginia for the imposition of our taxing jurisdiction. Nexus is

Sharon G. Bias

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bank, but the Ohio corporation would be subject to this State's taxing powers when it begins building the plant in this State.

QUESTION 3:

Is there really a "double tax" on out of state financial institutions who will now be required to pay tax in West Virginia under this new law, or will most states give their own domiciled banks "credit" for taxes which will now have to be paid in West Virginia?

RESPONSE TO QUESTION 3:

Whether or not a double tax would exist would depend on the facts of each situation, in particular the taxing scheme of the other states. To some extent, multiple taxation is constitutionally permissible as long as the apportionment formulas used are reasonable. West Virginia uses a single factor apportionment formula based on gross receipts. The United States Supreme Court has upheld the constitutionality of single factor apportionment formulas, so it seems reasonable to assume West Virginia's gross receipts apportionment formula would withstand judicial scrutiny.

The relevant inquiry if impermissible multiple taxation occurs is whether the impermissibility arises from this State's tax or elsewhere. West Virginia cannot be held accountable for, and should not be unduly concerned with, any unconstitutional multiple taxation which may occur as a result of another state's tax laws and practices. If a bank domiciled in another state does sufficient business in West Virginia to subject it to this state's tax on financial organizations, it is required to apportion the percentage of its gross receipts attributable to this State. The fairness of this approach seems almost self evident. If the state where the bank is domiciled taxes all of the bank's income, without apportioning, granting a credit or in some other way excluding from its tax that which is attributable to another state, then it is that other state's tax laws which may be constitutionally suspect. West Virginia tax laws do provide such a credit for banks with their commercial domicile in this State.

QUESTION 4:

If West Virginia state, county and municipal bonds are purchased by out-of-state financial institutions, is that considered "lending" in West Virginia and therefore taxable under this new law?

RESPONSE TO QUESTION 4:

The term "lending" is not defined (or used) in Senate Bill 632, so the term should be given its common and ordinary meaning.

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a nebulous concept in constitutional law which is difficult to apply with any degree of certainty, and is thus ultimately determined on a case-by-case basis.

Senate Bill 632 legislatively establishes a bright line nexus rule for financial organizations and the Department of Tax and Revenue to follow, by creating a quantified nexus presumption. According to Senate Bill 632, a financial organization whose commercial domicile is out of state must apportion income and capital if it regularly engages in business in this State. The nexus presumption provides that a financial organization is considered to be regularly engaging in business in this State if, during any year, (1) it obtains or solicits business with 20 or more persons within this State, or (2) if the sum of its gross receipts attributable to sources in this State equals or exceeds \$100,000.

The second part of the question is whether a financial organization must make new loans in a certain amount each year in order to be required to apportion its income to West Virginia. Our position is that new loans are not required each year, as long as business is maintained with 20 or more persons in this State or the amount of gross receipts from existing West Virginia loans is \$100,000 or more during that tax year. Even if the gross receipts from existing loans drops below \$100,000, if the gross receipts from new loans and old loans together is \$100,000 or more, then apportionment is still required. It should be kept in mind that the nexus presumption contains an "either/or" type of test for nexus to be presumed; namely, the financial organization would be required to file if it meets either the \$100,000 gross receipts test or the 20 person test.

QUESTION 2:

Would nexus be created if a New York bank loaned an Ohio corporation money to build a plant in West Virginia? ✓

RESPONSE TO QUESTION 2:

There would be no nexus for West Virginia to impose corporation net income tax or business franchise tax on a New York bank making a loan to an Ohio corporation, even though the money may be spent building a plant in West Virginia, because there would be insufficient minimum contacts between the New York bank and West Virginia for this State to constitutionally impose its jurisdiction to tax. Neither of the tests contained in the nexus presumption would be met in such a scenario, since the loan to an Ohio corporation would not constitute soliciting or obtaining a loan in West Virginia, and the gross receipts from the loan would be from the situs of the loan, which is in Ohio rather than West Virginia. The fact that the Ohio corporation uses the proceeds of the loan in West Virginia would not vicariously confer nexus on the New York

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Banking be able to obtain from the Department of Tax and Revenue regarding the filing of Business Activities Reports and payment of taxes by out-of-state financial institutions under this new apportionment requirement?

RESPONSE TO QUESTIONS 6 AND 7:

Senate Bill 632 contains no provisions regarding confidentiality, so the general confidentiality rules would apply. The general rule of confidentiality, W. Va. Code § 11-10-5d prohibits divulging any tax information, except as expressly authorized by statute. One such exception is contained in W. Va. Code § 11-10-5d(1)(1)(A), which authorizes the Tax Commissioner to disclose the names and addresses of persons who have a current business registration certificate, if he believes that enforcement of the tax laws will be enhanced by the disclosure. If the names and addresses were provided for the purpose of tax enforcement, such information could obviously be disclosed. But even if the primary purpose were not tax enforcement, such information could be disclosed if it would be likely to enhance tax enforcement.

At the present time, any details of tax filings by financial organizations other than names and addresses could not be accomplished by entering into a reciprocal agreement. West Virginia Code § 11-10-5s permits the Tax Commissioner to enter into exchange of information agreements with the Commissioners of labor, employment security and workers' compensation, and with other agencies pursuant to legislative rules, for the purpose of facilitating premium collection, tax collection and licensure requirements of those agencies. This provision would permit disclosure of tax return information to the Banking Division if the Tax Commissioner were to promulgate legislative rules to that effect, once those rules became effective. Even without an exchange of information agreement, available statistical information could be provided, as long as specific taxpayers cannot be identified from the information. Of course, authority for disclosure of tax return information to the Division of Banking could be obtained through legislation.

QUESTION 8:

What types of internal or external information gathering is planned by the Department of Tax and Revenue to monitor the taxes paid under this new apportionment law and what types of information will be made public?

RESPONSE TO QUESTION 8:

The Department of Tax and Revenue intends to monitor financial organizations to ensure they are complying with Senate Bill 632 and

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While the state, county and municipality may be said to be "borrowing" money when they issue bonds, the purchasers of such bonds are not lending the state the money. Bonds are investment securities, not loans; correspondingly, purchasing bonds is the investing, not the lending, of money. Thus, the purchase of West Virginia state, county or municipal bonds would not itself subject an out-of-state financial organization to West Virginia's business franchise tax and corporation net income tax laws. Even if the out-of-state financial organization is otherwise subject to West Virginia's business franchise tax and corporation net income tax laws, these types of bonds and the interest therefrom are generally exempt from those taxes.

**QUESTION 5:**

If an out-of-state bank sells federal funds (excess bank reserves) to a West Virginia bank, is that sale of funds taxable under this new law as a loan?

**RESPONSE TO QUESTION 5:**

Under Senate Bill 632, any out-of-state bank will be presumed to have tax nexus during the year if it obtains or solicits business with twenty or more persons (including banks) within West Virginia, or if the sum of the value of its gross receipts attributable to sources (such as bank loans) in West Virginia is \$100,000 or more. Among the ways in which an out-of-state bank could meet this nexus presumption during a twelve month period would be for it to lend its excess reserves to twenty or more West Virginia banks, or to make such loans with interest totalling \$100,000 or more. While such transactions may confer nexus to tax, however, the special gross receipts factor used to apportion income to this state does not include gross receipts from loans of excess bank reserves. Thus, in effect, such receipts would be untaxed. For example, if the only gross receipts attributable to West Virginia were from interest on loans of excess bank reserves, the gross receipts factor would be zero, so the corporation net income tax owed to this State would also be zero.

**QUESTION 6:**

Will it be possible for the Division of Banking to enter into a confidential information sharing agreement with the Department of Tax and Revenue to obtain the names of out-of-state lenders who register under this new tax requirement and/or the details of tax filings by these institutions?

**QUESTION 7:**

If the answer to question 6 above is NO, what types of information will the Division of

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are paying appropriate taxes. Only information which is not confidential will be released to the public.

QUESTION 9:

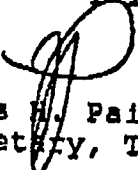
When were the first tax payments due to the Department of Tax and Revenue under this new apportionment rule?

ANSWER TO QUESTION 9:

Senate Bill 632 requires out-of-state financial organizations to apportion using the single gross receipts factor for tax years beginning on or after January 1, 1991. The first installment of estimated tax would normally have been due on the fifteenth day of the fourth month of the taxable year, which for most taxpayers would have been April 15, 1991. However, the new law was not signed into law until April 3, 1991. In order to provide new taxpayers a reasonable amount of time to comply with the new law, they were granted an extension of time to July 15, 1991 in which to file their declarations of estimated tax and to pay the first two installments of estimated tax. The first annual return and tax for taxable year 1991 will be due not later than the fifteenth day of the third month following the close of the taxable year, which for most taxpayers would be March 15, 1992.

I trust this information will be of assistance.

Very truly yours,

  
James H. Paige, III  
Secretary, Tax and Revenue

LD:kl/ts

pc: Alan L. Mierke  
Assistant Secretary/Acting Tax Commissioner

## § 11-23-5a

## TAXATION

(v) Money or its equivalent held as a credit balance by a financial organization on behalf of its customer if such entity is engaged in soliciting and holding such balances in the regular course of its business.

(B) "Sales" means:

For purposes of apportionment, the "sales" of a financial organization shall mean the gross receipts described in the gross receipts factor in this subsection, regardless of their source.

(3) *Commercial domicile — Apportionment or credit.* — Financial organizations which do not have their commercial domicile in West Virginia shall use the apportionment rules set forth in this section. Financial organizations with their commercial domicile in West Virginia may not apportion their tax base, but shall allocate all capital to West Virginia without apportionment: Provided, That any financial organizations with their commercial domicile in West Virginia shall be allowed the credit against their business franchise tax liability as described in section twenty-seven (§ 11-23-27) of this article.

(4) *Apportionment rules.* — (A) *General method.* — If a financial organization not having its commercial domicile in this state is engaging in business both within and without this state, the portion of its capital attributable to such business, which is derived from sources within this state, shall be determined by apportionment in accordance with this subsection. The apportioned capital shall be determined by multiplying capital by the special gross receipts factor as defined in this subsection. Neither the numerator nor the denominator of the gross receipts factor shall include receipts from obligations described in paragraphs (A), (B), (C) and (D), subdivision (1), subsection (f), section six [§ 11-24-6(f)(1)(A) to (f)(1)(D)], article twenty-four of this chapter.

(B) *Special gross receipts factor.* — The gross receipts factor is a fraction, the numerator of which is the total gross receipts of the taxpayer from sources within this state during the taxable year and the denominator of which is the total gross receipts of the taxpayer wherever earned during the taxable year.

*Numerator.* — The numerator of the gross receipts factor shall include, in addition to items otherwise includable in the sales factor under section five of this article, the following:

(i) Gross receipts from the lease or rental of real or tangible personal property (whether as the economic equivalent of an extension of credit or otherwise) if the property is located in this state;

(ii) Interest income and other receipts from assets in the nature of loans which are secured primarily by real estate or tangible personal property if such security property is located in this state. In the event that such security property is also located in one or more other states, such receipts shall be presumed to be from sources within this state, subject to rebuttal based upon factors described in rules to be promulgated by the tax commissioner, including the factor that the proceeds of any such loans were applied and used by the borrower entirely outside of this state;

(iii) Interest income and other receipts from consumer loans which are unsecured or are secured by intangible property that are made to residents of this state, whether at a place of business, by traveling loan officer, by mail, by telephone or other electronic means or otherwise;



BUSINESS FRANCHISE TAX

§ 11-23-5a

§ 11-24-3

(iv) Interest income and other receipts from commercial loans and installment obligations which are unsecured or are secured by intangible property if and to the extent that the borrower or debtor is a resident of or is domiciled in this state: Provided, That such receipts are presumed to be from sources in this state and such presumption may be overcome by reference to factors described in rules to be promulgated by the tax commissioner, including the factor that the proceeds of any such loans were applied and used by the borrower entirely outside of this state;

No rules

(v) Interest income and other receipts from a financial organization's syndication and participation loans, under the rules set forth in items (i) through (iv) above;

(vi) Interest income and other receipts, including service charges, from financial institution credit card and travel and entertainment credit card receivables and credit card holders' fees if the borrower or debtor is a resident of this state or if the billings for any such receipts are regularly sent to an address in this state;

(vii) Merchant discount income derived from financial institution credit card holder transactions with a merchant located in this state. In the case of merchants located within and without this state, only receipts from merchant discounts attributable to sales made from locations within this state shall be attributed to this state. It shall be presumed, subject to rebuttal, that the location of a merchant is the address shown on the invoice submitted by the merchant to the taxpayer;

(viii) Gross receipts from the performance of services which are attributed to this state if:

(I) The service receipts are loan-related fees, including loan servicing fees, and the borrower resides in this state; except that, at the taxpayer's election, receipts from loan-related fees which are either: (a) "Pooled" or aggregated for collective financial accounting treatment; or (b) manually written as non-recurring extraordinary charges to be processed directly to the general ledger may either be attributed to a state based upon the borrowers' residences or upon the ratio that total interest sourced to that state bears to total interest from all sources;

(II) The service receipts are deposit-related fees and the depositor resides in this state, except that, at the taxpayer's election, receipts from deposit-related fees which are either: (a) "Pooled" or aggregated for collective financial accounting treatment; or (b) manually written as nonrecurring extraordinary charges to be processed directly to the general ledger may either be attributed to a state based upon the depositors' residences or upon the ratio that total deposits sourced to that state bears to total deposits from all sources;

(III) The service receipt is a brokerage fee and the account holder is a resident of this state;

(IV) The service receipts are fees related to estate or trust services and the estate's decedent was a resident of this state immediately before death; or the grantor who either funded or established the trust is a resident of this state; or

(V) The service receipt is associated with the performance of any other service not identified above and the service is performed for an individual

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**EXHIBIT J: 21:**

**Memorandum from Joe Huddleston  
(Commissioner of Revenue, State of Tennessee)  
(April 15, 1992)**



RECEIVED  
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COMMISSIONER

NED McWHERTER  
Governor

STATE OF TENNESSEE  
DEPARTMENT OF REVENUE  
ANDREW JACKSON STATE OFFICE BUILDING  
NASHVILLE, TENNESSEE 37242

JOE HUDDLESTON  
Commissioner

M E M O R A N D U M :

TO: ALL STATE TAX ADMINISTRATORS

FROM: Joe Huddleston, Commissioner of Revenue  
State of Tennessee

SUBJECT: Taxation of Financial Institutions

DATE: April 15, 1992

Because I will be unable to attend the meeting between state representatives and members of the financial institutions industry scheduled by the MTC/FTA on April 29 and 30, 1992, I would like to take this opportunity to offer a few comments for your consideration concerning the issues which will be raised at this meeting.

As noted in Commissioner Heitkamp's recent memorandum, representatives from New York, Minnesota, California, West Virginia, Illinois, New York City, and Tennessee have met over the past few months as a subcommittee to discuss various issues pertaining to bank taxation. These discussions centered primarily on the apportionment formula used in corporate taxes with the view toward exploring the possibility of developing one apportionment formula to be used by all states. At one end of the spectrum was the destination-oriented, single-factor formula with the three-factor, domicile-oriented formula at the other.

While the hard work and time necessary to facilitate this exchange of information and opinions was certainly beneficial, it quickly became apparent that the underlying reasons which give rise to the different approaches to state taxation in the first place run too deep to quickly achieve a comprise apportionment formula. What did emerge from the subcommittee was a five-factor hybrid apportionment formula which sought to reflect equally money center and market state concerns by splitting the way the factors are sourced to a state for tax purposes. It is my understanding that this formula does not reflect a consensus among the members of the subcommittee, and Tennessee did not and

cannot support the offering of the five-factor formula as a viable alternative. From an administrative standpoint alone, the formula is overly burdensome to taxpayers and state tax administrators alike, and it appears neither to reconcile nor offer any meaningful resolution to the issues raised by the subcommittee.

Following the conclusion of this series of meetings, Tennessee continued the dialog with the others states which have already adopted market-oriented financial institution tax legislation. During the process, Minnesota proposed a three-factor apportionment formula which more nearly represents the market approach. However, while we agree on many philosophical points raised by the representatives from Minnesota, West Virginia and Indiana, Tennessee continues to feel that the single-factor formula measured by credit-related receipts most fairly measures the extent of a financial institution's business within a state and represents a methodology which affords for both ease of administration and taxpayer compliance.

As discussed by representatives from the market states, with the increase in the conduct of business transactions through telecommunications and rapid expansion of geographical contacts, the distinction between what makes a state a money center or what classifies it a market state is rapidly becoming blurred. While only a few states may be called money centers, all states, including the headquarter states, are market states to some degree. The single factor formula, therefore, represents a more inclusive, rather than exclusive, measure of business activity throughout the states and permits each state to tax the corporation's income proportionate to its contribution to the institution's overall market.

As an expansion of my brief comments to a very detailed subject, I have enclosed a recent memorandum from Dr. William Fox, Professor of Economics at the University of Tennessee, which explores in greater depth the concerns Tennessee feels in this area. Please feel free to call with any questions or comments you may have.

JH:AHD:tc

Enclosure

**EXHIBIT J: 22:**

**Letter from Douglas L. Whitley  
Director, Illinois Department of Revenue  
(August 27, 1992)**



# Illinois Department of Revenue

Douglas L. Whitley, Director  
100 West Randolph, Suite 7-500  
Chicago IL 60601

August 27, 1992

Alan H. Friedman  
General Counsel  
Multistate Tax Commission  
386 University Avenue  
Los Altos, California 94022

Dear Alan:

I am writing this letter to inform you that Illinois will no longer be able to contribute to the Bank Taxation Working Group. This has become necessary because of the continuing need to downsize the Illinois Department of Revenue and the resulting assignment of new Department duties and responsibilities to John Malach. These new duties and responsibilities will preclude him from being able to continue working on this project.

The Illinois Department of Revenue continues to be very interested in the results of the Bank Taxation Working Group. We will continue to internally review and study Illinois' and other states taxation of financial institutions.

The Illinois Department of Revenue fully supports the goals of the Bank Taxation Working Group. We feel that any steps that can be taken to achieve uniformity in the state taxation of financial institutions is good tax policy both for the states and for taxpayers. I am sorry that we cannot devote more resources to the working group at this time.

Please express my apologies to the other members of the working group.

Sincerely,

A handwritten signature in cursive script that reads "Doug".

Douglas L. Whitley, Director  
Illinois Department of Revenue

DLW:jat

**EXHIBIT J: 23:**

**Letter from Haskell Edelstein  
(Citicorp/Citibank, N.A.)  
(October 29, 1992)**

399 Park Avenue  
New York, NY  
10043

**Haskell Edelstein**  
Senior Vice President and  
General Tax Counsel

October 29, 1992

Alan Freedman, Esq.  
General Counsel  
Multistate Tax Commission  
386 University Avenue  
Los Altos, C.A. 94022

Re: **Allied Signal**

Dear Alan:

As a follow-up to the interesting discussion in Washington last week on where to go after this Supreme Court decision, I have just noted the Virginia Department of Taxation reaction. Virginia Tax Bulletin No. 92-6, 9/15/92 (copy attached).

The Virginia approach, in my view, reinforces the conclusion I espoused at the meeting - abolish the distinction between business and non-business income of corporations. Virginia would require that, in order for the taxpayer to demonstrate that income is non-business, it must identify and account for all income and expenses attributable to a purported investment function in a separately identifiable manner. As a practical matter, determination of the income from an investment should be simple. However, segregation of all expenses attributable to the investment may not only be impossible, but is almost guaranteed to generate audit disputes.

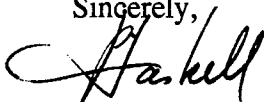
In New York, the banking industry has had, and to some extent continues to have, significant experience with these types of problems. Prior to 1985, New York State and City bank income was determined on the basis of "separate branch accounting," under which the bank branches, New York vs. foreign branches, were to be treated as if they were separately taxable entities. While the proper sourcing of income was the major issue, proper attribution of expenses to the foreign branches was also a major point of dispute. That problem continues today, albeit in a much smaller context, in the case of the International Banking Facilities (IBF's) of the New York banks, since the banks can elect to determine net income of the IBF under the separate branch accounting approach. The same types of audit issue continue.

If the Virginia approach were to be vigorously and strictly applied, the state will



have probably largely eliminated the application of the non-business income concept, since there will almost inevitably be disputes over the extent to which indirect expenses are attributable to non-business income. It suggests to me that the states can easily reach the same objective as I have suggested, by simply bypassing the Allied-Signal decision and adapting conforming rules which make it practically impossible to demonstrate to the states' satisfaction the net income from non-business investment activities.

Sincerely,

  
Haskell Edelstein

are not considered occasional sales). An occasional sale also includes the sale or exchange of all or substantially all the assets of any business, provided that such sale does not require the holding of a certificate of registration.

#### Confirmation of Exemption

Organizations that have questions regarding their taxable status are encouraged to contact either the department's Taxpayer Assistance Section, Post Office Box 1880, Richmond, Virginia 23282-1880, phone (804) 367-8037, or their nearest District Office.

[¶ 202-185] Virginia Tax Bulletin 92-6, September 15, 1992.

**Corporate Income—Constitutional Provisions—Federal Constitution—Due Process of Law—Capital Gains of Income of Nondomiciliary Corporation.**—The text of the Department of Taxation Bulletin 92-6, regarding the interaction of the *Allied Signal* decision with Virginia corporate income taxes, is reproduced below.

See ¶ 10-080, 10-401.

#### Interaction of the Allied-Signal Decision with Virginia Corporate Income Taxes

On June 15, 1992, the U.S. Supreme Court issued its opinion in *Allied-Signal, Inc. v. Director, Division of Taxation*, 60 USLW 4554, holding that income of a multistate corporation may be subject to apportionment even if there is no unitary relationship between the taxpayer and the payer of the income. In order to exclude from apportionable income in that circumstance, the Court reiterated that the taxpayer must prove that the income was earned in the course of activities unrelated to those carried out in the taxing state. In the case of investments, the taxpayer must prove that a capital transaction serves an investment function rather than an integral operational function. The inquiry must focus on the objective characteristics of the asset's use and its relation to the taxpayer and its operational business activities in Virginia.

The *Allied-Signal* decision supersedes the Virginia Supreme Court's opinion in *Corning Glass v. Virginia Dept. of Taxation*, 241 Va. 353 (1991), which focused exclusively on the lack of a unitary relationship between the taxpayer and the payer of the income. The Virginia Supreme Court did not consider whether the taxpayer's evidence demonstrated that the income at issue was unrelated to the taxpayer's Virginia operational activities.

If a unitary relationship exists between a taxpayer and the payer of the income at issue, the taxpayer may not exclude investment income other than dividends from Virginia apportionable income. However, if a unitary relationship does not exist between a taxpayer and payer of the income at issue,

taxpayers may exclude non-dividend income from apportionable income only by demonstrating with clear and cogent evidence that the income is of a passive investment, and not of an integral operational, nature. Evidence hearing on the determination could include, in the case of a manufacturer, whether the transactions at issue constitute an integral part of a taxpayer's manufacturing process. For example, income from an interim use of idle funds accumulated for future business operations use is sufficiently close to an "operational nature" to support the apportionment of income arising from the acquisition, ownership, sale, or exchange of assets purchased with such idle funds.

Taxpayers subtracting or allocating components of federal taxable income in determining Virginia taxable income must reduce the respective components by all related expenses incurred in the taxable year in which the excluded income is earned. In addition, the apportionment factors must *exclude* the property, payroll and sales producing the excluded gross income item. A taxpayer's failure to identify and account for all income and expenses attributable to a purported investment function in a separately identifiable manner, with respect to income and apportionment factor calculation, may indicate that the taxpayer's "investments" are operational in nature.

The department will closely scrutinize any claim that investment income should be excluded in determining apportionable income. Any such claim must include sufficient evidence proving (1) a lack of a unitary relationship between a taxpayer and the payer of the income, (2) that the income at issue is of an "investment" versus "operational" nature, and (3) that the income and relevant apportionment factors have been

¶ 202-185

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appropriately adjusted by related expenses and items used to produce the excluded income.

detail, and welcomes any comments and suggestions.

The department will be promulgating a regulation addressing these issues in more

[¶ 202-186] Virginia Tax Bulletin 92-7, September 15, 1992.

**Sales and Use—Taxability of Persons and Transactions—Construction—Nonprofit Organizations, Private Schools, and Churches—Installation Charges—Sale and Installation of Floor Coverings.**—The text of the Department of Taxation Bulletin 92-7, concerning the application of the retail sales and use tax to the sale and installation of floor coverings, is reproduced below.

See ¶ 60-330, 60-580, 61-160.

#### SALE AND INSTALLATION OF FLOOR COVERINGS

The purpose of this Tax Bulletin is to alert floor covering dealers as to the proper application of the retail sales and use tax to the sale and installation of floor coverings.

**DEFINITION OF FLOOR COVERINGS.** The term "floor coverings," as distinguished from floors themselves, is defined in Virginia Regulation (VR) 630-10-27G as including rugs, mats, padding, wall-to-wall carpets when installed by the tack strip or stretch-in methods, and other floor coverings which are not glued, cemented, or otherwise permanently attached to the floor below. However, any floor covering which is glued, cemented, or otherwise permanently attached to the floor below is deemed to be a "floor."

**SALE AND INSTALLATION OF FLOOR COVERINGS AND FLOORS.** A retailer, any person who maintains a retail or wholesale place of business, an inventory of floor coverings and/or materials which enter into or become a component part of such, and who performs installation as part of or incidental to the sale of such items, must collect the tax on its sales of floor coverings. However, installation charges are nontaxable provided they are separately stated on a sales invoice.

Installations of floors are always considered contract work and the seller/installer is treated as a contractor. Therefore, a retailer is deemed to be a using and consuming contractor with respect to installations of

floors, including floor coverings which become permanently attached. For such installations, he must pay the tax on the cost price of the floor.

Persons who are not classified as retailers as set forth above and who sell and install floors and floor coverings are deemed to be contractors, regardless of whether the floor coverings remain tangible personal property or are permanently attached to the floors. Contractors are required to pay the tax on their purchases at the time of purchase or remit the tax directly to the department.

However, uninstalled sales of floor coverings are always retail sales, even if the seller is normally a contractor, and the seller must collect and remit the tax on its sales.

**SALES TO NONPROFIT ORGANIZATIONS.** The tax does not apply to sales to governmental entities and certain nonprofit organizations when the applicable exemption certificate is obtained. However, persons selling and installing floors and floor coverings which become permanently attached to floors to governmental entities and nonprofit organizations are deemed contractors and must pay use tax on the cost price of items used in performing contract work, including the floors and floor coverings, even if furnished an exemption certificate.

**FOR ADDITIONAL INFORMATION.** Questions may be directed to the Department of Taxation, Office of Taxpayer Services, P.O. Box 1880, Richmond, Virginia 23282-1880, (804) 367-8037.

[¶ 202-187] Virginia Tax Bulletin 92-9, September 24, 1992.

**Administration—Penalties and Interest—Interest on Underpayments and Overpayments—Interest Rates for Fourth Quarter of 1992.**—The text of the

Virginia Tax Reports

¶ 202-187

**EXHIBIT J: 24:**

**Letter from Anne H. Dougherty  
(Assistant General Counsel, Revenue Department, State of Tennessee)  
(April 27, 1993)**



STATE OF TENNESSEE  
DEPARTMENT OF REVENUE  
ANDREW JACKSON STATE OFFICE BUILDING  
NASHVILLE, TENNESSEE 37242

April 27, 1993  
(615) 741-2348

Alan H. Friedman  
MultiState Tax Commission  
444 North Capitol Street NW  
Suite 409  
Washington, DC 20001

Dear Alan:

I am in receipt of the March 17, 1993 draft of the Financial Institution Apportionment Regulations and would like to take this opportunity to express my appreciation for the time and hard work spent by the other state and industry members in producing this near final product.

While I have no specific comments or changes to any particular item of the proposed regulations that I've not expressed before, we continue to have concerns over the substantive issues and their impact on tax administration. These concerns, however, are not within the scope of your request for comments and should be more properly addressed perhaps through a response to the scheduled public hearings.

Sincerely,

A handwritten signature in cursive script, reading "Anne H. Dougherty".

Anne H. Dougherty  
Assistant General Counsel

AHD:ln

**EXHIBIT J: 25:**

**Comments of the Franchise Tax Board of the State of  
California re MTC Proposal submitted by Ben Miller,  
Counsel, Multistate Tax Affairs (June 4, 1993)**

**FRANCHISE TAX BOARD**

Mailing Address:

Legal Division

P.O. Box 1468

Sacramento, CA 95812-1468

(916) 369-3320

June 4, 1993

In reply refer to  
410:BFM:md:FRIEDMAN

Alan H. Friedman, General Counsel  
Multistate Tax Commission  
386 University Avenue  
Los Altos, CA 94022

RE: Hearing in Los Angeles  
MTC Regulation VI.18.(i), May 27, 1993

Dear Alan:

Enclosed are the comments of the California Franchise Tax Board  
regarding financial institutions.

Very truly yours,

*Ben Miller*  
*md*

Benjamin F. Miller  
Counsel, Multistate Tax Affairs

Enclosure

**COMMENTS OF THE FRANCHISE TAX BOARD OF THE STATE  
OF CALIFORNIA WITH RESPECT TO MULTISTATE TAX  
COMMISSION'S PROPOSED REGULATION VI.18(1) -- ATTRIBUTION  
OF INCOME FROM THE BUSINESS OF FINANCIAL INSTITUTIONS**

The Franchise Tax Board of the State of California would like to commend the efforts of the Multistate Tax Commission, the Federation of Tax Administrators, the FIST coalition, the individual participating states and the individual participating financial institutions for their efforts in attempting to achieve a uniform mechanism for attributing the income of financial institutions amongst the various states. It is our hope that the product developed, and the process employed, will serve as a model for state tax administrators and other industries and taxpayer groups in their efforts to find a mutually acceptable solution to many of the problems that still remain in the area of income attribution.

The Notice of Public Hearing published by the Multistate Tax Commission asks for comments on six specific items. We welcome the opportunity to provide you with the thoughts of the staff of the Franchise Tax Board on these issues.

1. **What is the most appropriate definition of the terms "financial institution" and "business of a financial institution" for purpose of statutory or regulatory coverage of the different kinds of financial institutions that are in substantial competition with one another?**

Financial Institution

California's Revenue and Taxation Code provides for different rates for "corporations" and "financial corporations." "Banks" are separately taxed at a rate which is directly comparable to that asserted with respect to "financial corporations." For California purposes, therefore, a "financial institution" presumably would include both "banks" and "financial corporations."

The principal attribute of a "financial" is that it provides money or moneyed capital to others through the mechanism of loans or similar undertakings. In most circumstances, it accepts deposits, but it is not required to do so. It has to extend credit. Equity participations, though providing a source of money to another, do not qualify by themselves as financial undertakings. In order to qualify as a financial activity, the extension of credit must be the principal business of the entity or the group. A rule for determining the principal business should be provided which excludes consideration of activities of an unusual or abnormal basis and provides for the determination to be made by the review of several years of activities.



It probably is appropriate to provide a list of entities or activities which are commonly accepted as financials, such as banks, savings and loans, thrifts, credit unions, consumer lenders, etc., and add a provision that other activities which are substantially similar should also be classified as financial.

In the circumstance of a combined report setting, or perhaps with respect to any wholly owned subsidiary in the case of separate entity states, an argument can be made that a subsidiary which performs functions of an ancillary nature, such as the holding of title to the buildings where business is performed or the providing of electronic data processing services, should be treated as a financial even though its own activities are not financial in nature. California's current practice based upon the differential treatment afforded "corporations" as compared to "banks" or "financial corporations" is to make its classification upon the individual activities of each corporation. The classification question in California has significance with respect to certain local taxes.

#### Business of a Financial Institution

We do not see the need for a separate definition of the "business of a financial." It appears that it should be included in the definition of a "financial."

2. **Should the receipts factor reflect the delivery of a financial institution's services on a destination basis or on a majority of "cost of performance" basis?**

The receipts factor was included in the apportionment formula to provide recognition to the market states. In the case of tangible property, it is the place where the customer is located. There is no justification to treat receipts generated from the providing of services in any different manner. Receipts from service should be assigned to the place where the services are consumed, where the customer is located. With respect to services, the "cost of performance" normally means the salaries of the individuals who are providing the services. These activities are already reflected in the payroll factor. There is no need to replicate this activity in the receipts factor.

The justification we perceive for the use of a "cost of performance" assignment rule is the Uniform Division of Income for Tax Purposes Act (UDITPA) treatment of these receipts. It is accepted that UDITPA was designed to provide rules for the assignment of the income of mining, manufacturing and mercantile businesses all of whose receipts arise principally from the sale of tangible property. UDITPA was written almost 40 years ago when commercial practices were substantially different and service industries were not a significant part of the multistate

business community. The treatment of receipts from the sale of other than tangible property is largely treated under UDITPA as an afterthought. The treatment of such receipts under the UDITPA has been a frequent source of controversy. We do not recommend that UDITPA be used as a model for a business whose receipts principally arise from activities other than the sale of tangible property.

If the market approach is adopted for assigning such receipts, it may be appropriate to provide a series of examples to illustrate how the rule would operate. In many circumstances, questions are likely to arise whether nexus exists in a state where a receipt might be assignable. A throwback rule should be included in the case nexus cannot be established.

3. **How should states treat intangible property in the form of unsecured or secured loans, investments in securities, etc., for income attribution purposes?**

#### Receipts Factor

If the receipts factor is intended to reflect the market place, then receipts from intangible property should, in a theoretically pure system, be assigned on a market basis. With respect to loans, the market is the location of the borrower or where the money is used. However, there are practical and compliance concerns which have to be dealt with in formulating any rule. The states cannot expect the borrower to always be able to determine where a fungible commodity, such as money, is used. Practical administration suggests that compromises should be made from a theoretically pure approach. For secured loans, the location of the security would provide an appropriate siting rule. For unsecured loans, the address or headquarters of the borrower could provide an acceptable location.

With respect to receipts derived from the investment in securities, it is more difficult to identify a "market" to which the receipts can be assigned. There is no customer involved and the "market" is not site specific. In many respects, these type of receipts arise from the business as a whole suggesting the use of a throwout approach or assignment by reference to other activities. If the receipts from this kind of activity are a major element of the total receipts of the business, it becomes difficult to support a throwout rule. Use of traditional concepts based upon the costs associated with managing the activity suffer from the defect to replicating the payroll factor. However, this is probably the most administrable manner in which an allocation can be made and in light of the significance of such receipts is probably the choice which must be made.

### Property Factor

The property factor serves a different function than the receipts factor. It is intended to reflect the place where capital is employed by the business. For banks and financials, the property factor should probably in some manner reflect the place where it obtains its capital.

In the case of money loaned, the **borrower** employs the capital at the place where it invests or uses the money. It could be argued that the **lender** also uses the money in the place where the borrower uses it. But for the lender, the place where the borrower uses the loan also represents the lender's market. While it is possible that the assignment of property and the receipts arising from that property may coincide, it is not necessary that they do so, and for purposes of banks and financials, it may be appropriate that they do not. The proposed statute/regulation adopts a locational rule based upon where the bank or financial "controls" the funds which it loans, the place where the loan is booked. We believe that, given the "market" orientation of the receipts factor, a booking rule is appropriate for property factor purposes.

In the case of other intangible property of financials, such as investments, the proposed regulation adopts a "throwout" rule. Justification for the use of a "throwout" rule arises when an item does not readily identify itself with some particular jurisdiction but represents an activity or asset of the business as a whole. A "throwout" rule appears to be particularly appropriate with respect to an item which represents an ancillary activity of the business. In the case of investment activity, as opposed to lending activity, the use of the throwout approach can be justified on an initial basis and its adoption is further buttressed by the "negotiated" nature of the regulation and the trade-offs between the receipts and property factors.

4. **With regard to states that apply the unitary business principle and combined reporting, what, if any, approach should the proposal take with regard to such principles?**

Because a substantial number of states do not use combined reporting, it does not appear that the MTC/FTA proposal should specifically address that concept except in the broadest possible terms.

As a matter of proper tax administration, California could certainly endorse the principle that combined reporting for financials should only be used in circumstances where it would be used for other corporations.

Another area which might be addressed if combined reports are used is whether or not all of the included entities would be classified as financial corporations.

5. **What approach, if any, should the proposal take with regard to nexus and/or de minimis concepts?**

#### Nexus

It would promote uniformity if all states could adopt a uniform nexus position and include that with a throwback or throwout rule for activities in non-nexus jurisdictions. Several problems arise, however. First, the determination of when nexus exists appears to be in an evolutionary state. It would be improper for the states to adopt a rule now which might not extend to the full constitutionally permitted extent. Second, the nature of the financial business is changing daily. It is probable that in five years financials will be engaged in transactions which are not even contemplated today. Third, the industry would almost surely object to more aggressive states' concept of what would constitute nexus.

#### De Minimis

The concept of de minimis has application in several areas. First, the states are prepared to agree that certain activities, particularly in the receipts factor, do not have to be specifically accounted for and allocated because of the immaterial effect they would have on the apportionment process. With respect to such receipts, a throwout rule is probably appropriate. Second, it should be possible to write a de minimis rule so returns would not have to be filed if a minimum amount of tax would result. Such rules would have to be carefully crafted for their justification lies in the cost of administration. If the rule is drafted so the calculation to be avoided is required to determine if the presence is de minimis, then the benefit arising from the rule is lost.

6. **Should a throwout, throwback or another approach be used to address the attribution of receipts that are sourced to states in which the taxpayer is not subject to taxation?**

A throwout rule is appropriate in those circumstances where an item arises from the business as a whole. As an example, see the comments offered with respect to the 2nd and 3rd questions and investment intangibles. In the circumstances where a receipt can be sourced to a particular jurisdiction but the taxpayer is not taxable, there we would prefer the throwback rule to the place of next closest connection. We subscribe to the principle of avoiding "nowhere" income and the throwback rule appears to be the best mechanism to prevent this result.

7. Such other issues and suggestions that state representatives and other members of the taxpaying community may wish to present for consideration.

Submission of Bank of America with respect to the booking of LPO loans

We share many of the concerns expressed by Bank of America with respect to possible audit problems concerning the booking of loans. The proposed regulation/statute contains the "SINAA" standard of allocation. We understand that this can become a substantial audit issue and would be supportive of any steps which can be taken to tighten application of the definition.

Definition of "finance leases"

California is currently considering the question of how a "finance lease" should be defined. The language which we are considering, and which has the tentative approval of some industry members, is as follows:

A lease which is the economic equivalent of an extension of credit, and which is not treated as a "true" lease for federal income tax purposes; i.e., the lessor is not entitled to a deduction for depreciation.

This definition ties back into Rev. Rul. 55-540 and Rev. Proc. 75-21, 12 U.S.C. 24(7) and (10), regulations of the Comptroller of Currency, and Regulation Y of the Federal Reserve System. (See attachments.)

We recommend that consideration be given to this alternative definition.

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OR PERSONAL EXEMPTIONS

PENDENT DEFINED

Rev. Rul. 55

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OR INDIVIDUALS AND CORPORATION

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al basis taxpayer who makes a vol-  
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 pense for that year, regard-  
 e kept on the cash receipts and  
 ual basis. Section 108.18(7)

Wisconsin Statutes, 1953, the provisions of which embody the cur-  
 rent law on the question involved and is the counterpart of the afore-  
 said section 108.18(4), states that a payment to the fund, in excess  
 of the statutory requirements, shall be credited as of the date paid,  
 except that any such payment made during January shall be cred-  
 ited as of the immediately preceding computation date, i. e.,  
 December 31, the end of the calendar year, and shall be treated as  
 having been required and irrevocably paid with respect to payrolls  
 preceding the date as of which it is thus credited.

Accordingly, it is held that where a lump sum payment is made vol-  
 untarily into the Wisconsin unemployment reserve fund by a cash basis  
 or accrual basis taxpayer to effect a reduction in the unemployment in-  
 surance rate, which reduction is applicable to the calendar year sub-  
 sequent to the year in which paid, the amount thereof nevertheless,  
 is deemed to have been incurred as a business expense in the taxable  
 year in which paid and is deductible in such year, under section 162(a)  
 of the Internal Revenue Code of 1954 (section 23(a) of the Internal  
 Revenue Code of 1939). Where a payment, for accomplishing the  
 stated purpose, is made in January after the close of a calendar year,  
 even though it shall be credited to the employer's account as of the pre-  
 ceding December 31, and shall be considered as having been required,  
 under the Wisconsin law, nevertheless the amount thereof will con-  
 stitute an allowable deduction, for Federal income tax purposes, under  
 either the cash or accrual basis of accounting, in the taxable year in  
 which paid. I. T. 3177, *supra*, supplemented.

(Also Section 167.)

Rev. Rul. 55-540

(Also Part II, Sections 23(a), 23(1); Regulations  
 118, Sections 39.23(a)-1, 39.23(a)-10, 39.23  
 (1)-1.)

Guides to be used in determining the treatment, for Federal  
 income tax purposes, of leases of equipment used in the trade or  
 business of the lessee.

SECTION 1. PURPOSE.

The purpose of this Revenue Ruling is to state the position of the  
 Internal Revenue Service regarding the income tax aspects of the  
 purported leasing of equipment for use in the trade or business of the  
 lessee. The issues and rules herein discussed are not all-inclusive,  
 and as new questions of importance arise additional Revenue Rulings  
 will be issued.

SEC. 2. BACKGROUND.

.01 Many new and unique types of agreements concerning the use  
 and disposition of equipment have been developed to meet the needs  
 and purposes of the users of industrial and business equipment. The  
 lessor, in devising these agreements, is primarily interested in dis-  
 posing of his wares to customers. (Here and elsewhere in this ruling  
 the terms "lessor" and "lessee" are used for convenience, without  
 intending to suggest the proper characterization of any agreement.)  
 The lessee, on the other hand, may have one or more reasons for leas-  
 ing instead of purchasing the equipment. He may have use for the  
 equipment for only a comparatively short period of time. He may

wish to experiment with a new process or product which requires equipment he does not own. He may have insufficient capital or credit with which to make an outright purchase, or have other needs for his working capital. A significant motive may, in some cases, be the tax advantages which might result because of the different timing of the deductions for rent as compared to depreciation.

.02 The agreements are generally cast in the form of chattel leases and are as varied as the reasons for entering into such arrangements. An approximate pattern is discernible, however, and many of the agreements may be loosely defined and grouped as follows:

(a) Short-term agreements which usually concern mobile equipment or relatively small articles of equipment. The "compensation for use" provisions in these agreements are usually expressed in terms of an hourly, daily, or weekly rental, and the rental rates are relatively high in relation to the value of the article. There may be an option to purchase the equipment at a price fixed in advance which will approximate the fair market value of the equipment at the time of the election to exercise the option. In this type of agreement, all costs of repairs, maintenance, taxes, insurance, etc., are obligations of the lessor.

(b) Agreements entered into by taxpayers engaged in the business of leasing personal property to others either as their principal business activity or incidental thereto. Under the terms of these agreements the amounts payable, called rental rates, are ordinarily based on normal operations or use, plus a surcharge for operations in excess of the normal stated usage. In some instances the rental is based on units produced or mileage operated. Termination of the agreement at stated periods is provided upon due notice by either party. If the agreement includes an option to purchase, the option price has no relation to the amounts paid as rentals.

(c) Agreements providing for a "rental" over a comparatively short period of time in relation to the life of the equipment. The agreed "rental" payments fully cover the normal purchase price plus interest. Title usually passes to the lessee upon the payment of a stated amount of "rental" or on termination of the agreement upon the payment of an amount which when added to the "rental" paid approximates the normal purchase price of the equipment plus interest.

(d) Agreements which provide for the payment of "rental" for a short original term in relation to the expected life of the equipment, with provision for continued use over substantially all of the remaining useful life of the equipment. During the initial term of the agreement, the "rental" approximates the normal purchase price of the equipment, plus interest, while the "rentals" during the remaining term or renewal period or periods are insignificant when compared to the initial rental. These agreements may or may not provide for an option to acquire legal title to the equipment upon the termination of the initial period or at any stated time thereafter.

(e) Agreements similar to the arrangement in (d) above, but with the added factor that the manufacturer of the equipment purports to sell it to a credit or finance company, which either

takes an assignment of s  
or itself later enters int  
some instances, the lessor  
of the original vendor.

### 3. NATURE OF THE PROPE

.01 Section 162(a)(3) of  
vides that there shall be allow  
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made as a condition to the  
es of the trade or business  
taxpayer has not taken c  
equity. Section 23(a)(1)  
contains substantially th  
of a deduction for rental

.02 In deciding whether r  
payments claimed to repr  
of 1954 or the Code of 1  
virtue of the agreement th  
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respect to agreements o  
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ality a lease or a conditio

### 4. DETERMINATION WI CONDITIONAL SALES CON

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granting treatment of a tra  
sale rather than as a lease  
to exist if, for example,  
present:

- (a) Portions of the p  
applicable to an equity t  
*Bowen v. Commissioner*,
- (b) The lessee will ac  
amount of "rentals" wh  
make. See *Hervey v.*  
U. S. 664 (1876); *Robe*  
808; *Truman Bowen v. C*
- (c) The total amount  
relatively short period

takes an assignment of such an existing agreement with the user or itself later enters into such an agreement with the user. In some instances, the lessor may be a trustee acting for or on behalf of the original vendor.

### SEC. 3. NATURE OF THE PROBLEM.

.01 Section 162(a)(3) of the Internal Revenue Code of 1954 provides that there shall be allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business of the taxpayer, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. Section 23(a)(1)(A) of the Internal Revenue Code of 1939 contains substantially the same language in respect to the allowance of a deduction for rental expense.

.02 In deciding whether a taxpayer is entitled to a deduction for any payments claimed to represent rentals under the provisions of the Code of 1954 or the Code of 1939, it is necessary to determine whether by virtue of the agreement the lessee has acquired, or will acquire, title to or an equity in the property. The determination of that question with respect to agreements of the type here involved will ordinarily depend upon whether the particular agreement should be treated as in reality a lease or a conditional sale contract.

### SEC. 4. DETERMINATION WHETHER AN AGREEMENT IS A LEASE OR A CONDITIONAL SALES CONTRACT.

.01 Whatever interest is obtained by a lessee is acquired under the terms of the agreement itself. Whether an agreement, which in form is a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed. In ascertaining such intent no single test, or any special combination of tests, is absolutely determinative. No general rule, applicable to all cases, can be laid down. Each case must be decided in the light of its particular facts. However, from the decisions cited below, it would appear that in the absence of compelling persuasive factors of contrary implication an intent warranting treatment of a transaction for tax purposes as a purchase and sale rather than as a lease or rental agreement may in general be said to exist if, for example, one or more of the following conditions are present:

(a) Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee. See *Truman Bowen v. Commissioner*, 12 T. C. 446, acquiescence, C. B. 1951-2, 1.

(b) The lessee will acquire title upon the payment of a stated amount of "rentals" which under the contract he is required to make. See *Hervey v. Rhode Island Locomotive Works*, 93 U. S. 664 (1876); *Robert A. Taft v. Commissioner*, 27 B. T. A. 808; *Truman Bowen v. Commissioner*, *supra*.

(c) The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large



proportion of the total sum required to be paid to secure the transfer of the title. See *Truman Bowen v. Commissioner, supra*.

(d) The agreed "rental" payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property. See *William A. McWaters et al. v. Commissioner*, Tax Court Memorandum Opinion, entered June 15, 1950; *Truman Bowen v. Commissioner, supra*.

(e) The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made. See *Burroughs Adding Machine Co. v. Bogdon*, 9 Fed. (2d) 54; *Holeproof Hosiery Co. v. Commissioner*, 11 B. T. A. 547. Compare *H. T. Benton et al. v. Commissioner*, 197 Fed. (2d) 745.

(f) Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest. See *Judson Mills v. Commissioner*, 11 T. C. 25, acquiescence, C. B. 1949-1, 2.

.02 The fact that the agreement makes no provision for the transfer of title or specifically precludes the transfer of title does not, of itself, prevent the contract from being held to be a sale of an equitable interest in the property.

.03 Conditional sales of personal property are, in general, recordable under the various State recording acts if the vendor wishes to protect its lien against claims of creditors. However, the recording or failure to record such a sales contract is usually discretionary with the vendor and is not controlling insofar as the essential nature of the contract is concerned for Federal tax purposes. See *Hervey v. Rhode Island Locomotive Works, supra*.

.04 Agreements are usually indicative of an intent to rent the equipment if the rental payments are at an hourly, daily, or weekly rate, or are based on production, use, mileage, or a similar measure and are not directly related to the normal purchase price, provided, if there is an option to purchase, that the price at which the equipment may be acquired reasonably approximates the anticipated fair market value on the option date. Thus, agreements of the type described in section 2.02(a) and (b), above, will usually be considered leases, in the absence of other facts or circumstances which denote a passing of title or an equity interest to the lessee.

.05 In the absence of compelling factors indicating a different intent, it will be presumed that a conditional sales contract was intended if the total of the rental payments and any option price payable in addition thereto approximates the price at which the equipment could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges. Agreements of the type described in section 2.02(c), above, will generally be held to be sales of the equipment.

.06 If the sum of the specified "rentals" over a relatively short part of the expected useful life of the equipment approximates the price

at which the equipment could be acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges on such amount. If the sum of the specified "rentals" over a relatively short part of the expected useful life of the equipment approximates the price at which the equipment could be acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges on such amount, the equipment will be treated as sold at the time of entering into the agreement. Agreements of the type described in section 2.02(c), above, will generally be held to be sales of the equipment.

#### SEC. 5. REPORTING OF INCOME BY THE LESSOR AND THE LESSOR'S VENDOR.

.01 The amounts paid for the equipment which is determined, under the agreement, to be rental income, less ordinary and necessary expenses incurred during the year which are attributable to the equipment, the lessor will be allowed to deduct pursuant to the provisions of section 167. In addition, the lessor will be allowed to deduct the stipulated rental payments paid by the lessee to the lessor, if the agreement provides in section 110.

.02 If the agreement is held to be a lease under the contract, the payments on the sales price which do not represent interest will be treated as payments for the life of the equipment.

#### SEC. 6. DEDUCTIONS ALLOWED TO THE LESSEE.

.01 If it is held, under the agreement, that the lease, the lessee may deduct all expenses which are incurred in the lease, including all expenses which are required to pay to, or are incurred by the lessee, provided by section 110 of the Internal Revenue Code, if the expenses are incurred as to constitute a deduction over the lease term.

.02 If under the provisions of the agreement it is to be treated as a sale, the payments for the life of the equipment do not represent interest, but are treated as payments for the life of the equipment.

#### SEC. 7. ILLUSTRATIONS.

.01 Revenue Rulings 55-25, 55-26, 55-27, 55-28, 55-29, and 59 of this Bulletin illustrate the foregoing principles.

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at which the equipment could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges on such amount, and the lessee may continue to use the equipment for an additional period or periods approximating its remaining estimated useful life for relatively nominal or token payments, it may be assumed that the parties have entered into a sale contract, even though a passage of title is not expressly provided in the agreement. Agreements of the type described in section 2.02(d), and (e), above, in general, will be held to be sales contracts.

#### SEC. 5. REPORTING OF INCOME AND DEDUCTIONS BY A LESSOR OR A VENDOR.

.01 The amounts paid for the use of equipment under an agreement which is determined, under the foregoing principles, to be a lease will be held to be rental income to the lessor. Such lessor may deduct all ordinary and necessary expenses paid or incurred during the taxable year which are attributable to the earning of the income. In addition, the lessor will be allowed a deduction for depreciation determined pursuant to the provisions of section 167 of the Code of 1954. If the lessee under the contract pays to the lessor a stipulated rental, and in addition pays certain other expenses which are properly payable by the lessor, the lessor is deemed to have received as rental income not only the stipulated rental but also the amount of such other expenses paid by the lessee to, or for the account of, the lessor, except as provided in section 110 of the Code of 1954.

.02 If the agreement is determined to be a sale, the amounts received under the contract by the vendor will be considered to be payments on the sales price of the equipment to the extent such amounts do not represent interest or other charges.

#### SEC. 6. DEDUCTIONS ALLOWABLE TO LESSEE OR PURCHASER.

.01 If it is held, under the foregoing principles, that an agreement is a lease, the lessee may deduct the amount of rent paid or accrued, including all expenses which under the terms of the agreement the lessee is required to pay to, for, or on account of the lessor, except as provided by section 110 of the Code of 1954. If the payments are so arranged as to constitute advance rental, such payments will be duly apportioned over the lease term. In computing the term of the lease, all options to renew shall be taken into consideration if there is a reasonable expectation that such options will be exercised.

.02 If under the provisions of this Revenue Ruling the agreement is to be treated as a sale, the amounts paid to the vendor will be considered as payments for the purchase of the equipment to the extent such amounts do not represent interest or other charges. Expenditures treated as payments for the purchase of the equipment may be recovered over the life of the asset through appropriate depreciation deductions.

#### SEC. 7. ILLUSTRATIONS.

Revenue Rulings 55-25, C. B. 1955-1, 283, and 55-541 and 55-542, pages 19 and 59 of this Bulletin, illustrate the application of some of the foregoing principles.

## SEC. 12. EFFECT ON OTHER DOCUMENTS

This Revenue Procedure supersedes Rev. Proc. 73-13, 1973-1 C.B. 776 and Rev. Proc. 74-46, 1974-2 C.B. 502.

26 CFR 601.201: Rulings and determination letters.  
(Also Part I, Sections 38, 61, 162, 167; 1.38-1, 1.61-1, 1.162-1, 1.167(a)-1.)

## Rev. Proc. 75-21<sup>1</sup>

### SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to set forth guidelines that the Internal Revenue Service will use for advance ruling purposes in determining whether certain transactions purporting to be leases of property are, in fact, leases for Federal income tax purposes. The type of transaction covered by this Revenue Procedure is commonly called a "leveraged lease". Such a lease transaction generally involves three parties: a lessor, a lessee and a lender to the lessor. In general, these leases are net leases, the lease term covers a substantial part of the useful life of the leased property, and the lessee's payments to the lessor are sufficient to discharge the lessor's payments to the lender.

### SEC. 2. BACKGROUND

Section 4.01 of Rev. Rul. 55-540, 1955-2 C.B. 39, sets forth certain conditions that, in the absence of compelling factors of contrary implication, would warrant treatment of a transaction for Federal income tax purposes as a conditional sales contract rather than a lease of equipment. See Rev. Rul. 55-541, 1955-2 C.B. 19; Rev. Rul. 55-542, 1955-2 C.B. 59; and Rev. Rul. 57-371, 1957-2 C.B. 214, for examples of transactions determined to be sales rather than leases. See Rev. Rul. 60-122, 1960-1 C.B. 56, for two transactions, one considered a lease and the other considered a sale. See also Rev. Rul. 72-403, 1972-2 C.B. 86, concerning the Federal income tax consequences of a transaction cast in the form of a

<sup>1</sup> Also released as TIR-1362, dated April 11, 1975.

lease subsequently determined to be a sale.

### SEC. 3. NATURE OF THE PROBLEM

Rev. Rul. 55-540, cited in section 2, provides guidelines for determining the existence of a conditional sales contract but does not contain guidelines for determining the existence of a lease. The guidelines set forth in section 4 of this Revenue Procedure are being published to clarify the circumstances in which an advance ruling recognizing the existence of a lease ordinarily will be issued and thus to provide assistance to taxpayers in preparing ruling requests and to assist the Service in issuing advance ruling letters as promptly as practicable. These guidelines do not define, as a matter of law, whether a transaction is or is not a lease for Federal income tax purposes and are not intended to be used for audit purposes. If these guidelines are not satisfied, the Service nevertheless will consider ruling in appropriate cases on the basis of all the facts and circumstances.

### SEC. 4. GUIDELINES

Unless other facts and circumstances indicate a contrary intent, for advance ruling purposes only, the Service will consider the lessor in a leveraged lease transaction to be the owner of the property and the transaction a valid lease if all the following conditions are met:

#### (1) MINIMUM UNCONDITIONAL "AT RISK" INVESTMENT.

The lessor must have made a minimum unconditional "at risk" investment in the property (the "Minimum Investment") when the lease begins, must maintain such Minimum Investment throughout the entire lease term, and such Minimum Investment must remain at the end of the lease term. The Minimum Investment must be an equity investment (the "Equity Investment") which, for purposes of this Revenue Procedure, includes only consideration paid and personal liability incurred by the lessor to pur-

chase the property. The net worth of the lessor must be sufficient to satisfy any such personal liability. In determining the lessor's Minimum Investment, the following rules will be applied:

(A) *Initial Minimum Investment.* When the property is first placed in service or use by the lessee, the Minimum Investment must be equal to at least 20 percent of the cost of the property. The Minimum Investment must be unconditional. That is, after the property is first placed in service or use by the lessee, the lessor must not be entitled to a return of any portion of the Minimum Investment through any arrangement, directly or indirectly, with the lessee, a shareholder of the lessee, or any party related to the lessee (within the meaning of section 318 of the Internal Revenue Code of 1954) (the "Lessee Group"). The lease transaction may include an arrangement with someone other than the foregoing parties that provides for such a return to the lessor if the property fails to satisfy written specifications for the supply, construction, or manufacture of the property.

(B) *Maintenance of Minimum Investment.* The Minimum Investment must remain equal to at least 20 percent of the cost of the property at all times throughout the entire lease term. That is, the excess of the cumulative payments required to have been paid by the lessee to or for the lessor over the cumulative disbursements required to have been paid by or for the lessor in connection with the ownership of the property must never exceed the sum of (i) any excess of the lessor's initial Equity Investment over 20 percent of the cost of the property plus (ii) the cumulative pro rata portion of the projected profit from the transaction (exclusive of tax benefits).

(C) *Residual Investment.* The lessor must represent and demonstrate that an amount equal to at least 20 percent of the original cost of the property is a reasonable estimate of

what the fair market value of the property will be at the end of the lease term. For this purpose, fair market value must be determined (i) without including in such value any increase or decrease for inflation or deflation during the lease term, and (ii) after subtracting from such value any cost to the lessor for removal and delivery of possession of the property to the lessor at the end of the lease term. In addition, the lessor must represent and demonstrate that a remaining useful life of the longer of one year or 20 percent of the originally estimated useful life of the property is a reasonable estimate of what the remaining useful life of the property will be at the end of the lease term.

#### (2) LEASE TERM AND RENEWAL OPTIONS.

For purposes of this Revenue Procedure, the lease term includes all renewal or extension periods except renewals or extensions at the option of the lessee at fair rental value at the time of such renewal or extension.

#### (3) PURCHASE AND SALE RIGHTS.

No member of the Lessee Group may have a contractual right to purchase the property from the lessor at a price less than its fair market value at the time the right is exercised. When the property is first placed in service or use by the lessee, the lessor may not have a contractual right (except as provided in section 4 (1) (A) above) to cause any party to purchase the property. The lessor must also represent that it does not have any present intention to acquire such a contractual right. The effect of any such right acquired at a subsequent time will be determined at that time based on all the facts and circumstances. A provision that permits the lessor to abandon the property to any party will be treated as a contractual right of the lessor to cause such party to purchase the property.

#### (4) NO INVESTMENT BY LESSEE.

No part of the cost of the property may be furnished by any member of

the Lessee Group. Nor may any such party furnish any part of the cost of improvements or additions to the property, except for improvements or additions that are owned by any member of the Lessee Group and are readily removable without causing material damage to the property. Any item that is so readily removable must not be subject to a contract or option for purchase or sale between the lessor and any member of the Lessee Group at a price other than its fair market value at the time of such purchase or sale. However:

(A) *Cost Overruns and Modifications.* If the cost of property exceeds the estimate on which the lease was based, the lease may provide for adjustment of the rents to compensate the lessor for such additional cost (but see section 5.01 concerning uneven rent payments).

(B) *Maintenance and Repair.* If the lease requires the lessee to maintain and keep the property in good repair during the term of the lease, ordinary maintenance and repairs performed by the lessee will not constitute an improvement or addition to the property.

#### (5) NO LESSEE LOANS OR GUARANTEES.

No member of the Lessee Group may lend to the lessor any of the funds necessary to acquire the property, or guarantee any indebtedness created in connection with the acquisition of the property by the lessor. A guarantee by any member of the Lessee Group of the lessee's obligation to pay rent, properly maintain the property, or pay insurance premiums or other similar conventional obligations of a net lease does not constitute the guarantee of the indebtedness of the lessor.

#### (6) PROFIT REQUIREMENT.

The lessor must represent and demonstrate that it expects to receive a profit from the transaction, apart from the value of or benefits obtained from the tax deductions, allowances, credits and other tax attributes arising from

such transaction. This requirement is met if:

the aggregate amount required to be paid by the lessee to or for the lessor over the lease term plus the value of the residual investment referred to in section 4(1)(C) above exceed an amount equal to the sum of the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property and the lessor's Equity Investment in the property, including any direct costs to finance the Equity Investment, and the aggregate amount required to be paid to or for the lessor over the lease term exceeds by a reasonable amount the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property.

#### SEC. 5. OTHER CONSIDERATIONS

.01 Leveraged lease transactions that satisfy the guidelines set forth in section 4 hereof nevertheless may contain uneven rent payments that result in prepaid or deferred rent. The Service ordinarily will not raise any question about prepaid or deferred rent if the annual rent for any year (i) is not more than 10 percent above or below the amount calculated by dividing the total rent payable over the lease term by the number of years in such term, or (ii) during at least the first two-thirds of the lease term is not more than 10 percent above or below the amount calculated by dividing the total rent payable over such initial portion of the lease term by the number of years in such initial portion of the lease term, and if the annual rent for any year during the remainder of the lease term is no greater than the highest annual rent for any year during the initial portion of the lease term and no less than one-half of the average annual rent during such initial portion of the lease term. Any ruling request involving uneven rent payments that do not satisfy the above exceptions must contain a request for a ruling as to whether any portion of the uneven

rent payments is prepaid or deferred rent. Any ruling issued by the Service as to the existence of a lease may contain an appropriate ruling or caveat as to such prepaid or deferred rent.

.02 The Service has not decided whether rulings will be issued with respect to property that is expected not to be useful or usable by the lessor at the end of the lease term except for purposes of continued leasing or transfer to any member of the Lessee Group. Prior to the final decision, consideration will be given to any comments pertaining thereto that are submitted in writing (preferably six copies) to the Commissioner of Internal Revenue at the address in Section 7 below by May 30, 1975. Designations of material as confidential or not to be disclosed, contained in such comments will not be accepted. Thus, a person submitting written comments should not include therein material that is considered to be confidential or inappropriate for disclosure to the public. It will be presumed by the Internal Revenue Service that every written comment submitted to it in response to this request is intended by the person submitting it to be subject in its entirety to public inspection and copying in accordance with the same procedures as are prescribed in 26 CFR 601.702(d)(9) for public inspection and copying of written comments received in response to a notice of proposed rule making.

#### SEC. 6. EFFECTIVE DATE

The provisions of this Revenue Procedure are effective with respect to those requests received after May 3, 1975.

#### SEC. 7. INQUIRIES

Inquiries regarding this Revenue Procedure should refer to its number and be addressed to the Commissioner of Internal Revenue, 1111 Constitution Avenue, N. W., Washington, D. C. 20224, Attention: T:C:C.

26 CFR 601.204: Changes in accounting periods and in methods of accounting.

(Also Part I, Sections 471, 472; 1.471-11, 1.472-1.)

### Rev. Proc. 75-22<sup>1</sup>

#### SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to set forth certain procedures to be used by the Internal Revenue Service in granting consent to taxpayers to change to the full absorption method of inventory costing as required by section 1.471-11(e)(1)(i) of the Income Tax Regulations whether or not such taxpayers have elected or will elect to use the last-in, first-out (LIFO) inventory method under section 472 of the Internal Revenue Code of 1954. The purpose of this Revenue Procedure is also to set forth procedures that the Service will use in the examination of returns involving related matters.

#### SEC. 2. SCOPE.

The scope of this Revenue Procedure is limited to the following situations:

.01 *Situation (1)* — Effective with the calendar year 1974, the taxpayer elected to use the LIFO inventory method under section 472 of the Code for all of its manufactured goods. In effecting the LIFO election the taxpayer, for Federal income tax purposes, used the same inventory costing method that it had used in the past for both tax and financial statement purposes, which did not reflect full absorption costing. Effective with the calendar year 1974, for financial statement purposes only, the taxpayer changed its inventory costing system to a full absorption costing method. For the calendar year 1975 taxpayer has elected to change to the full absorption method of inventory costing for Federal income tax purposes under the provisions of section 1.471-11(e)(1)(ii) of the regulations.

.02 *Situation (2)* — Effective with the calendar year 1974, the taxpayer elected the LIFO inventory method under section 472 of the Code for all of its manufactured goods. The

taxpayer reviewed its inventory costing method for Federal income tax purposes and believed that its method complied with the full absorption method of inventory costing as described in section 1.471-11(a) of the regulations. Accordingly, the taxpayer used the same inventory costing method under the LIFO inventory method that it had previously used. Subsequently, the taxpayer's Federal income tax return for 1974 is examined and the Service determines that additional items of production cost should be included in the taxpayer's inventory under the full absorption method. The taxpayer agrees to the Service's determination.

.03 *Situation (3)* — The situation is the same as *Situation 2*, except that during the transition period referred to in section 1.471-11(e)(1)(ii) of the regulations, the taxpayer filed a "protective" Form 3115 (Application to Change Accounting Method) in which the taxpayer "elects" to change to the full absorption method of inventory costing in the event the Service determines that its present method of inventory costing method is not consistent with the provisions of section 1.471-11(a).

.04 *Situation (4)* — The situation is the same as in *Situation 3*, except that the taxpayer has not elected to use the LIFO method under section 472 of the Code and does not anticipate doing so. Instead, it has used and will continue to use the first-in, first-out (FIFO) inventory method under section 471 of the Code.

#### SEC. 3. BACKGROUND.

.01 Section 472(a) of the Code authorizes the use of the LIFO inventory method if the taxpayer makes a proper application for such method under the regulations.

Section 472(b) provides in inventoring goods specified in the application described in subsection (a), the taxpayer shall:

(1) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year

<sup>1</sup> Also released as TIR-1358, dated April 2, 1975.

**PART 23—LEASING**  
 [Added by 56 Fed. Reg. 28314,  
 6/20/91; eff 7/22/91.]

**[¶ 3323]**

Subpart A—General Provisions			Subpart B—CEBA Leases		
Sec.		¶	Sec.		¶
23.1	Authority	3323.1	23.7	General rule	3323.7
23.2	Net lease basis	3323.2	23.8	Lease term	3323.8
23.3	Investment in personal property	3323.3	23.9	Transition period	3323.9
23.4	Segregation of records	3323.4	Subpart C—Leases Under the Authority of 12 U.S.C. 24(7)		
23.5	Application of lending limits; restrictions on transactions with affiliates	3323.5	Sec.		¶
23.6	Consumer Leasing Act of 1978	3323.6	23.10	General rule	3323.10
			23.11	Maximum estimated residual value	3323.11
			23.12	Transition rule	3323.12
			Authority: 12 U.S.C. 12 U.S.C. 24(7) and [10]: 93a.		

**Subpart A—General Provisions****☛ [¶ 3323.1] § 23.1 Authority.—**

(a) A national bank may engage in lease financing transactions under either of two distinct lines of authority. In order to enter into a lease financing transaction as specifically authorized by 12 U.S.C. 24(10), *i.e.*, a CEBA Lease, a national bank must comply with subparts A and B of this part. In order to enter into a lease financing transactions as generally authorized by 12 U.S.C. 24(7), a national bank must comply with subparts A and C of this part.

(b) On entering into a lease financing transaction in compliance with this subpart, a bank must reasonably expect to realize a return of its full investment in the leased property, plus the estimated cost of financing the property over the term of the lease, from—

- (1) Rentals;
- (2) Estimated tax benefits; and
- (3) The estimated residual value of the property at the expiration of the term of the lease.

**☛ [¶ 3323.2] § 23.2 Net lease basis.—**

(a) A *net lease* is a lease under which the national bank will not, directly or indirectly, provide or be obligated to provide for:

- (1) The servicing, repair or maintenance of the leased property during the lease term.
- (2) The purchasing of parts and accessories for the leased property; however, improvements and additions to the leased property may be leased to the lessee upon its request in accordance with any applicable requirements for maximum estimated residual value.
- (3) The loan of replacement or substitute property while the leased property is being serviced.
- (4) The purchasing of insurance for the leases, except where the lessee has failed in its contractual obligation to purchase or maintain the required insurance.
- (5) The renewal of any license or registration for the property unless such action by the bank is necessary to protect its interest as owner or financier of the property.

(b) If, in good faith, a national bank believes that there has been an unexpected change in conditions which threatens its financial position by significantly increasing its exposure to loss, the limitations contained in paragraph (a) of this section shall not prevent the bank—

(1) As the owner and lessor under a net lease, (including a full-payout lease entered into under 12 U.S.C. 24(7)), from taking reasonable and appropriate action to salvage or protect the value of the property or its interests arising under the lease; or

(2) As the assignee of a lessor's interest in a lease, from becoming the owner and lessor of the leased property pursuant to its contractual right, or from taking any reasonable and appropriate action to salvage or protect the value of the property or its interests arising under the lease.

(c) The limitations contained in paragraph (a) of this section do not prohibit a national bank from including any provisions in a lease, or from making any additional agreements, to protect its financial position or investment in the circumstances set forth in paragraph (b) of this section.

(d) The limitations contained in paragraph (a) of this section do not prohibit a national bank from arranging for any of the services enumerated in paragraph (a) of this section to be provided by a third party to a lessee (at the expense of the lessee) with respect to property leased by the lessee.

☛ [ ¶ 3323.3 ] § 23.3 Investment in personal property.—

(a) A national bank may acquire specific property to be leased only after the bank has entered into either:

(1) A legally binding written agreement which indemnifies the bank against loss in connection with its acquisition of the property; or

(2) A legally binding written commitment to lease the property on terms which comply with the provisions of this subpart and either subpart B or C of this part.

(b) At the expiration of the lease (including any renewals or extensions with the same lessee), or in the event of a default on a lease agreement prior to the expiration of the lease term, all of the bank's interest in the property shall either be liquidated or re-leased in conformance with this subpart and either subpart B or C of this part, as soon as practicable, but in no event later than two years from the expiration of the lease. Property which the bank retains in anticipation of re-leasing must be revalued at the lower of current fair market value or book value prior to any subsequent lease.

(c) Notwithstanding the provisions of paragraph (b) of this section, on the return of the leased property at the expiration of a conforming lease term, or on the default of a lessee, a short-term bridge or interim lease is permissible if it otherwise conforms with the net lease requirements of § 23.2 of this subpart A. Such a short-term bridge or interim lease need not comply with the further requirements of subpart B or C of this part. Short-term bridge or interim leases may be used pending the sale of off-lease property, or its re-lease as a conforming long-term lease financing transaction.

☛ [ ¶ 3323.4 ] § 23.4 Segregation of records.—

Where a national bank enters into both CEBA leases and leases under the authority of 12 U.S.C. 24(7), the bank must specifically identify any records it maintains on its CEBA leases to distinguish them from those records which the bank maintains on its leases under the authority of 12 U.S.C. 24(7).

☛ [ ¶ 3323.5 ] § 23.5 Application of lending limits; restrictions on transactions with affiliates.—

Leasing financing transactions entered into under this part are subject to the limitations on loans or extensions of credit under 12 U.S.C. 84 and to the restrictions on transactions with affiliates under 12 U.S.C. 371c and 371c-1. The Comptroller of the Currency reserves the right to determine that such leases are also subject to the limitations of any other law, regulation or ruling.

☛ [ ¶ 3323.6 ] § 23.6 Consumer Leasing Act of 1979.—

Nothing in this part shall be construed to be in conflict with the duties, liabilities and standards imposed by the Consumer Leasing Act of 1975, 15 U.S.C. 1687 *et seq.*

**Subpart B—CEBA Leases****☛ [¶ 3323.7] § 23.7 General rule.—**

Pursuant to 12 U.S.C. 24(10), a national bank may invest in tangible personal property, including, without limitation, vehicles, manufactured homes, machinery, equipment, or furniture, for lease financing transactions on a net lease basis, or may become the owner and lessor of such tangible personal property by purchasing the property from another lessor in connection with its purchase of the related lease; provided that the requirements of subpart A of this part and this subpart are met, and the aggregate book value of all tangible personal property held for lease (under the authority of 12 U.S.C. 24(10)) does not exceed 10 percent of the consolidated assets of the national bank.

**☛ [¶ 3323.8] § 23.8 Lease term.—**

(a) Lease financing transactions entered into under this subpart must have an initial term of not less than 90 days.

(b) The minimum lease term provided for in paragraph (a) of this section, shall not be applicable to the acquisition of property subject to an existing lease with a remaining maturity of less than 90 days, provided that, at its inception, such lease was in conformance with the requirements of subpart A of this part and this subpart.

**☛ [¶ 3323.9] § 23.9 Transition period.—**

(a) Lease financing transactions entered into under the authority of 12 U.S.C. 24(10) prior to July 22, 1991 may continue to be administered in accordance with the lease financing terms agreed to by the bank/lessor and lessee. With respect to the applicability of § 23.8, when making new extensions of credit, including leases, to a customer, a national bank must consider all outstanding leases regardless of the date on which they were made.

(b) Any lease which was entered into in good faith prior to July 22, 1991 which does not satisfy the requirements of subpart A of this part and this subpart may be renewed without violation of this part only if there is a binding agreement in the expiring lease which requires the bank to renew it at the lessee's option, and the bank cannot otherwise reasonably or properly avoid its commitment to do so, and the bank in good faith determines and demonstrates, by full documentation, that renewal of the lease is necessary to avoid significant financial loss and recover its total investment in, plus the cost of financing, the property.

**Subpart C—Leases Under the Authority of 12 U.S.C. 24(7)****☛ [¶ 3323.10] § 23.10 General rule.—**

Pursuant to 12 U.S.C. 24(7), a national bank may become the legal or beneficial owner and lessor of specific personal property or otherwise acquire such property; or become the owner and lessor of personal property by purchasing the property from another lessor in connection with its purchase of the related lease; and incur obligations incidental to its position as the legal or beneficial owner and lessor of the leased property; provided that the lease is a net, full-payout lease representing a noncancelable obligation of the lessee, notwithstanding the possible early termination of that lease, and the requirements of subpart A of this part and this subpart are met.

**☛ [¶ 3323.11] Maximum estimated residual value.—**

(a) Any unguaranteed portion of the estimated residual value relied upon by the bank to yield a full return under this subpart shall not exceed 25 percent of the original cost of the property to the lessor. The amount of any estimated residual value guaranteed by the manufacturer, the lessee, or a third party which is not an affiliate (as defined by 12 U.S.C. 371c) of the bank, may exceed 25 percent of the original cost of the property, where the bank has determined, and can provide full, supporting documentation, that the guarantor has the resources to meet the guarantee.



(b) Calculations of estimated residual value on issues of personal property to Federal, State, or local governmental entities may be based on reasonably anticipated future transactions or renewals.

(c) In all cases, both the estimated residual value of the property and that portion of the estimated residual value relied upon by the lessor to satisfy the requirements of a full-payout lease must be reasonable in light of the nature of the leased property and all relevant circumstances so that realization of the lessor's full investment plus the cost of financing the property primarily depends on the creditworthiness of the lessee and any guarantor of the residual value, and not on the residual market value of the leased item.

**• [ § 3323.12 ] Transition rule.—**

This part shall not apply to any leases executed prior to June 12, 1979. With respect to the applicability of § 23.5, when making new extensions of credit, including leases, to a customer, a national bank must consider all outstanding leases regardless of the date on which they were made. Any lease which was entered into in good faith prior to such date which does not satisfy the requirements of this part may be renewed without violation of this part only if there is a binding agreement in the expiring lease which requires the bank to renew it at the lessee's option, and the bank cannot otherwise reasonably or properly avoid its commitment to do so, and the bank in good faith determines and demonstrates, by full documentation, that renewal of the lease is necessary to avoid significant financial loss and recover its total investment in, plus the cost of financing, the property.

- (iii) Providing portfolio investment advice<sup>1</sup> to any other person;
- (iv) Furnishing general economic information and advice, general economic statistical forecasting services and industry studies;<sup>2</sup> and
- (v) Providing financial advice to state and local governments, such as with respect to the issuance of their securities.
- (5) *Leasing personal or real property.* Leasing personal or real property or acting as agent, broker, or adviser in leasing such property if:
- (i) The lease is to serve as the functional equivalent of an extension of credit to the lessee of the property;
- (ii) The property to be leased is acquired specifically for the leasing transaction under consideration or was acquired specifically for an earlier leasing transaction;
- (iii) The lease is on a nonoperating basis;<sup>3</sup>
- (iv) At the inception of the initial lease the effect of the transaction (and, with respect to governmental entities only, reasonably anticipated future transactions<sup>4</sup>) will yield a return that will compensate the lessor for not less than the lessor's full investment in the property plus the estimated total cost of financing the property over the term of the lease,<sup>5</sup> from:
- (A) Rentals;
- (B) Estimated tax benefits (investment tax credit, net economic gain from tax deferral from accelerated depreciation, and other tax benefits with a substantially similar effect);
- (C) The estimated residual value of the property at the expiration of the initial term of the lease, which in no case shall exceed 20 percent of the acquisition cost of the property to the lessor; and
- (D) In the case of a lease of personal property of not more than seven years in duration, such additional amount, which shall not exceed 60 percent of the acquisition cost of the property, as may be provided by an unconditional guarantee by a lessee, independent third party, or manufacturer, which has been determined by the lessor to have the financial

**[Footnote 6321.25]** (1) The term "portfolio investment" is intended to refer generally to the investment of funds in a "security" as defined in section 2(1) of the Securities Act of 1933 (15 U.S.C. 77b) or in real property interests, except where the real property is to be used in the trade or business of the person being advised. In furnishing portfolio investment advice, bank holding companies and their subsidiaries shall observe the standards of care and conduct applicable to fiduciaries.

(2) This is to be contrasted with "management consulting," which the Board views as including, but not limited to, the provision of analysis or advice as to a firm's (A) purchasing operations, such as inventory control, sources of supply, and cost minimization subject to constraints; (B) production operations, such as quality control, work measurement, product methods, scheduling shifts, time and motion studies, and safety standards; (C) marketing operations, such as market testing, advertising programs, market development, packaging, and brand development; (D) planning operations, such as demand and cost projections, plant location, program planning, corporate acquisitions and mergers, and determination of long-term and short-term goals; (E) personnel operations, such as recruitment, training, incentive programs, employee compensation, and management-personnel relations; (F) internal operations, such as taxes, corporate organization, budgeting systems, budget control, data processing systems evaluation, and efficiency evaluation; or (G) research operations, such as product development, basic research, and product design and innovation. The Board has determined that "management consulting" is not an activity that is so closely related to banking or managing or controlling banks as to be a proper incident thereto.

(3) For purposes of the leasing of automobiles, the requirement that the lease be on a nonoperating basis means that the bank holding company may not, directly or indirectly: (A) provide for the servicing, repair, or maintenance of the leased vehicle during the lease term; (B) purchase parts and accessories in bulk or for an individual vehicle after the lessee has taken delivery of the vehicle; (C) provide for the loan of an automobile during servicing of the leased vehicle; (D) purchase insurance for the lessee; or (E) provide for the renewal of the vehicle's license merely as a service to the lessee where the lessee could renew the license without authorization from the lessor.

(4) The Board understands that some federal, state and local governmental entities may not enter into a lease for a period in excess of one year. Such an impediment does not prohibit a company authorized to conduct leasing activities under this paragraph from entering into a lease with such governmental entities if the company reasonably anticipates that the governmental entities will renew the lease annually until such time as the company is fully compensated for its investment in the leased property plus its costs of financing the property. Further, a company authorized to conduct personal property leasing activities under this paragraph may also engage in so-called "bridge" lease financing of personal property, but not real property, if the lease is short-term pending completion of long-term financing, by the same or another lender.

(5) The estimate by the lessor of the total cost of financing the property over the term of the lease should reflect, among other factors, the term of the lease, the modes of financing available to the lessor, the credit rating of the lessor and/or the lessee, if a factor in the financing, and prevailing rates in the money and capital markets.

resources to meet such obligation, that will assure the lessor of recovery of its investment and cost of financing;

(v) The maximum lease term during which the lessor must recover the lessor's full investment in the property, plus the estimated total cost of financing the property, shall be 40 years; and

(vi) At the expiration of the lease (including any renewals or extensions with the same lessee), all interest in the property shall be either liquidated or released on a nonoperating basis as soon as practicable but in no event later than two years from the expiration of the lease;<sup>6</sup> however, in no case shall the lessor retain any interest in the property beyond 50 years after its acquisition of the property.

(6) *Community development.* Making equity and debt investments in corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas by providing housing, services, or jobs for residents.

(7) *Data processing.* Providing to others data processing and data transmission services, facilities (including data processing and data transmission hardware, software, documentation or operating personnel), data bases, or access to such services, facilities, or data bases by any technological means, if:

(i) The data to be processed or furnished are financial, banking, or economic, and the services are provided pursuant to a written agreement so describing and limiting the services;

(ii) The facilities are designed, marketed, and operated for the processing and transmission of financial, banking, or economic data; and

(iii) The hardware provided in connection therewith is offered only in conjunction with software designed and marketed for the processing and transmission of financial, banking, or economic data, and where the general purpose hardware does not constitute more than 30 percent of the cost of any packaged offering.

(8) *Insurance agency and underwriting.* (i) *Credit Insurances.* Acting as principal agent, or broker for insurance (including home mortgage redemption insurance that is:

(A) Directly related to an extension or credit by the bank holding company or any of its subsidiaries; and

(B) Limited to assuring the repayment of the outstanding balance due on the extension of credit<sup>7</sup> in the event of the death, disability, or involuntary unemployment of the debtor.

(ii) *Finance company subsidiary.* Acting as agent or broker for insurance directly related to an extension of credit by a finance company<sup>8</sup> that is a subsidiary of a bank holding company, id:

(A) The insurance is limited to assuring repayment of the outstanding balance on such extension of credit in the event of loss or damage to any property used as collateral for the extension of credit; and

(B) The extension of credit is not more than \$10,000, or \$25,000 if it is to finance the purchase of a residential manufactured home<sup>9</sup> and the credit is secured by the home; and

(C) The applicant commits to notify borrowers in writing that: (1) they are not required to purchase such insurance from the applicant; (2) each insurance does not insure any

**[Footnote ¶ 6321.25 continued]**

(6) In the event of a default on a lease agreement prior to the expiration of the lease term, the lessor shall either release the property, subject to all the conditions of this paragraph, or liquidate the property as soon as practicable but in no event later than two years from the date of default on a lease agreement or such additional time as the Board may permit under section 225.22(c)(1) of this regulation, as if the property were DPC property.

(7) "Extension of credit" includes direct loans to borrowers, loans purchased from other lenders, and leases of real or personal property as long as the leases are nonoperating and full payout leases that meet the requirements of paragraph [b](5) of this section.

(8) "Finance company" includes all nondeposit-taking financial institutions that engage in a significant degree of consumer lending (excluding lending secured by first mortgages) and all financial institutions specifically defined by individual States as finance companies and that engage in a significant degree of consumer lending.

(9) These limitations increase at the end of each calendar year, beginning with 1982, by the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published by the Bureau of Labor Statistics.

other officers, define their duties, require bonds of them and fix the penalty thereof, dismiss such officers or any of them at pleasure, and appoint others to fill their places.

**Sixth.** To prescribe, by its board of directors, bylaws no inconsistent with law, regulating the manner in which its stock shall be transferred, its directors elected or appointed, its officers appointed, its property transferred, its general business conducted, and the privileges granted to it by law exercised and enjoyed.

**Seventh.** To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes. The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund, except that this limitation shall not require any association to dispose of any securities lawfully held by it on August 23, 1935. As used in this section the term "investment securities" shall mean marketable obligations, evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the Unit-

ed States, or general obligations of any State or of any political subdivision thereof, or obligations of the Washington Metropolitan Area Transit Authority which are guaranteed by the Secretary of Transportation under section 9 of the National Capital Transportation Act of 1969 [D.C.Code § 1-2458], or obligations issued under authority of the Federal Farm Loan Act, as amended, or issued by the thirteen banks for the cooperatives of any of them or the Federal Home Loan Banks, or obligations which are insured by the Secretary of Housing and Urban Development under title XI of the National Housing Act [12 U.S.C.A. § 1749aaa et seq.] or obligations which are insured by the Secretary of Housing and Urban Development (hereafter in this sentence referred to as the "Secretary") pursuant to section 207 of the National Housing Act [12 U.S.C.A. § 1713], if the debentures to be issued in payment of such insured obligations are guaranteed as to principal and interest by the United States, or obligations, participations, or other instruments of or issued by the Federal National Mortgage Association or the Government National Mortgage Association, or mortgages, obligations, or other securities which are or ever have been sold by the Federal Home Loan Mortgage Corporation pursuant to section 305 or Section 306 of the Federal Home Loan Mortgage Corporation Act [12 U.S.C.A. §§ 1434 or 1455], or obligations of the Federal Financing Bank or obligations of the Environmental Financing Authority, or obligations or other instruments or securities of the Student Loan Marketing Association, or such obligations of any local public agency (as defined in section 110(h) of the Housing Act of 1949 [42 U.S.C.A. § 1460(h)]) as are secured by an agreement between the local public agency and the Secretary in which the local public agency agrees to borrow from said Secretary, and said Secretary agrees to lend to said local public agency, monies in an aggregate amount which (together with any other monies irrevocably committed to the payment of interest or such obligations) will suffice to pay, when due, the interest on and all installments (including the final installment) of the principal of such obligations, which monies under the terms of said agreement are required to be used for such payments, or such obligations of a public housing agency (as defined in the United States Housing Act of 1937, as amended [42 U.S.C.A. § 1437 et seq.]) as are secured (1) by an agreement between the public housing agency and the Secretary in which the public housing agency agrees to borrow from the Secretary, and the Secretary agrees to lend to the public housing agency, prior to the maturity of such obligations, monies in an amount which (together with any other monies

irrevocably committed to the payment of interest on such obligations) will suffice to pay the principal of such obligations with interest to maturity thereon, which monies under the terms of said agreement are required to be used for the purpose of paying the principal of and the interest on such obligations at their maturity, (2) by a pledge of annual contributions under an annual contributions contract between such public housing agency and the Secretary if such contract shall contain the covenant by the Secretary which is authorized by subsection (g) of section 6 of the United States Housing Act of 1937, as amended, [42 U.S.C.A. § 1437a(g)], and if the maximum sum and the maximum period specified in such contract pursuant to said subsection 6(g) [42 U.S.C.A. § 1437d(g)] shall not be less than the annual amount and the period for payment which are requisite to provide for the payment when due of all installments of principal and interest on such obligations, or (3) by a pledge of both annual contributions under an annual contributions contract containing the covenant by the Secretary which is authorized by section 6(g) of the United States Housing Act of 1937 [42 U.S.C.A. § 1437d(g)], and a loan under an agreement between the local public housing agency and the Secretary in which the public housing agency agrees to borrow from the Secretary, and the Secretary agrees to lend to the public housing agency, prior to the maturity of the obligations involved, moneys in an amount which (together with any other moneys irrevocably committed under the annual contributions contract to the payment of principal and interest on such obligations) will suffice to provide for the payment when due of all installments of principal and interest on such obligations, which moneys under the terms of the agreement are required to be used for the purpose of paying the principal and interest on such obligations at their maturity: *Provided*, That in carrying on the business commonly known as the safe-deposit business the association shall not invest in the capital stock of a corporation organized under the law of any State to conduct a safe-deposit business in an amount in excess of 15 per centum of the capital stock of the association actually paid in and unimpaired and 15 per centum of its unimpaired surplus. The limitations and restrictions herein, contained as to dealing in and underwriting investment securities shall not apply to obligations issued by the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank or the Inter-American Investment Corporation,<sup>1</sup> or obligations issued by any State or political subdivision or any agency of a State or

political subdivision for housing, university, or dormitory purposes, which are at the time eligible for purchase by a national bank for its own account, nor to bonds, notes and other obligations issued by the Tennessee Valley Authority or by the United States Postal Service: *Provided*, That no association shall hold obligations, issued by any of said organizations as a result of underwriting, dealing, or purchasing for its own account (and for this purpose obligations as to which it is under commitment shall be deemed to be held by it) in a total amount exceeding at any one time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund. Notwithstanding any other provision in this paragraph, the association may purchase for its own account shares of stock issued by a corporation authorized to be created pursuant to Title IX of the Housing and Urban Development Act of 1968 [42 U.S.C.A. § 3931 et seq.], and may make investments in a partnership, limited partnership, or joint venture formed pursuant to section 907(a) or 907(c) of that Act [42 U.S.C.A. § 3937(a) or 3937(c)]. Notwithstanding any other provision of this paragraph, the association may purchase for its own account shares of stock issued by any State housing corporation incorporated in the State in which the association is located and may make investments in loans and commitments for loans to any such corporation: *Provided*, That in no event shall the total amount of such stock held for its own account and such investments in loans and commitments made by the association exceed at any time 5 per centum of its capital stock actually paid in and unimpaired plus 5 per centum of its unimpaired surplus fund. Notwithstanding any other provision in this paragraph, the association may purchase for its own account shares of stock issued by a corporation organized solely for the purpose of making loans to farmers and ranchers for agricultural purposes, including the breeding, raising, fattening, or marketing of livestock. However, unless the association owns at least 80 per centum of the stock of such agricultural credit corporation the amount invested by the association at any one time in the stock of such corporation shall not exceed 20 per centum of the unimpaired capital and surplus of the association: *Provided further*, That, notwithstanding any other provision of this paragraph, the association may purchase for its own account shares of stock of a bank insured by the Federal Deposit Insurance Corporation or a holding company which owns or controls such an insured bank if the stock of such bank or company is owned exclusively (except to the extent directors' qualifying shares are required by law) by

depository institutions and such bank or company and all subsidiaries thereof are engaged exclusively in providing services for other depository institutions and their officers, directors, and employees, but in no event shall the total amount of such stock held by the association in any bank or holding company exceed at any time 10 per centum of the association's capital stock and paid in and unimpaired surplus and in no event shall the purchase of such stock result in an association's acquiring more than 5 per centum of any class of voting securities of such bank or company. The limitations and restrictions contained in this paragraph as to an association purchasing for its own account investment securities shall not apply to securities that (A) are offered and sold pursuant to section 4(5) of the Securities Act of 1933 (15 U.S.C. 77d(5)); or (B) are mortgage related securities (as that term is defined in section 3(a)(41) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(41))), subject to such regulations as the Comptroller of the Currency may prescribe, including regulations prescribing minimum size of the issue (at the time of initial distribution) or minimum aggregate sales prices, or both.

A national banking association may deal in, underwrite, and purchase for such association's own account qualified Canadian government obligations to the same extent that such association may deal in, underwrite, and purchase for such association's own account obligations of the United States or general obligations of any State or of any political subdivision thereof. For purposes of this paragraph—

(1) the term "qualified Canadian government obligations" means any debt obligation which is backed by Canada, any Province of Canada, or any political subdivision of any such Province to a degree which is comparable to the liability of the United States, any State, or any political subdivision thereof for any obligation which is backed by the full faith and credit of the United States, such State, or such political subdivision, and such term includes any debt obligation of any agent of Canada or any such Province or any political subdivision of such Province if—

(A) the obligation of the agent is assumed in such agent's capacity as agent for Canada or such Province or such political subdivision; and

(B) Canada, such Province, or such political subdivision on whose behalf such agent is acting with respect to such obligation is ultimately and unconditionally liable for such obligation; and



(2) the term "Province of Canada" means a Province of Canada and includes the Yukon Territory and the Northwest Territories and their successors.

**Eighth.** To contribute to community funds, or to charitable, philanthropic, or benevolent instrumentalities conducive to public welfare, such sums as its board of directors may deem expedient and in the interests of the association, if it is located in a State the laws of which do not expressly prohibit State banking institutions from contributing to such funds or instrumentalities.

**Ninth.** To issue and sell securities which are guaranteed pursuant to section 1721(g) of this title.

**Tenth.** To invest in tangible personal property, including without limitation, vehicles, manufactured homes, machinery, equipment, or furniture, for lease financing transactions on a net lease basis, but such investment may not exceed 10 percent of the assets of the association.

(R.S. § 5136; July 1, 1922, c. 257, § 1, 42 Stat. 767; Feb. 25, 1927, c. 191, § 2, 44 Stat. 1226; June 16, 1933, c. 89, § 16, 48 Stat. 184; Aug. 23, 1935, c. 614, § 308, 49 Stat. 709; Feb. 3, 1938, c. 13, § 13, 52 Stat. 26; June 11, 1940, c. 301, 54 Stat. 261; June 29, 1949, c. 276, § 1, 63 Stat. 298; July 15, 1949, c. 338, Title VI, § 602(a), 63 Stat. 439; Apr. 9, 1952, c. 169, 66 Stat. 49; Aug. 2, 1954, c. 649, Title II, § 203, 68 Stat. 622; Aug. 23, 1954, c. 834, § 2, 68 Stat. 771; July 26, 1956, c. 741, Title II, § 201(c), 70 Stat. 667; Aug. 6, 1959, Pub. L. 86-137, § 2, 73 Stat. 285; Aug. 7, 1959, Pub. L. 86-147, § 10, 73 Stat. 301; Sept. 8, 1959, Pub. L. 86-230, § 1(a), 73 Stat. 457; Sept. 16, 1959, Pub. L. 86-278, 73 Stat. 563; Sept. 23, 1959, Pub. L. 86-372, Title IV, § 420, 73 Stat. 679; Sept. 2, 1964, Pub. L. 88-560, Title VII, § 701(c), 78 Stat. 800; Pub. L. 89-369, § 10, 80 Stat. 72; Nov. 3, 1966, Pub. L. 89-754, Title V, § 504(a)(1), 80 Stat. 1277; May 25, 1967, Pub. L. 90-19, § 27(a), 81 Stat. 28; Aug. 1, 1968, Pub. L. 90-448, Title VIII, §§ 804(c), 807(j), Title IX, § 911, Title XVII, § 1705(h), 82 Stat. 543, 545, 550, 605; Aug. 12, 1970, Pub. L. 91-375, § 6(d), 84 Stat. 776; June 23, 1972, Pub. L. 92-318, Title I, § 133(c)(1), 86 Stat. 269; Dec. 9, 1969, Pub. L. 91-143, § 12(b), as added July 13, 1972, Pub. L. 92-349, Title I, § 101, 86 Stat. 466; Oct. 18, 1972, Pub. L. 92-500, § 12(n), 86 Stat. 902; Aug. 16, 1973, Pub. L. 93-100, § 5(c), 87 Stat. 344; Dec. 29, 1973, Pub. L. 93-224, § 14, 87 Stat. 941; Dec. 31, 1973, Pub. L. 93-234, Title II, § 207, 87 Stat. 984; Aug. 22, 1974, Pub. L. 93-383, Title II, § 206, Title VIII, § 805(c)(1), 88 Stat. 668, 66; Pub. L. 96-221, Title VII, § 711, 94 Stat. 189; Aug. 13, 1981, Pub. L. 97-35, Title XIII, § 1342(a), 95 Stat. 743; Oct. 13, 1982, Pub.

Title 12 --Banks and Banking; Revised as of January 1, 1991

CHAPTER II--FEDERAL RESERVE SYSTEM

PART 225 --BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL

Subpart C--Nonbanking Activities and Acquisitions by Bank Holding Companies

§ 225.25 List of permissible nonbanking activities.

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(a) Closely related nonbanking activities. The activities listed below are so closely related to banking or managing or controlling banks as to be a proper incident thereto and may be engaged in by a bank holding company or a subsidiary thereof in accordance with and subject to the requirements of this regulation.

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(b)(1) Making and servicing loans. Making, acquiring, or servicing loans or other extensions of credit (including issuing letters of credit and accepting drafts) for the company's account or for the account of others, such as would be made, for example, by the following types of companies:

- (i) Consumer finance;
- (ii) Credit card;
- (iii) Mortgage;
- (iv) Commercial finance; and
- (v) Factoring.

(2) Industrial banking. Operating an industrial bank, Morris Plan bank, or industrial loan company, as authorized under state law, so long as the institution is not a bank.

(3) Trust company functions. Performing functions or activities that may be performed by a trust company (including activities of a fiduciary, agency, or custodial nature), in the manner authorized by federal or state law, so long

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as the institution is not a bank and does not make loans or investments or accept deposits other than:

- (i) Deposits that are generated from trust funds not currently invested and that are properly secured to the extent required by law;

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(ii) Deposits that are generated from these funds not currently invested and that are properly secured to the extent required by law;

(ii) Deposits representing funds received for a special use in the capacity of managing agent or custodian for an owner of, or investor in, real property, securities, or other personal property; or for such owner or investor as agent or custodian of funds held for investment or as escrow agent; or for an issuer of, or broker or dealer in securities, in a capacity such as a paying agent, dividend disbursing agent, or securities clearing agent; provided such deposits are not employed by or for the account of the customer in the manner of a general purpose checking account or interest-bearing account; or

(iii) Making call loans to securities dealers or purchasing money market instruments such as certificates of deposit, commercial paper, government or municipal securities, and bankers acceptances. (Such authorized loans and investments, however, may not be used as a method of channeling funds to nonbanking affiliates of the trust company.)

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(4) Investment or financial advice. Acting as investment or financial adviser to the extent of:

(i) Serving as the advisory company for a mortgage or a real estate investment trust;

(ii) Serving as investment adviser (as defined in section 2(a)(20) of the Investment Company Act of 1940, 15 U.S.C. 80a-2(a)(20)), to an investment company registered under that act, including sponsoring, organizing, and managing a closed-end investment company;

(iii) Providing portfolio investment advice n1 to any other person;

(iv) Furnishing general economic information and advice, general economic statistical forecasting services and industry studies; n2 and

(v) Providing financial advice to state and local governments, such as with respect to the issuance of their securities.

n1 The term "portfolio investment" is intended to refer generally to the investment of funds in a "security" as defined in section 2(1) of the Securities Act of 1933 (15 U.S.C. 77b) or in real property interests, except where the

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real property is to be used in the trade or business of the person being advised. In furnishing portfolio investment advice, bank holding companies and their subsidiaries shall observe the standards of care and conduct applicable to fiduciaries.

n2 This is to be contrasted with "management consulting," which the Board views as including, but not limited to, the provision of analysis or advice as to a firm's (A) purchasing operations. such as inventory control. sources of

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views as including, but not limited to, the provision of analysis or advice as to a firm's (A) purchasing operations, such as inventory control, sources of supply, and cost minimization subject to constraints; (B) production operations, such as quality control, work measurement, product methods, scheduling shifts, time and motion studies, and safety standards; (C) marketing operations, such as market testing, advertising programs, market development, packaging, and brand development; (D) planning operations, such as demand and cost projections, plant location, program planning, corporate acquisitions and mergers, and determination of long-term and short-term goals; (E) personnel operations, such as recruitment, training, incentive programs, employee compensation, and management-personnel relations; (F) internal operations, such as taxes, corporate organization, budgeting systems, budget control, data processing systems evaluation, and efficiency evaluation; or (G) research operations, such as product development, basic research, and product design and innovation. The Board has determined that "management consulting" is not an activity that is so closely related to banking or managing or controlling banks as to be a proper

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incident thereto.

(5) Leasing personal or real property. Leasing personal or real property or acting as agent, broker, or adviser in leasing such property if:

(i) The lease is to serve as the functional equivalent of an extension of credit to the lessee of the property;

(ii) The property to be leased is acquired specifically for the leasing transaction under consideration or was acquired specifically for an earlier leasing transaction;

(iii) The lease is on a nonoperating basis, n3

(iv) At the inception of the initial lease the effect of the transaction (and, with respect to governmental entities only, reasonably anticipated future transactions n4) will yield a return that will compensate the lessor for not less than the lessor's full investment in the property plus the estimated total cost of financing the property over the term of the lease, n5 from:

(A) Rentals;

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(B) Estimated tax benefits (investment tax credit, net economic gain from tax deferral from accelerated depreciation, and other tax benefits with a substantially similar effect);

(C) The estimated residual value of the property at the expiration of the initial term of the lease, which in no case shall exceed 20 percent of the acquisition cost of the property to the lessor; and

(D) In the case of a lease of personal property of not more than seven

years in duration, such additional amount, which shall not exceed 50 percent of

years in duration, such additional amount, which shall not exceed 60 percent of the acquisition cost of the property, as may be provided by an unconditional guarantee by a lessee, independent third party, or manufacturer, which has been determined by the lessor to have the financial resources to meet such obligation, that will assure the lessor of recovery of its investment and cost of financing;

(v) The maximum lease term during which the lessor must recover the lessor's full investment in the property, plus the estimated total cost of financing the property, shall be 40 years; and

(vi) At the expiration of the lease (including any renewals or extensions with the same lessee), all interest in the property shall be either liquidated

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or released on a nonoperating basis as soon as practicable but in no event later than two years from the expiration of the lease; n6 however, in no case shall the lessor retain any interest in the property beyond 50 years after its acquisition of the property.

n3 For purposes of the leasing a automobiles, the requirement that the lease be on a nonoperating basis means that the bank holding company may not, directly or indirectly: (A) provide for the servicing, repair, or maintenance of the leased vehicle during the lease term; (B) purchase parts and accessories in bulk or for an individual vehicle after the lessee has taken delivery of the vehicle; (C) provide for the loan of an automobile during servicing of the leased vehicle; (D) purchase insurance for the lessee; or (E) provide for the renewal of the vehicle's license merely as a service to the lessee where the lessee could renew the license without authorization from the lessor.

n4 The Board understands that some Federal, state and local governmental entities may not enter into a lease for a period in excess of one year. Such an impediment does not prohibit a company authorized to conduct leasing activities under this paragraph from entering into a lease with such governmental entities if the company reasonably anticipates that the governmental entities will renew the lease annually until such time as the company is fully compensated for its investment in the leased property plus

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its costs of financing the property. Further, a company authorized to conduct personal property leasing activities under this paragraph may also engage in so-called "bridge" lease financing of personal property, but not real property, if the lease is short-term pending completion of long-term financing, by the same or another lender.

n5 The estimate by the lessor of the total cost of financing the property for the term of the lease should reflect, among other factors: the term of the lease, the modes of financing available to the lessor, the credit rating of the lessor and/or the lessee, if a factor in the financing, and prevailing rates in the money and capital markets.

n6 In the event of a default on a lease agreement prior to the expiration of the lease term, the lessor shall

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of the lease term, the lessor shall either release the property, subject to all the conditions of this paragraph, or liquidate the property as soon as practicable but in no event later than two years from the date of default on a lease agreement or such additional time as the Board may permit under § 225.22(c)(1) of this regulation, as if the property were DPC property.

(6) Community development. Making equity and debt investments in corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas by providing

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housing, services, or jobs for residents.

(7) Data processing. Providing to others data processing and data transmission services, facilities (including data processing and data transmission hardware, software, documentation or operating personnel), data bases, or access to such services, facilities, or data bases by any technological means, if:

(i) The data to be processed or furnished are financial, banking, or economic, and the services are provided pursuant to a written agreement so describing and limiting the services;

(ii) The facilities are designed, marketed, and operated for the processing and transmission of financial, banking, or economic data; and

(iii) The hardware provided in connection therewith is offered only in conjunction with software designed and marketed for the processing and transmission of financial, banking, or economic data, and where the general purpose hardware does not constitute more than 30 percent of the cost of any packaged offering.

12 CFR 225.25

agency activities prior to January 1, 1971, as a consequence of approval by the Board prior to January 1, 1971.

n7 "Extension of credit" includes direct loans to borrowers, loans purchased from other lenders, and leases of real or personal property so long as the leases are nonoperating and full payout leases that meet the requirements of paragraph (b)(5) of this section.

n8 "Finance company" includes all nondeposit-taking financial institutions that engage in a significant degree of consumer lending (excluding lending secured by first mortgages) and all financial institutions specifically defined by individual States as finance companies and that engage in a significant degree of consumer lending.

n9 These limitations increase at the end of each calendar year, beginning with 1982, by the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published by the Bureau of Labor Statistics.

LEXIS.MEXICO. LEXIS.MEXICO.

**EXHIBIT J: 26:**  
**Letter from Fred E. Ferguson (FIST)**  
**(June 11, 1993)**

ARTHUR  
ANDERSEN

ARTHUR ANDERSEN & CO. SC

Arthur Andersen & Co.  
Office of Federal Tax Services

1666 K Street NW  
Washington DC 20006-2873  
Writer's Direct Dial

June 11, 1993

202/862-7480

Mr. Alan H. Friedman  
Hearing Officer  
Multistate Tax Commission  
444 North Capitol Street, NW, Suite 425  
Washington, DC 20001

Re: May 27, 1993 Multistate Tax Commission Hearing on  
Proposed Regulation IV.18.(i) Apportioning the Income of Financial Institutions

Dear Alan:

On behalf of our client, the Financial Institutions State Tax (FIST) Coalition, which consists of:

Bank of America, NT & SA  
The Bank of New York Company, Inc.  
Bankers Trust Company  
Boatmen's Bancshares, Inc.  
Capital Holding Corporation  
The Chase Manhattan Bank, N.A.  
Citicorp/Citibank, N.A.  
First Chicago Corporation  
First Interstate Bancorp  
Great Western Financial Corporation  
KeyCorp  
Morgan Guaranty Trust Company of New York  
NationsBank  
Shawmut National Corporation  
Wachovia Corporation

this letter is in support of the **STATUTORY PROPOSAL FOR APPORTIONMENT AND ALLOCATION OF NET INCOME OF FINANCIAL INSTITUTIONS** as contained in Attachment 1 of the May 10, 1993 Interim Report of the Hearing Officer regarding Proposed Multistate Tax Commission Regulation IV.18.(i) Apportioning the Income of Financial



# ARTHUR ANDERSEN

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Mr. Alan H. Friedman  
June 11, 1993  
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Institutions subject to the provisions contained in this letter. FIST intends to submit a detail mark-up of the uniform rules.

*It is important to understand that the FIST Coalition and its member financial institutions support these uniform rules (statute / regulations) not because they derive any financial gain or tax benefit from their adoption, but because they are proposed as a uniform methodology for both financial institutions and the states. These rules represent a studied approach and are, as pointed out in the interim report, the result of a cooperative effort between the states and industry to design a balanced and administrable tax system.*

## **Support of the Studied Approach**

The FIST Coalition would like to commend the Multistate Tax Commission (MTC), the Federation of Tax Administrators (FTA) and the many state tax professionals, commissioners and technical staff, for their tireless work on these rules. While the list of individuals who contributed to these rules is extensive, there are three state tax commissioners who deserve specific recognition. Without the early support of New York and California this studied approach would not have been possible. Both Gerald H. Goldberg, Executive Officer of the California Franchise Tax Board, and James W. Wetzler, Commissioner of the New York State Department of Taxation and Finance played early and decisive leadership in making the studied approach (*i.e.*, state/industry meetings) work. A special note of appreciation also goes to Heidi Heitcamp, Attorney General of North Dakota (formerly Tax Commissioner) for her leadership and voice of support for the state/industry meetings both as Chairman of the MTC and as the Chair of the state delegation (the MTC/FTA Working Group on Financial Institutions) to the state/industry meetings.

The studied approach has worked because it has involved state and industry representatives dedicated to reaching a fair, administrable, and uniform methodology of apportioning income and because it involved states with different interests, perspectives and desired outcomes--without both "money-center states" and "market-states" involved in the process, any agreement would have been hollow.

FIST continues to support the process. On May 12th, FIST and the American Bankers Association (ABA) hosted a briefing in Washington, DC for financial institutions that had not been a part of the state/industry meetings. In addition, FIST has held two briefings in New York City--May 18th for broker/dealers and May 19th for international banks. FIST has already briefed 185 bank tax professionals and additional briefings are scheduled for New Orleans (June 8th at Bank Administration Institute) with plans being finalized for future briefings in San Francisco and Chicago.

The formulation of the proposed rules is only the first step in the adoption of uniform laws. While FIST has pledged its support for the adoption of the proposed rules, the states themselves must take the lead on ensuring that statutes/regulations are adopted uniformly. Early in the

Mr. Alan H. Friedman  
June 11, 1993  
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state/industry meetings industry representatives told the states in an effort to make it work, FIST would contribute to the analysis, construction and missionary work, but the states would have to embrace the methodology to make it work. In the end, the success of any uniform methodology can only be measured by its application.

### **Support for Allocation and Apportionment Rules**

FIST supports of the **STATUTORY PROPOSAL FOR APPORTIONMENT AND ALLOCATION OF NET INCOME OF FINANCIAL INSTITUTIONS** as contained in Attachment 1 of the May 10, 1993 Interim Report of the Hearing Officer regarding Proposed Multistate Tax Commission Regulation IV.18.(i) Apportioning the Income of Financial Institutions. These rules represent a blending of interests from both money-center and market states and provide a workable apportionment methodology, which is a key element in any uniform rules for the taxation of financial institutions. To be uniform these rules need to be applied uniformly and be adopted by a substantial number of the states. Unilateral modifications by states of the apportionment formula (either sourcing or weighting) in any substantial manner will undermine all the cooperative work achieved. If either the money-center states fail to adopt market state sourcing or the market states fail to adopt money-center state factors, there will be no uniformity. You stated it well in the interim report:

***"All involved in this effort - industry representatives, tax officials and legislatures - are requested to keep in focus the cooperative manner by which the following draft statute was created, its weighting of competing interests between government and industry, as well as among the government entities themselves."***

### **Reserved Issues**

For various reasons FIST has agreed to reserve comment at the current time on three issues: definition of a financial institution, jurisdiction to tax (nexus) and combined reporting. However, with respect to the nexus, please note that FIST reads Quill v. North Dakota, 112 S.Ct 1904 (1992), as support for the notion that physical presence is required for a finding of Constitutional nexus in the area of operational taxes. Notwithstanding these open issues, FIST does not want any of these issues to deter the uniform adoption of apportionment and allocation rules.

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### Specific Comments

The FIST Coalition believes there are areas in which the language included in the uniform rules (statute/regulations) should be clarified or tightened or where changes of a cosmetic nature should be made. With respect to these items, we intend to provide a technical markup of the rules during the hearing process. However, we believe there are four areas in which the needed modifications should be addressed immediately. The four areas are: Section 1 should be deleted, Sections 3(q) and 4(m)(1)(B) need to be modified; and the definition of "state" should be added.

**Section 1 Should be Deleted.** The uniform rules are not designed for an imposition of a tax. Presumably the rules will either replace an apportionment and allocation statute in an existing taxing statute or become an industry specific apportionment and allocation provision in an existing taxing statute that currently does not include apportionment rules for financial institutions. We do not believe that the proposed regulations should be the basis for setting policy as to implementing a tax where none currently exists, or for changing from an income tax to a franchise tax, value added tax (single business tax), gross receipts tax or any type of tax. Accordingly, since this section does not belong in regulations covering apportionment and allocation of income, it should be deleted. Footnote 1 (without prejudice for a franchise tax) should be attached to the section entitled "Apportionment and Allocation".

**Section 3(q) Should be Modified.** Two modifications should be made to section 3(q), which provides the definition of "Taxable in another state." First, because the word "taxable," rather than the phrase "taxable in another state" is used for purposes of determining whether a taxpayer may apportion its income and whether the throwback rule applies for receipts factor purposes, the definition in paragraph (q) should be of the word "taxable," rather than the phrase "taxable in another state."

Second, the definition included in the proposed regulations prohibits taxpayers from apportioning income and permits the throwback of sales where a taxpayer's activities in another state would subject the taxpayer to the jurisdiction of a state to impose a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock or earned surplus tax in a state, if that state did not in fact impose such a tax. We do not believe that this definition should be limited in that manner and suggest that the definition should be modified to read as follows:

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**"Taxable"** means that a taxpayer is either:

- (1) subject to a franchise tax measured by net income, a net income tax, a franchise tax for the privilege of doing business, or a corporate stock or earned surplus tax in a state; or
- (2) subject to the jurisdiction of a state to impose such a tax regardless of whether, in fact, the state does or does not do so.

**Section 4(m)(1)(B) Should be Modified.** We believe it was the intention of this proposal to include in the receipts factor coupon interest received from long positions only to the extent it exceeds the coupon interest paid on short positions, such as recorded in an arbitrage book. Moreover, this paragraph should permit the netting of interest income and interest expense from securities sold and not yet purchased in order to be consistent with the netting of federal funds sold and resale agreements with federal funds purchased and repurchase agreements. Due to the significant dollar amounts involved, the inclusion of the gross interest income from long positions would create distortion in the receipts factor. In addition, the aforementioned netting situations have been specifically permitted in this proposal to prevent similar distortion. Finally, in order for this section to be consistent with other paragraphs, the word "dividends" should be included in this section.

Based on the discussion above, we believe this section should be modified as indicated below to include the items highlighted in bold.

(B) The receipts factor shall include the amount by which interest, **dividends**, net gains and other income from trading assets and activities, including but not limited to assets and activities in the matched book, in the arbitrage book, and foreign currency transactions, exceed **interest expense from securities sold not yet purchased** and net losses from such assets and activities.

**Definition of "State" should be added.** To ensure that a financial institution can apportion its income if it is taxable in a foreign jurisdiction and to ensure that receipts properly assigned to a foreign jurisdiction are not thrown back to the taxpayer's state of commercial domicile, the following definition should be added:

**"State"** means a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States or any foreign country.

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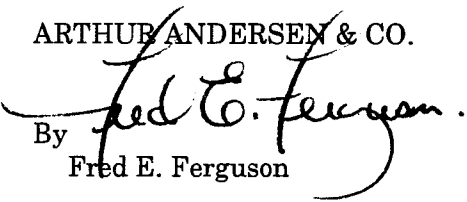
Mr. Alan H. Friedman  
June 11, 1993  
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We appreciate the opportunity to submit these comments and thank you for all the work you have dedicated to this project.

Very truly yours,

ARTHUR ANDERSEN & CO.

By

  
Fred E. Ferguson

dnt

Enclosures

Copies to: Ms. Sharon Morrow, Chair of Multistate Tax Commission  
FIST Coalition

**EXHIBIT J: 27:**

**Letter from Brenda Jo Seipel  
(Credit Union National Association, Inc.)  
(June 11, 1993)**



**CUNA & Affiliates**  
A Member of the Credit Union System

**Credit Union  
National Association, Inc.**

Suite 300  
805 15th Street NW  
Washington, D.C.  
20005-2207

Telephone:  
(202) 682-4200

June 11, 1993

Mr. Alan H. Friedman, General Counsel  
Multistate Tax Commission  
386 University Avenue  
Los Altos, CA 94022

Dear Mr. Friedman:

Credit Union National Association and Affiliates (CUNA) takes this opportunity to request an oral presentation on Multistate Tax Commission's (MTC) proposed regulation VI.18.(i) dealing with the attribution of income from the business of financial institutions at the Thursday, July 15, 1993 public hearing, beginning at 10:00 a.m. at the Hall of the States, Washington, D. C. CUNA represents approximately 13,000 of the nation's state and federally chartered credit unions organized by state, District of Columbia, and Puerto Rico, and their 62 million credit union members.

CUNA is extremely concerned about the manner in which MTC's proposed regulation is attempting to compare credit unions with for-profit financial institutions by recommending imposing similar tax requirements. In reality, and by statute, there can be no comparison!

Credit unions are non-profit, member-owned cooperatives. Membership is limited to persons within a field of membership - general employment, association or geographic in nature. Credit unions are democratically controlled with each individual member of the credit union having one vote, regardless of the number of dollars on deposit at the credit union. The vast majority are small, and by statute, board and committee positions are staffed by volunteer personnel. These unique financial institutions return to their owners (members) every penny of income earned in excess of operating expenses, required reserves and undivided earnings transfers.

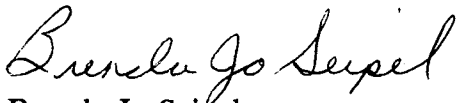
Operating within federal and state statutory frameworks which recognize the unique and distinct role of credit unions as cooperative institutions, credit unions have been a source have been a source of credit for millions of consumers, many of whom could neither qualify for not afford to borrow elsewhere. Credit unions are a consumer-oriented alternative to for-profit financial institutions by providing readily available credit on reasonable terms and

a host of other fairly priced financial services to their members. Service, not profit is credit unions' primary motive - this is as true of credit unions today as it was when the first credit union was chartered in American in 1909 - and clearly distinguishes credit unions from other financial institutions.

CUNA welcomes the opportunity on July 15, 1993 to testify before the MTC on the numerous, unique characteristics of credit unions that clearly distinguish them from for-profit financial institutions and will request, in light of the obvious differences, that credit unions be specifically exempted from the proposed regulation VI.18(i).

If you have any questions or need further information prior to the hearing, please do not hesitate to contact me.

Sincerely yours,



Brenda Jo Seipel  
Vice President  
State Governmental Affairs



**EXHIBIT J: 28:**

**Letter from Kim Burse  
(Secretary, Kentucky Revenue Cabinet)  
(July 12, 1993)**

BRERETON C. JONES  
GOVERNOR

**RECEIVED**



KIM BURSE  
SECRETARY

REVENUE CABINET

OFFICE OF THE SECRETARY

FRANKFORT, KENTUCKY 40620

JUL 20 1993

MTC/DC

July 12, 1993

Mr. Alan H. Friedman, General Counsel  
Multistate Tax Commission  
444 North Capitol St., N.W.  
Washington, DC 20001

Re: Statutory Proposal for Apportionment and Allocation of  
Net Income of Financial Institutions

Dear Mr. Friedman:

The Kentucky Revenue Cabinet reviewed the draft proposal for apportioning income of financial institutions. The Multistate Tax Commission, industry and government representatives who participated in the working groups are to be commended for the considerable efforts put forth on this proposal. Such cooperative efforts make government more responsive and efficient.

Kentucky law currently exempts from both corporate income and license taxes most, if not all, of the businesses deemed financial institutions. Therefore, we reviewed the proposal, not from the standpoint of altering apportionment methods, but rather from the standpoint of recognizing changes in the financial industry and potential fundamental changes to Kentucky's tax structure. Because success of the proposed apportionment method is contingent upon substantial uniformity in apportioning net income of financial institutions, Kentucky cannot fail to acknowledge the importance of the proposed methodology. Kentucky shares the concern that all financial institutions (banks, savings and loan, credit unions, finance companies and loan companies) be treated under a uniform and equitable method of taxation.

The proposed measure is a step in the right direction for the states that levy income and franchise taxes as it would provide uniform allocation procedures among states as well as ensuring against double taxation. If Kentucky adopted an income and license tax on banks in lieu of the current bank shares tax, the proposed measure would provide an equitable taxation for the financial community. The big question would be how much revenue would be exported from Kentucky due to the business conducted by Kentucky based banks and conversely how much revenue would be generated from non Kentucky banks and other institutions business within Kentucky.

Alan H. Friedman  
July 12, 1993  
Page Two

In summary the Revenue Cabinet recognizes the proposal could provide a level playing field for financial institutions, but further study of the impact to Kentucky's revenue base and financial services industry would need to be studied.

Sincerely,



KIM BURSE, Secretary  
Kentucky Revenue Cabinet

/sb

**EXHIBIT J: 29:**

**Testimony of Barbara Davis  
(Credit Union National Association)  
(July 15, 1993)**

**STATEMENT BY**  
**BARBARA DAVIS**  
**BEFORE THE MULTISTATE TAX COMMISSION**  
**ON BEHALF OF THE**  
**CREDIT UNION NATIONAL ASSOCIATION, INC.**  
**July 15, 1993**

STATEMENT BY  
BARBARA DAVIS  
BEFORE THE MULTISTATE TAX COMMISSION  
ON BEHALF OF THE  
CREDIT UNION NATIONAL ASSOCIATION, INC.  
July 15, 1993

Thank you for the opportunity to appear before you this morning. I am Barbara Davis, chief executive officer of Houston Municipal Employees Credit Union in Houston, Texas. It is a pleasure for me to represent the Credit Union National Association (CUNA) and its affiliated organizations and discuss the Multistate Tax Commission's proposed tax policy for financial institutions.

CUNA is the only trade association in the nation representing exclusively the interests of the nation's 13,400 state and federal credit unions and the 65 million American consumers who are the member-owners of their credit unions. CUNA is a confederation of 52 credit union leagues, located in each state, the District of Columbia, and Puerto Rico.

The Commission's proposal would require that financial institutions with income from taxable business activities "allocate and apportion" net income based on the provisions and formulas set forth in the proposed statute.

Our testimony today is in response to the Commission's request for comments on the recommended definition of business organizations and activities which may be subject to the apportionment formulas.

We are extremely concerned that the Commission's proposed definition would include credit unions. If adopted on a nationwide scale, each of the 5,485 state-chartered credit unions would be adversely affected by the proposal. Federal credit unions would, however, be exempt from the statute by virtue of the exemption accorded them by federal law (12 U.S.C. 1768).

CUNA urges the Commission to exempt credit unions from its proposal. Including not-for-profit, consumer-owned credit unions in the proposal would mean they would be taxed in the same manner as for-profit, shareholder-held corporations. This would be unfair to the taxpayers in our states who own their credit unions. Such a policy would unfortunately treat credit unions like for-profit financial institutions even though credit unions are by statute, philosophy, and operating practice distinctly different types of institutions. I would like to explain this important point in more detail.

Credit unions are non-profit, member-owned cooperative financial institutions. Their structure is based on the simple idea that people can pool their money together and make loans to each other. Only members may vote, serve on the committees and boards, and participate in the credit union's thrift and credit programs.

These unique financial institutions return to their owner-members every penny of income earned in excess of operating expenses and transfers to reserves. Earnings received by credit union members are already subject to taxes at the federal level and in the state where the member resides. Imposing yet another level of taxation on credit union members' own income would be extremely burdensome and unfair.

It is important to fully consider the many unique characteristics that clearly distinguish credit unions from for-profit financial institutions. Unfortunately, many people do not fully understand the uniqueness of credit unions. For example:

- Credit unions are financial cooperatives that are owned and democratically controlled by their members. Members -- the owners of credit unions -- join together with each other, in a cooperative form and structure, to encourage savings by offering a good return, to use collective monies to make loans to members at competitively low interest rates, and to provide other financial services.



Each member has one vote, regardless of the number of dollars (shares) on deposit at the credit union. If at any time, credit union members feel that the institution is not being operated in their best interest, they can--and do--elect new directors. Through this process they totally influence policy making, service offerings, and to a great extent, the day-to-day operation of the credit union.

No other financial institution operates this way.

■ Credit union membership is limited to persons within a field of membership -- general employment, association or geographic in nature. Membership is limited by a common bond, as specified in the credit union charter.

No other financial institution operates this way.

■ As volunteers, credit union members serve their fellow members in the true spirit of volunteerism. These volunteers are willing to be involved and devote substantial amounts of their time without pay because they are committed; they really believe in what the credit union is doing.

No other financial institution operates this way.

■ Credit unions have never operated for the purpose of making a profit. Our motto, "Not for profit, not for charity, but for service," captures the essence of the credit union movement. Credit unions return to their owners (members) every penny of income earned in excess of operating expenses and reserves.

No other financial institutions operate this way.

Credit unions were created as an alternative to for-profit financial institutions. The statutory framework of credit unions has not changed. Credit unions have remained true to their principles. They are cooperative institutions that operate "not for profit, not for charity, but for service."

Any attempt at treating credit unions the same as for-profit financial institutions, as suggested by the Commission's proposed language, would be detrimental to the credit unions and their members. Not only would it cost our credit unions in terms of tax dollars, but perhaps even more costly would be the administrative burdens this proposal would create.

And states themselves could experience unexpected consequences. It has long been known that a dual chartering system -- the choice between a federal and state charter -- has provided healthy competition between federal and state governments to appropriately control and respond to regional, geographic and economic situations.

Adoption of this proposal by state legislatures would provide a strong incentive to state-chartered credit unions to convert to federal charters which, as noted earlier, are exempt from such taxes. If this were to happen, the state would lose its control over existing state chartered credit unions, and also lose the revenues it now receives from these credit unions.

The evidence already exists. There is currently a franchise tax policy awaiting enforcement that would impose a new, 7% tax on state-chartered credit unions. Of the 250 state-chartered credit unions in California, 70 have already requested conversion to federal charter. The California Credit Union League has reported that unless the tax provision is amended, the state could lose up to \$10 million a year in revenues and destroy California's dual chartering system.

Other states that require additional taxes from our state chartered credit unions would well encounter a similar migration. By driving state credit unions to change charters, the Commission's proposal would weaken the dual chartering system which is already teetering out of balance and a cause for concern to state governments and state-chartered institutions. Ironically, then, the states that desire such a tax could find themselves worse off because of it.

In conclusion, CUNA strongly urges the Multistate Tax Commission to exempt credit unions from the statutory proposal in recognition of their numerous unique characteristics that clearly distinguish them from for-profit financial institutions. Including credit unions in the proposed definition of financial institutions would seriously undermine the non-profit credit union alternative to the for-profit sector. In the long run, the 65 million citizens who are members of America's credit unions would be the losers.

Thank you.

**EXHIBIT J: 30:**

**Testimony of Doug Duerr  
(National Association of State Credit Union Supervisors)  
(July 15, 1993)**

Oral Testimony

July 15, 1993

Multistate Tax Commission Proposal

I'm Doug Duerr, President and CEO of The National Association of State Credit Union Supervisors.

My members, like the members of the Commission, are *STATE Agencies Represented by* state executive employees.

My members regulate the nation's <sup>5485</sup>~~5,740~~ state-chartered credit unions in 47 states and Puerto Rico.

Most of my members administer agencies which are primarily self funded, but like your members, my

members go to work everyday facing the strains brought about by shrinking revenues and the increased demands which are placed on their agencies.

My association is well aware of the considerable efforts that have been put forth by this Commission toward developing a uniform method of apportioning the income derived from the multistate business of financial institutions.

We think the Multistate Tax Commission is to be applauded for its innovative thinking, and for its efforts in directing this revenue to its rightful source.

And, generally, we believe this proposal has considerable merit.

Still, I'm here today to urge you to specifically and decisively exclude credit unions from your regulation.

Here's why:

Number One - This proposal would lead to a decline in the number of state-chartered credit unions and, perhaps, the ultimate demise of the credit union dual chartering system;

Number Two - A loss of state-chartered credit unions would consequently result in a loss of revenue for many states; and



**Number Three - The accounting and compliance burden would be a serious problem for credit unions, and because federally-chartered credit unions will not be subject to these compliance burdens, state-chartered credit unions could reasonably be expected to convert to federal charters to escape the burdens.**

**These are three reasons why it is absolutely imperative that credit unions not be subject to the Commission's proposal. Let me elaborate.**

### **Dual Chartering**

Credit unions can be chartered under the rules of the state in which they are located, or under the rules of the federal government.

Initially, credit unions were state-chartered.

In 1909, Massachusetts enacted the first legislation which provided for the organization and function of credit unions in the United States, and the first credit union was opened there.

Subsequently, other states enacted similar legislation.

Recognizing the value of credit unions as the states did, the federal government moved to promote a

national proliferation of credit unions and, in 1934, enacted the enabling federal legislation that created the dual chartering system which remains intact today.

This gave credit unions a choice: to charter under the laws of their respective states, or under the Federal Credit Union Act.

Interestingly, this federal legislation extended broad and unique tax exemptions to credit unions licensed under the federal act, and to a large extent, those exemptions remain in effect today. As an instrumentality of the federal government, the Federal Credit Union Act exempts federal credit unions from

the state and local taxes which, in most states, state-chartered credit unions are required to pay.

Today, there are more than 13,000 credit unions in the United States -- nearly 8,000 are federally-chartered, and nearly 6,000 chartered under the law of 47 states and the territory of Puerto Rico. (Three states, Delaware, South Dakota and Wyoming, and the District of Columbia do not have state credit union legislation.)

Generally, state credit unions are subject to sales taxes, local property taxes and related business and franchise taxes.

Despite the seeming economic advantage enjoyed by the federally-chartered credit unions, credit unions continue to operate and be organized under state laws - - primarily because they feel the unique considerations found in state statutes, at least for now, outweigh the apparent tax disparity.

### **Self-defeating**

From this short explanation, I'm sure you can see that of all the financial institutions covered under this proposal, credit unions alone bring a unique scenario to the mix.

Of all the institutions included in this proposal, it is only credit unions that can find tax relief simply by changing their charter!

This proposal, as applied to credit unions, can ONLY apply to state-chartered credit unions, not their federally-chartered counterparts. Therefore, by federal law, a majority of the credit unions would be exempt from this proposal.

Because credit unions are able to decide whether to be federally- or state-chartered, credit unions have the ability to seek relief from this tax-related proposal simply by changing their charters, and that stark reality makes proposed regulation IV.18(i) self-defeating!

The added costs brought about by this proposal will, undoubtedly, drive credit unions to reevaluate their charter options.

An exodus from the state-chartering system would be a loss for the credit union movement, and the flight of credit unions from state charters to federal charters would result in a significant revenue loss to all state governments.

It is for this reason that this proposal may be self-defeating.

**Compliance burdens may outweigh tax burdens**

It is also important for the Commission to realize that the financial burdens incurred by credit unions as a result of this proposal will not be limited to the payment of possible new taxes at different rates.

Credit unions, not being profit driven, have never had the inclination to analyze member accounts to determine individual profitability.

Logically, therefore, unlike other financial institutions, credit unions have never developed or implemented the technology or proficiency necessary to identify and allocate revenue sources as would be required by this proposal.



This proposal would impose a significant financial obligation on credit unions for the purchase and implementation of technology, and perhaps, the human resource development or acquisition necessary to comply with the proposed regulation.

Our mutual interest

*Mr. Frisk*

Gentlemen, both of our constituencies are concerned about the state revenue crunch and are jealously pinching every dollar. Both of our constituencies are looking for innovative ways to increase state revenues. Both have obligations to the states which employ them.

Indeed, in many ways, we have mutual interests.

Our association is of the opinion that the proposed tax revenue gains, at best, will be short-lived and the losses in revenues will exceed those gains in short order.

We are also concerned that the inclusion of credit unions in this proposal will subvert state public policy, which has been to encourage the existence of state-chartered credit unions as a means of managing financial services activities to the benefit of the constituents of the state.

We urge the Commission to recognize that any model must consider the unique implications associated with credit unions, and frankly, gentlemen, we are

concerned that the inclusion of credit unions in this proposal is a prescription for the demise of the precarious balance of state- and federally-chartered credit unions.

Because this proposal can, by law, only impact state-chartered credit unions, I urge you to amend, in clear and precise language, the final report and model guidelines to include specific language exempting credit unions from compliance with this proposal and from any taxes which might be imposed by this regulation.

Thank you for inviting me to represent the view of my members. I assure you that we remain interested in

working with the Commission as it makes its final  
decisions.

**EXHIBIT J: 31:**

**Statement by Norma J. Lauder  
(First National Bank of Chicago) "Historical Perspective  
on Multistate Taxation of Financial Institutions"**

**HISTORICAL PERSPECTIVE ON  
MULTISTATE TAXATION OF FINANCIAL  
INSTITUTIONS**

presented by

Norma J. Lauder  
Senior Vice President  
and Director of Taxes  
First National Bank of Chicago  
Chicago, Illinois

**Opening Remarks of Norma J. Lauder--Conference Chairperson  
Senior Vice President and Director of Taxes, First Chicago**

**Historical Perspective on Multistate Taxation of  
Financial Institutions**

State taxation of banks and other financial institutions is in a period of rapid transition. Both the federal government and the individual state governments have exerted substantial power over the activities of banks and other financial institutions. The industries with which banks compete, the products they sell, the geographic areas where they operate, and the ways they can be taxed are all changing. Given the enormous pressure to raise revenues, states now have a challenging task to design a tax structure for this new environment which treats banks evenly relative to each other, relative to other industries, relative to other states, and does not curb economic growth.

Historically, the state bank tax structure has been dramatically influenced by constitutional and statutory limitations on the ability of states to tax national banks and to tax the interest earned on federal securities. Banks have historically been exempt from most state and local taxation outside the states where they have full banking offices. Prior to 1864, two Supreme Court decisions governed the manner in which states taxed national banks. The Court adopted a federal tax immunity standard for national banks which restricted the states

from taxing either national banks or federal obligations without Congressional permission. The National Bank Act of 1864 (Section 5219 of the Revised Statutes) and its successors imposed comprehensive restrictions upon the taxation of national banks by state and local governments.

Under this statute, states were permitted to tax the real property of national banks but limits were established to prevent taxation of shares, dividends or income at higher rates than were imposed on other entities. However, the state's authority to tax national banks or their shares was limited to banks with their principal offices within the state. The concept of Federal statutory limitations on state taxation, devised to protect national banks as Federal instrumentalities, remained intact throughout 1864-1969.

Prompted by two U.S. Supreme Court decisions, Congress reassessed its position in 1969. In 1968, the U.S. Supreme Court upheld the contention of a Massachusetts national bank that Section 5219 protected it from sales and use taxes. In 1969, the Court affirmed a decision that Florida could not require a national bank to pay a documentary tax. These rulings precipitated the Congressional intervention that produced Public Law 91-156. According to the new law, a national bank was to be treated as a bank organized and existing under the laws of the state in which its principal office was located. The only remaining restriction on state taxation of national banks was that such taxes could not discriminate against national banks.

With the approval of Public Law 91-213, Congress delayed the

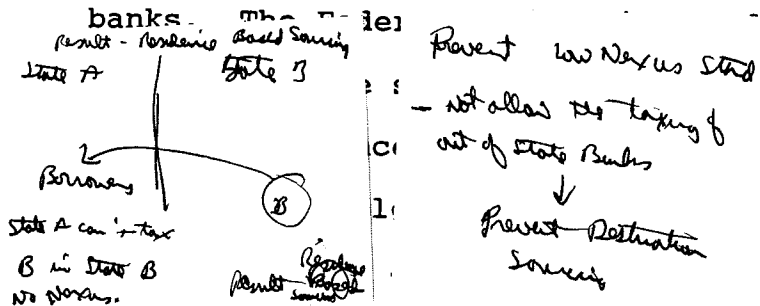


effective date of the new law to January 1, 1973, in order to provide time for a study and a report by the Federal Reserve Board ("Board") on how state taxes on out-of-state national banks would affect the economic efficiency of the banking system and the mobility of capital. The Board's major recommendations related to two areas: (1) taxation of intangible personal property and (2) taxation by states other than the state in which a bank's principal office is located.

With respect to intangibles, the Board recommended that the denial of state and local government authority to tax intangible personal property of national banks, which was implicit in Section 5219 from the outset and made explicit in the 1969 "amendment", should be continued without a time limit and that such a denial be extended to cover state banks and other depository institutions. The Board suggested a Federal statute should be adopted that would "(1) establish uniform criteria for determining when a state can exercise jurisdiction to tax a non-resident bank; (2) provide parameters for certain common occurrences that do not by themselves constitute a sufficient connection with the state to establish jurisdiction to tax (i.e. holding of security interests in the state or solicitation of borrowers); (3) include rules for the division of each type of tax base when the rules for jurisdiction have been satisfied; and (4) set forth rules that will guide the states in their administrative procedures."

In 1973, Congress extended its prior moratorium on state taxation of banks with the enactment of Public Law 93-100. From

1973 to 1976, the new moratorium prohibited states from imposing any tax measured by income or receipts or any other "doing business" taxes on federally insured out-of-state depositories. In the same law, Congress directed the Advisory Commission Intergovernmental Relations ("ACIR") to undertake a study of all the pertinent matters relating to the application of state "doing business" taxes on out-of-state financial institutions. The ACIR study was to include recommendations for legislation that would provide equitable state taxation of those entities. The ACIR concluded that the precedent of P.L. 86-272 might advantageously be extended to interstate activities of depositories such as



1, however, establish a terms of a substantial state (i.e. regular office provision would be aration of policy regulating

interstate division of the taxable base of any depositories subject to a "doing business" tax outside the home-office state.

Congress, however, failed to act and, in 1976, the language as originally drafted in 1969 became law. Thus, the permanent amendment to 12 U.S.C. 548 is now in effect, leaving the states free to impose any nondiscriminatory tax on any national or state bank having taxable nexus within the state. Proposed legislation has been drafted in response to the lapse of the moratorium of 12 U.S.C. 548 and in response to the ACIR report.

The American Bankers Association Taxation Committee prepared two bills: S. 3368, the Interstate Taxation Depositories Act of

1976, introduced in the 94th Congress, contained explicit provisions addressing the ACIR recommendations and certain failings of those recommendations and S. 1900, introduced in the 95th Congress, was a refinement of S. 3368. The refinements were reached as a result of discussions with the U.S. Savings League, with certain state tax administrators around the country and with Congressional aides. Additionally, several Senators introduced S. 719 in the 95th Congress which provided for a jurisdictional standard based upon a business location which consisted of a brick and mortar or a regular presence of employees in the state. Both bills failed to be enacted. In 1981, the American Bar Association (with the help of the American Bankers Association) drafted proposed legislative language which provided for a nexus test similar to the language under P.L. 86-272--bricks and mortar or the regular presence of employees. The Bar proposal also contained apportionment rules which the commercial banking industry did not support and therefore, the Bar proposal did not receive wide support in Congress. Congressional activity with respect to the state taxation of banks has remained quiet since the late 1970's.

Yet, the bank regulatory climate today is one of expansiveness. While the Supreme Court has struck down restrictions on the interstate financial activities of nonbanks, Congress and state legislatures have permitted more traditional banking institutions to conduct limited interstate activities and to acquire other institutions within defined geographic areas. The New England states first instituted regional interstate

banking on a reciprocal basis. The U.S. Supreme Court found these New England reciprocal interstate statutes to be valid in Northeast Bancorp, Inc. v. Board of Governors Fed. Reserve Sys., 105 S.Ct. 2545 (1985). In many states, interstate acquisition is permitted only on a reciprocal basis--the state of the acquiring institution must grant banks from the home state of the target institution the ability to make the same sort of acquisitions in the acquiring bank's state. Under the 1982 Garn-St Germain banking legislation, Congress authorized the acquisition of failing banks by out-of-state banks and bank holding companies regardless of state law strictures. The 1991 Treasury Banking Reform legislation would permit nationwide interstate banking and branching, albeit on a delayed basis. As banks and other financial institutions look toward continued expansion of their products and services authorities and broadening of their markets, the states have begun to examine their traditional taxing systems to more aggressively tax those new and different products and activities.

The Multistate Tax Commission ("MTC"), which has 19 member states (including D.C.) has studied, at some length, the issue of state taxation of banking activities and has promulgated a proposed regulation dealing with the application of the state income or net income franchise tax to interstate banking activities. The proposed regulation describes the maximum extent to which its drafters believe a state may venture in taxing interstate activities of the expanding banking industry. The proposed regulation has been drafted and redrafted on a number of

occasions. Currently, the most recent draft is in limbo as the Multistate Tax Commission conducts additional studies into the economic impact of the proposed rules upon the states.

States generally did not contemplate legislation that would tax income earned by out-of-state banks until 1987 when the MTC published its first draft of model rules. The MTC's 1987 proposed rules would have subjected an out-of-state bank to taxation if the bank had either 20 customers or \$5 million in assets or deposits within the state. Minnesota adopted the MTC's first draft in 1987. In 1989, Indiana also adopted the MTC's first draft but with a major modification--a credit for taxes paid on the same income elsewhere. In 1989, the MTC issued its second draft which increased the thresholds from 20 customers to 100 and the dollar amounts from \$5 million to \$10 million and provided an additional threshold test for receipts, \$500,000. In 1990, Tennessee adopted a modified version of the MTC's first draft--it included the \$5 million threshold for deposits and assets but did not include a minimum customer amount. At the end of 1989, Iowa made regulatory changes to its definition of "doing business" as it applies to a bank's activities in the state. Under the new definition, a bank does not have to be physically located in Iowa to be doing business. On April 3, 1991, the West Virginia Governor signed a banking bill which will tax out-of-state financial institutions if they have 20 customers or \$100,000 in gross receipts in West Virginia. This legislation is effective beginning January 1, 1991. Additionally, Massachusetts is considering the adoption of the 1987 MTC version--further

consideration by the Massachusetts' legislature is expected later this year.

Thus, today, the only statutory restriction on state taxation of national banks is that such taxes must not discriminate against national banks. The constitutionality, however, of the MTC rules and those adopted by the aforementioned states has not been judged to date.

To: Commissioner Joe Huddleston, Tennessee Department of Revenue  
From: William F. Fox, Professor of Economics, University of Tennessee

Subject: Taxation of Financial Institutions

Date: April 13, 1992

Thank you for the opportunity to respond to recent proposals on taxation of financial institutions. Let me begin by saying that I avoid using prejudicial terms such as market state or money center state when describing what I believe to be the best approach for taxing financial institutions. This terminology suggests that different approaches are best for each set of states and often leads to the assumption that these groups are in competition with each other for tax dollars. However, the preferred approach is in the long run best interest of both groups of states and can lead to greater total tax collections. Thus, all states can receive more without placing inappropriate burdens on financial institutions.

Proposals for improving taxation of financial institutions frequently have focused on how to redistribute the tax revenues between states. This focus seems to permeate the documents you provided me. The presumption appears to be that the problem with existing taxation of financial institutions is that the share of tax revenues which should go to each state needs to be reconsidered. This focus on tax revenues has led to arguments over situs rules and apportionment factors, where the primary concern seems to be who are the revenue winners and losers. I contend that these arguments are aimed at the wrong issue -- the primary concern is not over the share

of revenues which should go to each state. Other important goals are more important reasons for reforming financial institutions taxation and achievement of these goals will lead to greater revenues as well.

The remainder of this memo addresses the reasons for improving state taxation of financial institutions and the characteristics of an effective tax structure. My conclusion is that a destination based approach is the appropriate way to tax financial institutions.

### Why a Destination Based Tax?

The criteria for a good tax system are widely accepted. The criteria include:

1. The tax should be easy for administration and compliance
2. The tax should minimize effects on the location of economic activity
3. The tax system should raise an acceptable amount of revenues

My thesis is that a destinations based tax is the only structure which effectively achieves these generally accepted goals. Existing tax structures fail, particularly on the second and third of these counts. As a result, the objective of state tax policymakers should be to design a tax system which overcomes these limitations.

The remainder of this section provides a description of why the existing system fails.

Consider the second goal. Financial institutions have both strong incentives for and ample opportunities to avoid taxation by altering their behavior. State tax rate differences are significant, with rates ranging from 0 to over 10 percent, and these differentials provide a strong incentive to avoid taxes. Financial institutions have a greater opportunity to engage in avoidance behavior than do firms in other industries. Like other firms, financial institutions can alter their tax liability by relocating some



of their operations. A number of production and wholesaling functions, such as credit card services, commercial lending, and retail credit processing functions, need not be located near the market and can be sited to minimize production and tax costs. But a broader range of alternative sites are available for producing these services compared with those available for most other industries, such as manufacturing. The main reason is transportation of financial services can be performed through telecommunications and does not require the significant costs that many manufacturers bear in transporting their products and raw materials. (Note that Saturn chose to locate in Tennessee, not Minnesota, substantially because of transportation cost differentials. But the same justification for locating in Tennessee would not hold for many financial services.) Numerous examples of relocation of financial wholesaling and production activities in states with attractive tax and regulatory practices can be seen by looking at financial services which have been transferred to Delaware and South Dakota. Further, financial institutions can avoid taxes in ways which are not available to other industries. For example, tax burdens can be changed by securitizing loans or by changing the types of financial instruments held. Thus, tax avoidance does not require any changes in the "real economic" activity of a firm and can be accomplished easily and at low costs.

A tax structure which levels the playing field between all domiciled and nondomiciled financial institutions in each state and which creates no disincentives to produce financial services in a state is in the best interest of all states, individually and as a group. The opportunities for avoidance imbedded in the current tax system often place taxed domiciled financial institutions in competition with untaxed

nondomiciled institutions, which often may operate through branchless means. Also, different tax structures or uneven capacities to undertake tax avoidance can lead various segments of the industry to bear different tax burdens.

Now consider the third goal, which specifies that the tax should raise an acceptable amount of revenues. Existing tax structures also fail to achieve this goal because a considerable share of financial institution income can go untaxed. Income earned through loan securitization and branchless banking are good examples where no tax may be paid. States as a group can raise more revenues if the base is broadened so that all income is taxed. Thus, a tax structure which provides a consistent means of taxing all income of financial institutions is imperative.

#### Designing A Destinations Tax

Only a destinations tax overcomes both of the problems discussed in the previous section. (I anticipate that destination taxes will be necessary for many other services as well in coming years.) Several strategies could be chosen to ensure that all revenues are subject to tax somewhere (goal 3), but the tax must be carefully structured to avoid relocation effects (goal 2). A destinations tax is levied on the market for services, regardless of where the service is produced. No incentive exists to relocate economic activity to avoid a tax on the market for a service, because the same tax is imposed regardless of where the service is produced. Similarly, all domiciled and nondomiciled activity is taxed in a state at the same tax rate so the playing field is leveled. Money center states may object, arguing that a destinations tax would allow some of their tax base to be shifted to market states. However, with a destinations tax money center states would receive revenues according to their (often

large) market, regardless of where the services were produced. Without the destinations tax these states may receive considerably less revenues because of tax avoidance. Existing tax structures normally prevent money center states from taxing credit card income produced out-of-state, for example. In addition, money center states that tax the production of financial services provide an incentive to relocate these activities to states with lower tax rates and with better regulatory environments. Even if revenue losses resulted for some states, keeping the economic activity should be much more important than a small amount of additional tax revenue.

The destinations tax has five important characteristics. First, nexus is determined on a solicitation basis. Second, a single factor receipts based formula is preferable. (This is similar to the tax structure used by most states for insurance companies). The payroll and property factors in the standard three factor formula are intended to measure where economic activity is produced, so they are inconsistent with the concept of a destinations tax. Third, the definition of a financial institution should be broadly set to include those entities which are substantially in competition in each market. Since the major source of financial income comes from lending, a destinations tax probably should define financial institutions according to whether their principal activity is lending. Fourth, combined reporting should be required for all those affiliated members of a holding company which individually meet the definition of a financial institution. This overcomes the need to make a determination of which transactions between affiliated companies are at arms length, and prevents firms from engaging in tax avoidance by shifting the situs of assets or profits to a holding company member which would be treated differently for tax purposes.

Finally, a rule must be developed for determining the treatment of income which cannot be sited on a destinations basis. Interest from federal government securities, working capital loans, and securitized loans may be examples. This is the one area where some room for negotiation between states may exist because no single conceptually correct approach exists. Receipts which do not have a clearly determined situs can be thrown out of the denominator of the apportionment formula, which effectively allocates this income according to the destination of the financial activity which has a clearly determined situs. Alternatively, the revenue could be thrown into the numerator of the domiciled state. This is similar to using a production tax framework for that part of income where the market cannot be associated with specific states. Justifications can be given for either approach.

The other goal mentioned above for the tax system was that it have low costs of administration and compliance. Implementation of the destinations tax initially may result in somewhat higher compliance costs for financial institutions because of the need to report their tax related information in a new way. However, we recently concluded that financial institutions have the ability to track their market because of regulatory requirements and internal business practices, so apportionment factors can be calculated using available data. Further, a major portion of the processing for financial institutions is handled at the service bureau or batch processing level, except for very large concerns. Therefore, the initial costs of implementation can be spread over a very large base, resulting in a small investment in administration costs at the firm level.

**EXHIBIT J: 32:**

**Letter from Fred E. Ferguson (FIST)  
(July 29, 1993)**

# ARTHUR ANDERSEN

ARTHUR ANDERSEN & CO, SC

July 29, 1993

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Arthur Andersen & Co.

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1666 K Street NW  
Washington DC 20006-2873  
Writer's Direct Dial

202/862-7480

Mr. Alan H. Friedman  
Hearing Officer  
Multistate Tax Commission  
444 North Capitol Street, NW, Suite 425  
Washington, DC 20001

Re: July 15, 1993 Multistate Tax Commission Hearing on Proposed Regulation IV.18.(i)  
Apportioning the Income of Financial Institutions

Dear Alan:

On behalf of the Financial Institutions State Tax (FIST) Coalition, which consists of:

Bank of America, NT & SA  
The Bank of New York Company, Inc.  
Bankers Trust Company  
Boatmen's Bancshares, Inc.  
Capital Holding Corporation  
The Chase Manhattan Bank, N.A.  
Citicorp/Citibank, N.A.  
First Chicago Corporation  
First Interstate Bancorp  
Great Western Financial Corporation  
KeyCorp  
Morgan Guaranty Trust Company of New York  
NationsBank  
Shawmut National Corporation  
Society National Bank  
SunTrust Banks, Inc.  
Wachovia Corporation

This letter provides a technical mark-up of the Multistate Tax Commission's Proposed Regulation IV.18.(i) Apportioning the Income of Financial Institutions. As discussed in our June 11, 1993 letter, the FIST Coalition believes there are areas in which the language included

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in the uniform rules (statutes/regulations) should be clarified or tightened or where changes of a cosmetic nature should be made. We have addressed these items in the technical mark-up below.

### **Support for Allocation and Apportionment Rules**

FIST supports of the **STATUTORY PROPOSAL FOR APPORTIONMENT AND ALLOCATION OF NET INCOME OF FINANCIAL INSTITUTIONS** as contained in Attachment 1 of the May 10, 1993 Interim Report of the Hearing Officer regarding Proposed Multistate Tax Commission Regulation IV.18.(i) Apportioning the Income of Financial Institutions. These rules represent a blending of interests from both money-center and market states and provide a workable apportionment methodology, which is a key element in any uniform rules for the taxation of financial institutions. To be uniform these rules need to be applied uniformly and be adopted by a substantial number of the states. Unilateral modifications by states of the apportionment formula (either sourcing or weighting) in any substantial manner will undermine all the cooperative work achieved. If either the money-center states fail to adopt market state sourcing or the market states fail to adopt money-center state factors, there will be no uniformity. You stated it well in the interim report:

*"All involved in this effort - industry representatives, tax officials and legislatures - are requested to keep in focus the cooperative manner by which the following draft statute was created, its weighting of competing interests between government and industry, as well as among the government entities themselves."*

### **Reserved Issues**

For various reasons FIST has agreed to reserve comment at the current time on three issues: definition of a financial institution, jurisdiction to tax (nexus) and combined reporting. However, with respect to the nexus issue, please note that FIST reads Quill v. North Dakota, 112 S.Ct 1904 (1992), as support for the notion that physical presence is required for a finding of Constitutional nexus in the area of operational taxes. Notwithstanding these open issues, FIST does not want any of these issues to deter the uniform adoption of apportionment and allocation rules.

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**Technical Mark-Up**

**Page 1:**

1. Delete Section 1. The statutory proposal will presumably either replace an apportionment and allocation statute in an existing taxing statute or become the apportionment and allocation statute in an existing taxing statute that currently has no apportionment or allocation methodology. Since this proposal should not be the basis for setting policy as to implementing a tax where none currently exists, or for changing from an income to a franchise tax, this section should be deleted.
2. Change "Section 2" to "Section 1".
3. Footnote 1 should be moved so that it immediately follows new "Section 1. Apportionment and Allocation".
4. The last sentence of footnote 1 should be deleted (see comment 1 above).
5. In new section 1(b), the references to sections 4, 5 and 6 should be changed to sections 3, 4 and 5 respectively.

**Page 2:**

1. "Section 3" should be changed to "Section 2".
2. The word "cardholder" in the bold print wording of the definition of "Borrower or credit cardholder located in this state" should be changed to "card holder" (i.e., two words).
3. The word "or" on the second line of the definition of "Borrower or credit card holder located in this state" should be deleted.

**Page 4:**

1. The word "other" on the fifth line of the first paragraph on the page should be deleted since the taxpayer may not be a depository institution.
2. Delete footnote 6. The list cannot be viewed as exclusive since the list ends in the words "and other similar items."
3. The second "from" on the sixth line of paragraph (m) should be changed to the word "to".



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4. The second sentence of paragraph (n) should read "Real and tangible personal property include land and stocks in goods." The words "and real and tangible property rented to the taxpayer" should be deleted because, if the items are rented to the taxpayer, they are not "owned" by the taxpayer. However, if the items are "rented" to the taxpayer but the taxpayer claims depreciation on the items, then the items fall into the "owned" category without the need for the confusing phrase.

**Page 5:**

1. To ensure that a financial institution can apportion if it is taxable in a foreign jurisdiction and to ensure that receipts properly assigned to a foreign jurisdiction are not thrown back to the taxpayer's state of commercial domicile, the following definition should be added: "State" means a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States or any foreign country.
2. Footnote 7 should be changed to footnote 6.
3. Because the word "taxable" (and not the wording "taxable in another state") is used when determining whether a taxpayer may apportion and whether the throwback rule applies, the definition in paragraph (q) should be of the word "taxable".
4. The definition of "taxable" should be changed to read "means that a taxpayer is either: (1) subject to a franchise tax measured by net income, a net income tax, a franchise tax for the privilege of doing business, or a corporate stock or earned surplus tax in a state; or (2) subject to the jurisdiction of a state to impose such a tax regardless of whether, in fact, the state does or does not do so."
5. Footnote 8 should be changed to footnote 7.
6. "Section 4" should be changed to "Section 3".

**Page 6:**

1. The word "property" on the third line of paragraph (c)(2) should be changed to "receipts".
2. The second sentence of paragraph (c)(2) should be changed to read: "The extent an aircraft will be deemed to be used in this state and the amount of receipts that is to be included in the numerator of this state's receipts factor is determined by multiplying all the receipts from the lease or rental of the aircraft by a fraction, the numerator of which is the number of landings of the aircraft in this state and the denominator of which is the total number of landings of the aircraft."

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3. Since a lender in an unsecured loan can seek the real property assets of a debtor in default, the second line of paragraph (d)(2) should read "principal amount of the loan is specifically and directly secured by real property at the time that the original...." The addition of "specifically and directly" ensures that unsecured loans are not included in the term "loans secured by real property."

**Page 7:**

1. The first sentence of paragraph (f) should end after the word "loans" since participations and syndications are included in the definition of the term "loan".
2. The word "all" on the second line of paragraph (h) should be deleted.
3. The end of paragraph (i) should read "card holders" rather than "card-holders".

**Page 9:**

1. The word "dividends," should be inserted between the words "interest," and "net gains" on the second line of paragraph (m)(1)(B).
2. The words "interest expense from securities sold not yet purchased and" should be inserted between the words "exceed" and "net losses" on the fourth line of paragraph (m)(1)(B).
3. The words "for tax purposes" on the sixth line of paragraph (m)(2)(A) should be deleted since paragraph (m)(5) on page 11 basically defines when something is properly booked for purposes of paragraph (m).
4. The words "for tax purposes" on the seventh to eighth line of paragraph (m)(2)(B) should be deleted.
5. The fourth line of paragraph (m)(2)(C) should read "transactions (but excluding amounts described in subparagraphs (A) or (B) of this paragraph), attributable to this".
6. The words "for tax purposes" on the eighth line of paragraph (m)(2)(C) should be deleted.

# ARTHUR ANDERSEN

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July 29, 1993  
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## Page 10:

1. The last word of paragraph (m)(2)(D) should be "four".
2. The words "for tax purposes" on the sixth line of paragraph (m)(3)(A) should be deleted.
3. The words "for tax purposes" on the seventh line of paragraph (m)(3)(B) should be deleted.
4. The word "account" on the second line of paragraph (m)(3)(C) should be deleted.
5. The fourth line of paragraph (m)(3)(C) should read "transactions (but excluding amounts described in subparagraphs (A) or (B) of this paragraph), attributable to this state and included in the numerator is determined".
6. The words "for tax purposes" on the seventh line of paragraph (m)(3)(C) should be deleted.

## Page 11:

1. The words "for tax purposes" on the second to third line of paragraph (m)(5) should be deleted.
2. Because a definition of "state" should be added and that definition includes a foreign country, the following words should be added in paragraph (m)(5)(A) after the word "state" and before the comma: "of the United States, the District of Columbia, the Commonwealth of Puerto Rico or any territory or possession of the United States".
3. An "s" should be added to the word "State" on the sixth line of paragraph (m)(5)(B).
4. "Section 5" should be changed to "Section 4".
5. In section (a) of the property factor, delete everything after "General." and insert the following:

The property factor is a fraction, the numerator of which is the average value of real property and tangible personal property rented to the taxpayer that is located and used within this state during the taxable year, the average value of the taxpayer's real property owned and tangible personal property owned that is located and used within this state during the taxable year, and the average value of the taxpayer's loans and credit card receivables that are located within this state during the taxable year, and the denominator of which is the average

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July 29, 1993  
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value of all such property located and, with respect to real and tangible personal property, used both within and without this state during the taxable year.

This change will ensure that the property factor includes real and tangible personal property rented to the taxpayer. In addition, it ensures that the word "used" modifies real and tangible personal property only.

**Page 12:**

1. Delete footnote 9.

**Page 14:**

1. The words "for tax purposes" in paragraphs (g)(1)(A)(i), (ii) and (iii) should be deleted since paragraph (g)(1)(B) defines when something is properly booked for purposes of paragraph (g).
2. Because a definition of "state" should be added and that definition includes a foreign country, the following words should be added on the second line in paragraph (g)(1)(A)(ii) after the word "state" and before the comma: "of the United States, the District of Columbia, the Commonwealth of Puerto Rico or any territory or possession of the United States".
3. The words "with a regular place of business of the taxpayer" should be deleted from paragraph (g)(1)(B) because of the interaction with paragraph (g)(1)(A)(ii) and (iii).
4. Footnote 10 should be changed to footnote 8.
5. The reference to Section 5(g)(1)(B) in new footnote 8 should be changed to Section 4(g)(1)(B).
6. "Section 6" should be changed to "Section 5".

**Page 15:**

1. Section (c)(3)(C) should read "if the principal base of operations and the place from which the services are directed or controlled are not in any state in which some of the service is performed but the employee's residence is in the state." The reason for this change is: if some of the services are performed in the state in which the principal base of operations is located then the rule in (c)(3)(A) should apply; if some of the services are performed in the

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state from which the services are directed or controlled but not in the state in which the principal base of operations is located then the rule in (c)(3)(B) should apply; but if services are not performed in the state in which the principal base of operations is located AND services are not performed in the state from which the services are directed or controlled, then the rule in (c)(3)(C) should apply.

**Appendix B:**

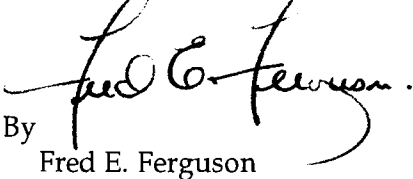
1. An end quotation mark should be added after "Financial institution.
2. The word "from" on the second line of paragraph (k) should be changed to the word "for".
3. The word "that" on the first line of paragraph (l) should be changed to the word "than".

**Appendix D:**

1. Paragraph 2 should read "In applying the standards for determining the state to which a loan is to be located, a preponderance of substantive contact shall be presumed to exist at the taxpayer's regular place of business to which it has been booked, if the loan is approved and administered there." If this was only a rebuttable presumption, there would continue to be the risk that more than one state would claim that the same loan or credit card receivable should be assigned to it.
2. Footnote 11 should be changed to footnote 9.

Very truly yours,

FINANCIAL INSTITUTIONS STATE TAX COALITION

  
By  
Fred E. Ferguson

DNT

Copies to: Ms. Sharon Morrow, Chair of Multistate Tax Commission  
FIST Coalition

**TECHNICAL MARK-UP PROVIDED BY THE FIST COALITION**  
**STATUTORY PROPOSAL FOR APPORTIONMENT AND ALLOCATION OF NET**  
**INCOME OF FINANCIAL INSTITUTIONS**

Section 1. Imposition of Franchise Tax.<sup>1</sup>

~~A franchise tax measured by net income is imposed on every financial institution for the privilege of doing business in this state and for exercising its franchise in a corporate or organized capacity.~~

Section 12. Apportionment and Allocation.<sup>1</sup>

(a) A financial institution having income from business activity which is taxable both within and without this state shall allocate and apportion its net income as provided in this Act. All items of nonbusiness income (income which is not includable in the apportionable income tax base) shall be allocated pursuant to the provisions of [ ]<sup>2</sup>. All business income (income which is includable in the apportionable income tax base) shall be apportioned to this state by multiplying such income by the apportionment percentage.

(b) The apportionment percentage is determined by adding the taxpayer's receipts factor (as described in section ~~34~~ of this article), property factor (as described in section ~~45~~ of this article), and payroll factor (as described in section ~~56~~

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<sup>1</sup> *This proposal assumes a tax measured by net income. There are a variety of other types of taxes that states may apply to financial institutions. While this proposal suggests a franchise tax that is measured by net income, other types of taxes that apply to financial institutions may be subjected to allocation and apportionment by the same or similar mechanism that is suggested here, and this section, as well as others, will need further modification. A franchise tax is selected here because it is clear that such a statute will not be precluded by federal law from including income earned from federal government obligations in its taxable base.*

<sup>2</sup> *While it is understood that all income derived from currently known activities of a financial institution, whether from deposit, lending and other credit activities or from investment activities dealing with tangible and intangible property, is business income, this sentence allows for the future possibility that some activity may be unrelated to the business activities commonly associated with financial institutions, but still authorized by law. Since this discrete business activity is theoretically possible, the proposed statute will more readily conform on its face to the dictates of the Allied Signal, Inc. v. Director, Div. of Taxation, 112 S.Ct. 2365 (1992).*

of this article) together and dividing the sum by three. If one of the factors is missing, the two remaining factors are added and the sum is divided by two. If two of the factors are missing, the remaining factor is the apportionment percentage. A factor is missing if both its numerator and denominator are zero, but it is not missing merely because its numerator is zero.

(c) Each factor shall be computed according to the method of accounting (cash or accrual basis) used by the taxpayer for the taxable year.<sup>3</sup>

(d) If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the State Tax Administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of any one or more of the factors,
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Section ~~23~~. Definitions.

As used in this [Act], unless the context otherwise requires:

(a) "**Billing address**" means the location indicated in the books and records of the taxpayer as the address where any notice, statement and/or bill relating to a customer's account is mailed.

(b) "**Borrower or credit card holder**~~cardholder~~ **located in this state**" shall mean (1) a borrower, other than a ~~or~~ credit card holder, that is engaged in a trade or business which maintains its commercial domicile in this state; and (2) a borrower that is not engaged in a trade or business or a credit card holder whose billing address is in this state.

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<sup>3</sup> . *Industry representatives have raised a compliance issue based upon the information that is to be used for calculating the factors - either financial book or tax basis. An industry suggested regulation is attached at Appendix A. which will be subject to comment during the public hearing process.*

(c) "**Commercial domicile**" means the headquarters of the trade or business, that is, the place from which the trade or business is principally managed and directed.

(d) "**Compensation**" means wages, salaries, commissions and any other form of remuneration paid to an employee for personal services that are included in such employee's gross income under the Federal Internal Revenue Code. In the case of employees not subject to the Federal Internal Revenue Code, e.g., those employed in foreign countries, the determination of whether such payments would constitute gross income to such employees under the Federal Internal Revenue Code shall be made as though such employees were subject to the Federal Internal Revenue Code.

(e) "**Credit card**" means credit, travel or entertainment card.

(f) "**Credit card issuer's reimbursement fee**" means the receipt a taxpayer receives from a merchant's bank because one of the persons to whom the taxpayer has issued a credit card has charged merchandise or services provided by the merchant to the credit card.

(g) "**Employee**" means, with respect to a particular taxpayer, any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee of that taxpayer.

(h) "**Financial institution**" means [insert state's definition here].<sup>4</sup>

(i) "**Gross rents**" means the actual sum of money or other consideration payable for the use or possession of property.<sup>5</sup>

(j) "**Loan**" means any extension of credit resulting from direct negotiations between the taxpayer and its customer, and/or the purchase, in whole or in part, of such extension of credit from another. Loans include participations, syndications, and leases treated as loans for federal income tax purposes.

Loans shall not include: loans representing property acquired in lieu of or

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<sup>4</sup> *No definition of 'financial institution' is proposed at this time, leaving the state to define their own coverage. However, the Hearing Officer reserves the option to make a final recommendation regarding coverage at a future time. The definition provided in Appendix B is set forth for comment and consideration in the determination of what types of business organizations and activities may be made subject to the recommended formula.*

<sup>5</sup> *In the interest of seeking additional uniformity, suggested regulatory language further defining the term 'gross rents' is offered at Appendix C.*



pursuant to a foreclosure under section 595 of the Federal Internal Revenue Code; futures or forward contracts; options; notional principal contracts such as swaps; credit card receivables, including purchased credit card relationships; non-interest bearing balances due from ~~other~~ depository institutions; cash items in the process of collection; federal funds sold; securities purchased under agreements to resell; assets held in a trading account; securities; interests in a REMIC, or other mortgage-backed or asset-backed security; and other similar items.<sup>6</sup>

(k) "**Merchant discount**" means the fee (or negotiated discount) charged to a merchant by the taxpayer for the privilege of participating in a program whereby a credit card is accepted in payment for merchandise or services sold to the card holder.

(l) "**Participation**" is an extension of credit in which an undivided ownership interest is held on a *pro rata* basis in a single loan or pool of loans and related collateral. In a loan participation, the credit originator initially makes the loan and then subsequently resells all or a portion of it to other lenders. The participation may or may not be known to the borrower.

(m) "**Principal base of operations**" with respect to movable property means the place of more or less permanent nature from which movable property is regularly directed or controlled. With respect to an employee, the "base of operations" means the place of more or less permanent nature from which the employee regularly starts his or her work and to which he or she customarily returns in order to receive instructions from the taxpayer, or communicates ~~to~~ from his or her customers or other persons, or performs any other functions necessary to the exercise of his or her trade or profession at some other point or points.

(n) "**Real property owned**" and "**tangible personal property owned**" means real and tangible personal property, respectively, (1) on which the taxpayer may claim depreciation for federal income tax purposes, or (2) property to which the taxpayer holds legal title and on which no other person may claim depreciation for federal income tax purposes (or could claim depreciation if subject to federal income tax). Real and tangible personal property include land, stocks in goods ~~and real and tangible personal property rented to the taxpayer~~. Real and tangible personal property do not include coin, currency, or property acquired in lieu of or pursuant to a foreclosure.

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<sup>6</sup> *The term "loan" is intended to have a broad meaning and the list of exclusions from the definition of "loan" is intended to be exclusive. For example, because an interest bearing balance due from another depository is not specifically mentioned in subparagraph (j), the underlying activity for such an account would be considered a loan.*

(o) "**Regular place of business**" means an office at which the taxpayer carries on its business in a regular and systematic manner and which is continuously maintained, occupied and used by employees of the taxpayer.

(p) "State" means a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States or any foreign country.

(qp) "**Syndication**" is an extension of credit in which two or more persons fund and each person is at risk only up to a specified percentage of the total extension of credit or up to a specified dollar amount.<sup>67</sup>

(rq) "~~**Taxable in another state**~~" means that a taxpayer is either:

(1) subject to a franchise tax measured by net income, a net income tax, a franchise tax for the privilege of doing business, or a corporate stock or earned surplus tax in a another state; or

~~(2) subject to the jurisdiction of a state to impose such a tax regardless of whether, in fact, the state does or does not do so that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not do so.~~<sup>78</sup>

#### Section 34. Receipts Factor.

(a) **General.** The receipts factor is a fraction, the numerator of which is the receipts of the taxpayer in this state during the taxable year and the denominator of which is the receipts of the taxpayer within and without this state during the taxable year. The method of calculating receipts for purposes of the denominator is the same as the method used in determining receipts for purposes of the numerator.

<sup>67</sup> This definition permits the taxing jurisdiction to look to either the Call Reports, Federal Reserve Form FR Y-9C dealing with Consolidated Financial Statements for Bank Holding Companies, or the financial institution's records to determine the amount of receipts attributable to syndications.

<sup>78</sup> The question of whether financial institutions are subject to a state's taxing jurisdiction will sometime depend upon what standard is to apply to determine the adequacy of nexus under applicable jurisdictional principles. Since financial institutions are service providers, as opposed to sellers of tangible personal property, Public Law 86-272 would not apply to such institutions. However, considerations under the Due Process and Commerce Clauses need be analyzed to determine issues of both taxability and throwback. See *Quill v. North Dakota*, 112 S.Ct. 1904 (1992).

The receipts factor shall include only those receipts described herein which are included in the computation of the apportionable income base for the taxable year.

(b) **Receipts from the lease of real property.** The numerator of the receipts factor includes receipts from the lease or rental of real property owned by the taxpayer if the property is located within this state or receipts from the sublease of real property if the property is located within this state.

(c) **Receipts from the lease of tangible personal property.**

(1) Except as described in paragraph (2) of this subdivision, the numerator of the receipts factor includes receipts from the lease or rental of tangible personal property owned by the taxpayer if the property is located within this state when it is first placed in service by the lessee.

(2) Receipts from the lease or rental of movable tangible personal property owned by the taxpayer, such as aircraft, rolling stock, water vessels, or mobile equipment, are included in the numerator of the ~~receipts~~<sup>property</sup> factor to the extent that the property is used in this state. The extent an aircraft will be deemed to be used in this state and the amount of receipts that is to be included in the numerator of this state's receipts factor is determined by multiplying all the receipts from the lease or rental of the aircraft by a fraction, the numerator of which is the number of landings of the aircraft in this state and the denominator of which is the total number of landings of the aircraft. ~~The extent an aircraft will be deemed to be used in this state is determined by multiplying the receipts from the lease or rental of the aircraft by a fraction, the numerator of which is the number of landings of the aircraft in this state and the denominator of which is the total number of landings of the aircraft.~~ If the extent of the use of any movable tangible personal property within this state cannot be determined, then the property will be deemed to be used wholly in the state in which the property has its principal base of operations. A motor vehicle will be deemed to be used wholly in the state in which it is registered.

(d) **Interest from loans secured by real property.**

(1) The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from loans secured by real property if the property is located within this state. If the property is located within this state and one or more other states, the receipts described in this subdivision are included in the numerator of the receipts factor if more than fifty percent of the fair market value of the real property is located within this state. If more than fifty percent of the fair market value of the real property is not located within any one state, then the receipts described in this subdivision shall be included in the numerator of the

receipts factor if the borrower is located in this state.

(2) A loan is secured by real property if fifty percent or more of the principal amount of the loan is specifically and directly secured by real property at the time that the original principal amount of the loan is secured by real property at the time that the original loan agreement was made.

(3) The determination of whether the real property securing a loan is located within this state shall be made as of the time the original agreement was made and any and all subsequent substitutions of collateral shall be disregarded.

(e) **Interest from loans not secured by real property.** The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from loans not secured by real property if the borrower is located in this state.

(f) **Net gains from the sale of loans.** The numerator of the receipts factor includes net gains from the sale of loans, ~~including participations and syndications.~~ Net gains from the sale of loans includes income recorded under the coupon stripping rules of section 1286 of the Internal Revenue Code.

(1) The amount of net gains (but not less than zero) from the sale of loans secured by real property included in the numerator is determined by multiplying such net gains by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subdivision (d) of this section and the denominator of which is the total amount of interest and fees or penalties in the nature of interest from loans secured by real property.

(2) The amount of net gains (but not less than zero) from the sale of loans not secured by real property included in the numerator is determined by multiplying such net gains by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subdivision (e) of this section and the denominator of which is the total amount of interest and fees or penalties in the nature of interest from loans not secured by real property.

(g) **Receipts from credit card receivables.** The numerator of the receipts factor includes interest and fees or penalties in the nature of interest from credit card receivables and receipts from fees charged to card holders, such as annual fees, if the billing address of the card holder is in this state.

(h) **Net gains from the sale of credit card receivables.** The numerator of the receipts factor includes ~~all~~ net gains (but not less than zero) from the sale of credit card receivables multiplied by a fraction, the numerator of which is the amount included in the numerator of the receipts factor pursuant to subdivision (g)

of this section and the denominator of which is the taxpayer's total amount of interest and fees or penalties in the nature of interest from credit card receivables and fees charged to card holders.

(i) **Credit card issuer's reimbursement fees.** The numerator of the receipts factor includes all credit card issuer's reimbursement fees multiplied by a fraction, the numerator of which is the amount included in the numerator of the receipts factor pursuant to subdivision (g) of this section and the denominator of which is the taxpayer's total amount of interest and fees or penalties in the nature of interest from credit card receivables and fees charged to card holder~~card holders~~.

(j) **Receipts from merchant discount.** The numerator of the receipts factor includes receipts from merchant discount if the commercial domicile of the merchant is in this state. Such receipts shall be computed net of any cardholder charge backs, but shall not be reduced by any interchange transaction fees or by any issuer's reimbursement fees paid to another for charges made by its card holders.

(k) **Loan servicing fees.**

(1) The numerator of the receipts factor includes loan servicing fees derived from loans secured by real property multiplied by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subdivision (d) of this section and the denominator of which is the total amount of interest and fees or penalties in the nature of interest from loans secured by real property.

(2) The numerator of the receipts factor includes loan servicing fees derived from loans not secured by real property multiplied by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subdivision (e) of this section and the denominator of which is the total amount of interest and fees or penalties in the nature of interest from loans not secured by real property.

(l) **Receipts from services.** The numerator of the receipts factor includes receipts from services not otherwise apportioned under this section if the service is performed in this state. If the service is performed both within and without this state, the numerator of the receipts factor includes receipts from services not otherwise apportioned under this section, if a greater proportion of the income-producing activity is performed in this state based on cost of performance.

(m) **Receipts from investment assets and activities and trading assets and activities.**

(1) Interest, dividends, net gains and other income from investment assets and activities and from trading assets and activities shall be included in the receipts factor. Investment assets and activities and trading assets and activities include but are not limited to: investment securities; trading account assets; federal funds; securities purchased and sold under agreements to resell or repurchase; options; future contracts; forward contracts; notional principal contracts such as swaps; equities; and foreign currency transactions. With respect to the investment and trading assets and activities described in subparagraphs (A) and (B) of this paragraph, the receipts factor shall include the amounts described in such subparagraphs.

(A) The receipts factor shall include the amount by which interest from federal funds sold and securities purchased under resale agreements exceeds interest expense on federal funds purchased and securities sold under repurchase agreements.

(B) The receipts factor shall include the amount by which interest, dividends, net gains and other income from trading assets and activities, including but not limited to assets and activities in the matched book, in the arbitrage book, and foreign currency transactions, exceed interest expense from securities sold not yet purchased and net losses from such assets and activities.

(2) The numerator of the receipts factor includes interest, dividends, net gains and other income from investment assets and activities and from trading assets and activities described in paragraph (1) that are attributable to this state.

(A) The amount of interest, dividends, net gains and other income from investment assets and activities in the investment account to be attributed to this state and included in the numerator of the receipts factor is determined by multiplying all such income from such assets and activities by a fraction, the numerator of which is the average value of such assets which are properly booked ~~for tax purposes~~ at a regular place of business of the taxpayer within this state and the denominator of which is the average value of all such assets.

(B) The amount of interest from federal funds sold and purchased and from securities purchased under resale agreements and securities sold under repurchase agreements attributable to this state and included in the numerator of the receipts factor is determined by multiplying the amount described in subparagraph (A) of paragraph (1) from such funds and such securities by a fraction, the numerator of which is the average value of federal funds sold and securities purchased under agreements to resell which are properly booked ~~for tax purposes~~ at a regular place of business of the taxpayer within this state and the denominator of which is the average value of all such funds and such securities.

(C) The amount of interest, dividends, net gains and other income from trading assets and activities, including but not limited to assets and activities in the matched book, in the arbitrage book and foreign currency transactions (but excluding amounts described in subparagraphs (A) or (B) of this paragraph), attributable to this, but excluding federal funds sold and purchased, attributable to this state and included in the numerator of the receipts factor is determined by multiplying the amount described in subparagraph (B) of paragraph (1) by a fraction, the numerator of which is the average value of such trading assets which are properly booked ~~for tax purposes~~ at a regular place of business of the taxpayer within this state and the denominator of which is the average value of all such assets.

(D) For purposes of this paragraph, average value shall be determined using the rules for determining the average value of tangible personal property set forth in subdivisions (c) and (d) of section ~~four~~five.

(3) In lieu of using the method set forth in paragraph (2) of this subdivision, the taxpayer may elect, or the State Tax Administrator may require in order to fairly represent the business activity of the taxpayer in this state, the use of the method set forth in this paragraph.

(A) The amount of interest, dividends, net gains and other income from investment assets and activities in the investment account to be attributed to this state and included in the numerator of the receipts factor is determined by multiplying all such income from such assets and activities by a fraction, the numerator of which is the gross income from such assets and activities which are properly booked ~~for tax purposes~~ at a regular place of business of the taxpayer within this state and the denominator of which is the gross income from all such assets and activities.

(B) The amount of interest from federal funds sold and purchased and from securities purchased under resale agreements and securities sold under repurchase agreements attributable to this state and included in the numerator of the receipts factor is determined by multiplying the amount described in subparagraph (A) of paragraph (1) from such funds and such securities by a fraction, the numerator of which is the gross income from such funds and such securities which are properly booked ~~for tax purposes~~ at a regular place of business of the taxpayer within this state and the denominator of which is the gross income from all such funds and such securities.

(C) The amount of interest, dividends, net gains and other income from trading ~~account~~ assets and activities, including but not limited to assets

and activities in the matched book, in the arbitrage book and foreign currency transactions (but excluding amounts described in subparagraphs (A) or (B) of this paragraph), attributable to this state and included in the numerator is ~~determined~~ transactions, attributable to this state and included in the numerator is determined by multiplying the amount described in subparagraph (B) of paragraph (1) by a fraction, the numerator of which is the gross income from such trading assets and activities which are properly booked for tax purposes at a regular place of business of the taxpayer within this state and the denominator of which is the gross income from all such assets and activities.

(4) If the taxpayer elects or is required by the State Tax Administrator to use the method set forth in paragraph (3) of this subdivision, it shall use this method on all subsequent returns unless the taxpayer receives prior written permission from the State Tax Administrator, or the State Tax Administrator requires, the use of a different method.

(5) The taxpayer shall have the burden of proving that an investment asset or activity or trading asset or activity was properly booked for tax purposes at a regular place of business outside of this state by demonstrating that the day-to-day decisions regarding the asset or activity occurred at a regular place of business outside the state. Where the day-to-day decisions regarding an investment asset or activity or trading asset or activity occur at more than one regular place of business and one such regular place of business is in this state and one such regular place of business is outside this state, such asset or activity shall be considered to be located at the regular place of business of the taxpayer where the investment or trading policies or guidelines with respect to the asset or activity are established. Unless the taxpayer demonstrates to the contrary, such policies and guidelines shall be presumed to be established:

(A) in the case of a taxpayer organized under the laws of the United States or of any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico or any territory or possession of the United States, at the commercial domicile of the taxpayer; or

(B) in the case of a taxpayer organized under the laws of a foreign country, in the state which the taxpayer has declared to be its home state pursuant to the provisions of the International Banking Act of 1978. If a taxpayer described in this clause has not made such a declaration or is not required to make such a declaration, the asset or activity shall be presumed to be located at the taxpayer's place of business in the United States to which the greatest number of employees are regularly connected or out of which they are working, irrespective of where the services of such employee are performed, as of the last day of the taxable year.



(n) **All other receipts.** The numerator of the receipts factor includes all other receipts pursuant to the rules set forth in ... [INSERT YOUR STATE'S REGULAR SITUSING RULES FOR THE RECEIPTS NOT COVERED BY THIS SECTION.]

(o) **Attribution of certain receipts to commercial domicile.** All receipts which would be assigned under this section to a state in which the taxpayer is not taxable shall be included in the numerator of the receipts factor, if the taxpayer's commercial domicile is in this state.

#### Section 45. Property Factor

(a) **General.** ~~The property factor is a fraction, the numerator of which is the average value of the taxpayer's real property, tangible personal property, loans and credit card receivables located and used<sup>9</sup> within this state during the taxable year and the denominator of which is the average value of all such property located and used both within and without this state during the taxable year.~~ The property factor is a fraction, the numerator of which is the average value of real property and tangible personal property rented to the taxpayer that is located and used within this state during the taxable year, the average value of the taxpayer's real property owned and tangible personal property owned that is located and used within this state during the taxable year, and the average value of the taxpayer's loans and credit card receivables that are located within this state during the taxable year, and the denominator of which is the average value of all such property located and, with respect to real and tangible personal property, used both within and without this state during the taxable year.

(b) **Property included.** The property factor shall include only property the income or expenses of which are included (or would have been included if not fully depreciated or expensed, or depreciated or expensed to a nominal amount) in the computation of the apportionable income base for the taxable year.

(c) **Value of property owned by the taxpayer.**

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<sup>9</sup> *While the phrase "located and used" quite applicable with regard to real and tangible personal property, it is much less so with regard to intangibles such as loans and credit card receivables. This provision is not intended to condition the location or assignment of these intangibles on their use in the state. With regard to these intangibles, the location of the intangible will control and their use, for example where the proceeds of a loan are applied or where the interest payment or loan repayment may be made, are neither relevant nor operative.*

(1) The value of real property and tangible personal property owned by the taxpayer is the original cost or other basis of such property for Federal income tax purposes without regard to depletion, depreciation or amortization.

(2) Loans are valued at their outstanding principal balance, without regard to any reserve for bad debts. If a loan is charged-off in whole or in part for Federal income tax purposes, the portion of the loan charged off is not outstanding. A specifically allocated reserve established pursuant to regulatory or financial accounting guidelines which is treated as charged-off for Federal income tax purposes shall be treated as charged-off for purposes of this section.

(3) Credit card receivables are valued at their outstanding principal balance, without regard to any reserve for bad debts. If a credit card receivable is charged-off in whole or in part for Federal income tax purposes, the portion of the receivable charged-off is not outstanding.

(d) **Average value of property owned by the taxpayer.** The average value of property owned by the taxpayer is computed on an annual basis by adding the value of the property on the first day of the taxable year and the value on the last day of the taxable year and dividing the sum by two. If averaging on this basis does not properly reflect average value, the State Tax Administrator may require averaging on a more frequent basis. The taxpayer may elect to average on a more frequent basis. When averaging on a more frequent basis is required by the State Tax Administrator or is elected by the taxpayer, the same method of valuation must be used consistently by the taxpayer with respect to property within and without the state and on all subsequent returns unless the taxpayer receives prior written permission from the State Tax Administrator or the State Tax Administrator requires a different method of determining average value.

(e) **Average value of real property and tangible personal property rented to the taxpayer.**

(1) The average value of real property and tangible personal property that the taxpayer has leased from another and which is not treated as property owned by the taxpayer for Federal income tax purposes, shall be determined annually by multiplying the gross rents payable during the taxable year by eight.

(2) Where the use of the general method described in this subdivision results in inaccurate valuations of rented property, any other method which properly reflects the value may be adopted by the State Tax Administrator or by the taxpayer when approved in writing by the State Tax Administrator. Once approved, such other method of valuation must be used on all subsequent returns unless the

taxpayer receives prior written approval from the State Tax Administrator or the State Tax Administrator requires a different method of valuation.

**(f) Location of real property and tangible personal property owned by or rented to the taxpayer.**

(1) Except as described in paragraph (2) of this subdivision, real property and tangible personal property owned by or rented to the taxpayer is considered to be located within this state if it is physically located, situated or used within this state.

(2) Movable tangible property, such as aircraft, rolling stock, water vessels, or mobile equipment, are included in the numerator of the property factor to the extent that the property is used in this state. The extent an aircraft will be deemed to be used in this state and the amount of value that is to be included in the numerator of this state's property factor is determined by multiplying the average value of the aircraft by a fraction, the numerator of which is the number of landings of the aircraft in this state and the denominator of which is the total number of landings of the aircraft everywhere. If the extent of the use of any movable tangible property within this state cannot be determined, then the property will be deemed to be used wholly in the state in which the property has its principal base of operations. A motor vehicle will be deemed to be used wholly in the state in which it is registered.

**(g) Location of loans.**

(1) (A) A loan is considered to be located within this state if -

(i) it is properly booked ~~for tax purposes~~ at a regular place of business of the taxpayer within this state; or

(ii) in the case of a taxpayer organized under the laws of the United States or of any state, the loan is properly booked ~~for tax purposes~~ at a place which is not a regular place of business of the taxpayer and such taxpayer's commercial domicile is within this state of the United States, the District of Columbia, the Commonwealth of Puerto Rico or any territory or possession of the United States; or

(iii) in the case of a taxpayer organized under the laws of a foreign country, the loan is properly booked ~~for tax purposes~~ at a place which is not a regular place of business of the taxpayer and such taxpayer has declared this state to be its home state pursuant to the provisions of the International Banking Act of 1978. If a taxpayer described in this clause has not made such a declaration or is not required to make such a declaration, the loan shall be presumed to be located at the

place in the United States to which the greatest number of employees are regularly connected or out of which they are working, irrespective of where the services of such employee are performed, as of the last day of the calendar year.

(B) The state in which a loan has a preponderance of substantive contact ~~with a regular place of business of the taxpayer~~ shall be the state in which a loan is properly booked.<sup>§19</sup>

(h) **Location of credit card receivables.** For purposes of determining the location of credit card receivables, credit card receivables shall be treated as loans and shall be subject to the provisions of subdivision (g) of this section.

Section 56. Payroll factor.

(a) **General.** The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the taxable year by the taxpayer for compensation and the denominator of which is the total compensation paid both within and without this state during the taxable year. The payroll factor shall include only that compensation which is included in the computation of the taxpayer's apportionable income tax base for the taxable year.

(b) **Compensation relating to nonbusiness income and independent contractors.**

The compensation of any employee for services or activities which are connected with the production of nonbusiness income (income which is not included in the apportionable income base) and payments made to any independent contractor or any other person not properly classifiable as an employee shall be excluded from both the numerator and denominator of the factor.

(c) **When compensation paid in this state.** Compensation is paid in this state if any one of the following tests, applied consecutively, is met:

(1) The employee's services are performed entirely within this state.

(2) The employee's services are performed both within and without the state, but the service performed without the state is incidental to the employee's service within the state. The term "incidental" means any service which is

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<sup>§19</sup> The phrase "preponderance of substantive contact" used in Section 45(g)(1)(B) to locate loans and credit card receivables requires further definition normally left for inclusion in regulations supporting the statute. Regulatory language is suggested at Appendix D.

temporary or transitory in nature, or which is rendered in connection with an isolated transaction.

(3) If the employee's services are performed both within and without this state, the employee's compensation will be attributed to this state:

- (A) if the employee's principal base of operations is within this state; or
- (B) if there is no principal base of operations in any state in which some part of the services are performed, but the place from which the services are directed or controlled is in this state; or
- (C) if the principal base of operations and the place from which the services are directed or controlled are not in any state in which some of the service is performed but the employee's residence is in the state~~if the principal base of operations or the place from which the services are directed or controlled is not in any state in which some part of the service is performed but the employee's residence is in this state.~~

## **APPENDIX A.**

### **Suggested Regulation - "Basis of information included in apportionment factors".**

At the election of the taxpayer, the information used in the calculation of the apportionment factors as provided in Sections 4 through 6 [of the Act] may be based either upon information contained in the taxpayer's financial books and records (book basis) or in the taxpayer's federal income tax return (tax basis), so long such information used fairly represents the extent of the taxpayer's activities in the state. Once such election is made of either book basis or tax basis, such basis shall be used by the taxpayer for all future years, unless permission is obtained in writing from the State Tax Administrator to use another basis.

## APPENDIX B

**Suggested definition of "financial institution" - [The following definition of "financial institution" is offered solely as a guide for those states that wish to follow it. It is to be emphasized that the pending proposal is one that is designed to assign uniformly the net income of a financial institution as that term may be defined by a state.]**

Term: Financial Institution.

"Financial institution" includes:

- (a) Any corporation or other business entity registered under state law as a bank holding company or registered under the Federal Bank Holding Company Act of 1956, as amended, or registered as a savings and loan holding company under the Federal National Housing Act, as amended;
- (b) A national bank organized and existing as a national bank association pursuant to the provisions of the National Bank Act, 12 U.S.C. §§21 et seq.;
- (c) A federal savings and loan association;
- (d) Any bank or thrift institution incorporated or organized under the laws of any state;
- (e) A mutual savings bank incorporated or organized under the laws of the United States or of any state;
- (f) Any corporation organized under the provisions of 12 U.S.C. 611 to 631.
- (g) Any agency or branch of a foreign depository as defined in 12 U.S.C. 3101;
- (h) A credit union;
- (i) A production credit association organized under the Federal Farm Credit Act of 1933, all of whose stock held by the Federal Production

Credit Corporation has been retired;

(j) Any corporation whose voting stock is more than fifty percent (50%) owned, directly or indirectly, by any person or business entity described in subsections (a) through (i) above other than an insurance company taxable under [insert applicable state statute] or a \_\_\_\_\_ company taxable under [insert applicable state statute];

(k) A corporation or other business entity that derives more than fifty percent (50%) of its total gross income ~~for from~~ financial accounting purposes from finance leases. For purposes of this subsection, a "finance lease" shall mean -

any lease transaction which is the functional equivalent of an extension of credit and that transfers substantially all of the benefits and risks incident to the ownership of property. The phrase shall include any "direct financing lease" or "leverage lease" that meets the criteria of Financial Accounting Standards Board Statement No. 13, "Accounting for Leases" or any other lease that is accounted for as a financing by a lessor under generally accepted accounting principles.

For this classification to apply,

(i) the average of the gross income in the current tax year and immediately preceding two tax years must satisfy the more than fifty percent (50%) requirement; and

(ii) gross income from incidental or occasional transactions shall be disregarded; or

(l) Any other person or business entity which derives more ~~than that~~ fifty percent (50%) of its gross income from activities that a person described in subsections (b) through (i) above is authorized to transact. For the purpose of this subsection, the computation of gross income shall not include income from nonrecurring, extraordinary items.



## APPENDIX C.

### **Suggested Regulation - "Gross rents described." (Section 3.(i)).**

"Gross rents" shall include, but not be limited to:

(1) any amount payable for the use or possession of real property or tangible property whether designated as a fixed sum of money or as a percentage of receipts, profits or otherwise,

(2) any amount payable as additional rent or in lieu of rent, such as interest, taxes, insurance, repairs or any other amount required to be paid by the terms of a lease or other arrangement, and

(3) a proportionate part of the cost of any improvement to real property made by or on behalf of the taxpayer which reverts to the owner or lessor upon termination of a lease or other arrangement. The amount to be included in gross rents is the amount of amortization or depreciation allowed in computing the taxable income base for the taxable year. However, where a building is erected on leased land by or on behalf of the taxpayer, the value of the land is determined by multiplying the gross rent by eight and the value of the building is determined in the same manner as if owned by the taxpayer.

(4) The following are not included in the term "gross rents":

(i) amounts payable as separate charges for water and electric service furnished by the lessor;

(ii) amounts payable as service charges, such as janitorial services, furnished by the lessor;

(iii) amounts payable for storage, provided such amounts are payable for space not designated and not under the control of the taxpayer; and

(iv) that portion of any rental payment which is applicable to the space subleased from the taxpayer and not used by it.

## APPENDIX D.

### **Suggested Regulation - "Preponderance of substantive contact for locating certain loans and credit card receivables; presumption." (Section 5(g)(1)(B)).**

(1) In order to determine the state in which loans or credit card receivables are properly booked under the "preponderance of substantive contact" test for the purpose of locating said property under Section 5(g)(1)(B), consideration is to be given to such things as: solicitation, investigation, negotiation, approval and administration. The terms "solicitation", "investigation", "negotiation", "approval" and "administration" are defined as follows.

(A) *Solicitation*. Solicitation is either active or passive. Active solicitation occurs when an employee of the taxpayer initiates the contact with the customer. Such activity is located at the regular place of business which the taxpayer's employee is regularly connected with or working out of, regardless of where the services of such employee were actually performed. Passive solicitation occurs when the customer initiates the contact with the taxpayer. If the customer's initial contact was not at a regular place of business of the taxpayer, the regular place of business, if any, where the passive solicitation occurred is determined by the facts in each case.

(B) *Investigation*. Investigation is the procedure whereby employees of the taxpayer determine the credit-worthiness of the customer as well as the degree of risk involved in making a particular agreement. Such activity is located at the regular place of business which the taxpayer's employees are regularly connected with or working out of, regardless of where the services of such employees were actually performed.

(C) *Negotiation*. Negotiation is the procedure whereby employees of the taxpayer and its customer determine the terms of the agreement (e.g., the amount, duration, interest rate, frequency of repayment, currency denomination and security required). Such activity is located at the regular place of business which the taxpayer's employees are regularly connected with or working out of, regardless of where the services of such employees were actually performed.

(D) *Approval*. Approval is the procedure whereby employees or the board of directors of the taxpayer make the final determination whether to enter into the agreement. Such activity is located at the regular place of business which the taxpayer's employees are regularly connected with or working out of, regardless of where the services of such employees were actually performed. If the board of

directors makes the final determination, such activity is located at the commercial domicile of the taxpayer.

(E) *Administration.* Administration is the process of managing the account. This process includes bookkeeping, collecting the payments, corresponding with the customer, reporting to management regarding the status of the agreement and proceeding against the borrower or the security interest if the borrower is in default. Such activity is located at the regular place of business which oversees this activity.

(2) In applying the standards for determining the state to which a loan is to be located, a preponderance of substantive contact shall be presumed to exist at the taxpayer's regular place of business to which it has been booked, if the loan is approved and administered there. ~~In applying the standards for determining the state to which a loan is to be located, a preponderance of substantive contact shall be presumed, subject to rebuttal, to exist at a taxpayer's regular place of business to which it has been booked, if the loan is approved and administered there.~~<sup>211</sup>

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<sup>211</sup> It was urged by some of the industry representatives that a presumption or convention of sorts be adopted to reduce the opportunity for more than one state to assign the same loan or credit card receivable to itself. Since the suggested property factor favors money-center state assignment for intangible property, the suggested preference here is consistent with that approach.

**EXHIBIT J: 33:**

**Letter from Brenda Jo Seipel  
(Credit Union National Association, Inc.)  
(August 11, 1993)**



**CUNA & Affiliates**

*A Member of the Credit Union System*

**Credit Union  
National Association, Inc.**

Suite 300  
805 15th Street NW  
Washington, D.C.  
20005-2207

Telephone:  
(202) 682-4200

August 11, 1993

Mr. Alan H. Friedman  
General Counsel  
Multistate Tax Commission  
119 Scenic Drive  
Redwood City, CA 94062

Dear Mr. Friedman:

On behalf of CUNA & Affiliates (CUNA), I want to thank you for the opportunity to testify July 15, 1993, on MTC's proposed regulation for the apportionment and allocation of net income of financial institutions.

As evidenced by our testimony, credit unions differ in many aspects from other providers of financial services. Credit unions are member-owned, not-for-profit cooperatives formed to permit those in the field of membership, specified by charter, to save, borrow and obtain related financial services. Members are united by a common bond and democratically operate the credit union under state or federal statute.

CUNA, representing the interests of the nation's 13,400 state and federal credit unions and their 65 million members, urges the MTC to exempt credit unions from the proposed definition of financial institutions which may be subject to the apportionment formulas. Both federal and state law, with the exception of Indiana, establish a statutory framework that recognizes the unique nature of credit unions and exempts them from income taxes.

As you indicated during the hearing, many fail to understand the unique differences of credit unions and essential function of this tax exemption, and continue to advocate the elimination of their tax exempt status. Proponents of taxation for credit unions contend that due to their "sheer growth", they should be taxed as a matter of competitive equity. This contention is wrong both in principal and in fact.

It is true that credit unions have grown. This growth is consistent with the general growth in the economy and primarily because of credit unions' dedication to the interests of their members. However, despite this growth, credit unions are still very small relative to banks. Credit unions had \$191.3 billion in assets at year-end 1992, compared to \$2,945.3 billion at commercial banks (see Chart #1).

Page 2  
August 11, 1993

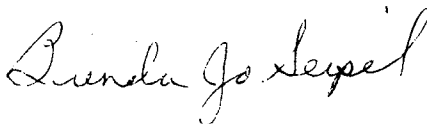
While the banks' share of the market has fallen from 34.2% in 1988 to 32.2% in 1992, credit unions' 2% market share has been the same for some years. Obviously, to find the explanation for the decrease in the banking market share, you must obviously look beyond credit unions as competition to other intermediaries, such as insurance companies and the various mutual funds (see Chart #2).

Most credit unions still remain relatively small organizations - an effect of the common bond requirement (see Chart #3). There are a few, however, that have grown large in size simply because their potential field of membership is large. For example, a number of larger credit unions serve the nation's government employees and the military personnel of the country. It is interesting to note that the average member's income is modest and the average deposit is small at these credit unions.

Credit unions, regardless of asset size or number of members served, still operate on the same principles of "not-for-profit, but for service," serving principally the consumer credit and savings market.

CUNA appreciates the MTC's consideration of arguments supporting credit unions' exemption from your proposed regulation. If you have any questions or need further information, please do not hesitate to contact me.

Sincerely yours,



Brenda Jo Seipel  
Vice President  
State Governmental Affairs

BJS/pmy

3 Enclosures

*Alan. Could you please send me  
information on the Sept  
30th hearing?*

## CHART #1

## U.S. Financial Assets (\$Billions)

As of December...	1988	1989	1990	1991	1992
<b>Commercial banks</b>	\$2,476.3	\$2,644.0	\$2,769.4	\$2,853.3	\$2,945.3
U.S. commercial banks	\$2,231.9	\$2,368.4	\$2,463.6	\$2,502.5	\$2,571.9
Foreign banking offices	\$215.6	\$242.3	\$270.8	\$319.2	\$335.8
Bank affiliates	\$13.4	\$16.2	\$13.4	\$11.9	\$17.6
Banks in U.S. possession	\$15.4	\$17.1	\$21.6	\$19.7	\$20.0
<b>Savings &amp; loans</b>	\$1,184.2	\$1,088.9	\$945.1	\$804.2	\$727.5
Mutual savings banks	\$240.6	\$241.1	\$227.1	\$211.5	\$210.2
Credit unions	\$147.2	\$154.9	\$163.4	\$174.9	\$191.3
<b>Insurance</b>	\$1,932.6	\$2,140.2	\$2,328.2	\$2,674.8	\$2,855.8
Life insurance cos.	\$920.0	\$1,013.1	\$1,116.5	\$1,199.6	\$1,289.4
Other insurance cos.	\$287.9	\$317.5	\$344.0	\$378.7	\$396.0
Private pension funds	\$358.5	\$394.7	\$431.3	\$622.2	\$661.1
St & loc govt retirement funds	\$366.2	\$414.9	\$437.4	\$474.3	\$509.3
<b>Other</b>	\$1,257.5	\$1,554.5	\$1,809.5	\$1,990.7	\$2,228.2
Finance companies	\$559.2	\$617.1	\$658.7	\$635.6	\$656.9
Mutual funds	\$283.4	\$307.2	\$360.2	\$450.5	\$582.8
Money market funds	\$224.7	\$291.8	\$372.7	\$402.7	\$404.1
REITs	\$7.8	\$8.4	\$7.7	\$7.0	\$7.4
Brokers & Dealers	\$46.7	\$142.9	\$177.9	\$226.9	\$267.1
Securzd credit oblig. Issuers	\$135.7	\$187.1	\$232.3	\$268.0	\$309.9
<b>Total Assets (\$Billion)</b>	<b>\$7,238.4</b>	<b>\$7,823.6</b>	<b>\$8,243.7</b>	<b>\$8,709.4</b>	<b>\$9,158.3</b>

Source: Federal Reserve Bulletin.

CHART #2

Market Shares of Financial Assets

As of December....	1988	1989	1990	1991	1992
Commercial banks	34.2%	33.8%	33.6%	32.8%	32.2%
U.S. commercial banks	30.8%	30.3%	29.9%	28.7%	28.1%
Foreign banking offices	3.0%	3.1%	3.3%	3.7%	3.7%
Bank affiliates	0.2%	0.2%	0.2%	0.1%	0.2%
Banks in U.S. possession	0.2%	0.2%	0.3%	0.2%	0.2%
Savings & loans	16.4%	13.9%	11.5%	9.2%	7.9%
Mutual savings banks	3.3%	3.1%	2.8%	2.4%	2.3%
Credit unions	2.0%	2.0%	2.0%	2.0%	2.1%
Insurance	26.7%	27.4%	28.3%	30.7%	31.2%
Life insurance cos.	12.7%	12.9%	13.5%	13.8%	14.1%
Other insurance cos.	4.0%	4.1%	4.2%	4.3%	4.3%
Private pension funds	5.0%	5.0%	5.2%	7.1%	7.2%
St & loc govt retirement funds	5.1%	5.3%	5.3%	5.4%	5.6%
Other	17.4%	19.9%	22.0%	22.9%	24.3%
Finance companies	7.7%	7.9%	8.0%	7.3%	7.2%
Mutual funds	3.9%	3.9%	4.4%	5.2%	6.4%
Money market funds	3.1%	3.7%	4.5%	4.6%	4.4%
REITs	0.1%	0.1%	0.1%	0.1%	0.1%
Brokers & Dealers	0.6%	1.8%	2.2%	2.6%	2.9%
Secrtzd credit oblig. issuers	1.9%	2.4%	2.8%	3.1%	3.4%
Total Assets (\$Billion)	\$7,238.4	\$7,823.6	\$8,243.7	\$8,709.4	\$9,158.3

Source: Federal Reserve Bulletin



CHART #3

Year-End 1992 Operating Ratios By Assets

Table 25a

Sample Information

By Asset Size (\$ in Millions)	Number Of Credit Unions In Sample	Percent Of Credit Unions	Assets Per Credit Union (\$ in Millions)	Members Per Credit Union	Members/ Potential Members
0.0 - 0.5	1,745	15.4 %	\$ 0.26	246	31.2 %
0.5 - 1.0	1,258	9.7	0.74	456	32.4
1.0 - 2.0	1,687	12.8	1.46	732	36.6
2.0 - 5.0	2,555	19.7	3.21	1,323	36.0
5.0 - 10.0	1,866	14.4	7.17	2,363	37.7
10.0 - 20.0	1,487	11.6	14.30	4,249	30.4
20.0 - 50.0	1,346	10.4	31.45	8,344	31.4
50.0 - 100.0	531	4.1	69.75	17,114	25.1
100.0 - 200.0	318	2.4	139.25	29,713	34.0
200.0 and Over	214	1.6	444.82	77,183	35.6
<b>Total</b>	<b>12,988</b>	<b>100.0 %</b>	<b>\$ 20.40</b>	<b>4,822</b>	<b>33.1 %</b>

Year-End 1992 Operating Ratios By Assets

Table 25b

Population Projections

By Asset Size (\$ in Millions)	Projected Number Of Credit Unions	Assets (\$ Billions)	Percent Of Assets	Members (Millions)	Percent Of Members
0.0 - 0.5	1,799	\$ 0.45	0.2 %	0.44	0.7 %
0.5 - 1.0	1,298	0.94	0.3	0.59	0.9
1.0 - 2.0	1,717	2.47	0.9	1.24	1.9
2.0 - 5.0	2,632	3.57	3.2	3.44	5.4
5.0 - 10.0	1,922	13.55	5.0	4.49	7.0
10.0 - 20.0	1,532	21.54	8.0	6.44	10.1
20.0 - 50.0	1,388	42.87	15.9	11.43	17.3
50.0 - 100.0	547	37.53	13.9	9.26	14.5
100.0 - 200.0	323	44.88	18.7	6.63	15.1
200.0 and Over	220	93.47	35.8	16.83	25.4
<b>Total</b>	<b>13,379</b>	<b>\$ 269.28</b>	<b>100.0 %</b>	<b>83.79</b>	<b>100.0 %</b>

SOURCE: CUNA'S ECONOMICS & RESEARCH DEPARTMENT

**EXHIBIT J: 34:**

**Letter from Ron Schreiner  
(Secretary of Revenue of South Dakota)  
(September 28, 1993)**



DEPARTMENT OF REVENUE

September 28, 1993

Alan H. Friedman, Hearing Officer  
Multistate Tax Commission  
386 University Ave  
Los Altos CA 94022

RE: PROPOSED MULTISTATE TAX COMM. REGULATION VI.18.(i)

Dear Mr. Friedman:

This letter is intended as public input from the South Dakota Department of Revenue regarding the above referenced proposed regulation. Our continuing opposition to the concept and general approach of the regulation in regard to the allocation of credit card interest and merchant fees to the domicile of the card holder/merchant is well established! We see no reason to repeat it here. Our comments will thus be confined to certain of the issues enumerated in your Notice of Public Hearing in the desire that should this regulation be adopted over our objections, it will contain some protection for states such as South Dakota.

Item 1. In addition to including banks chartered either Federally or by the states, savings banks, finance companies, mortgage banks etc., the definition should be sufficiently broad to cover entities which operate in direct competition to or provide substantially similar services as banks. The definition set forth at Appendix B appears sufficiently comprehensive though there may be some concern over the arbitrary nature of a 50% of income test as it applies to 'leasing' companies.

Item 2. South Dakota has testified in favor of a "cost of performance" or source state approach on several preceding occasions and will stand on our record in regard to this issue.

Item 3. Our position would be that such intangible property should be allocated to the state where it is properly booked.

GREAT FACES. GREAT PLACES.


This property constitutes assets of the taxpayer and is owned, managed by and has most other substantive contact with that state. See Item 7 for our position on the treatment of certain intangibles for purposes of the property factor.

Item 6. The inclusion of a throwback provision is strongly encouraged. This is an appropriate response to our earlier contention that the concept of the rule promotes 'nowhere income' and allows the clever taxpayer to escape assessment because of confusion over the allocation formula or through suspect accounting methods. ((However, We would prefer the definition of 'taxable in another state' at section 3 (q) be amended to exclude subdivision (2) so that income would be thrown back to the domiciliary state if the other state did not in fact tax these receipts.)) This would most effectively eliminate nowhere income. ((Jurisdictional questions arising from this narrow definition would be easier to resolve than the confusion that results from having to make educated guesses under (2) or the temptation to exclude the receipts altogether.))

Item 7. We would urge the Commission to delay adoption or implementation of the regulation until such time as a predetermined number of states (20 has been seriously discussed) have individually adopted a market state approach to income allocation. If the number is set at a realistic level, this trigger mechanism would insure that critical mass is present before plunging both the states and industry into the throes of change and contention.

We would support the Commission in its adoption of a property factor which allocates loans and credit card receivables to the state in which they are properly booked. This straight forward method of allocation promotes simplicity, and certainty. Further, it eliminates the duplication of elements between the receipts factor and the property factor which occurs when income from loans and credit card receivables are sourced to the residence of the borrower under the receipts factor and it reestablishes the property factor as an independent factor.

Sincerely yours,



Ron Schreiner  
SECRETARY OF REVENUE

**EXHIBIT J: 35:**

**Letter from John B. Rice  
(Coopers & Lybrand)  
(September 28, 1993)**

**Exhibit J35 is missing**

**EXHIBIT J: 36:**

**Testimony of Linda A. Kern  
(American Bankers Association)  
(September 30, 1993)**

Statement of  
LYNDA A. KERN  
on behalf of the  
AMERICAN BANKERS ASSOCIATION  
concerning the  
MULTISTATE TAX COMMISSION'S  
Proposed Regulation Apportioning the Income  
of Financial Institutions

September 30, 1993

On behalf of the American Bankers Association (ABA), I am pleased to appear at this hearing to present the ABA's views on the proposed regulation apportioning the income of financial institutions, as contained in the Hearing Officer's Interim Report of May 10, 1993. My name is Lynda A. Kern, Vice President-Taxation, AmSouth Bank NA, Birmingham Alabama, and Chairperson of the ABA Taxation Committee. The ABA is the national trade and professional association for America's commercial banks. ABA members include banks of all sizes and types -- community banks, regional banks, and money center institutions. The assets of ABA member banks are approximately ninety percent of the industry total.

The ABA testimony on this subject in 1990 reflected the strong concerns of the banking industry that the primary effect of the MTC project was to facilitate market state taxation of banks, even where the state law forbids out-of-state banks from having a physical location in the market state. Even today we still do not have a court decision on the constitutional law issue of whether the states can apply an income tax on out-of-state banks based solely on the location of the customer, or in other words based solely on economic presence. That legal issue cannot be resolved at this hearing, so my testimony today will focus on other issues.

The circumstances under which banks do business outside of their home states are changing, albeit at an uneven pace. Federal laws adopted many years ago effectively restrict nationwide banking.<sup>1</sup> In the last decade, the principal development has been interstate acquisitions of banks under initiatives in several states which authorize regional reciprocal

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<sup>1</sup> The McFadden Act (12 U.S.C. 36) restricts interstate branching by national banks to those states which authorize branching by state banks. The Douglas Amendment (12 U.S.C. 1843(d)) prohibits a bank holding company from acquiring a bank in another state unless expressly authorized by state law. There is an exception (12 U.S.C. 1823(f)), enacted in 1982, which permits acquisitions of failing institutions.



bank acquisitions, upheld by the Supreme Court. My own bank holding company has acquired financial institutions in Tennessee, Florida and Georgia. Thus, AmSouth, like many other banks, already pays taxes in states outside its home state, albeit through subsidiary banks in those states.

Banks and holding companies have also long served customers in states where they have no physical location, based on customer choice. Both depositors and borrowers have always been free to patronize banks in other states, conducting business by mail or travelling to the bank. Often bank customers move outside their bank's market area, but wish to retain their relationship with the bank. While credit card operations were initially franchised to serve market areas, the growth of nationwide credit card operations is now the most common form of bank lending across state lines. If the market state approach for taxation, adopted in Minnesota and elsewhere, is upheld, banks will file more state returns in new states, pay more state income tax, and potentially double state tax on some income.

Several factors have come together to create enormous pressure for more uniformity in state taxation of financial institutions. These developments include the change of the state laws restricting out-of-state acquisitions, a shift to taxation based on customer location, and needs to enhance revenues in many states.

#### Need for Uniformity

The complexity faced by banks in the state tax area is increasing. In some states, the tax law predates the current banking environment. Many of the states have different types of taxes, and even in states where a franchise tax is the norm, there are differing tax bases (both concerning income taxed and deductions permitted), and different sourcing rules for attribution of income. Moreover, some states have throwback rules, and some permit consolidated reporting, whereas others do not. Consolidated reporting is sometimes permitted for commercial banks because the restrictions under Federal and state law of permissible activities for banks forces holding companies to pursue business opportunities through a variety of different corporate entities, some of which are subsidiaries of the bank and some of the holding company only.

The MTC proposal is the result of a dialogue between state tax officials and bankers who are experts in state taxation of financial institutions. ABA believes that the proposal is a useful model for uniform state taxation of financial institutions. We would note, however, that it is not necessary to require that a state enact a franchise tax measured by net income, if a state sought to achieve a similar level of uniformity by employing the approach of the MTC in the context of a different state tax. Frankly, we don't think the MTC proposal

should be read to require states to adopt a franchise tax in addition to their existing tax or that they should have to switch to the franchise tax approach. In general, the proposed three factor formula and the attribution of income rules reflect a reasonable balance between the headquarters states and the market states. The difficulty will be in holding that balance together and not having individual states pick and choose among factors, or double weight factors in their favor to the disadvantage of financial institutions.

As different states have wrestled with state taxation of banks in recent years, it is our observation that the states will benefit from the MTC's study of financial institutions and the effort to resolve competing considerations. Frankly, it is very difficult for state legislatures to address a complex subject such as the taxation of financial institutions during the hectic schedule of a legislative session. We believe that the MTC's proposal is a more thoughtful approach than can be expected from a pressure packed drafting session in any state legislature. Certainly the states that have already adopted a market state approach have had to consider revision of their statutes.

The most important feature of the MTC proposal is that it establishes rules for the taxation of out-of-state banks which either have no physical presence in the state or which are located in the state, but headquartered elsewhere. In effect this means that it is adaptable to future changes in the laws affecting where banks are permitted to locate. It should be understood that the uniformity of state tax laws could result in a shifting of current tax revenues among the states.

### Interstate Branching

The balance of tax base between market states and headquarters states will be especially important in an interstate branching environment. In 1991, both houses of Congress passed versions of interstate branching, only to have the issue dropped in conference. Those bills have been reintroduced in this Congress,<sup>2</sup> hearings have been held in the House Subcommittee on Financial Institutions<sup>3</sup> and the Clinton Administration is expected to endorse some form of interstate legislation in the near future.

In an interstate branching environment, a multibank holding company which owns banks in several states will likely be able to designate a headquarters state and then convert its banks outside

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<sup>2</sup> Among the bills introduced are H.R. 2235 (Rep. Vento) and S. 810 (Sen. Ford).

<sup>3</sup> Hearings were held September 28 and 29. Hearings are also scheduled in the Senate Banking Committee on October 5, 1993.

of that state to branches. Congress made it clear in the debate in 1991 that it wants to be sure that the states will still be able to tax the branches of those out-of-state institutions.<sup>4</sup> Indeed, banks want to remain good corporate citizens and pay their fair share of state taxes. If interstate banking legislation is passed by Congress, some states may have to redesign their state tax statutes to reach in-state branches of banks headquartered in other states and thereby preserve their tax base. The MTC proposal is a good model for accomplishing that redesign.

#### Definition of Financial Institution

The ABA believes that the definition of the term "financial institution" be drafted to cover the different kinds of financial institutions that are in substantial competition with one another. The clear movement at the Federal level is toward functional regulation and functional taxation of competing financial institutions. The most recent example is the enactment of Internal Revenue Code Section 475 which applies mark to market taxation to "dealers" in "securities" with both terms broadly defined. The provision is not limited by the type of charter of the taxpayer.

At the August 1990 MTC hearing, as well as the July 15, 1993 hearing, the credit union industry asked for exemption, relying on their cooperative status and the current exemption from federal taxation. Tax exemption is not necessary for cooperative entities, as is exemplified by mutual thrift institutions which lost their federal exemption in 1951. Moreover, the federal exemption for credit unions, which was also enacted in 1951, was based on a very different set of facts than exists today.

Credit unions are now a \$200+ billion industry providing diversified financial services to a wide array of customers who are no longer connected by a traditional common bond. Credit unions no longer function in a "cooperative" manner based on the shared deposits and loans of their members, but rely on a deposit insurance fund enacted in 1970. Moreover, they offer many new products and are managed by professional managers and employees. State chartered credit unions are subject to state income tax, so there is no reason why the MTC should exempt these institutions from the proposed regulation.

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<sup>4</sup> See Section 309 of H.R. 6 as reported by the House Banking Committee in 1991 and Section 302 of S. 543 as reported by the Senate Banking Committee in 1991. While the debate focussed on the ability of the states to apply a franchise tax on income from federal obligations, it seems likely that the same policy arguments will apply.

## Nexus Threshold

While I stated at the outset that the nexus issue involves a yet-to-be-decided constitutional law question, there are other aspects to the issue. The MTC should consider advocating a threshold provision in order to improve the prospects for enactment of the proposed regulations in a critical mass of states.

First, it should be clear from the MTC's inquiry into this subject that there is a minimum level of taxation of financial institutions below which it is in neither the states' interest nor the taxpayers' interest in going to the expense of a full tax return filing and audit.

Consider a bank with \$10 million in assets in the state, an average return on assets of 1%, and a state tax rate of 6%. An analysis of the cost to the taxpayer of preparing a valid return and the cost to the state of auditing that return diminishes the value of the \$6000 tax due to virtually nothing. This case gets even more difficult when the legal nexus might be based on the movement of tangible personal property such as a leased automobile that is registered in a new state.

Second, smaller financial institutions, which would be hit most severely by the compliance costs involved, will be very vocal in their opposition to any state legislation that doesn't include a threshold rule. They know that the action in their state legislatures will be watched in neighboring states. If there is no threshold provision in their state, there probably won't be one in the next state that would protect them.

There may be an alternative that finesses the undecided legal question and simplifies the process for all parties involved. A threshold could be established based on relatively easily determined data such as total assets in the state based on customer zip codes. Any bank with less than a minimum dollar amount or minimum percentage of assets could merely file a letter with the state revenue authority together with a minimum fee acknowledging presence without establishing legal nexus. No audit would be needed, and the state would know that the taxpayer has some presence in the states.

## Conclusion

The ABA appreciates the time and hard work of the MTC and the efforts of those in the banking industry in developing a more uniform approach to state taxation of institutions. It is clear that uniformity is an important long term goal. If we are going to really reach that goal the proposal should be complete -- that is, the MTC should specifically endorse a threshold rule that allows banks, especially the smaller institutions, to avoid having to compute a de minimis liability and to reduce the administrative burden on both the state revenue department and

the taxpayer.

Finally, the ABA defers to the state bankers associations on matters of state legislation. The state associations have extensive knowledge of their state law and expertise about banking in each state, underscoring the benefits of such an ABA policy. While we believe the MTC proposed regulations are a constructive approach if it is amended to include a threshold provision, our comments should neither be construed as an ABA endorsement of any specific state legislation nor an indication of the views of the state bankers associations.

**EXHIBIT J: 37:**

**Letter from Brenda Jo Seipel  
(Credit Union National Association, Inc.)  
(September 27, 1993)**



**CUNA & Affiliates**  
A Member of the Credit Union System

**Credit Union  
National Association, Inc.**

Suite 300  
805 15th Street NW  
Washington, D.C.  
20005-2207

Telephone:  
(202) 682-4200

September 27, 1993

Mr. Alan H. Friedman, General Counsel  
Multistate Tax Commission  
119 Scenic Drive  
Redwood City, CA 94062

Dear Mr. Friedman:

Credit Union National Association (CUNA) and the New York State Credit Union League request an oral presentation on MTC's proposed regulation VI.18(i) on Thursday, September 30, 1993. Our witness is Tom Siciliano, General Counsel for Municipal Credit Union, a state chartered credit union in New York City.

CUNA is appreciative of MTC's consideration of our requests to exempt credit unions' from your proposed definition which may be subject to the apportionment formulas set forth in the regulation. Both federal and state law, with the exception of Indiana, establish a statutory framework that recognizes the unique nature of credit unions and exempts them from income taxes. At the last hearing, however, you raised a number of concerns relative to credit unions' tax exemption and the differences of credit unions between for-profit financial institutions. We will fully address these concerns on Thursday.

If you have any questions or need further information, please do not hesitate to contact me.

Sincerely yours,

Brenda Jo Seipel  
Vice President  
State Governmental Affairs

**Coopers  
& Lybrand**

certified public account

To	Alan Friedman	From	John B. Rice
Co.		Co.	
Dept.		Phone #	(415) 259-2576
Fax #	(415) 348-8582	Fax #	

September 28, 1993

**By Fax: (415) 941-0556**

Alan H. Friedman  
General Counsel  
Multistate Tax Commission  
386 University Avenue  
Los Altos, CA 94022

Re: Prop. Reg. IV.18(i)

Dear Mr. Friedman:

In accordance with our recent telephone conversation, I am summarizing a request for consideration of an amendment to the above-referenced proposed regulation.

In determining the receipts factor, the proposed regulation presently does not appear to contain any specific rule for sourcing receipts from the sale of tangible personal property inventory by a financial institution. One of our financial institution clients maintains inventories of precious metals, including gold bullion and coins, which it sells to customers in the ordinary course of business. For Federal income tax purposes, these items are properly treated as inventory. They are held in vaults and are actually shipped to customers within and without the state in which the bank is incorporated and does business. Our client's practice is in contrast to some institutions whose sales of such items are not actually shipped to customers (i.e., the institution may continue to hold the items in its vault for the customers who make the purchases).

While there may be relatively few financial institutions which have sales of tangible personal property inventory, I believe that it would nonetheless be appropriate to include a destination-based rule for such receipts, to place financial institutions on a parity with regular corporations (which generally (under either the UDITPA sourcing rule or a particular state's sourcing rule for receipts) are permitted to source receipts from sales of inventory on a destination basis). Otherwise, financial institutions conducting such business are put at an economic disadvantage relative to general corporations conducting the same business.

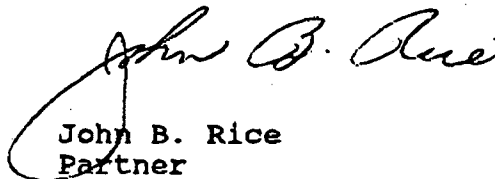
I respectfully request that due consideration be given to inclusion of this concept in the proposed regulation. In addition, I anticipate that I will be attending the September 30, 1993 hearing and request the opportunity to present and elaborate on these comments in person.



If you have any questions, please feel free to call me at (212)259-2576.

Thank you for your consideration.

Sincerely,



John B. Rice  
Partner

**EXHIBIT J: 38:**

**Testimony of Donald N. Adler  
(Chairman, American Financial Services Association)  
(September 30, 1993)**



American Financial Services Association

October 22, 1993

Mr. Alan H. Friedman  
General Counsel  
Multistate Tax Commission  
444 North Capitol Street, N.W.  
Suite 425  
Washington, D.C. 20001

Dear Alan:

I am writing in response to the Notice of Public Hearing relating to Public Law (P.L.) 86-272, copy enclosed, on behalf of the American Financial Services Association (AFSA).

The Notice of Public Hearing requests in question 7, comments related to "such other issues and suggestions that state representatives and other members of the taxpaying community may wish to present for consideration."

AFSA believes that the nexus standard for taxability of financial institutions and organizations as well as other types of service enterprises should be the same as for sellers of tangible personal property under federal law P.L. 86-272. AFSA's reasoning in support of this position was more fully described in the testimony which I delivered at the MTC public hearing which you conducted in New York City on September 30, 1993 related to the Proposed Multistate Tax Commission Regulation IV. 18 (i) dealing with the Attribution of Income From the Business of a Financial Institution, a finalized copy of which is enclosed.

Please call me (708/405-1429) if you should have questions regarding the above or require further information.

Best regards,

A handwritten signature in cursive script, reading "Donald N. Adler", is written over the typed name.

Donald N. Adler  
Chairman, AFSA Multistate Tax Task Force

Enclosures

1373kz

American Financial Services Association

Testimony on Proposed Multistate Tax Commission  
Regulation IV.18.(i) Dealing with the Attribution of Income  
From the Business of a Financial Institution

September 30, 1993

Good morning. My name is Donald N. Adler and I am Director, Tax for the Credit Services segment of Dean Witter, Discover & Co.

Today, I am testifying on behalf of the American Financial Services Association (AFSA). I am presently serving as Chairman of AFSA's Multistate Tax Task Force. AFSA is the nation's largest trade association representing non-bank providers of consumer financial services. Organized in 1916, AFSA represents 367 companies engaged in extending over \$200 billion of consumer credit throughout the United States. These companies range from independently-owned consumer finance offices to the nation's largest financial services, retail, and automobile companies. Consumer finance companies hold over \$150 billion of consumer credit outstanding and \$67 billion in second mortgage credit, representing one quarter of all consumer credit outstanding in the United States. AFSA member companies are vitally concerned with the state and local income taxes applicable to their operations. Accordingly, the proposed apportionment regulation and its potential impact is of great interest to these firms.

AFSA appreciates the opportunity to present its views, and would like to commend the Multistate Tax Commission (the "MTC") for undertaking the project of addressing state taxation of financial institutions. This matter has many facets and presents numerous difficult issues.

My comments today fall into three categories: background and status of the project; general comments; and specific comments with respect to the statutory proposal for apportionment and allocation of net income of financial institutions (the "Proposal").

I. Background and Status of the Project

A. Background

The efforts to develop an acceptable alternative to an earlier MTC model regulation draft (most recently issued in May, 1990) on the taxation of financial institutions began in mid - 1991 with a joint meeting of representatives of various states, the Multistate Tax Commission, the Federation of Tax Administrators, and the financial services industry, principally members of the Financial Institutions State Taxation Coalition (F.I.S.T.), held July 15 - 16, 1991 in San Francisco. The objective of the group, which became known as the State/Industry Financial Working Group (S/IFWG), was to seek an acceptable uniform set of rules for states' taxation of multistate financial institutions.

The attached article (Exhibit I) by Mr. Haskell Edelstein, an industry participant in S/IFWG, provides a good background on this issue. On page 70 of this article, requirements for a workable and equitable system for taxing financial institutions are proposed, namely (in summary):

1. Fair and equitable to all states;
2. Prevent double-taxation;
3. Simple to understand and apply;

4. Easy compliance and auditing; and
5. Rules determined by nature of the business or product rather than the character of the institution doing the business.

The article then goes on (Pg. 71) to describe the critical elements in a "Proposal For a Fresh Approach" which was put forth by Mr. Edelstein as a member of F.I.S.T. (see also Exhibit II attached) at the July 15 - 16, 1991 meeting in San Francisco referred to above, as follows (in summary):

1. Uniform adoption procedures to avoid multiple taxation;
2. Minimal compliance costs;
3. Determinable nexus;
4. Reasonable information requirements; and
5. Averaging of apportionment formula elements.

Based upon these above-noted points, what was proposed was that the changes needed to develop a workable and equitable system for the taxation of financial institutions would have to address:

- o Nexus;
- o Apportionment Procedures;
- o Uniform adoption procedures;
- o Uniform application of the rules to taxpayers based upon the nature of their business (i.e., need for a

definition of a financial institution/organization);  
and, as an overall consideration,

- o Administrability and simplicity.

The S/IFWG held another meeting in late April, 1992 in New York. From that meeting numerous drafting teams were formed which included state and industry representatives to address various issues and topics. As a side note, I was a participant on several of these teams. A subsequent meeting was held in Chicago in November, 1992 to review progress. The statutory proposal for apportionment and allocation which is the subject of this hearing was the end product of this process.

While the proposal is a significant achievement, I would point out that it addresses only one of the four key components for a tax system for financial institutions. The other key components which were identified at the onset of the formation of the S/IFWG are not addressed, namely; nexus, uniform adoption procedures, and uniformity of application (definition of a financial institution/organization).

Due to the significance of these items, as noted below in my general comments, AFSA believes that these elements must be addressed and included in any truly uniform system for the taxation of financial organizations. Consequently, we would urge that the MTC fully address these issues before it releases any uniform rules.

B. Status of the Project

An interim Hearing Officer report dated May 10, 1993 accompanied the release of the Proposal. In it, the Hearing Officer has noted that the Proposal is the joint effort of industry and state representatives. While recognizing this as the case, I would also point out that the portion of the financial services industry participating in the S/IFWG was relatively small in light of the broad scope and size of the industry.

Large segments of the financial services industry, which are potentially impacted, for example mortgage banking, leasing, and non-bank financial organizations, have either not been heard from or have participated to only a limited degree. Given the potential, and unknown, application of the Proposal, AFSA believes this to be a significant point and that to suggest that the Proposal has "industry" support appears to overstate the case.

II. General Comments

AFSA's comments here relate to the broad-based issues identified above with respect to the development of a uniform state taxation system for financial institutions and the salient features of the Proposal.

A. Nexus

1. Observations

As the Interim Report of Hearing Officer Regarding Proposed Regulation IV.18 (i) Apportioning the Income of Financial Institutions (Hearing Officer's Report) indicates on page 4, the MTC



Proposal does not address the issue of nexus, and "... assumes that Constitutional nexus exists in the state for apportionment purposes." The Hearing Officer makes reference to the U.S. Supreme Court's decision in Quill v. North Dakota (112 S. Ct. 1904 (1992)), refers to his expressed views on this matter, and goes on to state that "... the Quill decision supports the notion that 'physical presence' of the taxpayer is not required for a finding of constitutional nexus in the area of operational taxes, such as the taxation of net income, that is derived from the rendering of financial services."

The development of the MTC Proposal commenced in mid-1991 at a point prior to the rendering of the Quill decision. The perspective of the S/IFWG was that the nexus issue was not resolvable by the group at that time, in light of the fact that the Quill case had not yet been decided. Consequently, the issue of apportionment rules was taken up first.

In determining the applicability of any tax to a taxpayer, the first matter of inquiry is nexus .. i.e., is the taxpayer subject to the tax by virtue of its activities in a particular jurisdiction or is it not? Once nexus is resolved, the mechanics of the tax are applied to determine the tax base and apportionment to arrive at the tax liability.

Given this logical ordering, nexus is the threshold issue relative to the application of income and franchise taxes to financial institutions and organizations. Consequently, AFSA views that it is absolutely necessary that

the MTC fully address the issue of nexus relative to the application of income and franchise (capital-based) taxes applicable to the rendering of financial services. The benefit of bright-line tests and settled expectations relative to taxability were clearly pointed out in the Quill decision. AFSA believes that there should be certainty as to when a financial services provider is taxable in a state and when it is not.

## 2. Recommendation

AFSA believes that the nexus standard for taxability of financial institutions and organizations as well as other types of service enterprises should be the same as for sellers of tangible personal property under federal law P.L. 86-272, which limits the ability of states to impose income taxes on interstate business.

AFSA believes that such an approach would generally equate to taxability of financial services providers based upon physical presence in a jurisdiction, an approach that would provide for a bright-line nexus standard.

P.L. 86-272 was enacted in 1959 as a temporary legislative solution. At that point in time, mercantile and manufacturing firms were by far conducting the largest share of interstate business. Services, and financial services in particular, were delivered on a local market basis. Obviously, the nature of the United States economy has changed substantially in the last thirty-four years. A nexus rule which puts

providers of good and services on the same basis is in order. AFSA suggests financial services providers should be protected from income and franchise (capital-based) taxation when activities are limited to solicitation and reasonable ancillary activities. This approach would avoid difficulties faced by certain taxpayers currently where states with dual-basis tax systems (income and/or capital) afford P.L. 86-272 protection for the income tax element, but deny it for the capital-based tax element, an illogical and unfair approach. Under these circumstances, the same activities of a taxpayer are subject to one type of tax (capital-based) but not the other (income-based), and can be subject to tax in one year but not the next. Clearly these types of situations do not promote uniformity or administrability.

Many AFSA members render financial services to customers through interstate commerce with no physical presence in the customer's state of residence. Obviously, the MTC proposal is of vital interest, and AFSA members want fair, workable, and consistent rules relative to nexus and believe that it is incumbent upon the MTC to address this issue as part of any set of uniform rules for the taxation of financial institutions in order to preclude unfair and unconstitutional double taxation. This is an opportune juncture for the MTC to address the issue of nexus and avoid unnecessary years of audit controversies and litigation.

**B. Definition of Financial Institution**

1. Observations

As presented, the Proposal does not define the term "Financial Institution". Rather, it is contemplated that a state which would adopt the Proposal would insert its own definition. A suggested definition is included in Appendix B to the Proposal.

Since the Proposal is intended to render a uniform allocation and apportionment method for financial institutions, the lack of a definition hollows the proposal and raises vital issues as to just which financial organizations the Proposal is intended to cover and how the Proposal can be uniform for various adopting states if they are left to their own means to develop and implement a definition of entities which constitute financial institutions.

AFSA is also concerned that by not specifically addressing this issue, adopting states may use the suggested definition of the term financial institution contained in the Proposal as a means for modifying existing definitions of the term or related terms, such as financial organization, which serve as the basis of combined and unitary groupings of entities. For example, the Proposal suggested definition includes finance lease companies. Several AFSA members have leasing subsidiaries which currently file combined returns with various entities which may or may not fall within the Proposal's suggested Financial Institution definition. The end result could be that long standing combined return groupings are adversely modified.

## 2. Recommendation

AFSA strongly recommends that the Proposal be modified to include a definition of financial institution. It is logical to define which firms the apportionment rules are to apply to as part of the allocation and apportionment Proposal. The definition should also address which organizations are not intended to be covered - e.g., securities broker-dealers, investment managers and distributors of mutual funds.

The suggested definition included in Appendix B focuses primarily on regulated institutions, such as banks and savings and loans, and contains a catch-all in section (1) for "Any other person or business entity which derives more than fifty percent (50%) of its gross income from activities that a person described in subsections (b) through (i) is authorized to transact". Since regulated banks are authorized to conduct a wide variety of activities, this approach could result in the unintended characterization of entities as financial institutions. Also, the Proposal's approach would be difficult to apply since its definition of a financial institution requires reference to non-tax bank regulatory rules.

AFSA believes that the focus should be on those firms whose predominant business is the making, acquiring, selling, or servicing of loans or extensions of credit. Indeed, most of the specific apportionment rules contained in the Proposal relate to those types of activities. An approach such as that used by Indiana in its Financial Institutions Tax law which contains a provision for an 80% of gross income test would

appear to be workable. The key point is that the end result of the definition should be that the same rules apply to those firms with a substantial involvement in business activities with customers related to the activities noted above - i.e., making, acquiring, selling, or servicing of loans or extensions of credit, as noted above.

C. Uniform Adoption Procedures

1. Observations

The Proposal does not address how it is to be adopted by states in order to avoid double taxation, whereby "market" states are taxing the the income of a financial institution based upon customer location via adoption of the Proposal, and the state of commercial domicile of the financial institution is taxing all of its income. Consequently, AFSA has great concerns that its members will be unfairly disadvantaged by inconsistent taxing procedures among states. The fiscal realities of today's economy leave many states with fiscal shortfalls. Due to the appeal of the potential revenue source resulting from the adoption of the Proposal by "market" states, it is unlikely that the issue of double taxation will be addressed, unfairly disadvantaging financial organizations.

2. Recommendation

AFSA believes that an adoption mechanism, such as that explained on pg. 11 of Exhibit II under "Adoption and Implementation", which assures a high level of uniformity of adoption and consistency among states is a vital element in any

uniform system for the income taxation of financial institutions. This mechanism should also address uniformity of weighting of apportionment factors, since this is also a critical element in consistency, as the interim report of the Hearing Officer (p. 3) points out.

D. Basis for Apportionment Factor Information

1. Observation

The compliance burden which the Proposal will generate will be substantial, since the information needed to comply does not currently exist in many financial institutions' systems.

2. Recommendation

Given the substantial changes which will be required, AFSA strongly urges that the book/tax option contained in Appendix A to the Proposal be made a part of the Proposal. Incorporation of this rule would greatly aid financial organizations that would be affected by the Proposal, if adopted, and improve administrability.

In summary, three of the above general issues are those which were identified at the outset of the S/IFWG deliberations as being key elements to a uniform system for the taxation of financial institutions. As was noted above, AFSA believes that these issues must be addressed if a fair and administrable system is to be developed. While AFSA recognizes that the apportionment Proposal is a significant accomplishment, it addresses only one of the four key elements. AFSA has significant concerns that states will view the

Proposal as all that is needed to tax financial institutions and organizations, and that the other key elements will not be addressed, with the end result of unfair double taxation, lack of administrability, and substantial litigation.

III. Specific Comments

- A. Sec. 1 - This section should be deleted as it imposes a tax. Since the purpose of the Proposal is to establish an apportionment and allocation mechanism, this section is not needed.
- B. Sec. 3 (e) - Consideration should be given to adding "charge card" to the definition of "credit card".
- C. Sec. 3 (f) - Re: Definition of "credit card issuer's reimbursement fee" - suggest striking the words "provided by the merchant" near the end of the sentence.
- D. Sec. 3 (j) - Re: Definition of "Loan" - while the term loan specifically excludes credit card receivables, the later term is not defined. It should include all amounts charged to customer credit card accounts from whatever source, including purchases of good and services, cash advances, fees, etc.
- E. Sec. 3 (q) - Need to add a definition for the term "state" which includes states, possessions and territories of the United States, the District of Columbia, Puerto Rico, and foreign countries.
- F. Secs. 4 (j), (k), and (l) - All of these receipts relate to services performed, and AFSA believes



that the preferable basis to apportion these receipts is cost of performance - that is, the receipts should be sourced to the location where the majority of the costs are incurred to produce the service.

AFSA is aware that there was a bias to source receipts to the "market" state as a compromise proposition since the payroll and property factors source to the "home" state. However, we believe that this approach produces illogical results and, when viewed in the broader context of sourcing the service revenues of all types of taxpayers, could produce very distortive results.

An example of this is the provision of Sec. 4(k). Under this provision, loan servicing fees derived from loans secured by real property are sourced to a state or states based upon the interest, fees and penalties earned by the financial institution on loans secured by real property located in the state or states. That is, the sourcing of receipts on mortgage loans held in portfolio or held in inventory for sale governs the sourcing of loan servicing fees. This sourcing rule represents a radical departure from current concepts which govern apportionment of receipts generally, and in effect constitutes third-party sourcing.

Mortgage loan servicing fees are paid by the owner of the loans to the servicer financial organization. These fees may be paid out of the gross interest income which accrues to the owner of the loans, but they are nonetheless paid by the owner of the loans. The Proposal's sourcing rule is designed to attempt to source these receipts to

the location of the mortgagors on serviced loans (a third party to the loan servicing transaction) through a surrogate approach. That is, the sourcing rule uses the location of interest received on real property -secured loans owned by the institution to source servicing fees received. This rule is illogical in that there may be absolutely no relationship between the location of mortgagors on loans owned by the financial institution and the location of mortgagors on serviced loans.

AFSA members have substantial involvement in the mortgage banking industry and are vitally concerned about this rule in the Proposal. Many mortgage banking firms have small loan origination functions which operate in limited geographic areas (e.g., one or two states). However, such firms may service substantial loan portfolios which were originated by other firms in other geographic areas. The effect of applying the Proposal's rule would be that all of the servicing fee receipts would be sourced to the one or two states in which the firm's own origination function operates, rather than to the state where the loan servicing function is being performed on the firm's much more significant serviced loan portfolio, which is not owned by the financial organization. AFSA believes that this rule could give rise to significant distortions, and that a better approach is to source such receipts to the location where the service is performed.

In closing today, I would like to express my appreciation for the opportunity to make AFSA's views known with respect to the vital issue of state taxation of financial institutions and organizations. Much work has been done on

this matter through the efforts of both state and financial industry representatives. However, AFSA firmly believes that there are several key components to a truly uniform state taxation system for financial institutions and organizations which remain to be addressed. Without resolution of these issues, a uniform system will not be possible, resulting in unfair and unconstitutional double taxation of financial organizations. AFSA would like to extend an offer to work with the MTC and others to address these issues.

**EXHIBIT J: 39:**

**Statement of Jonathan Robin  
(Assistant Commissioner, New York City Department of Finance)  
(September 30, 1993)**

STATEMENT OF JONATHAN ROBIN  
ASSISTANT COMMISSIONER FOR AUDIT  
NEW YORK CITY DEPARTMENT OF FINANCE  
TO  
THE MULTISTATE TAX COMMISSION (MTC)  
REGARDING  
PROPOSED MTC REGULATION IV.18(i)  
DEALING WITH THE ATTRIBUTION OF INCOME  
FROM THE BUSINESS OF FINANCIAL INSTITUTIONS

9/30/93

Good Morning. My name is Jonathan Robin and I am the Assistant Commissioner for Audit in the New York City Department of Finance. I am joined here today by Jerry Rosenthal and Michael Hyman of the City's Office of Tax Policy. Thank you for the opportunity to comment on the Multistate Tax Commission's proposed regulation dealing with the attribution of income from the business of financial institutions.

As a representative of the City of New York, I am pleased to be present at this public hearing. Even though the City of New York is not a member of the Multistate Tax Commission, the staff of the City's Department of Finance has participated fully in the drafting of these model apportionment provisions.

The reason for our participation is a familiar one to those who have heard a former City Finance Commissioner's comment on this multi-year drafting effort: We view banking as a home town

industry. New York City reigns as one of the world's premier banking centers. Six of the ten largest U.S. commercial banks are headquartered here and more foreign banks have branches or offices in the City than in any other city in the world. In addition, New York City is home or host to many of the major non-bank financial institutions in the world.

Therefore, it is perfectly natural that what concerns our banks, concerns us.

A few years ago we began hearing from the banks that a growing number of states outside New York were taxing or were planning to tax income banks earned from transactions with their residents. Banks argued that as a result of the use of the "market state" approach in the taxation of financial institutions, the same income could be subject to tax both by the bank's home state and the state where the customer was located. Not only did banks face sourcing rules which attributed the same income to more than one jurisdiction, but several states adopted apportionment formulas which gave disproportionate weight to their market-state oriented receipts factor.

This problem gained a degree of urgency because of the efforts of some "market states" to spread the broadest possible tax net on bank income. For example, under the laws of one state a bank could be subject to taxation if it had as few as 20 customers in the state, even if the bank had no physical presence there.

This turn of events alarmed the banks. It was of such serious concern that they were contemplating seeking help from Washington if the states and localities could not cooperate and resolve the problem among themselves.

Although there is still a long road ahead of us, some progress has been made thanks to the efforts of the MTC and, in particular, Alan Friedman. Over the past several years, states and the City have worked hard through the good offices of the MTC to devise a theoretical tax apportionment model which takes into consideration aspects of both the market- and headquarters-state approaches.

In this process all the participants contributed their practical experience and technical expertise in dealing with apportionment issues. Our primary objective was to develop an apportionment formula which was fair and had an appropriate theoretical basis.

As the headquarters and the location of senior bank management, the City of New York is concerned that its essential contribution to the production of bank income be given proper weight. Major financial institutions are among our top property owners and commercial tenants, and the banking sector employs more than 130,000 individuals in the City. In short, the City's premier status as an international financial center, where major transactions are negotiated and finalized, cannot be underestimated in evaluating our role in banking activity.

At the same time, we recognized the need to take into account the contribution of the market jurisdiction in determining the source of taxable economic activity. Beyond that, we wanted a set of rules that would not place too great an administrative burden on taxpayers and on tax administrators.

We think that the MTC's draft model statute embodies these principles. It addresses economic as well as administrative issues regarding the mechanics of the apportionment formula. And we are here today to say so. However, it is important not to forget that we are still in the early stages of what is expected to be an extended process. There several reasons for this outlook.

First, we have not yet assessed the fiscal implications of this approach for New York City and secondly we cannot predict the future legislative process which must be traversed before the model can be implemented in New York.

With respect to the fiscal analysis, that process is getting under way with the cooperation of major domestic banks. The analysis will tell us whether our efforts constitute a practical solution to the issues raised by the banks. This is of crucial importance to New York City, as I'm sure it is to many jurisdictions. The City has projected budget gaps of more than \$4 billion over the next several years which it is struggling to close, and this hard reality will inevitably play an important role in the evaluation process.



The success of the fiscal analysis will depend on the banking community's commitment to the process. As everyone knows by now, we are heavily dependent on the banks for data to enable us to even begin the analysis. The involvement of the full array of banking sectors is crucial.

We are pleased by the input and cooperation of the domestic banks so far in the process and we look forward to working with them in determining the fiscal impact. However, foreign banks have not been involved in the project thus far. Although these institutions have a large presence in New York, paying more than half of our bank tax, we have yet to hear their perspective on the MTC draft statute. Without their involvement in the fiscal analysis, it will be impossible to accurately estimate the impact of the rules.

Let me take this opportunity to assure the banks that any data they provide will be used solely for the fiscal analysis of the MTC draft regulations. This analysis will be conducted by our Office of Tax Policy. As you know, we have informed the banks that we are willing to provide them with a written commitment on this matter if they so desire.

Assuming that a reasonable fiscal result can be demonstrated, it is, of course, ultimately up to State and local executive and legislative processes to determine whether those of us who have been working on this project at the staff level have produced an acceptable model for bank income apportionment. That process could

very likely raise additional apportionment issues which would affect the revenue impact of revising New York City's current rules.

For example, the appropriate weights of the apportionment factors may need to be addressed. The MTC draft statute assumes that the factors will be equally weighted. However, the City's current apportionment scheme for banks double weights certain factors and discounts the numerator of the payroll factor. Such issues would need to be fully evaluated if the MTC proposal were to be considered by our legislature. Thus, today's hearing is but a step, albeit an important one, in an ongoing process.

The MTC posed a number of specific questions which we will not attempt to respond to today. At this point, we view our mission as limited to apportionment issues affecting taxpayers currently subject to New York City's bank tax. We are not now proposing to redefine who is a taxpayer under our tax, or establish a new nexus standard or develop new rules on when consolidated or combined returns should be filed.

This is not meant to minimize the importance of these issues. For example, the definition of "financial institution" has great significance for New York City, with its large concentration of financial sector firms that compete with banks in many areas of business but that are now subject to City Corporation Tax which differs in important ways from the City's Bank Tax.

However, these issues go beyond the immediate task of devising an apportionment scheme that reduces or eliminates double taxation for banks engaged in multistate or international banking businesses. If we stray too far from the immediate goal, we may unduly delay the process we have begun and perhaps lose our focus.

We intend to continue working in close cooperation with the banks and other taxing jurisdictions with the ultimate aim of producing a fair and simple system under which the banking community can meet its tax obligations.

This concludes my remarks. Thank you for the opportunity to be heard.

**EXHIBIT J: 40:**

**Statement of Jeffrey Serether  
(Citibank/Citicorp and FIST)  
(September 30, 1993)**

MULTISTATE TAX COMMISSION HEARING ON  
PROPOSED REGULATION IV.18.(i)  
APPORTIONING THE INCOME OF FINANCIAL INSTITUTIONS

NEW YORK, NEW YORK  
SEPTEMBER 30, 1993

My name is Jeffrey Serether, I am a Vice President of Citibank, N.A. and I am testifying today on behalf of FIST, the Financial Institution State Tax Coalition. The FIST Coalition, as you know, consists of 18 financial institutions (see membership on next page) that have been actively involved with the Multistate Tax Commission, the Federation of Tax Administrators and various state and city taxing authorities in the effort to develop uniform rules for the apportionment of income earned by financial institutions.

Our coalition provided testimony at the Los Angeles and Washington, D.C. hearings convened by the Multistate Tax Commission regarding its statutory proposal for apportionment and allocation of net income of financial institutions, as contained in Attachment 1 of the May 10, 1993 Interim Report of the Hearing Officer Regarding Proposed Multistate Tax Commission Regulation IV.18.(i) Apportioning Income of Financial Institutions.

At those hearings we testified as to our support of the process and, in general, of the Multistate Tax Commission's proposal itself. We did, however, note that there were several issues that should be deferred so as not to create obstacles for the adoption of uniform apportionment and allocation rules. In addition, on

July 29, 1993, we provided the Hearing Officer with specific comments in the form of a mark-up of the May 10, 1993 draft of the Multistate Tax Commission's allocation and apportionment proposal.

We are here today to reiterate our support for allocation and apportionment rules for the income of financial institutions that are uniform among the states and that apply to taxpayers engaged in similar lines of business. In addition, we continue to be of the view that, since the proposed rules deal with allocation and apportionment, provisions dealing with other issues such as nexus should not be a part of these rules. Finally, we would like you to know that FIST is available today, or at any time after this hearing, to answer any questions you may have regarding our technical mark-up.

Thank you for this opportunity to be heard and for all of your efforts in this project.

FIST MEMBERSHIP: Bankers Trust Company  
Bank of America, NT & SA  
Bank of New York Company, Inc.  
Boatmen's Bancshares, Inc.  
Capital Holding Corporation  
The Chase Manhattan Bank, N.A.  
Citicorp/Citibank, N.A.  
First Chicago Corporation  
First Interstate Bancorp  
First Union Corporation  
Great Western Financial Corporation  
KeyCorp  
Morgan Guaranty Trust Company of New York  
NationsBank  
Shawmut National Corporation  
Society Corporation  
SunTrust Banks, Inc.  
Wachovia Corporation

**EXHIBIT J: 41:**

**Statement of Thomas G. Siciliano  
(Credit Union National Association and New York  
State Credit Union League)  
(September 30, 1993)**

STATEMENT BY  
THOMAS G. SICILIANO  
BEFORE THE MULTISTATE TAX COMMISSION  
ON BEHALF OF  
CREDIT UNION NATIONAL ASSOCIATION AND  
THE NEW YORK STATE CREDIT UNION LEAGUE

September 30, 1993



STATEMENT BY  
THOMAS G. SICILIANO  
BEFORE THE MULTISTATE TAX COMMISSION  
ON BEHALF OF  
CREDIT UNION NATIONAL ASSOCIATION AND  
THE NEW YORK STATE CREDIT UNION LEAGUE

September 30, 1993

THANK YOU FOR THE OPPORTUNITY TO APPEAR BEFORE YOU THIS MORNING.

MY NAME IS THOMAS G. SICILIANO AND I AM SENIOR VICE PRESIDENT AND GENERAL COUNSEL FOR MUNICIPAL CREDIT UNION. I AM ALSO A MEMBER OF THE NEW YORK STATE BANKING BOARD, HOLDING THE CREDIT UNION POSITION ON THE BOARD.

MUNICIPAL CREDIT UNION IS CHARTERED UNDER THE LAWS OF THE STATE OF NEW YORK AND OUR ALMOST 200,000 MEMBERS ARE COMPRISED OF MAINLY NEW YORK CITY EMPLOYEES AND NEW YORK STATE EMPLOYEES WHO WORK IN THE CITY OF NEW YORK.

I APPRECIATE THE OPPORTUNITY, ON BEHALF OF CUNA AND THE NEW YORK STATE CREDIT UNION LEAGUE TO COMMENT ON MTC'S PROPOSED REGULATION WHICH WOULD REQUIRE THAT FINANCIAL INSTITUTIONS WITH INCOME FROM TAXABLE BUSINESS ACTIVITIES "ALLOCATE AND APPORTION" NET INCOME BASED ON PROVISION AND FORMULAS SET FORTH IN THE PROPOSED STATUTE.

OUR TESTIMONY IS IN RESPONSE TO THE COMMISSION'S REQUEST FOR COMMENTS ON THE RECOMMENDED DEFINITION OF BUSINESS ORGANIZATION AND ACTIVITIES WHICH MAY BE SUBJECT TO APPORTIONMENT FORMULAS.

WE URGE THE MTC TO CONTINUE THE INTENT OF CONGRESS AND THE MAJORITY OF STATE LEGISLATURES AND EXEMPT CREDIT UNIONS FROM THE PROPOSED REGULATION.

CREDIT UNIONS ARE NOT-FOR-PROFIT, MEMBER-OWNED COOPERATIVES. MEMBERSHIP IS LIMITED TO PERSONS WITHIN A FIELD OF MEMBERSHIP. THIS FIELD OF MEMBERSHIP MAY BE BASED ON OCCUPATION, ASSOCIATION, OR GEOGRAPHIC BOUNDARIES. CREDIT UNIONS ARE DEMOCRATICALLY CONTROLLED WITH EACH MEMBER OF THE CREDIT UNION HAVING

ONE VOTE, REGARDLESS OF THE NUMBER OF DOLLARS ON DEPOSIT AT THE CREDIT UNION. THE VAST MAJORITY OF CREDIT UNIONS ARE SMALL, AND BY STATUTE, BOARD AND COMMITTEE POSITIONS ARE HELD BY VOLUNTEERS WHO ARE COMMITTED TO PROVIDING FINANCIAL SERVICES. OUR UNIQUE FINANCIAL INSTITUTIONS RETURN EVERY PENNY OF INCOME EARNED IN EXCESS OF OPERATING EXPENSES, REQUIRED RESERVES AND UNDIVIDED EARNINGS TRANSFERS, TO OUR MEMBERS.

INCLUDING NOT-FOR-PROFIT MEMBER-OWNED CREDIT UNIONS IN THE MTC PROPOSAL MEANS THEY COULD BE TAXED IN THE SAME MANNER AS FOR-PROFIT FINANCIAL INSTITUTIONS. THIS CONTRADICTS FEDERAL LAW AND MOST STATES' LAW, WHICH PROVIDE A STATUTORY FRAMEWORK THAT EXEMPTS CREDIT UNIONS FROM TAXES ON EARNINGS OR INCOME.

THIS STATUTORY FRAMEWORK HAS COME TO SYMBOLIZE THE PUBLIC, SOCIAL, AND ECONOMIC POLICY UNDERSTANDING BETWEEN THE CREDIT UNION MOVEMENT AND ELECTED OFFICIALS AT EVERY LEVEL OF GOVERNMENT. THE SERVICE CREDIT UNIONS PROVIDE IS VALUED BY MILLIONS, AS A UNIQUE CONSUMER ORIENTED ALTERNATIVE TO THE TRADITIONAL FOR-PROFIT

BANKING SYSTEM. MANY OF OUR CREDIT UNION MEMBERS  
COULD NEITHER QUALIFY, NOR AFFORD TO BORROW ELSEWHERE.

THERE ARE MANY WHO FAIL TO UNDERSTAND THE UNIQUENESS  
OF CREDIT UNIONS AND THE ESSENTIAL FUNCTION OF THE TAX  
EXEMPTION IN PROMOTING THESE SOCIAL AND ECONOMIC  
OBJECTIVES.

THOSE WHO ADVOCATE CREDIT UNION TAXATION HAVE ARGUED  
THAT CREDIT UNIONS ARE IN DIRECT COMPETITION WITH BANKS  
AND OTHER FINANCIAL INSTITUTIONS. THESE GROUPS HAVE  
URGED CREDIT UNION TAXATION AS A MEANS OF "LEVELING THE  
PLAYING FIELD."

CREDIT UNIONS' FINANCIAL MARKET SHARE HAS BEEN THE SAME  
FOR SOME YEARS - 2%. BANKS SERVICE 34% OF THE FINANCIAL  
MARKET: OBVIOUSLY, YOU MUST LOOK BEYOND CREDIT UNIONS  
TO OTHER INTERMEDIARIES, SUCH AS INSURANCE COMPANIES AND  
THE VARIOUS MUTUAL FUNDS TO SEE THE TRUE COMPETITORS OF  
BANKS.

FURTHERMORE, TAXING CREDIT UNIONS WOULD NOT PROVIDE A

"LEVEL PLAYING FIELD." IF ANYTHING, BANKS ALWAYS HAVE HAD, AND CONTINUE TO HAVE, A COMPETITIVE ADVANTAGE OVER CREDIT UNIONS. CREDIT UNIONS HAVE LIMITS AND RESTRICTIONS WHICH THE COMMERCIAL BANKING SYSTEM DOES NOT HAVE. FOR INSTANCE, BANKS OPERATE FOR-PROFIT, WHILE CREDIT UNIONS EXIST FOR THE SOLE PURPOSE OF PROVIDING SERVICE TO THEIR MEMBERS. THE FIELD OF MEMBERSHIP REQUIREMENT, SET FORTH BY STATUTE, RESTRICTS WHOM CREDIT UNIONS ARE ABLE TO SERVE. BANKS CAN MAKE A CUSTOMER OUT OF ANYONE. CREDIT UNIONS ARE SEVERELY RESTRICTED IN THEIR INVESTMENTS. BANKS MAY INVEST IN REAL ESTATE, THE STOCK MARKET, COMMERCIAL VENTURES AND THIRD WORLD DEBT. BANKS MAY GIVE LOANS FOR COMMERCIAL REAL ESTATE, UNDERWRITE STOCK ISSUANCES FOR NEW AND EXISTING BUSINESSES, AND PAY THEIR BOARD OF DIRECTORS. CREDIT UNIONS ARE RESTRICTED IN ALL THESE AREAS AND MORE.

ANOTHER REASON SOME CITE FOR TAXING CREDIT UNIONS IS BECAUSE OF THEIR "SHEER GROWTH". IT IS TRUE THAT CREDIT UNIONS HAVE GROWN... HOWEVER, THIS IS BECAUSE OF THEIR DEDICATION TO THE INTERESTS OF THEIR MEMBERS. DESPITE THIS GROWTH, CREDIT UNIONS ARE STILL VERY SMALL IN COMPARISON

TO THE FOR-PROFIT FINANCIAL INDUSTRY. CREDIT UNIONS HAD \$191.3 BILLION IN ASSETS AT YEAR END 1992, COMPARED TO \$2.945 TRILLION AT COMMERCIAL BANKS. MOST CREDIT UNIONS STILL REMAIN RELATIVELY SMALL ORGANIZATIONS. AT YEAR-END 1992, ONLY 548 (4%) OF THE NATIONS' 14,000 CREDIT UNIONS HAD ASSETS OF MORE THAN \$100 MILLION. AND THE MAJORITY OF ALL CREDIT UNIONS, 53% (7,446), ARE UNDER \$5 MILLION IN ASSETS.

AS SENIOR VICE PRESIDENT AND GENERAL COUNSEL FOR MUNICIPAL CREDIT UNION, I CAN ASSURE YOU THAT THE ASSET-SIZE OR NUMBER OF MEMBERS OF A CREDIT UNION DOES NOT DISTRACT FROM A CREDIT UNION'S COOPERATIVE STRUCTURE AND NOT-FOR-PROFIT, BUT FOR SERVICE CONCEPT.

MUNICIPAL CREDIT UNION PRINCIPALLY SERVES LOW AND MODERATE INCOME MEMBERS, AND MAINTAINS BRANCHES IN INNER-CITY NEIGHBORHOODS. MUNICIPAL CREDIT UNION PROVIDES LOW-COST FINANCIAL SERVICES FOR ITS MEMBERS AND PROVIDES LOANS AT AFFORDABLE RATES OF INTEREST. DESPITE OUR SIZE AND SOPHISTICATION, WE STILL MAKE SMALL PERSONAL LOANS WHICH FOR- PROFIT FINANCIAL INSTITUTIONS DO NOT FIND PROFITABLE OR WORTHWHILE ENOUGH TO DO.

AMIDST THESE ARGUMENTS, IT IS ALWAYS IMPORTANT, OF COURSE, TO REMEMBER THAT THE TAX EXEMPTION IS NOT BASED ON THE NUMBER, OR THE ASSET SIZE OF CREDIT UNIONS. INTERESTINGLY, THE CREDIT UNION TAX EXEMPTION WAS ENACTED BY CONGRESS IN 1937 DURING A TIME OF TREMENDOUS GROWTH. IN 1930, THERE WERE 1,100 CREDIT UNIONS, BY 1935 THERE WERE 3,600. THE INTERNAL REVENUE CODE SECTION 501 (C) (14) (a) STATES THAT CREDIT UNIONS (1) OPERATING ON A NOT-FOR-PROFIT BASIS, (2) ORGANIZED WITHOUT CAPITAL STOCK, AND (3) OPERATING FOR MUTUAL PURPOSES, QUALIFY FOR THE TAX EXEMPTION.

THE CONCEPT OF ENTITIES ORGANIZED FOR SERVICE AND NOT-FOR-PROFIT, AND AS SUCH, RECEIVING TAX ADVANTAGES, IS NOT PECULIAR IN OUR SOCIETY.

FOR EXAMPLE, FOR PROFIT HOSPITALS ARE TAXED. NON-PROFIT HOSPITALS ARE NOT TAXED. THEIR SERVICES ARE THE SAME, HOWEVER, RECOGNITION OF THE NON-PROFIT'S CONTRIBUTION TO SOCIETY - PROVIDING MORE AFFORDABLE HEALTH CARE - GIVES THEM THEIR TAX EXEMPTION. THE SIZE OF THE HOSPITAL AND THE NUMBER OF PATIENTS IT SERVES DOES NOT AFFECT ITS

STATUS.

ANY PLAN TO TREAT CREDIT UNIONS THE SAME AS FOR-PROFIT, STOCK ORGANIZED FINANCIAL INSTITUTIONS WOULD SERIOUSLY JEOPARDIZE THE CREDIT UNION CONCEPT AND CONTRADICTS CURRENT LAW.

THE MTC PROPOSAL, IF ADOPTED ON A NATIONWIDE SCALE, WOULD ALSO SERIOUSLY IMPACT THE DUAL CHARTERING SYSTEM - THE ABILITY TO CHOOSE BETWEEN A STATE OR FEDERAL CHARTER. MANY OF THE 5,485 STATE CHARTERED CREDIT UNIONS ADVERSELY AFFECTED BY THE PROPOSAL, WOULD LIKELY CONVERT TO FEDERAL CHARTERS FOR PROTECTION BY VIRTUE OF THE EXEMPTION ACCORDED THEM BY FEDERAL LAW (12 U.S.C. 1768).

A NUMBER OF STATES EXPERIENCING BUDGET DIFFICULTIES HAVE REVIEWED THE CREDIT UNION TAX EXEMPTION; HOWEVER THESE STATE GOVERNMENTS HAVE WISELY CONCLUDED THAT CREDIT UNION TAXATION WOULD ACTUALLY DECREASE REVENUE TO THE STATE. THIS WAS RECENTLY THE CASE IN THE STATE OF CALIFORNIA, WHERE LEGISLATION TO OVERTURN A RECENT



RULING BY THE CALIFORNIA FRANCHISE TAX BOARD WHICH IMPOSED A TAX ON STATE-CHARTERED CREDIT UNIONS, HAS PASSED BOTH HOUSES OF THE CALIFORNIA STATE LEGISLATURE AND NOW AWAITS THE GOVERNOR'S SIGNATURE.

IF THE BILL WOULD NOT HAVE PASSED, THERE WOULD HAVE BEEN A WAVE OF CONVERSIONS TO FEDERAL CHARTERS IN ORDER TO AVOID THE NEW TAX LIABILITY. CONVERSION BY THE 250 STATE CHARTERED CREDIT UNIONS IN CALIFORNIA WOULD HAVE LED TO THE LOSS OF \$10 MILLION A YEAR IN EXISTING REVENUE, SINCE THESE CREDIT UNIONS ARE ALREADY SUBJECT TO A STATE SALES TAX, AND EXAMINATION AND LICENSING FEES. IN ADDITION, THE STATE WOULD NO LONGER HAVE A VIABLE DUAL CHARTERING SYSTEM.

IN CONCLUSION, CUNA AND THE NEW YORK STATE CREDIT UNION LEAGUE STRONGLY URGE MTC TO EXEMPT CREDIT UNIONS FROM THE STATUTORY PROPOSAL. STATUTORY FRAMEWORK SET FORTH BY THE FEDERAL LAW AND STATE LAW RECOGNIZES THE UNIQUE NATURE OF CREDIT UNIONS, AND AS SUCH, EXEMPTS THEM FROM TAXES ON EARNINGS OR INCOME. CREDIT UNIONS EARN THEIR TAX EXEMPTION EVERY DAY. WE URGE MTC TO FULLY CONSIDER

THE MULTIPLE NEGATIVE IMPLICATIONS OF TAXING CREDIT  
UNIONS, AND AS SUCH, EXEMPT THEM FROM THE PROPOSAL.

**EXHIBIT J: 42:**

**Letter from John J. Quick  
(Beneficial Management Corporation)  
(October 26, 1993)**



Joseph A. Furey  
Vice President - Tax  
908 781-3023

Beneficial Management Corporation  
300 Beneficial Center  
Peapack, New Jersey 07977

October 26, 1993

Alan H. Friedman, General Counsel  
Multistate Tax Commission  
520 Virginia Avenue  
San Mateo, CA 94402

RE: Proposed Regulation IV.18.(i) Apportioning  
the Income of Financial Institutions

Dear Mr. Friedman:

We hereby submit for your consideration Beneficial Management Corporation's comments on the six questions listed in Attachment Three of the Interim Report of Hearing Officer Regarding Proposed Regulation IV.18.(i) Apportioning the Income of Financial Institutions.

It is our understanding that the written comments previously submitted by FIST will be mailed later this week to those who were in attendance at the September 30, 1993 New York City Hearing with any comments related to the FIST submission due back to you no later than November 30, 1993.

Should you desire any additional information or clarification on any of the issues hereinafter discussed please call me at (908) 781-3381.

Very truly yours,

A handwritten signature in cursive script that reads "John J. Quick".

John J. Quick  
Assistant Vice President - State and Local Tax

Enclosures

cc: Teresa Moore, Multistate Tax Commission, Washington, D.C.

QUESTION NO. 1. WHAT IS THE MOST APPROPRIATE DEFINITION OF THE TERMS "FINANCIAL INSTITUTION" AND "BUSINESS OF A FINANCIAL INSTITUTION" FOR THE PURPOSE OF STATUTORY OR REGULATORY COVERAGE OF THE DIFFERENT KINDS OF FINANCIAL INSTITUTIONS THAT ARE IN SUBSTANTIAL COMPETITION WITH ONE ANOTHER?

**Appendix B** contains the suggested definition of "financial institution". In a catch-all provision, subsection (1) states:

Any other person or business entity which derives more than fifty percent (50%) of its gross income from activities that a person described in subsections (b) through (i) above is authorized to transact. For the purpose of this subsection, the computation of gross income shall not include income from nonrecurring, extraordinary items.

The Advisory Commission on Intergovernmental Relations (ACIR) issued a report in December 1989 entitled "State Taxation of Banks: Issues and Options". The ACIR reported that "some 25 states allow their state-chartered banks to engage in some securities activities, 17 states allow banks to underwrite insurance and/or act as an insurance agent or broker, and 26 states permit state banks to invest in and develop real estate and/or act as a real estate broker." This report is now three-and-a-half years old.

Large investment banks and money-center banks are also becoming extensively involved in making loans that are subsequently pooled and packaged for sale as securities in the financial markets to institutional (bank and non-bank) and individual investors. Such loan-pool securities are typically made up of home mortgages, but can also include credit card, car and boat loans. Financial packages may also be either sold or transferred to related affiliates for business purposes.

In the area of high technology, there are many detailed discussions about the blur between telecommunications and data processing. This "blur" between a traditional regulated utility and a general corporate activity has developed into the new hybrid field of "information movement and management" with the participants therein seeking to be taxed as general corporations. A similar "blur" is taking effect in the financial area which would appear to require the MTC to reexamine the wording of proposed subsection (1) so as to exclude activities related to the securities industry, insurance underwriters, agents and brokers as well as real estate investors, developers and brokers.

It is respectfully submitted that subsection (1) be rewritten so as to include only those enterprises that are subject to the jurisdiction of either a state or federal banking commission or regulators.

QUESTION NO. 2. SHOULD THE RECEIPTS FACTOR REFLECT THE DELIVERY OF A FINANCIAL INSTITUTION'S SERVICES ON A DESTINATION BASIS OR ON A MAJORITY OF "COST OF PERFORMANCE" BASIS?

The receipts factor should reflect the delivery of services on a majority of "cost of performance" basis.

The purpose of allocation and apportionment provisions are to fairly represent the extent of a corporation's business activities within a particular state. The business of a financial institution extends far beyond the simple physical transfer of funds between two parties. An article on multistate taxation in the September 28, 1992 issue of Forbes magazine began as follows:

A Minnesota developer travels to New York, where he borrows from a bank to build apartments in Tennessee. The loan is collateralized by Indiana property. Which state claims the right to tax the bank's income from the loan? ... All four.

Marilyn M. Kaltenborn, Chief of Tax Regulations with the New York State Department of Taxation and Finance, wrote in the Winter 1990 issue of the Journal of State Taxation that:

The problems that must be overcome in developing a receipts factor that reflects the contribution of the market state to corporations that provide financial or other services and/or deal in intangibles are significant. For the banking industry, one of the most difficult areas concerns the siting of unsecured loans made to multistate or multinational corporations. The most conceptually correct rule is to situs the loan to the place where the borrowing corporation used the proceeds of the loan. This would most clearly approximate the destination basis used for sales of TPP. However, since money is fungible and since the borrowing corporation is likely to have several sources of funds (for example, the sale of additional stock, the issuance of bonds, one or more bank borrowings, and retained earnings), it is very difficult, if not impossible, to know where the proceeds of any given loan are used. This problem also exists for collateralized loans, since the giving of collateral in connection with a loan does not necessarily mean that the proceeds of the loan were used to purchase the collateral. (Emphasis added). Kaltenborn, State Taxation of Financial Institutions and Other Financial Services Companies, Journal of State Taxation, Vol.9, No. 3 (Winter 1990).

The "cost of performance" is the more accurate reflection of income:

The key element of the bank's role as "financial intermediary" (between borrowers and suppliers of funds) is that of taking risks.

...

...taking risks involves primarily exercising judgement making decisions, and carrying out conclusions based on the analysis of the facts on which the judgements are determined. That is, and can only be, done by people. Thus, interest earned by taking risks is earned by people, and where they perform their functions is where that income is earned. In the case of risks, that is where the risks are managed. Edelstein, How Should the Income of Banks With Multistate Operations Be Allocated? Journal of State Taxation, May/June 1992.

The goal of apportionment is to fairly represent the extent of a taxpayer's business activities among the states in which it does business. Tangible property is apportioned to the state where it is located and actually used in the trade or business. If there is a question about sourcing payroll, it goes to the base of operations, or if there is no base of operations, the place from which the service is directed or controlled. Consistency with the principles underlying the above apportionment factors dictate that the receipts factor reflect the delivery of a financial institution's services on a majority of "cost of performance" basis.

QUESTION NO. 3. HOW SHOULD STATES TREAT INTANGIBLE PROPERTY IN THE FORM OF UNSECURED OR SECURED LOANS, INVESTMENTS IN SECURITIES, ETC. FOR INCOME ATTRIBUTION PURPOSES?

In an article entitled, "How Should the Income of Banks With Multistate Operations Be Allocated?", which was published in the May/June 1992 issue of The Journal of Multistate Taxation, Haskell Edelstein stated that:

The key element of the bank's role as "financial intermediary" (between borrowers and suppliers of funds) is that of taking risks.

...

...taking risks involves primarily exercising judgement, making decisions, and carrying out conclusions based on the analysis of the facts on which the judgements are determined. That is, and can only be, done by people. Thus interest earned for taking risks is earned by people, and where they perform their functions is where that income is earned. In the case of risks, that is where the risks are managed.

And that is where portfolios are bought and sold; investments are made and disposed of; bad debts are written off; and ultimate responsibility is accepted for said decisions. That is the jurisdiction to which the receipts should be "attributed to" for purposes of the multistate financial institution.



QUESTION NO. 4. WITH REGARD TO STATES THAT APPLY THE UNITARY BUSINESS PRINCIPLE AND COMBINED REPORTING, WHAT, IF ANY, APPROACH SHOULD THE PROPOSAL TAKE WITH REGARD TO SUCH PRINCIPLES?

California is often looked to as the model of unitary and combined filing. In Legal Ruling No. 370 (1974), the Franchise Tax Board sets forth special rules for when a unitary business includes both general corporations and financial corporations in a combined report. Legal Ruling No. 385 states that a California corporate insurer engaged in a unitary business must be excluded from a combined report for apportionment of unitary income, because the state constitution exempts such organizations from franchise and income taxes.

In the area of high technology, there are many detailed discussions about the blur between telecommunications and data processing. This "blur" between a traditional regulated utility and a general corporate activity has developed into the new hybrid field of "information movement and management" with the participants therein seeking to be taxed as general corporations. A similar "blur" is taking effect in the financial area which would appear to require the MTC and its member states to determine whether the aforementioned California rulings have become obsolete in today's economic environment.

The Advisory Commission on Intergovernmental Relations (ACIR) issued a report in December 1989 entitled "State Taxation of Banks: Issues and Options". The ACIR reported that "some 25 states allow their state-chartered banks to engage in some securities activities, 17 states allow banks to underwrite insurance and/or act as an insurance agent or broker, and 26 states permit state banks to invest in and develop real estate and/or act as a real estate broker." This report is now three-and-a-half years old.

Large investment banks and money-center banks are also becoming extensively involved in making loans that are subsequently pooled and packaged for sale as securities in the financial markets to institutional (bank and non-bank) and individual investors. Such loan-pool securities are typically made up of home mortgages, but can also include credit card, car and boat loans. Financial packages may also be either sold or transferred to related affiliates for business purposes.

In the same manner that the lap-top personal computer has replaced the office adding machine, the neighborhood bank has evolved via the aforementioned "blur" into a multistate family of corporations, each marketing a variety of financial products and services to a broad horizon of markets. The concept of unitary taxation in the area of financial institutions must, by necessity, say good-bye to the aforementioned California regulatory restrictions and evolve along with the financial products and institutions it seeks to tax.

The general rules of combined reporting should be applied to today's financial institutions.

**QUESTION NO.5. WHAT, IF ANY, APPROACH SHOULD THE PROPOSAL TAKE WITH REGARD TO NEXUS AND/OR DE MINIMIS CONCEPTS?**

In the section of the Interim Report dealing with nexus (page 4) the Hearing Officer states:

Issues of nexus for corporate income or franchise purposes have also been set aside in an effort to achieve consensus as to the appropriate apportionment approach to be used. The proposal assumes that Constitutional nexus exists in the state for apportionment purposes.

...

However, neither the definition of a financial institution, nor the issues of nexus or combination, need be resolved before an acceptable apportionment method is to be suggested for the states' consideration. (Emphasis added.)

P.L. 86-272 was enacted in 1959 as temporary legislation to limit the ability of states to impose their income taxes on interstate business:

Nowhere within Public Law 86-272 are the terms "solicitation" and "delivery" defined. Because both terms describe activities that a business can conduct within a state without subjecting its income to taxation by that state, the definition of these terms is critical in defining the degree of protection afforded by this federal legislation. Accordingly, our judicial system, by default, has been left with the task of interpreting their meanings. Tatarowicz, State Judicial and Administrative Interpretations of U.S. Public Law 86-272, Tax Lawyer, Vol. 38, No. 2.

For 33 years the judicial system worked at interpreting the subject terms until June of 1992 when the tax community anticipated that the U.S. Supreme Court would finally resolve the issue in Wisconsin v. Wrigley. In Wrigley the Court not only failed to finally define "solicitation" but came up with a new concept of a "de minimis" exception to P.L. 86-272. It is safe to assume that the next generation of nexus litigation in the income tax area will deal with whether taxpayer activities within a particular jurisdiction meet the "de minimis" exception.

The year 1992 was also the year that North Dakota v. Quill reviewed the precedent established by the U.S. Supreme Court in their 1967 National Bellas Hess decision in the area of sales and use tax nexus. In finding for Quill, the Court stated that while, "a corporation may have the "minimum contacts" with a taxing state as required by the Due Process Clause, and yet lack the "substantial nexus" with the state as required by the Commerce Clause." Although the Court rejected the concept of "economic nexus", taxpayers were again left without the final definition of nexus (in this case for sales and use tax purposes) that they anticipated. The Court stated that "Congress has plenary power to regulate commerce among the states and thus may authorize actions that burden interstate commerce", ie., "the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve."

The Multistate Tax Commission (MTC) is in a unique position with this proposed regulation. The Hearing Officer appears to be of the position that it is not important that the MTC define nexus for financial institutions at this time. To the

contrary, now is the opportune moment. The initial reaction of many reading the proposed regulation was, "Does this apply to our organization based upon our activities in the State of "X"?" By laying the foundation now by establishing a nexus standard, the MTC may avoid years of audit controversy, ruling requests, administrative releases and regulations, and numerous levels of litigation.

**Appendix D** contains the Suggested Regulation "Preponderance of substantive contact for locating certain loans and credit card receivables; presumption." This proposed regulation contains definitions for the terms "solicitation", "investigation", "negotiation", "approval" and "administration". Taken in its entirety, the proposed regulation forms the perfect foundation for the concept of nexus for financial institutions. It is respectfully submitted that the concept of "administration" be expanded to include the function of management, i.e., finance, accounting, legal, EDP, marketing, etc.

The immediate need for a nexus standard is best exemplified by the interstate bank that can make loans and receive deposits from customers in any state electronically through the use of a shared ATM. Now is the time to create the nexus standard and **Appendix D** is the framework to do it.

QUESTION NO. 6. SHOULD A THROWBACK, THROWOUT OR ANOTHER APPROACH BE USED TO ADDRESS THE ATTRIBUTION OF RECEIPTS THAT ARE SOURCED TO STATES IN WHICH THE TAXPAYER IS NOT SUBJECT TO TAXATION?

Section (4)(o) of the proposed regulation states that:

**Attribution of certain receipts to commercial domicile.** All receipts which would be assigned under this section to a state in which the taxpayer is not taxable shall be included in the numerator of the receipts factor, if the taxpayer's commercial domicile is in this state.

In an article entitled, "How Should the Income of Banks With Multistate Operations Be Allocated?", which was published in the May/June 1992 issue of The Journal of Multistate Taxation, Haskell Edelstein stated that:

The key element of the bank's role as "financial intermediary" (between borrowers and suppliers of funds) is that of taking risks.

...

...taking risks involves primarily exercising judgement, making decisions, and carrying out conclusions based on the analysis of the facts on which the judgements are determined. That is, and can only be, done by people. Thus interest earned for taking risks is earned by people, and where they perform their functions is where that income is earned. In the case of risks, that is where the risks are managed.

And that is where portfolios are bought and sold; investments are made and disposed of; bad debts are written off; and ultimate responsibility is accepted for said decisions. That is the jurisdiction to which the receipts should be "throwback" in the words of the MTC proposal or "attributed to" for purposes of the multistate financial institution. This center of control and/or responsibility may or may not be the taxpayer's commercial domicile.

**EXHIBIT J: 43:**

**Letter from Brenda Jo Seipel  
(Credit Union National Association, Inc.)  
(November 1, 1993)**



**CUNA & Affiliates**  
A Member of the Credit Union System

**Credit Union  
National Association, Inc.**

Suite 300  
805 15th Street NW  
Washington, D.C.  
20005-2207

Telephone:  
(202) 682-4200

November 1, 1993

Mr. Alan H. Friedman  
General Counsel  
Multistate Tax Commission  
119 Scenic Drive  
Redwood City, CA 94062

Dear Mr. Friedman:

On behalf of CUNA & Affiliates, representing the interests of the nation's 13,400 state and federal credit unions and the 65 million American consumers who are the member-owners, I'd like to take this final opportunity and urge MTC to exempt credit unions from the proposed definition of financial institutions which may be subject to the apportionment formulas set forth in Regulation IV.18(i).

Previous testimony given during the hearing process (July 15, 1993 in Washington, D. C. and September 30, 1993 in New York, New York) highlighted the differences of not-for-profit, member-owned credit unions from other for-profit providers of financial services. In recognition of these differences, the U. S. Congress and State Legislatures, with the exception of Indiana and Oklahoma, have established a statutory framework which exempts credit unions from taxes on earnings or income.

This statutory framework has come to symbolize the public, social, and economic policy understanding between the credit union movement and elected officials at every level of government. Contrary to testimony offered by the American Bankers' Association (ABA), this tax exemption has been reviewed numerous times by both Congress and the State Legislatures. In all instances, the tax exemption has remained intact because credit unions, as it was when the first credit union was chartered in America in 1909, still operate on a not-for-profit basis, without capital stock and for mutual purposes. State governments have wisely concluded, as was recently the case in California, that taxing state credit unions would actually decrease revenue to the state and would seriously undermine the dual chartering system and a state's ability to control their own economic destiny.

During the hearing process, it was evident that the banking lobby is attempting to accomplish

Mr. Alan H. Friedman  
October 29, 1993  
Page 2

through MTC what they have been unsuccessful in accomplishing with Congress and State Legislatures. Their testimony, both oral and written, cited concerns with unfair competition and the need for a "level playing field." In order to put their concerns in a more realistic light, I'd like to offer the following points:

- 1) The average bank, at \$300 million, is 15 times the size of the average credit union at \$20 million.
- 2) The largest bank holding company (Citicorp) has \$220 billion in assets. That's 80% of the assets of the entire credit union movement (\$270 billion).
- 3) The two largest bank holding companies (add BankAmerica Corp. at \$190 billion) have one and a half times the assets of the entire credit union movement.
- 4) Last year, total bank profits (after tax: \$32 billion) amounted to almost 12% of total credit union assets.
- 5) Since 1980, consumer-owned deposits at commercial banks have grown at an average annual rate of 9.7%, from \$585 billion to \$1,783 billion. Credit union savings have grown by 12.2% per year over the same period, from \$62 billion to \$244 billion. As a result, credit union savings now stand at 13.7% of bank household deposits, as opposed to 10.5% in 1980. (In terms of total assets, which include non-consumer deposits, other liabilities and equity, credit unions' assets amount to only 7.8% of bank assets.) Were the growth trend of the past twelve years to continue indefinitely, it would take almost 90 years for credit union savings to catch up to consumer-owned deposits at commercial banks (at about \$7.5 quadrillion in the year 2080.)
- 6) It is true that banks have lost some of their market share in the most significant market they share with credit unions: consumer installment credit. Since 1987, the banks share of consumer installment credit has dropped from 46 percent to 44 percent. But the blame doesn't fall on credit unions. The credit union share of the consumer installment credit market has remained relatively stable (about 13 percent) in the last six years. However, the market share for other providers of consumer installment credit - the captive finance companies of the auto manufacturers, credit arms of companies such as General Electric and Sears - has been making the biggest inroads into the market since 1987. Their portion of consumer credit has risen from 40 percent to 42 percent.

I urge the MTC to consider these statistics which clearly do not support the contention that credit unions are running away with business or that "the marble will roll off the table in favor of credit unions." Furthermore, is it realistic for banks to request "leveling the playing field"

Mr. Alan H. Friedman

October 29, 1993

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without giving up profits, paid directors and stockholders, as credit unions have done?

CUNA strongly urges MTC to exempt credit unions from the proposed definition of financial institutions subject to apportionment formulas in recognition that the U. S. Congress and most State Legislatures, pursuant to their authority, have voted to provide for the tax exemption of credit unions.

If you have any questions or need further information, please do not hesitate to contact me.

Sincerely yours,



Brenda Jo Seipel

Vice President

State Governmental Affairs



**EXHIBIT J: 44:**

**Letter from Roy E. Crawford  
(American Bar Association Banking and Savings Institutions Committee  
and State and Local Tax Committee)  
(November 3, 1993)**

BROBECK, PHLEGER & HARRISON

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PALO ALTO, CALIFORNIA 94303  
(415) 424-0160

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SUITE 1000  
NEWPORT BEACH, CALIFORNIA 92660  
(714) 752-7535

November 3, 1993

Alan Friedman, General Counsel  
Multistate Tax Commission  
520 Virginia Avenue  
San Mateo, California 94402

Re: Proposed Regulation IV.18(i)  
Apportionment of Income of Financial Institutions

Dear Mr. Friedman:

Members of both the Banking and Savings Institutions Committee and State and Local Taxes Committee of the American Bar Association Section of Taxation have reviewed your Interim Report of Hearing Officer Regarding Proposed Regulation IV.18(i) Apportioning the Income of Financial Institutions, and have the following comments. The views expressed herein consist of a collection of comments from individual members of both Committees, and are not intended to represent an official position of either Committee, the Section, or the American Bar Association.

1. General Comments.

It is understood that the Proposed Uniform Allocation and Apportionment Method for Financial Institutions was the product of many months of effort by a broad spectrum of participants, who represented both governmental and industry interests. The draft formula, which in general terms sources the receipts factor to the location of customers of financial institutions and sources the property factor to the location of the financial institutions, represents a compromise that appears to be acceptable to a significant majority of the participants. The two Committees of the Section of Taxation believe that the proposal represents a remarkable advance in what otherwise might have been viewed as a hopeless task of resolving the conflicting interests of the diverse effected parties. We accordingly

Alan Friedman, General Counsel  
November 3, 1993

Page 2

believe that it would serve no good purpose to suggest alternative apportionment factors or to suggest changes to sourcing rules of a magnitude that might upset the compromise that has been reached. The Committees agree with the concept that uniformity in financial institution apportionment schemes should be the principal goal of the various participants.

In general, there is some skepticism whether a uniform statute is a practical objective, in view of the legislative process where local interests and concerns are often reflected in modifications to a proposed uniform statute. However, it may be encouraging that a certain amount of momentum has been created by the process that may assist in resisting local pressure for modification. For example, at a recent meeting of the California Franchise Tax Board, a banking industry representative testified against a double-weighted sales factor that would reduce the California tax liability of the representative's bank, seeking to preserve uniformity with the single weighted sales factor of the draft statute.

The Interim Report provides that the issue of nexus has been set aside to achieve consensus. Members of the Committees differed on the question whether a nexus provision was an essential element of an apportionment statute. An unrealistic nexus rule would seriously impede the possibility of gaining widespread acceptance of this apportionment methodology. An example might be the early MTC draft regulation on apportionment of bank income that was adopted statutorily by Minnesota, which requires the filing of a tax return on the basis of the most insignificant activity, where the burden of filing a tax return by a financial institution could greatly outweigh the de minimis tax that would be generated by the filing. Some members of the Committees asserted that the benefits from realistic bright-line tests are sufficiently important that the proposed uniform statute should contain uniform nexus rules. We did not attempt to formulate a nexus rule, but would be pleased to participate in an effort to do so.

## 2. Specific Comments.

a. It is suggested that language in current use be used in favor of alternative descriptions. For example, the first sentence in Section 2(a) should read:

Alan Friedman, General Counsel  
November 3, 1993

Page 3

A financial institution having income from ~~business activity which is taxable both within and without~~ sources in this state shall allocate and apportion its net income as provided in this Act.

Similarly, the last sentence on page five should read:

The receipts factor shall include only those receipts described herein which are included in the computation of ~~the apportionable income base~~ ~~business income~~ for the taxable year.

b. The phrase "properly booked for tax purposes" occurs repeatedly throughout the draft.<sup>1/</sup> It is understood that there is no existing common meaning of the phrase, which suggests that there are different booking rules for tax purposes than for financial or regulatory accounting purposes. We suggest that the words "for tax purposes" be deleted.

c. The draft statute assumes that a financial institution is engaged in only one unitary business activity. It may be possible that a financial institution is engaged in two or more unitary businesses within the meaning of the uniform regulation adopted by the MTC under Section 1 of the Uniform Division of Income for Tax Purposes Act (UDITPA). Section 2(a) should be clarified to limit application of the proposal to the apportionment of business income from the unitary financial business of a financial institution, subject to the proposition that the apportionment formula for financial institutions must be used for apportioning the financial income of financial institutions.

d. Some respondents expressed a clear preference for the inclusion of a definition of "financial institution" in Section 2(h). Uniformity would be promoted by defining the class of taxpayers subject to the statute.

e. Section 4(c) provides specific rules for sourcing receipts from aircraft, but not receipts from rolling stock and water craft vessels. It would be helpful to provide specific rules for these classes of movable property.

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<sup>1/</sup> A possibly noninclusive list includes Sections 4(m)(2)(A), (B), and (C); Sections 4(m)(3)(A), (B), and (C); Section 4(m)(5); Sections 5(g)(1)(A)(i), (ii), and (iii).

Alan Friedman, General Counsel  
November 3, 1993

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f. Specific rules are provided for many fee items. The California regulation provides, in addition to those items listed in the proposed statute, for location of fees from traveler's checks. A similar rule is suggested.

g. Section 4(k)(1) provides that loan servicing fees derived from loans secured by real property are sourced to a state based upon the interest, fees, and penalties earned by the financial institution on loans secured by real property located in the state. Stated another way, the sourcing of receipts from portfolio loans governs the sourcing of loan service fees. This rule produces an unusual result where the financial institution derives substantial fees from the servicing of loans owned by another, unrelated, financial institution. It would seem more appropriate to source such service fees either to the location where the servicing function is being performed or to the location of the customer that receives the benefits of the services, the third party lender. It is true that the ultimate source of payment is from the borrower, but those payments are fully includible in the receipts factor of the third party lender.

h. Section 6(c) defines when compensation is paid in this state. It has been observed that this provision uses different language than section 13 of UDITPA, but no substantive change is intended. We understand that the draft language was intended to make clear that wages paid to employees in foreign branches are includible in the denominator, and that the motivation for the change was an existing audit practice that looked only to U.S. wage payments to determine the denominator. However, Section 13 of the UDITPA definition clearly includes wages paid outside the U.S. in the denominator. To avoid confusion whether the new definition is intended to modify the existing UDITPA definition, we suggest that the UDITPA definition be used.

i. Appendix D provides rules for sourcing loans and credit card receivables under the "preponderance of substantive contact" test. Consideration is to be given to five specific activities: solicitation, investigation, negotiation, approval, and administration. Subsection (2) provides that a rebuttable presumption exists that the preponderance of substantive contacts will be at the taxpayer's regular place of business where the loan is booked if the loan is approved and administered there.

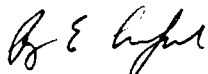
The difficulty in applying this criteria can be illustrated by a common commercial lending situation. A typical loan made to a borrower in a state other than the commercial

Alan Friedman, General Counsel  
November 3, 1993

Page 5

domicile of the lender occurs when an out-of-state loan production office of a bank solicits a prospective customer. Usually the investigation and negotiation of the loan occurs at the loan production office. Because a bank under current law can only approve loans in the state in which its commercial domicile is located, approval will always be in that state, and the loan will be booked there. The loan will also normally be administered in the state of commercial domicile. Under this standard multistate scenario, three enumerated factors are in the state in which the loan production office is located (solicitation, investigation, and negotiation), while two enumerated factors (approval and administration) plus booking, are in the state of commercial domicile. The regulation accordingly provides for a built-in tension for locating each multistate loan, the resolution of which is only partially assisted by the rebuttable presumption. Unfortunately, there is a long history of loan sourcing disputes: it makes little sense to set the stage for further disputes. We suggest that the presumption be a conclusive presumption for this property factor test, which we understand to be oriented to the commercial domicile.

Very truly yours,



Roy E. Crawford

REC:si

**EXHIBIT J: 45:**

**Letter from Henry Ruempler  
(American Bankers Association)  
(November 18, 1993)**

AMERICAN  
BANKERS  
ASSOCIATION

1120 Connecticut Avenue, N.W.  
Washington, D.C.  
20036



DIRECTOR, TAX AND ACCOUNTING  
Henry Ruempler  
202/663-5317

November 18, 1993

Alan H. Friedman  
General Counsel  
Multistate Tax Commission  
386 University Ave.  
Los Altos, CA 94022

Dear Alan:

Based on your memorandum of October 27, 1993, the American Bankers Association hereby submits further comments in connection with the MTC's hearing on apportionment of income derived by financial institutions. In general, our further comments are designed to underscore our position on three points, (1) the nature of the tax imposed by the state which is subject to the MTC apportionment rules, (2) the definition of financial institutions, (3) a de minimis level of activity for application of the apportionment rules.

As many other witnesses testified, we believe that the MTC should not prescribe that the state enact a franchise tax on financial institutions. The apportionment rules can be used in connection with other types of state taxes calculated on the basis of business income. The Congress appears to be giving approval of a variety of types of state taxes on financial institutions income, as reflected in the debate on interstate banking and branching. A bill introduced by Sen. Wendell Ford (D-KY) would specifically preserve the right of Kentucky to collect a shares tax based on income, even if the financial institution presence in the state is only by branch. This language was passed by the Senate in 1991, and reintroduced by Sen. Ford in 1993 as S. 810 and is contained in the markup document to be used by the Senate Banking Committee when it considers interstate banking legislation.

We recommend that the MTC define the term financial institutions to include credit unions. Credit unions perform the same functions as other types of financial institutions and therefore any model statute or regulation on the taxation of financial institutions should include credit unions. If the states wish to make a political judgment to exclude credit unions



or a decision is made to adopt a de minimis rule to exclude small credit unions (and small banks and thrifts) that decision should be made by the state legislatures, not the MTC. In support of this argument, I have included for your information an advertisement that appeared in the Washington Post on the Sunday after the New York hearing. It must be more than coincidence that this advertisement appeared and touted that the Navy Federal Credit Union was seeking a mortgage lending professional to oversee a staff of 300 employees and mortgage operations in 27 states and the District of Columbia. Res ipsa loquitur.

Most importantly, the MTC should include in its report a recommendation that the states adopt a de minimis rule for apportionment of financial institution income. The record which the MTC has developed on this issue, as well as its experience on state tax issues must surely confirm that both taxpayers and tax collectors will benefit from reasonable de minimis rules. (Note that in using the term de minimis rule, I am avoiding the legal question of nexus to tax.)

We believe that in order to be effective, the de minimis standard for apportionment should be determined on the basis of an "eyeball" test, rather than by requiring the potential taxpayer to do all of the work that would be required for completing a tax return. Financial institutions which have property in a state other than in the one in which they are headquartered, less than a de minimis asset level could be required to file a letter with the state together with an excise fee of a minimum amount. The enactment of the de minimis amount would not be treated as an admission of nexus and the filing of the letter and the paying of the fee would not concede the existence of nexus. The MTC regulations will be enhanced by a de minimis rule that protects both home state and out of state banks from apportionment.

Finally, we want to restate our support for enactment of uniform rules of apportionment for financial institution income. The fact that this objective may take a long time to achieve does not diminish its significance.

Sincerely,

  
Henry Ruempfer

## **Mortgage Lending Professional**

Navy Federal Credit Union is a \$7.5 billion dollar credit union located in Northern Virginia. We are seeking a Mortgage Lending Professional to oversee a staff of 300 employees and mortgage operations in 27 states and the District of Columbia. We are interested in applicants who have strong backgrounds in origination, secondary marketing, processing and closing. Proven leadership ability and excellent communication skills are necessary.

A competitive compensation and benefits package will be offered to the successful candidate.

Please forward a cover letter and resume with salary expectations by October 18 to:

### **Navy Federal Credit Union**

P.O. Box 3400  
Merrifield, Virginia 22119  
ATTN: N.H.

EOE M/F/V/D

**EXHIBIT J: 46:**

**Letter from Fred E. Ferguson (FIST)  
(November 19, 1993)**

# ARTHUR ANDERSEN

ARTHUR ANDERSEN & CO. SC

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Arthur Andersen & Co.  
Office of Federal Tax Services

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1666 K Street NW  
Washington DC 20006-2873  
Writer's Direct Dial  
(202) 862-7480

November 19, 1993

Mr. Alan Friedman  
Hearing Officer  
Multistate Tax Commission  
444 North Capitol Street, N.W.  
Suite 425  
Washington, D.C. 20001

RE: Multistate Tax Commission Proposed Regulation IV.18.(i)  
Apportioning the Income of Financial Institutions

Dear Alan:

On behalf of the Financial Institutions State Tax (FIST) Coalition, which consists of:

Bank of America, NT & SA  
The Bank of New York Company, Inc.  
Bankers Trust Company  
Boatmen's Bancshares, Inc.  
Capital Holding Corporation  
The Chase Manhattan Bank, N.A.  
Citicorp/Citibank, N.A.  
First Chicago Corporation  
First Interstate Bancorp  
First Union Corporation  
Great Western Financial Corporation  
KeyCorp  
Morgan Guaranty Trust Company of New York  
NationsBank  
Shawmut National Corporation  
Society National Bank  
SunTrust Banks, Inc.  
Wachovia Corporation

this letter provides additional comments to our technical mark-up dated July 29, 1993, (note that all references to section numbers and letters are based on the revised section numbers and letters included in our July 29, 1993 mark-up).

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MTC / DC

Mr. Alan Friedman  
Page 2  
November 19, 1993

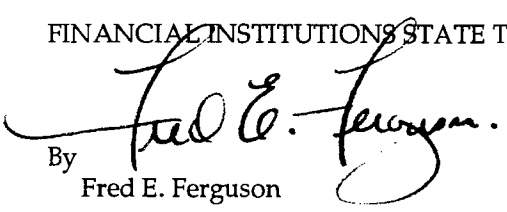
1. In footnote 1, the word "franchise" in the third sentence should be deleted.
2. The definition of the term "billing address" in Section 2(a) should be changed to read "means the location indicated in the books and records of the taxpayer at the end of its taxable year (or at such earlier time in the taxable year when the customer relationship ceased to exist) as the address where any notice, statement and/or bill relating to a customer's account is mailed."
3. In the first sentence of the definition of the term "loan" in Section 2(j) the word "such" should be replaced with the word "any". Accordingly, the first sentence should read "'Loan', means any extension of credit resulting from direct negotiations between the taxpayer and its customer, and/or the purchase, in whole or in part, of any extension of credit from another."
4. The second sentence of the definition of "real property owned" and "tangible personal property owned" in Section 2(n) should read: "Real and tangible personal property include land and stocks in goods." Note that the listing of the changes sent to you with the marked text in July was correct but that the marked text itself was not correct.
5. In the definition of the word "taxable" in Section 2(r), the word "another," instead of the word "a," should be used before the word "state" in paragraph (1) and before the word "state" the first time that word appears in paragraph (2). (Note that the "(2)" should not have been deleted in the July mark-up.)
6. In Section (4)(g)(1)(ii) (property factor, location of loans) of the mark-up text, the words "of the United States, the District of Columbia, the Commonwealth of Puerto Rico or any territory or possession of the United States" should have been inserted after the word "state" the first time that "state" appears in the sentence, rather than where it was inserted in our July mark-up.
7. In Appendix A, the references to Sections 4 through 6 should be to Sections 3 through 5.

If you have any questions regarding FIST's additional comments, please contact me.

Very truly yours,

FINANCIAL INSTITUTIONS STATE TAX COALITION

By

  
Fred E. Ferguson

JS

Copies to: Mr. Timothy Leathers, Chair of Multistate Tax Commission  
FIST Coalition

**EXHIBIT J: 47:**

**Letter from Ben Miller and Mike Brownell  
(California Franchise Tax Board)  
(December 15, 1993)**

STATE OF CALIFORNIA

**FRANCHISE TAX BOARD**

Mailing Address:

Legal Division

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Sacramento, CA 95812-1468

(916) 369-5245

410:mtcfinrg.com

December 15, 1993

Alan Friedman  
Multistate Tax Commission  
520 Virginia Ave.  
San Mateo, CA 94402

Re: MTC Financial Corporation Apportionment Proposal

Dear Alan:

This letter will provide the department's response to the proposed MTC Allocation and Apportionment Method for Financial Institutions. We appreciate your extension of time to December 15, 1993 for the department to respond the MTC proposal.

At the outset, we should state that we are keenly aware of the fact that the MTC proposal is the product of a series of difficult negotiations, involving many participants from the government and private sectors. We offer the comments below in the hope that they are seen as constructive. We have no interest in changing the relative apportionment effects between the various states of the often difficult negotiations that have culminated in the currently considered proposal. Our interest is improving the proposal to avoid uncertainties and to improve its administrability. It should also be understood that the recommendations or suggestions we offer below, if not accepted or adopted at the present stage, are not expected to cause the department to later reject the proposal within the MTC. However, to the extent that such recommendations or suggestions are incorporated into the MTC proposal, the proposal becomes that much more attractive for adoption by California in its own regulatory scheme.

We have broken the commentary into two classes, one substantive and one technical. The latter class can probably be amended into the MTC proposal without much controversy. Other departmental personnel are currently examining the MTC proposal, and there may

Mr. Alan Friedman  
December 15, 1993  
Page 2

be other technical concerns not identified herein. If desired, we can communicate any such to concerns to you at a later date.

Substantive Commentary.

1. Section 3n. The MTC proposal excludes realty received from a foreclosure of a loan from the definition of real property. Under the traditional UDITPA rules, owned real estate would be included in a taxpayer's property factor, and would be assigned to its location. The MTC may wish to consider the rationale for the exclusion of such property from the property factor to determine whether circumstances specific to the financial industry justify that exclusion.

There are arguments both for and against such exclusion which should be considered in that review.

Arguments in favor of the exclusion include:

a) Foreclosed property does not produce interest income, and is generally not held for income production, but is instead a means to prevent further loss with respect to a bad loan.

b) The foreclosed property represents a substitute for the loan from which it originated, and may be accounted for in the bad debt reserve mechanism, depending upon whether a bank or a savings and loan is involved.

c) A number of states may have laws similar to California Corporation Code §191(d) and §2104, which limit jurisdiction to tax if the taxpayer's contact with the state is limited to acquisition of foreclosure property.

d) The MTC proposal attempts to achieve a compromise which balances the interest of market and home states. Because a loan is generally assigned to the home state for property factor purposes, assignment of foreclosure property to the state where the property is located could change a property factor component to a market orientation. The exclusion of foreclosure property from the property factor retains the home office orientation of the property factor.

Arguments against the exclusion include:

a) Foreclosure property is a business asset, and a use of capital. Inclusion of such property in the property factor represents the actual benefits and protections afforded by the



Mr. Alan Friedman  
December 15, 1993  
Page 3

taxing state with respect to the physical property held by the taxpayer.

b) Section 18 of UDITPA, the provision under which California would likely adopt the MTC proposal, is a business activity based examination. A taxpayer with foreclosure property in the taxing state has business activity in that state. Such property is traditional UDITPA property, and a taxpayer challenging the rule might argue that exclusion of such property does not properly reflect their activity in the state where such property is held.

c) Foreclosure property is an economic substitute for a loan, which, after foreclosure, is no longer in the property factor. Thus, the taxpayer's economic interest in that value is not reflected in the apportionment. The fact that the original loan situs may be different than the foreclosed property situs, is not material, as the nature of the property has clearly changed, and the benefits and protections afforded by the taxing states to the taxpayer have changed as well.

The Hearing Officer's report might appropriately consider these arguments and, in any event, fully explain the rationale for the MTC's determination.

2. Section 4(f). Net gains from the sale of loans and receivables are included in the receipts factor. The gains are assigned to the states using the ratio of the interest assigned to the state from the particular class of loan (secured by real estate, unsecured, credit card) to the total interest from such loans.

The use of interest as a proxy for apportionment of net gains works well enough if the taxpayer's loan portfolio is relatively static. However, distortion can occur if a bank decides to terminate its connection with a particular region. For example, if a bank disposes of its western loan portfolio in January, if the gains are apportioned using the now predominantly eastern interest ratio, the western market will not be properly reflected.

We would suggest a permissive variation, similar in principle to the variation which appears in Section 4(m)(3), which would assign such gains to the state of the location of the securing realty or the state of the customer, as the case may be, if a disproportionate disposition of such loans occurs.

3. Section 4(j). Merchant discount from credit cards is assigned to the commercial domicile of the merchant. There may be compliance concerns with respect to a bank's ability to

Mr. Alan Friedman  
December 15, 1993  
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determine the merchant's commercial domicile. In lieu of commercial domicile, a credit card interest proxy could be used to assign merchant discount, on the premise that customers predominantly utilize merchant services in the state of the credit card's billing address.

4. Sections 4(m)(2-3). The MTC proposal provides for separate apportionment of income from 1) investment assets, 2) sale of federal funds and repurchase agreements and 3) trading assets and activities, as defined. Receipts from each asset pool is apportioned by the ratio of asset value for the pool treated as "booked for tax purposes" in the state to the total asset value everywhere for that pool. If necessary to fairly represent activity in a state, in lieu of an asset rule, a ratio of a gross income "booked" to the state to total gross income for the pool. Each asset pool has its own apportionment.

The phrase "booked for tax purposes" is not specifically defined. Section 4(m)(4), however, provides the taxpayer with the burden of proving that the assets were "booked for tax purposes" at a "regular place of business" by demonstrating the "day-to-day decisions" regarding the asset activity were conducted at such regular place of business. If such decisions were conducted in more than one place of business, the location is the place of business where investment or trading policies or guideline are established. Such activities are presumed to have occurred at the financial corporation's commercial domicile, or, if a foreign corporation, at the U.S. "home state" location (International Banking Act of 1978) or, if none, the location where the most employees are employed.

A. We are concerned that there is no specific booking rule. The thrust of the MTC rules is to overcome a standard booking rule in special situations, without defining what the standard booking rule is. It is unclear whether "booking" is governed by specific financial accounting principles, by regulatory accounting principles, or merely by reference to the taxpayer's internal accounting practices. If clear and specific financial accounting principles or regulatory accounting principles apply, they should be incorporated by reference in a definition section. If only internal accounting methods apply, there is no guarantee of consistency between financial institutions. If there are no standard and consistent rules outside of the tax arena, we would recommend adoption of a standard rule for assignment of these receipts, avoiding the term "booking" entirely.

B. The process of assigning receipts from the described asset pools is quite complex. Some of the complexity appearing in Section (4)(m)(3) might be reduced by simply assigning income

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from these assets to the state where the income is "properly booked" or assigned under another standard rule.

To illustrate, the MTC proposal contemplates multiplying the income from an asset pool by the ratio of income from an asset pool "booked" to a given state, to the total income from the pool. Mathematically, it appears that a ratio is unnecessary. The equation sets up as

$$\frac{A}{B} \times B = \text{Income assigned to the numerator}$$

In the equation, A is income of the asset class "properly booked" to the state, B is total income in that class. The equation simply reduces to A = income assigned to the numerator, suggesting that the ratio may be unnecessary.

C. If a specific state trading center for these asset pools cannot be identified, the MTC proposal treats assets as "booked" at the corporation's commercial domicile. Foreign banks and financial corporations are presumed to have a "proper booking" in the U.S. "home state" under the International Banking Act of 1978, or if none exists, its U.S. place of business with the most employees. While this rule may be appropriate for federal funds and, to a lesser extent, repurchase agreements (because of their flavor of dealing with the federal government or its obligations), the presumption does not seem appropriate for an apportioning foreign bank whose actual commercial domicile is outside of the U.S. and whose actual trading activity is undertaken outside of the U.S. We would suggest that the presumption take effect only to the extent that there is an identified trading activity undertaken within the United States, or the income from the trading activity is treated as U.S. source income for federal income tax purposes.

5. Section 5(g). Loans, and credit card receivables are assigned to the property factor, on the basis of where the loans and receivables are "properly booked for tax purposes." Section 5(g)(1)(B) states that "the state in which a loan has a preponderance of substantive contact with a regular place of business of the taxpayer shall be the state in which a loan is properly booked."

A. There is ambiguity in these provisions. It is unclear whether it is intended that the operative rule be a "booking rule" used for financial or regulatory accounting purposes for such loans (if one exists), or whether a "substantive contact" rule is intended to displace any conflicting financial or regulatory accounting rule.

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For example, if a loan is "properly booked" for financial or regulatory purposes to State A (where some "substantive contact" occurred at a regular place of business in that state), but the preponderance of substantive contact is a regular place of business in state B, would the MTC proposal assign the loan to State B? Section 5(g)(1)(B) suggests that it is.

If that is the case, then the use of the term "properly booked for tax purposes" is misleading, because the loan is not "booked" there for any purpose other than the MTC proposed rules. If an independent substantive rule is intended, we would suggest consideration of the term "assigned," rather than "booked," to avoid confusion with any standard booking practices that may exist.

On the other hand, is the MTC proposed rule instead designed, like the investment asset rule, merely to overcome a standard booking rule, if the standard booking rule assigns a loan to state where no regular place of business exists? If the latter, then, as in the case of the "booking rule" for the investment asset pools described above, the MTC proposal does not specifically define what the "booking rule" actually is. As previously noted, it is unclear whether "booking" is governed by specific financial accounting principles, by regulatory accounting principles, or merely by reference to the taxpayer's internal accounting practices. If clear and specific financial accounting principles or regulatory accounting principles apply, they should be incorporated by reference in a definition section. As noted above with respect to the investment receipt rules, if only internal accounting methods apply, there is no guarantee of consistency between financial institutions.

B. If a "preponderance of substantive contact" principle is in fact intended to be the operative property factor rule, the primary MTC proposal does not offer a definition of "substantive contact" used in the rule. Footnote 10 appears to leave this to the states. We are concerned that the MTC proposal leaves a substantial, if not predominant, part of an important apportionment factor determination completely undefined. We are concerned that this status will not further the objective of the proposal to seek uniformity in this difficult area. While the lack of a rule may in part reflect differences and difficulties in negotiations on the question, insertion of a rule that has no operative definition may foster confusion and uncertainty, and lack of uniformity in practice. Accordingly, it may be advisable to attempt to provide a substantive rule in the primary proposal.

Attached to the proposal as Appendix D, is a "suggested" regulation for the "preponderance" test (as we understand it,

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based on a similar rule currently in use in New York). Under the MTC proposal, preponderance is determined on a facts-and-circumstances basis, with "consideration" given to employees' time devoted to "such things" as solicitation, investigation, negotiation, approval, and administration of the loan. The suggested proposal, at Section (2), contains a presumption that the regular place of business where the loan is "booked" (assumed to be a reference to financial, regulatory, or internal accounting standards) is the place of substantive contact, if approved and administered there.

It is not clear that the MTC in fact recommends the "suggestion," as opposed to merely offering it as one possible definition of the phrase "substantive contact." If the MTC actually recommends the "suggested regulation," perhaps it should say so. If it does not, then the uncertainty of the primary rule remains.

C. If the MTC were to actually go on record as recommending the "suggested" regulation as a substantive rule, there is potential for substantial administrative problems with the regulation proposal. The suggested regulation proposes a loan-by-loan facts and circumstances analysis, requiring a comparative analysis of the relative participation of the taxpayer's employees' time in the acts of solicitation, negotiation, investigation, approval, and servicing occurring in a given state. However, there is no indication how the weighing of such time is to be made--is it based on actual time spent or relative value of time spent (e.g. weighing "approving" personnel time more substantially than "servicing" personnel time)?

There is also no indication of the kinds of records that must be maintained to establish these relative values. It is doubtful, without systematic record keeping of time spent on each loan, that, with the millions of loans that a large financial corporation makes, that taxpayer's geographic assignment of loans could be practically verified by examination, or if the burden of proof is shifted to the taxpayer, whether the taxpayer could make a compelling case for its jurisdictional assignments.

The proposed regulation appears to recognize the difficulty of such a determination, and further suggests a presumption of substantive contact by assignment of loans to the state where "approved and administered." However, there is no description of the role of the presumption (i.e., affecting the burden of going forward with the evidence or affecting the burden of proof), or whether the taxing agencies would be required to bear the burden of proof to rebut the presumption (in contravention to the normal circumstance where the taxpayer bears the burden of proof as to tax matters).

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6. Section (5)(g)(iii). This section treats a loan as assigned to a bank or financial corporation's "commercial domicile" if it cannot be assigned to a "regular place of business." Under the MTC proposal, foreign entities are required assign loans which have no associated "regular place of business" to its "home state" or its place of business where most of the employees in the U.S. are employed as their place of assignment of such loans. Are some foreign loans of foreign banks and financials assigned to a U.S. state under this rule? For example, if a foreign lender assigns a loan to a "fictitious branch", the loan is assigned to a U.S. location, even if the U.S. employees had nothing to do with the loan. Is this intended? Why shouldn't the bank's foreign commercial domicile control? Assignment to a U.S. state should be made only if employees of a U.S. branch were significantly involved in the lending process, or if income from the loan is treated as U.S. source income for purposes of the Internal Revenue Code. See similar discussion with regard to the "home state" rule with regard to investment assets pools, above.

#### Technical Observations.

1. Section 3(b). There are different rules for "locating" borrowers depending upon whether they are commercial or noncommercial borrowers. This rule has significance for receipts factor assignment of interest on unsecured loans. Commercial borrowers can include individual proprietors, who really don't have a "commercial domicile" in a traditional sense. Should the rule assign location of individual commercial borrowers to the borrower's billing address?

2. Section 3(e). Should the definition of credit cards also include "debit" cards? This would provide a rule for any fee income from such cards.

3. Section 3(n)(1-2). The first sentence definition of real property arguably includes only real property subject to depreciation, and not underlying land. The second sentence "includes" land in the definition. The term "includes" is often used in regulations to highlight an example, or a list of examples, of a rule, rather than to state an independent substantive rule, as appears here. Redrafting for clarity might help.

4. Section 4(b, c). Receipts from leases of property are included in the receipts factor. Because leases which are substantively loans for federal income tax purposes are included in the rules for loans, the lease rules should be amended to state "receipts from the lease or rental of real [tangible

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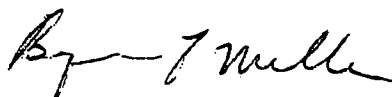
personal] property (other than a lease treated as a loan under section 3(j))..."

5. Section 4(c)(2). The terms "movable tangible personal property" and "mobile property" need clarification. By definition, all tangible personal property is movable. It appears what is intended in this section is "transportation equipment."

6. Section 5(b). The emphasis on depreciation, and the word "only" can be taken to imply that nondepreciable land is excluded from the property factor. Such land would be a UDITPA property item under the normal rules. See similar discussion regarding section 3(n)(1-2), above. The term "only" also conflicts with the later inclusion of loans in the property factor.

7. Section 5(f). Same observation as that for "mobile" and "movable property" section 4(c)(2), above.

If you have any questions, please contact Ben Miller (916-369-3320) or Mike Brownell (916-369-5245).



Ben Miller  
Multistate Counsel



Mike Brownell  
Sr. Tax Counsel

**EXHIBIT K**  
**ARTICLES, PAMPHLETS AND OUTLINES**



**EXHIBIT K: 1**

**Advisory Commission on Intergovernmental Relations, "Monitoring and Working Group on State Taxation and Regulations of Banks" (July 7, 1989)  
(briefing paper and collection of presentations and articles)**

Monitoring and Working Group on  
State Taxation and Regulation of Banks  
July 7, 1989



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2. Brief on State Taxation & Regulation of Banks      TAB B:
3. ACIR Statement Before the Federal Reserve  
Board Relating to Regulation Y      TAB C:
4. State Regulation of Banks In An Era of  
Deregulation (A-110)      TAB D:
5. Survey of State Bank Tax Taxation      TAB E:
  - o Characteristics of Banks  
by State
  - o State Taxation of Banks
  - o Survey of State Bank Taxation
6. State Taxation of Banks: Issues and Options      TAB F:
7. Banking: Other Related Papers      TAB G:

**AGENDA**

**Friday, July 7, 1989**

**Monitoring and Working Group on the  
State Taxation and Regulation of Banks  
of the  
U.S. Advisory Commission on Intergovernmental Relations**

1. Call to Order:                   The Honorable John T. Bragg  
  Deputy Speaker  
  Tennessee House of Representatives
2. Introduction of Members and Guests
3. Chairman's Comments
4. Overview of the Issues:   Sandra B. McCray
5. Presentation and Discussion Relating to Regulatory Issues  
      Steven Weiss                   Controller of the Currency  
      William Hrindec               Federal Deposit Insurance  
  Corporation  
      Donald Savage                 Federal Reserve Board  
      Robert Richard                Council of State Bank  
  Supervisors
6. Presentation and Discussion Relating to State Taxation of  
    Banking  
      William Fox                    University of Tennessee  
      John James                    Minnesota Department of Revenue  
      Patrick Kiely                 Indiana House of Representatives  
      Haskel Edelstein             Citibank, N.A.  
      Philip Plant                  Bank of America
7. Discussion of Working Group Agenda and Budget
8. Other Business
9. Adjournment:    2:30 p.m.



ADVISORY  
COMMISSION ON INTERGOVERNMENTAL RELATIONS  
WASHINGTON, D.C. 20575

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Superseded 07/07/89

**TENTATIVE AGENDA**

**Friday, July 7, 1989**

**Monitoring and Working Group on the  
State Taxation and Regulation of Banks  
of the  
U.S. Advisory Commission on Intergovernmental Relations**

1. Call to Order: 11:00 a.m.  
ACIR Conference Room  
1111 20th Street, N.W., Suite 2000  
Washington, DC 20575
2. Introduction of Members
3. Presentation and Discussion Relating to Regulatory Issues
  - Steven Weiss                      Controller of the Currency
  - William Hrindec                  Federal Deposit Insurance  
Corporation
  - Myron Kwast                      Federal Reserve Board
  - Robert Richard                  Council of State Bank  
Supervisors
4. Presentation and Discussion Relating to State Taxation of  
Banking
  - John James                      Commissioner of Revenue  
Minnesota
  - Patrick Kiely                    Indiana House of Representatives
  - Haskel Edelstein                Citibank, N.A.
  - Philip Plant                      Bank of America
5. Discussion of Working Group Agenda and Budget
6. Other Business
7. Adjournment: 2:30 p.m.

**A**





ADVISORY  
COMMISSION ON INTERGOVERNMENTAL RELATIONS  
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State Taxation and Regulation of Banks  
July 7, 1989  
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JOHN T. BRAGG

Representative Bragg is in his twelfth term in the Tennessee House of Representatives. He has chaired the House Finance, Ways and Means Committee since 1973. He serves as Chairman of the Tennessee Advisory Commission on Intergovernmental Relations. He is a member of the Fiscal Review, Transportation, Publications, Education Oversight, Business Tax, and Calendar and Rules Committees, as well as serving on the Council on Pensions and Retirement, the Information Systems Council and the Task Force on Children and Youth.

Representative Bragg was the first Chairman of the Conference of State Legislatures' and the Task Force on Pension Reform, and later served as chairman of the Committee on Government Operations and the State-Federal Assembly. He served as President of the NCSL in 1985, and is past President of the Foundation of State Legislatures.

Representative Bragg is past Chairman of the Southern Legislative Conference and serves on its Executive Committee. He was the first Chairman of SLC's Fiscal Affairs Committee. He was a member of President Carter's Commission on Pension Policy during its existence from 1979-1981. He also served on a U.S. Department of Labor Task Force on Worker Dislocation and Economic Adjustment.

He is a graduate of Middle Tennessee State University and has done graduate work at the University of Tennessee

DAVID E. NETHING

Senator Nething was elected to the North Dakota Senate in 1966 and served as Majority Leader for many years. He also has been a member of the Legislative Council, Garrison Overview Committee, Budget Section, and Legislative Procedure and Arrangements Committee, and Chairman of Interim Committee on Industry, Business and Labor.

He is a former President of the National Conference of State Legislatures, the Council of State Governments and the National Republican Legislators Association. In 1982 the National Republican Legislators Association cited Senator Nething as "Legislator of the Year." He was a member of Secretary Regan's "Unitary Tax Working Group."

Senator Nething was appointed to the Advisory Commission on Intergovernmental Relations (ACIR) by President Reagan in 1982, and reappointed him in 1985 and 1987.

He holds degrees from Jamestown College and the University of North Dakota School of Law

KENNETH BIEDERMAN

Kenneth R. Biederman is a consultant on housing and financial institutions with Texas Lenders' Services in Houston, Texas. Prior to joining Texas Services he was the Treasurer of the State of New Jersey under Governor Thomas Kean, a member of the Federal Home Loan Bank Board, and a member of the staff of the U.S. Senate Budget Committee.

Mr. Biederman is a frequent consultant on banking and savings institutions, and has also been a Professor of Economics at Georgetown University and Purdue University. A native of Ohio, Mr. Biederman received his B.A. in economics from Miami University and his Ph.D. from Purdue.

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Mr. Edelstein is a Senior Vice President and General Tax Counsel of Citicorp and Citibank, N.A. since 1981. He has headed the Corporate Tax Division of Citicorp/Citibank, N.A. since 1978 and associated with Citicorp/Citibank, N.A. since 1973, first as International Legal and Tax Counsel for Citicorp Leasing International (1973-75) and thereafter as head of the Domestic Tax Advisory function of the Corporate Tax Division (1975-78).

Prior to joining Citibank, Mr. Edelstein was a partner in the New York City law firm of Soll, Connelly & Marshall and its predecessors, which association began in 1969. His Commission and Committee work includes the Tax Committees of FEI, New York State Bankers Association (Chairman 1985-1987), New York Clearing House Association (Chairman 1986-1987), the Business Roundtable Taxation Coordinating Committee, Tax Foundation Tax Advisory Council, and the New York State Temporary Commission to Review the Bank Tax. Mr. Edelstein has recently been appointed a member of the Tax Commission of the Bank Administration Institute. Author of various articles on Earnings and Profits, including the BNA Tax Management Portfolios.

He was graduated from Amherst College (B.A., 1954), Union University - Albany Law School (J.D., 1957) and New York University Graduate School of Law (LL.M. in Taxation, 1958).

WILLIAM F. FOX

Bill Fox, Professor of Economics at the University of Tennessee, Knoxville, is also Research professor and Associate Director for the Center for Business and Economic Research, and auxiliary of the College of Business Administration. Since 1982 Bill has served as a consultant on a variety of public policy issues in developing countries including the Philippines, Egypt, Hungary and Haiti. He has worked on tax study commissions in Arizona, Hawaii, Minnesota, and Tennessee.

His other advising experience includes the National Council on Public Works Improvement, the Association of Tennessee Life Insurance Companies, the Tennessee Municipal League, and the U.S. Department of Agriculture.

Professor Fox has published widely on topics dealing with public finance, regional economies, urban economics, and state and local government finance.

He holds a B.A. degree from Miami University, Oxford, Ohio, and M.A. and Ph.D. are from Ohio State University. In addition to his teaching responsibilities at UT, Bill is director of the Tennessee Econometric Model and consultant to state government on finance, taxation, and economic development. He is currently serving as a Visiting Scholar for the Federal Reserve Bank of Kansas City.

STEVEN D. GOLD

Steven Gold is the director of Fiscal Studies for the National Conference of State Legislatures. His major duties are to provide technical assistance to legislatures and to prepare reports on fiscal issues facing state and local governments. He is also the director of the Fiscal Federalism Project funded by the Ford Foundation. He serves on the editorial boards of three journals, including the National Tax Journal, and on the board of directors of the American Education Finance Association. He has written or edited ten books, the most recent of which, The Unfinished Agenda for State Tax Reform, was published in November 1988.

Prior to joining NCSL in 1981, Dr. Gold was Professor of Economics at Drake University, where he was on the faculty for nine years.

Dr. Gold received his Ph.D. from the University of Michigan and B.A. from Bucknell University.



WILLIAM HRINDAC

William Hrindac joined the FDIC in 1962 as an examiner in the New York Region where he participated in the conduct of examinations of insured nonmember banks located throughout New York, New Jersey, Delaware and Puerto Rico. In 1966, he transferred to the Washington office where he has held a number of positions in both the Legal Division and the Division of Bank Supervision.

He holds a B.A. degree in Political Science from Westminster College, New Wilmington, Pennsylvania, and a Bachelor of Laws degree from the University of Pennsylvania, Philadelphia, Pennsylvania. He is a member of the bar of Maryland. Currently, he is serving as an Examination Specialist in the Planning and Program Development Section of the Division of Bank Supervision.

JOHN JAMES

John James was appointed Commissioner of the Minnesota Department of Revenue by Governor Rudy Perpich on December 18, 1987. The department, which employs about 1,000 people, is responsible for the application and enforcement of the state's tax laws and development of tax policy; became Assistant Commissioner of the department's tax compliance program in February 1986 and acting commissioner on October 21, 1987.

Before joining the Revenue Department, James was a partner in the Minneapolis law firm of Gray, Plant, Mooty, Mooty and Bennett where he was employed for 11 years. He became a partner in 1980 and specialized in tax law. Mr. James worked on the audit staff of Price Waterhouse and Company in Chicago from 1968 to 1969, and for the Chicago Board of Trade from 1969 to 1971 in management accounting and systems analysis.

In addition to a law degree, which he received from Harvard Law School in 1974, Mr. James received a B.B.A. in accounting from the University of Iowa in 1968 and became a certified public accountant in 1969.

PATRICK J. KIELY

Representative Kiely was elected to the Indiana House of Representatives in 1978. He serves as Co-Chairman of the House Ways and Means Committee and as a member of the State Budget Committee, the State Tax and Financing Policy Commission, the House Ethics Committee, and the Indiana Economic Development Council.

He also is a member of the National Conference of State Legislatures' State-Federal Assembly/Committee on Federal Budget and Taxation and is on the Board of Directors of Madison County Bank and Trust.

Representative Kiely holds a B.S. degree from Ball State University, and attended the Institute of Organization Management, Notre Dame University.

MYRON KWAST

Myron Kwast joined the staff of the Federal Reserve Board in 1978. While at the Board Mr. Kwast has worked on a variety of projects in the areas of banking, finance, and monetary policy. His most recent responsibilities have focused on expanded powers for bank holding companies, deposit insurance reform, the effects of financial futures and options on the economy, and competitive aspects of mergers and acquisitions in banking.

He has published numerous articles in professional journals. His present research interests include the management and measurement of risk in banks and financial markets, and the economic viability of real estate specialized depository institutions. He was formerly on the staff of the Federal Deposit Insurance Corporation before attending graduate school.

Mr. Kwast received his B.A. in international relations from American University in 1969. He received his M.S. and Ph.D. degrees in economics from the University of Wisconsin.

ROBERT F. MIALLOVICH

Robert Miallovich is an assistant director of the FDIC's Division of Bank Supervision. He has responsibilities for planning, policy and program development, securities and accounting issues, and registration and disclosure matters.

He joined the FDIC in 1963 as a bank examiner in the San Francisco region and has held a wide range of positions since moving to Washington in 1975.

Mr. Miallovich received a B.A. degree from the University of California at Berkeley and is a graduate of the Pacific Coast Banking School at the University of Washington.

PHILIP M. PLANT

Philip M. Plant is Vice President and Assistant General Tax Counsel at Bank of America and presently chairs the California Bankers Association Taxation Committee and the State and Local Taxes Subcommittee of the Banking and Savings Institutions Committee of the American Bar Association Section of Taxation. Prior to joining Bank of America in 1979, Mr. Plant served for 10 years as a Deputy Attorney General for the State of California. In that capacity, he represented California state taxing authorities in judicial proceedings to include the United States Supreme Court case of National Geographic Society vs. California Board of Equalization and the superior court trial of Container Corporation of America vs. Franchise Tax Board.

Mr. Plant is a member of the California State Bar Association. He received his B.S. from the University of California (Berkeley) and his J.D. from Hastings College of the law. He is a consulting editor for the Matthew Bender "California Taxation" series, a past professorial lecturer in the Golden Gate University Graduate Tax Program and a frequent speaker on state tax developments.

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**B**

**EXHIBIT K: 2**

**Advisory Commission on Intergovernmental Relations, "State Taxation of  
Banks: Issues and Options", Report M-168 (December, 1989)**

# State Taxation of Banks: Issues and Options



Advisory Commission on  
Intergovernmental Relations

**M-168**  
December 1989

## Preface and Acknowledgments

This is the second report in a two-part study of state regulation and taxation of banking. Sandra B. McCray is the principal author of both reports.

The first report, *State Regulation of Banks in a Era of Deregulation* (A-110), was published in September 1988. That study focused on the complex issues facing the present dual system by which the states and the federal government regulate banks and banking activities.

This study focuses on the complementary issue of state taxation of banks in an era of regulatory and technological change. With the advent of the recent and rapid blurring of the lines of business between banking and other commercial activities, combined with the relaxation of restraints on interstate banking, state policymakers are faced with a range of issues and policy alternatives for structuring bank tax systems.

The move toward reform of state bank tax laws is well under way. Major reforms of the tax structure have been enacted in New York, Minnesota, and Indiana. Other states have initiated reform on a smaller scale by amending formulas for apportioning multijurisdictional receipts through rulemaking.

The purpose of this report is to inform policymakers and practitioners of the range of available policy options. The report begins with an historical review of the constitutional and legal underpinnings of the present debate, and then discusses the key issues to be resolved by the nation's legislatures.

Specific topics that are addressed in the report include the goals and objectives of bank tax policy, the difficulties of defining a taxable entity, the nature of alternative methods of defining the bank net income tax base, and the policy tradeoffs that must be made when states select among the several methods for apportioning income from multistate activity.

The report concludes with a review of administrative and other policy aspects of tax reform, and a survey of the current status of state bank tax practice among the 50 states and the District of Columbia.

We wish to thank the following persons who read and commented on drafts of this study: Michael E. Brownell, Roy E. Crawford, Haskell Edelstein, William F. Fox, John Gambill, Paul J. Hartman, Walter Hellerstein, Marilyn M. Kaltenborn, Albin C. Kock, I. M. Labovitz, Ranjana G. Madhusudhan, John P. Malach, Jr., Philip M. Plant, Robert W. Rafuse, Jr., and Henry Ruempler.

Final responsibility for the contents of the report rests with the Commission and its staff.

**John Kincaid**  
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**Robert D. Ebel**  
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## Introduction

### The Birth of the Federal Tax Immunity Doctrine

In 1819, in *McCulloch v. Maryland*,<sup>1</sup> the U.S. Supreme Court first announced its doctrine of federal tax immunity.<sup>2</sup> 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 tax or a similar tax. When branches of the Second Bank of the United States refused to comply with Maryland's tax statute, the state brought suit to recover the tax and penalties. In a sweeping opinion in which Chief Justice John Marshall uttered his famous statement that the "power to tax involves the power to destroy,"<sup>3</sup> the Court held unconstitutional almost all state taxes levied on a federal governmental instrumentality, such as the national bank.<sup>4</sup> The necessary and proper clause<sup>5</sup> and the supremacy clause<sup>6</sup> formed the constitutional bases for the Court's holding.

In 1829, the Court applied its federal tax-immunity doctrine to strike down a property tax imposed by the City of Charleston, South Carolina, on stock issued by the Bank of the United States and held by a private individual.<sup>7</sup> Like the Maryland law in *McCulloch*, the Charleston ordinance exempted from the tax all stock issued by the state of South Carolina. According to the Court, the tax violated the borrowing clause of the Constitution<sup>8</sup> because it was "a tax on the power to borrow money on the credit of the U.S. . . ."<sup>9</sup>

These two decisions set the stage for complete congressional domination of state taxation of national banks and federal obligations that continues today: states cannot tax either national banks or federal obligations without the permission of the Congress. The effect of congressional restrictions on state taxation of the income from federal obligations has been much less dramatic, however, than that of federal restrictions on state taxation of national banks.

Federal constraints on state taxation of the income from federal obligations have remained virtually unchanged since the latter half of the 19th century.<sup>10</sup> Today, state taxation of such income is limited by federal statutory law, which 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.<sup>11</sup>

In contrast, congressional restrictions on state taxation of national banks have changed considerably over the century and a half since the *McCulloch* decision.

### The Evolution of State Taxation of National Banks

The history of congressional limits on state taxation of national banks is long and tortured. In 1864, the Con-

gress passed the *National Currency Act*,<sup>12</sup> which codified *McCulloch* by limiting state taxation of national banks to bank real estate and shares<sup>13</sup>—the two options left open by the decision.<sup>14</sup> Section 41 of the act specifically granted the state in which a national bank was located the right to tax the shares of stock in such bank. The actual tax was levied on the individual or corporate shareholder, but most states assessed and collected the tax from the bank. Assessment at the source facilitated collection of the tax. If, for example, the shareholder was a nonresident, the bank could be used as an agent of the stockholder to collect the tax. The bank then reimbursed itself from the dividends or other income distributed to the stockholder.<sup>15</sup> Section 41 also limited the rate of the state tax imposed on national bank shares to the lower of (1) the rate assessed on “other moneyed capital” in the hands of individual citizens of such state or (2) the rate imposed on the shares in any state-chartered bank.<sup>16</sup>

Although the Congress could dictate the conditions under which states could tax national banks, it could not control how states and the judiciary interpreted those conditions. For example, the limitation on the rate of bank share taxation to one no greater than the rate assessed on “other moneyed capital”<sup>17</sup> generated decades of litigation. The purpose of this restriction was to prevent states from discriminating against national banks by favoring their competitors.<sup>18</sup> The statute did not specify, however, how states should calculate a nondiscriminatory rate, and states adopted various methods. Moreover, because the Supreme Court had previously held that the rate of taxation includes the entire process of valuation and assessment,<sup>19</sup> national banks accused states of setting discriminatory rates when they applied different rules of valuation as well as when they used different percentages in computing the taxes on fixed valuations.

The high Court was called on numerous times to determine which inequalities would constitute discrimination in violation of the *National Currency Act*. Time and again, the Court scrutinized mind-numbing differences in state assessments and valuation of investments in order to determine whether national banks had been treated in a discriminatory manner. For example, in 1874, the Court considered whether a state that had assessed bank shares at market value and bonds and mortgages at par or nominal value had thereby discriminated against national banks.<sup>20</sup> On other occasions, the Court found that the following state practices did *not* discriminate against national banks: (a) denying shareholders the right to deduct from the value of their national bank shares the amount of their capital invested in real property situated outside the state,<sup>21</sup> (b) exempting from state taxation deposits in savings banks or funds of charitable institutions, provided that the exemption was for reasons of public policy,<sup>22</sup> and (c) allowing holders of “credits” in unincorporated banks to deduct their debts from their taxable credits, while denying the same right to shareholders of national banks.<sup>23</sup> Conversely, the Court found that many state practices did discriminate against national banks, including: (a) exempting from property taxation the income from loans and securities of real estate firms, partnerships, and cor-

porations while subjecting national banks to property taxation;<sup>24</sup> and (b) taxing the investments of individuals in bonds and notes at a lower rate than that imposed on national bank shares.<sup>25</sup>

Although plentiful, cases regarding state tax rates on national banks constituted only a small fraction of the litigation generated by Section 41 of the *National Currency Act*. Most of the litigation involved the meaning of the phrase “other moneyed capital.” In its interpretations of this phrase, the Supreme Court frequently used the legal method of exclusion and inclusion. For example, in separate holdings, the Court found that investments in the following entities were excluded from the disputed phrase: trust and insurance companies;<sup>26</sup> manufacturing, mining, and railroads;<sup>27</sup> and telephone companies.<sup>28</sup> States were free, therefore, to set their rates on those entities without regard to their rates on national banks. In another line of reasoning, the Court also began to develop an affirmative definition of the phrase “other moneyed capital,” which, unfortunately, often conflicted with its holdings in the assessment cases. For example, in *Hepburn v. The School Directors*,<sup>29</sup> the Court found that securities (both stocks and bonds) might be considered “other moneyed capital,” while in *Mercantile Bank v. New York*,<sup>30</sup> the Court upheld a state tax on national bank shares that was higher than the state’s tax on the stock of railroads and certain corporations.<sup>31</sup>

Later, the Court began to focus its interpretation of “other moneyed capital” more narrowly, finding that “the true test of the distinction [between investments that come within the meaning of the disputed phrase and those that do not] . . . can only be found in the nature of the business in which the corporation is engaged.”<sup>32</sup> This new interpretation led to another round of litigation in which the Court described the business of banking and compared that business with various others in which individuals and banks might invest to determine whether such investments constituted “other moneyed capital.” Again, a rash of conflicting opinions followed, causing litigants and scholars to charge the Court with gross inconsistency.<sup>33</sup>

Finally, in 1923, the Congress amended the law in an attempt to bring some order into the chaos. Under the new law, now referred to as section 5219, a state could choose any one of three methods (in addition to a real estate tax) to tax a national bank: (1) a bank shares tax; (2) a tax on the dividends received by the owners or holders of the bank’s stock; or (3) a net income tax.<sup>34</sup> In 1926, a fourth option was added: a state could choose a franchise or excise tax according to or measured by the entire net income of the national bank.<sup>35</sup> This option enabled states to include interest on federal obligations (otherwise exempt from state taxes) in the tax base. Because the income from governmental obligations represents a large fraction of the income of commercial banks, the addition of this method of taxation conferred a significant revenue benefit on states.<sup>36</sup>

These amendments, too, contained several conditions. For example, if a state chose the income or franchise tax option, the law directed it to set the rates of the income and franchise taxes on national banks no higher

than its rate on other financial corporations or mercantile, manufacturing, and business corporations. States that chose the dividend option were instructed to tax dividends from general business also. States that selected a bank shares tax were still required to assess such shares at a rate no higher than the rate on "other moneyed capital." To clarify the meaning of that phrase, the Congress instructed states to tax shares of national banks

at a rate [no greater] than is assessed upon other moneyed capital in the hands of individual citizens of such State coming into competition with the business of national banks; Provided, that Bonds, notes or other evidences of indebtedness in the hands of individual citizens not employed or engaged in the banking or investment business and representing merely personal investments not made in competition with such business, shall not be deemed moneyed capital. . . .<sup>37</sup>

Far from solving the problem of state taxation of national banks, these amendments with their numerous conditions set the stage for more litigation and conflicting interpretations. The law did not indicate, for example, how states that adopted the income or franchise tax option should compare the tax rates on general business corporations with those on national banks in order to meet the mandate of nondiscriminatory treatment. That omission left states free to choose their own techniques of comparison. Some states chose to compare effective tax burdens rather than nominal tax rates. By comparing effective tax rates, states sought to overcome the inequity created by the congressional prohibition against levying sales and personal property taxes on national banks, two taxes regularly assessed against general business corporations. In order to equalize the effect of taxes on the two kinds of entities, states combined the net income, personal property, and sales taxes paid by general business corporations and calculated a composite rate, which was then contrasted with the nominal tax rate on national banks. During the period from 1926 to 1969, national banks frequently litigated the question of how states should calculate the effective tax rate on general business corporations. Also during this period, litigation of the phrase "other moneyed capital" continued, despite the congressional attempt at clarification.<sup>38</sup>

In the mid-1950s, a new issue arose—state taxation of the interstate activity of *state banks*. Although banks did not maintain offices outside of their domiciliary state, they frequently did make loans to residents of other states by sending personnel there or by using the services of correspondent banks located in other states. Unlike the situation with state taxation of national banks, which was limited by the Congress to taxation of domiciliary banks, states were free to tax the interstate activities of state banks so long as such taxation was consistent with the due process and commerce clauses.

In 1959, after a long history of interpreting the commerce and due process clauses to ban state taxation of the interstate activities of corporations, the Supreme Court changed its interpretation and upheld state taxation of nondomiciliary corporations that do business with their

residents. In *Northwestern States Portland Cement Co. v. Minnesota*,<sup>39</sup> the high Court validated a state net income tax on a nondomiciliary (general business) corporation that had an office in the taxing state. In another case—*Brown-Forman Distillers Corp. v. Collector of Revenue*<sup>40</sup>—the U.S. Supreme Court declined to overturn a decision of the Louisiana Supreme Court upholding the state's tax on a nondomiciliary corporation whose contacts with Louisiana consisted solely of personnel soliciting orders there.

The effect of these decisions was limited, however, by immediate congressional action. In 1959, the Congress passed P.L. 86-272,<sup>41</sup> which prohibited states from taxing foreign corporations whose only activity within the state was the solicitation of orders by the seller or its representative. Because P.L. 86-272 covered only the solicitation of orders for tangible personal property, the activities of financial institutions were not subject to its prohibitions.

As a result of the above Supreme Court decisions and the earlier congressional restrictions against state taxation of nondomiciliary national banks, states were free to tax nondomiciliary *state* banks but not out-of-state *national* banks. Some states took advantage of their expanded taxing power to tax nondomiciliary state banks, creating an inequity between state and national banks. Over time, therefore, the congressional restrictions on state taxation of national banks, originally intended to prevent state discrimination against national banks, had created a tax scheme that favored national banks.

#### Congressional Resolution of the Problem

In the early 1960s several bills were introduced in the Congress to correct the imbalance that federal law had created between state and national banks. All failed to pass. In 1968, however, the Supreme Court unknowingly dealt the final blow to the congressional statutory scheme by carrying it to its logical absurdity.<sup>42</sup> In *First Agricultural National Bank v. State Tax Commission*,<sup>43</sup> the Court struck down a state sales tax levied on a national bank's purchase of tangible personal property for its own use. Three justices dissented with language that moved the Congress to act: "[t]he Constitution of its own force does not prohibit [a state] from applying its uniform sales and use taxes to, among other things, [a bank's] wastebaskets."<sup>44</sup>

In 1969, the Congress repealed prior restrictions on state taxation of national banks, bringing to an end more than a century of congressional tax preferences granted to national banks.<sup>45</sup> According to the new law: "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."<sup>46</sup> Thus, the only remaining restriction on state taxation of national banks was that such taxes must not discriminate against national banks. The Congress delayed the effective date of the new law to January 1, 1973, in order to provide time for a study and report by the Federal Reserve Board on how state taxes on out-of-state national banks would affect the economic efficiency of the banking system and the mobility of capital.

In 1973, the Congress, still uneasy about prospective state taxation of out-of-state depositories, extended its



prior moratorium on state taxation of national banks. From 1973 to 1976, the new moratorium, set forth in P.L. 93-100, prohibited states from imposing any tax measured by income or receipts or any other "doing business" taxes on federally insured out-of-state depositories. In the same law, the Congress directed ACIR to undertake a "study of all pertinent matters relating to the application of State 'doing business' taxes on out-of-state commercial banks, mutual savings banks, and savings and loan associations." The ACIR study was to include recommendations for legislation that would provide equitable state taxation of those entities.<sup>47</sup>

The 1975 study accomplished this and more. Nearly two years in the making and over 1,000 pages long, the study examined in depth the depository business, multi-state taxation of general business corporations, the question of federal legislation, and alternative approaches to state taxation of depositories. The study concluded with five basic policy choices, framed in terms of alternative recommendations for the Commission to consider. Briefly, the choices were:

No federal statutory limitations on state and local taxation of out-of-state depositories (beyond existing statutory requirements for like treatment of federally chartered and state-chartered depositories).

A federal statute prescribing negative guidelines; i.e., specifying jurisdictional tests and division-of-base rules that may not be used by the states as a basis for taxing out-of-state depositories.

A federal statute prescribing positive guidelines which bind the states in their taxation of out-of-state depositories; i.e., affirmatively prescribing certain jurisdictional standards and division-of-base rules to which states must conform if they tax out-of-state depositories.

A federal statute permitting only the state of domicile (the state of the principal or home office) to tax depositories, and prohibiting net income or other "doing business" taxes upon out-of-state depositories.

A federal statute to compel standardization by substituting a federally collected, state-shared surcharge on depository institutions for state income or other "doing business" taxes on depositories, or allowing a credit for qualified state taxes against the federal tax.

The Commission recommended a policy of negative federal guidelines. Impressed by the precedent of P.L. 86-272, which set negative jurisdictional thresholds for state taxation of interstate businesses, the Commission favored a similar, but higher, tax jurisdiction threshold for banks, as well as a congressional "declaration of policy" as to the appropriate division of the taxable base.<sup>48</sup> According to the Commission's recommendations, a state would have jurisdiction to tax out-of-state depositories only if they had a "substantial physical presence" within the tax-

ing state, such as a regular office location, the regular presence of employees or agents, or the ownership or use of tangible property, including property involved in lease-financing operations.

Other recommendations included:

"No congressional action which would require states to adopt a standardized definition of taxable income in the taxation of out-of-state financial depositories";

Amendment of federal law "to authorize states to include, in the measure of otherwise valid direct net income taxes, income realized by financial depositories from federal government obligations";

Federal safeguards against discriminatory taxation;

Federal legislation requiring a domiciliary state that taxes the entire income of the depository to allow the depository a credit for taxes paid to nondomiciliary states; and

A reservation of power to the states to resolve any disagreements between them and taxpayers.

Congress failed to act, however, and, in 1976, the language as originally drafted in the 1969 statute became law. Thus, today the only restriction on state taxation of national banks is that such taxes must not discriminate against national banks.

### Summary and Comment

In 1819, the U.S. Supreme Court held in *McCulloch v. Maryland* that a Maryland stamp tax levied on the Bank of the United States was unconstitutional. The *McCulloch* decision set the stage for congressional domination of state taxation of national banks and federal obligations that continues today. States cannot tax either national banks or federal obligations without statutory permission from the Congress.

The Congress began exercising its control over state taxation of national banks with the passage of the *National Currency Act* in 1864. The act codified the *McCulloch* holding by permitting states to tax the real property and shares of national banks. One section of the act limited state taxes on national bank shares to a rate no greater than the rate assessed on "other moneyed capital." This first congressional foray into the business of regulating state taxation of national banks through specific statutory directives and limitations signaled the beginning of over a century of litigation involving a bewildering array of differences in state calculations of their rates of taxation and interpretations of the phrase "other moneyed capital."

By 1969, the Congress had recognized that neither further amendments, which merely led to a new round of litigation, nor judicial mediation, which produced a large body of inconsistent and conflicting opinions, could bring order or clarity to state taxation of national banks. Moreover, the federal restrictions, which were originally intended to prevent state discrimination against national banks, had over time created a tax scheme that favored national banks. Finally, in 1976, the Congress revised the

law and removed all prior conditions and limitations on state taxation of national banks and passed legislation requiring only that states tax national banks in the same manner as they tax their state-chartered banks.

The history of congressional restrictions on state taxation of national banks contains valuable lessons for proponents of federal intervention in state taxing powers.

First, congressional intervention in state taxation, which is effected through specific statutory limitations and/or directives, is subject to differing interpretations by the states. Years of litigation are unlikely to bring either order or clarity to state tax systems. Judicial opinions are, by their nature, piecemeal and narrow. Issues that are suitable for judicial resolution involve questions of wheth-

er a state has interpreted a given law reasonably or whether a certain state or federal statute violates the U.S. Constitution. The judiciary does not have the power to analyze and revamp entire state tax systems. As the Supreme Court itself has recognized on numerous occasions, spasmodic and unrelated instances of litigation cannot afford an adequate basis on which to create consistent rules in the area of state taxation.<sup>49</sup>

Second, laws that contain specific directives and limitations often have unintended consequences brought about by changing judicial interpretations and by new business practices. In an area of law like tax jurisdiction, which must respond to technological advances,<sup>50</sup> and in a business like banking, which is currently highly innovative, such unintended consequences are inevitable.

## The Issues

### Goals and Objectives for Tax Policy

The 1975 ACIR study identified eight goals and objectives as guides for national policy regulating state taxation of multistate business generally. Those goals remain valid today:

1. Preservation of the autonomy of the states;
2. Simplification of the tax system;
3. Standardization or uniformity of taxes on multistate business;
4. Reduction of compliance burdens and enforcement costs;
5. Provision of certainty and regularity for taxpayers and administrators;
6. Promotion of competitive equality or neutrality between domestic and out-of-state firms;
7. Avoidance of discrimination among different lines of business;
8. Avoidance of trade barriers.

Like the situation with state regulation of banks and bank holding companies,<sup>51</sup> the public policy objectives for state taxation of banks and bank-like entities are sometimes complementary and at other times contradictory. For example, the goal of preserving the autonomy of the states may conflict with the objective of creating a uniform and simple tax system. As noted in an earlier ACIR report:

Differences in the tax structures of states and subdivisions have long been viewed as wasteful by many critics—and certainly by spokesmen for multistate taxpayers. Taxpayers' compliance problems and state administration of the taxes are more complicated than they would be if taxes were uniform. Also these differences hinder the free exchange of trade and commerce across jurisdictional lines. Elimination or reduction of local diversities is seen as promoting simplicity in the entire tax system, an objective long sought by taxpayers and legislators in all the states, as well as on the national level.

On the other side, interstate differences arise from the distinctive policies and needs of the individual state or local communities—from the special needs of agricultural or mining communities compared with those where economic activities are primarily manufacturing, mercantile, or service-oriented; from the differing needs and taxpaying capacities (or customs) of states that are predominantly urban or rural; from the differences between market states and producing states, or between border states and interior states; and from the differing political philosophies of voters and their elected representatives in states with a conservative tradition and those with a recent populist or frontier outlook. The special characteristics of tax laws and administration in each state are a product of the efforts of policymakers and legislators to reflect the partic-

ular heritage of that state. Special adjustments and differing tax forms are provided to accommodate and preserve local interests. The price of simplification may in fact include a sacrifice of some of the special essence of each state. For those who value regional distinctions, these diversities are the core and justification of our federal system. They may view pressures for homogeneity and simplicity in state tax systems as threats to all the other valued differences.

Others argue that some proposals for simplification, such as general acceptance of a standard formula apportionment for the entire net income of each taxpayer, could result in inequitable or inappropriate division of the tax base among states.<sup>52</sup>

Because the different objectives of a sound tax policy are frequently contradictory, one cannot design a single tax system that will satisfy all of the goals. Implementation of any bank income tax will require compromise and trade-offs among goals.

### Environmental Considerations

Any new state bank tax should be evaluated not only by reference to the tax policy objectives cited above but also within the context of the changes taking place in the business of banking. The interstate banking environment today is vastly different than it was in 1975, the date of the prior ACIR report. The most important changes involve interstate branch banking, the growth of sophisticated bank technology, the expansion of bank products and services, and the advent of loan securitization.

### Interstate Branch Banking

Proof of the proposition that changes in the bank regulatory laws of one state can influence the regulatory policy of all states is found in interstate branch banking laws. In 1982, Massachusetts was the first state to pass a regional reciprocal interstate banking law.<sup>53</sup> Other states soon followed with reciprocity laws, and, today, 46 states allow some form of interstate banking. Twenty-six states permit regional or regional reciprocal interstate banking (nine of these state laws contain a nationwide trigger, that is, a date by which the state will allow nationwide interstate banking), and 20 states allow nationwide interstate banking.<sup>54</sup> A summary of the current status of interstate banking legislation is provided in Table 1. The vast majority of states that allow interstate banking do so through the bank holding company mechanism (i.e., they enact laws permitting out-of-state banks to enter only after their parent bank holding company applies for and receives permission to establish or acquire a subsidiary or to merge with a bank in the host state). Entry through a bank holding company gives a state maximum control over the new bank. A legislative grant of entry through direct branching makes it difficult for the host state to exercise control over the branch, even if it is a state bank branch, because the chartering state remains the primary regulator and super-

visor of the branch. Some commentators believe that the future viability of the dual banking system requires that states allow interstate banking only through the holding company mechanism.<sup>55</sup>

Because most state laws no longer prohibit out-of-state bank holding companies from operating subsidiary banks across the nation, and because banks solicit loans through loan production offices located in several states, it is difficult today to pinpoint the "source" of a loan for purposes of state apportionment formulas. The Congress noted the problem of finding the actual "source" of bank loans during the debates on the *Tax Reform Act of 1986*. According to the Congress, "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."<sup>56</sup>

### Technological Developments: Branchless Banking

The judicial branch, too, has contributed to the expansion of interstate banking. A recent U.S. Circuit Court of Appeals opinion, which interpreted the federal banking laws, paved the way for banks and bank-like entities to engage in de facto interstate branch banking. By interpreting the terms "branch" and "bank" narrowly, the opinion limited state authority to regulate interstate branch banking. For example, in *Independent Bankers Association v. Marine Midland Bank*,<sup>57</sup> the Second Circuit Court of Appeals held that a bank that effects loan and deposit transactions with its customers electronically through a shared use automatic teller machine (ATM) does 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.

This decision allows banks and bank-like entities to circumvent the remaining state regulatory restrictions on interstate branch banking by delivering their services through electronic devices located across the nation in a form of "branchless banking." Today, it is legally and technologically possible for banks to enable their customers to make a deposit in an out-of-state bank through an in-state shared-use ATM without thereby engaging in branch banking.

Several banks currently operate nationwide through branchless banks. For example, in January 1986, the New England Federal Savings Bank of Wellesley, Massachusetts, opened for business.<sup>58</sup> The bank has no walk-in place of business. Customers 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 50 states. The bank 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 accounts and Keogh accounts. Many other banks engage in some form of branchless banking. For ex-

Table 1  
Interstate Banking Legislation by State  
(as of February 1, 1989)

State	Effective Date	Area	Number of Partner States
Alabama	Currently	Reciprocal, 12 states and DC (AR, FL, GA, KY, LA, MD, MS, NC, SC, TN, VA, WV).	13
Alaska	Currently	National, no reciprocity.	50
Arizona	Currently	National, no reciprocity.	50
Arkansas	Currently	Reciprocal, 16 states and DC (AL, FL, GA, KS, LA, MD, MS, MO, NE, NC, OK, SC, TN, TX, VA, WV). Reciprocity hinges on commitments to community reinvestment.	17
California	Currently 1/1/91	Reciprocal, 11 states (AK, AZ, CO, HI, ID, NV, NM, OR, TX, UT, WA). National, reciprocal.	11
Colorado	Currently	Reciprocal, 7 states (AZ, KS, NE, NM, OK, UT, WY).	5
Connecticut	Currently	Reciprocal, 5 states (MA, ME, NH, RI, VT).	5
Delaware	Currently 6/30/90	Reciprocal, 5 states and DC (MD, NJ, OH, PA, VA). Special-purpose banks permitted. National, reciprocal.	6
DC	Currently	Nationwide, no reciprocity if community development commitments are made.	50
Florida	Currently	Reciprocal, 11 states and DC (AL, AR, GA, LA, MD, MS, NC, SC, TN, VA, WV). Under a 1972 law, NCNB and Northern Trust Corporation are grandfathered and can make further acquisitions.	12
Georgia	Currently	Reciprocal, 10 states and DC (AL, FL, KY, LA, MD, MS, NC, SC, TN, VA).	11
Hawaii	None		0
Idaho	Currently	National, no reciprocity.	50
Illinois	Currently 12/1/90	Reciprocal, 6 states (IA, IN, KY, MI, MO, WI). Nationwide, organizations may acquire failed institutions if the failed institution is larger than \$1 billion in assets. Under a 1981 law, General Bancshares Corporation is grandfathered and can make further acquisitions in the state. National, reciprocal.	6
Indiana	Currently 7/1/92	Reciprocal, 11 states (IA, IL, KY, MI, MO, OH, PA, TN, VA, WI, WV). National, reciprocal.	11
Iowa	1972	Under a 1972 law, Norwest Corporation is grandfathered and is permitted to acquire banks in Iowa.	0
Kansas	None		0
Kentucky	Currently	National, reciprocal.	31*
Louisiana	Currently	National, reciprocal.	29*
Maine	Currently	National, no reciprocity.	50
Maryland	Currently	Reciprocal, 14 states and DC (AL, AR, DE, FL, GA, KY, LA, MS, NC, PA, SC, TN, VA, WV) and special-purpose banks.	15
Massachusetts	Currently	Reciprocal, 5 states (CT, ME, NH, RI, VT).	5
Michigan	Currently	National, reciprocal.	20*
Minnesota	Currently	Reciprocal, 11 states (CO, IA, ID, IL, KS, MO, MT, ND, SD, WA, WY).	11
Mississippi	Currently 7/1/90	Reciprocal, 4 states (AL, AR, LA, TN). Reciprocal, 13 states (AL, AR, FL, GA, KY, LA, MO, NC, SC, TN, TX, VA, WV).	4

*Table 1 (cont.)*  
**Interstate Banking Legislation by State**  
 (as of February 1, 1989)

State	Effective Date	Area	Number of Partner States
Missouri	Currently	Reciprocal, 8 states (AR, IA, IL, KS, KY, NE, OK, TN).	8
Montana	None		0
Nebraska	Currently 1/1/90 1/1/91	Special-purpose banks. Reciprocal, 10 states (CO, IA, KS, MN, MO, MT, ND, SD, WI, WY). National, reciprocal.	0
Nevada	Currently	National, no reciprocity.	50
New Hampshire	Currently	Reciprocal, 5 states (CT, MA, ME, RI, VT).	5
New Jersey	Currently	National, reciprocal.	21*
New Mexico	Currently 1/1/90	Nationwide acquisition of failing banks. National, no reciprocity.	50
New York	Currently	National, reciprocal.	19*
North Carolina	Currently	Reciprocal, 12 states and DC (AL, AR, FL, GA, KY, LA, MD, MS, SC, TN, VA, WV).	13
North Dakota	Currently	A grandfathered interstate banking organization is permitted to sell its North Dakota banks to out-of-state bank holding companies.	0
Ohio	Currently	National, reciprocal.	23*
Oklahoma	Currently	National, no reciprocity.	50
Oregon	Currently 7/1/89	8 states, no reciprocity (AK, AZ, CA, HI, ID, NV, UT, WA). National, no reciprocity.	8
Pennsylvania	Currently 3/4/90	Reciprocal, 7 states and DC (DE, KY, MD, NJ, OH, VA, WV). National, reciprocal.	8
Rhode Island	Currently	National, reciprocal.	23*
South Carolina	Currently	Reciprocal, 12 states and DC (AL, AR, FL, GA, KY, LA, MD, MS, NC, TN, VA, WV)	13
South Dakota	Currently	National, reciprocal and special-purpose banks.	21*
Tennessee	Currently	Reciprocal, 13 states (AL, AR, FL, GA, IN, KY, LA, MO, MS, NC, SC, VA, WV).	13
Texas	Currently	National, no reciprocity.	50
Utah	Currently	National, no reciprocity.	50
Vermont	Currently 2/1/90	Reciprocal, 5 states (CT, MA, ME, NH, RI). National, reciprocal.	5
Virginia	Currently	Reciprocal, 12 states and DC (AL, AR, FL, GA, KY, LA, MD, MS, NC, SC, TN, WV).	13
Washington	Currently	National, reciprocal. Failing institutions may be acquired by organizations from any state.	21*
West Virginia	Currently	National, reciprocal.	29*
Wisconsin	Currently	Reciprocal, 8 states (IA, IL, IN, KY, MI, MN, MO, OH).	8
Wyoming	Currently	National, no reciprocity.	50

\* Does not count the two states where nationwide entry by acquisition of failing banks is possible.

Source: Compiled by the Federal Reserve Bank of Atlanta, and reported by B. Frank King, Sheila L. Tschinkel, and David D. Whitehead, "Interstate Banking Developments in the 1980s," *Economic Review*, May/June, 1989, pp. 32-51.

ample, of the 30,000 depositors of Colonial National Bank of Wilmington, Delaware, only 10,000 come from Wilmington walk-in trade.<sup>59</sup> The remaining 20,000 depositors live in all 50 states and do business by telephone, mail, and nationwide automatic teller machines, and use debit and credit cards and checks. Chemical Bank of New York offers a branchless banking service called "Premium Banking" to residents of Connecticut.<sup>60</sup> The service works as follows: (1) Connecticut customers call a New York toll-free number staffed seven days a week by Chemical Bank personnel; (2) customers receive instant access to credit lines; and (3) customers who need cash immediately can make withdrawals at any automatic teller machine linked to the New York Cash Exchange.

The effect of these developments is significant. The advent of electronic banking has rendered obsolete state jurisdiction rules based on physical presence and has greatly increased the mobility of bank assets and deposits, making it difficult to locate such assets and deposits in one state.

### Expansion of Bank Products and Services

Another important change in the banking environment involves the definition of the business of banking. The prior barriers between banking and commerce are falling. Three new products and services are of particular interest to banks: securities, insurance, and real estate. Both state and national banks have pushed for new powers in these areas, arguing that allowing them to offer these 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.

In many states, banks have convinced legislators of the merit of expanding bank powers. Currently, 25 states allow their state-chartered banks to engage in some securities activities,<sup>61</sup> 17 states allow banks to underwrite insurance and/or act as an insurance agent or broker,<sup>62</sup> and 26 states permit state banks to invest in and develop real estate and/or act as a real estate broker.<sup>63</sup> In addition to their contention that the expanded powers will benefit consumers, businesses, and state governments, banks argue that the new powers are necessary to create a level playing field between banks and the growing number of nonbank entities that are free to engage in banking services. As evidence of the lack of a level playing field, banks cite the increasing competition that they face from unregulated entities, such as retailers that issue credit cards, securities firms that attract deposits by offering cash management accounts, and automobile manufacturers that provide financing for new cars.

Given this blurring of the lines between bank and nonbank financial institutions, state tax laws that are

based on a traditional regulatory definition of a bank may no longer be appropriate.

### Loan Securitization

A corollary to the expansion of bank securities powers is the increased securitization of bank assets. This phenomenon is changing the entire nature of the banking business. Traditionally, commercial banks solicited deposits in order to make loans that were held in their portfolios until they were paid off. Recently, however, banks have begun making loans that are subsequently pooled and packaged for sale as securities in the financial markets to institutional (bank and nonbank) and individual investors. The packaging and distribution of securitized loans is usually done by investment banks or large money-center banks. Because securitization offers significant benefits to the lending bank (i.e., allowing it to remove the loans from its books, thereby reducing capital requirements and improving liquidity), loan securitization is likely to continue.<sup>64</sup>

Potentially, banks can securitize and sell all classes of loans.<sup>65</sup> Typical securitized loans today include those for mortgages, credit cards, cars, and boats.<sup>66</sup> It is easy to see that a securitized loan does not have a traditional "home" for purposes of state taxation; it can be sold to another bank, insurance company, pension fund, or individual investor anywhere across the nation.

The advent of securitized loans creates a profound dilemma for states that apportion the income of their domiciliary banks. 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 dissolution of this relationship 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 secured loans to an out-of-state investor. 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.

Suppose, now, that Bank B, which is domiciled in State B, purchases the securitized loans from Bank A. State B will apply its apportionment formula to determine how much of the interest income from the securitized loans it can tax.<sup>67</sup> Typically, state apportionment formulas attribute the interest income from loans to the state in which the loan originated (i.e., where the loan solicitation, negotiation, and/or administration occurred)<sup>68</sup> or to the state in which the property securing the loan is located.<sup>69</sup> 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 Bank B (1) was not involved in the solicitation, negotiation, or administration of the underlying loans, and (2) none of the property securing the underlying loans is located in State B. Thus, 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.

Alternatively, State B might apportion the interest income from the securitized loans according to special rules for income from securities.<sup>70</sup> In this case, some of the income may be attributed to State B. Nevertheless, much of the income would again be attributed out of state, and may thereby escape taxation by any state.

This dilemma cannot be solved fully through the use of an apportionment formula, although some commentators have suggested a partial solution in the form of a throwback rule.<sup>71</sup> The rule would allow the domiciliary state to throw back and tax the receipts from securities not taxed by any other state. As currently construed by the courts, however, the throwback rule does not allow the domiciliary state to reach either the property or payroll associated with those receipts. Alternatively, the dilemma can be solved fully through the use of the dual system, which is discussed in greater detail below.

## Summary and Comment

It is not possible yet to describe all the contours of the "best" bank tax. In addition to the conflicts among the goals of a good tax policy, two other factors contribute to the difficulty of formulating a single bank tax system at this time. First, states have only recently begun to amend their bank tax laws to take advantage of the lifting of prior congressional restraints on state taxation of banks; therefore, one cannot measure the relative effectiveness of the different new state bank taxes. Second, the business of banking is changing rapidly, requiring states to maintain a flexible approach to bank taxation. The bank tax that is appropriate during this evolutionary period may not be suitable once the contours of the business become settled. For these reasons, this report will focus on alternative tax systems, evaluating each against the above goals and the changing nature of banking.



## The Options

According to a recent survey conducted jointly by ACIR and the Federation of Tax Administrators, a majority of states use some form of a net income tax for banks (i.e., either a franchise tax measured by net income or a direct net income tax).<sup>72</sup> The findings from the survey, which provide a wide range of information regarding the status of state bank taxation are presented in Appendix A. Because of the prevalence of net income taxation, this report will focus on that method of taxation.

### The Tax Base

The starting point for most state corporate net income tax measures is the federal taxable income base.<sup>73</sup> Federal law prohibits states from including the income from federal obligations in the net income tax base unless they comply with the requirements of 31 U.S.C. sec. 3124. According to that statute, a state tax on the income from federal obligations must meet two tests: (1) it must be a nondiscriminatory tax, and (2) it must be a franchise or other nonproperty tax. In *Memphis Bank & Trust v. Garner*,<sup>74</sup> the U.S. Supreme Court invalidated as discriminatory a Tennessee franchise tax that included interest received on federal obligations but excluded interest earned on the obligations of Tennessee and its political subdivisions.<sup>75</sup>

According to *Memphis Bank & Trust*, a state can use a franchise tax measured by net income and include in such tax base the income from federal obligations if and only if the state taxes its own obligations (and those of its political subdivisions) as well as federal obligations.<sup>76</sup> Currently, 25 states include the value of, or income from, federal obligations in their bank tax base.<sup>77</sup>

Because federal obligations comprise a large percentage of the income of a financial institution, the failure to use a franchise tax will result in a significant tax break for banks. To create neutrality and fairness across industries, then, a comparable income exemption should be granted to nonfinancial entities.

### Alternative Methods of Income Taxation

Four models of corporate income taxation exist: (1) pure residence-based taxation, (2) pure source-based taxation with separate accounting, (3) pure source-based taxation with formula-based apportionment, and (4) a dual system consisting of residence-based taxation coupled with a credit for domiciliary entities and source-based taxation for nondomiciliaries.

A pure residence-based income tax applies only to domiciliary banks and operates on the entire income of the domiciliary bank without regard to the source of that income. Thus, all banks domiciled in the taxing state—state banks that received their charter there and national and foreign banks that are incorporated there—pay tax on their total taxable income base regardless of where the income is earned; and all nondomiciliary banks—state banks chartered out-of-state and national and foreign banks incorporated in another state or country—pay no tax at all even if they have earned income from activities within the host state.

A pure source-based tax attempts to measure the amount of income of a multistate entity that is earned within a given taxing state. For this purpose, a state uses either separate accounting or formula-based apportionment. Pure source-based taxation with formula-based apportionment is used by nearly all of the states for their general business corporations.

A state that uses a dual system levies its tax, in the first instance, on the entire net income of its domestic banks. Then, it allows those banks a tax credit for taxes paid to other states. The amount of the credit is limited to the amount that would have been paid under the domiciliary state's tax. Out-of-state or nondomiciliary banks are taxed according to source principles; that is, an apportionment formula to measure what fraction of the income of an out-of-state bank is earned within the host state.

### **Pure Residence-Based Tax**

Until very recently, most states taxed banks using residence-based tax principles, a system of taxation not used with other businesses.

A pure residence-based tax system meets many of the objectives of a good tax. It is simple, provides certainty and regularity for taxpayers and administrators, has minimal compliance burdens and enforcement costs, and avoids trade barriers. In addition, when freely chosen by states, it preserves their autonomy. One can fault a residence-based tax, however, for failing to promote competitive equality between domestic and out-of-state firms, with discriminating among different lines of business, and with creating the potential for multiple taxation.

The lack of competitive equality between in-state and out-of-state banks, which occurs with the use of a pure residence-based tax, comes from the differences in state tax rates and bases. For example, assume that two banks, Bank A and Bank B, are doing business in State Y. Bank A is domiciled in State Y, which has a 9 percent tax rate; and Bank B is domiciled in State Z, which has a 7 percent tax rate. Bank A, domiciled in State Y, will pay an income tax at a 9 percent rate to State Y regardless of where it earned that income. Bank B, domiciled in State Z, but doing business in State Y in competition with Bank A, will pay a tax at a 7 percent rate to State Z, its domiciliary state. The use of a pure residence-based tax in this situation may have the effect of encouraging Bank B to do business in State Y, where it has a tax advantage over State Y domiciliary banks. State Y, however, has two reasons to complain about this situation. First, State Y fails to collect any tax revenue from Bank B, although Bank B does business there. Second, State Y's domiciliary banks are placed at a tax rate disadvantage vis-a-vis the banks from State Z because State Z banks compete with State Y banks for business but pay a lower tax rate.

In practice, a pure residence-based tax also discriminates against different lines of business within a state. Nearly every state uses source principles to tax its multistate general business corporations. Source-based taxation requires general business corporations to apportion their income among the states in which they do business. Unlike the situation with residence-based taxation, a state

applies its source-based tax to both in-state and out-of-state firms so that each will pay tax at the same rate and base on the fraction of income earned within the taxing state. Thus, competing in-state and out-of-state general business corporations are not subject to different tax bases and rates, as are domiciliary and nondomiciliary banks in the example above.

Unless adopted by every state, a pure residence-based tax also creates a problem for banks that do business in more than one state. Suppose that a bank does business in several states and one of those states, using source principles with an apportionment formula, taxes the income it earns there. Then, the bank may become subject to multiple taxation. Consider, for example, the following situation:

States Y and Z have the same income tax rate and base. State Y taxes its domestic banks on their entire income. Bank A is domiciled in State Y. Bank A does 70 percent of its business in State Y and 30 percent in State Z; it conducts its activities in State Z solely by mail and electronic means. State Z uses source-based taxation to tax foreign banks transacting business there, whether or not the bank has a physical presence within the state.<sup>78</sup> Bank A will pay tax to its domiciliary state on 100 percent of its income and tax to State Z on 30 percent of its income. Thus, 130 percent of its income will be subject to tax.

This problem, negligible today, will become more acute as prior restraints on interstate banking continue to dissolve, as the technology for delivering bank services electronically becomes more sophisticated, and as states amend their bank tax laws to reflect these changes. The constitutionality of a pure residence-based tax is doubtful when used in such an interstate environment.<sup>79</sup>

### **Pure Source-Based Tax: Separate Accounting**

In theory, a pure source-based tax system permits states to divide the tax base of a multistate corporation among the states in which such corporation conducts its business activities in a manner that approximates the corporation's level of business activity in each state. One way in which a state can use a pure source-based tax to accomplish this goal is through the use of separate accounting.

When used to assign income of a multistate business to a given state for tax purposes, the separate accounting method deems the in-state operations of a corporate branch or subsidiary as a taxable entity unconnected to its out-of-state parent. The income of the branch or subsidiary is isolated as if the entire business operations were conducted in the taxing state.<sup>80</sup> The U.S. Supreme Court recognized the limitations of this method very early. If, for example, a multistate manufacturing business is a vertically or horizontally integrated group of entities, its operations are not conducted in any single state separately. Instead, the income of the business is earned "by a series of multistate transactions beginning with manufacturing profit in one state and ending with sales profit in other states."<sup>81</sup> Such was in fact the finding of the Supreme

Court in the case of *Underwood Typewriter Co. v. Chamberlain*.<sup>82</sup>

Two methods of separate accounting exist to isolate the net income of a multistate business in a given state. A state can either:

(1) Ascertain the actual cost of manufacturing and add a reasonable profit, determined by reference to such standards as the profit made by other corporations and the opinions of businessmen. The manufactured goods are then deemed to have been sold by the manufacturing department to the selling department at the price indicated. Specific costs of each department are computed, and overhead, administrative, and other general expenses are charged to the various departments.

or

(2) Ascertain the price at which the articles manufactured may be purchased from other manufacturers in the categories and quantities desired. Utilize this figure as the cost of goods, and otherwise proceed as indicated in (1) above.<sup>83</sup>

Commentators have criticized separate accounting as "fearfully expensive," "impracticable,"<sup>84</sup> "arbitrary," and "uncertain."<sup>85</sup> Few states use the method today, and at least one state that purports to do so allows a multistate business to isolate its in-state income by means of applying formula-based apportionment.<sup>86</sup>

Pure source-based taxation with separate accounting scores low in the criteria of simplicity and reduction of compliance burdens and enforcement.

#### Pure Source-Based Tax: Formula-Based Apportionment

Another way to use pure source-based taxation to accomplish the goal of dividing the tax base of a multistate corporation is through formula-based apportionment. The apportionment formula is designed to measure the fraction of a multijurisdictional taxpayer's income that should be attributed to a given state by comparing the taxpayer's in-state income-producing activities with its 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.

As a general rule, an apportionment formula should comply with two principles: (1) the factors should bear a reasonable relationship to the income being apportioned, 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.<sup>87</sup> To date, neither federal statutory law nor judicial decisions impose any particular formula or situs rules on states.<sup>88</sup> Thus, states are free to adopt any apportionment formula and situs rules they choose, as long as they comply with the above general fairness rules. The freedom to choose among apportionment formulas allows states autonomy in adminis-

tering state taxes on multistate corporations. Each state can adopt its statutes, rules, and policies without regard to whether another state applies different rules. Conflicts among state statutes, rules, and policies are deemed irrelevant to the taxing state, which administers its laws as if it were the sole taxing state.

If the freedom in their choice of apportionment formulas maximizes the autonomy of states, it greatly increases the compliance burden for multistate corporations, which must comply with a wide variety of formulas and situs rules. With the use of pure source-based taxation and formula-based apportionment, states have made scant progress toward the goal of uniformity.

The problems with formula-based apportionment can be illustrated by reviewing briefly the long history of state uses of formulas to apportion the income of multistate general business corporations. Today, there is little disagreement among the states as to the appropriate factors for a manufacturing firm. Most states use the so-called Massachusetts formula, an equally weighted 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). 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:

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

Forty-five out of the 46 states (including the District of Columbia) that levy corporate taxes measured by net income have adopted the three-factor formula.<sup>89</sup> In 1957, the formula—consisting of property, payroll and sales, and detailed situs rules—was codified in the *Uniform Division for Tax Purposes Act* (UDITPA).<sup>90</sup> Currently, 23 states use some version of the UDITPA formula.<sup>91</sup> Yet, because many of the states that use the Massachusetts formula (with or without adopting UDITPA) have modified it, there is little uniformity among the states.<sup>92</sup> According to Jerome Hellerstein, a leading scholar of state taxation, states vary as to (1) what items should be included in each factor, (2) how to value the items that are included, (3) the relative weights assigned to the three factors, and (4) the definition of terms used in the formula.<sup>93</sup>

For example, state laws differ as to the propriety of including the following elements in the property factor: rented property, inventory in transit between the taxing state and other states, mobile property, and property under construction. State laws also differ on the proper manner in which to value property that is included in the property factor: some states use fair market value, others use book cost less accrued depreciation, and still others employ undepreciated original or book cost.<sup>94</sup> Similar

conflicts in state rules occur in connection with the payroll and receipts factors.<sup>95</sup>

Although the original formula gave identical weight to each of the three factors, 12 states have modified the relative weights.<sup>96</sup> States do this in order to accomplish two goals: to increase the amount of net income assigned to the state and/or to favor domiciliary corporations. Typically, states modify the evenly weighted formula by "double-weighting" the sales factor, according it twice as much value as either of the other two factors.<sup>97</sup> The effect of double-weighting the sales factor is to favor domiciliary multistate corporations, which commonly have more property and payroll than sales in their home state, over out-of-state corporations, which commonly have more sales than property and payroll in the host state.<sup>98</sup>

There is little uniformity among state situs rules.<sup>99</sup> This diversity has an effect similar to double-weighting the sales factor, rendering the "standard" three-factor formula even less authoritative. The situs rules control which elements go into the numerator of the three-factor formula, thereby increasing or decreasing the amount of income attributed to a given state. The choice carries important revenue considerations. Many states will seek to increase their tax revenue by adopting situs rules designed specifically for that purpose.

Even when situs rules appear to be similar, differences may arise because states apply different definitions to specific words in the rules. For example, although 40 of the 45 states that use a sales or receipts factor use a "destination" situs rule for that factor, attributing it to the numerator of the state to which merchandise or property is shipped or delivered, the laws do not necessarily agree as to the meaning of "delivered" or "shipped."<sup>100</sup> Some states also use the throwback rule to change the situs of the receipts factor from destination to "origin" (i.e., the state from which the merchandise is shipped) if the state of destination does not tax the corporation.<sup>101</sup> In sum, after over a half-century of experience with apportionment of the income of general business corporations, there is still little uniformity among state situs rules.

There is reason to believe that state laws for apportioning bank income may differ even more than those respecting the income of manufacturing and merchandising corporations.<sup>102</sup> Banks and other financial institutions earn income primarily from intangible property that, unlike real or tangible personal property, has no natural physical location. For this reason, the U.S. Supreme Court has interpreted the due process clause of the U.S. Constitution to require a situs rule based on the relationship between the intangible property and the taxing state. According to the Court, the required relationship is found at the domiciliary state of the creditor, the domiciliary state of the debtor, or the state in which the intangible debt has a business situs.<sup>103</sup>

Because the due process clause does not prohibit double taxation,<sup>104</sup> all three states could include income from intangibles and the intangibles themselves in the numerators of their receipts and property factors.

The differences in state apportionment formulas and situs rules can increase the total tax burden of multistate

corporations, including banks. Consider the following example:

Assume that State X is the domiciliary state of Bank A. Bank A does business in States X, Y and Z. The tax rate of all three states is 7 percent. According to the situs rules of State X, Bank A has earned 80 percent of its income there. States Y and Z apportion 20 percent and 10 percent to themselves. Bank A pays State X \$56,000 ( $\$1,000,000 \times 80\% = \$800,000 \times 7\% = \$56,000$ ); State Y \$14,000 ( $\$200,000 \times 7\% = \$14,000$ ); State Z \$7,000 ( $\$100,000 \times 7\% = \$7,000$ ). Bank A would pay tax on 110 percent of its income for a total tax of \$77,000.

The Supreme Court has upheld differing state apportionment formulas, reasoning that a particular formula need produce only a rough approximation of the income of a multistate corporation that is attributable to a given state.<sup>105</sup> Therefore, the overlapping taxation that is caused by conflicting formulas and situs rules is not likely to be deemed unconstitutional.<sup>106</sup>

States that use pure source-based taxation have difficulty formulating situs rules that are "fair" (i.e., neutral between in-state and out-of-state businesses) and uniform because there is an irreconcilable conflict between the taxation of domiciliary and nondomiciliary banks. In an interstate environment, the home state of a domiciliary bank is also the host state of a nondomiciliary bank. States cannot, with one set of situs rules, reconcile the conflict created by this dual role. The situs rules that will attribute the most income from domiciliary banks to the home state will also attribute the least income from nondomiciliary banks to the host state, as the following example illustrates.

Bank A is domiciled in State Y and makes loans in States Y and Z. Bank B is domiciled in State Z and also makes loans in States Z and Y. Assume that State Y has situs rules that allow it to include in the numerator of its receipts factor all interest and fee income from loans if the loans are made by a bank domiciled in State Y. This situs rule will have the effect of attributing all of the receipts from loans made by Bank A (and other domiciliary banks) to State Y. The rule will also have the effect of attributing none of the income of nondomiciliary Bank B to State Y, although Bank B makes loans there. A similar conflict arises if State Y has a situs rule that directs all banks doing business there to include in the numerator of their receipts factor all interest and fee income from loans if such loans are made to residents of State Y. This rule will increase significantly the amount of the income of Bank B (and other nondomiciliary banks) attributed to State Y, but it will also decrease the amount of income of Bank A (and other domiciliary banks) that is attributed to State Y.<sup>107</sup>

This problem is particularly troublesome when an apportionment formula is used in connection with *branchless* banks. For example, suppose that a branchless bank operates in a state that uses a formula that includes payroll, real and tangible personal property, and receipts fac-

tors.<sup>108</sup> Because a branchless bank, by definition, has no payroll or (real or tangible personal) property in its market states, the numerators of those two factors in the market states will be zero, thus significantly reducing the amount of income attributed there, and potentially giving it an unfair advantage over home state banks that must operate with a physical presence in the state.

The home state/host state dilemma also decreases the possibility of states agreeing on a uniform apportionment formula. For example, a state that is the domicile of many large banks ("money center") can increase its revenue by choosing situs rules that attribute most of the income and assets to the home state. Conversely, a state that is the home of relatively small banks may be better able to increase its revenue by choosing situs rules that attribute bank income and assets to the host (or market) state. The implementation of a voluntary uniform apportionment formula would require states to agree not to use apportionment formulas to: (1) seek to increase their revenue, (2) favor domiciliary corporations, or (3) engage in interstate tax competition.

In addition to the problems created by the use of an apportionment formula for both domiciliary and nondomiciliary banks, the use of pure source-based taxation with formula-based apportionment in connection with securitized loans creates the potential for widespread tax avoidance, as described above.

Finally, the use of pure source-based taxation with formula-based apportionment has a discriminatory effect on community-based banks because the system gives multistate banks a significant state tax advantage. In the present environment, large multistate banks have the option to move their assets and profits to jurisdictions with low tax rates or no tax at all, thereby reducing their overall tax burden. Smaller, community-based banks cannot take advantage of such mobility in order to obtain tax breaks.

In short, a pure source-based tax with formula-based apportionment scores low on several tax policy goals, including: simplification of tax systems;<sup>109</sup> reduction of compliance burdens; fairness; provision of certainty and regularity for taxpayers; uniformity of taxes on multistate businesses; and exportability, a goal pursued by many states.

Despite its low score in some of the elements of a good tax, a pure source-based tax ranks high in avoiding discrimination among different lines of business. The reason for this is simple: nearly every state has adopted pure source-based taxation with formula-based apportionment for its general business corporations. Yet, significant differences between general business corporations and banks and bank-like entities may dictate different tax treatment for financial institutions. For example, the drafters of UDITPA exempted financial institutions from the act.<sup>110</sup> Manufacturing and mercantile corporations produce and/or market a tangible product that is both visible and allocable to one state. Banks, on the other hand, deal in intangibles that are neither visible nor assignable to only one state, and bank assets are very mobile. With a pure source-based tax, a domiciliary bank can shift its assets and/or profits to a branch in a state that has a low tax

rate or no tax, thereby escaping its home state tax. With residence-based taxation, however, the bank has no incentive to do so because its home state retains taxing jurisdiction over all of its assets/profits. Because a pure source-based tax is the most easily manipulated of the alternative methods of taxation, the use of that system with banks and bank-like entities, which can readily move assets among jurisdictions, may have adverse revenue consequences for states. For these reasons, neutrality in the methods of taxing corporations that do business in a significantly different manner may be neither possible nor desirable. Substantial neutrality—neutrality in both rate and base—is, of course, possible.

### Dual System: Residence-Based and Source-Based Tax

The dual system rests on a different theoretical base than does the pure source-based tax. Source-based taxation permits states to adopt and administer tax laws without regard to the differing and/or conflicting laws of other states. The dual system of residence and source taxation requires states to recognize the interaction of tax systems in the growing interstate and international environment.

The United States international tax system is a dual system. The U.S., using residence principles, taxes the worldwide net income of its domestic multinational corporations, allowing domestic multinational corporations a credit for the net income taxes they have paid to the foreign countries in which they do business (to solve the multiple taxation problem). The amount of the credit is limited: foreign income taxes can be credited only to the extent of the U.S. tax allocable to the taxpayer's "foreign source" income. Expressed as a fraction, the maximum allowable credit is:

$$\text{U.S. income tax (on world-wide income, before credit)} \times \frac{\text{foreign source taxable income}}{\text{U.S. consolidated income}}$$

The effect of the foreign tax credit limitation is that U.S. multinational corporations pay taxes on their foreign source income at the higher of the foreign tax rate or the U.S. rate. Foreign multinationals that do business in the U.S. are taxed only on the income earned there.

States can use such a dual tax system, too.<sup>111</sup> At least 42 states do so with their personal income taxes.<sup>112</sup> Alabama does so with its general business corporations, and Rhode Island and Indiana do so with their bank taxes.<sup>113</sup> The dual tax system appears to be consistent with the directives of the due process and commerce clauses.<sup>114</sup>

The domestic bank component of the dual system consists of a residence-based tax coupled with a credit, and meets many of the same objectives of a good tax as does a pure residence-based tax. Although not as simple as a pure residence-based tax, it is relatively easy to administer. First, a domiciliary state taxes its domestic banks on their entire income, regardless of where it is earned. Domiciliary banks that are subject to this residence-based tax include (1) state banks licensed under the law of the taxing state, (2) foreign banks<sup>115</sup> operating in the taxing

state under a state license, (3) national banks that have designated the taxing state as their principal place of business in their charter, and (4) foreign banks operating in the taxing state under a federal license as a "federal branch" or a "federal agency."<sup>116</sup> The domiciliary state grants such banks a credit for income taxes paid to other states. There are only two circumstances under which a domiciliary state will grant a credit: (1) for activities conducted by a branch of a domiciliary bank, which is located out of state and taxed by the state in which it is doing business; and (2) for branchless banking activities, which are conducted by a domiciliary bank out of state and are taxed by the state in which the activities are conducted.<sup>117</sup>

States will not face the administrative and compliance burdens of the system that the United States uses to tax international income.<sup>118</sup> Unlike the wide variety of tax bases used by foreign countries, nearly every state that imposes a corporate income tax uses a net income base that conforms broadly to the measure of the federal income tax.<sup>119</sup> Therefore, a state could define a creditable tax as a net income tax, a franchise tax measured by net income, or a tax in lieu of a net income tax (i.e., an alternative minimum tax).

States can bypass yet another difficulty in the application of the United States tax on multinational corporations—the calculation of the foreign tax credit limitation. As noted, the U.S. limit is expressed by a formula, the numerator of which is the bank's "foreign source" taxable income and the denominator of which is the U.S. consolidated income. The Internal Revenue Code requires that foreign source income be defined by U.S. tax law rather than by foreign law. To calculate its foreign tax credit limit, therefore, a U.S. multinational must first "re-source" its foreign income according to the extremely complex source rules in sections 861-864 of the Code. These source rules are necessary in the international arena because no constitutional limits exist to prevent foreign countries from overreaching in their definitions of foreign source income. Within the national arena, however, the due process and commerce clauses limit state definitions of the source of income. Thus, states have no need for complex source rules; they can simply limit the amount of their credit by reference to their own rate. The use of effective state tax rates rather than nominal rates will remove any distortions caused by the differences in state net income tax bases.

Unlike the pure residence-based tax, a residence-based tax coupled with a credit does not have the defect of multiple taxation. A simple example will illustrate this proposition.

Assume that Bank A, domiciled in State X, does business in and is taxed by three states: X, Y and Z. Assume further that Bank A has \$1,000,000 of net income for fiscal year 1 and that all three states would calculate the corporation's income in the same manner. All three states have a 7 percent tax rate. Bank A earned income in all three states. State Y determined that 20 percent of the income was earned there and apportioned \$200,000 to itself. State Z determined

that 10 percent of the income was earned there and apportioned \$100,000 to itself. State X assesses its tax on the entire net income of Bank A, but gives a credit for the taxes the corporation pays to States Y and Z. Given these rules, Bank A would pay a \$14,000 income tax to State Y ( $\$200,000 \times 7\% = \$14,000$ ); \$7,000 income tax to State Z ( $\$100,000 \times 7\% = \$7,000$ ); and \$49,000 income tax to State X ( $\$1,000,000 \times 7\% = \$70,000 - \$21,000 \text{ tax credit} = \$49,000$ ). Thus, Bank A pays tax on 100 percent of its income, and its total tax liability is \$70,000.

Because most states use pure source-based taxation with formula-based apportionment for general business corporations, the use of residence-based taxation with a credit for taxes paid to other states can create some tax disparity between banks and general business corporations. On the one hand, the total tax burden on Corporation A will be the same under formula-based apportionment and a system of tax credits as long as State A has a tax rate that is *equal to* that of all other states taxing the corporation, as the following example illustrates:

Assume that Bank A, domiciled in State X, does business in and is taxed by three states: X, Y, and Z. Assume further that Bank A has \$1,000,000 of net income for fiscal year 1 and that all three states use formula-based apportionment to determine the tax liability of Bank A. According to the states' formulas, 70 percent of the company's income is attributable to its activities in State X, 20 percent to those in State Y, and 10 percent to those in State Z. If all three states had the same 7 percent tax rate, Bank A would pay \$49,000 income tax to State X ( $70\% \times \$1,000,000 = \$700,000 \times 7\% = \$49,000$ ); \$14,000 tax to State Y ( $20\% \times \$1,000,000 = \$200,000 \times 7\% = \$14,000$ ); and \$7,000 tax to State Z ( $10\% \times \$1,000,000 = \$100,000 \times 7\% = \$7,000$ ). Thus, Bank A pays tax on 100 percent of its income and its total tax liability is \$70,000, which is the same tax liability that the bank would have under a residence-based tax coupled with a credit.<sup>120</sup>

On the other hand, Bank 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 host states that tax the bank, as the following example shows:

State X, the domiciliary state, has a tax rate of 9 percent, State Y's rate is 8 percent, and State Z's rate is 7 percent. State X taxes the entire net income (\$1,000,000) of Bank A, and States Y and Z tax 20 percent and 10 percent respectively. Bank A's aggregate tax burden is \$90,000. It pays State X \$67,000 ( $\$1,000,000 \times 9\% = \$90,000 - \$23,000 = \$67,000$ ); State Y \$16,000 ( $\$200,000 \times 8\% = \$16,000$ ); State Z \$7,000 ( $\$100,000 \times 7\% = \$7,000$ ). In effect, the bank has paid tax on \$1,000,000 at the rate of 9 percent.<sup>121</sup>

Compare the result under formula-based apportionment with the same 9 percent, 8 percent, 7 percent tax rates:

Bank A's aggregate tax burden would have been \$86,000 rather than \$90,000. It would have paid

\$63,000 to State A ( $\$700,000 \times 9\% = \$63,000$ ), \$16,000 to State Y, and \$7000 to State Z.

(This example assumes, however, that the situs rules of the three states are identical. If, as was described in the preceding section, the situs rules of the three states differ, overlapping taxation will exist under formula-based apportionment, increasing the corporation's overall tax burden).

The residence-based tax with a credit need not, however, create tax disparity among *competitive* lines of business. For example, as described below, some states have adopted a broad definition of a "bank" in order to subject all competing entities to the same tax.

The residence-based tax with a credit also scores high in creating neutrality between small, community-based banks and large multistate banks in that both are taxed under the same rules. With a pure source-based system, multistate banks, which have the option of moving their assets and profits to low-tax or no-tax jurisdictions and reducing their overall tax burden, have a significant state tax advantage. Under the residence-based tax with a credit, however, the multistate banks would still pay a state tax up to the rate of its domiciliary state, just as community banks do.

The out-of-state or nondomiciliary bank component of the dual system is a source-based tax with an apportionment formula. In order to treat domiciliary and nondomiciliary banks equally, states that choose the dual system would want to use a formula tailored for nondomiciliary banks just as the residence-based portion of the tax is tailored for domiciliary banks. States can do this by adopting a uniform single-factor receipts formula for nondomiciliary banks. The proof of this proposition requires an understanding of which banks are taxed as out-of-state or nondomiciliary banks under the dual system.

Most interstate banking occurs through a merger between an out-of-state bank and an in-state bank, an acquisition of an in-state bank by an out-of-state bank, or de novo entry by a bank holding company. Interstate banking through any of the above methods will create 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 host or 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* is also 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 or market state to choose a single-factor receipts formula to apportion the income of a branchless bank. By definition, a branchless bank has no place of business and no employees in the taxing state. Even in the case of a branch bank (whether state-chartered, national, or foreign), 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 property factor (intangible) typically duplicate those for the receipts factor; and (2) the addition of a payroll factor would attribute more revenue to the host state than a receipts formula only if the receipts-to-payroll ratio of the branch in the

host state is less than the average in the entire corporation.<sup>122</sup> This condition would require that the branch earn less revenue per employee than the average of the entire corporation, an unlikely event because the branch presumably would be able to take advantage of many services provided by the home-office employees of its parent corporation rather than hiring separate branch employees.

The dual system may help to create uniformity among state tax systems. There is little reason for a state to modify the apportionment formula for nondomiciliary corporations under the dual system. As noted, there are two reasons for a state to modify its apportionment formula: to increase the amount of revenue assigned to the state and/or to favor their domiciliary corporations. With a dual system, the reasons for altering an apportionment formula disappear. First, because the formula is used only for nondomiciliary banks, a state will not change the formula to benefit its domiciliary corporations, either by modifying the weight of a given factor or by altering situs rules. Second, a uniform single-factor receipts formula with market-state situs rules will nearly always attribute the most income to a taxing state.

Also, the use of the dual system will solve the serious dilemma, described previously, which is created by the increasing securitization of loans, and which cannot be remedied fully under a pure source-based tax. Under the dual system, a domiciliary state would levy its tax on the entire interest income received by a domestic bank from the securitized loans, thereby closing the tax avoidance problem described previously.

The dual system suffers from two political handicaps, however. First, it requires states to adopt a method of taxation that is different from the one currently used by most states. Second, the dual system would close many of the tax loopholes that now exist with pure source-based taxation and that allow multistate banks to move their assets and profits to low-tax rate or no-tax jurisdictions. The familiar experience of the federal government with tax reform illustrates the difficulties involved in plugging tax loopholes.

### Summary and Comment

Four methods exist for the taxation of the income of banks: pure residence-based taxation, pure source-based taxation with separate accounting, pure source-based taxation with formula-based apportionment, and a dual system consisting of residence-based (with a credit) and source-based taxation. None of the four alternatives will satisfy all eight policy goals set forth in the 1975 ACIR study.

A pure residence-based tax receives the highest marks for simplicity, low compliance and enforcement burdens, certainty, and avoidance of trade barriers. Yet, a pure residence-based tax has several flaws, including discrimination between different lines of business, the failure to promote competitive equality between in-state and out-of-state banks, and the potential for multiple taxation. The last two flaws are particularly serious in light of the increased interstate banking activity originating from legislative and judicial actions and technological progress.

A dual system consisting of a residence-based tax with a credit for domiciliary banks and a source-based tax for nondomiciliary banks scores high in the elements of neutrality, fairness, simplicity, and exportability. Under the dual system, small community banks and large multistate banks are taxed under the same rules. The use of the dual system would also solve two serious problems that cannot be remedied under a pure source-based tax system. First, because the dual system requires the use of an apportionment formula only for nondomiciliary banks, no home state/host state dilemma exists. Instead, a state can adopt a formula that is tailored to apportion the income of nondomiciliary banks. Second, the dual system prevents the tax avoidance created by the increasing securitization of bank loans. Under the dual system, a domiciliary state would levy its tax on the entire interest income received by a domestic bank from the securitized loans. The goal of creating a uniform apportionment formula should be attainable under a dual system. Conversely, the dual system suffers from political handicaps.

Viewed from a national perspective, the pure source-based tax ranks low in the criteria of simplicity, uniformity, provision of certainty and regularity for taxpayers, and reduction of compliance burdens. The use of pure source-based taxation with formula-based apportionment

in an interstate environment causes several problems for states. Because of the home state/host state conflict in situs rules, pure source-based taxation with formula-based apportionment scores low in exportability and competitive equality between domiciliary and out-of-state banks. This problem is particularly acute in the case of branchless banks. Also, the use of pure source-based taxation with formula-based apportionment in connection with securitized loans creates the potential for widespread tax avoidance, also decreasing the fairness of the tax. Finally, the use of pure source-based taxation with formula-based apportionment has a discriminatory effect against community-based banks. With a pure source-based system, multistate banks have a significant state tax advantage over community banks. In the present environment, large multistate banks have the option to move their assets and profits to jurisdictions that have a low tax rate or no tax at all, thereby reducing their overall tax burden considerably. Smaller, community-based banks cannot take advantage of such tax breaks. Conversely, because most states today use formula-based apportionment, that method ranks high on avoidance of discrimination between banks and general (nonfinancial) businesses.



**Source-Based Taxes:  
Alternative Apportionment Formulas**

States that adopt a pure source-based tax must select among several possible factors and situs rules. Many states also will alter the respective weights that they assign to the factors chosen in order to increase their revenue and/or favor their domiciliary corporations.

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. The situs rules then spread the income of the corporate taxpayer among the states having jurisdiction to tax it. Within general fairness guidelines, states have wide latitude in the selection of apportionment formulas.<sup>123</sup>

Banks earn income by soliciting deposits, which in turn permits them to create loans and investments that 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. Thus, in the case of bank income, payroll receipts, intangible property, and deposits are all potential factors. No existing federal laws or judicial decisions require states to choose any one or any combination of these potential factors. No empirical evidence exists that suggests that any factor is better than any other or that any combination will produce a better result when used for both domiciliary and market states.

Moreover, any uniform apportionment formula would require significant compromises; that is, states would have to agree not to use apportionment formulas to (1) seek to maximize their revenue, (2) favor domiciliary corporations, or (3) engage in interstate tax competition, an event that appears unlikely given the experience with state formulas for multistate general business corporations. Although presently it is not feasible to describe the best formula for banks, it is possible to evaluate the formulas now in use.

**UDITPA Formula**

The UDITPA formula contains a property factor (real and tangible personal property), a sales factor, and a payroll factor. 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 makes that formula unsuitable for bank income; in fact, the act specifically exempts financial institutions. While the omission of intangible property may not rise to the level of a constitutional flaw, it changes significantly how the income of a bank is spread among the states in which it transacts business. For example, the situs of real and tangible personal property is attributed to 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 only the domiciliary state. If, as is true in the case of UDITPA,

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the formula also contains a payroll factor, the balance will be tipped even further in favor of the domiciliary state because most employees will be located there, too.

Moreover, the use of the UDITPA formula may have a discriminatory effect. Real and tangible personal property (such as machinery and equipment) is likely to comprise a large percentage of the assets of a general business (nonfinancial) corporation, while intangible property will represent a small fraction of its assets. This situation is reversed in the case of a financial institution. Typically, financial institutions have very little real and tangible personal property, whereas intangible property, such as loans and securities, constitute their entire business. Thus, use of the UDITPA formula excludes most of the property of financial institutions, but not that of general business corporations.

Despite these flaws, approximately 11 states use the three-factor UDITPA formula.<sup>124</sup> Typically, these states have not attempted to design a formula that is tailored for banks, but have simply borrowed the UDITPA formula. A few states include intangible property in the property factor of their apportionment formula.<sup>125</sup> Unlike the situation with real property or tangible personal property, the legal situs of intangible property can exist in more than one state,<sup>126</sup> namely, the domicile of the creditor, the domicile of the debtor, and/or the state in which the intangible has a business situs.<sup>127</sup> The inclusion of intangible property in the property factor coupled with a situs rule based on the residence of the debtor would benefit market states.

### New State Apportionment Formulas

Recognizing the defects of the UDITPA formula, some states have adopted new formulas specifically tailored to banking. The new laws of New York and Minnesota represent two different approaches to the problem of apportioning the income of multijurisdictional banks.

**The New York Law.** In 1985, New York completely revised its bank tax to make it similar to the tax on general business corporations, that is, the state uses a pure source-based tax for banking corporations. The factors chosen to apportion the income of banking corporations are receipts, deposits, and payroll. The numerator of the payroll factor is 80 percent of in-state wages, salaries, and other personal services compensation.<sup>128</sup> The receipts and deposits factors are double-weighted.

The receipts factor consists of 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, although a portion of such income is excluded from the tax base.

The regulation contains separate "situs" rules for each receipt. The rules have a strong domiciliary state bias. 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."<sup>129</sup> A loan is deemed located in New York if the greater portion of income-producing activity relating to the loan (i.e., solicitation, investigation, negotiation, approval, and administration) takes place in the state. 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.<sup>130</sup>

2) The situs of income from bank, credit, travel, entertainment and other card operations is the state of domicile of the credit card holder.<sup>131</sup>

3) 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 within New York.

The deposits and payroll factors also exhibit a domiciliary state bias. 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 within and outside of New York.<sup>132</sup> Deposits made by an out-of-state individual or business are deemed to exist in the state in which the deposit is maintained. The payroll factor is the ratio of 80 percent of in-state wages, salaries, and other personal services compensation to total wages, salaries, and other personal services compensation.

**The Minnesota Law.** Minnesota revised its bank income tax law in 1987 and 1988. The factors selected by Minnesota—payroll, property, and receipts—are similar to those in the UDITPA formula. The similarity between the two formulas ends there, however. Two differences are particularly important. First, the Minnesota formula includes intangible as well as tangible and real property in the property factor.<sup>133</sup> Second, the three factors are not weighted evenly. 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.<sup>134</sup>

The Minnesota situs rules, which have a distinctly market state flavor, differ significantly from the New York rules, as the following examples illustrate:

1. Receipts from Loans. The situs of income and other receipts from loans secured by real estate or tangible property is in Minnesota if such property is located in the state. 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.<sup>135</sup> The situs of income and other receipts from unsecured consumer loans is in Minnesota if the borrower is a resident of Minnesota.<sup>136</sup>

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.<sup>137</sup>

3. The situs of receipts from the performance of services is in Minnesota if the benefits of the services are con-

sumed in the state, regardless of where the services are performed.<sup>138</sup>

The state's situs rules for the property factor track those of the receipts factor.<sup>139</sup> 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.<sup>140</sup>

### Summary and Comment

To date, two states—New York and Minnesota—have completely revamped their state bank tax laws using pure source-based principles. Each state has chosen very different situs rules. The differences reflect the states' perception of their status as a home state or a host state. For example, New York, which is a money center state, has chosen situs rules that locate most bank receipts and deposits in New York. The New York receipts and deposits factors are double-weighted. Minnesota, which deems itself to be primarily a host state, has selected situs rules that have a market state bias: receipts and intangible property are located in the state of the borrower. According to the Minnesota situs rules, receipts are weighted more heavily than either property or payroll.

Although these differences in state apportionment formulas do not appear to raise a federal constitutional question,<sup>141</sup> they do cause overlapping taxation. As more states pass new bank tax laws, the lack of uniformity will produce more tax overlap and greater administrative burdens for banks operating across state lines.

### Definition of Taxable Entities: What is a Bank?

Until recently, most states defined a "bank" in harmony with the regulatory definition of a bank. Consequently, a "bank" was defined as an entity regulated by the state's Department of Banking. Many states that used this definition taxed banks differently than they taxed other depositories, such as savings and loan institutions. Now, however, states are beginning to enlarge their narrow definition of a bank in order to create tax parity among like institutions. The use of a definition of the taxable entity that includes all or most competing institutions will go a long way toward creating a neutral and fair tax system. State experiments in this area range from an expanded regulatory definition of a "banking corporation" to an open-ended definition of a "financial institution." The laws of New York, Michigan, and California illustrate the possibilities.

### The New York Definition

The New York law applies to every "banking corporation" that is exercising its franchise or is doing business in New York. In general, 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, thrift, or bank holding company and that is engaged in a business that can be conducted lawfully by a commercial bank, 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 that is either doing a banking business or is a subsidiary of a bank, thrift, or 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 that is substantially similar to the business of a traditional bank.

The law makes the task of revenue authorities and taxpayers easier because it defines which entities are subject to the tax. This is done by regulations that give specific examples of the kinds of entities that are banks, thrifts, or bank holding companies and then by referencing the federal regulations that specifically list the subsidiaries of bank holding companies that are banking corporations under (b) above.

### The Michigan Definition

Michigan defines a "financial organization" for the purpose of its single business tax as a "bank, industrial bank, trust company, savings and loan association, bank holding company . . . credit union . . . and any other association, joint stock company, or corporation at least 90 percent of whose assets consist of intangible personal property and at least 90 percent of whose gross receipts income consists of dividends or interest or other charges resulting from the use of money or credit."<sup>142</sup> According to Michigan tax officials, many nonbank institutions that compete with banks for automobile, mortgage, and other loans come within this definition.<sup>143</sup> Other entities that some commentators deem to be competitors of banks, such as securities brokerage and investment firms and insurance companies, are excluded from the Michigan financial organization tax.<sup>144</sup>

By focusing on the unique aspects of banks and financial institutions (i.e., institutions whose assets consist primarily of intangible property and whose income is generated through the use of money and credit), the Michigan statute creates a significant degree of tax parity among competing entities.

### The California Definition

California's financial institutions law contains a very broad definition of a taxable entity. The law provides for the apportionment of the income of banks and "financial institutions." Case law defines a financial institution as an entity that deals in "moneyed capital" in substantial competition with national banks. By administrative policy, the California Franchise Tax Board applies a "more than 50 percent of gross income" test. Thus, a financial institution is an entity that receives more than 50 percent of its gross income from the use of its capital in substantial competition with other moneyed capital. Thus, entities engaged in

consumer financing, including automobile financing, come within the definition of a financial institution.<sup>145</sup> Although California has not issued regulations implementing the vague case law, the state has published legal rulings that give examples of the kinds of entities that will be deemed financial institutions.

### Use of the Unitary Business Principle

States developed the unitary business principle to counter the problem of tax avoidance through interstate profit shifting by general business corporations.<sup>146</sup> Because they deal in intangibles, banks can shift assets and profits among taxing jurisdictions much more easily than can general business corporations. According to the unitary business principle, the apportionable tax base of multistate Corporation A that is doing business within State X includes the combined income of all members of Corporation A's unitary group, which consists of the parent and any of its controlled (i.e., related by more than 50 percent common ownership) subsidiaries that are engaged with it in a "functionally integrated" enterprise.<sup>147</sup> The amount of the combined unitary base that is attributable to Corporation A's activities in State X is determined by multiplying the base by the state's apportionment formula. The numerators of the factors will include the property, payroll, and receipts of Corporation A, while the denominator of the formula must include the gross receipts, property, payroll, etc., of the entire unitary group.

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 stated that "the prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not flow of goods."<sup>148</sup> Taxpayers assert that because the unitary method is based on 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 seldom arises with banks and bank-like entities.<sup>149</sup> 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<sup>150</sup> or "closely related to banking or managing or controlling banks" in the case of bank holding companies.<sup>151</sup> Hence, no bank or bank holding company subsidiary can engage in a business unrelated to that of banking, thus removing the major impediment to the use of the unitary business principle.

An important application of the unitary business principle in connection with state taxation of banks is the protection of the integrity of a state's franchise tax. As noted, many states have adopted a franchise tax measured by net income for banks because that tax provides the only method by which states can include the income from federal securities in a bank's tax base. Yet, because not every state has a franchise tax and because bank assets are very mobile, the franchise tax is easily avoided through "tax planning" techniques, such as the following:

Assume that Bank X is a domiciliary bank of State A. State A has a franchise tax and taxes federal securities. Bank X can avoid the tax on federal obligations by transferring its federal securities to Subsidiary Y located in State B, a state that does not have a bank franchise tax and cannot, therefore, tax the income from such securities.

The use of the unitary business principle would allow State A to combine the income of Subsidiary Y with that of Bank A for purposes of its state tax.

The unitary business principle is compatible with both the pure source-based and dual tax systems. A residence-based tax can be translated easily into the source-based tax that is necessary for combined reporting. A residence-based tax can be represented by an apportionment formula that attributes 100 percent of the factors (i.e., gross receipts, intangible property, etc.) to the domiciliary state. Once the residence-based tax is transformed into an apportionment formula, the factors of all of the members of the unitary group can be combined to determine what fraction of the combined apportionable income base is attributable to the taxing state. The actual tax is then calculated by applying the rate to the base and subtracting the credit. As described earlier, the use of a single-factor receipts formula will, in most cases, attribute the most income to the taxing state.

### Jurisdiction Rules

As noted, banks can and do conduct business in many states without having a physical location there. Many banks regularly make loans and solicit deposits by mail, telephone, or electronic means. As electronic communications systems become more sophisticated, interstate branchless banking will increase. Such an environment renders jurisdiction rules based on a physical presence obsolete.

Branchless banking can create tax avoidance and tax discrimination between in-state and out-of-state banks. 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 50 states. Through these mail-order operations, Company A makes loans to consumers in every state, earning interest and fee income from their residents.

Even if we assume that one of these states, State B, has a source component, it normally will not tax Company A on the interest and fee income it receives from residents of State B because Company A, which is domiciled in State 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. The domiciliary banks in State B, on the other hand, may also issue credit cards to residents of State B. Unlike Company A, State B's domiciliary banks will pay taxes on the interest and fee income to State B.<sup>152</sup>

In spite of the fact that branchless banking may result in tax avoidance and discrimination against domiciliary banks, most states still have tax jurisdiction rules that prevent them from taxing out-of-state banks that regularly solicit business from their residents by mail, telephone, or electronic means. It is unlikely that the U.S. Constitution will be interpreted to prevent states from adopting broader income tax jurisdiction rules for nondomiciliary banks that make loans to their residents.<sup>153</sup> As the U.S. Supreme Court has noted in upholding a state's exercise of judicial jurisdiction over an out-of-state defendant who had no office or other physical presence in the state asserting jurisdiction, "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."<sup>154</sup> Two states, Indiana and Minnesota, have broadened their tax jurisdiction rules by statute. Similar legislation is pending in Massachusetts. According to the 1988 ACIR survey, 11 other states do so by administrative policy.

### The New York Jurisdiction Rules

According to the New York rules, foreign banking corporations "doing business" in New York apportion their income according to a three-factor formula. A banking corporation is deemed to be "doing business" in New York if, within the state, it operates a branch, a loan production office, a representative office, or a bona fide office.<sup>155</sup>

### The Minnesota Jurisdiction Rules

Minnesota's tax jurisdiction rules are broader than those in New York. Activities that create jurisdiction to tax in Minnesota include both the traditional "doing business" test, which is based on 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 "conducts a trade or business which . . . regularly 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 [stations]. . . .<sup>156</sup>

A financial institution is deemed to have "regularly" solicited business from within the state if it "conducts activities with twenty or more persons within [Minnesota] during any tax period, or the sum of its assets and deposits attrib-

utable to Minnesota sources equals or exceeds \$5,000,000."<sup>157</sup>

### Reporting Requirements

Broad jurisdiction rules allow a state to tax an out-of-state branchless bank, but they do not provide a mechanism for identifying which entities are taxable. Assuming that it is possible for a state to detect the existence of a branchless bank, it still cannot tax such an entity unless the activities of the branchless bank have met the constitutionally required threshold. An attempt to assert tax jurisdiction over a branchless bank without some proof of the extent of its activities within the taxing state would lead inevitably to protracted litigation over the constitutionality of the tax. The issue may have to be litigated again with each separate branchless bank because the nature and extent of the activities of each such entity may vary.

To overcome this problem, some states have turned to reporting statutes. Typically, such statutes require 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 in question to file a Notice of Business Activities. Because a reporting statute does not in itself subject the foreign corporation to tax, the use of a reporting statute solves the problem of case-by-case litigation over the taxability of each branchless bank.<sup>158</sup>

Minnesota has such a statute. According to the Minnesota statute, every corporation that during the calendar year obtained any business from within Minnesota must file a Notice of Business Activities Report with the state's tax commissioner unless

- 1) It is a financial institution that conducts activities with less than 20 persons within Minnesota during the tax year and the sum of its assets and deposits attributable to Minnesota sources is less than \$5,000,000;
- 2) It is engaged solely in secondary market activity in Minnesota as defined by Minnesota law;<sup>159</sup>
- 3) It has a certificate of authority to do business in Minnesota;
- 4) It has filed a timely Minnesota corporate franchise tax return; or
- 5) The corporation is tax-exempt.<sup>160</sup>

Under this law, a corporation must file the notice even if it does not have a physical presence in Minnesota.

Because the Minnesota reporting statute is based on a similar statute in New Jersey, the recent litigation over the New Jersey penalty provisions may affect the Minnesota law. According to both statutes, the failure to file the required business activities report results in certain penalties, including the loss of access to the state's courts. Section 13A:13-20(b) of the New Jersey statute provides that:

The failure of a foreign corporation to file a timely report shall prevent the use of the courts in this state for all contracts executed and all causes of action that arose at any time prior to the end of

the last accounting period for which the corporation failed to file a timely report.<sup>161</sup>

The validity of this section is in doubt. Recently, the New Jersey Supreme Court reviewed *First Family Mortgage Corp. v. Durham*,<sup>162</sup> a case that presented a challenge to the reporting statute. First Family Mortgage Corporation, a Florida corporation that was not authorized to do business in New Jersey, acquired 54 mortgages on New Jersey homes. Although it came squarely within the terms of the New Jersey law, First Family failed to file an activities report. When Linda Durham, the owner of one of the homes mortgaged, defaulted on her mortgage payments, First Family initiated a foreclosure action in a New Jersey court. Durham moved to dismiss the case on grounds that First Family did not comply with the reporting statute. First Family challenged the statute claiming that by prohibiting access to the state's courts, the statute violated the commerce clause of the U.S. Constitution.

Although the New Jersey Supreme Court upheld the state's reporting statute in general, it found that the above section violated the commerce clause because it did not

give the offending corporation the right to regain access to the courts by filing the required report and paying any taxes, interest, or penalties due. In order to preserve the constitutionality of the statute, therefore, the New Jersey Supreme Court interpreted section 14A:13-20(b) as being subject to the general "cure" provisions in section 14A:13-20(c)(1)-(2). The latter section allows a court to excuse the failure to file if:

- 1) The failure to file a timely report was done in ignorance of the requirement to file, such ignorance was reasonable in all circumstances; and
- 2) All taxes, interest, and civil penalties due the state for all periods have been paid, or provided for by adequate security or bond approved by the director, before the suit may proceed.

The Minnesota law (which has not been challenged) does not contain an "ignorance" requirement; that is, a taxpayer can regain access to the courts simply by filing and paying any taxes, penalties, and interest due.

## Conclusion

The 1819 decision of the Supreme Court in *McCulloch v. Maryland* set the stage for congressional domination of state taxation of national banks and federal obligations that continues today. States cannot tax either national banks or federal obligations without statutory permission from the Congress.

The Congress began exercising its control over state taxation of national banks with the passage of the *National Currency Act* in 1864. The act codified the *McCulloch* holding by permitting states to tax the real property and shares of national banks. One section of the act limited state taxes on national bank shares to a rate no greater than the rate assessed on "other moneyed capital." This first congressional foray into the business of regulating state taxation of national banks through specific statutory directives and limitations signaled the beginning of over a century of litigation involving mind-numbing differences in state calculations of their rates of taxation and interpretations of the phrase "other moneyed capital."

By 1969, the Congress had recognized that neither further amendments, which merely led to a new round of litigation, nor judicial mediation, which produced a large body of inconsistent and conflicting opinions, could bring order or clarity to state taxation of national banks. In a final revision of the law, the Congress removed all prior conditions and limitations on state taxation of national banks and passed legislation that directed states to tax national banks in the same manner as they tax their state banks. The new law became effective in 1976.

Given the long history of congressional control over the methods by which a state could tax national banks, it is not surprising that most states have not yet revised their laws to reflect either the changes in federal law or the changes in the business of banking. For example, some states still tax their domestic banks using pure residence-based taxation, even though that system fails to promote competitive equality between in-state and out-of-state banks and creates the potential for multiple taxation. Approximately 32 states apportion the income of multistate banks. About 11 of those states apportion the income of in-state and out-of-state banks using the UDITPA three-factor formula, which was designed for manufacturing companies. By failing to take account of intangible property, such as loans and government securities, the UDITPA formula misallocates income among the states when used for banks. There is no commonality among the apportionment rules in the remaining 21 states. Also, most states still use jurisdiction rules based on a physical presence, although such rules appear obsolete in an era in which loans are made and deposits solicited interstate by mail, telephone, and other electronic means.

It is not possible yet to describe all the contours of the "best" bank tax. States have only recently begun to amend their bank tax laws to take advantage of the lifting of prior congressional restraints; therefore, one cannot measure the relative effectiveness of the new taxes. The three states that have recently revamped their laws—Minnesota, New York, and Indiana—have adopted very different approaches to the taxation of bank income. Both Minne-

sota and New York choose pure source-based taxation. Yet, Minnesota has broad jurisdiction rules and an apportionment formula with a market state bias, while New York requires an office location in the state in order to establish tax jurisdiction and has adopted an apportionment formula with a domiciliary state bias. Indiana adopted the dual system of taxation, whereby domestic banks are taxed using a residence-based tax with a credit and out-of-state banks are taxed by means of a single-factor receipts formula. Several other states are in the process of amending their bank tax laws, and eventually every state that has a pure residence-based tax may have to amend its law in order to eliminate multiple taxation.

States are still searching for a system that will satisfy the criteria of a good tax and interstate uniformity. At least in the case of general business corporations, the goal of uniformity has proved elusive. In order to settle on a uniform apportionment formula with a pure source-based tax, states will have to make significant compromises. Specifically, states would have to agree *not* to use apportionment formulas to (1) seek to maximize their revenue, (2) favor domiciliary corporations, or (3) engage in interstate tax competition.

A promising possibility that meets many of the criteria of a good tax is the dual tax system, whereby domiciliary banks are taxed on their entire income, with a credit for taxes paid to other states, while nondomiciliary banks are taxed according to source principles.

Although it is not yet clear what the best bank tax will be, it is imperative to monitor and evaluate the new bank taxes as they are adopted by the states. Such efforts will help states to identify the most effective method for taxing banks, and thereby promote uniformity among state bank taxes.

#### Notes

- <sup>1</sup> 17 U.S. (4 Wheat.) 315 (1819).
- <sup>2</sup> An excellent and detailed discussion of the federal immunity doctrine can be found in Paul J. Hartman, *Federal Limitations on State and Local Taxation* (New York: The Lawyers Cooperative Publishing Company, 1981).
- <sup>3</sup> 17 U.S. at 429.
- <sup>4</sup> A national bank holds a federal rather than a state charter. A national bank is a governmental instrumentality because it is created by the Congress.
- <sup>5</sup> US Const. Art VI, sec. 2. Because a national bank was necessary and proper, the decision of the Congress to incorporate such banks was part of the supreme law of the land.
- <sup>6</sup> *Weston v. Charleston*, 27 U.S. 448 (1829).
- <sup>7</sup> US Const. Art I, sec. 8, cl. 27.
- <sup>8</sup> US Const. Art I, sec. 8, cl. 27.
- <sup>9</sup> *Weston*, 27 U.S. 469.
- <sup>10</sup> In 1862, the Congress codified the prohibitions of the *Weston* decision in an act that provided that, "All stocks, bonds and other securities of the United States held by individuals, corporations, or associations . . . shall be exempt from taxation by or under State authority." This *per se* prohibition was rendered ineffective, however, by two later decisions of the Supreme Court that upheld bank shares taxes, measured by the value of all bank assets, including federal obligations (*Home*

*Insurance Co. v. New York*, 134 U.S. 594, 1890), and franchise taxes measured by the entire net income of corporations, including the income from federal obligations (*Society for Savings v. Coite*, 73 U.S. 594, 1867).

- <sup>11</sup> 31 U.S.C. sec. 3124 (a). This restriction has led many states to adopt for banks a franchise tax measured by net income instead of a direct net income tax. With a franchise tax, a state can include the income from federal obligations in the tax base. This is an important advantage because the income from federal and state securities comprises a significant fraction of the income of banks.
- <sup>12</sup> 13 Stat. 112. Earlier, the Congress had passed the Currency Act of 1862, which exempted from state taxation "all stocks, bonds, and other securities of the United States held by individuals, corporations or associations within the United States." 12 Stat. 346.
- <sup>13</sup> 13 Stat. 112.
- <sup>14</sup> *McCulloch*, 17 U.S. at 435.
- <sup>15</sup> John B. Woosley, *State Taxation of Banks* (1935), reproduced in Board of Governors of the Federal Reserve System, *State and Local Taxation of Banks, Report of a Study under Public Law 91-156*, Before the Senate Committee on Banking, Housing, and Urban Affairs, 92nd Congress, 1st Session (Committee Print, 1971).
- <sup>16</sup> Section 41 also permitted a state to tax the real estate of national banks to the same extent that it taxed other real estate.
- <sup>17</sup> The second limitation was dropped in an 1868 amendment to the Act. 15 Stat. 34.
- <sup>18</sup> *Woosley, State Taxation of Banks*.
- <sup>19</sup> *People v. Weaver*, 100 U.S. 539 (1879).
- <sup>20</sup> *Hepburn v. The School Directors*, 90 U.S. (23 Wall.) 480 (1874). The Court found no discrimination in this practice. Typically, these suits were brought by national banks, although the actual tax was levied on the shareholder.
- <sup>21</sup> *Commercial Bank v. Chambers*, 182 U.S. 556 (1901).
- <sup>22</sup> *Aberdeen Bank v. Chehalis County*, 166 U.S. 440 (1897); *Mercantile Bank v. New York*, 121 U.S. 138 (1887); *Davenport Bank v. Davenport Board of Equalization*, 123 U.S. 83 (1887); *Bank of Redemption v. Boston*, 125 U.S. 60 (1888).
- <sup>23</sup> *First National Bank of Wellington v. Chapman*, 173 U.S. 205 (1899).
- <sup>24</sup> *First National Bank of Hartford v. City of Hartford*, 237 U.S. 548 (1927).
- <sup>25</sup> *National Bank of Richmond v. City of Richmond*, 256 U.S. 635 (1921).
- <sup>26</sup> *People v. Commissioners*, 71 U.S. (4 Wall.) 244 (1866); *Mercantile Bank v. New York*, 121 U.S. 138 (1887); *Bank of Redemption v. Boston*, 125 U.S. 60 (1888); *Aberdeen Bank v. Chehalis County*, 166 U.S. 440 (1897).
- <sup>27</sup> *Mercantile Bank v. New York*, 121 U.S. 60 (1888); *Talbot v. Silver Bow County*, 139 U.S. 438 (1891).
- <sup>28</sup> *Bank of Redemption v. Boston*, 125 U.S. 60 (1888).
- <sup>29</sup> 90 U.S. at 484 (1874).
- <sup>30</sup> 121 U.S. 138 (1887).
- <sup>31</sup> *Woosley*, p. 241.
- <sup>32</sup> *Mercantile Bank v. New York*, 121 U.S. 138, 154 (1887).
- <sup>33</sup> *Woosley*, p. 239.
- <sup>34</sup> 42 Stat. 1499.
- <sup>35</sup> 44 Stat. 223.
- <sup>36</sup> See text, page XX (note 11), for statutory limitations on state taxation of federal obligations.



- 37 44 Stat. 223.
- 38 Woosley, p. 288.
- 39 358 U.S. 450 (1959).
- 40 101 So.2d 70 (1958), appeal dismissed and cert. denied, 359 U.S. 28 (1959).
- 41 15 U.S.C. sec. 381 (1959).
- 42 See Jerome R. Hellerstein, *Tax Law Review* 30 (1975): 155, 156. (1975)
- 43 392 U.S. 339 (1968).
- 44 392 U.S. at 348.
- 45 See Hartman, p. 376.
- 46 12 U.S.C. sec. 548 (1982).
- 47 Advisory Commission on Intergovernmental Relations (ACIR), *State and Local "Doing Business" Taxes on Out-of-State Financial Depositories, Report of a Study under Public Law 93-100*, Before the Senate Committee on Banking, Housing, and Urban Affairs, 94th Congress, 1st Session (Committee Print, 1975), p. v.
- 48 ACIR, *State and Local "Doing Business" Taxes*, pp. 48-49.
- 49 Cf. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 476; *McCarroll v. Dixie Greyhound Lines, Inc.*, 309 U.S. 176, 188-189 (1940).
- 50 See e.g. *Burger King v. Rudzewicz*, 471 U.S. 462 (1985). In upholding jurisdiction over an out-of-state defendant who had no office or other physical presence in the state asserting jurisdiction, the high Court noted that "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."
- 51 See ACIR, *State Regulation of Banks in an Era of Deregulation* (Washington, DC: ACIR, 1988).
- 52 ACIR, *State and Local "Doing Business" Taxes*, pp. 374-375.
- 53 The Massachusetts law provided that an out-of-state bank holding company with its principal place of business in one of five New England states (Connecticut, Maine, New Hampshire, Rhode Island, and Vermont), which is not directly or indirectly controlled by another corporation with its principal place of business located outside of New England, may establish or acquire a Massachusetts-based bank or bank holding company, provided that the other New England state accords equivalent reciprocal privileges to Massachusetts banking organizations. Massachusetts Gen. Laws Ann., ch. 167A, sec. 2.
- 54 See Conference of State Bank Supervisors, *State of the State Banking System* (Washington, DC: the Conference, 1989). For a complete description of state regulation of interstate banking, see, ACIR, *State Regulation of Banks in an Era of Deregulation*.
- 55 See e.g. Douglas H. Ginsburg, "Interstate Banking," *Hofstra Law Review* 9 (1981): 1133.
- 56 House Report. No. 99-426, 99th Congress, 1st Session (1986), p. 393.
- 57 757 F.2d 453 (2nd Cir., 1985); cert. denied, 106 S.Ct. 2926 (1986).
- 58 "New England Bank without Walls Depends on US Mail to Bring Deposits Offering Investors Higher Rates." *American Banker*, June 23, 1986, p. 24.
- 59 "TSO Welcomes Long-Distance/Nationwide Customers with System that Could Make Walk-in Banking Passe." *American Banker*, August 4, 1986, back page.
- 60 "Chemical Enters Connecticut Consumer Market with Phone and Mail Premium Banking Service," *American Banker*, December 17, 1985, p. 23.
- 61 See Conference of State Bank Supervisors, *State of the State Banking System*, 1989.
- 62 Ibid.
- 63 Ibid.
- 64 According to regulatory accounting practices, only loans that are sold without recourse can be removed from the institution's balance sheet. Once the loans are sold without recourse, banks have no legal or contractual obligation to buy back the assets. Nevertheless, some regulators maintain that loan securitization is not risk-free. For example, one official at the Office of the Comptroller of the Currency has warned that "cultural forces morally obligate banks to buy back sour assets . . . you honor what the market perceives to be your commitment, and that is to back up the assets you sell." "Regulator Cites Risks of Asset Securitization," *American Banker*, March 30, 1989, p. 3.
- 65 See e.g. "Securitization: What Will They Package Next." *American Banker*, January 7, 1987, p. 1; and "Securitization May Soon Extend to Commercial Loans," *American Banker*, December 16, 1987, p. 16.
- 66 Ibid.
- 67 Unless the state considers the securitized loans nonbusiness income, an unlikely event.
- 68 See 1985 New York Tax Law, sec. 1454; 20 NYCRR 19-6.2 (d) (1)-(5).
- 69 See Minnesota Stat. Ann. sec. 290.191, subd. 6.
- 70 For example, see New York Tax Law 1454 (a)(2)(E); and Minnesota Stat. Ann. 290.191, subd. 7.
- 71 In a July 7, 1989, memorandum to the Bank Working Group of the U.S. Advisory Commission on Intergovernmental Relations, William Fox argues that a source-based approach with direct allocation to the home state of all bank income not taxed elsewhere will avoid a non-neutrality inherent in the dual approach, whereby "banks will be placed at a disadvantage when operating in any state that has a lower effective rate than their state of domicile because they will pay their home state's higher rates (on their total income)." This non-neutrality does not occur in reverse, however, because a bank domiciled in a low-tax state will pay the high-state's tax rate only on income earned in that state. A state also can attempt to allocate to itself all of the income received by its domiciliary banks from securities. Because the income from securitized loans is surely "business income," however, it may not be possible for a domiciliary state using source-based taxation with formula-based apportionment to allocate the income from securities to itself.
- 72 John Kincaid and Sandra B. McCray, "State Bank Taxation and the Rise of Interstate Banking: A Survey of States," *Intergovernmental Perspective* 14 (Fall 1988): 18. Seven states reported that they use a bank shares tax, four levy a gross receipts tax, and six impose another type of tax on banks.
- 73 Jerome R. Hellerstein, *State Taxation* (Boston: Warren, Gorham, & Lamont, 1983), p. 266.
- 74 *Memphis Bank & Trust Company*, 103 S.Ct. 692 (1983).
- 75 Hartman, *Federal Limitations on State and Local Taxation*, Cumulative Supplement 237.
- 76 For a discussion of state franchise taxes on banks, see Sandra B. McCray, "State Taxation of Interstate Banking," *Georgia Law Review* 21 (1986): 283. 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. *Werner Machine Co. v. Director of Taxation*, 350 U.S. 492 (1956).

<sup>77</sup> Kincaid and McCray, "State Bank Taxation and the Rise of Interstate Banking: A Survey of States."

<sup>78</sup> See e.g. 1988 Minnesota Statutes 290.01. Such a tax jurisdiction rule should be constitutional. See e.g. McCray, "State Taxation of Interstate Banking."

<sup>79</sup> See Sandra B. McCray, "Constitutional Issues in State Apportionment of Income: Financial Institutions," *Albany Law Review* 51 (1987): 895. If State A taxes its domiciliary Bank A on 100 percent of its net income and State B taxes Bank A on its income from loans made to residents of State B, multiple taxation will result. In such a case, it is likely that the residence-based tax of State A will fall. See *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980).

<sup>80</sup> Hartman, *Federal Limitations on State and Local Taxation*, p. 522.

<sup>81</sup> *Ibid.* See *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 120.

<sup>82</sup> 254 U.S. 113 (1920).

<sup>83</sup> Hellerstein, *State Taxation*, p. 323.

<sup>84</sup> *Ibid.*, p. 325

<sup>85</sup> Hartman, *Federal Limitations on State and Local Taxation*, p. 523.

<sup>86</sup> In its response to the ACIR survey, Alabama reported that it allows banks to use the UDITPA apportionment formula to calculate their separate tax liability within the states.

<sup>87</sup> See generally *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).

<sup>88</sup> "States have wide latitude in the selection of apportionment formulas. . . ." *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 274 (1978).

<sup>89</sup> Hellerstein, *State Taxation*, p. 495.

<sup>90</sup> 7A U.L.A. 331 (1957).

<sup>91</sup> See Hellerstein, *State Taxation*, pp. 496-498, for charts listing jurisdictions that have adopted UDITPA.

<sup>92</sup> *Ibid.*, pp. 495-536.

<sup>93</sup> *Ibid.*, pp. 572-600.

<sup>94</sup> *Ibid.*, p. 577.

<sup>95</sup> *Ibid.*, pp. 578-600.

<sup>96</sup> Those states are: Connecticut, Florida, Illinois, Kentucky, Massachusetts, New York, Ohio, West Virginia, Wisconsin, Minnesota, Nebraska, and North Carolina.

<sup>97</sup> The resulting formula looks as follows:

$$\frac{1}{4} \frac{\text{payroll in state}}{\text{payroll in all states}} + \frac{\text{tangible property in state}}{\text{tangible prop. in all states}} + 2x \frac{\text{sales in state}}{\text{sales in all states}}$$

<sup>98</sup> The following examples illustrate the effects of double-weighting the sales factor.

*Situation 1. Effect of a Double-Weighted Sales Factor on Domiciliary Corporations*—Assume that 60 percent of a taxpayer's property, 60 percent of its payroll, and 25 percent of its sales were in State X. If State X weighted each of those factors evenly, then, the average of those three factors would be 145 percent/3 or 48.33 percent. With an evenly-weighted formula, 48.33 percent of the taxpayer's apportionable income would be attributed to State X for corporate income tax purposes. Now suppose that State X modifies its formula to

double-weight the sales factor. The effect would be to reduce the percentage of income attributed to State X to 42.5 percent  $[(.60 + .60 + 2x.25)/4 = .425 = 42.5\%]$ . The bias in favor of domiciliary corporations with a double-weighted sales factor is even greater if the taxpayer has a greater portion of its property and payroll in the state and still makes a major portion of its sales to out-of-state buyers. Suppose that the mix is 90 percent property, 90 percent payroll, and 15 percent sales in-state. The evenly-weighted formula will attribute 65 percent of the taxpayer's income to State X  $[(.90 + .90 + .15)/3 = 65\%]$ . The same mix will produce a percentage of only 52.5 percent under the double-weighted sales factor formula  $[(.90 + .90 + 2x.15)/4 = 52.5\%]$ .

*Situation 2. The Effect of a Double-Weighted Sales Factor on Out-of-State Corporations*—Assume that the out-of-state taxpayer has only 5 percent of its property and 5 percent of its payroll within State X but makes 20 percent of its sales into State X. The evenly-weighted three-factor formula attribute 10 percent of the taxpayer's income to State X  $[(.05 + .05 + .20)/3 = 10\%]$ . The double-weighted sales factor will increase that percentage to 12.5 percent  $[(.05 + .05 + 2x.20)/4 = 12.5\%]$ .

The examples are based on those given by Eugene Corrigan of the Multistate Tax Commission in *Multistate Tax Review* 2 (June 1987): 9. For a thorough discussion of the effects of the double-weighted receipts factor, see Gerald Pomp, "Reforming a State Corporate Income Tax," *Albany Law Review* 51 (1987): 383, 570.

<sup>99</sup> See generally Hellerstein, *State Taxation*, pp. 582-600.

<sup>100</sup> *Ibid.*, pp. 583-588.

<sup>101</sup> *Ibid.*, pp. 588-594. Other differences in state rules, too numerous to list here, appear in Hellerstein, *State Taxation*, Tables 9-2 through 9-5, pp. 618-629.

<sup>102</sup> According to Hellerstein, "The selection of the situs to which to attribute intangible property is fraught with exceptional complications." Hellerstein, *State Taxation*, p. 573.

<sup>103</sup> In fact, the Court has recognized three different places at which the situs of a debt might be fixed: the domicile of the owner (creditor) (*State Tax on Foreign Held Bonds*, 15 Wall. 300 (1872); *Kirtland v. Hotchkiss*, 100 U.S. 491 (1879), the domicile of the debtor (*Blackstone v. Miller*, 188 U.S. 189 (1903) (ovrld. *Farmer's Loan Co. v. Minn.*, 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 (*New Orleans v. Stempel*, 175 U.S. 309 (1899), *Bristol v. Washington County*, 177 U.S. 133 (1900), *Metropolitan Life Insurance Co. v. New Orleans*, 205 U.S. 395 (1907)). According to the Court, each of those states offered the taxpayer the benefits and protections of its laws. See generally McCray, "State Taxation of Interstate Banking," p. 283. As pointed out by Paul Hartman, Professor Emeritus at Vanderbilt University Law School, it is somewhat anomalous to speak of the "situs" of intangibles. Citing *State Tax Commission v. Aldrich*, 316 U.S. 174, 178, Hartman notes that the "situs" of intangibles is just a judicially approved taxable "relationship" between persons, natural or corporate. Correspondence from Paul Hartman, August 4, 1988.

<sup>104</sup> *Curry v. McCannless*, 307 U.S. 357 (1939). Of course, the commerce clause does prohibit multiple taxation.

<sup>105</sup> *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 273 (1978).

<sup>106</sup> See McCray, "Constitutional Issues in State Apportionment of the Income of Multistate Businesses: Financial Institutions."

- <sup>107</sup> Both states have a legitimate claim to include the interest and fee income from the loan in the numerator. Both states have the necessary nexus to do so. See note 103.
- <sup>108</sup> This is the UDITPA formula, which is used by approximately 11 states to apportion the income of banks; see text, page 22 (note 125).
- <sup>109</sup> Viewed from a nationwide perspective, formula-based apportionment is far from simple. See text, pages 15-16 (notes 86-100).
- <sup>110</sup> 7A U.L.A. sec.2, at 340 (1957).
- <sup>111</sup> It is important to recognize that a special set of potentially difficult problems may occur if states try to conform fully to the federal model. Key issues would arise, for example, regarding whether the states decided to embrace federal concepts, such as sourcing and allocation rules, that have been developed in the international context.
- <sup>112</sup> Commerce Clearing House, *All States State Tax Guide*, 1523. Seven states are not represented in the CCH Tables.
- <sup>113</sup> Alabama Code, sec. 40-18-21; Rhode Island G.L., secs. 44-14-11 and 44-14-13. The Rhode Island law allows domestic banks a deduction, but not a credit, for taxes paid to other states. The tax was recently upheld by the Rhode Island Supreme Court in *Commercial Credit Consumer Services v. Norberg*, 518 A2d 1336 (R.I. 1986). Indiana H.B. 1625 was passed by the Indiana legislature in the 1989 legislative session and signed by the Governor in May 1989.
- <sup>114</sup> The due process clause does not preclude the state of domicile from taxing the entire income of its citizens, *Lawrence v. State Tax Commission*, 286 U.S. 276 (1932); *New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937). Nor does the due process clause prevent the state of domicile from taxing the entire income of its domestic corporations, *Matson Navigation Co. v. State Board of Equalization*, 297 U.S. 441 (1936); *Cream of Wheat v. County of Grand Forks*, 253 U.S. 325 (1920); *G. Altman & F. Keesling, Allocation of Income in State Taxation* (2d ed. 1950), p. 31. Recently, the high Court has indicated that a tax credit will satisfy the "fair apportionment" requirement of the Commerce Clause. See *Tyler Pipe Indus. v. Washington Dept of Revenue*, 107 S. Ct. 2810, 2819-21; *D.H. Holmes Co. Ltd. v. McNamara*, 108 S. Ct. 1619 (1988). And see McCray, "Constitutional Issues in State Apportionment of Income."
- <sup>115</sup> For the definition of a "foreign bank" see 12 U.S.C. 3101 (7), (8).
- <sup>116</sup> See 12 U.S.C. 3103 et seq.
- <sup>117</sup> If the domiciliary bank is part of a bank holding company that operates in several states through separately chartered subsidiaries, each such subsidiary is by definition a domiciliary bank of the state which it has designated as its principal place of business.
- <sup>118</sup> Many commentators have noted the complexity of the U.S. system, particularly the calculation of the foreign tax credit and the application of the source rules. For example, the Internal Revenue Code ("Code") gives a tax credit only for "net income taxes" paid to foreign countries. This provision has proved difficult to administer. Many foreign countries levy "taxes" that bear little resemblance to the U.S. net income tax, and the Internal Revenue Code does not permit multinationals to claim a credit against such charges. For this reason, the Internal Revenue Code contains intricate rules that control which foreign charges are creditable.
- <sup>119</sup> Hellerstein, *State Taxation*, p. 266.
- <sup>120</sup> Given the same facts, Bank A would pay a total tax of \$70,000 under formula-based apportionment, calculated as follows:
- \$49,000 to State X ( $\$1,000,000 \times 70\% = \$700,000 \times 7\% = \$49,000$ ), \$14,000 tax to State Y ( $20\% \times \$1,000,000 = \$200,000 \times 7\% = \$14,000$ ); and \$7000 tax to State Z ( $10\% \times \$1,000,000 = \$100,000 \times 7\% = \$7000$ ). The total tax burden on Bank A will also be the same under the dual system and formula-based apportionment if its domiciliary state has a tax rate which is less than that of all other states taxing the bank.
- <sup>121</sup> Because the disparity is inherent in the differing rate structures, not in the tax credit system itself, the system is not constitutionally infirm. A state tax system that is internally consistent, as is the dual system, is not unconstitutional simply because the tax scheme of another state increases the aggregate tax burden on a multistate corporation. *Armco, Inc. v. Hardesty*, 467 U.S. 638, 644-45 (1984); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); McCray, "Constitutional Issues in State Apportionment of Income."
- <sup>122</sup> 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<sub>b</sub> and P<sub>b</sub> 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 employs 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  $T_2/T_1 > 1$ , or  $[1/2][R_b/R + P_b/P][R/R_b] > 1$ . A little algebra shows that this equation is tantamount to the equation  $R_b/P_b < R/P$ .
- <sup>123</sup> *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267.
- <sup>124</sup> Kincaid and McCray, "State Bank Taxation and the Rise of Interstate Banking: A Survey of States."
- <sup>125</sup> New York, California, and Minnesota are three such states.
- <sup>126</sup> 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*. 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 House Report No. 99-426, 99th Congress, 1st Session (1986), p. 393.
- <sup>127</sup> See note 103.
- <sup>128</sup> 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 1990's?" *Journal of State Taxation* 4 (1985): 225.
- <sup>129</sup> 1985 New York Tax Law, sec. 1454; 20 NYCRR 19-6.2(a). 1985 New York Tax Law, sec. 1454; 20 NYCRR 19-6.2(a).
- <sup>130</sup> Consider, for example, the following definitions of the terms "solicitation," "investigation," "negotiation," and "administration." According to the regulation, "active solicitation" occurs when an employee of the banking corporation initiates the contact with the customer. Such activity is located at the office where the bank's employee is regularly connected, regardless of where the services of such employee were actually performed. "Passive solicitation" occurs when the customer initiates the contact with the taxpayer. If the customer's initial contact was not at an office of the taxpayer, the office where the passive solicitation is deemed to occur 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 employee were actually performed. "Negotiation" and "approval" are located accord-

ing to the rule for investigation above. "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. 20 NYCRR 19-6.2 (d) (1)-(5).

<sup>131</sup> 1985 New York Tax Law, sec. 1454; 20 NYCRR 19-6.6.

<sup>132</sup> 1985 New York Tax Law, sec. 1454; 20 NYCRR 19-7.8.

<sup>133</sup> Minnesota Stat. Ann., sec. 290.191, subd.3.

<sup>134</sup> Ibid.

<sup>135</sup> Minnesota Stat. Ann., sec. 290.191, subd.6.

<sup>136</sup> Ibid.

<sup>137</sup> Ibid.

<sup>138</sup> Ibid.

<sup>139</sup> Minnesota Stat. Ann., 290.191, subd.11.

<sup>140</sup> Minnesota Stat. Ann., sec. 290.191, subd.12.

<sup>141</sup> *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267; and see McCray, "Constitutional Issues in State Apportionment of Income."

<sup>142</sup> Michigan Stat. Ann., 7.558 (10).

<sup>143</sup> Phone conversation with Fred Lynch, Administrator, Michigan Single Business Tax, August 16, 1988.

<sup>144</sup> Ibid.

<sup>145</sup> Phone conversation with Benjamin Miller, Counsel for Multistate Tax Affairs, California Franchise Tax Board, September 7, 1988.

<sup>146</sup> 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. Company A manufactures widgets and company 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 Company 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. Company A merely charges Company B an artificially low price for the widgets, so that it receives little income in State A. Company B then sells the widgets at their normal retail price and receives all of the profits in State B, which has no income tax. Multistate Tax Affairs, California Franchise Tax Board, September 7, 1988.

<sup>147</sup> Corporation A may file a combined report in State X. After eliminating intercorporate transactions (because the transactions between Corporation A and the members of its unitary group cannot produce a real economic profit or loss, income is recognized for tax purposes only when the entire process of production and sale is completed, i.e., on the ultimate sale to third parties), the total gross receipts and total deductions for the entire economic enterprise are itemized and netted to produce the apportionable base. This base is then apportioned

among the jurisdictions in which the unitary group conducts its activities according to a formula that measures the contribution of such activities in each state to the profit of the whole.

<sup>148</sup> *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 178 (1983).

<sup>149</sup> California, a pure source-based income tax state, has, however, recently begun dealing with the application of the unitary business principle to unitary enterprises that are engaged in both general businesses and financial businesses. The first case to be litigated in California involved Sears (a general business under California law) and Sears Roebuck Acceptance Corporation (a financial business under California law). The Franchise Tax Board is in the process of drafting regulations that would require "preapportionment" of the income of such a combined group in order to separate the general business income from the financial income. The separation is necessary because the formula used for general business corporations is different than that used for financial institutions. Phone conversation with Ben Miller.

<sup>150</sup> 12 U.S.C. 24 (1984).

<sup>151</sup> 12 U.S.C. 1843(a) (1982).

<sup>152</sup> It is true that State A could assess its tax on the income received by it from Company A's credit card activities. It is unlikely to do so, however, since one of the reasons for setting up credit card subsidiaries is to take advantage of low-tax or no-tax jurisdictions (originally, the primary reason for setting up credit card subsidiaries was to escape state usury ceilings).

<sup>153</sup> See McCray, "State Taxation of Interstate Banking."

<sup>154</sup> *Burger King v. Rudzewicz*, 471 U.S. 462, 476 (1985).

<sup>155</sup> 1985 New York Tax Law, sec. 1451 (a), sec. 1462 (f).

<sup>156</sup> Minnesota Stat. Ann., sec. 290.015. In addition to the four items listed, "solicitation" includes advertising in publications with their circulation primarily in Minnesota; advertising in regional or Minnesota editions of national publications; advertising in national publications sold over the counter or by subscription in Minnesota; direct telephone or other electronic solicitation in Minnesota.

<sup>157</sup> Ibid.

<sup>158</sup> See *First Family Mortgage v. Durham*, 528 A.2d 1288 (1987).

<sup>159</sup> Minnesota Stat. Ann., sec. 290.015, subd. 3(b).

<sup>160</sup> See Minnesota Stat. Ann., sec. 290.371.

<sup>161</sup> New Jersey Stat. Ann., 14A:13-20(b). Another section of the statute has language which permits the offending corporation to cure the defect and regain access to the state's courts. New Jersey Stat. Ann., 14A: 13-20(a) provides that, "No foreign corporation carrying on any activity or owning or maintaining any property in this State which has not obtained a certificate of authority to do business in this State and disclaims liability for the corporation income tax shall maintain any action or proceeding in any State or Federal court in New Jersey, until such corporation shall have filed a timely notice of business activities report" (emphasis added). The Minnesota statute contains similar provisions.

<sup>162</sup> 528 A.2d 1288 (1987).

*Appendix*

## State Bank Tax Survey and Findings

### Taxation of Financial Institutions

1. Does your state tax banks using a franchise tax, net income tax, bank shares tax, gross receipts tax, or other tax?
2. If your state uses a franchise tax, is that tax measured by net income or some other method?
3. Does your state include the value of or income from federal and state obligations in the measure of the tax?
4. Does your state tax general (nonfinancial) business corporations in the same manner as it taxes banks (if no, explain the differences)?
5. Does your state tax savings and loan institutions in the same manner as it taxes banks (if no, explain the differences)?

### State Constitutional Limits

6. Does your state constitution place any restrictions on state taxation of domestic banks or savings and loan institutions (if yes, what are the restrictions)?
7. Does your state constitution place any restrictions on state taxation of out-of-state banks or savings and loan institutions (if yes, what are the restrictions)?
8. Does your state constitution place any restrictions on state taxation of income from state or municipal obligations (if yes, what are the restrictions)?

### Taxation of Income of Out-of-State Banks

9. Does your state tax any of the following interstate income-producing activities of out-of-state banks? For each activity, indicate whether taxation is by statute, regulation, or administrative practice:
  - a. interest income from credit cards issued to residents of the state by an out-of-state bank that has no office or employees in your state
  - b. interest income from loans solicited by in-state representatives of out-of-state banks
  - 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
  - d. interest income from loans made to residents of your state by an out-of-state bank that has no office, employees, or representatives in your state and secured by personal property located in your state
  - e. interest income from loans made to residents of your state by an out-of-state bank that has no office, employees, or representatives in your state and secured by real property located in your state

\*Now part of the Federation of Tax Administrators.

10. Does your state require an out-of-state bank that solicits loans or deposits in your state through a loan production office to register or apply for a license (if yes, what are the requirements)?
11. Does your state require an out-of-state bank that solicits loans or deposits in your state through an agent or representative to register or apply for a license (if yes, what are the requirements)?
12. Does your state require the agent or representative of an out-of-state bank who solicits loans or deposits in your state to register or apply for a license (if yes, what are the requirements)?

#### **Apportionment of Taxable Income**

13. Does your state bank tax law or department regulations contain an apportionment formula to measure the taxable income of banks (if yes, describe the formula)?

14. If your state does not have either a law or regulations governing the apportionment of bank income, do you use the three-factor UDITPA formula or some other formula to apportion that income (give a brief description of the formula)?

#### **Future Plans**

15. Does your state have any plans to broaden its jurisdictional rules in order to tax the income that out-of-state banks receive from banking transactions conducted with residents of your state solely by mail or through electronic means (if yes, indicate legislation, regulations, or administrative interpretations)?
16. Does your state have any plans to change the formula it currently uses to apportion the income of banks (if yes, indicate whether legislation, regulations, or administrative interpretations)?

# Findings

Table 1  
State Bank Taxes  
(Survey Questions 1 and 2)

State	Franchise	Net Income	Bank Shares	Gross Receipts	Other
Alabama*	X				
Alaska		X			
Arizona		X			
Arkansas	X	X			
California*	X				
Colorado		X			
Connecticut*	X				
Delaware*	X				
District of Columbia*	X				
Florida*	X				
Georgia		X		X	A
Hawaii*	X				B
Idaho		X			
Illinois		X			
Indiana		X	X	X	
Iowa*	X				
Kansas*	X				
Kentucky			X		
Louisiana	X	X	X		
Maine*	X				
Maryland*	X				
Massachusetts*	X				
Michigan					C
Minnesota*	X				
Mississippi	X	X	X		D
Missouri*	X				
Montana*	X				
Nebraska	X				
Nevada					E
New Hampshire		X	X		
New Jersey*	X				
New Mexico	X	X		X	
New York*	X				
North Carolina	X	X			
North Dakota*	X				
Ohio	X				
Oklahoma	X	X			
Oregon		X			
Pennsylvania			X		
Rhode Island*	X	X	X		F
South Carolina*	X				
South Dakota*	X				
Tennessee	X	X			G
Texas	X				
Utah*	X	X			
Vermont	X				
Virginia	X				
Washington				X	
West Virginia	X	X			
Wisconsin*	X				
Wyoming					E

\* States that measure franchise tax by net income. Missouri also has a franchise tax measured by bank shares and surplus.

A—corporate net worth tax

B—use tax

C—single business tax

D—ad valorem property tax

E—real and tangible personal property tax only

F—excise tax on banks on the higher of 8 percent of net income or \$2.50 for each \$10,000 of authorized capital stock

G—annual assessment of 1/25 percent of bank assets

*Table 2*  
**States Reporting Inclusion of Federal  
or State Obligations in Bank Tax**  
(Survey Question 3)

State	State Obligations	Federal Obligations	State	State Obligations	Federal Obligations
Alabama	X	X	Minnesota	X	X
Alaska	X		Missouri	X	X
California	X	X	Montana	X	X
Connecticut	X	X	New Jersey	X	X
Delaware	X	X	New York	X	X
District of Columbia	X		North Carolina	X	X
Florida	X	X	North Dakota	X	X
Georgia	X	X	Ohio	X	X
Hawaii	X	X	Pennsylvania	X	
Illinois	X		South Carolina	X	X
Iowa	X	X	South Dakota	X	X
Kansas	X	X	Tennessee	X	X
Kentucky	X		Utah	X	X
Maine	X	X	Virginia	X	X
Maryland	X	X	West Virginia	X	
Massachusetts	X	X	Wisconsin	X	X
Michigan	X				

*Table 3*  
**States Reporting Taxing Banks and Other Corporations  
in the Same Manner**  
(Survey Questions 4 and 5)

State	General Business	Savings and Loans	State	General Business	Savings and Loans
Alabama		X	Montana	X	X
Alaska	X	X	Nebraska		X
Arizona	X	X	Nevada	X	X
Arkansas	X	X	New Hampshire		X
California		X	New Jersey	X	X
Colorado	X		New Mexico	X	
Connecticut	X	X	New York		X
District of Columbia	X	X	North Carolina	X	X
Florida	X	X	North Dakota		X
Georgia		X	Ohio		X
Hawaii		X	Oregon	X	X
Idaho	X	X	Rhode Island		X
Illinois		X	South Dakota		X
Iowa		X	Tennessee	X	X
Kansas		X	Texas	X	
Maine		X	Utah	X	X
Maryland		X	Vermont		X
Massachusetts		X	Washington	X	X
Michigan	X	X	West Virginia	X	X
Minnesota	X	X	Wisconsin	X	X
Mississippi	X	X	Wyoming		X
Missouri		X			



*Table 4*  
**States Reporting Constitutional Restrictions on Taxation**  
(Survey Questions 6, 7, and 8)

State	Domestic Banks or S&Ls	Out-of-State Banks or S&Ls	Income from State/Municipal Obligations
Alabama		X	
Arizona			X
California	X	X	X
Kentucky			X
Ohio		X	
Oregon			X
West Virginia	X		

*Table 5*  
**States Reporting Taxation of Income of Out-of-State Banks, by Type of Income and Method**  
(Survey Question 9)

State	Type of Income (Method)				
Alabama	C(P)				
Alaska	A(P)	B(P)	C(P)		
Arizona	A(P)	B(P)	D(P)	E(P)	
California	A(R)				
Connecticut	B(R)	C(R)			
District of Columbia	C(S)	D(R)	E(R)		
Florida	A(S)	C(S)	D(S)	E(S)	
Georgia	A(S)	B(S)	C(S)	D(S)	E(S)
Hawaii	C				
Idaho	B(S)	C(S)			
Indiana	B	C			
Louisiana	B(S)	C(S)			
Maine	C(R)				
Maryland	C(P)				
Minnesota	A(S)	B(S)	C(S)	D(S)	E(S)
Mississippi	B(S)	C(R)			
Missouri	B	C	D	E	
Nebraska	A(R)	B	C	D	E
New Hampshire	A(S)	B(S)	C(S)	D(S)	E(S)
New Mexico	A(S)	B(S)	C(S)	D	E(S)
North Carolina	B(R)	C(R)			
North Dakota	C	D	E		
Ohio	A(S)	B(R)	C(S)	D(S)	E(S)
Oregon	B(R)	C(R)	E(R)		
Rhode Island	C(P)				
South Carolina	B(P)	C(P)			
South Dakota	B(S)	C			
Tennessee	C				
Virginia	C				
West Virginia	B(P)	C(P)			
Wisconsin	C(S)				

**Key:**

- A—interest income from credit cards issued to state residents by an out-of-state bank with no office or employees in the state (e.g., issuance of credit cards through the mail)
- B—interest income from loans solicited by in-state representatives of out-of-state banks (call programs)
- C—interest income from loans solicited at loan production offices located in the state but closed at the out-of-state home office of the soliciting bank
- D—interest income from loans made by an out-of-state bank with no office, employees, or representatives in the state to a resident of the state and secured by personal property in the state
- E—interest income from loans to residents of the state made by an out-of-state bank with no office, employees, or representatives in the state and secured by real property located in the state
- P—administrative practice
- R—regulation
- S—statute

*Table 6*  
**States Reporting License or Registration Requirements for Loans and Deposits on Out-of-State Banks**  
 (Survey Questions 10, 11, and 12)

State	Solicit through Loan Production Office	Solicit through Agent or Representative	Have Agent or Representative	State	Solicit through Loan Production Office	Solicit through Agent or Representative	Have Agent or Representative
Alabama	X	X	X	Missouri	X	X	
Alaska	X			New Mexico	X	X	X
California	X	X		New York	X	X	
Colorado	X		X	North Dakota	X	X	
Delaware		X		Oklahoma	X		
District of Columbia	X	X	X	South Carolina	X	X	X
Hawaii	X			South Dakota	X		
Idaho	X	X	X	Texas	X	X	X
Illinois	X	X		Utah	X	X	
Indiana	X	X	X	Washington	X		X
Maryland	X			West Virginia	X	X	
Minnesota	X	X					

*Table 7*  
**States Reporting Apportionment Formulas to Measure Taxable Bank Income, by Method**  
 (Survey Question 13)

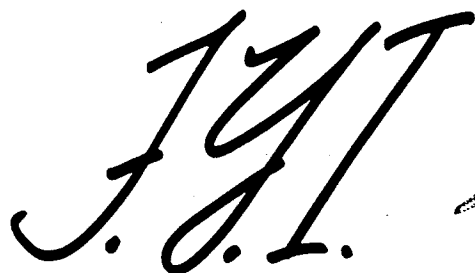
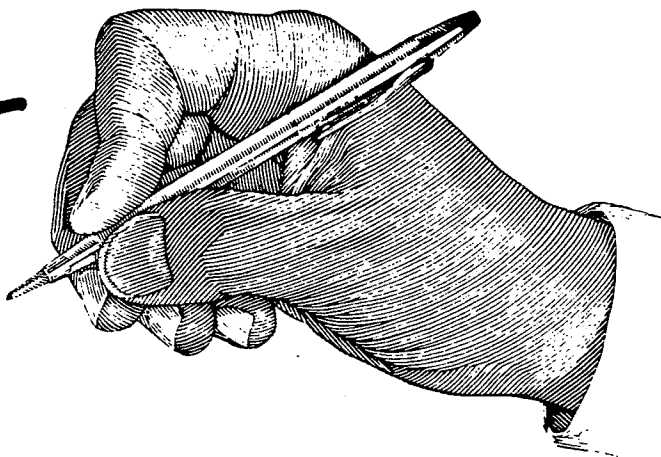
State	Law	Regulation	State	Law	Regulation
Alaska	X		New Jersey	X	X
California		X	New Mexico	X	
District of Columbia		X	New York	X	X
Florida	X		North Carolina	X	X
Georgia	X		North Dakota	X	X
Illinois	X		Ohio	X	
Kansas	X		Oklahoma	X	X
Louisiana	X		Oregon		X
Maine	X		South Dakota	X	
Maryland	X		Tennessee	X	X
Michigan	X		Washington	X	
Minnesota	X		West Virginia	X	X
Montana	X		Wisconsin		X

*Table 8*  
**States Reporting Apportionment Formulas, by Type**

State	UDITPA	Other	State	UDITPA	Other
Alaska		X	Minnesota		X
Arizona	X		Montana	X	
California		X	Nebraska		X
Connecticut		X	New Jersey	X	
District of Columbia		X	New Mexico	X	
Florida		X	New York		X
Georgia		X	North Carolina		X
Hawaii		X	North Dakota		X
Idaho	X		Oregon	X	
Illinois		X	South Carolina		X
Indiana	X		South Dakota	X	
Iowa		X	Tennessee		X
Kansas	X		Utah	X	
Maine	X		Vermont		X
Maryland		X	West Virginia	X	
Michigan		X	Wisconsin		X

*Table 9*  
**States Reporting Plans for Bank Tax Changes**  
 (Survey Questions 15 and 16)

State	Broaden Jurisdictional Rules	Change Apportionment Formula	State	Broaden Jurisdictional Rules	Change Apportionment Formula
Alabama	X		Kansas	X	X
Arizona	X	X	Massachusetts		X
California		X	Michigan	X	X
Colorado		X	Montana	X	X
District of Columbia	X		Ohio	X	
Georgia		X	Oklahoma	X	X
Idaho	X	X	Pennsylvania	X	X
Indiana	X	X	Utah	X	X
Iowa		X			

The logo for the Federal Reserve Bank of Atlanta, consisting of the letters 'FBI' in a stylized, cursive script.

## Interstate Banking Developments in the 1980s

B. Frank King, Sheila L. Tschinkel, and David D. Whitehead

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A 1983 *Economic Review* article published by this Bank depicted an extensive interstate presence by commercial banking organizations, even though state and national statutes had sought to constrain the establishment of full-service offices across state lines.<sup>1</sup> Banks and bank holding companies had successfully used a variety of methods to cross these boundaries, to the point where domestic and foreign banking organizations had almost 7,500 offices outside their home states. Two years later an update of the interstate situation noted that interstate banking presence was increasing and several states were enacting legislation to allow full-service interstate banking, though at the time

no mergers or acquisitions had actually been consummated under these new laws.<sup>2</sup>

Developments since that time have been quite dramatic, and the country has moved significantly, albeit haltingly, toward nationwide banking. By the end of 1988, all but three states allowed interstate acquisitions of at least some of their banks. A new count reveals no less than 14,600 offices of banking organizations existed outside the organizations' home states. Of these, 7,500 offices were permitted to offer all banking services. Thrift institutions operated more than 1,600 interstate offices.

The passage of state laws that allow full-service interstate branches has not entirely eliminated incentives for using other means of establishing interstate offices. Some states continue to be excluded from regional compacts that allow interstate banking with other reciprocating states. Also, under some circumstances, banking organizations still seem to prefer operating more limited nonbank offices in order to maintain an out-of-home-state presence. In addition, economic weakness in some areas and the problems faced by a number of thrift institutions have also spurred the growth of

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*They acknowledge Pamela S. Frisbee, an economic analyst in the financial section of the Atlanta Fed's research department, who gathered and organized the data for this article.*

interstate banking offices. After reviewing the legislative evolution of interstate banking, this article describes its recent developments, including changes in the top 50 banking organizations, outlines some explanations for its progress, and assesses some general policy implications of the nation's present course of action regarding banking expansion across state lines.

## **The Legislative Background of Interstate Banking**

**Full-service Offices.** As the unsteady course of interstate banking indicates, laws governing interstate expansion by banking organizations have developed in a complex way. Throughout the nation's history each state has determined branching rules for banks under its charter. The McFadden Act, originally passed in 1927 and amended in 1933, clarified such restrictions for nationally chartered banks. In its 1933 version, the act allowed national banks the same geographic branching rights as those allowed to state-chartered institutions in their home states. That is, a national bank based in Tennessee would have the same branching rights as a bank chartered in that state. The effect of this legislation was to limit branching activity of national banks to a single state at most.

The McFadden Act left open the possibility of crossing state lines by using a bank holding company, which could own separate bank charters. Bank holding companies had not been widely used for interstate expansion before passage of the 1956 Bank Holding Company Act, but concerns about their possible proliferation were sufficient to prompt Congress to add the Douglas Amendment as part of the act. This law prohibited bank holding companies from acquiring banks outside their home state unless the other state explicitly allowed such purchases. Banking organizations that already used the holding company form to establish an interstate presence were permitted to maintain their existing interstate ties. This provision of the Douglas Amendment accounts for a few large regional organizations, such as First Interstate Bancorp in the West as well as First Bank System and Norwest Corporation in the upper Midwest.

The McFadden Act and the Douglas Amendment seemed to have closed the door to any additional interstate banking from 1956 to 1975. Then, however, after a special study of its financial laws and regulations, Maine passed legislation allowing out-of-state bank holding companies to acquire Maine-chartered institutions if bank holding companies headquartered in Maine were permitted reciprocal rights. Thus, Maine was the first state to take advantage of the Douglas Amendment's provision authorizing the entry of out-of-state holding companies. (Maine's reciprocity requirement was later dropped.)

Other states initially showed little interest in permitting this cross-state activity until 1982, when New York passed nationwide reciprocal banking legislation and Massachusetts led the New England states into a regional banking compact. Policymakers in New England sought to develop the region's relatively small banks into larger regional institutions that were deemed more effective in attracting capital to the region. The 1982 Massachusetts regional reciprocal law included Maine, Connecticut, Rhode Island, New Hampshire, and Vermont. Rhode Island and Connecticut enacted similar legislation in 1983, naming the same group of partner states.

With capital attraction motives similar to the New England states' and with the desire to build banking organizations large enough to resist takeover by banks from outside their region, other states began to consider and enter into regional compacts. Only the southeastern states were able to create a fairly uniform region, but even these states' laws differed in their lists of partner states. Several other states have adopted reciprocal laws lacking in uniformity and often including states that permit widely varying degrees of entry into other markets. Indiana's reciprocal law, for instance, currently includes 11 partners. Four of these have national reciprocal laws; three have regional reciprocal laws that exclude Indiana; and one allows interstate expansion by only one company.

Some states, mainly the large money center banks' headquarters, were excluded from each "region." New York, for example, is not mentioned in any regional legislation. This use of regional reciprocal banking laws to exclude organizations from outside a region evoked a constitutional issue of discrimination, which

was resolved in 1985 when the Supreme Court ruled that states could, in fact, define their own regional partners.

Even though many states initially took the regional-compact approach to interstate banking, broader access has dominated recent developments. Several states have opened their doors to banks from any state, either on a reciprocal or nonreciprocal basis. Some of these states, like Rhode Island, did so after initially allowing only regional entry into their markets. Others, like Arizona, have gone directly to national entry, thinking that less restrictive rules would encourage greater interest in acquisition of their banks, including perhaps weak or failing ones. At this writing, all but three states have enacted some form of interstate banking legislation. Twenty-one states and the District of Columbia allow national entry of one sort or another. Table I shows each state's type of legislation and its effective date.

As noted, southeastern states moved fairly early to adopt interstate banking by setting up a regional reciprocal compact that in 1985 became effective for several states. Except for Louisiana—where a weak economic and banking environment led to the permission of nationwide entry starting January 1, 1989—and Kentucky, the Southeast's approach to interstate banking has continued to be through regional compacts. As a group, the states of New England and the Southeast had the most restrictive interstate banking laws. Recently, however, Rhode Island has joined Maine with a national interstate law, and Vermont is scheduled to do so next year.

One effect of these restrictions is that large southeastern banks which have been formed during the last four years may have difficulty maintaining their relative size as banks from other states with newer regional and national interstate banking laws expand. For example, Michigan, New Jersey, and Ohio already have nationwide reciprocal banking, and other states are liberalizing their laws.

Though not used as widely as the state interstate banking laws, the emergency provisions of the 1982 Garn-St Germain Act provided another way for banking organizations to acquire and operate full-service offices in more than one state. This law permitted out-of-state banking organizations to acquire certain large, troubled commercial banks and insured mutual savings

banks. Its provisions were modified and extended by the Competitive Equality in Banking Act of 1987, which also authorized the Federal Deposit Insurance Corporation (FDIC) to arrange interstate takeovers of institutions with assets of more than \$500 million as long as the FDIC granted the necessary financial assistance. In addition, some states enacted laws that allow out-of-state banks and thrifts to acquire failing in-state institutions.

Foreign banks may own American-chartered banks and bank holding companies. Foreign banks that owned U.S. banks were not limited to one state until 1978. The passage of the International Banking Act in that year placed banks domiciled outside the United States on essentially the same footing as purely domestic institutions; foreign banks were required to choose one state in which they would own a bank or holding company and operate according to the laws of that state. Grandfather provisions permitted these firms to maintain their existing interstate systems.

**Offices Limited to International Transactions.** Foreign banks themselves were also allowed to have offices that perform only particular transactions in much the same way that U.S. banks could establish an interstate presence on a limited basis. Interstate expansion of foreign banks is controlled by state laws that vary in effect from prohibiting expansion outright to allowing only offices that provide financial services related to international transactions. Foreign institutions consequently can and do operate offices in several states.

Congress has long allowed U.S. banks to compete with foreign firms in the financing of international trade. Both domestic and foreign banks and bank holding companies were permitted by the Edge Act of 1919 to establish banking corporations, provided they serviced only those firms engaged in international trade. As U.S. trade links with the rest of the world expanded, so did the growth of Edge Act corporations. This structure allowed many banks to establish a corporate presence in another state.

**Nonbank Banks.** As Congress was seeking to limit geographic expansion through commercial banks' full-service offices, innovation in other areas was steadily eroding the legal barriers to interstate banking. A noteworthy but short-lived innovation that demonstrated banks' desires

**Table 1.**  
**Interstate Banking Legislation by State**  
*(as of February 1, 1989)*

State	Effective Date	Area	Number of Partner States
Alabama	Currently	Reciprocal, 12 states and D.C. (AR, FL, GA, KY, LA, MD, MS, NC, SC, TN, VA, WV).	13
Alaska	Currently	National, no reciprocity.	50
Arizona	Currently	National, no reciprocity.	50
Arkansas	Currently	Reciprocal, 16 states and D.C. (AL, FL, GA, KS, LA, MD, MS, MO, NE, NC, OK, SC, TN, TX, VA, WV). Reciprocity hinges on commitments to community reinvestment.	17
California	Currently	Reciprocal, 11 states (AK, AZ, CO, HI, ID, NV, NM, OR, TX, UT, WA).	11
	January 1, 1991	National, reciprocal.	
Colorado	Currently	Reciprocal, 7 states (AZ, KS, NE, NM, OK, UT, WY).	7
	January 1, 1991	National, reciprocal.	
Connecticut	Currently	Reciprocal, 5 states (MA, ME, NH, RI, VT).	5
Delaware	Currently	Reciprocal, 5 states and D.C. (MD, NJ, OH, PA, VA). Special-purpose banks permitted.	6
	June 30, 1990	National, reciprocal.	
District of Columbia	Currently	Nationwide, no reciprocity if community development commitments are made.	50
Florida	Currently	Reciprocal, 11 states and D.C. (AL, AR, GA, LA, MD, MS, NC, SC, TN, VA, WV). Under a 1972 law, NCNB and Northern Trust Corporation are grandfathered and can make further acquisitions.	12
Georgia	Currently	Reciprocal, 10 states and D.C. (AL, FL, KY, LA, MD, MS, NC, SC, TN, VA).	11
Hawaii	None		0
Idaho	Currently	National, no reciprocity.	50
Illinois	Currently	Reciprocal, 6 states (IA, IN, KY, MI, MO, WI). Nationwide, organizations may acquire failed institutions if the failed institution is larger than \$1 billion in assets. Under a 1981 law, General Bancshares Corporation is grandfathered and can make further acquisitions in the state.	6
	December 1, 1990	National, reciprocal.	
Indiana	Currently	Reciprocal, 11 states (IA, IL, KY, MI, MO, OH, PA, TN, VA, WI, WV).	11
	July 1, 1992	National, reciprocal.	
Iowa	1972	Under a 1972 law, Norwest Corporation is grandfathered and is permitted to acquire banks in Iowa.	0
Kansas	None		0
Kentucky	Currently	National, reciprocal.	31*
Louisiana	Currently	National, reciprocal.	29*

*continued on next page*

Table 1 continued

State	Effective Date	Area	Number of Partner States
Maine	Currently	National, no reciprocity.	50
Maryland	Currently	Reciprocal, 14 states and D.C. (AL, AR, DE, FL, GA, KY, LA, MS, NC, PA, SC, TN, VA, WV) and special-purpose banks.	15
Massachusetts	Currently	Reciprocal, 5 states (CT, ME, NH, RI, VT).	5
Michigan	Currently	National, reciprocal.	20*
Minnesota	Currently	Reciprocal, 11 states (CO, IA, ID, IL, KS, MO, MT, ND, SD, WA, WY).	11
Mississippi	Currently July 1, 1990	Reciprocal, 4 states (AL, AR, LA, TN). Reciprocal, 13 states (AL, AR, FL, GA, KY, LA, MO, NC, SC, TN, TX, VA, WV).	4
Missouri	Currently	Reciprocal, 8 states (AR, IA, IL, KS, KY, NE, OK, TN).	8
Montana	None		0
Nebraska	Currently January 1, 1990 January 1, 1991	Special-purpose banks. Reciprocal, 10 states (CO, IA, KS, MN, MO, MT, ND, SD, WI, WY). National, reciprocal.	0
Nevada	Currently	National, no reciprocity.	50
New Hampshire	Currently	Reciprocal, 5 states (CT, MA, ME, RI, VT).	5
New Jersey	Currently	National, reciprocal.	21*
New Mexico	Currently January 1, 1990	Nationwide acquisition of failing banks. National, no reciprocity.	50
New York	Currently	National, reciprocal.	19*
North Carolina	Currently	Reciprocal, 12 states and D.C. (AL, AR, FL, GA, KY, LA, MD, MS, SC, TN, VA, WV).	13
North Dakota	Currently	A grandfathered interstate banking organization is permitted to sell its North Dakota banks to out-of-state bank holding companies.	0
Ohio	Currently	National, reciprocal.	23*
Oklahoma	Currently	National, no reciprocity.	50
Oregon	Currently July 1, 1989	8 states, no reciprocity (AK, AZ, CA, HI, ID, NV, UT, WA). National, no reciprocity.	8
Pennsylvania	Currently March 4, 1990	Reciprocal, 7 states and D.C. (DE, KY, MD, NJ, OH, VA, WV). National, reciprocal.	8
Rhode Island	Currently	National, reciprocal.	23*
South Carolina	Currently	Reciprocal, 12 states and D.C. (AL, AR, FL, GA, KY, LA, MD, MS, NC, TN, VA, WV).	13
South Dakota	Currently	National, reciprocal and special-purpose banks.	21*
Tennessee	Currently	Reciprocal, 13 states (AL, AR, FL, GA, IN, KY, LA, MO, MS, NC, SC, VA, WV).	13
Texas	Currently	National, no reciprocity.	50
Utah	Currently	National, no reciprocity.	50

continued on next page



Table 1 continued

State	Effective Date	Area	Number of Partner States
Vermont	Currently February 1, 1990	Reciprocal, 5 states (CT, MA, ME, NH, RI). National, reciprocal.	5
Virginia	Currently	Reciprocal, 12 states and D.C. (AL, AR, FL, GA, KY, LA, MD, MS, NC, SC, TN, WV).	13
Washington	Currently	National, reciprocal. Failing institutions may be acquired by organizations from any state.	21*
West Virginia	Currently	National, reciprocal.	29*
Wisconsin	Currently	Reciprocal, 8 states (IA, IL, IN, KY, MI, MN, MO, OH).	8
Wyoming	Currently	National, no reciprocity.	50

\* Does not count the two states where nationwide entry by acquisition of failing banks is possible.

Source: Compiled by the Federal Reserve Bank of Atlanta.

to expand across state lines with deposit-gathering offices was the nonbank bank.

The wording of the Bank Holding Company Act defines a bank as any institution that both accepts demand deposits and makes commercial loans. By engaging in only one of these activities, several financial and nonfinancial companies were able to obtain bank charters and to qualify for FDIC deposit insurance in any state they chose to enter. Since these firms had not met its dual criteria, they were not banks for the purposes of the Bank Holding Company Act. The term *nonbank bank* derived from the fact that these institutions could perform some of the functions of a full-service bank but not all.

By 1983 congressional and regulatory concerns over a rash of nonbank bank charter applications led the Comptroller of the Currency to declare a moratorium on processing such requests. Though the Federal Reserve Board also sought to halt the establishment of these organizations, the central bank began processing applications after the Supreme Court in 1986 upheld the legality of nonbank banks. The situation remained unresolved until the passage of the Competitive Equality in Banking Act of 1987, which effectively prohibited the establishment of new nonbank banks. The existing ones were grandfathered and, as of this writing, 166 of them exist.

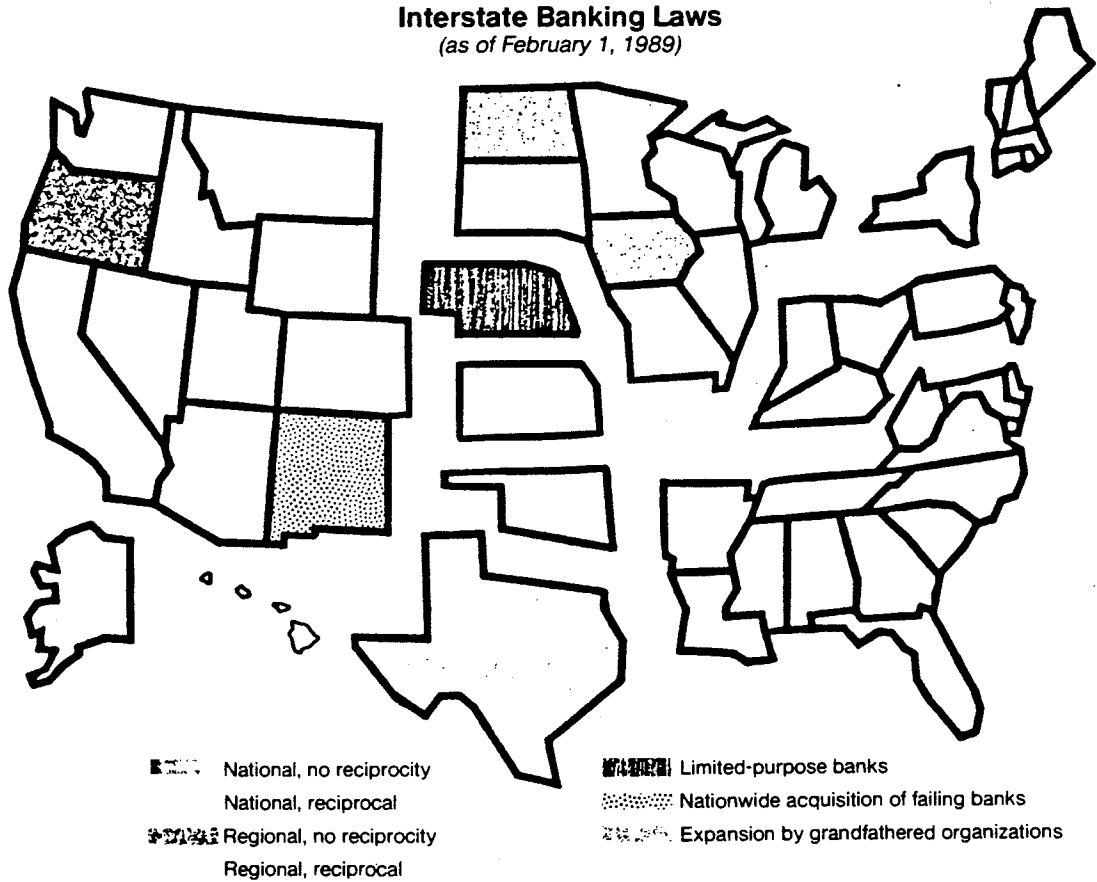
**Nonbank Offices.** Another way banking organizations innovated around limits to geographic

expansion was to establish loan production offices on an interstate basis. Though doing little more than maintaining a staff of calling officers, these divisions of a banking company generate business for the head office and help establish a corporate identity in other states.

Until regional interstate banking took hold, the major avenue used by bank holding companies to move across state lines was the establishment of offices of nonbank subsidiaries under section 4(c)(8) of the Bank Holding Company Act as amended in 1970. This section allows bank holding companies to engage in certain activities other than taking deposits through subsidiaries established for this purpose. The laws prohibiting banking organizations from crossing state lines with full-service offices do not apply to 4(c)(8) subsidiaries because they do not meet the dual criteria for qualifying as a bank. A 4(c)(8) subsidiary may branch without McFadden Act or Douglas Amendment restrictions, giving banking organizations an opportunity to offer many services on a nationwide basis.

Section 4(c)(8) gave the Federal Reserve Board the authority to determine the activities in which subsidiaries formed under 4(c)(8) could engage. Various types are permitted provided that they are "so closely related to banking or managing or controlling banks as to be a proper incident thereto." Since 1970 the Federal Reserve has authorized many such activities by

**Chart 1.**  
**Interstate Banking Laws**  
*(as of February 1, 1989)*



regulation (that is, those generally approved for all holding companies) and by order (through case-by-case approvals resulting from special circumstances). Certain types of business have also been denied, however. (Appendix 2 to this article shows the activities permitted and denied as of January 31, 1989.)

**Thrift Institution Offices.** Thrift institutions also operate interstate offices that take deposits and make loans. Although the savings and loan industry never fell under the federal prohibitions relating to interstate banking, for many years the Federal Home Loan Bank System had precluded such activity by regulation and general policy. Starting in 1981, though, the Federal Home Loan Bank Board began allowing interstate mergers when an institution was in danger of failing. The Garn-St Germain Act of

1982 established provisions for these types of mergers. In 1986 the Federal Home Loan Bank Board issued a regulation similar to the Douglas Amendment on interstate activities of savings and loan institutions and mutual savings banks. In essence, this regulation permits interstate acquisitions for thrifts parallel to those for commercial banks.

### Developments in Interstate Banking

The study that appeared in this Bank's *Economic Review* in 1983 reported estimates based on an extensive inventory of interstate offices operated by banking organizations. This inventory, which has remained unique to this day,

**Table 2.**  
**Changes in Interstate Banking Presence**  
(1983-88)

Type of Office	Number Reported in 1988	Number Reported in 1983	Change in Number Reported	Percent Change
Bank Offices Controlled by Domestic Bank Holding Company	7,364	1,258	6,106	485
Bank Offices Controlled by Foreign Bank Holding Company	128	148	-20	-14
<b>Total Bank Offices</b>	<b>7,492</b>	<b>1,406</b>	<b>6,086</b>	<b>433</b>
Offices of Foreign Banks	302	241	61	25
Domestic Edge Act Corporations	79	143	-64	-45
<b>Total Offices for Foreign Transactions</b>	<b>381</b>	<b>384</b>	<b>-3</b>	<b>-1</b>
Section 4(c)(8) Offices	6,446	5,500	946	17
Loan Production Offices	332	202	130	64
<b>Total Nonbank Offices</b>	<b>6,778</b>	<b>5,702</b>	<b>1,076</b>	<b>19</b>
<b>Total Offices of Banks</b>	<b>14,651</b>	<b>7,492</b>	<b>7,159</b>	<b>95</b>
Thrift Institutions	1,616	N.A.		
<b>Total Interstate Offices</b>	<b>16,267</b>	<b>N.A.</b>		

Sources: See Appendix 3 and David D. Whitehead, *A Guide to Interstate Banking*, Federal Reserve Bank of Atlanta, 1983.

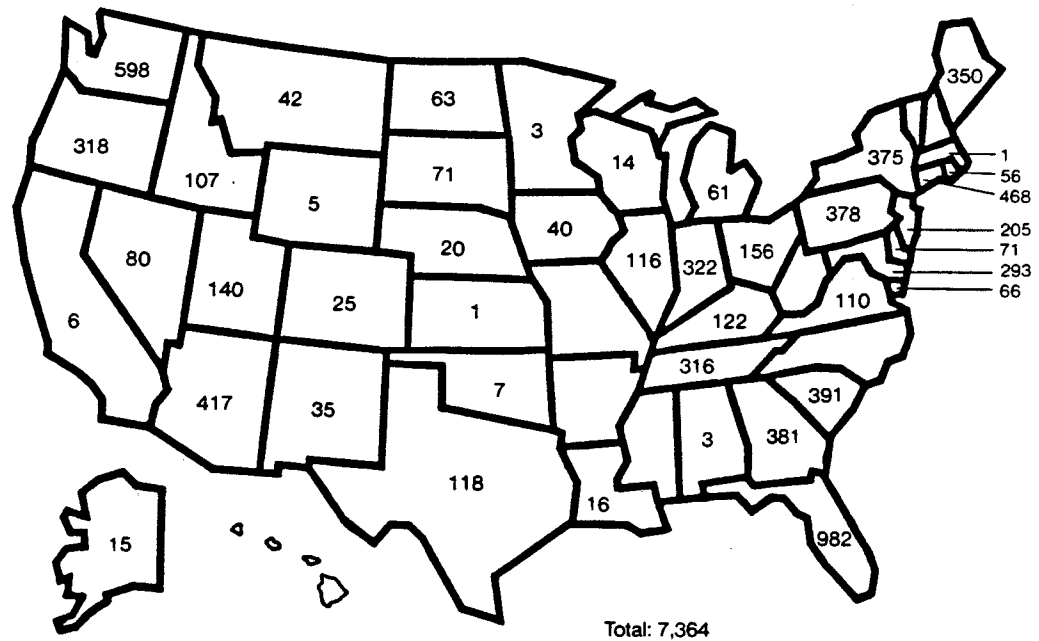
found a rather large network of interstate offices, relatively few of which were permitted to offer a full range of banking services. All these full-service offices were in grandfathered banks. The vast majority of interstate offices were nonbank offices such as 4(c)(8) subsidiaries; loan production offices; foreign banks' branches, agencies, and representative offices; and Edge Act offices. The current data reported below come from new counts of interstate offices. (See Appendix 1 for a summary of interstate activity and Appendix 3 for sources.) Particularly in dealing with 4(c)(8) and loan production offices, the totals may not be 100 percent inclusive.

**Full-service Offices.** Between the time of the 1983 report and the end of 1988, as Table 2 clearly shows, the most dramatic development has been the rapid growth in domestically owned full-service interstate banking offices, which have quadrupled to more than 7,300 during this period. This spread of interstate full-

service offices has not been uniform throughout the nation, however. Instead, several patterns of expansion are emerging, some related to each state's history of interstate banking and intrastate branching legislation and others related to features of the state's economy.

In some states that are part of regional compacts, a history of more liberal intrastate expansion laws led to the development of larger banks and their greater penetration throughout the state. The advent of interstate legislation helped these larger banks move quickly into surrounding states. North Carolina and Virginia are examples of states in which local banks rapidly acquired a substantial presence in neighboring states; at the same time, however, few if any banks from other states included in the regional compacts sought entry into those two states' markets. Similarly, the bigger Massachusetts economy and a fairly liberal intrastate expansion environment produced larger banks

**Chart 2.**  
**Number of Banking Offices in a Given State**  
**Controlled by Out-of-State Domestic Bank Holding Companies**



relative to those in other states in the New England compact. Only one bank—with just one office—has entered Massachusetts, while Massachusetts banks have spread.

Elsewhere, large economies or rapid economic growth, and thus a favorable banking market, seem to be important factors in attracting both full- and limited-service offices from other states. Eight of the top 15 states in the number of interstate nonbank offices in 1981 and 9 of the top 15 in 1988 also ranked among the top 15 states in interstate full-service bank offices. Florida, where the growth of full-service banks owned by out-of-state organizations has been especially rapid, along with Georgia, New York, Pennsylvania, and Arizona, exemplifies this linkage.

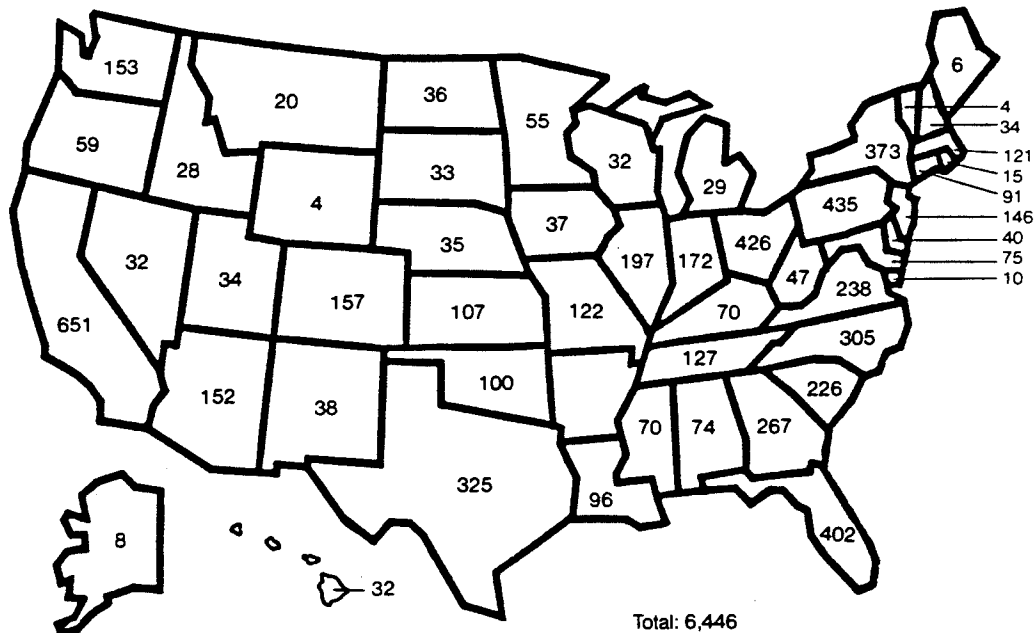
Clearly, the length of time since enabling legislation was enacted to permit interstate banking has also affected the pattern. Developments in the New England compact's states illustrate this effect. Out-of-state banks have made substantial penetration into Connecticut and Rhode Island, whose regional laws became

effective in 1983. New Hampshire and Vermont, which first allowed interstate banking in late 1987, have not yet seen banks enter. More liberal legislation in terms of partner states also has resulted in considerable out-of-state entry. Maine and Arizona, which allow nationwide non-reciprocal entry, have experienced substantial inroads by out-of-state banking organizations.

At the same time, the number of full-service offices of U.S. banks directly owned by foreign banks has declined. A significant decrease in California, where a major foreign-owned bank merged with a domestic bank, explains much of the drop.

**Offices Limited to International Transactions.** The number of offices limited to international transactions has declined slightly. The total of foreign banks' branch, Edge Act, and agency offices, which concentrate on investment-banking types of services, increased modestly during the period. Both the concentration and growth of these offices were greatest in California, Illinois, New York, Florida, and Georgia. The use of domestic Edge Act corporations, on the

**Chart 3.**  
**Number of Interstate 4(c)(8) Offices in a Given State**  
**Established by Nonbank Subsidiaries**



other hand, has actually waned as other types of offices that can make international loans and take international deposits have expanded. A reduction in U.S. banks' interest in international lending may also have played a part in the decline. At the end of 1988, 79 domestic Edge Act offices were operating in 16 states, down from 143 offices in 18 states in the 1983 survey. Most domestic Edge Act offices are still in New York, California, and Florida, owing to the active international banking environments in those states.

**Nonbank Offices.** The use of this earlier alternative means of gaining presence across state lines has continued, but its spread has not been as dramatic as that of full-service interstate banking offices. Out-of-state loan production offices, for example, now exist in most states.

For domestic banks, the count of section 4(c)(8) subsidiaries increased from 5,500 to almost 6,500, and loan production offices rose from 202 to more than 325 over the same period. In contrast to the data on interstate banking offices, the total of 4(c)(8) offices masks develop-

ments in the spread of this type of nonbank operation. When bank holding companies merge across state lines, nonbank subsidiaries of the acquired company typically are transferred to the acquiring company. Former nonbank subsidiaries of the acquired company in the acquirer's state are thus no longer counted as interstate. Thus, the tally of interstate 4(c)(8) subsidiaries underestimates cross-boundary expansion since declines in the count of 4(c)(8) subsidiaries from this source partially offset new openings of interstate 4(c)(8) offices. The data in Table 2 thus indicate that interstate 4(c)(8) offices continued to increase in number even though alternatives for interstate expansion have broadened.

**Thrift Institution Offices.** In the thrift industry, financial difficulties faced by certain institutions have spurred interstate activity. The number of thrifts whose offices cross state lines has increased from 29 to 57 over the six-year period covered by the 1983 and 1988 surveys. As mentioned earlier, interstate thrift offices currently number 1,616.

## Summary and Implications

Interstate banking has expanded significantly since the early 1980s. Bank holding companies at first relied mainly on nonbank subsidiaries to establish offices outside their home states. Now, however, the spread of state laws allowing entry from other states has resulted in full-service offices' becoming the dominant mode of establishing a presence outside a bank's home state. These operations account for slightly more than half of all interstate bank offices.

This trend is likely to grow throughout the nation since more interstate banking laws are becoming national in scope. The legal environment has already shifted toward increasing the number of partner states. Moreover, further movement in this direction seems likely since several states have national trigger mechanisms attached to their legislation. These allow nationwide entry after a period of limited reciprocal entry, and several will soon go into effect.

The nationwide entry allowed by more recent state laws has put pressure on the nation's two relatively exclusive regional compacts, those of New England and the Southeast. Attractive merger partners in both regions are growing scarcer, thus limiting the expansion capabilities of large banks within the narrowly defined regions. Banks in newly formed compacts and in states with nationwide expansion possibilities can potentially grow larger than banks in New England and the Southeast. In the more limited regions, the number of bidders for banks that would consider selling out is also limited. In New England, Rhode Island and Vermont have more recently recognized both problems and adopted national reciprocal laws. In the Southeast, Kentucky and Louisiana have made similar moves.

Expansion of state laws permitting nationwide entry, along with opportunities for banks in states with such laws, is pressuring state legislatures to enact, once and for all, nationwide banking with full-service offices. Firms' choices over the past several years indicate that full-service branches are preferable in many instances to offices limited to international transactions or to the activities allowed in section 4(c)(8) of the Bank Holding Company Act. There is little evidence that expanded interstate presence has resulted in the most egregious kinds of public harm often predicted. The country has witnessed the emergence of super-regional banks, whose size relative to the money-center banks has grown appreciably. However, superregionals in states in New England and the Southeast, which adhere to narrow regions, are now seeing their newly gained relative size threatened by their counterparts elsewhere under newer and broader interstate banking laws. On the purely positive side, smaller banks and failing banks have available to them more potential purchasers from a national pool.

At the same time, the current legal environment for interstate banking has created a patchwork of laws which is sustaining the use of limited-service banking offices in areas with narrow banking compacts. Aside from states that restrict interstate banking to others subscribing to a regional compact, some states still allow little or no out-of-state entry. These arrangements are probably inefficient since banks need to use alternative means to evade geographic restraint. In addition, it renders large banks whose home-state charters impose geographic limitations less able to grow relative to banks elsewhere in the nation. Nationwide interstate banking could level this dimension of an "uneven playing field" and achieve a more equitable arrangement for all banks.

## Changes in the Largest Banking Organizations during the Time of Interstate Banking

An important development of this decade has been a major restructuring of the list of the nation's largest banks.<sup>1</sup> Not only has a significant group of banks moved up into the ranks of the nation's largest banks, but relative rankings have

also shifted dramatically and banks in the lower part of the rankings have increased in size relative to banks ranking in the top 10. Most of the lower-ranked banks that have grown in this manner can trace their size increase at least partly to expan-

sion allowed by interstate banking laws. Banks throughout the top 50 list now operate full-service offices in multiple states.

Three phenomena, all involving consolidation of relatively large banks, account for these shifts:

- a set of intrastate and interstate mergers of large troubled banks, such as Seafirst, into other large banks, such as BankAmerica Corp.;
- another group of intrastate consolidations of large healthy banks, such as that of Bank of New York Co. and Irving Bank Corp.; and
- a group of interstate mergers, such as that of Sun Banks of Florida and Trust Company of Georgia, that were allowed by new state laws.

An analysis of changes in the largest 50 banks in the nation, as measured by asset size, between the end of 1982 and the end of 1988 indicates the type and magnitude of the changes during the development of state-sponsored interstate banking (see next page). More than one-quarter of the banking organizations ranked in the top 50 in asset size at the end of 1982 have been replaced. Thirteen organizations have moved onto the top-50 list since 1982. Several of these banks have made large increases in rank; 3 were not even in the largest 100 in 1982. Of the banks displaced from the top-50 list, 11 were merged out of existence, and 2 have shifted out of the rankings.

Not only has the makeup of this list changed, but shifts in rank have also been significant. Among 1988's 50 largest banks, 18 institutions had moved up in rank by 10 or more places since 1982; 8 ascended 40 or more places. Mergers in this group of fast-climbing banks have resulted in the formation of a group of banks that financial analysts and the press have dubbed "superregionals." Such companies are neither new nor unique. In fact, the 1983 Atlanta Fed study documented the existence of a few large regional bank holding companies that operated under grandfather provisions of the Bank Holding Company Act long before the recent wave of state laws allowing interstate entry. In addition, interstate acquisitions have not been limited to new members of the top 50. Several of the country's 10 largest banks have made interstate bank and thrift acquisitions during this decade.

Nevertheless, new large banks formed mainly through interstate mergers account for most of the major increases in rank and in relative size recorded during this decade among more sizable institutions. For instance, 9 banks entered the top 25 between 1982 and 1988. Of these, eight owe a

**Table 1.**  
**Comparison of Average Assets**  
**by Ranking Group for Top 50**  
**U.S. Banking Organizations**  
**1982 and 1988**

Ranking Group	Average Assets (billion \$)		Average Assets in Ranking Group to Average Assets of Top 10 (percent)	
	1988	1982	1988	1982
Largest 10	84.8	66.5	100.0	100.0
11th - 20th Largest	35.2	22.2	41.0	33.4
21st - 30th Largest	26.2	12.5	30.5	18.8
31st - 40th Largest	20.0	7.3	23.6	11.0
41st - 50th Largest	13.1	6.3	15.4	9.5

Source: Compiled by the Federal Reserve Bank of Atlanta from data obtained from the Board of Governors of the Federal Reserve System.

major part of their external growth to interstate mergers allowed under new state laws. (The ninth, Barnett Banks of Florida, grew mainly by acquisitions in Florida, but that company also made interstate acquisitions in Georgia.) Another institution, Bank of Boston, moved up within the top 25 mainly through interstate mergers. Thus, the states' goal of building larger banks headquartered in their region was achieved under the regional interstate pacts: 3 of the 9 new entrants to the top 25 were in the Northeast and 4 were in the Southeast.

Of the second 25 largest banks, upward moves from outside the top 50 accounted for the presence of 8 institutions. All rose in the ranking through at least some interstate acquisitions. Two of the banks moving up into the second 25 are headquartered in the Southeast region.

The largest banks in the country, most often located in money centers and often precluded from interstate acquisitions of all but failing institutions, lost size relative to the rest of the top 50 between 1982 and 1988. Outright shrinkage by some large troubled banks makes comparisons imperfect, but some indication of relative size changes can be found by comparing the average assets for each successive group of 10 banks in the ranking with average assets for the top 10 (see

**Table 2.**  
**Top 50 Banking Organizations, 1982-88**  
*(ranked by consolidated assets)*

Banking Organization	1988	1982	Rank Change 1982 to 1988
Citicorp, New York	1	1	0
Chase Manhattan Corp, New York	2	3	+1
BankAmerica Corp., California	3	2	-1
J.P. Morgan & Co., New York	4	4	0
Security Pacific Corp., California	5	10	+5
Chemical Banking Corp., New York	6	6	0
Manufacturers Hanover Corp., New York	7	4	-3
First Interstate Bancorp., California	8	8	0
Bankers Trust New York Corp., New York	9	9	0
Bank of New York Co., New York	10	24	+14
Wells Fargo & Co., California	11	13	+2
First Chicago Corp., Illinois	12	11	-1
PNC Financial Corp., Pennsylvania	13	32	+19
Bank of Boston Corp., Massachusetts	14	18	+4
Bank of New England Corp., Massachusetts	15	60	+45
Mellon Bank Corp., Pennsylvania	16	14	-2
Continental Bank Corp., Illinois	17	7	-10
NCNB Corp., North Carolina	18	26	+8
First Fidelity Bancorp., New Jersey	19	89	+70
Suntrust Banks, Georgia	20	71	+51
Fleet/Norstar Financial Group, Rhode Island	21	70	+49
First Union Corp., North Carolina	22	46	+24
Shawmut National Corp., Massachusetts	23	55	+32
Marine Midland Banks, New York	24	16	-8
Barnett Banks, Florida	25	38	+13
Bank One Corp., Ohio	26	62	+36
Natwest Holdings, New York	27	37	+10
Republic New York Corp., New York	28	29	+1
First Bank System, Minnesota	29	22	-7
NBD Bancorp., Michigan	30	25	-5
Sovran Financial Corp., Virginia	31	80	+49
Norwest Corp., Minnesota	32	20	-12
First Wachovia Corp., North Carolina	33	40	+7
National City Corp., Ohio	34	41	+7
Citizens and Southern Corp., Georgia	35	46	+11
Midlantic Corp., New Jersey	36	73	+37
Bank of Tokyo*	37	31	-6
MNC Financial, Maryland	38	61	+23
MCorp, Texas	39	27	-12

*continued on next page*



Table 2 continued

Banking Organization	1988	1982	Rank Change 1982 to 1988
Corestates Financial Corp., Pennsylvania	40	44	+4
Southeast Banking Corp., Florida	41	34	-7
Boatmen's Bancshares, Missouri	42	112	+70
Keycorp, New York	43	109	+66
U.S. Bancorp, Oregon	44	51	+7
Bankmont Financial Corp., Illinois	45	36	-9
Barclays USA, Inc., Delaware	46	136	+90
First City Bancorp. of Texas	47	23	-24
Valley National Corp., Arizona	48	35	-13
Michigan National Corp., Michigan	49	43	-6
Comerica, Michigan	50	33	-17

\* Assets of U.S. banks only.

Source: See Table 1.

Table 1). For each group of 10 below the top group, mean assets were a considerably larger proportion of mean assets of the 10 largest banks in 1988 than they were in 1982. (Removing BankAmerica from the top 10 in each year has little impact on relative mean assets.)

Clearly, banks with substantial operations in several states have become more important during this decade, and the state-granted opportunity to consolidate across state lines has been a major factor in the growth. Banks in the Southeast, in particular, have expanded. With their two- to three-year head start, banks in the southeastern compact accounted for 9 of the top 50 institutions in 1988 as compared to 6 in 1982. Though 4 of the 25 largest banks in 1988 were southeastern banks, no institutions from this region were present in the top 25 in 1982. More recently strong gains in size and rank have come from states in the East and the

Midwest, which have only recently enacted regional laws or expanded their list of partner states. It is possible that banks in states new to interstate banking and in states with national entry will catch up with southeastern banks since state legislatures have in the past two or three years made the process easier.

#### Note

The term *bank* here includes all organizations operating a full-service banking business in the United States. All but one of the organizations listed in the top 50 in 1988 were domestically chartered bank holding companies. (Three of these were owned by foreign organizations.) The other is a foreign institution that directly owns three U.S.-chartered banks.

**Appendix I.  
Summary Table of Interstate Activity**

State	Bank Offices										Offices Limited to International Transactions				Nonbank Offices	
	Domestic					Foreign					Loan Production Offices	Offices of 4(c)(8) Subsidiaries	Total Offices of Banking Organizations	Savings and Loans	Total Interstate Offices	
	Out-of-State Organizations Represented	Banking Offices Controlled by Out-of-State Bank Holding Companies	Out-of-State Banking Organizations Represented	Out-of-State Bank Holding Companies	Banking Offices Controlled by Out-of-State Bank Holding Companies	Agency	Edge	Branch	Domestic Edge Act Corporations	Offices of 4(c)(8) Subsidiaries						
Alabama	1	3									5	74	82	1	83	
Alaska	2	15										8	23		23	
Arizona	11	417	1	1							5	152	575	15	590	
Arkansas											1		1	31	32	
California	1	6	5	66	70	1	8	17			33	651	852	28	880	
Colorado	8	25									10	157	192	111	303	
Connecticut	7	468									8	91	567	1	568	
Delaware	17	71	3	3								40	114	9	123	
District of Columbia	5	66								2	3	10	81	54	135	
Florida	21	982									21	402	1,465	425	1,890	
Georgia	6	381									20	267	685	25	710	
Hawaii											1	32	36	18	54	
Idaho	2	107										28	135	28	163	
Illinois	15	116									22	197	388	57	445	
Indiana	10	322									4	172	498	33	531	
Iowa	2	40										37	77	9	86	
Kansas	1	1									2	107	110	21	131	
Kentucky	10	122									5	70	197	30	227	
Louisiana	1	16									4	96	117	13	130	
Maine	6	350									4	6	360	12	372	
Maryland	12	293									10	175	480	46	526	
Massachusetts	1	1									20	121	150	14	164	
Michigan	5	61									6	29	97	21	118	
Minnesota	1	3									3	55	63	16	79	
Mississippi											1	70	71		71	
Missouri											4	122	126	54	180	

continued on next page

Appendix I continued

State	Bank Offices										Officers Limited to International Transactions					Nonbank Offices		
	Domestic					Foreign					Domestic Edge Act Corporations	Loan Production Offices	Offices of (H)B Subsidiaries	Total Offices of Banking Organizations	Savings and Loans	Total Interstate Offices		
	Out-of-State Banking Organizations Represented	Bank Holding Companies	Out-of-State Banking Organizations Represented	Bank Holding Companies	Banking Offices Controlled by Out-of-State Bank Holding Companies	Agency	Edge	Branch	Offices									
Montana	3	42											20	62	6	68		
Nebraska	3	20											35	55		55		
Nevada	3	80											32	113	8	121		
New Hampshire													34	37		37		
New Jersey	2	205											146	364	30	394		
New Mexico	1	35											38	77		77		
New York	4	375	8		39	16	2	43	20				373	896	74	970		
North Carolina			1		19								305	331	1	332		
North Dakota	3	63											36	99		99		
Ohio	3	156							1				426	592	131	723		
Oklahoma	3	7											100	109	10	119		
Oregon	4	318						5	2				59	388	85	473		
Pennsylvania	5	378						5	1				435	828	13	841		
Rhode Island	3	56											15	72		72		
South Carolina	8	391											226	621	1	622		
South Dakota	3	71											33	104	4	108		
Tennessee	7	316											127	451	11	462		
Texas	6	118				14	8		5				325	512	78	590		
Utah	5	140											34	174	11	185		
Vermont													4	5		5		
Virginia	7	110							1				238	356	22	378		
Washington	6	598						10	2				153	757	55	812		
West Virginia	3	14											47	47	2	49		
Wisconsin	3	5											32	48		48		
Wyoming	3	5							1				4	11	2	13		
TOTAL		7,364			128	154	19	129	79				6,446	14,651	1,616	16,267		

**Appendix 2.**  
**Activities of 4(c)(8) Offices Permitted by Regulation**  
*(as of January 1989)*

Making, acquiring, or servicing loans such as would be made by the following companies:

- consumer finance
- credit card
- mortgage
- commercial finance
- factoring

Operating an industrial or Morris Plan bank or other industrial loan company

Performing trust company or fiduciary activities

Investment or financial advising

Full payout leasing of personal or real property

Investments in community welfare projects

Data processing services

Acting as insurance agent or broker primarily in connection with credit extensions

Underwriting credit life, accident, and health insurance

Courier services

Management consulting to depository institutions

Issuance and sale at retail of money orders with a face value of not more than \$1,000, U.S. savings bonds, and travelers checks

Real estate and personal property appraisal

Arranging commercial real estate equity financing

Securities brokerage

Underwriting and dealing in U.S. government obligations and money market instruments

Foreign exchange advisory and transactional services

Futures commission merchant

Investment advice on financial futures and options on futures

Consumer financial counseling

Tax planning and preparation

Check-guaranty services

Operating a collection agency

Operating a credit bureau

**Activities of 4(c)(8) Offices Permitted by Order**

Operating a "pool reserve plan" for loss reserves of banks for loans to small businesses

Operating a savings and loan type business in Rhode Island

Operating certain state stock savings banks

Buying and selling gold and silver bullion and silver coin for the account of customers

Operating an Article XII New York Investment Company  
Performing commercial banking functions at offshore locations  
Offering NOW accounts  
Operating a distressed savings and loan association  
Issuance and sale of variably denominated payment instruments (maximum face value of \$10,000)  
Operating a chartered bank that does not both take demand deposits and make commercial loans  
Providing financial feasibility studies for specific projects of private corporations; valuations of companies and large blocks of stock for a variety of purposes; expert witness testimony on behalf of utility companies in rate cases  
Providing advice regarding loan syndications, advice in connection with merger, acquisition/divestiture, and financing transactions for nonaffiliated financial and nonfinancial institutions; valuations for nonaffiliated financial and nonfinancial institutions; fairness opinions in connection with merger, acquisition, and similar transactions for nonaffiliated financial and nonfinancial institutions  
Executing and clearing futures contracts on stock indexes and options on such futures contracts  
Advisory services with respect to futures contracts on stock indexes and options on futures contracts  
Credit card authorization services and lost or stolen credit card reporting services  
Acting as a broker's broker of municipal securities  
Employee benefits consultant  
Student loan servicing activities  
Offering the combination of securities brokerage services and related investment advice to institutional customers  
Printing and selling checks  
Cash management services  
Acting as agent and adviser to issuers of commercial paper in connection with the placement of such paper with institution purchasers  
Underwriting and dealing in, to a limited extent, municipal bonds, mortgage-related securities, consumer-receivable related securities, and commercial paper  
Provision of financial office services  
Operating a proprietary system for trading put and call options on U.S. Treasury securities  
Retention of a thrift after the thrift's parent is acquired by a new bank holding company  
Acquisition of a healthy savings bank which qualifies as a commercial bank on the basis of its commercial loans and demand deposits  
Permitting a nonprofit tax-exempt college to become a bank holding company and engage in college activities, including fund raising incidental to educational activities, but requiring the college to divest real estate received as gifts  
Consulting and management services to insolvent thrifts  
Corporate bond trading

**Activities Prohibited under Section 4(c)(8)**

Insurance premium funding  
Underwriting life insurance that is not related to credit extension

*continued on next page*

*Appendix 2 continued*

Real estate brokerage  
Land investment or real estate development  
Real estate syndication  
Management consulting  
Property management services  
Operating a travel agency  
Contract data entry services  
Underwriting property and casualty insurance  
Dealing in platinum and palladium  
Engaging in pit arbitrage  
Public credit ratings on bonds, preferred stock, and commercial paper  
Acting as a specialist in French franc options on the Philadelphia Stock Exchange  
Selling title insurance  
Sale of certain thrift notes  
Oil and gas activities  
Timber brokerage activities  
Sale of level-term credit life insurance  
Acceptance of deposit accounts linked to credit card accounts  
Selling auto club memberships

**Appendix 3.  
Sources for Information**

Domestic Banking Offices	Federal Reserve Board of Governors and Federal Reserve Bank of Atlanta. Number of offices as of December 31, 1987. Structure as of September 15, 1988.
Foreign Banking Offices	Federal Reserve Board of Governors. Structure as of June 30, 1988. Number of offices as of December 31, 1987.
Foreign Banks: Agency, Edges, and Branches	Federal Reserve Board of Governors as of June 30, 1988.
Domestic Edges	Federal Reserve Board of Governors as of June 30, 1988.
Loan Production Offices	Federal Reserve Bank of Atlanta 1987 Survey of 200 Largest Banking Organizations in the United States.
Offices of 4(c)(8) Subsidiaries	Federal Reserve Bank of Atlanta survey and Federal Reserve Banks of Minneapolis, St. Louis, Boston, and Atlanta.
Savings and Loan Associations	Federal Home Loan Bank Board as of June 30, 1988.

## Notes

<sup>1</sup>David D. Whitehead, "Interstate Banking: Taking Inventory," Federal Reserve Bank of Atlanta *Economic Review* 68 (May 1983): 4-20. For more detail on the interstate presence of commercial banks in the early 1980s, see David D.

Whitehead, *A Guide to Interstate Banking 1983*, Federal Reserve Bank of Atlanta, 1983.

<sup>2</sup>David D. Whitehead, "Interstate Banking: Probability or Reality?" Federal Reserve Bank of Atlanta *Economic Review* 70 (March 1985): 6-19.



## STATE FISCAL CAPACITY AND EFFORT: AN UPDATE

by Carol Cohen

*Carol Cohen is a senior analyst at the Advisory Commission on Intergovernmental Relations.*

*In this article, Cohen reports on the updated work of the ACIR dealing with the measurement of state-local fiscal capacity and effort. ACIR has devised a Representative Tax System (RTS) and a Representative Revenue System (RRS) as measures of the states' revenue raising abilities. RTS is a measure based on the national average of the taxes levied in the states. RRS also is based on averages, but is a broader measure that includes some nontax revenue sources, including user fees. Cohen presents tables showing the revenue capacities of the states. Tax effort is measured by comparing the level of taxes collected to what would have been collected if the state and local governments collected taxes equal to the national average level of taxation. Tables are presented showing these data. Cohen also notes that the work on state tax capacity and effort has led to interest in similar efforts at the local level.*

The extent of differences among state and local governments' abilities to raise revenues relative to the cost of their public service responsibilities—their fiscal capacities—long has been of interest to ACIR and others. Because the ability of a government to raise revenue depends largely on its underlying economy, and because state and local economies differ, states vary considerably in their revenue-raising abilities. Likewise, the cost of providing services varies across states and localities in relation to the scope of services that are needed and the price differentials governments face. Such variations contribute to differences in the range and level of services provided across states and in the degree to which citizens must tax themselves to finance comparable levels of service.

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***Per capita personal income . . . does not accurately reflect a state or local government's ability to raise revenues.***

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### **Measuring Fiscal Capacity: The ACIR Approach**

ACIR has recently released *1986 State Fiscal Capacity and Effort*,<sup>1</sup> with estimates of fiscal capacity using the ACIR-developed Representative Tax System (RTS) and the Representative Revenue System (RRS). The report also describes the two systems, details the methods and data used, and analyzes the 1986 estimates.

To date, ACIR's work on fiscal capacity has focused on developing improved measures for quantifying the revenue-raising aspect of state fiscal capacity. As previous ACIR reports have explained, although per capita personal income is the most widely used indicator of fiscal capacity, this measure does not accurately reflect a state or local government's ability to raise revenues. Personal income is a poor indicator of revenue-raising ability because not all taxes or nontax revenue sources used by state and local governments are levied on income or are even closely related to personal income. Furthermore, it does not capture the ability of governments to "export" taxes by collecting some, such as hotel room taxes and



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**TAX NOTES, July 3, 1989**

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<sup>1</sup>ACIR, *1986 State Fiscal Capacity and Effort*, M-165 (Washington, D.C.: ACIR, March 1989).



## SPECIAL REPORTS

some business taxes, from nonresidents; it thus understates the capacity of states with exceptional tax exportation potential, such as mineral-rich Alaska and tourist-rich Nevada.

ACIR developed alternative measures of revenue-raising ability that are based on the tax bases (RTS) and other revenue sources (RRS) used by state and local governments. The RTS approximates a "representative" state-local system of tax rates and bases for a particular year, using national average tax rates and typical tax bases. The RTS thereby abstracts from the tax policy of any one state, but is grounded in the average behavior of the states in aggregate. The RRS is a parallel measure that includes additional nontax revenues, such as user charges. By applying these systems in every state and estimating the revenue yields, the ACIR approach measures the relative ability of each state to raise revenues. The calculated yields, or relative revenue-raising abilities, of the states vary with the magnitude of the underlying tax bases, such as retail sales or mineral production. Thus, they implicitly capture the tax exportation opportunities that are ignored by personal income.

The RTS and RRS also provide measures of fiscal effort, namely, the burden that each state places on each tax or revenue base relative to the national average. Using the RTS or RRS, any state's actual revenue raised from a particular tax or set of taxes can be compared with the estimate of revenue that could be raised using the representative tax or revenue systems; these tax utilization measures then can be compared with those of other states or the national average. The RTS and RRS are the only indicators of revenue-raising ability that allow for this standardized, disaggregated analysis of capacity and effort. For this reason, they are extremely useful to state and local tax policymakers and analysts.

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***At the Federal level, fiscal capacity measures are used...to provide greater assistance to those states with lesser ability to raise revenues....***

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### Uses of Fiscal Capacity Indicators

Indicators of state revenue-raising ability and fiscal capacity are used at both the state and Federal levels. State policymakers and analysts use measures of revenue-raising ability to compare the relative revenue potential of state tax systems as a whole and of specific types of revenue sources. Measures of revenue capacity and effort also are commonly used to compare the level, mix, and utilization of tax and other revenue sources used by states. It should be noted that indicators of revenue-raising ability, such as the RTS and RRS, are descriptive rather than prescriptive. They are not meant to imply that a state should or should not, for example, have a particular tax effort or revenue mix. Furthermore, state rankings in fiscal capacity do not imply better or worse services or revenue systems, or more or less efficiency in taxation.

At the Federal level, fiscal capacity measures are used in grant formulas that are designed to provide greater assistance to those states with lesser ability to raise revenues to support their service needs or with specified tax effort levels. To date, per capita income and another

fiscal capacity measure, Total Taxable Resources, have been incorporated in such formulas; the RTS has been proposed in legislation; and still other measures have been researched and developed. In Canada, a measure akin to the RTS and RRS is used in the formula that distributes federal equalization aid to the provinces. Measures of fiscal capacity also are used to monitor and analyze state and regional variations in economies and revenue systems.

### The 1986 Estimates

Table 1 shows the states ranked by their 1986 overall indices of RTS fiscal capacity. (The capacity indices and rankings by the RRS, which are not included in the table, show the same general patterns among states.) The overall indices are based on the per capita tax yields of the RTS compared with a national average set equal to 100. For example, California's index of 118 means that in 1986 the state had the capacity to generate an amount of tax revenue 18 percent above that of the average U.S. state. Pennsylvania's index of 90 means that its revenue-raising potential as measured by the RTS was 10 percent below the U.S. average.

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***Per capita income does not capture the high fiscal capacities of states with significant tax exportation opportunities....***

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The disparities in fiscal capacities among states are immediately apparent, as the indices range from 177 in Alaska to 65 in Mississippi. On the other hand, most states fall within 20 percent of the national average; only eight states are higher and eight states lower. The range of fiscal capacity at the upper end, however, is much larger than that at the lower end of the scale.

Table 1 also shows each state's 1986 per capita income index. In general, the per capita income and RTS indices are similar, especially at the lower end of the scale, but the RTS shows a much wider range of capacity than does per capita income. Specifically, per capita income does not capture the high fiscal capacities of states with significant tax exportation opportunities, including Alaska, Wyoming, and Nevada.

The last two columns of Table 1 show the state indices in total RTS and RRS effort. The effort indices are the ratio of a state's actual revenues for the taxes or revenues included in the measure to the estimated yield of the representative systems in that state, multiplied by 100. A state's effort index indicates its collections compared with those it could gain with a national-average system and thus provides a measure of the utilization of each tax base relative to the national average. For example, New York's overall RTS effort index of 152 means that, in aggregate, its state and local governments place a burden 52 percent higher than average on their tax bases, while Nevada's RTS effort index of 65 means that its bases are taxed at an overall rate 35 percent below the national average.

### Regional Patterns

The 1986 RTS fiscal capacity and effort indices strongly suggest some regional patterns. To the extent that states within a region have similar economic bases and/or tax

**Table 1**  
**1986 Fiscal Capacity and Effort Indices**  
 (100 = U.S. Average)

	Fiscal Capacity Indices		Fiscal Effort Indices	
	Representative Tax System	Per Capita Personal Income	Representative Tax System	Representative Revenue System
1. Alaska .....	177	122	168	139
2. Wyoming .....	151	87	117	119
3. Nevada .....	147	105	85	76
4. Connecticut .....	135	134	94	86
5. Massachusetts .....	124	121	103	96
6. D.C. (Washington) .....	122	132	143	129
7. Delaware .....	121	103	81	98
8. New Jersey .....	121	127	103	94
9. New Hampshire .....	119	109	82	68
10. California .....	118	115	95	96
11. Colorado .....	117	104	83	88
12. Hawaii .....	113	102	105	102
13. Maryland .....	108	115	99	98
14. New York .....	107	117	152	141
15. Florida .....	105	100	77	84
16. Texas .....	104	92	79	84
17. Minnesota .....	102	102	108	113
18. Virginia .....	101	105	85	89
19. Vermont .....	99	91	91	97
20. Arizona .....	99	92	99	96
21. Oklahoma .....	98	84	85	92
22. Washington .....	98	103	103	106
23. Michigan .....	96	101	118	114
24. Illinois .....	96	106	106	97
25. Kansas .....	96	100	96	95
26. Maine .....	95	87	99	94
27. Georgia .....	94	92	89	98
28. North Dakota .....	94	85	89	103
29. Oregon .....	93	91	98	103
30. Missouri .....	93	94	82	82
31. Rhode Island .....	92	100	111	102
32. New Mexico .....	91	78	88	94
33. Nebraska .....	91	94	96	104
34. Ohio .....	91	95	103	100
35. Louisiana .....	90	76	91	99
36. Pennsylvania .....	90	97	101	98
37. North Carolina .....	88	85	92	90
38. Montana .....	88	81	103	101
39. Indiana .....	87	90	94	97
40. Wisconsin .....	86	95	134	128
41. Iowa .....	84	91	113	114
42. Tennessee .....	84	82	84	90
43. Utah .....	80	75	107	108
44. South Carolina .....	79	77	94	101
45. South Dakota .....	78	81	95	96
46. Idaho .....	77	77	90	94
47. West Virginia .....	76	72	98	103
48. Kentucky .....	76	77	89	94
49. Alabama .....	74	77	86	102
50. Arkansas .....	73	76	91	91
51. Mississippi .....	65	66	97	109

Source: ACIR compilation.

policies, the fiscal capacity and effort indicators of those states should be around the same level.

**Capacity.** The map on page 110 shows that the ranges of capacity for states in a region do tend to be close. In general, the states in New England, the Mideast, and the Far West, along with certain mineral-rich states in other

regions, have the highest fiscal capacities, while the Southeastern states and some agriculture-dependent states in other regions have the lowest capacities.

Eight of the 11 states in the New England and Mideast regions have above-average fiscal capacity, and four of these states (Connecticut, Massachusetts, Delaware, and

**SPECIAL REPORTS**

New Jersey), as well as the District of Columbia, have capacities over 20 percent above the national average. Of the four states below the national average (Maine, Rhode Island, Vermont, and Pennsylvania), all are within 10 percent of the average.

The other region of the country with generally high fiscal capacity is the Far West, where California, Nevada, Alaska, and Hawaii all have capacity at least 10 percent above the national average. Alaska and Nevada are two of the three highest-ranking states in the country, the other being Wyoming. The other two states in the region, Oregon and Washington, have capacities no more than 10 percent below average.

At the opposite end of the spectrum, the Southeast contains the most states with low capacities. Six states (Alabama, Arkansas, Kentucky, Mississippi, South Carolina, and West Virginia) have capacities below 80 percent of the national average, and another two (North Carolina and Tennessee) are below 90 percent of average. The other four states range from 10 percent below average (Louisiana) to five percent above (Florida).

In the Great Lakes, Plains, Southwest, and Rocky Mountain regions, the states with capacities well above average are Colorado (at 117) and Wyoming (at 151), both with significant amounts of mineral resources. The states with capacities well below average are South Dakota (78) and Idaho (77), whose economies are largely

agricultural-based. With the exceptions of Indiana, Wisconsin, Iowa, Montana, and Utah on the low end (between 80 and 90 percent of average) and Minnesota and Texas on the high end (just over 100 percent of average), all of the states in these regions have capacities that are below average, but by less than 10 percent.

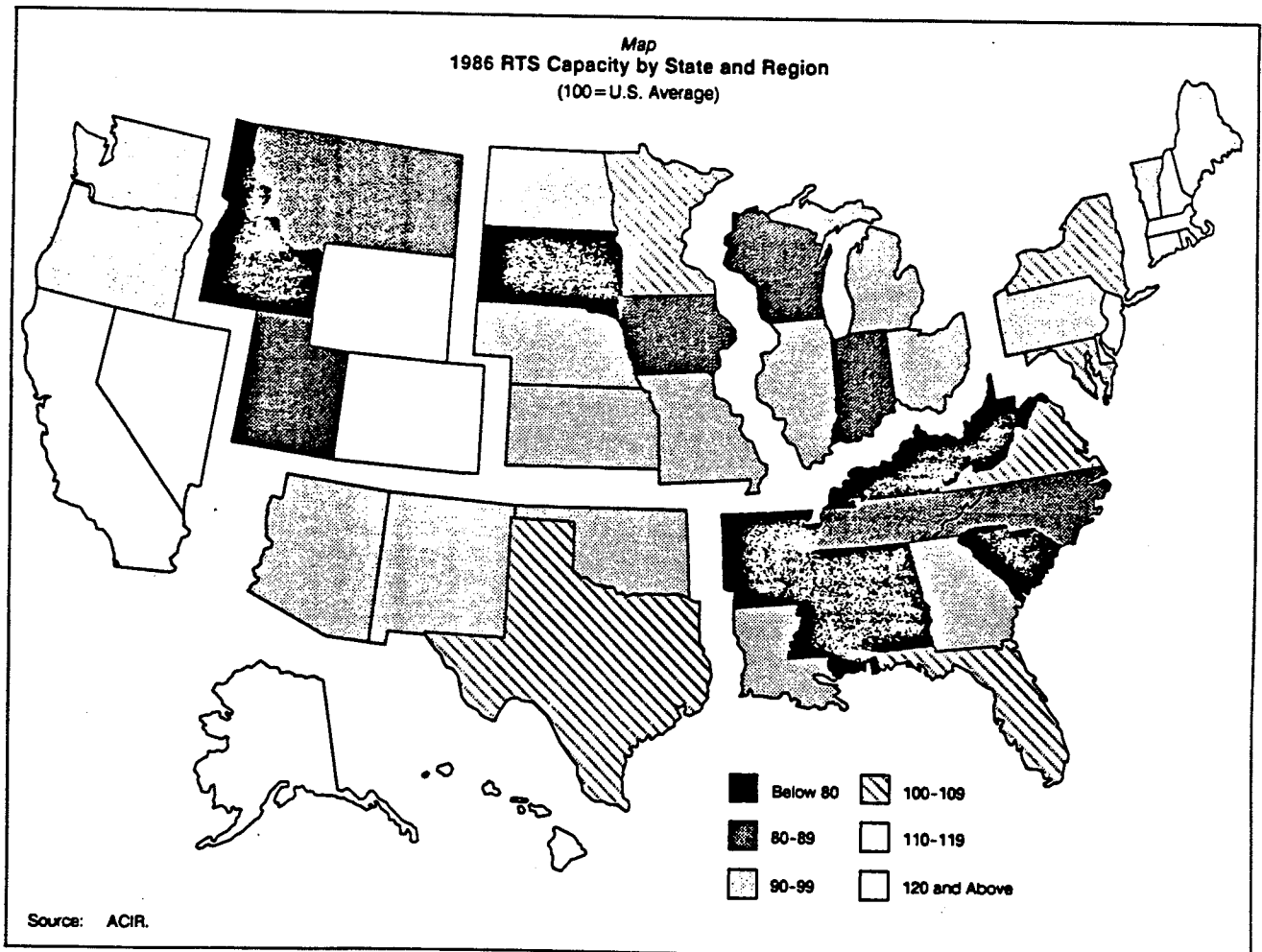
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***There is no necessary relationship between the capacity and effort levels for a particular state.***

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**Effort.** Several observations can be made about regional patterns in tax effort. First, there is no necessary relationship between the capacity and effort levels for a particular state. States exhibit a wide range of tax policy regardless of their level of fiscal capacity.

States with above-average capacity, however, tend to have a wider range of tax effort than states with below-average capacity. In 1986, for example, some of the states with the highest capacity, namely Alaska and Wyoming, along with the District of Columbia, were also some of the ones with the highest effort, while other states with



high capacity, including Nevada and New Hampshire, had some of the lowest effort indices among the states.

Another pattern apparent from the 1986 data is the below-average tax effort of the Southeastern states when measured by the RTS. By this measure, all 12 of the states in the region have tax efforts below the national average, and half have tax efforts below 90 percent of the average. However, the RTS measure does not include user charges, which are generally used more heavily than average by these states. When effort is measured by the RRS, which includes revenues raised through user charges, all of the Southeastern states except Florida and Virginia have effort indices within 10 percent above or below the national average.

**Relationship of Capacity and Effort.** The combination of tax capacity and effort gives some indication of the governmental service expenditures in each state. In general, those states with the lowest capacity and effort have the lowest levels of governmental expenditures, and those with high capacity and effort have the highest level of expenditures. However, because the capacity and effort measures are linked (most importantly, effort is measured relative to capacity), changes in a state's effort may reflect changes not only in its tax policy, but in its capacity as well.

**Changes in Capacity Over Time**

ACIR publishes annual estimates of fiscal capacity using the RTS and RRS, thus providing a longitudinal series of data on each state's capacity. These series point up strong trends in fiscal and economic well-being throughout the country. Figure 1 graphs the RTS capacity indices for five states from 1981 to 1986. These states illustrate several of the trends occurring over this period.

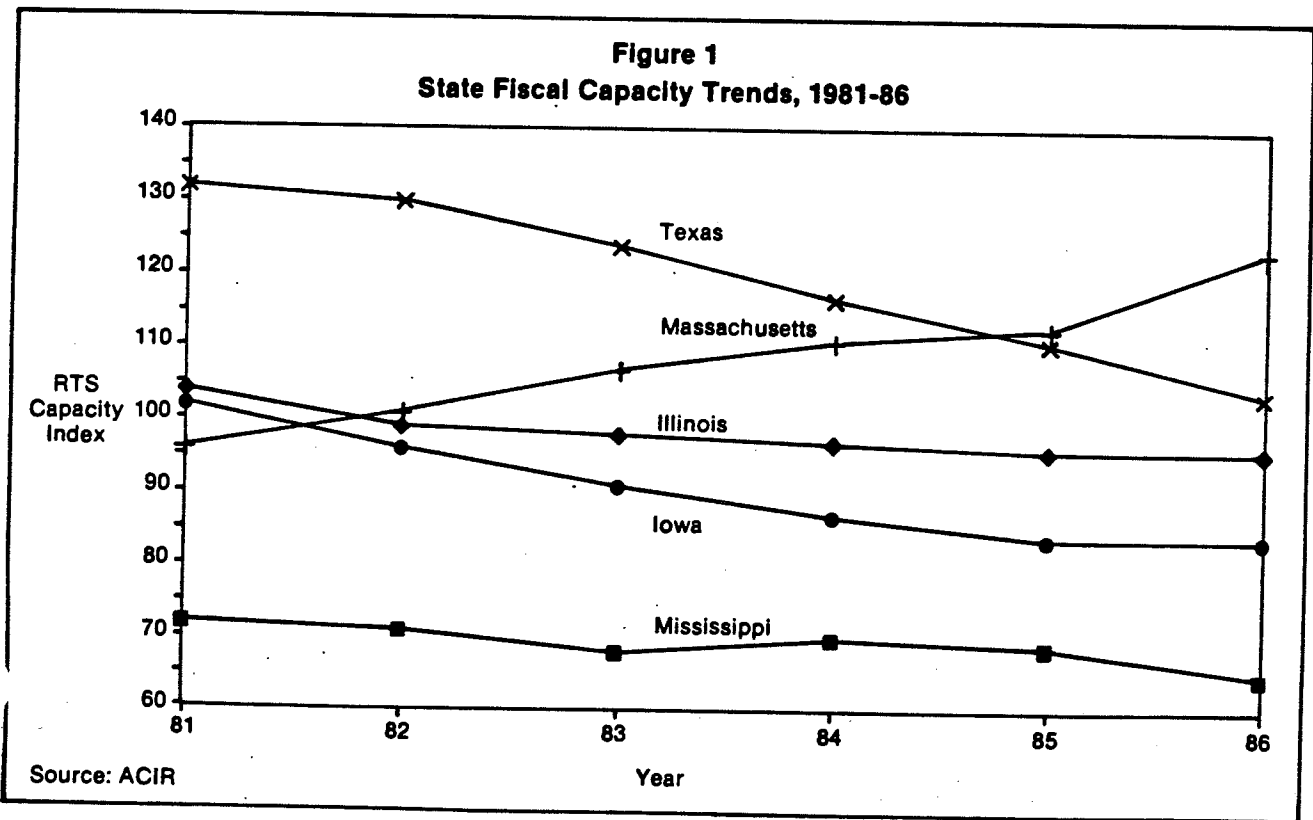
Trend data for all 50 states and the District of Columbia are graphed in the full report.

Texas and other major oil and gas producing states, including Alaska, Wyoming, Oklahoma, and Louisiana, experienced sharp declines in revenue-raising ability between 1981 and 1986. The declines were particularly dramatic for Alaska and Wyoming, whose RTS capacity indices fell from 324 to 177 and 216 to 151, respectively. This pattern reflects the falling energy prices over this period that directly reduced the value of the mineral tax bases in those states, as well as the general downturn in the economies of these states due to the decline in their energy sectors.

**Major oil and gas producing states... experienced sharp declines in revenue-raising ability between 1981 and 1986.**

Massachusetts is typical of most Northeast and Mideast states, whose economies were hurt by the recession of 1981-82 but have since rebounded. Connecticut, Delaware, Maryland, New Hampshire, New Jersey, New York, Rhode Island, and the District of Columbia all have shared in this recent economic growth.

Illinois is an example of the older industrial states whose capacities declined during the recession and have remained below their 1981 levels. Some of these states, including Ohio, Wisconsin, and, particularly Michigan,



## SPECIAL REPORTS

have shown improvements in their fiscal capacity since 1984.

The Plains states, with the exceptions of Minnesota and Missouri, have experienced fiscal declines of varying degrees since 1981, reflecting conditions in their agricultural and manufacturing sectors. While Iowa's 18-point decline was among the largest of these states, Kansas' fiscal capacity fell by 13 index points over this period, South Dakota's by eight, and Nebraska's by six. North Dakota was hit by declines in both its energy and agricultural sectors; its capacity fell by 30 points between 1981 and 1986.

Mississippi is representative of those states that, from 1981 to 1986, have consistently had the lowest fiscal capacities. The relative capacities of some of these states, including Arkansas, Kentucky, and Mississippi, actually have declined since 1981. The capacities of other of the lowest-ranking states have either remained about constant (Alabama) or increased slightly (South Carolina).

### Directions for Future Research

A number of interesting areas for research regarding the measurement and analysis of fiscal capacity remain. For example, the development of state fiscal capacity measures has sparked interest among state and local officials in developing local fiscal capacity measures. While the RTS has been extended to some local governments in earlier ACIR efforts and the approach has been used by several states in developing their own measures, more work needs to be done on the special technical problems involved in measuring local fiscal capacity.<sup>2</sup>

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### *The development of state fiscal capacity measures has sparked interest... In measuring local fiscal capacity.*

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Another new direction in fiscal capacity research is the effort to measure the relative service needs of the states and costs of providing those services. A paper published by the U.S. Department of the Treasury in 1986 set out an approach to the measurement of the relative cost of public services in the states.<sup>3</sup> Robert W. Rafuse, Jr., the author of that paper and currently a Visiting Senior Fellow at ACIR, is extending and updating that work. A report on the results of this effort is scheduled to be considered by the Commission at its June meeting.

There are a number of questions regarding the reasons for the pattern of fiscal capacity among the states that

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<sup>2</sup>For the ACIR efforts, see *Measuring the Fiscal Capacity and Effort of State and Local Areas*, M-58, March 1971; and *Measuring Metropolitan Fiscal Capacity and Effort: 1967-1980*, Working Paper 1, July 1983. For a review of local government fiscal capacity studies conducted by states, see Texas Advisory Commission on Intergovernmental Relations, "Local Government Fiscal Capacity Measures: A Profile of State Studies," in U.S. Department of the Treasury, Office of State and Local Finance, *Federal-State-Local Fiscal Relations*, Technical Papers, Volume I (Washington, D.C.: Treasury, September 1986), pp. 263-295.

<sup>3</sup>Robert W. Rafuse, Jr., "A Representative-Expenditure Approach to the Measurement of the Cost of the Service Responsibilities of States," in Treasury, *Federal-State-Local Fiscal Relations*, pp. 133-186.

warrant research. For example, what are the political, economic, historic, and other factors associated with the level of fiscal capacity and effort in each state? Why do states respond differently to regional or national economic trends? What policies are linked to higher or lower fiscal capacities?

These and other directions for further research demonstrate the continuing evolution of the fiscal capacity debate. Since ACIR began its pioneering work in this field, several fiscal capacity measures have been developed and refined, and this process is ongoing. In today's intergovernmental fiscal environment, it is increasingly important for the Federal government to have the tools to target its aid to state and local governments, and for state and local governments to have the information that will enable them to make informed tax and economic development policy decisions. These concerns ensure that the measurement and analysis of fiscal capacity will continue to be of considerable interest in the future.



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# WAYS & MEANS

NATIONAL CENTER FOR POLICY ALTERNATIVES

IN THIS ISSUE: BANKING ON THE STATES

## State Bank Regulators Need More Voice in Development

by Edward W. Hill and John Clair Thompson

How well is "the market" — the commercial banking system — playing its role in supplying capital to finance business growth and community economic development? The question is critical: Access to private sources of finance is key to local economic growth. Interstate banking underscores the importance of that question. Newly merged banking organizations tend to be extremely large. Their size raises the possibility that commercial and industrial finance for all but the largest businesses — those with access to the commercial paper market — will be controlled by a string of regional oligopolies. If large banks did discriminate against smaller commercial borrowers, either denying them access to the market by rationing funds or charging interest rates unjustified by the risk of the loan, then development finance would be more difficult to obtain.

Answers are elusive. In most states, banks report the percentage of their assets invested in commercial and industrial loans, but do not divulge either the location or size of the borrowing firm.

### Expert Opinion

We turned to state bank regulators for our answers. Between January and June of 1987, we polled all state and territorial regulatory agencies; 47 responded. Their answers to our survey supported four conclusions about banks and state economic development policy —

- Promoting local economic development is an important objective to state bank regulatory officials. It was the third goal of most of our respondents after ensuring safety and soundness and providing banking services.

*continued p. 2*

Volume 12, Number 1

April 1989

### Also In This Issue

- How state bank regulators can help communities: New survey findings
- New York State Banking Superintendent Jill Considine and Minnesota Commerce Commissioner Michael Hatch: Two profiles
- Two New Mexico union programs bank on people
- Arkansas invests in rural development

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## PRESIDENT'S COLUMN

by Linda Tarr-Whelan

### Banking on Change

Over four years ago, NCPA began work in a new area of social change — developing "quid pro quo" strategies to guarantee that capital flowed to communities.

In West Virginia, a state devastated by floods and high unemployment, community needs were left out of the banking industry's plans for regional and interstate banking. Women and Employment invited NCPA to meet with activists and progressive members of banking committees in West Virginia. This Christmas, 1985 meeting and the ones that followed succeeded in linking economic development and banking deregulation.

Before that meeting — and even now in states still without working Community Reinvestment Acts — discussions about restructuring financial institutions were held as a family meeting of bankers. While the various bankers differed on how to proceed, there was no public interest represented.

Deregulation of the financial services industry is one of a series of events that thrust states into the spotlight for banking law. The savings and loan crisis, capital flight, and redlining have also played a role.

Progressive legislators and advocates need a place at the table when the financial decisions are made. Building on the earlier work of Lee Webb and Farley Peters at NPCA, Bob Stumberg and Roxanne Ward continue to provide models and resources to make change

*continued p. 2*

## More Voice *from p. 1*

- Yet regulatory officials are rarely included in state development cabinets. This isolation persists despite wide-ranging structural changes in the banking industry, among them increases in both bank failures and interstate banking, that affect the market for development finance.
- The banking industry is moving toward a market structure that makes a capital gap more — rather than less — likely. More than two-thirds of the regulators saw a relationship between the size of banking organizations and the size of their commercial and industrial customers. Most believed that bigger banks “often” or “always” prefer to lend to bigger customers.
- Interstate banking legislation appears to have gained widespread approval for reasons other than perfecting the flow of capital among the states. Endorsement of interstate banking appears to hinge on to encouraging employment in the banking industry rather than enhancing the performance of the local capital market.

“Capital markets work efficiently,” most of the regulators say, with the exception of the continuing crisis in the thrift industry. But they go on to describe investment decisions that closely parallel the description of the capital gap. Thus 87.9 percent believe that interstate banking has not resulted in lower interest rates to commercial and industrial borrowers. Two-thirds say that local commercial borrowers do not have improved access to capital. As the banking industry restructures — with the number of banks with assets larger than \$20 billion increasing and the number of regional banks with assets smaller than \$10 billion decreasing — the likelihood of a capital gap also increases. State regulators do not expect to see the environment for development finance improve because of current structural changes in the commercial banking industry.

### Closer Coordination

Closer coordination between economic development officials and bank regulators can offset the threat of capital

gaps. Their roles are highly compatible: Economic development officials have better information about the demand for credit and capital, while regulators have better information about the supply and cost of funds. Regulators can also keep development officials alert to institutions amenable to providing credit for younger and smaller ventures — without violating the confidentiality of bank records. Yet, by and large, state developers do not understand how they can influence the investment decisions of banks in their states. And regulators have little voice in development decisions.

We argue, therefore, that state bank regulators should be formally included in the economic development cabinets of state governments. Government must play a role in ensuring that finance markets remain competitive and that information about market conditions is readily available to commercial and industrial borrowers. In addition, state development officials can sensitize bank regulators to the real — or perceived — problems in local credit markets so that action can be taken.

Cooperating, development officials and regulators can also direct public funds most effectively into economic development. Public “seeding” can both fund demonstration loans and reassure banks about the worthiness of new ventures. In turn, private lending is encouraged.

## President's Column *from p. 1*

happen in state after state. Now 26 states have some form of community reinvestment act. Leading banking regulators and supervisors are ensuring that pools of public capital exist.

NCPA's interest is simple. We believe that financial institutions have a responsibility to their communities. That relationship must be reconfigured in light of new patterns and needs. Small depositors need protection, small businesses and homeowners need capital, and communities need resources for economic development.

This edition of *Ways and Means* introduces leading people, cutting-edge policies, and strategies that make financial institutions — and the capital they control — accessible to the public.

A final element of policy coordination between regulators and developers is possible though controversial. Banks currently disclose mortgage information as a matter of law. Similar information could be provided for commercial and industrial loans. State funds and business could then be guided to those banks that meet public purposes while maintaining their fiduciary responsibility.

Banks hold a charter to fulfill a public purpose: maintaining the system of payments and financing commercial activity. Is it, then, asking too much that one group of public officials — bank regulators — provide information to another group — public developers — on how well local banks are meeting their public purpose?

*Edward W. Hill is assistant professor of Urban Studies and Public Administration at Cleveland State University's College of Urban Affairs and senior scholar in the college's Urban Center. John Clair Thompson is associate professor of Business Environment and Policy at the University of Connecticut's School of Business Administration. We print the conclusion of their research with the kind permission of Economic Development Commentary, a quarterly publication of the National Council for Urban Economic Development, 1730 K St., NW, Suite 915, Washington, D.C. 20006 (202)223-4735.*

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**EXHIBIT K: 3**

**American Bar Association, Committee on Banking and Savings Institutions,  
"Tax Section Recommendation No. 1981-3", Tax Lawyer, Vol. 34, No. 3,  
(Spring 1981) p.861**



United States Court of Claims within three years from the time the return was filed or two years from the time the tax was assessed, whichever is later.

**SPECIAL COMMITTEE ON TAXATION AND PRICE INDEXING  
LEGISLATIVE RECOMMENDATION**

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO PROVIDE FOR COST OF LIVING ADJUSTMENTS TO GIFT AND ESTATE TAX RATE BRACKETS, THE UNIFIED GIFT AND ESTATE TAX CREDIT, THE ANNUAL GIFT TAX EXCLUSION, THE BRACKETS FOR STATE DEATH TAX CREDITS, THE MINIMUM GIFT AND ESTATE TAX MARITAL DEDUCTIONS, THE CREDITS FOR GIFT AND ESTATE TAXES PAID ON PRIOR TRANSFERS, AND THE LIMITS ON SPECIAL VALUATION OF FARM AND BUSINESS REAL PROPERTY, ON THE AMOUNT OF ESTATE TAX SUBJECT TO THE FOUR PERCENT INTEREST RATE, AND ON THE ORPHANS DEDUCTION.

**Summary**

During periods of inflation the effect of progressive estate and gift tax rates is an increased real tax burden on any given amount of real assets transferred. Similarly, the real value of fixed dollar estate and gift tax credits, deductions, exemptions, limitations, and other numerical items declines. The resulting increase in the ratio of gross tax revenues to the aggregate of gross gifts and estates and corresponding reduction in real assets available for the heirs of a decedent are effected annually without congressional action.

*It is recommended* that annual cost of living adjustments be made to the fixed dollar brackets in the gift and estate tax rate tables, the unified gift and estate tax credit, the annual gift tax exclusion, the rate brackets for state death tax credits, the minimum estate and gift tax marital deductions, and the limits on special valuation of farm and business real property, on the amount of estate tax subject to the special four percent interest rate, and on the orphans deduction.

*It is further recommended*, consistent with the foregoing, that the dollar amounts of prior gifts and the credits for gift and estate taxes paid on prior transfers be adjusted for price level changes between the year such amounts were established and the year in which a subsequent gift or the decedent's death occurs.

34 Tax Lawyer 861 (Spg 1981)

**COMMITTEE RECOMMENDATION**

**Committee on Banking and Savings Institutions**

TAX SECTION RECOMMENDATION No. 1981-3

*Editors' Note: Tax Section Recommendation No. 1981-3 is published in this Issue of The Tax Lawyer to serve as a basis for discussion of that subject at the May Meeting. This Recommendation will be presented for Section action at the Annual Meeting. A more complete explanation of Recommendation No. 1981-3, historical materials and examples may be requested from the Chairman of the Committee on Banking and Savings Institutions (Thomas L. Kummer, P.O. Drawer 84, Winston-Salem, NC 27102.)*

TO AMEND TITLE 12 OF THE UNITED STATES CODE RELATING TO BANKS AND BANKING, TO PROVIDE THAT (1) A STATE OR POLITICAL SUBDIVISION MAY IMPOSE DOING BUSINESS TAXES ONLY ON DEPOSITORIES HAVING A SIGNIFICANT BUSINESS LOCATION IN THE STATE OR POLITICAL SUBDIVISION; (2) NO STATE OR POLITICAL SUBDIVISION MAY IMPOSE ANY TAX ON A DEPOSITORY NOT HAVING ITS PRINCIPAL OFFICE WITHIN THE STATE OR POLITICAL SUBDIVISION WHICH TAX IS MORE BURDENSOME THAN TAXES IMPOSED UPON DEPOSITORIES HAVING THEIR PRINCIPAL OFFICE WITHIN THE STATE OR POLITICAL SUBDIVISION; (3) NO STATE OR POLITICAL SUBDIVISION MAY IMPOSE A DOING BUSINESS TAX UPON A DEPOSITORY OR AN AFFILIATED GROUP OF WHICH THE DEPOSITORY IS A MEMBER IN EXCESS OF THE TAX ATTRIBUTABLE TO THE STATE OR POLITICAL SUBDIVISION BY APPLICATION OF A TWO FACTOR APPORTIONMENT FORMULA BASED ON PAYROLL AND RECEIPTS.

*RESOLVED that the following Resolutions be submitted by the Section of Taxation to the House of Delegates of the American Bar Association:*

**RESOLUTIONS**

RESOLVED that the American Bar Association recommends to the Congress that title 12 of the United States Code be amended to provide that:

(1) a state or political subdivision (hereinafter collectively referred to as "state") may impose doing business taxes upon any institution the deposits of which are insured under the Federal Deposit Insurance Act or by the Federal Savings and Loan Insurance Corporation, any institution which is a member of a Federal Home Loan Bank, any other bank or thrift institution incorporated or organized under the laws of any state or foreign country which is engaged in the business of receiving deposits in the United States, any corporation organized under the provisions of 12

U.S.C. §§ 611-631, and any agency of a foreign depository as define in 12 U.S.C. § 3101 (hereinafter collectively referred to as a "depository"), only if such depository has a significant business location within such state;

(2) no state may impose a more burdensome tax of any kind on a depository not having its principal place of business in the state than is imposed upon a depository having its principal office in the state;

(3) no state may impose any doing business tax upon the apportionable base of a depository or of an affiliated group of which a depository is a member which is greater than the apportionable base attributable to the taxing state computed by application of an apportionment formula which gives equal weight to a payroll factor and a receipts factor;

(4) the provisions of 12 U.S.C. § 627 (relating to exemption of Edge Act Corporations from nondomiciliary state taxation) be repealed.

FURTHER RESOLVED that the Section of Taxation is directed to urge on the proper committees of the Congress amendments which will achieve the foregoing results.

## REPORT

### Summary

Under current law, a depository is taxable in any state with which it has "nexus." There is no federal or uniform state law setting forth threshold jurisdictional standards for taxation of depositories; nor is there any federal or uniform state law governing allocation of the tax base among the states in which the depository operates. Without federal establishment of rules for determining when states have jurisdiction to tax nondomiciliary depositories and providing for allocation of the tax base among the taxing states, barriers may develop to the free flow of credit. These barriers may arise from discriminatory taxation of nondomiciliary depositories, assertion of jurisdiction to tax depositories having only minimal contacts with the state, or taxation by states or political subdivisions in the aggregate of more than 100 percent of the tax base of the depository.

*It is recommended* that states and political subdivisions be prohibited from:

(1) imposing a doing business tax on a depository unless the depository has a significant business location within such state or political subdivision.

(2) imposing taxes upon a nondomiciliary depository having a business location within such state or political subdivision that are more burdensome than such taxes imposed by the state upon domiciliary depositories.

(3) imposing a doing business tax upon the tax base of a depository, or an affiliated group of which a depository is a member, that is greater than the amount determined by multiplying the tax base of the depository or affiliated group by a fraction, the numerator of which is the sum of a payroll factor and a receipts factor and the denominator of which is two.

*It is further recommended* that 12 U.S.C. § 627 be repealed.

### Discussion

From 1864 until 1973, federal legislation limited the power of states to levy taxes on nondomiciliary national banks and savings and loan associations. 12 U.S.C. §§ 548 and 1464(h). Generally, nondomiciliary states could tax the real property of banks and savings and loan institutions, but other taxes could not be levied. In 1969,

Congress replaced these restrictions on the multistate taxation of depositories with the so-called "permanent amendment," Pub. L. No. 91-156 (December 24, 1969), leaving states broad latitude to tax nondomiciliary depositories. This change, subjecting depositories to the diversity of state taxing systems, may lead to restrictions on the free flow of credit.

The Board of Governors of the Federal Reserve System was directed in the permanent amendment to study the probable impact of the new policy, and on May 5, 1971 the Board submitted its report recommending among other things, that Congress act to restrict the power of states to impose "doing business taxes" on depositories. In response to the Board's recommendations, Congress granted a moratorium, effective through 1975, on state application of doing business taxes to out-of-state depositories. Pub. L. No. 93-100 (August 16, 1973). The moratorium was extended to September 12, 1976, Pub. L. No. 94-222 (February 27, 1976), but no further extension has been enacted. The Advisory Commission on Intergovernmental Relations ("ACIR") was directed by Pub. L. No. 94-222 to make a report and formulate recommendations on the interstate taxation of depositories. The ACIR report was submitted in May, 1976, but no action was taken by Congress on the recommendations made. The American Bankers Association, United States League of Savings and Loans, and others have developed legislative proposals to deal with the problems of the multistate taxation of depositories, but none of them has been adopted.

Depositories are excluded from the coverage of Pub. L. No. 86-272 (September 14, 1959), which is the only federal legislation restricting the power of states to impose taxes upon interstate commerce. Under Pub. L. No. 86-272, states are prohibited from imposing a net income tax on income derived in a state if the only business activities within the state consist of the solicitation of orders for sales of tangible personal property, provided the orders are sent out of state for approval and are filled by shipment or delivery from a point outside the state. Depositories are also specifically excluded from the Uniform Division of Income For Tax Purposes Act and the provisions of the Multistate Tax Compact, both of which have been adopted by a number of states and represent efforts by the states to provide uniformity in the taxation of interstate commerce. Therefore, under current law a depository is taxable in every state which may constitutionally assert taxing jurisdiction, and there is no uniform state or federal law governing the allocation of the depository's tax base among the taxing states.

The Recommendation sets forth certain jurisdictional rules to determine when a state or its political subdivisions (hereinafter collectively referred to as "state") would have jurisdiction to tax a depository. Under the Recommendation a nondomiciliary state would have jurisdiction to tax a depository only if the depository has more than \$1,000,000 of either payroll or receipts attributable to the state and if during the taxable year the depository:

(1) maintains an office in the state (unless the only activity conducted at the office is, or is in connection with, maintaining or defending a suit, obtaining an interest in or protecting collateral, or acting as a fiduciary); or

(2) has one or more employees having a regular presence in the state (unless the employee or employees are in the state only to acquire loans from an independent contractor, work with an independent contractor at its office within the state, or participate in loans with other depositories having an office in the state, or unless the

only activity conducted is or is in connection with maintaining or defending a suit, or obtaining an interest in or protecting collateral, or acting as a fiduciary); or (3) leases tangible property located in the state in a transaction which is a true lease for federal tax purposes, or owns tangible property located in the state which it uses in connection with activities within the state.

The jurisdictional rules contain both positive and negative standards, because mere extension of the negative standards approach of Pub. L. No. 86-272 would in some instances enable depositories to conduct very substantial activities within a state and yet not be subjected to tax by that state, while other activities of considerably less significance might create taxing jurisdiction. Similar problems are inherent in the adoption of positive standards only.

The Recommendation provides that a depository has a business location within a state if the depository maintains an office in the state, unless the only activities of the depository within the state are in connection with maintaining or defending suits, protecting collateral upon default, or acting as fiduciary. An office is maintained wherever a depository has established a regular, continuous, and fixed place of business.

The Recommendation adopts a *de minimis* rule that provides that a depository will not be considered to have a business location within a nondomiciliary state if it has less than \$1,000,000 of either payroll or receipts attributable to the state.

The Recommendation also uses the regular presence of an employee within a state as a basis for taxing jurisdiction. Where an employee has a regular presence is generally determined by where a majority of the employee's service is performed. If a majority of an employee's service is performed in several states, then he is deemed to have a regular presence in the state in which the office is located from which his activities are directed or controlled. An employee does not have a regular presence in a state, however, regardless of the services performed in the state, if his only activities are, or are in connection with, acquisition or purchase of loans from independent contractors, activities in the state of independent contractors, loan participation, inspecting collateral, and soliciting loan applications, deposits, or financial services (if approved, maintained, or performed outside the state). These exceptions to the general "regular presence" rule recognize the unique nature of the depository industry and seek to place depositories in a similar position to other enterprises governed by the "nexus" rules of Pub. L. No. 86-272.

The Recommendation utilizes leasing within a state and ownership of property used by the depository within a state as separate bases for taxing jurisdiction. True leases are distinguished from transactions which are leases in form but are treated for federal tax purposes as loans. This distinction is necessary to insure that the substance of the transaction is controlling rather than its form.

It was decided that a separate jurisdictional standard involving electronic funds transfer ("E.F.T.") equipment would not be appropriate. The development of interstate E.F.T. systems has not been such that it is possible to anticipate what form future development will take. However, either ownership of E.F.T. equipment in a state or use of E.F.T. machines to establish a regular, continuous and fixed place of business in a state would create taxing jurisdiction.

The Recommendation prohibits any state from imposing any tax on a depository not having its principal office within the state which is more burdensome than the tax imposed upon a depository having its principal office within the state. The concept of more burdensome taxation is consistent with the permanent amendment

and allows a state to levy different forms of tax upon a domiciliary and a nondomiciliary depository as long as the ultimate tax burden is nondiscriminatory.

The apportionment and jurisdiction provisions of the Recommendation are applicable to all "doing business taxes," which are defined as any taxes except sales and use taxes, real property taxes, documentary taxes, and tangible and intangible personal property taxes. The term also includes any tax imposed on a shareholder or depositor of a depository on his interest as a shareholder or depositor paid by the depository and not reimbursed to the depository. Moreover, because of the unique nature of the depository industry, the Recommendation is limited to depositories. The term "depository" is defined as any institution which is authorized both to receive deposits within the United States and make loans, Edge Act Corporations, and agencies of foreign depositories.

The Recommendation does not seek to define the tax base upon which a state may levy its tax, nor does the Recommendation in any way sanction or prohibit state taxation of income, receipts or capital recorded on the books and records of an office outside the United States. The Recommendation defers to state law in defining the "tax base."

In order to insure that no more than 100 percent of the total tax base will be taxed in the aggregate by the various states, the Recommendation includes an apportionment formula. Under the formula, the Recommendation will have no effect on state taxes if the state-imposed tax does not exceed the maximum computed under the formula. Thus, the Recommendation sets forth only the maximum tax base upon which a state may levy its tax rather than requiring states to adopt a federally mandated system of taxation. The formula includes a payroll factor and a receipts factor.

The payroll factor is defined as a fraction, the numerator of which is the total wages paid in the state and the denominator of which is the total wages paid in all states. For purposes of the Recommendation, wages are defined by reference to section 3401 of the Internal Revenue Code. Wages are deemed paid in a state if paid to an employee deemed to have a regular presence in the state. If wages are paid to an employee having a regular presence in a state without jurisdiction to tax, the wages are excluded from both the numerator and denominator of the fraction. For purposes of the receipts factor, receipts from loans secured primarily by real property are deemed located in the state where the predominant part of the collateral is located, and receipts from other loans are deemed located in the state where the loan originated. Fees and other receipts from performance of services are deemed located in a state to the extent the services are performed in such state. Receipts from leased property are assigned to the jurisdiction where the property is deemed to be located, and interest, dividends and net gains from the sale of securities are deemed located in the state where the depository is required to treat the securities as assets on its books. Interest and service charges from bank credit cards are located in the state in which the credit card holder resides, and fees from the issuance of travelers checks and money orders are located in the state of issue.

The Recommendation provides that the formula is to be applied to the depository's "Apportionable Base." Apportionable Base is defined as gross income, net income, gross receipts, capital or other tax base, upon whichever the taxing state levies its tax, from activities conducted both within and without the state, reduced by certain exclusions. The law of the taxing state determines what type of receipts are included in gross receipts, what items are deductible in determining net income,

what items are included in capital and so on. From this computed state tax base several Apportionable Base Adjustments are deducted to determine the Apportionable Base, which then is to be apportioned among the various taxing states. The Apportionable Base Adjustments are as follows:

(1) Net income, gross income, gross receipts, capital or other base which, under the laws of the taxing state, is determined to be attributable to the conduct of business at an office maintained outside any state. However, the Recommendation neither prohibits nor sanctions the taxation of such items.

(2) Net income, gross income, gross receipts, capital or other base of foreign corporations. Any tax base attributable to a foreign corporation is excluded from the Apportionable Base. However, net income, gross income, gross receipts or capital attributable to an agency or branch of a foreign depository is located in a state if under the laws of that state such item is determined to be derived from or attributable to the conduct of business within the state.

The Apportionable Base concept, therefore, involves the least possible intrusion into the taxing systems of the various states, while at the same time it provides assurance that the tax base will be taxed only to the extent of 100 percent.

Under the Recommendation, the combined reporting provisions apply only to determine the maximum Apportionable Base of an affiliated group attributable to a taxing jurisdiction under certain circumstances. They do not require states to change the type or form of return required or to permit combination or consolidation if they choose not to do so. Under the Recommendation, if the domiciliary state requires combined or consolidated reporting, the depository may choose to determine the federal maximum of the affiliated group and any of its members by reference to the combined base and apportionment factors of the affiliated group. Otherwise, only if the taxing jurisdiction requires combination or consolidation is the maximum Apportionable Base attributable to that jurisdiction determined by reference to the base and factors of an affiliated group. In any event, where combined base and apportionment rules are applicable, either under the law of the taxing state, or as elected by the depository, the factors and Apportionable Base of the entire affiliated group are used to determine the maximum base of the group attributable to the taxing state.

The Recommendation defines affiliated corporation and affiliated group with reference to section 1563 of the Code, with the exception that a fifty-percent test is substituted for the eighty-percent test, and insurance companies as defined in subchapter L of the Code are excluded. An affiliated group is defined to include all corporations affiliated with a depository if the sum of either the payroll or receipts factors attributable to depository members of the group account for at least twenty percent of either of the factors of the entire group.

Various members of the originating committee have been or are employed by institutions interested in accomplishing the goals of the Recommendation. However, because the Recommendation is to be given only prospective application, clients would not be affected in any pending matters concerning years prior to the effective date.

#### PROPOSED STATUTORY LANGUAGE

*RESOLVED that the Section of Taxation implement the foregoing by urging the following amendments, or their equivalent in purpose and effect, on the proper committees of the Congress:*

Sec. 1. Title 12 of the United States Code is amended by the addition of new sections 571 through 577 providing as follows:

#### § 571. JURISDICTION TO TAX

(a) No State or political subdivision thereof shall impose any doing business tax on a depository unless such depository has a business location in the state or political subdivision during the taxable year.

(b) No State or political subdivision shall impose taxes on any depository not having its principal office within the State if such taxes are more burdensome than the taxes which would be imposed if the depository had its principal office within the taxing State.

#### § 572. DEFINITIONS

For purposes of sections 571 through 577 of this title, the following definitions shall apply:

(a) **AFFILIATED CORPORATIONS.** — Corporations shall be considered "affiliated corporations" if they qualify as members of a "controlled group" within the meaning of section 1563(a) of the Internal Revenue Code of 1954, except that the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears therein, and section 1563(b)(2) of the Internal Revenue Code of 1954 shall not apply. No corporation which qualifies as an insurance company under section 801 of the Internal Revenue Code of 1954 shall be considered affiliated with any other corporation.

(b) **AFFILIATED GROUP.** — An "affiliated group" consists of the group of all affiliated corporations of which a depository is a member if the sum of either the payroll or receipts factor of all depository members, as defined in sections 574 and 575 of this title, respectively, exceeds 20 percent of either the combined payroll or receipts factor of the entire group.

#### (c) **BUSINESS LOCATION.** —

(1) **GENERAL RULE.** — A depository has a "business location" in a State in a taxable year only if:

(A) such depository maintains an office in such State;

(B) one or more employees of the depository has or have a regular presence in such State; or

(C) such depository leases tangible property located in such State in a transaction which is a true lease, or otherwise owns tangible property located in such State which it uses in connection with its activities within the State.

(2) **EXCEPTIONS FROM GENERAL RULE REGARDING PRESENCE OF EMPLOYEES.** — For purposes of this subsection no employee shall be deemed to have a regular presence in a State if the only activities engaged in by such employee within the State are, or are in connection with, one or more of the following:

(A) acquisition or purchase of loans, secured or unsecured, or any interest therein from one or more independent contractors;

(B) business activities in the State of one or more independent contractors, including but not limited to the collecting and servicing of loans in any manner whatsoever;

(C) participation in loans made by other depositories having offices in the State;

(D) soliciting applications for loans which are sent outside the State for approval, deposits which are received and maintained at an office outside the State, or financial or depository services which are performed outside the State; or

(E) making credit investigations and physical inspections and appraisals of real and personal property securing or proposed to secure any loan.

(3) EXCEPTIONS FROM BUSINESS LOCATION. — A depository shall be deemed to have a business location in a nondomiciliary State only if it has more than \$1,000,000 of either payroll or receipts attributable to such State under section 574 or 575 of this title. Notwithstanding any other provision of this title, a depository shall not be deemed to have a business location in a State if the only activities of the depository in the State are, or are in connection with:

(A) maintaining or defending any action or suit; or  
(B) filing, modifying, renewing, extending or transferring a mortgage, deed of trust, or security interest; or

(C) acquiring, holding, leasing, mortgaging, foreclosing, contracting with respect to, or otherwise protecting or conveying property in the State as a result of default under the terms of a mortgage, deed of trust, or other security instrument relating thereto; or  
(D) acting as executor of an estate, trustee of a benefit plan, employees' pension, profit-sharing or other retirement plan, testamentary or inter vivos trust, corporate indenture, or in any other fiduciary capacity, including but not limited to holding title to real property in the State.

(d) DEPOSITORY. — A "depository" is an institution the deposits or accounts of which are insured under the Federal Deposit Insurance Act or by the Federal Savings and Loan Insurance Corporation, any institution which is a member of a Federal Home Loan Bank, any other bank or thrift institution incorporated or organized under the laws of a State or any foreign country which is engaged in the business of receiving deposits in the United States, any corporation organized under the provisions of sections 611 to 631 of this title (Edge Act Corporations), and any agency of a foreign depository as defined in section 3101 of this title.

(e) DOING BUSINESS TAX. — A "doing business tax" is any tax imposed by a State or political subdivision thereof except sales and use tax, real property tax, documentary tax, tangible and intangible personal property tax, payroll tax, and excise tax upon the ownership, use or transfer of tangible or intangible personal property. The term "doing business tax" shall include any tax imposed on a shareholder or depositor of a depository on his interest as a shareholder or depositor which is paid by the depository and not reimbursed to the depository by such shareholder or depositor.

(f) DOMICILIARY STATE. — The State in which a depository's principal office is located is its "domiciliary State." In the case of a corporation which is not a depository, the term "domiciliary State" means the State in which such corporation has its commercial domicile. In the case of an Edge Act Corporation, the term "domiciliary State" means the State designated as the place where the home office is to be located in its organization certificate made pursuant to section 613 of this title. In the case of a branch or agency of a foreign depository, the term

"domiciliary State" means the State designated as the principal office pursuant to section 3101 of this title, and the applicable regulations thereunder.

(g) EMPLOYEE. — Any individual to whom wages are paid within the meaning of section 3401 of Title 26 is an "employee."

(h) INDEPENDENT CONTRACTOR. — An "independent contractor" is any individual, corporation, partnership, voluntary association, trust or other entity engaged in business (1) on behalf of itself and one or more principals, or (2) on behalf of two or more principals. Such term does not include an employee or any affiliated corporation.

(i) MAINTAINS AN OFFICE. — A depository "maintains an office" wherever it has established a regular, continuous and fixed place of business.

(j) ORIGINATION OF LOANS AND FINANCING TRANSACTION. — A loan is deemed to have originated in the State in which the principal activities associated with making the loan are performed. If a depository maintains an office within a State, the principal activities associated with loans made to borrowers residing or having their commercial domicile within the State are deemed to have been performed at such office within the State.

(k) PROPERTY LOCATED IN A STATE. —

(1) GENERAL RULE. — Except as otherwise provided in this section, tangible property, including leased property, shall be deemed to be located in the State in which such property is physically situated.

(2) MOVING PROPERTY. — Tangible personal property which is characteristically moving property, such as motor vehicles, rolling stock, aircraft, vessels, mobile equipment, and the like, shall be deemed to be located in a State if:

(A) the operation of the property is entirely within the State, or the operation without the State is occasional or incidental to its operation within the State; or

(B) the operation of the property is in two or more States, but the principal base of operations from which the property is sent out is in the State; or

(C) if there is no principal base of operations and the operation of the property is in two or more States, the State which is the commercial domicile of the lessee or other user of the property.

(l) REGULAR PRESENCE OF EMPLOYEES. — An employee shall be deemed to have a regular presence in a State if:

(1) a majority of the employee's service is performed within the State, or  
(2) if a majority of the employee's service is not performed in any one State, then in the State in which the office is located from which his activities are directed or controlled.

(m) SECURITIES. — United States Treasury securities, obligations of United States Government agencies and corporations, federal funds sold, clearinghouse funds sold, securities purchased under agreements to resell, commercial paper, purchased certificates of deposit, obligations of States and political subdivisions, corporate stock and other securities, participations in securities backed by mortgages held by United States or State government agencies, and similar obligations.

(n) STATE. — Any of the several States of the United States, the District of Columbia, the Commonwealth of Puerto Rico, and any territory or possession of the United States.

(o) TAXABLE YEAR. —

(1) Unless the laws of a State require a corporation to prepay a tax imposed on, according to, or measured by income, the calendar year, fiscal year or other period upon which its taxable income is computed for purposes of federal income tax.

(2) If the laws of a State require prepayment of a tax, the calendar year, fiscal year or other periods upon which the tax base is computed under the laws of such State.

(p) TRUE LEASE. — A true lease is any leasing transaction in which the lessor is treated as owner of the leased property for federal tax purposes. All other leasing transactions shall be treated as loans for purposes of sections 572, 575 and 576 of this title.

**§573. MAXIMUM AMOUNT OF INCOME, RECEIPTS OR CAPITAL ATTRIBUTABLE TO TAXING JURISDICTION**

(a) No State may impose any doing business tax upon the Apportionable Base of a depository in excess of the Apportionable Base attributable to the State determined by multiplying such depository's Apportionable Base by a fraction, the numerator of which is the sum of the payroll factor and the receipts factor, and the denominator of which is two.

(b) APPORTIONABLE BASE. —

(1) The Apportionable Base of a depository shall be its net income, gross income, gross receipts, capital or other tax base for the taxable year as determined under the laws of the taxing State before apportionment or allocation within and without the taxing State, and before determining what items are business or nonbusiness; provided, however, there shall be excluded from Apportionable Base:

(A) net income, gross income, gross receipts, capital or other tax base which under the laws of the taxing State is determined to be attributable to the conduct of business at an office maintained outside any State; and

(B) except as provided in paragraph (2) below, net income, gross income, gross receipts, capital or other tax base recorded on the books or records of any corporation organized under the laws of any jurisdiction other than the United States or any State.

(2) The Apportionable Base of an agency or branch within the meaning of section 3101 of this title shall be its net income, gross income, gross receipts, capital or other tax base which under the laws of the taxing State is determined to be derived from, or attributable to the conduct of business at an office within a State.

**§574. PAYROLL FACTOR**

(a) IN GENERAL. — The payroll factor is a fraction, the numerator of which is the total wages paid in the State and the denominator of which is the total wages as defined in section 3401 of Title 26 paid in all States.

(b) LOCATION OF COMPENSATION. — Wages are paid in a State if paid to an employee having a regular presence therein.

(c) WAGES EXCLUDED FROM NUMERATOR AND DENOMINATOR. — Neither the numerator nor the denominator of the payroll factor shall include wages paid to an employee having a regular presence in a State without jurisdiction to tax. **§575. RECEIPTS FACTOR**

(a) IN GENERAL. — The receipts factor is a fraction, the numerator of which is total receipts located in the State and the denominator of which is the total receipts located in all States.

(b) LOCATION OF RECEIPTS. —

(1) All receipts from loans secured primarily by real property are located in the State in which the predominant part of the security real property is or will be located. All receipts from other loans are located at the place of origination except as otherwise provided. Receipts from loans do not include principal repayments.

(2) All receipts from performance of services are located in a State to the extent the services are performed in the State. If services are performed partly within two or more States, the receipts located in each State shall be measured by the ratio which the time spent in performing such services in the State bears to the total time spent in performing such services in all States. Time spent in performing services in a State is the time spent by employees located in the State in performing such services.

(3) Receipts from true lease transactions are located in the State in which the leased property is deemed located.

(4) Interest or service charges from bank, travel and entertainment card receivables and credit card holders' fees are located in the State in which the credit card holder resides in the case of an individual or, if a corporation, in the State of the corporation's commercial domicile.

(5) Merchant discount income derived from credit card holder transactions with a merchant are located in the State in which the credit card holder resides, if an individual, or has its commercial domicile, if a corporation.

(6) Interest, dividends and net gains from sale or disposition of securities are located in the State in which the depository maintains an office which treats such securities as assets on its books or records.

(7) Fees or charges from the issuance of travelers checks and money orders are located in the State in which such travelers checks or money orders are issued.

(c) RECEIPTS EXCLUDED FROM NUMERATOR AND DENOMINATOR. — All receipts not described in paragraphs (1) through (7) of subsection (b) and all receipts located in a State without jurisdiction to tax shall be excluded from both the numerator and denominator of the receipts factor.

**§576. COMBINED AND CONSOLIDATED REPORTING**

In determining the maximum Apportionable Base attributable to a taxing State for purposes of the limitations imposed by section 573 of this title, the following rules apply:

(a) If any taxing State requires a member of an affiliated group to determine its doing business taxes by reference to the combined or consolidated base of the affiliated group or any of its members, the provisions of section 573 of this title shall apply to the affiliated group in that State.

(b) If the domiciliary State of a depository which is a member of an affiliated group requires the depository to determine its doing business taxes by reference to

the combined or consolidated base of the affiliated group or any of its members, section 573 of this title shall apply to determine the maximum Apportionable Base of the affiliated group attributable to each State in which such depository or other member of the affiliated group is taxable. However, if two or more depositories are members of the affiliated group, the Apportionable Base attributable to the domiciliary State of each depository shall be computed by reference to the combined or consolidated base of the affiliated group only if such State would determine the doing business taxes of the domiciliary depository by reference to such combined or consolidated base.

(c) In applying the provisions of section 573 of this title pursuant to subsections (a) and (b) hereof to an affiliated group, the Apportionable Base and apportionment factors of the entire affiliated group are to be used in calculating the maximum Apportionable Base of the group attributable to a taxing State.

(d) In determining the Apportionable Base of an affiliated group, dividends from members of the affiliated group and investments in or advancements to affiliated corporations by members of the affiliated group are to be eliminated.

(e) In computing the payroll and receipts factors for any taxing State, only those factors attributable to taxpayers over which the taxing State has jurisdiction shall be included in the numerator.

(f) No State may require or permit the determination of the doing business taxes of a depository by reference to the combined or consolidated base of corporations unless they are members of an affiliated group of which such depository is also a member.

#### §577. POLITICAL SUBDIVISIONS

(a) For purposes of determining whether a depository is taxable in a political subdivision, or whether payroll or receipts are located in a political subdivision, appropriate provisions of this Act shall be applied by treating each reference therein to a State as a reference to a political subdivision.

(b) The maximum income, receipts, capital, or other base attributable to a political subdivision for tax purposes shall be determined under this title in the same manner as though such political subdivision were a State.

Sec. 2. Section 627 of this title is hereby repealed.

Sec. 3. The amendments made by Secs. 1 and 2 shall apply to taxable years beginning after December 31, 1987.

#### EXPLANATION OF PROPOSED STATUTORY LANGUAGE

Conforming and clerical amendments have not been made.

## REPORT OF THE NOMINATING COMMITTEE

The Nominating Committee hereby makes and reports nominations for the following offices, for election at the 1981 Annual Meeting.

#### Chairman-Elect:

M. Bernard Aidinoff, New York, New York

#### Vice-Chairmen:

Hugh Calkins, Cleveland, Ohio

John B. Jones, Jr., Washington, D.C.

James B. Lewis, New York, New York

Charles B. Stacy, Charleston, West Virginia

#### Secretary:

Albert C. O'Neill, Jr., Tampa, Florida

#### Council:

*For the three-year terms ending 1984:*

Richard A. Freling, Dallas, Texas

Stephen J. Martin, San Francisco, California

Jere D. McGaffey, Milwaukee, Wisconsin

Under the By-Laws, the present Chairman-Elect, John S. Nolan, Washington, D.C., will automatically become Chairman.

Respectfully submitted,

LIPMAN REDMAN, Chairman

**EXHIBIT K: 4**

**American Bar Association, State and Local Tax Committee, "Review of the  
MTC Statutory Proposal for Apportionment and Allocation of Net Income of  
Financial Institutions"(May 10, 1993)**



AMERICAN BAR ASSOCIATION  
STATE AND LOCAL TAX COMMITTEE  
AUGUST 6, 1993

REVIEW OF THE  
MTC STATUTORY PROPOSAL FOR  
APPORTIONMENT AND ALLOCATION OF  
NET INCOME OF FINANCIAL INSTITUTIONS  
DATED MAY 10, 1993

SECTION 1: IMPOSITION OF FRANCHISE TAX

Section 1 of the MTC proposal imposes a franchise tax measured by net income on every financial institution for the privilege of doing business in the state and for exercising its franchise. The MTC has chosen a franchise tax so that income earned from federal obligations could be subject to tax.

Industry's understanding of the MTC's proposal is that it will either replace an apportionment and allocation statute in an existing taxing statute, or become the apportionment and allocation statute in an existing taxing statute that has no apportionment or allocation methodology for financial institutions. Since this proposal should not be the basis for changing from an income tax to a franchise tax, industry believes that this section of the proposal should be deleted and the proposal should deal only with apportionment and allocation.

the taxpayer's state of commercial domicile. Therefore, "state" should be defined to mean a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States or any foreign country.

The second significant change that should be made in the definition section relates to the definition of "taxable in another state." Because the word "taxable" (and not "taxable in another state") is used when determining whether a taxpayer may apportion and whether the throwback rule applies, the definition should be of the word "taxable." In addition, the definition of "taxable" should be changed. In particular, subsection (2) should be rephrased to read "subject to the jurisdiction of another state to impose such a tax regardless of whether, in fact, the state does or does not do so." This should ensure that the ability to tax by the other state is not limited to its ability to impose a net income tax.

Finally with regard to the definitions section, note that there is no definition of "financial institution" proposed at this time. However, Appendix B contains a definition for purposes of comment and consideration. The banks are concerned with two aspects of any final definition: first, we would like to ensure that all members of a bank holding company's affiliated group are subject to the same apportionment rules so that we only need to maintain one set of records and systems; and second, that non-bank entities that

the state when the property is first placed in service by the lessee.

With respect to movable tangible personal property owned by the taxpayer, receipts from the lease or rental of such property are included in the numerator to the extent the property is used in the state. The proposal provides for 2 rules as to "use in the State": aircraft is deemed to be used in the state based on the number of landings of the aircraft in the state; and motor vehicles are deemed to be used entirely in the state in which they are registered. If the extent of the use of any type of movable tangible personal property within the state cannot be determined, then the property is deemed to be used wholly in the state in which the property has its "principal base of operations" (defined for this purpose as the place of more or less permanent nature from which moveable property is regularly directed or controlled).

Moving to receipts from loans, the term "loan" is defined as any extension of credit resulting from direct negotiations between the taxpayer and its customer, and/or the purchase, in whole or in part, of such extension of credit from another. The term includes participations, syndications and leases treated as loans for tax purposes. The term DOES NOT include loans representing property acquired in foreclosure under IRC section 595, futures or forward contracts, options, swaps, credit card receivables, non-interest bearing balances due from depository institutions, fed funds sold,

of interest from such loans if the borrower is located in the state (i.e., either based on commercial domicile or billing address).

The numerator of the receipts factor includes net gains from the sale of loans secured by real property based on the same in-state percentage as determined when sourcing interest from loans secured by real property. Likewise, for net gains from the sale of loans not secured by real property, the amount of such gains included in the numerator is determined by multiplying the net gains by the same percentage as determined when sourcing interest from loans not secured by real property.

Moving to receipts related to credit cards, the numerator includes interest and fees or penalties in the nature of interest from credit card receivables, and receipts from fees charged to cardholders, if the billing address of the cardholder is in the state. In addition, net gains from the sale of credit card receivables are sourced by using the same percentage as determined when sourcing interest, etc. from credit card receivables.

As for credit card issuer's reimbursement fees (defined as the receipt a taxpayer receives from a merchant's bank because one of the taxpayer's credit card holders has charged merchandise or services to the card), the numerator includes total credit card issuer's reimbursement fees multiplied by the same percentage as determined when sourcing interest, etc. from credit card

Probably the most complicated sourcing rule and the most difficult to write for both the state and the industry members is the rule that sources receipts from investment and trading assets and activities. The rule is broken down into five subsections. The first subsection defines investment assets and activities and trading assets and activities. These assets and activities include, but are not limited to, investment securities, trading account assets, fed funds, securities purchased and sold under agreements to resell or repurchase, options, futures contracts, forward contracts, notional principal contracts, equities and foreign currency transactions.

While the receipts factor includes interest, dividends, net gains and other income from investment and trading assets and activities, the receipts factor includes only net income from certain such assets and activities. With respect to fed funds and securities repos, the receipts factor includes the amount by which interest from fed funds sold and securities purchased under resale agreements exceeds interest expense on fed funds purchased and securities sold under repurchase agreements. In addition, the receipts factor includes income from trading assets and activities such as assets and activities in the matched book, in the arbitrage book, and foreign currency transactions, only to the extent such income exceeds net losses from such assets and activities. Note that since the intention here was to include certain income only to the extent it exceeds certain expenses, we have requested that

(other than amounts sourced under the other 2 rules) that is to be included in the numerator is determined by multiplying the net amount described earlier by a fraction, the numerator of which is the average value of such trading assets which are properly booked at a regular place of business of the taxpayer in the state and the denominator of which is the average value of all such assets.

The third subsection of this sourcing rule provides an alternative sourcing method that the taxpayer may elect, or the state tax administrator may require, in order to fairly represent the business activity of the taxpayer in the state. This method is based on the gross income of the various assets and activities as opposed to the average value of the assets. The fourth subsection provides that if this alternative method is used, it must be used on all subsequent returns unless the taxpayer receives prior permission to change or the state tax administrator requires the use of a different method.

Finally, the fifth subsection provides that the taxpayer has the burden of proving that an investment or trading asset or activity was properly booked at a regular place of business outside the state by demonstrating that the day to day decisions regarding the asset or activity occurred at a regular place of business outside the state. If the day to day decisions are made at more than one regular place of business, then the asset or activity is considered located at the regular place of business where the investment or

state during the taxable year and the denominator is the average value of all such includible property located and used both within and without the state during the taxable year. The proposal contains a footnote that is intended to clarify the term "located and used." With respect to intangibles that are sourced, location will control, and their use (e.g., where the proceeds are applied) is neither relevant nor operative. Rather than the footnote, industry has provided Alan with suggested language to be inserted in the text of the proposal that we believe is necessary to ensure proper application of this intention.

The average value of property owned by the taxpayer is computed by taking the value at the beginning of the taxable year and the value at the end of the taxable year and dividing the sum by 2. The State tax administrator may require averaging on a more frequent basis if the beginning and end of year method does not properly reflect average value. In addition, the taxpayer may elect to average on a more frequent basis. In either case, once a more frequent method is used, the same method must be used subsequently unless the taxpayer receives permission to change or the State tax administrator requires a change.

The value of real and tangible personal property owned by the taxpayer is the original cost or other basis of such property without regard to depletion, depreciation or amortization.

properly booked at a regular place of business of the taxpayer within the state. A "regular place of business" is defined as an office at which the taxpayer carries on its business in a regular and systematic manner and which is continuously maintained, occupied and used by employees of the taxpayer. If a loan is properly booked at a place which is not a regular place of business of the taxpayer and the taxpayer is organized under the laws of the US or of any state, then the loan is located in the state of the taxpayer's commercial domicile. Several other presumptions apply with respect to sourcing loans of a taxpayer organized under the laws of a foreign country when such loans are properly booked at a place which is not a regular place of business of the taxpayer.

A loan is deemed to be properly booked in the state in which the loan has a preponderance of substantive contact. The phrase "preponderance of substantive contact" is not defined in the proposal and it has been suggested by the states and industry that any further definition be left for regulations supporting the statute. However, Appendix D of the proposal contains a suggested regulation which happens to be very similar to New York's regulation under Article 32 that provides rules for determining where the greater portion of income-producing activity relating to a loan occurred. Pursuant to the provisions of the appendix, in evaluating the preponderance of substantive contact test, consideration is given to such things as solicitation, investigation, negotiation, approval and administration. The



the computation of the taxpayer's apportionable income tax base for the taxable year (e.g., with respect to a foreign taxpayer, generally only payroll related to effectively connected income is included). In addition, compensation of an employee connected with the production of non-business income is excluded from the numerator and denominator of the payroll factor as are payments made to independent contractors.

Compensation is "paid in the state" if the employee's services are performed entirely in the state. However, if the employee's services are performed in more than one state, but the services performed outside one particular state are incidental to the services performed in that particular state, then the compensation is deemed to be paid in that particular state. If the employee's services are performed in more than one state and the services performed outside one particular state are not incidental to the services performed in that particular state, then the compensation is sourced to the state in which the employee's principal base of operations is located. Finally, several further rules are provided if, after going through all these tests, you haven't yet determined whether compensation belongs in the numerator of the payroll factor. If there is no principal base of operations in any state in which some of the services are performed but the place from which the services are directed or controlled is in a state in which some of the services are performed, then the compensation is sourced to the state in which the services are

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### **Strengths and Weaknesses of Dual Regulation**

Because there is more than one regulator of banking activity, there naturally occurs some conflict due to jurisdictional overlap. Although there is at times some tension between federal and state levels of regulation, there seems to be more documented cases of

"turf battles" among the various federal regulators. At the state level the larger issue is that state control of banks will be preempted by federal legislation. At present, one source of state/federal tension is the states' control of the securities activities of state-chartered nonmember banks. The only federal restriction at this point is an FDIC rule that requires nonmember banks to house their securities activities in a subsidiary of the bank. However, a 1988 Proxmire-Garn bill, designed to repeal the Glass-Steagle Act, would require among other things that all banks engaging in securities activities become subject to the Federal Reserve Board's regulatory and supervisory authority. The bill died in the House, but is due to be reintroduced.

The dual banking system has also been criticized as promoting competition in laxity. This view argues that competition among federal and state regulators for control over larger shares of the industry has resulted in continual relaxing of regulations to attract banking firms.

The major strength of the dual banking system, that some argue outweighs the detriments, is that it provides flexibility that encourages innovation and experimentation. In a rapidly changing industry states play the role of laboratories for innovation. New technologies, products or procedures can be implemented on a small scale without major upheaval to the industry, and then adopted on a larger scale if found useful. It has also been argued that the dual banking system provides a check against excessive regulation since banks can escape the regulation of one level of government

by transferring to the jurisdiction of the other. Moreover, the dual system allows states to tailor the type of banking structure within its boundaries to its own needs, a fundamental principle of federalism.

#### **B. Tax Issues and Policy Implications**

Historically, the power to allow entry of out-of-state banks has been left up to the individual states, but only in the 1980's have states begun to relax restrictions against interstate banking. State bank tax laws however have failed to keep pace with the rapid rate of change in the industry. Based as they are on the outdated premise that each bank is doing business in, and is taxed by, only one state, there may emerge cases of multiple taxation of income. In addition, as banks become active in securities, real estate and insurance, and nonbank firms begin taking deposits and making loans, consistent tax treatment of the competing entities is called for. Historically, this has not been the case as banks at times have received favorable tax treatment (eg. as with the exemption of income from federal obligations), but have also been more strictly regulated as noted above.

In trying to adapt their tax systems to the new banking environment, further difficulties will arise for states when trying to identify the proper tax base on which to levy taxes. For example, the advent of branchless banking through automatic teller machines means that banks can undertake business in a state without actually having a physical presence in the state. Traditionally,

a physical presence, property or personnel, has been an important component of the typical business tax base. Also, the loan securitization phenomenon means that a state loses jurisdiction over the interest income once the loans are sold, and another state, depending on its tax formula, may not entirely recapture this income. This opens the door for potentially widespread tax avoidance maneuvers.

### The 1975 ACIR Study

Congress has long been uneasy about the effects of state taxation of out-of-state banks, and until 1976 had a moratorium on state taxation of out-of-state national banks. In 1973 Congress directed the ACIR to undertake a "study of all pertinent matters relating to the application of state "doing business" taxes on out-of-state commercial banks, mutual savings banks and savings and loan associations." The study suggested five policy options:

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A statute permitting only the home state to tax depositories, and prohibit all "doing-business" taxes on out-of-state depositories.

A statute to compel uniformity of tax burdens by imposing a federally-collected tax that would be redistributed to the states, or to allow a credit of state taxes against the Federal tax.

A statute requiring only that out-of-state banks not be

discriminated against in favor of home banks under a state's tax laws.

This final like-treatment option had earlier been passed into law and would take effect when the moratorium expired. The ACIR recommended prescribing some specific negative guidelines, but Congress failed to act and the like-treatment rule is the only statutory restriction on state taxation of out-of-state banks that prevails today.

#### Apportioning Multistate Bank Income

As banking expands across state borders, the natural response is to initially view banks as any other corporation that does business in more than one state. Although there are a number of ways to structure a corporation tax, nearly all states use a method of source-based formulary apportionment of income. Under this method a state apportions a percentage of the corporation's total income to itself; usually this percentage is determined by the percentage of the property, payroll and sales located in the state. Then the tax is applied to this portion of the corporation's income. The difficulty with this form of taxation is that states differ in what they include in their apportionment formulas, which can lead to overlapping taxation of income and nonuniformity of tax burdens across states. For the banking sector these problems are magnified because of the intangible nature of a bank's products, the ease with which a bank can carry out operations without a substantial physical presence and because of the ability of banks

to shift income producing assets to low tax locations (eg. through selling securitized loans to a subsidiary).

Furthermore, an apportionment formula that generates the most revenue from a home bank will typically generate the least revenue from out-of-state banks. For example, putting relatively greater weight on receipts will typically generate the most revenue from out-of-state banks, but putting greater weight on property and payroll will usually generate the most revenue from home banks. A state with many home banks will have an incentive to use an apportionment formula very different than a state with many out-of-state banks, creating different tax structures across states and potentially a wasteful shifting of banking firms.

Another method of corporate income taxation is a source-based tax with separate accounting. The separate accounting method of assigning income to the state is to treat all business activity carried out by the corporation within the state as if it were undertaken by a single independent entity and to count this as the income attributable to the state for tax purposes. However, many corporations are horizontally or vertically integrated across states and the costs of transactions between departments must then be determined in order to derive the income generated in a particular state. The accounting procedures necessary for these types of calculations are typically complicated and prohibitively costly, and such problems are likely to be particularly acute for the banking industry.

Bank income could also be taxed according to pure residence-



based tax principles. Under these principles a tax is applied only on home banks and levied on the banks full income no matter where the source. Any bank doing business in the state, but chartered or incorporated elsewhere, pays no tax at all to the state. Although this tax has the benefit of simplicity, it has the detriment of providing an unfair advantage to out-of-state banks relative to home banks. If this continued as the prevailing method of bank taxation, one could imagine all banks choosing the lowest tax state as their home base and carrying out only branch activities in other states. Furthermore, since other financial corporations that compete with banks tend to be taxed according to source based principles, taxing banks according to residence-based principles may cause unequal treatment of firms. Finally, it is clear that if some states tax banks according to residence based principles while others tax according to source-based principles, there will occur complicated overlapping of tax bases and multiple taxation of income.

McCray advocates that states use a dual system of taxation. Under this system a state levies its tax on the entire income of domestic banks, and uses an apportionment formula to measure the fraction of income of out-of-state banks on which to levy its tax. Then a credit is provided to the domestic banks for the taxes paid to other states; the amount of the credit can not exceed the amount that would have been paid by the domestic bank on its out-of-state income had that income been taxed at the home state's tax rate. According to McCray this tax structure has the benefit of being

relatively simple to administer and avoids problems of multiple taxation. It will also eliminate the problem of states choosing apportionment formulas that favor domestic banks, since the apportionment formula will only apply to out-of-state banks. Moreover, the state levies the same tax rate on the domestic bank's income and the out-of-state bank's apportioned income, so there is some notion of neutral taxation of banks doing business within the state. Also the potential for tax avoidance with securitized loans will be reduced under the dual system since all income not taxed by some state will be imputed to the home state.

An important advantage of the dual system of taxation is that it should lead toward some degree of uniformity in apportionment formulas across states. Most states will probably choose to use a single-factor receipts formula, since only the income of out-of-state banks will be apportioned. The difficult question of how states identify and define this factor still remains, however. A state must not only be able to identify the existence of a bank's activities within its boundaries, but to detect the extent of those activities as well. One way to achieve this may be to require any out-of-state financial corporation soliciting business within the state to file a report indicating the portion of its income and assets attributable to the state.

McCray notes two political handicaps for the dual system, however. First, it requires states to adopt a tax structure different from the one currently in use, and second it closes many tax loopholes that allow banks to assign large portions of their

taxable income to low tax states while doing business in higher tax states.

This brief can only be considered a summary of some preliminary insights into these complex and important issues. The rapid changes taking place in the banking industry imply that fifty states will be simultaneously attempting to adapt their regulatory and tax structures to the changing circumstances. The job of the monitoring and working group will be to gear states and the federal government toward a nationwide set of state taxes that is fair, easy to administer and efficient in the sense that it will not cause great behavioral changes by potential tax payers trying to avoid the tax; and that retains the autonomy of the states. The variation in tax structures across states, that is characteristic of a federal system of government, does have greater administrative and efficiency costs than would a uniform federal tax, but these costs provide the benefits of allowing many diverse states to meet the distinctive needs of their populations and business sectors.

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