

EXHIBIT K: 5

Ames, Joanne (American Bankers Association), Outline on "Comparison of Nexus or 'Doing Business' Statutes for Financial Institutions" (undated)

253

6

253

**COMPARISON OF NEXUS or "DOING BUSINESS"
STATUTES FOR FINANCIAL INSTITUTIONS**

MINNESOTA

*Affects bank holding companies, national or state banks, specialized lending corporations, credit card companies and corporations engaged in lending activities and meet a 50% gross income test (i.e. 50% of its gross income is derived from lending activities).

- I. Physical Presence
 - A. Place of business
 - B. Owns or leases property in state
 - C. Employees in state
- II. Obtains Business within State -- subject to a rebuttable presumption
 - A. Transactions with customers in state involving intangible assets valued at \$5,000,000 or more during any tax period;
 - B. Deposits from customers in state valued at \$5,000,000 or more;
 - C. Any combination of A or B totaling \$5,000,000 or more; or
 - D. Obtains business in state from 20 or more customers during tax period.
- III. Regularly Solicits Business within State
 - A. Targeted and focused solicitation by advertising in media or directly via mail, phone, or other electronic means
- IV. Business Activities Reporting Requirement

INDIANA

*Affects any holding company, regulated financial corporation, foreign bank or subsidiary that derives more than 80 percent of its gross income from making, acquiring, selling or servicing loans or extensions of credit; leasing or acting as an agent for leasing of real or personal property; or operating a credit card business.

- I. Physical Presence
 - A. Maintains an office in Indiana
 - B. Has an employee, representative or independent contractor conduct business
 - C. Owns or leases property located in Indiana
- II. Regularly sells to customers in Indiana that receive products or services in Indiana
- III. Regularly Solicits Business from within Indiana
 - A. Conducts activities with 20 or more persons within Indiana during the taxable year; or

B. Sum of assets and absolute value of deposits attributable to Indiana are \$5,000,000 or more.

IV. Regularly performs services outside Indiana that are consumed within Indiana

V. Regularly engages in transactions in Indiana that involve intangible property and result in receipts flowing to the taxpayer from within Indiana

VI. Regularly solicits and receives deposits from customers in Indiana

VII. Business Activities Reporting Requirement

TENNESSEE

*Affects a holding company, any regulated financial corporation, a subsidiary of a holding company or regulated financial corporation, or any other corporation carrying on the business of a financial institution unless the income earned from the financial institution's business is less than 50% of the corporation's gross income.

I. Physical Presence

A. Maintains an office in Tennessee

B. Has an employee, representative or independent contractor conduct business

C. Owns or leases property located in Tennessee

II. Regularly sells to customers in Tennessee that receive products or services in Tennessee

III. Regularly solicits business from potential customers within Tennessee -- subject to rebuttable presumption

A. Sum of assets and absolute value of deposits attributable to Tennessee are \$5,000,000 or more

IV. Regularly performs services outside Tennessee that are consumed within Tennessee

V. Regularly engages in transactions in Tennessee that involve intangible property and result in receipts flowing to the taxpayer from within Tennessee

VI. Regularly solicits and receives deposits from customers in Tennessee

MULTISTATE TAX COMMISSION PROPOSAL

*Affects regulated financial corporations, corporations organized and operated similar to banks, trust companies and credit unions and corporations which derive more than 50 percent of their gross income from lending operations.

- I. Physical Presence
 - A. Has a place of business in state
 - B. Has employees, representatives, or independent contractors conducting business activities on its behalf
 - C. Owns or leases property in state
- II. Makes direct loan secured by real or tangible personal property in state
- III. Regularly solicits in this state which results in creation of a depository or direct debtor/creditor relationship with a resident of state
 - A. Regular solicitation = relationships with 100 or more residents during any tax period;
 - B. \$10,000,000 or more of assets attributable to sources within state; or
 - C. More than \$500,000 in receipts attributable to sources within state at anytime during the tax period.

Prepared by:

Joanne Ames, Esq.
American Bankers Association

COMPARISON OF APPOINTMENT FACTORS

MINNESOTA	INDIANA	TENNESSEE	MULTISTATE TAX COMMISSION PROPOSAL
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(MARKET-STATE SITUS RULES FOR DOMESTIC & NON-RESIDENT BANKS)	(DUAL SYSTEM OF TAXATION-- SOURCE-BASED TAXATION FOR NONRESIDENT BANKS)	(SOURCE-BASED TAXATION FOR BOTH DOMESTIC & NON-RESIDENT BANKS)	(MARKET-STATE SITUS RULES)
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70% OF RECEIPTS %	RECEIPTS %	RECEIPTS %	1/3 OF RECEIPTS %
15% OF PAYROLL %			1/3 OF PAYROLL %
15% OF PROPERTY %			1/3 OF PROPERTY %
(INCL. INTANGIBLES)			

COMPARISON OF SOURCING RULES FOR RECEIPTS

MINNESOTA	INDIANA	TENNESSEE	MULTISTATE COMMISSION PROPOSAL
(COMBINED REPORTING FOR BANKS ENGAGED IN UNITARY)	(COMBINED REPORTING REQUIRED FOR BANKS ENGAGED IN UNITARY)	(COMBINED REPORTING REQUIRED FOR BANKS ENGAGED IN UNITARY IN & OUT OF TN)	

RENTAL RECEIPTS- TRUE LEASES	REAL OR PERSONAL PROPERTY LOCATED IN STATE	REAL OR PERSONAL PROPERTY LOCATED IN STATE	REAL OR PERSONAL PROPERTY LOCATED IN STATE	REAL OR PERSONAL PROPERTY LOCATED IN STATE
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INTEREST FROM
SECURED LOANS

MN

SECURED REAL OR
PERSONAL PROPERTY
LOCATED IN STATE
(INCLUDING FINANCE
LEASES &
PARTICIPATIONS)

IN

SECURED REAL OR
PERSONAL PROPERTY
LOCATED IN STATE
(INCLUDING FINANCE
LEASES &
PARTICIPATIONS)

TN

SECURED REAL OR
PERSONAL PROPERTY
LOCATED IN STATE
(INCLUDING FINANCE
LEASES &
PARTICIPATIONS)

MTC

SECURED REAL OR
PERSONAL PROPERTY
LOCATED IN STATE
(INCLUDING FINANCE
LEASES &
PARTICIPATIONS)

INTEREST FROM
UNSECURED CONSUMER
LOANS

RESIDENCE OF
BORROWER

RESIDENCE OF
BORROWER

RESIDENCE OF
BORROWER

RESIDENCE OF
BORROWER

INTEREST FROM
UNSECURED COMMERCIAL
LOANS & INSTALLMENT
OBLIGATIONS

STATE WHERE LOAN
PROCEEDS ARE
APPLIED (INCLUDES
PARTICIPATIONS)

STATE WHERE LOAN
PROCEEDS ARE
APPLIED (INCLUDES
PARTICIPATIONS)

STATE WHERE LOAN
PROCEEDS ARE
APPLIED (INCLUDES
PARTICIPATIONS)

RESIDENCE OF
BORROWER
(INCLUDES
PARTICIPATIONS)

FEE INCOME AND
RECEIPTS FROM
LETTERS OF CREDIT
GUARANTEES, ETC.

STATE WHERE LOAN
PROCEEDS ARE
APPLIED

STATE WHERE
PROCEEDS ARE
APPLIED

INTEREST FROM
PARTICIPATION LOANS

(SEE SECURED
LOANS AND
COMMERCIAL LOANS)

(SEE SECURED
LOANS AND
COMMERCIAL LOANS)

(SEE SECURED
LOANS AND
COMMERCIAL LOANS)

(SEE SECURED
LOANS AND
COMMERCIAL LOANS)

CREDIT CARD
INTEREST AND
SERVICE CHARGES

STATE TO WHICH
HOLDER'S CHARGES
ARE BILLED

STATE TO WHICH
HOLDER'S CHARGES
ARE BILLED

STATE TO WHICH
HOLDER'S CHARGES
ARE BILLED

STATE TO WHICH
HOLDER'S CHARGES
ARE BILLED

MERCHANT DISCOUNT
INCOME

STATE IN WHICH
MERCHANT IS
LOCATED

STATE TO WHICH
CHARGES ARE BILLED

STATE TO WHICH
CHARGES ARE BILLED

STATE IN WHICH
MERCHANT IS
LOCATED

FIDUCIARY INCOME

STATE IN WHICH
SERVICES ARE
CONSUMED

STATE IN WHICH
SERVICES ARE
CONSUMED

STATE IN WHICH
SERVICES ARE
CONSUMED

	<u>MN</u>	<u>IN</u>	<u>TN</u>	<u>MTC</u>
OTHER SERVICES INCOME	STATE IN WHICH SERVICES ARE CONSUMED	STATE IN WHICH SERVICES ARE CONSUMED	STATE IN WHICH SERVICES ARE CONSUMED	STATE OF PERFORMANCE
LOAN RELATED FEES; DEPOSIT RELATED FEES; CHECK PROCESSING FEES				RESIDENCY OF BORROWER, DEPOSITOR, OR 3RD PARTY INSTITUTION
BROKERAGE FEES				LOCATION OF BROKERAGE ACCOUNT
ESTATE OR TRUST FEES				RESIDENCY OF EXECUTOR OR TRUSTEE
SALES OF TRAVELERS CHECKS AND MONEY ORDERS	STATE WHERE PURCHASED	STATE WHERE PURCHASED	STATE WHERE PURCHASED	STATE WHERE PURCHASED
SECURITIES(STATE)	SECURITIES OF STATE ATTRIBUTED TO ISSUING STATE	SECURITIES OF STATE ATTRIBUTED TO ISSUING STATE	SECURITIES OF STATE ATTRIBUTED TO ISSUING STATE	SECURITIES OF STATE ATTRIBUTED TO ISSUING STATE
SECURITIES (NONSTATE) AND MONEY MARKET INSTRUMENTS (INTEREST & TRADING)	ALLOCATED BASED ON DEPOSITS IN STATE	ATTRIBUTED TO STATE OF BANK'S COMMERCIAL DOMICILE		ALLOCATED BASED ON DEPOSITS IN STATE

CAF:misc datapoint md

Prepared by:

Joanne Ames, Esq.
 American Bankers Association

EXHIBIT K: 6

Brownell, Michael E. (California Franchise Tax Board), Comments submitted to John Kincaid of ACIR regarding draft of Report M-168 (see Exhibit K: 2) (August 30, 1988)

FRANCHISE TAX BOARD

Mailing address:

Legal Division

P.O. Box 1468

Sacramento, CA 95807-1468

(916) 369-3322

In reply refer to
410: MEB

August 30, 1988

Mr. John Kincaid
Advisory Commission on Intergovernmental
Relations
Washington, D.C. 20575

Dear Mr. Kincaid:

This letter is in response to your letter of August 4, 1988, in which you request comment on a draft report on "State Taxation of Banks: Issues and Options" by Sandra B. McCray.

Sandy's central thesis is that a residence based tax with a credit for taxes paid to other states, coupled with a source based tax for nonresident financial institutions (a so-called "dual system") is superior to a source based tax or a residence based tax. While this system does have some advantages (particularly from a tax administrator's point of view), there are some difficulties which should be explored and discussed.

1. Sandy asserts, in comparing a dual system with the comparable system at the federal level, that the dual system is more workable at the state level, because "states will seldom need rules to define what is a creditable tax." (p31) That assessment may prove somewhat optimistic. If a U.S. domestic bank lends to borrowers in a foreign country, and pays tax in that foreign country, to fairly allow the domestic state to tax the foreign source income under a dual tax system, some credit mechanism is needed for foreign taxes, imposed both at the national level and the subnational level of the foreign jurisdiction. If the foreign nation uses a tax base not entirely similar to the U.S. income system, the determination as to whether the tax is a creditable type of tax will still have to be made. In addition, some kind of source rule will have to be made to determine the limit of the foreign tax credit, since the credit is limited by the ratio of foreign source income over worldwide income. Either a world-wide receipts factor sourcing mechanism, or a U.S. source rule, or a foreign source rule will have to be invoked to determine that limit.

2. It is stated that the dual system does not suffer the infirmity of multiple taxation, given its credit mechanism for taxes paid to other states. However, in its place it suffers the infirmity of the state of domicile taxing income earned outside of its borders. To illustrate, if Bank X is domiciled in state A and derives income from doing business in state B, and state B does not impose a tax, under the dual system, state A will tax Bank X's income earned in both states A and B. While the draft argues that such a system would be constitutional, such a position raises serious policy questions as to whether it is appropriate for the state of the bank's domicile to tax extraterritorial income. These questions should also be discussed.

3. Discussion of the question as to whether it is constitutional for the state of the bank's domicile to tax extraterritorial income should be a part of this paper. The simple reference to Sandy's yet unpublished article on the subject is insufficient, since it is the major theoretical underpinning upon which the dual system is based.

4. The assertion that the dual system "does not create competitive inequality between in-state and out of state banks" (p 32) does not appear to be true. To illustrate, assume that Bank A is commercially domiciled in State X and Bank B is commercially domiciled in State Y. Both states have a dual system of taxation. Both banks derive \$50,000 of their income from activities in State X, and \$50,000 of their income from activities in State Y. The tax rate in State X is 5% and the tax rate in State Y is 10%. The corporations will pay tax as follows:

	Corporation A	Corporation B
State X:		
Income	\$100,000	\$50,000
Tax	\$5,000	\$2,500
Credit ^{1/}	(\$2,500)	0
Net Tax	\$2,500	\$2,500

^{1/} Limited by the ratio of foreign income to worldwide income multiplied by the tax paid in the state of domicile.

State Y:

Income	\$50,000	\$100,000
Tax	\$5,000	\$10,000
Credit ^{2/}	0	(\$2,500)
Net Tax	<u>\$5,000</u>	<u>\$7,500</u>

In the illustration, Corporation A, domiciled in State X, will pay a total combined tax of \$7,500 to both States X and Y, while Corporation B, domiciled in State Y, will pay a total combined tax of \$10,000. Thus, notwithstanding identical incomes in both states, Corporation A will pay higher tax than its competitor Corporation B. Thus, it cannot be said that the dual system "does not create competitive inequality". In fact, it can be argued that the dual system in the above illustration is not particularly fair. This also raises policy considerations which are deserving of some discussion.

5. The difference in tax effect between high and low tax states in such a system will tend to drive financial institutions to shift their commercial domicile to the low tax states, without affecting any change in their basic operations. The trend toward greater facility of interstate banking will make such a transition easier. The threat of higher taxes on domestic banks than similarly situated foreign banks that would exist in high tax rate states may make a dual system politically unpopular in such states. In addition, the specter of "bank flight" (although more apparent than real) from existing bank centered states, such as New York and California, may add fuel to the fire for those who would oppose a dual system in states which pride themselves as bank commercial centers. In contrast, low tax rate states could promote themselves as a tax haven for such banks. While there has been a trend of banks moving some of their interstate banking activities to low tax jurisdictions, this trend has not yet extended to movement of commercial domicile.

6. The principle objection that Sandy raises with respect to a source based tax results from lack of uniformity between the apportionment rules of the states. If uniform apportionment rules were adopted, most of Sandy's concerns with respect to a source based system would disappear. At least some of the paper's efforts should be focused on what uniform rules would be appropriate, both from a policy and administrative perspective, in a uniform source rule environment. Sandy's paper appears to place all of the eggs of potential reform in a dual system basket that may be politically unrealistic. There is no assurance that a dual system would ever be enacted. The problem of establishing uniform apportionment rules in a source-based system still critically needs resolution right now, and should be given at least equal time.

^{2/} Limited to the tax actually paid to the foreign state.

7. There may be double taxation even under the dual system suggested in Sandy's paper. A source-based state taxing its commercially domiciled financial institutions may have significantly different apportionment rules than the receipts-factor only approach in the suggested dual system used for taxing nonresident financial institutions. For example, payroll, property and receipts factors may be retained by the source based system. Lack of uniformity between the dual system apportionment and the source system apportionment can therefore result in double taxation, just as Sandy has described in a source-only environment where there are different apportionment rules. The cure to this problem, of course, is for the source based state to enact legislation to pick up the dual system. But the problem can equally be cured by the dual system state picking up the source based rules of the source based state. Thus, the real problem is a lack of uniformity, not the particular tax system chosen.

8. More needs to be written in the area of unitary taxation. It is not clear, for example, whether each financial institution in the unitary group is taxed in its own respective state of domicile under a dual system, or only the "key" parent is to be taxed under the dual system. Major problems occur with either alternative. If the entire unitary income of the group is taxed in the key financial institution's state of domicile, there will be certain constitutional challenge to such attempt, because the tax is levied on extraterritorial income of members of the unitary group which are not domiciled in the key financial institution's state.

If each financial institution which is a member of the unitary group is taxed on a dual system in its respective domicile, a mechanism is needed to determine that portion of the entire unitary income of the group is allocable to each separately domiciled financial institution. Presumably, source rules, such as the receipts-only factor, will be used for this purpose. But in so doing, much of the advantage of the dual system is lost, because each member of the group will have to have its slice of the total unitary income determined and a separate system of credits for each corporation in the group would have to be maintained. Not all states have adopted the unitary system. In many states, it would be a more politically difficult to adopt than a totally uniform source rule, because in those states, unitary taxation is, to state it mildly, not universally approved of.

9. It is asserted that "no bank or bank holding company subsidiary can engage in a business unrelated to banking, removing the major impediment to the use of the unitary business principle." This statement tends to too lightly dismiss a

potentially serious problem. Banks, of course, even with the "incidental to the business of banking" limitation, have been expanding in many traditionally nonbanking roles, such as securities trading (witness Bank of America's acquisition of Charles Schwab). The Banks have been pressuring the Federal Reserve and Congress to further expand permissible banking activity to such activities as real estate brokering and insurance. Under current law, nonfinancial corporations can acquire and operate financial institutions, including "acceptance" corporations and even some regulated institutions, such as savings and loans. The problem of division of income between general corporations and financial corporations under the unitary method is a serious problem, and is likely to become more pronounced as businesses expand from financial to general activity and vice versa. The problem is exacerbated by the use of a single factor formula for the proposed "dual system" for financial corporations and other apportionment formulae currently in place for nonfinancial corporations (usually payroll, property, and sales). It is even more exacerbated by a mixture of a source-based system and a dual system within a single unitary structure.

10. The assertion that "no constitutional impediment exists to prevent states from adopting broader jurisdictional rules" is not universally accepted. While there is a strong argument that the Supreme Court has sufficiently expanded its concepts of jurisdiction to place the limiting case of National Bellas Hess into some question, the absence of difficulty with respect to asserting jurisdiction should not be assumed without discussion. Sandy has written extensively in this area, but given the importance of the subject matter and the role that this case might play in taxation of nondomiciliary banks, at least some of the argument should find its way into this paper.

11. On page 50, Sandy states that case law in California "defines a financial institution as an entity that receives more than 50% of its gross income from the use of its capital in substantial competition with other moneyed capital." Actually, the case law only provides that a financial institution is one that deals in moneyed capital in substantial competition with national banks. The 50% of gross income test is not a product of case law, it reflects the current Franchise Tax Board administrative practice. Regulations which would codify the definition of a financial institution are currently under consideration.

12. Finally, and perhaps this is quibbling, but Sandy states that "two reasons exist for a state to modify its apportionment formula: to increase the amount of revenue assigned to the state and/or to favor the state's domiciliary corporations." (p39) A third reason the state may modify its apportionment formula is to

arrive at a more equitable method of apportionment. I don't think its fair to ascribe to the state only revenue or business enhancement motive.

I hope that these comments will prove useful. I would appreciate receiving a copy of the final report. As I am leaving state service, I would appreciate it you could send a copy to my new address:

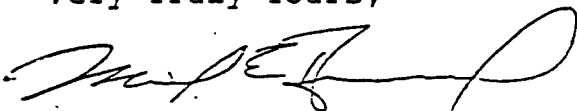
Michael Brownell
Arthur Anderson & Co.
300 Capitol Mall
Sacramento, Calif. 95814

In addition, I would appreciate it you could send a copy to the Director of Multistate Tax Affairs for the Franchise Tax Board at the following address:

Mr. Benjamin Miller
Director Multistate Tax Affairs
Legal Division, Franchise Tax Board
P.O. Box 1468
Sacramento, CA 95807

Thank you for allowing me to participate in this endeavor. It is a timely and important undertaking.

Very Truly Yours,



Michael E. Brownell
Counsel
Multistate Tax Affairs

EXHIBIT K: 7

**Chamberlin, Holly (Price Waterhouse), "Multistate Taxation of Financial Institutions" (Outline of 1991 State Tax Legislative Developments)
(April 1991)**

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Multistate Taxation of Financial Institutions

April 18 - 19, 1991

**THE WESTIN HOTEL
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1991 State Tax Legislative Developments

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Multistate Taxation of Financial Institutions

1991 State Tax Legislative Developments

ALL STATES

Multistate Tax Commission Proposed Regulations on Taxation of Financial Institutions - Reg. IV.18.(i)

The Multistate Tax Commission ("MTC") on May 10, 1990, released model regulations entitled, "Attribution of Income from the Business of a Financial Institution." The proposed regulations are now formally "noticed," but on November 14, 1990, the MTC announced a delay from the originally-scheduled adoption date of July, 1991. The model regulations are currently expected to be adopted next year. A series of public hearings have been held on these regulations as follows:

Washington, DC, August 21, 1990
San Francisco, California, August 23, 1990
Chicago, Illinois, December 3, 1990
Atlanta, Georgia, December 4, 1990

General Application of the Proposed Regulations

The proposed regulations are intended to amend the standard three-factor Uniform Division of Income for Tax Purposes Act ("UDITPA") apportionment formula currently used by many states to tax financial institutions. The new formula is generally known as a "market state" concept, which uses the taxpayer's "exploitation of the local market" within a state, rather than the existing standard of physical presence. In addition, the proposed regulations adopt a nexus standard that is based on the market state theory. Thus, a financial institution engaging in credit card solicitation by mail, for example, in a state with these regulations in effect may be required to file a net income tax return.

Receipts Factor: The "exploitation of the market" theory is clearly demonstrated by the proposed receipts factor ratio contained in these regulations. Under the proposed regulations, a bank must include the following in the numerator of its receipts factor:

- (a) rental receipts from the lease or rental of personal property located within the taxing jurisdiction (including receipts from finance leases),
- (b) interest income from secured loans, if the security is located in-state,
- (c) interest from unsecured consumer loans, if the borrower resides within the taxing jurisdiction,
- (d) interest from unsecured commercial loans, if the debtor resides within the taxing jurisdiction,
- (e) a portion of the interest income from participation loans or syndications,
- (f) credit card interest and other receipts from credit card holders residing within the jurisdiction,
- (g) merchant discount income derived from credit card transactions with in-state merchants,

***Multistate Taxation of Financial Institutions
1991 State Tax Legislative Developments
Page 2***

(h) service fees, if:

- the borrower is an in-state resident or the fees are related to a deposit from an in-state resident, or
 - the fee is a brokerage fee from an in-state resident, or
 - the service receipts are related to a trust or estate of an in-state decedent or grantor,
- (i) receipts from travelers checks purchased in-state,
- (j) investment receipts from securities and money market instruments, based on the relative size of in-state deposits held by the taxpayer, and
- (k) all other receipts received by a taxpayer in its domicile state, if not taxed by other jurisdictions ("throw-back" rule).

Property Factor: The recognition of specialized assets, *i.e.* intangible assets, is evident in the proposed property factor. Intangibles and other assets are to be included in the property factor at the original cost value, less any value for goodwill. Rental property is to be valued at eight times the net annual rental rate, which is similar to the standard UDITPA property factor. In addition, the proposed property factor is to include the value of:

- (a) currency located in-state,
- (b) lease financing receivables if the underlying property is located in-state,
- (c) secured loans if the security is located in-state,
- (d) unsecured consumer loans made to in-state residents,
- (e) unsecured commercial loans made to in-state debtors,
- (f) funds deposited by the taxing state,
- (g) a proportional share of participation loans and syndications,
- (h) credit card receivables, if card holder is an in-state resident, and
- (i) intangible assets, such as securities and money market instruments, based on the relative size of in-state deposits held by the taxpayer.

Payroll Factor: The proposed regulations for financial institutions generally adopt the standard UDITPA definition of the payroll factor, including all payroll made during the tax year in the taxing jurisdiction in the payroll factor numerator. The denominator must reflect the total amount of compensation paid by the financial institution.

ARIZONA SB 1289

**Sponsor: Sen. Manuel Pena, Jr. (D-22)
Franchise tax on financial institutions**

SB 1289 imposes a franchise tax of 9.3% on the entire net income of financial institutions. The bill includes a three-factor apportionment formula composed of payroll, receipts and deposits for banks doing business within and without the state. Receipts from loans are sourced to the state where the greater portion of income producing activity related to the loan occurs; interest and fees from bank cards are sourced to the state if the card holder's domicile is in the state. The payroll factor is computed using only 80% of in-state payroll in the numerator, and the deposits factor is computed using the average value of deposits during the taxable year.

Multistate Taxation of Financial Institutions
1991 State Tax Legislative Developments
Page 3

Arizona currently imposes a 9.3% income tax on financial institutions. Changing the bank tax from an income tax to a franchise tax measured by net income allows the state to tax interest from federal obligations held by banks in the state, and is one of the recommendations of the Arizona Fiscal 2000 Committee. SB 1289 carries an effective date of December 31, 1991.

Intro Date: 02/11/91

Ref: Fin: 02/11/91

CALIFORNIA PROPOSED REGULATIONS

REG. SEC. 23183

Definition of Financial Institution

The first part of the Franchise Tax Board ("FTB") plan to adopt banking regulations sets forth a definition of "financial corporation," as an entity in which over 50% of total gross income is attributable to dealings in money or moneyed capital in substantial competition with the business of national banks.

The FTB plans to adopt banking regulations in three parts: Definition of Financial Corporation; Doing Business -- Financial institutions and Banks; and Allocation of Income of Financial Institutions. This first part is intended to reflect existing case law and rulings in the state. According to the FTB Legal Division the draft regulations on nexus and allocation & apportionment for banks are still under review. It should be noted that the FTB is proposing to apply these regulations retroactively.

A hearing on October 15, 1990, resulted in non-substantive change to the proposed rules.

HAWAII HB 1111

Sponsor: Rep. Mazie Hirono (D-32)

Financial Institution Tax Rate Decrease

HB 1111 would reduce the tax rate from 11.6% to 6.4% and would expand the tax to include financial institution holding companies and trust companies. The legislation is reportedly no longer under consideration, due to its failure to meet the 2/22/91 committee deadline to report legislation out of the committee of origin.

Intro Date: 01/31/91

Ref: Consumer Protection: 02/07/91

ILLINOIS

RETALIATORY ACTION AGAINST INDIANA BANK TAX

During October, 1990, the Illinois General Assembly adopted Senate Resolution 1502, which criticizes legislation adopted by the states of Indiana, Tennessee and Minnesota that imposes a tax on Illinois banks doing business in those states. The Resolution rejects multistate taxation of financial institutions based on the sourcing of income to the states where customers or secured properties are located.

Senator "Babe" Woodyard (R-53), whose district lies along Illinois' border with Indiana, indicated last fall that he intended to sponsor retaliation legislation against the Indiana Bank Tax. He did so in 1990, but the legislation later died in committee. Both SR 1502 and its companion, HR 2419, were adopted by their respective houses.

ILLINOIS SB 376

Sponsor: Sen. Stanley B. Weaver (R-52)
Limitation of Corporate Deductions to 2% of Income

SB 376 would require all corporations to pay a minimum tax of 2% of the federal taxable income plus additions, and with no deductions. This effectively would deny the deduction for interest, which affect financial institutions directly. It should be noted that this would include federal securities in the tax base for these purposes, which poses a substantial question as to its constitutionality. This bill is not expected to pass.

Intro Date: 03/20/91
Ref: Revenue: 04/12/91

INDIANA HB 1875

Sponsor: Rep. Patrick Bauer (D-7)
Bank Tax Unitary Filing Requirement

The Indiana Senate Finance Committee has approved HB 1875, a "technical corrections" bill which includes a requirement for a single return to be filed for all members of a water's-edge unitary group. This requirement would apply to all corporate members of the group, whether or not each individual entity has nexus to Indiana. The change is intended to be effective for tax years beginning on or after January 1, 1992.

HB 1875 was written by the Indiana Revenue Department. Under current law, the Department requires "nexus combination" returns (*i.e.*, only those corporate entities with nexus in the state are included in the combination).

Multistate Taxation of Financial Institutions
1991 State Tax Legislative Developments
Page 5

In other provisions, HB 1875 includes federal credit unions in the definition of "taxpayer," effective January 1, 1991, and amends the add-back provisions to include local income taxes, among other changes.

The Indiana Senate is expected to adopt HB 1875. The Legislature will reportedly adjourn soon in order to reconvene in Special Session for purposes of the state budget.

INDIANA HB 1986

Sponsor: Rep. Floyd Dale Grubb (D-42)
Exemption for Initial \$10 Million Banking Activity

The original version of HB 1986 amended the emphasis of the financial institution tax from an economic presence to a physical presence. The Financial Institutions Committee substitute for the bill, however, removes this language, and instead amends the tax to provide for an exemption for the first \$10 million of loan or credit activity in the state. One exemption is allowed to the unitary group (not one per corporation) and the exemption is allowed only if that \$10 million is "subject to tax in another jurisdiction." The effective date of HB 1986 is January 1, 1992.

The original version of this bill was beneficial to most out-of-state banks because it prevented imposition of the tax unless the out-of-state bank had actual property (not including credit cards) in the state. Three Illinois Representatives and several Illinois banks testified in favor of the original version, which was opposed by the Indiana Bankers Association. The substitute for HB 1986 has passed the House and now awaits committee action in the Senate.

Intro: 01/31/91

Ref: Fin: 01/31/91

Ref to Subcomm on Financial Institutions: 02/20/91

Committee Substitute: 02/20/91

Passed to Hse: 02/26/91

Passed: 03/05/91

Rec'd by Sen: 03/05/91

Ref: Fin: 03/18/91

MARYLAND HB 382

Sponsor: Sen. R. Hergenroeder (D-43)
Repeal of S&L Association Franchise Tax

HB 382 would repeal the savings and loan association franchise tax in Maryland. This tax is currently levied at the rate of .013% of taxable deposits located in the state.

The fiscal note on this bill indicates a cost of approximately \$2 million per year. It is not expected to pass.

Intro Date: 01/30/91

Ref: W&M: 01/30/91

MASSACHUSETTS HB 1836 and SB 1204

Sponsors: Representative John F. Cox (D-17) and Senator John Olver
(D-Franklin/Hampshire)
Net Income Taxes on Financial Institutions

General: These two bills would impose a new net income tax on financial institutions doing business within Massachusetts. SB 1204 would impose a 12.54% tax and requires that in-state financial institutions include the entire taxable income in the tax base, with a credit for taxes paid to other states. All other banks must apportion income, and are not allowed a credit. A single-factor receipts formula is provided, with income sourced using the "market state" theory (*e.g.*, income from unsecured commercial loans is sourced where the loan proceeds are to be applied). The unitary method of combination is required. HB 1836 would impose a 10.5% net income tax on all financial institutions, including community credit unions. It requires that all financial institutions apportion income using a two-factor apportionment formula. No credit is allowed for taxes paid to other states. The apportionment formula consists of payroll and receipts, using a similar "market state" theory. No unitary method of combination is required.

Effective Dates: SB 1204 would be effective for tax years beginning on or after 1/1/90, and sunsets on 1/1/97. A commission is to be established in 1994 to determine whether it should be continued. HB 1836 would be effective for tax years beginning on or after 10/31/91.

Multistate Taxation of Financial Institutions
1991 State Tax Legislative Developments
Page 7

Both HB 1836 and SB 1204 are very similar to bills introduced last year, when the taxation of financial institutions was considered to be linked with the issue of interstate banking within the Commonwealth. Neither tax bill was adopted during the last session, and many in Boston believe that this session will see serious consideration of this issue. The Massachusetts Bankers Association is reportedly giving its support to HB 1836. The bills were briefly considered in a hearing of the Joint Committee on Taxation on March 6, 1991, and no action has been taken. No further hearing dates have been set.

SB 1204

Intro - 02/01/91
Ref: Tax - 02/01/91
Hearing - 03/06/91

HB 1836

Intro - 02/05/91
Ref: Tax - 02/05/91
Hearing - 03/06/91

MINNESOTA HB 432

Sponsor: Rep. Jerry R. Janezich (D-5B)
Apportionment of Receipts for Financial Institutions

HB 432 provides that for purposes of inclusion in the receipts factor for financial institutions, receipts from investments in securities and money market instruments must be apportioned to the state based on the ratio that total deposits in Minnesota bear to deposits everywhere. For unregulated financial institutions, such receipts are apportioned based on the ratio of gross business income from in-state sources over gross business income everywhere. Gross business income is calculated excluding such receipts. The bill also provides for a tax on corporation income if assets are transferred from a C corporation to an S corporation.

HB 432 was substituted in subcommittee and is currently before the full committee in the House. It is identical to SB 363, which was scheduled for a hearing in the Senate Committee on April 2. The bills would be effective for taxable years beginning after December 31, 1990.

Intro Date: 02/21/91
Ref: Taxes: 02/21/91

MISSISSIPPI HB 1574

Sponsor: Rep. Hubert S. McMillan (D-46)
New Excise Tax on Financial Institutions

This legislation would impose an excise tax on net income on all financial institutions doing business in Mississippi, effective January 1, 1991. The tax would be levied at a rate of 5% of income over \$10,000. The bill sets forth specific deductions from gross income, including bad debts, depreciation, interest paid and other deductions.

HB 1574 is no longer under consideration, due to the fact that it failed to meet the February 28 House passage deadline for appropriations and revenue bills.

Intro Date: 02/22/91
Ref: W&M: 02/22/91

MISSOURI SB 294

Sponsor: Sen. Truman Wilson (D-34)
"Innovation Center" Tax Credit for Financial Institutions

SB 294 would allow an economic development tax credit for financial institutions that meet the requirements of Chapter 348 of the Missouri statutes.

Intro Date: 01/16/91
Ref: Financial Institutions: 01/28/91
Passed to Hse: 02/18/91
Passed: 02/27/91
Rec'd by Hse: 03/06/91
Ref: Commerce: 03/06/91

MONTANA SB 339

Sponsor: Senator Steve Doherty (D-20)
Income Tax on Financial Institutions

SB 339 would impose a net income tax on financial institutions doing business within and without the State of Montana. Taxable income is measured by a three-factor apportionment formula, as follows:

- o Receipts factor includes rental income from property located in-state, income from secured loans if the underlying property is located in-state, income from unsecured loans if made to residents of Montana, credit card receipts if the account is billed to a resident of the state, and other miscellaneous receipts.

***Multistate Taxation of Financial Institutions
1991 State Tax Legislative Developments
Page 9***

- o Property factor includes the average value of coin and currency located in-state, receivables from lease financing if the underlying property is located in-state, assets securing loans that are attributable to Montana, consumer loans (including credit card accounts) made to residents of the state, income from services related to in-state intangibles and other intangible property "attributable" to the state during the tax period.
- o Payroll factor includes all in-state compensation. The new tax would apply to in-state and out-of-state corporations (including credit unions and savings and loan institutions) doing business in the state, but nexus does not result from merely evaluating or maintaining a participation loan or its security, money market instruments, a pool of promissory notes or other minimum asset management activities. Obtaining credit card customers within the state does create nexus under the proposed legislation, with no minimum threshold of customers provided.

This legislation proposes a net income tax on banks very similar to that proposed by regulations of the Multistate Tax Commission (MTC). A hearing on SB 339 was held on Thursday, February 21, 1991, in the Senate Taxation Committee. No further action is expected on the bill.

Intro Date: 02/09/91

Ref: Tax: 02/09/91

Hearing: 02/21/91

NEW JERSEY SB 1083

Sponsor: Sen. Matthew Feldman (D-37)

Prohibition of "Investment Company" Treatment for Bank Subsidiaries

For purposes of the corporation business tax, SB 1083 would prevent banking subsidiaries from electing treatment as an "investment company."

This bill follows a recommendation of the State and Local Expenditure and Revenue Policy Commission (SLERP) of 1990. It is not expected to pass.

Intro Date: 01/09/90

Ref: State Tax: 01/09/90

NEW YORK

BANK TAX AUDIT FEES

During the 1990 legislative session, an appropriations bill included specific instructions to the Commissioner of Taxation to begin charging fees to financial institution taxpayers in New York for time spent on their tax audits. On October 22, 1990, the Commissioner signed regulations imposing a \$110 per hour fee for each auditor's time at the taxpayer's location and time otherwise spent on specific audits. The fees are reportedly being assessed for costs incurred between April 1, 1990 and April 1, 1991. The New York State Bankers Association has filed suit challenging imposition of the fees.

Multistate Taxation of Financial Institutions
1991 State Tax Legislative Developments
Page 10

NEW YORK AB 6993

Sponsor: Assemblyman Arthur Eve (D-Buffalo)
Bank "IBF" Deduction Repeal

HB 6993 would reduce the current deduction allowed for 100% of income from International Banking Facilities ("IBF's") to 50% of such income, effective for tax years beginning on or after January 1, 1991. It is not expected to pass.

Intro Date: 03/27/91
Ref: W&M: 03/27/91

NEW YORK SB 2942

Bank Minimum Tax -- Budget Bill

SB 2842, part of the Governor's Budget Package, would establish the minimum tax for financial institutions at \$350, against which the use of credits is prohibited.

Intro : 02/28/91
Ref: Fin: 02/28/91

NORTH DAKOTA HB 1484

Sponsor: Rep. Steve Gorman (R-46)
NOL Carryforward

HB 1484 provides that banks, trust companies and building and loan associations having net operating losses may carry forward such losses for the same time period that an identical federal net operating loss may be carried forward. It is effective for taxable years beginning on or after January 1, 1991.

Intro Date: 01/21/91
Ref: Fin & Tax: 01/21/91
Passed to Hse: 02/07/91
Passed: 02/08/91
Rec'd by Sen: 02/12/91
Ref: Fin & Tax: 02/12/91
Passed: 03/07/91
Signed by Governor: 03/28/91

*Multistate Taxation of Financial Institutions
1991 State Tax Legislative Developments
Page 11*

SOUTH DAKOTA HB 1331

Sponsor: Rep. Jerome B. Lammers (R-10)
Revised Banking Tax Rate

HB 1331 amends the current rate of tax on financial institutions to 6% of net income under \$500 million, decreasing to a rate of 1% of income over \$600 million annually. This bill was signed by the Governor on February 15, 1991.

Intro Date: 01/24/91
Ref: State Affairs: 01/24/91
Passed to Hse: 01/30/91
Passed: 01/31/91
Rec'd by Sen: 02/01/91
Ref: State Affairs: 02/01/91
Passed to Sen: 02/08/91
Passed: 02/11/91
Signed by Governor: 02/15/91

TEXAS HB 236

Sponsor: Rep. L.P. Patterson (D-2)
Gross Deposits Tax on Banks

HB 236 would establish a new tax on the deposits of all banks and savings and loan associations conducting business in Texas. The proposed tax is at the rate of 5% of the taxpayer's average annual net taxable deposits. "Deposits" are defined as money held in the usual course of business by a financial institution for which it is obligated to give credit to a customer's account or that is evidenced by a certificate of deposit. Average annual gross deposits are calculated by dividing the sum of daily deposits by 365. Net taxable deposits (after a \$300 million threshold) are calculated by eliminating deposits from other financial institutions and government entities, and by factoring in certain local lending activities. The bill contains a requirement that all Texas branches or offices of an out-of-state financial institution report deposits and file tax returns on a separate basis. Provisions are made to divide the \$300 million threshold amount of deposits among the various branches according to the proportionate share of average annual gross deposits.

This legislation was first considered in Texas during the 1990 Special Session, though it was never formally introduced. The annual filing date for the new tax is March 15, beginning in 1992. Provisions for penalties and interest for failure to file a proper report are also included.

Intro Date: 01/08/91
Ref: W&M: 01/28/91

WEST VIRGINIA SB 632

Net Income Tax on Financial Institutions

SB 632 has amended the West Virginia business franchise tax (a capital stock tax) and the corporation net income tax to include special treatment for banks and other financial institutions. The amendments are effective for tax years beginning on or after January 1, 1991, and apply to banks, bank holding companies, thrift institutions, West Virginia credit unions and other corporations which derive more than 50% of gross income from loans, installment obligations, mortgages, credit card loans, certain estate or trust services and other "non-bank" banking activities. A nexus threshold is established at 20 in-state customers or at least \$100,000 gross receipts within West Virginia.

The legislation establishes a "dual system" of taxation for in-state and out-of-state banks conducting business in West Virginia. In-state banks are prohibited from apportioning income, but are provided a credit for taxes paid to other states. Non-West Virginia banks must apportion income and are not allowed a credit.

SB 632 requires that out-of-state financial institutions doing business in the West Virginia (*i.e.*, those that are not commercially domiciled in the state) must use a special single-factor apportionment formula under both the franchise tax and the net income tax. The receipts factor formula includes rental income from property located in-state, income from secured loans if the underlying property is located in-state, income from unsecured loans if made to residents of West Virginia, credit card receipts if the account is billed to a resident of the state, and other miscellaneous receipts. The language of this bill is much like the bank tax statute of Indiana.

SB 632 was introduced and passed by both houses of the legislature in eight days. The bill was signed by the Governor on April 3, 1991.

Intro Date: 02/27/91
Ref: Fin: 02/27/91
Passed to Sen: 02/27/91
Sen Amend: 03/01/91
Passed: 03/01/91
Rec'd by Hse: 03/02/91
Ref: Fin: 03/02/91
Amend: 03/06/91
Passed to Hse: 03/06/91
Passed: 03/07/91
Concurred: 03/08/91
Signed by Governor: 04/03/91

EXHIBIT K: 8

**Douglas, Carol, "State Officials Debate Methods of Taxing Financial
Institutions", Tax Notes, December 25, 1989**

State Officials Debate Methods Of Taxing Financial Institutions

State taxes on banks and financial institutions are changing and will continue to change, said state officials, tax experts, and banking industry representatives at a December 13 seminar on State Taxation and Regulation of Banking. The meeting, held in Washington, D.C., was sponsored by the National Conference of State Legislatures (NCSL), the Advisory Commission on Intergovernmental Relations (ACIR), the Multistate Tax Commission (MTC), and The National Center for Policy Alternatives.

'Any state that has not revamped its taxation of financial institutions in the last five years should do so now,' said James.

"Any state that has not revamped its taxation of financial institutions in the last five years should do so now," said MTC Chairman and Minnesota Commissioner of Revenue John James. "Nearly every state's bank tax was written at a time when banks only did business in a single state, which is no longer the case." Retaining such laws means that states are allowing significant economic activities to go untaxed, he said. Taxing all competing financial institutions similarly is a question of fairness, James added.

The Market State Approach

States are taking widely different approaches to the taxation of financial institutions. The basic options are the market state approach used by Minnesota, the money center approach used by New York, and the combined approach used by Indiana. Officials from those states debated the virtues and drawbacks of each.

Financial institutions and money center states must understand the contribution of the market state or state where the customer is located, James said. For instance, if a financial institution makes home mortgage loans to residents of another state, the institution depends on that state to provide public services and schools that will maintain the value of the homes, James said. Also, the financial institution may depend on the courts of that state to foreclose if the borrowers stop making payments. Market states therefore must tax some part of the bank's income, James said.

"Some people think that if the market states would just forget about the issue, there would not be a problem," James said. They must realize that the old concept of tangible presence in a state in the form of bricks and mortar is outdated, he said. In apportionment, it is generally accepted that receipts are attributed on a destination basis, which would be to the market state, James said.

Minnesota revised its financial institution taxes in 1987 based on a draft recommended by the MTC. Minnesota Department of Revenue Appeals and Legal Services Division Attorney Jerome J. Sicora outlined the new law, which says the state has nexus to tax any financial institution that has 20 or more Minnesota customers in any tax year, and deposits in the state that exceed \$5,000,000. Revisions of the 1987 law specify that banks that acquire Minnesota assets through buying a package of loans from a Minnesota bank will not be subject to the tax, if that is their only activity in Minnesota. The tax is apportioned according to a three-factor formula in which sales are weighted at 70 percent and payroll and property are each weighted at 15 percent. Sicora noted that the purpose of the law is to require out-of-state banks to pay more taxes, while Minnesota-domiciled banks pay less tax.

'The destination approach to the taxation of banks is fraught with pitfalls,' D'Angelis said.

"Minnesota's threshold for nexus is far too low," said Bank of America Counsel Michael D'Angelis. "Is the revenue stream worth going after?" D'Angelis asked. He noted that if a bank had 20 credit card customers with an average \$1,500 account in Minnesota, the tax the state would collect would be \$36. "The destination approach to the taxation of banks is fraught with pitfalls," D'Angelis continued. "The location of the customer is not an appropriate indication of where the business is done." Banks would have to modify their computer systems to get information on where their customers are located, information that the banks would not need for any other purpose than to calculate taxes to market states, D'Angelis said.

The biggest problem for financial institutions is the overlap between taxation of domiciliary institutions by money center states and destination-based taxation by market states, D'Angelis said. Also, states have incompatible apportionment factors, he said, noting that Minnesota has a 70 percent sales factor while Indiana has single factor sales and Florida double weights sales. "The evolution of new taxing approaches should be orderly and gradual," D'Angelis suggested.

In 1989, Indiana revised its bank tax to end the competitive disadvantage faced by domestic financial institutions, which were taxed while other financial service providers were not, said Indiana House Ways and Means Committee Cochairman Patrick Kiely (R). The state now imposes a franchise tax of 8.5 percent on all financial institutions and has eliminated all other taxes on them except for some personal property taxes. Lawmakers decided to create a dual system with a residence-based tax for domestic banks and a source-based system for non-

domiciliary banks, Kiely said. Domestic banks are taxed on all of their income regardless of the source. Out-of-state banks are given a credit for the tax they pay to other states, up to the amount they would pay if they were taxed in Indiana. Indiana has adopted a unique single factor apportionment based on sales.

Lawmakers had bipartisan support for the banking tax revision from the start, Kiely said. The administration of Gov. Evan Bayh (D), which had come in late in the process of negotiations, initially wanted a rate of 12.5 percent, but was persuaded to reduce it to get the bill passed, according to Kiely.

The Money Center Approach

New York State Taxation and Finance Commissioner James Wetzler strongly disagreed with the market state approach. Wetzler defended the position of the origin state, where the service is performed. The origin state should not be called the headquarters state, as it sometimes is, because the headquarters may not be where the services are located, Wetzler said.

If states use different apportionment formulas, there is a danger that some income will not be taxed, as well as a danger of multiple taxation, Wetzler said. "Banks are not politically popular," so it is not surprising that state legislators want to get revenue from them, Wetzler said, but some of the approaches "don't make good sense."

'The dirty secret of the market state approach is that neither the service business nor the taxing authority know where the service is consumed,' Wetzler said.

"The dirty secret of the market state approach is that neither the service business nor the taxing authority know where the service is consumed," Wetzler said. For instance, buyers of cars may move from state to state while they are paying off the loan, he said.

"You admit that one of the purposes of the Minnesota law was to lower taxes on your banks and raise them on our banks," Wetzler said to James and Sicora. Wetzler contended that the state of origin is in a better position to monitor tax compliance. The different approaches taken by different states will make it easier for taxpayers to avoid taxation, Wetzler charged. He also wondered if the proliferation of different approaches in different states will lead to banks offering special rates in low tax states.

The MTC approach embraced by Minnesota is of questionable constitutionality, Wetzler charged. Banks will litigate and will not pay the tax because so many states will not give them refunds for payment of taxes declared unconstitutional, Wetzler said. The Indiana credit approach is not satisfactory either, because it "imposes the entire burden of

NEWS

double taxation on the headquarters state," Wetzler said. In an unusual statement for a state tax official, Wetzler warned that Federal intervention may be necessary to cope with the proliferation of state bank taxes. He suggested to other states, "the constitutional way to tax these banks is to allow them to open branches in your states."

California: Moving Slowly to the Market Approach?

"California has traditionally been a money center state, but it strongly supports apportionment. Does that mean it is leaning toward a market state approach?" asked California Franchise Tax Board (FTB) Senior Staff Counsel Eric Coffill.

In 1987, California revised its franchise tax on banks from a standard based on whether they were "located within California" to a standard based on "doing business in California." The revision made the tax similar to the tax on financial institutions, which has been on a "doing business" basis since 1929. In three or four months, the Franchise Tax Board will release new draft regulations revising the definition of "doing business in California," Coffill said. Currently, doing business is taken to mean actively engaging in any transaction for financial gain. Coffill specified that the FTB "does not want to adopt a 'doing business' standard that banks can't comply with."

California maintains that credit cards should be taxed where the holder resides, but that loans be taxed where the application is submitted.

Currently, California maintains that credit cards should be taxed where the holder resides, but that loans are taxed where the application is submitted. Coffill said he does not think that adopting the "doing business" standard means moving entirely to a market approach, but he thinks that California could be moving slowly to a market approach. Coffill thinks California probably would have a higher nexus threshold than the "20 credit card holders in the state" standard used by Minnesota.

The Bankers' View

Bank representatives at the meeting seemed to agree more with the tax officials from their states than the tax officials of market states agreed with Wetzler of New York.

Bankers from Minnesota and Indiana—Russell Taylor, Assistant Vice President of Taxes, First Bank System, Inc., of Minneapolis and Gregory A. Schenkel, First Vice President, Government and Corporate Affairs, INB Financial Corporation, of Indianapolis—said that their state legislators and tax departments

have worked with them and tried to take their needs into account in revising banking laws.

Citicorp/Citibank Senior Vice President and General Tax Counsel Haskell Edelstein of New York also defended his state's approach, strongly supporting taxation by the money center states rather than the market states. However, Edelstein said, banks "don't care which state gets the revenue," and will not "pay twice on the same income." If the conflict between the market and money center states is not resolved, "Congress will move in," Edelstein warned.

'Banks are the new pariahs, replacing the oil and insurance industries,' Edelstein maintained.

If money center states lose revenue, banks will "need protection" against the ways they will try to make up for the loss, Edelstein said, adding that "banks are the new pariahs, replacing the oil and insurance industries." Therefore, it is not difficult to impose a tax on financial services, Edelstein said. However, it is "the customers who pay anyway." If the states need a new source of revenue, perhaps they should impose transaction taxes, Edelstein suggested.

"The market state approach is bad tax policy," Edelstein asserted. Many bank taxes are income taxes, and an income tax should be imposed where the income is earned, which is where the service is performed, Edelstein said. Edelstein also called the market state approach "an out and out money grab." The nexus standards used "have got to be contested," Edelstein said.

Taxes and Location

University of Tennessee Professor of Economics William Fox outlined the variety of state taxes on banking. Seventeen states impose a corporate income tax on banks. Thirty-four states impose a franchise or privilege tax on banks; 22 of those base the franchise tax on income, but others use a different standard. Three states have no tax on banks. Michigan imposes its Single Business Tax, which is a value-added tax, on banking activities.

Financial institutions may be more likely than manufacturers to base location on state and local taxes, according to a survey Fox has conducted with fellow University of Tennessee Professor of Economics Harold Black. Banks may want to avoid an income tax, Fox notes. On the other hand, if there is an intangibles tax, the banks may move their assets out of state, Fox suggested. Regulations also have had an impact on bank location, Fox notes. South Dakota and Delaware attracted many banks by being the first states to end their usury limits, but other states who tried to copy some of their regulatory moves apparently were not successful in attracting more banks, Fox said.

State Cooperation Urged

New York Legislative Tax Study Commission Consultant Sandra B. McCray, who drafted the proposed MTC bank tax law that Minnesota adopted, said that states should work together to devise a solution to the problem of overlapping and unclear tax jurisdictions. McCray noted that the coexistence of the money center and market state approaches means that a South Dakota-based bank could send credit cards to all 50 states, with the income theoretically taxable both by South Dakota and by all of the other states.

McCray says she does not believe the Supreme Court will decide which state has the best approach, but will allow the states a wide latitude in deciding on bank taxes. McCray suggested that adopting uniform apportionment rules might be a useful approach.

States' banking taxes and regulation will always lag behind the innovations and ways to avoid taxes because banks can hire tax attorneys at higher salaries who will be brighter, said C. James Judson, a partner in the Seattle firm of Davis Wright & Jones. Increasing tax rates is not necessarily the best way to raise revenue, said Judson, citing the example of Delaware's paring of restrictions. Some states that want to increase their flow of capital, such as Hawaii, do not tax out-of-state financial institutions that make loans to commercial business, Judson noted. He agreed with McCray that the Supreme Court is not going to favor one apportionment scheme over another except in extreme cases.

States will have to increase their tax rates in the 1990s because Federal cutbacks will leave the states as the major providers of services, Strauss said.

Financial institutions may be protesting new bank tax vehemently because they have been taxed for a long time at rates much lower than those imposed on most corporations, suggested Robert Strauss, Director of the Center for Public Financial Management at Carnegie Mellon University. Strauss noted that commercial banks are acquiring failing savings & loans and thus lowering their tax liabilities.

States will have to increase their tax rates in the 1990s because Federal cutbacks and budget troubles will leave the states as the major providers of services, Strauss said. Strauss said states might want to consider treating financial institutions more like the general mercantile corporations with which they increasingly compete. On the other hand, if states use an income-based tax, there may be some limits on what they can tax, but there are few constitutional limitations on the imposition of a franchise tax or wealth tax, Strauss said.

The Federal system should avoid multiple taxation, Strauss said. Most taxes on business already use the market state approach, so using that approach for financial institutions would mean treating them more like other businesses, which Strauss advocates. Strauss said he "strongly dislikes double-, triple- and quadruple-weighted apportionment." Tax departments of major companies can find ways around these formulas, Strauss said.

Strauss suggested that the argument that businesses do not know where their customers are located is specious. Strauss urged meeting participants to go home and ask the person who manages computers at the local bank if it is possible to find where the customers are located. The answer will be "yes" because banks need the information for marketing and evaluation of marketing efforts, he suggested.

'States can find common ground to develop a common approach to taxing financial institutions,' asserted MTC Executive Director Dan Bucks.

"States can find common ground to develop a common approach to taxing financial institutions," said MTC Executive Director Dan Bucks. The MTC's 19 member states reflect a cross-section of banking approaches, such as California, Indiana, and Minnesota, so the MTC is a good forum to develop a compromise, Bucks said. (An additional 12 states have consulting status with the MTC.) The MTC is now ending its initial research phase on state bank taxes and will be holding meetings to draft a possible compromise. However, the MTC does not adopt resolutions unless a majority of its affected member states say they will give serious consideration to adopting the proposal.

Although participants in the debate on banking taxes talk as if money center and market states are fixed entities, that assumption may be false, Bucks cautioned. He noted that when he worked for the state of South Dakota in the 1970s, it was not a money center state. Money is the most mobile of all commodities, Bucks said. "Don't assume you always will be a money center or market state," Bucks advised. "In the next decade you may switch. Take a long view."

State officials considering bank tax laws need to be willing to look beyond their own short-term interests, Bucks suggested. "States should see that financial services need reasonably compatible state tax laws." On the other hand, "the industry should recognize that a stable and effective system of revenue that reflects economic activity is needed." As for the possible threat of Federal intervention, Bucks said, "Congress is not a model for effective

NEWS

management. . . . Even where Congress has done a good job," such as with the 1986 tax act, "they have not stuck with it."

"The track record of Congress in preempting state taxation is terrible. The 4-R Act has practically destroyed the property tax system in Nebraska and could do the same in other states," Bucks said. "Congress can give away state tax dollars because it does not face the responsibility for providing the

services. Federal preemption of state taxes strikes at the lifeblood of state government."

States generally have been successful in resisting Federal preemption, Bucks said. However, having 40 different state taxes on banks and financial institutions is not the best solution, he maintained as he called for cooperation. ■

— Carol Douglas



EXHIBIT K: 9

Duffy, Susan G. and Judson, C. James, "State and Local Taxation of Financial Institutions: An Opportunity for Reform," Vanderbilt Law Review, May 1986, pp. 1057-1080

State and Local Taxation of Financial Institutions: An Opportunity for Reform

C. James Judson*
Susan G. Duffy**

I.	INTRODUCTION	1057
II.	BACKGROUND: A REGULATED INDUSTRY	1058
	A. <i>A Regulatory History of Commercial Banks</i> ..	1059
	B. <i>The Expansion of the Banking Business</i>	1063
III.	STATE TAXATION OF BANKS	1067
	A. <i>Due Process Clause Limitations</i>	1067
	B. <i>Commerce Clause Restrictions</i>	1070
	C. <i>Statutory Restrictions</i>	1071
IV.	POLICY QUESTIONS	1073
	A. <i>Jurisdictional Issues</i>	1073
	B. <i>Nature of Tax Base</i>	1076
	C. <i>Apportionment Issues</i>	1078
V.	CONCLUSION	1079

I. INTRODUCTION

Forces at work in both public and private sectors may soon change the way state and local political subdivisions tax financial institutions. The market for financial services is changing dramatically. Governments have expanded substantially the scope of activities in which financial depositories¹ may engage. The competitive

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1. The terms "financial depository," "financial intermediary," "financial industry," and "financial institution" are used interchangeably in this Article to refer to an institution that accepts deposits from the public and private sectors and lends the accumulated deposits to customers in the ordinary course of business.

environment for financial activities also is changing as general business corporations enter the financial services field, an area previously considered the exclusive domain of financial institutions. Financial institutions have increasing opportunities for interstate activity, which offers both risks and challenges. These changes have occurred during a period in which the extensive framework of state and federal governmental regulation and protection of financial activity has been curtailed substantially.

At the same time that financial institutions adjust to the changing market for their services, state and local governments are attempting to address increasing revenue needs. Although the budget difficulties that state and local governments face are mainly unrelated to the financial industry, the governments' financial crisis is magnified by an inability to collect taxes traditionally paid by financial depositories. Moreover, a series of Supreme Court and state court decisions have restricted the ability of the states to tax the principal or interest on federal obligations held by financial depositories.²

Partly because of the general fiscal crisis and partly because of these court decisions, a number of states are searching for a revised basis on which to tax financial institutions. State legislatures should consider carefully the changing market forces affecting the financial industry to determine the appropriate basis for taxation. This Article examines the legal developments, both in financial industry regulation and in federal limitations on state taxation, that have helped to shape the current market for financial services. This analysis and a review of relevant tax policy issues suggest that the states' interest in taxing the financial industry on a thorough but rational basis will be served best by a state income tax on financial institutions that is based on uniform jurisdictional rules and uniform apportionment standards.

II. BACKGROUND: A REGULATED INDUSTRY

Historically, the banking industry has been regulated heavily. The Federal Reserve Board, the Comptroller of the Currency, the Federal Home Loan Bank Board, and other federal agencies,³ as

2. *First Nat'l Bank v. Bartow County Bd. of Tax Assessors*, 105 S. Ct. 1516 (1985); *Am. Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983); *Memphis Bank & Trust Co. v. Garner*, 624 S.W.2d 551 (Tenn. 1981), *rev'd* 459 U.S. 392 (1983); see Blasi & Judson, *Supreme Court Provides Guideline for Taxing of Federal Securities by States*, 64 J. TAX'N 42 (1986).

3. Other federal agencies include the Federal National Mortgage Association. Federal

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well as comparable state agencies, have exercised considerable statutory authority and administrative discretion in circumscribing the activities in which financial institutions may engage. Each of these agencies responded to a specific legislative mandate. Congress charged the Federal Reserve Board with regulating bank holding companies, restraining undue concentration of commercial banking resources, operating a check or bank note clearance system, and establishing and maintaining bank reserve and examination mechanisms.⁴ The Comptroller of the Currency was directed to control and regulate the national currency and to supervise national banks.⁵ The Federal Home Loan Bank Board was directed to supervise Federal Home Loan Banks.⁶ Until recently these federal regulatory schemes and the corresponding state schemes have restricted the business operations of financial institutions both substantively and geographically.

A. A Regulatory History of Commercial Banks

The financial industry consists of several different types of businesses. The most visible segment of the industry includes the commercial banks, which operate in their permitted business sphere either directly or through affiliates and subsidiaries. Another major segment of the industry consists of savings and loan and other thrift institutions, including mutual savings banks. A third segment is composed of investment banks, whose operations typically are limited to underwriting, distributing, and trading securities. Quasi-governmental entities—including the federal land banks,⁷ intermediate credit banks,⁸ and others⁹—make up a final

Land Banks, the Federal Savings and Loan Insurance Corporation, the Federal Deposit Insurance Corporation, Production Credit Associations, and the Import-Export Bank.

4. See Federal Reserve Act, ch. 6, 38 Stat. 251 (1913) (codified as amended at 12 U.S.C. §§ 221-522 (1982)).

5. National Banking Act, ch. 106, § 1, 13 Stat. 99 (1864) (codified as amended at 12 U.S.C. § 21 (1982)).

6. Federal Home Loan Bank Act, ch. 522, § 17, 47 Stat. 736 (1932) (codified as amended at 12 U.S.C. § 1437 (1982)).

7. See Federal Farm Loan Act, ch. 245, 39 Stat. 360 (1916), *repealed by Farm Credit Act of 1971*, ch. 181, § 5.26(a), 85 Stat. 583, 624.

8. See Federal Farm Loan Act, ch. 245, tit. II, § 201(a) (1916), *repealed by Farm Credit Act of 1971*, ch. 181, § 5.26(a), 85 Stat. 583, 624.

9. E.g., Farm Credit Administration, Federal Farm Loan Act amendments, ch. 25, § 40, 48 Stat. 41, 51, *repealed by Farm Credit Act of 1971*, ch. 181, § 5.26(a), 85 Stat. 583, 624; Federal Credit Unions, 12 U.S.C. §§ 1751-1795 (1982); Production Credit Associations, *Farm Credit Act of 1933*, ch. 98, 48 Stat. 257, *repealed by Act of Sept. 6, 1966*, ch. 554, § 1(a), 80 Stat. 378, 648.

group within the financial industry.

Each segment of the industry historically has been subject to heavy regulation.¹⁰ Prior to 1791 the banking industry largely was unregulated. In that year Alexander Hamilton successfully persuaded Congress to charter the first Bank of the United States for twenty years. The Bank of the United States participated in financing the federal government's cash flow and in making loans to the general public. It accepted deposits from both public and private parties. In 1811 political forces¹¹ combined in opposition to continuing the Bank's charter, and the first Bank of the United States was dissolved.

The nation's monetary situation deteriorated significantly from 1811 to 1816. The lack of a central federal bank became a critical problem because of the government's need to borrow heavily to fund the War of 1812.¹² In 1816, as a result of its financial requirements, Congress determined to charter the second Bank of the United States, again for a limited period of twenty years. In 1836, however, states' rights advocates, easy-money promoters, and various proponents of private bank ownership found a powerful ally in President Andrew Jackson, who vetoed the congressional action that would have renewed the Bank's charter.¹³

The dissolution of the Bank of the United States left the chartering of financial institutions to state legislatures. In 1838 New York adopted the Free Banking Act to regularize and bureaucratize bank chartering and to depoliticize the chartering process.¹⁴ Michigan adopted a similar law in 1937.¹⁵ During the next thirty years, eighteen of the thirty-three state legislatures enacted legislation permitting the charter of state banks on a depoliticized basis.¹⁶

Congress reintroduced a national banking system through the National Banking Act of 1864.¹⁷ The legislation had two primary

10. This Article offers a brief regulatory history of the commercial banking industry. For a more detailed examination of the relationship among various financial institution regulatory schemes, see Report of the President's Commission on Financial Structure and Regulation (the "Hunt Report"), December, 1971.

11. See H. WALGREN, *PRINCIPLES OF BANK OPERATIONS*, 321-323 (1975).

12. See Huertas, *The Regulation of Financial Institutions: A Historical Perspective on Current Issues*, *FINANCIAL SERVICES: THE CHANGING INSTITUTIONS AND GOVERNMENT POLICY*, 8 (1983).

13. See H. WALGREN, *supra* note 11, at 322.

14. Act of April 13, 1838, ch. 684, 1838 N.Y. Laws 1763.

15. Act of July 28, 1937, no. 341, 1937 Mich. Pub. Acts 702.

16. See Huertas, *supra* note 12, at 11.

17. The National Banking Act, ch. 106, 13 Stat. 99 (1864) (codified as amended at 12

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objectives. The first goal was to finance the Civil War through substantial government borrowing. The Banking Act's second objective was to eliminate the myriad state bank paper money certificates in circulation, many of which were fraudulent.¹⁸ The National Banking Act contemplated the following three events: (1) regularly issuing national currency with a consistent design; (2) creating a network of national banks operating in compliance with federal regulatory standards; and (3) requiring national banks to maintain specified reserves.

Following the passage of the National Banking Act, the country had a dual banking system—a substantial number of small banks created under state law, and a smaller number of relatively larger banks created under the National Banking Act. In 1954 Congress attempted to eliminate the state component of the dual banking system by levying a substantial tax on bank notes issued by state banks.¹⁹ The increased use of bank checks rather than bank notes as a medium of exchange rendered this effort largely ineffective. Consequently, the dual banking system survived congressional attack and persists today.

The next substantial reform in the nation's banking system was the passage of the Federal Reserve Act in 1913.²⁰ The Act provided for partially centralized control of the commercial banking industry through a system of regional Federal Reserve Banks, but concentrated control of certain important national issues in the Federal Reserve Board. The Federal Reserve Act did not try to abolish the dual banking system. Instead, it gave state banks the option of choosing to become members of the Federal Reserve System.

The country's banking system was a major casualty of the economic depression following the stock market crash of 1929. A large number of the banks in the United States failed between 1929 and 1933.²¹ Congress enacted the Banking Act of 1933²² and its sequel,

U.S.C. §§ 1-216(d) (1982)).

18. Walgren notes: "Nicholas' Bank Note Reporter, published in 1858, gave 5,400 separate descriptions of fraudulent notes in circulation. Only about 7,000 different kinds of genuine notes were in use at the time." H. WALGREN, *supra* note 11, at 324.

19. Internal Revenue Code of 1954, Pub. L. No. 591-736, § 4881, 68A Stat. 587 (1954) repealed 1976).

20. Federal Reserve Act, ch. 6, 38 Stat. 251 (1913) (codified as amended at 12 U.S.C. §§ 221-522 (1982)).

21. From 1930 to 1933 nearly 9,000 banks failed. H. WALGREN, *supra* note 11, at 334.

22. The Banking Act of 1933, ch. 39, 48 Stat. 162 (1933) (codified as amended at 12 U.S.C. §§ 1511-1832 (1982)).

the Banking Act of 1935,²³ in response to the banking crisis. The 1933 Banking Act created the Federal Deposit Insurance Corporation (FDIC) and required all Federal Reserve System member banks to become participants in the FDIC system.²⁴

Branching is another area of bank operations that legislatures historically have restricted. The National Bank Act and most corresponding state legislative schemes prohibited either interstate or intrastate branching by national and state banks.²⁵ The McFadden Act,²⁶ which Congress enacted in 1927, permitted national banks to branch within their domiciliary states, but only if local state law permitted the branching. The McFadden Act permitted banks operating branches at the time of its enactment to maintain those branches under grandfathering provisions.²⁷

The McFadden Act did not entirely prohibit interstate branching. The Act, however, required interstate branching to be carried on through a bank holding company. A bank holding company is a corporation that, although not itself a bank, controls all or a substantial majority of the shares of one or more banks located within one state or in several states. A number of bank holding companies were created during flurries of holding company activity in the 1900s, the 1920s, and the early 1950s.²⁸

In 1956 the Bank Holding Company Act²⁹ brought all bank holding companies under the Federal Reserve Board's supervision. The Act also restricted the activities in which multibank holding companies could engage. Congress adopted this legislation partly as a response to the activities of TransAmerica Corporation. TransAmerica acted as a financial services holding company and owned interests in banks, insurance companies, and related entities.³⁰ Congress was concerned that TransAmerica would, in effect, monopolize the range of financial services, resulting in concentration of ownership of banking, insurance, stock brokerage, and other

23. The Banking Act of 1935, ch. 614, 49 Stat. 684 (1935) (codified as amended at 12 U.S.C. §§ 1811-1832 (1982)).

24. Act of Sept. 21, 1950, ch. 967, § 4(b), 64 Stat. 875 (codified at 12 U.S.C. § 1814(b) (1982)).

25. 12 U.S.C. § 36 (1982); see, e.g., WASH. REV. CODE ANN. §§ 30.40.010-.060 (1961 & Supp. 1986).

26. McFadden Act, ch. 191, § 7, 44 Stat. 1225, 1228 (1927) (codified as amended at 12 U.S.C. § 36 (1982)).

27. 12 U.S.C. § 36(a) (1982).

28. See H. WALGREN, *supra* note 11, at 335.

29. Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841-1850 (1982)).

30. See Huertas, *supra* note 12, at 18.

the banking crisis. The Deposit Insurance Corporation Reserve System member system.²⁴

legislatures Bank Act and most courts either interstate or banks.²⁵ The McFadden Act permitted national banks to do business only if local state law permitted banks to do business in that state to maintain those banks.

prohibit interstate interstate branching to be a bank holding company. A bank holding company, controls all one or more banks located in a number of bank holding company states.²⁶

Act²⁷ brought all bank holding companies under the Federal Reserve Board's supervision. This legislation partly explains why the American Bankers Association's holding company and bank holding companies, and related entities in America would, in effect, result in concentration of bank assets, stock brokerage, and other

financial operations. The concern was exacerbated by the ability of many holding company affiliates to branch on an interstate basis without substantial regulation. The Bank Holding Company Act prohibited interstate branching of bank holding company affiliates, an area that federal law had not previously restricted. Section 3(d) of the Act limited a holding company's right to acquire a bank outside the holding company's domiciliary state to acquisitions permitted by the laws of the state in which the target bank primarily operated.³¹

The Bank Holding Company Act also limited multibank holding companies to activities that were "closely related" and "properly incidental" to the main activities of conducting a banking business.³² Congress amended the Bank Holding Company Act in 1970 to bring one-bank holding companies under the Federal Reserve Board's control. The amendments gave the Board broad authority and discretion to interpret the "closely related" and "properly incidental" language of the Holding Company Act of 1956.³³ The 1970 amendments also directed the Board to weigh on a case-by-case basis the positive consequences of bank consolidations, including public convenience, necessity, and efficiency, against the undue influence attendant to concentration of banking assets.

B. *The Expansion of the Banking Business*

The financial industry quickly has taken advantage of the relaxed legislative constraints on the banking business. Banks have substantially expanded their business opportunities by diversifying the services they provide directly or through affiliates and by using several devices to create or increase their interstate presence. The regulations of the Federal Reserve Board³⁴ and of the Comptroller of the Currency³⁵ govern how bank holding companies and banks permissibly can expand their business operations. The McFadden Act³⁶ and the Bank Holding Company Act's Douglas Amendment³⁷

31. Bank Holding Company Act of 1956, ch. 240 § 7(d), 70 Stat. 133, 135 (also known as the Douglas Amendment) (codified as amended at 12 U.S.C. § 1842(d) (1982)).

32. 12 U.S.C. § 1843(c)(8) (1982).

33. Bank Holding Company Act Amendments of 1970, Pub. L. 91-607, § 103(4), 84 Stat. 1760 (codified at 12 U.S.C. § 1843(c)(8)(G) (1982)).

34. 12 C.F.R. §§ 225.1-43 (1986).

35. 12 C.F.R. §§ 5.30-35 (1986).

36. McFadden Act, ch. 191, § 7, 44 Stat. 1225, 1228 (1927) (codified as amended at 12 U.S.C. § 36 (1982)).

37. Bank Holding Company Act of 1956, ch. 240, § 7(d), 70 Stat. 133, 135 (codified as amended at 12 U.S.C. § 1842(d) (1982)).

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contain the rules governing interstate and intrastate branching for, respectively, banks and bank holding company affiliates. The financial industry has aggressively tested the limits of interstate activities under these rules.

Case law and Federal Reserve and Comptroller regulations have permitted banks, bank affiliates, or both to engage in leasing businesses,³⁸ to own commercial finance corporations,³⁹ to operate credit unions,⁴⁰ to operate certain computer services,⁴¹ to speculate in futures markets,⁴² to deal in credit-related life insurance,⁴³ and to engage in certain securities brokerage activities.⁴⁴ Banks or their affiliates, acting through subsidiaries or through branch offices, may conduct many of these activities on an interstate scale without substantial limitation under state or federal law. Commercial banks' direct interstate activities also have increased dramatically. Loan production offices (LPOs) have been a major force in the competition for major loan funding. In 1981, for example, the number of commercial bank LPOs located in states other than the sponsoring bank's domiciliary state is estimated to have been 350.⁴⁵ Bank call officer programs are another major force in the market for lending opportunities.⁴⁶

38. *M & M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377 (9th Cir. 1977).

39. Gerber, *Current Legal and Regulatory Developments*, 3 NATIONAL BANKING REV. 269, 264 (1966).

40. Gerber, *Current Legal and Regulatory Developments*, 2 NATIONAL BANKING REV. 573, 576 (1965).

41. See *National Retailers Corp. v. Valley Nat'l Bank*, 604 F.2d 32 (9th Cir. 1979), holding that a national bank can engage in computer service activity only to support activities expressly authorized by the National Banking Act. A national bank exceeded its powers when it went beyond this limitation and offered data processing services to the public generally.

42. Lehr, *Current Legal and Regulatory Developments*, 3 NATIONAL BANKING REV. 549, 551 (1966).

43. *First Nat'l Bank v. Smith*, 436 F. Supp. 824 (S.D. Tex. 1977).

44. See OCC Interpretive Letter (1977), [1978-1979 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 85037 (promoting bank participation in treasury bill and GNMA mortgage futures markets). In *Securities Indus. Ass'n v. Comptroller of Currency*, 758 F.2d 739 (D.C. Cir. 1985), cert. denied, 54 U.S.L.W. 3460 (U.S. Jan. 14, 1986), the court determined that a national bank's operation of a securities brokerage subsidiary does not violate federal law, but faces geographical limits in the McFadden Act's imposition of state law branch banking restrictions on national banks.

45. *Geographic Restrictions on Commercial Banking in the United States*, Report of the President of the United States at 6 (January 1981).

46. Call programs enable banks to provide loans to businesses across the country. "It is not possible to estimate the magnitude of business generated by calling officers." Cohen, *Interstate Banking: Myth and Reality*, 18 LOY. L.A.L. REV. 965, 973 (1985). Under a call officer program, a bank targets potential borrowers in another state to receive the concerted attention of one or more traveling loan officers. On large transactions this kind of call officer

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comptroller regulations to engage in leasing corporations,³⁹ to operate services,⁴¹ to speculate in life insurance,⁴³ and activities.⁴⁴ Banks or their through branch offices interstate scale without general law. Commercial increased dramatically. a major force in the for example, the num- states other than the imated to have been er major force in the

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More recently, a flood of "nonbank banks" have entered the financial market.⁴⁷ The Bank Holding Company Act defines a bank as an institution that accepts demand deposits and makes commercial loans.⁴⁸ An institution that does not accept demand deposits or does not make commercial loans does not fall within the Bank Holding Company Act's definition of a bank and thus is not subject to the Act's interstate branching restrictions.

In 1984 the Federal Reserve Board adopted regulations that expanded the regulatory definition of a bank to prohibit the interstate branching of nonbank banks.⁴⁹ In *Board of Governors v. Dimension Financial Corporation*⁵⁰ the Supreme Court struck down the Board's regulatory efforts and ruled that only Congress has the authority to change the definitions upon which banking regulation is based. The decision permits nonbank banks to continue operating interstate branches, despite the Federal Reserve Board's attempt to restrict this practice. Proposed federal legislation, however, would change the statutory treatment of nonbank banks.⁵¹

In addition to the approximately one hundred⁵² nonbank or limited-service banks that have sprung up in the United States, nonfinancial commercial companies are using the nonbank bank rules to set up large, nationwide financial empires. Sears, Roebuck and Company, for example, owns the Greenwood Trust Company of Greenwood, Delaware. Sears is using Greenwood Trust as a vehicle for interstate distribution of the new Sears credit card, "Discover," a general purpose card similar to Visa or Mastercard.⁵³ The J.C. Penney Company, Dreyfus Corporation, Dean Witter Finan-

program results in additional business for the lending institution. A large loan placed by a call officer is a low-overhead loan which can be priced at an extremely attractive interest level. Such a loan frequently will escape the attention of the taxing authorities of the state where the borrower is domiciled, another factor contributing to the relatively attractive interest rate.

47. Ellis, *Nonbanks: Who's Getting the Bucks—and Who's Not*, BUS. WK., Feb. 10, 1986, at 67.

48. 12 U.S.C. § 1481(c) (1982).

49. Demand deposits were expanded to include any deposits that "as a matter of practice" were payable on demand. 12 C.F.R. § 225.2(a)(1)(A) (1986). Commercial loans were expanded to include "the purchase of retail installment loans or commercial paper, certificates of deposit, bankers' acceptances, and similar money market instruments, the extension of broker call loans, the sale of federal funds, and the deposit of interest-bearing funds." 12 C.F.R. § 225.2(a)(1)(B) (1986).

50. 54 U.S.L.W. 4101 (U.S. Jan. 22, 1986).

51. See H.R. 20, 99 Cong. 1st Sess. (1985) (changing the definition of a "bank" under the Bank Holding Company Act).

52. Ellis, *supra* note 47.

53. *Id.*

cial Services, and many other commercial firms have undertaken similar efforts.⁵⁴

While the Supreme Court has struck down restrictions on the interstate financial activities of nonbank banks, 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 northeastern states first instituted regional interstate banking on a reciprocal basis.⁵⁵ Some state legislatures have adopted legislation that permits limited interstate banking by allowing a bank headquartered outside the state to acquire an in-state bank if the acquiring bank agrees to limit its presence in the state.⁵⁶ Some states have limited permissible interstate acquisitions to situations in which the local bank has financial difficulty;⁵⁷ other states have conditioned the interstate acquisition on the acquiring bank's conducting commercial or industrial development activity in the target bank's state.⁵⁸

The barriers once presented to a national, interstate banking system have been eroded substantially. Under current law, a bank or bank holding company can expand anywhere in the country by using a nonbank bank, a loan production office, a subsidiary engaged in a related financial business, or a call officer program. In some regions of the country, interstate acquisition of commercial banks is legal. It appears that interstate activity by financial institutions will continue to increase rather than decrease in the future.

The expanding scope and breadth of financial activity have consequences for both the regulators and the banking industry. State and local governments must make difficult decisions about regulatory issues, including capital requirements, local qualification, and registration for service of process. Legislatures also must resolve the application of traditional banking rules in areas of commerce that the Uniform Commercial Code, consumer protection acts, and other commercial legislation govern. Banks must make numerous organizational decisions regarding the structure of their operations in the expanded interstate markets. Banks must focus

54. *Id.*; see also *Things to Watch*, U.S. NEWS & WORLD REPORT.

55. A history of the N.E. Banking Compact is found in *Northeast Bancorp, Inc. v. Board of Governors Fed. Reserve Sys.*, 105 S. Ct. 2545, 2548-49 (1985), in which the Court held valid the statutes of the New England states authorizing interstate bank acquisitions on a regional basis.

56. *E.g.*, DEL. CODE ANN. tit. 5 § 803 (Supp. 1983).

57. *E.g.*, WASH. REV. CODE ANN. § 30.04.230 (1986 Supp.).

58. D.C. City Council Bill 6-276, "D.C. Regional Interstate Banking Act of 1985."

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III. STATE TAXATION OF BANKS

The previous section describes the extent to which the federal government traditionally has regulated financial institutions. Federal law also significantly has limited the ability of state and local governments to tax financial institutions. These limitations, found both in the United States Constitution and in federal legislation, provide the legal framework within which a state may design a scheme for taxing the financial industry.

A. Due Process Clause Limitations

Some limitations on state taxation of banks in general and national banks in particular derive from the due process clause of the United States Constitution. Courts have eroded these limitations substantially over the past two hundred years. Today, virtually any regular and purposeful economic activity that a bank conducts within the taxing state will satisfy due process requirements.

The Supreme Court interpreted current due process limitations in *National Geographic Society v. California Board of Equalization*.⁵⁹ The Court stated that due process requires "some definite link, some minimum connection, between [the State and] the person . . . it seeks to tax."⁶⁰ The Court did not accept the more attenuated connection the California Supreme Court urged: that the "slightest presence" of a taxpayer in the state should establish a sufficient nexus to support the imposition of a sales tax collection and payment requirement.⁶¹ The Supreme Court noted that its affirmation of the California court's decision did not imply acceptance of the "slightest presence" standard.⁶²

The Supreme Court's "minimum connection" due process test, however, requires little more than the slightest presence in a particular jurisdiction. Courts have reduced the minimum connection to its most basic elements. An entity conducting regular and purposeful economic activity within a taxing jurisdiction permits the jurisdiction to levy its tax on the entity. Modern case law in the

59. 430 U.S. 551 (1977).

60. *Id.* at 561 (quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-345 (1954)).

61. *National Geog. Soc'y v. State Bd. of Equalization*, 16 Cal. 3rd 637, 547 P.2d 458, 462, 128 Cal. Rptr. 682 (1976) *aff'd* 430 U.S. 551 (1977).

62. 430 U.S. at 556.

areas of jurisdictional due process⁶³ and taxation due process indicates that virtually any economic market penetration that is purposeful and regular will satisfy the minimum connection required under *National Geographic*.⁶⁴

The required connection between the state and the taxpayer has grown progressively more attenuated. Nearly three decades ago in *McGee v. International Life Insurance Co.*⁶⁵ the Supreme Court considered California's jurisdiction over an out-of-state insurance company that solicited insurance contracts by mail. The mail solicitation and the contract between the out-of-state insurer and the California insured was the only aspect of the relationship that occurred within California. The Court held that the contract's substantial connection with the state satisfied the requirements of due process.⁶⁶

Hanson v. Denckla,⁶⁷ decided a year later, involved litigation between Florida estate beneficiaries and the Delaware trustees of a trust created outside the decedent's will. In considering whether a Florida court had jurisdiction over a Delaware trustee with no discernable contact with the State of Florida, the Supreme Court noted that technological progress and increased interstate activity had increased demands for jurisdiction over nonresidents. The Court, however, found essential for jurisdiction "some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws."⁶⁸

The Supreme Court stated a similar standard in *World-Wide Volkswagen Corp. v. Woodson*.⁶⁹ Under the 'World-Wide Volkswagen' standard, a manufacturer's or distributor's attempts to serve the forum state's market satisfies due process requirements. Thus, if a corporation entered its products "into the stream of commerce" flowing to the forum state's consumers, "personal juris-

63. Caselaw suggests that the jurisdictional due process test and the taxation due process test are the same: "[T]he activities which establish [an entity's] 'presence' subject it alike to taxation by the state and to suit to recover the tax." *International Shoe Co. v. Washington*, 326 U.S. 310, 321 (1945).

64. See, McCray, *Overturing Bellas Hess: Due Process Considerations*, 1985 B.Y.U. L. Rev. 265.

65. 355 U.S. 220 (1957).

66. *Id.* at 223.

67. 357 U.S. 235 (1958).

68. *Id.* at 253.

69. 444 U.S. 286 (1980).

due process indication that is purposefully directed toward residents of the state.

and the taxpayer three decades ago. The Supreme Court of-state insurance. The mail solicitation of the insurer and the relationship that occurs under the contract's subsequent requirements of due

involved litigation where trustees of a trust are considering whether to sue a trustee with no disinterested Supreme Court interstate activity nonresidents. The act by which the trustee invokes the bene-

rd in *World-Wide Volkswagen*. The court's attempts to meet the requirements of due process into the stream of interstate commerce, "personal juris-

and the taxation due process clause's 'presence' subject to the International Shoe Co. v. Washington

considerations, 1985 B.Y.U.

diction over the corporation would be possible.⁷⁰ The Court recently further attenuated jurisdictional connection requirements in *Burger King Corp. v. Rudzewicz*.⁷¹ The Court held that a firm not physically present in a state nevertheless may be subject to that state's laws if the firm engages in commercial efforts "'purposefully directed' toward residents" of the state.⁷²

Under these Supreme Court formulations, states now easily meet the due process standards for taxation. Commercial activities that have been fairly regular and "purposefully directed" toward residents of the taxing state will support jurisdiction over a nonresident. The typical commercial activities of financial institutions in a modern market normally will satisfy this jurisdictional test. The mere physical presence in a state of a loan production office or of a call officer who operates out of his home will provide the regular, "purposefully directed" activities required by the due process clause. The regular and purposeful exploitation of a market through frequent mailings of credit card solicitations and placement of credit card applications at commercial locations throughout a state also may satisfy this test. Extension of computerized banking services through automatic teller machines and other electronic funds transfer mechanisms, or through personal home computers may satisfy the test. Regular solicitation of loan customers through the mail or by telephone similarly may satisfy the due process "purposeful activity" test.

When a financial institution conducts these interstate activities, its customer's state of residence offers the institution a significant benefit—the right to sue the customer for nonperformance of his obligations incident to the transaction with the financial institution. In most situations, a bank soliciting interstate business can sue an individual customer only in his state of residence. Individual bank customers rarely have sufficient connections with other states to support personal jurisdiction.⁷³

70. *Id.* at 297-298.

71. 105 S. Ct. 2174 (1985).

72. *Id.* at 2177.

73. See *World-Wide Volkswagen*, 444 U.S. at 286; but see *Proctor & Schwartz, Inc. v. Cleveland Lumber Co.*, 323 A.2d 11 (Pa. 1974), in which a nonresident corporation conducted extensive and active negotiations with a bank in the forum state. The Pennsylvania court held that exercise of jurisdiction by the state court was "fair and reasonable" because the nonresident corporation reasonably could have anticipated that failure to make installment payments would result in consequences within the forum state.

B. Commerce Clause Restrictions

Like the due process clause, the commerce clause of the United States Constitution limits a state's power to tax. The Supreme Court stated the commerce clause test in *Association of Washington Stevedoring Cos. v. Department of Revenue*:⁷⁴ "The Court repeatedly has sustained taxes that are applied to activity with a substantial nexus with the State, that are fairly apportioned, that do not discriminate against interstate activity, and that are fairly related to the services provided by the State."⁷⁵ The test's first and fourth elements involve an analysis similar to that employed for due process clause purposes.⁷⁶ The Supreme Court strictly analyzes the test's third requirement, that the tax be non-discriminatory; any remotely supportable suggestion that the tax discriminates against interstate commerce will result in a repudiation of the taxing scheme.⁷⁷ The Court, however, broadly construes the requirement of fair apportionment. In *Moorman Manufacturing Co. v. Bair*⁷⁸ the Court noted that the taxpayer has the burden of proof in showing that the application of a particular apportionment formula will lead to a distorted result and permitted the state to apply a single-factor apportionment formula. The latitude afforded the states in creating apportionment formulas and the burden placed on the taxpayer of proving distortion have combined to make virtually any apportionment formula constitutionally fair.

Thus, any purposeful interstate solicitation or market penetration activity that a financial institution regularly conducts apparently will subject the institution to taxation in the jurisdictions in which the activity takes place. States are free to levy nondiscriminatory, fairly apportioned taxes on interstate activity. Both state and federal courts have issued decisions consistent with this interpretation. Notwithstanding the *American Refrigerator* cases,⁷⁹ the

74. 435 U.S. 734 (1978). That banking constituted "commerce" in the constitutional sense, however, was not always certain. The Supreme Court in the *Philadelphia Bank Case* held that banking is a line of commerce in the antitrust sense and that therefore bank mergers are subject to Section 7 of the Clayton Act. *United States v. Philadelphia National Bank*, 374 U.S. 321 at 356 (1963).

75. 435 U.S. at 750.

76. The Supreme Court initially set out these tests in their present form in *International Shoe Co. v. Washington*, 326 U.S. 310 (1945).

77. See *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984). But see *National Can Corp. v. Department of Rev.*, 105 Wash. 2d 327, 715 P.2d 327 (1986).

78. 437 U.S. 267 (1978).

79. See *American Refrigerator Transit Co. v. State Tax Comm'n*, 395 P.2d 127

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merce clause of the power to tax. The Supreme Court in *Association of Banks v. United States*,⁷⁴ "The tax is applied to activity that is fairly apportioned to the state and interstate activity, and by the State."⁷⁵ The analysis similar to that in *The Supreme Court* that the tax be non-discriminatory and that the tax result in a repudiation of the equal protection clause, broadly construes the *Norman Manufacturing Co. v. United States* taxpayer has the burden of showing that the particular apportionment is fair and permitted the formula. The latitude in the use of different formulas and the distortion have come from the formula constitution-

in or market penetration. A company that primarily conducts activity in one state but also has activity in other states is not to levy nondiscriminatory activity. Both state courts and the Supreme Court are consistent with this interpretation in the *Refrigerator cases*,⁷⁶ the

merce" in the constitutional case the *Philadelphia Bank Case* and that therefore bank mergers v. Philadelphia National

their present form in *International Brotherhood of Teamsters v. United States* see *National Can Corp. v. United States*

Tax Comm'n, 395 P.2d 127

rule⁸⁰ requires regular, purposeful activity directed toward a market state. Deriving income from a state is not itself sufficient to permit taxation.⁸¹

C. Statutory Restrictions

Banks historically have been subject to state taxation only in the state of their principal commercial domicile. The National Bank Act of 1864⁸² and successive legislation imposed comprehensive restrictions on state and local taxation of national banks. In 1969, prompted by two Supreme Court decisions,⁸³ Congress enacted both a permanent and a temporary amendment to the banking laws that restricted taxation of national banks.⁸⁴ The permanent amendment went into effect in 1976⁸⁵ and made a state free to tax any bank having a taxable nexus with the state, subject only to the requirement of equal treatment of national and state banks. Although legislators have attempted⁸⁶ to restore federal regulation regarding the taxation of financial institutions' interstate activities, Congress has not yet adopted any proposal.

Aside from the specific statutory requirement of nondiscriminatory taxation,⁸⁷ few federal statutes currently restrict the power of states to tax financial institutions. One federal statute, however, restricts the states' ability to tax the interest or principal of federal obligations. The statute provides:

Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing the tax, except . . . a non-discriminatory franchise tax or other nonproperty tax instead of a franchise tax, imposed on a corporation; and . . . an estate or inheritance tax.⁸⁸

(Or. 1964); *Oklahoma Tax Comm'n v. American Refrigerator Transit Co.*, 349 P.2d 746 (Okla. 1959); *Commissioner v. Pacific Fruit Express Co.*, 296 S.W.2d 676 (Ark. 1956); *Kentucky Tax Comm'n v. American Refrigerator Transit Co.*, 294 S.W.2d 554 (Ky. 1956). But see *John H. Grace Co.*, (CCH) ¶ 206-416 (Cal. Bd. of Equalization, Oct. 28, 1980).

80. See *Standard Pressed Steel Co. v. Department of Rev.*, 419 U.S. 560 (1975).

81. 395 P.2d at 131.

82. National Banking Act, ch. 106, § 1, 13 Stat. 99 (1864) (codified as amended at 12 U.S.C. § 21 (1982)).

83. *First Agricultural Bank v. Tax Comm'n*, 392 U.S. 339 (1968); *Dickenson v. First Nat'l Bank*, 393 U.S. 409 (1969).

84. Pub. L. No. 91-156, 83 Stat. 434 (1969).

85. State Taxation of Depositories Act, Pub. L. No. 93-100, § 7, 87 Stat. 342 (1973).

86. See S. 3368, 94 Cong., 1st Sess. (1975); S. 1900, 95 Cong., 1st Sess. (1977).

87. Pub. L. No. 91-156, 83 Stat. 434 (1969).

88. 31 U.S.C. § 3124 (1982).

The courts will permit neither a tax scheme that taxes interest earned on federal obligations but not the interest earned on state obligations,⁸⁹ nor an income tax that includes the income from federal obligations in the tax base.⁹⁰ Recent case law, however, has enhanced the states' ability to include indirectly in the tax base those sums whose direct inclusion is forbidden. *First National Bank of Atlanta v. Bartow County Board of Tax Assessors*⁹¹ is particularly significant in enabling state taxation of federal obligations. The Court upheld a Georgia shares tax that provided no direct reduction or exemption from the shares tax base for federal obligations. The Georgia Department of Revenue interpreted the Georgia tax provisions to permit a proportional reduction of the taxpayer's capital on a formula basis. The taxpayer's total capital was multiplied by the proportion of the taxpayer's total assets held in federal obligations. The Georgia scheme excludes the resulting dollar amount from the tax base. The Court stated that this approach to determining the exempt portion of the tax base would do "no more than allocate to tax-exempt values their 'just share of a burden fairly imposed.'"⁹² In light of this holding, states are free to tax at least a portion of federal obligations that a bank holds. States also may use some other approach, such as denying banks deductions for income earned on federal obligations, which ordinarily would be available to a bank.⁹³

Several states have adopted specific statutory limitations—"negative jurisdiction" statutes—that restrict the state's ability to tax interstate financial activities.⁹⁴ Other state legislatures have adopted taxing provisions affirmatively requiring that the taxpayer have conducted a defined minimum of local business activity before the state's authority to tax is established. These laws are known as "affirmative jurisdiction" statutes.⁹⁵

California has adopted a statute that contains a negative juris-

89. *Memphis Bank & Trust Co. v. Garner*, 624 S.W.2d 551 (Tenn. 1981), *rev'd*, 459 U.S. 392 (1983).

90. *Dale Nat. Bank v. Pennsylvania*, 465 A.2d 965 (Pa. 1983).

91. 105 S. Ct. 1516 (1985).

92. *Id.* at 1521 (quoting *Denman v. Slayton*, 282 U.S. 514 at 519 (1931)).

93. See *infra* text accompanying notes 101-02.

94. See, e.g., W. VA. CODE § 11-24-6(f) (Supp. 1985); ALASKA ADMIN. CODE, tit. 15, § 20.620 (1984). Whether the Alaska provision has sufficient legislative authorization is questionable.

95. Washington's business tax scheme, for example, is applicable only if a taxpayer is "doing business" in the state. WASH. REV. CODE ANN. § 82.04.230-.290 (1982).

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97. *Id.* §

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diction test.⁹⁶ Foreign banks that do not maintain a place of busi- ness or conduct certain disqualifying business activities in the state are exempt from state licensing requirements and from some taxes otherwise imposed on banking institutions in the state. The out-of- state banks must limit their activities to making and servicing loans and to arranging security for the loans.⁹⁷ This legislation re- flects a clear policy decision. The statute's purpose is to encourage bank lending activity that, absent some exemption from state taxa- tion, might not be made available within the state. The effective- ness of the jurisdictional statutes in promoting or discouraging specific banking activity is not yet clear.

IV. POLICY QUESTIONS

The financial industry is in the process of expanding the scope of its business operations. The current climate of relaxed regula- tion and heightened competition permits and demands that banks diversify the services they provide to the individual consumer and the commercial marketplace. As a result, banks and their affiliates are engaging in a wider range of business activities. Commercial corporations also are expanding their activities in the financial sphere and are competing effectively with the traditional bank and its affiliated corporate group. Moreover, both banks and their affli- ates and commercial corporations and their affiliates are expanding their financial services across state lines. Interstate market pene- tration by nonbank banks, by mail, telephone, television, and ra- dio, and by computer networks soon will be commonplace.

These developments should lead both the states and their lo- cal political subdivisions to address several important tax policy issues as these governments consider reforming their schemes for taxing the financial industry. Significant issues include the follow- ing: (1) the proper jurisdictional standard, (2) the appropriate tax- ing method or tax base for determining the financial institutions' tax liability, and (3) the method for apportioning or allocating an interstate financial depository's tax base among multiple jurisdic- tions in which that bank may be taxed.

A. Jurisdictional Issues

Judicially determined due process and commerce clause stan- dards bind a state or local political subdivision that seeks to tax

⁹⁶ CAL. CORP. CODE §§ 191(d) and 2104 (West 1977).

⁹⁷ *Id.* § 191(d).

interstate activity. In addition, issues of a proposed tax's equity, its practicality, and its effect on economic development must be considered. From one perspective, a state's taxing all activity it is constitutionally permitted to tax is a desirable tax goal. This tax strategy protects local industry from the risk that out-of-state competitors will have an unfair advantage in local markets because they have no obligation to pay local taxes. This potential advantage particularly concerns the financial industry, in which large out-of-state banks frequently compete with local institutions for loans to substantial borrowers. The out-of-state competitor frequently lacks the benefits of a local office, individual representative, direct or indirect advertising, or regular market penetration. In a competitive loan environment, in which a bid interest rate's success or failure is measured by hundredths of a percentage point, even a relatively minor tax on earnings from a large loan will place the taxed financial institution at a significant disadvantage.

From another point of view, a state has a valid interest in not taxing activity that is either too infrequent or too insubstantial to constitute an appreciable local economic presence. Furthermore, any taxing jurisdiction should strive not to exact a tariff whose costs of taxpayer compliance or costs of audit confirmation exceed the amount of additional tax revenues. Although modern computer technology has substantially reduced the compliance costs for most taxpayers,⁹⁸ any filing response necessarily involves an appreciable cost for both the taxpayer and the taxing authority. States should keep the cost/benefit ratio of any taxing scheme in perspective.

A state legislature attempting to develop a taxing scheme for the financial industry also should consider the type and extent of the benefits the state extends to the financial industry. New York, a money center state, extends different benefits than does Montana, a market state. New York provides the financial industry with access to capital that can be lent to customers all over the world. According to one estimate, for example, Citibank, headquartered in New York, accrues over half its annual earnings on business outside the United States.⁹⁹ Montana, by comparison, provides financial institutions with a ready market for their lending activities. Montana's farming, mining, and timber industries all require substantial borrowing, and the funds generated through sav-

98. See Westphal, *The Computer's Role in Simplifying Compliance with State Taxation*, 39 VAND. L. REV. 1099 (1986).

99. Table, *Geographical Distribution of Revenue*, 1984 Citicorp Annual Report.

ings and other individual accounts in that sparsely populated state are not likely to meet the demand for loan capital.

Because New York provides the financial industry with the ability to raise lending capital, New York's establishing a jurisdictional test that attributes to New York a substantial portion of the income earning activities of banks with fund raising offices in that state would be logical. If the primary benefit New York provides to the financial industry is a source of funds, then New York should design its jurisdictional test to insure that it taxes institutions that derive economic benefit from that source of funds. Conversely, Montana, as a market state, legitimately might establish a jurisdictional test that allows it to tax financial institutions that regularly and purposefully exploit Montana's market for their lending activities. Montana would direct its jurisdictional test specifically at lending activity rather than at fund raising activity.

Changes in a particular state's economic climate may affect the flow of loan dollars into that state. That a particular jurisdiction's tax climate may affect the willingness of the financial industry to engage in activities in that state is a frequent assumption. Recently, several Japanese companies announced that the adoption by some states of unitary tax schemes¹⁰⁰ will cause the Japanese to invest in other states with tax regimes more favorable to foreign-owned economic activity.¹⁰¹ In spite of assertions of this kind, however, the question whether a particular state's tax climate does have a significant effect on industry's willingness to conduct business in the state remains open. A more accurate assessment might be that industry tends to locate where it believes it can make a profit and that general economic factors normally out-

100. Under a unitary tax scheme a tax, typically an income tax, is levied against all members of a corporate group with interrelated business activities, rather than against one member of the affiliated group which may have local activity in the taxing state. A unitary group must therefore meet what have been called the "three unities test": unity of ownership, operation and use. Unity of ownership is shown by more than 50% ownership among the corporate group. Unity of operation is demonstrated by central purchasing, advertising, accounting, and legal departments. Unity of use is suggested by a centralized executive office and general system of operation. If a group of corporations meets these tests (and other subttests developed by the courts) the group is said to be a unitary group. The income of all members of the unitary group is then combined (and intercompany items eliminated) in order to ascertain the tax base which the taxing state may reach. Apportionment is similarly ascertained on a combined basis, although only apportionment factors of those members of the unitary group which actually are subject to the tax jurisdiction of the particular state may be utilized in ascertaining the apportionment formula under the standard three-factor approach.

101. See Seattle Times, July 7, 1985, at D1; June 25, 1985, at A7; March 10, 1985, at C1.

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weigh state tax considerations in business location and market penetration decisions.

A state considering creation of a tax jurisdictional standard also should take into account the state's need for steady revenue at an adequate level. In an era of declining federal financial aid to state and local governments and rising demand for state and local services, each state has a serious need for revenue. A reduced or minimum contacts jurisdictional test for nondomiciliary business activity may help a state meet its revenue needs.

B. Nature of Tax Base

The financial industry is currently subject to several alternative and cumulative tax schemes. In some states the primary tax on banks is the capital or shares tax.¹⁰² A shares tax levies on the bank's capital. Local tax rules measure the shares tax by applying a rate against the institution's capital. The tax at issue in *First National Bank of Atlanta*¹⁰³ was a bank shares tax. A shares tax allows few exclusions or deductions from the tax base.

Although several states have adopted capital based tax schemes, a capital base is unwise from a tax policy perspective. First, the base is not economically elastic. Although a bank's capital will increase during good economic times, it will do so at a lower rate than income or receipts. Correspondingly, a bank's capital will decline during poor economic times, but the rate of decline will be relatively shallow. Because the tax base is not in harmony with economic conditions, the tax will encourage or discourage specific activities. The tax therefore lacks desirable economic neutrality.

Second, states using a capital tax may not be able to reach certain bank assets, such as federal obligations,¹⁰⁴ and may find that taxation of other assets, such as state and local obligations, is politically unacceptable. Furthermore, a capital tax is an unwieldy mechanism for attempting to tax the interstate activities of financial institutions. Attributing capital among a number of taxing jurisdictions on any reasoned basis is difficult. Frequently, states simply regard all of a domiciliary institution's capital as taxable

102. See, e.g., IND. CODE ANN. § 6-5-10 to -17 (Burns 1984); LA. REV. STAT. ANN. §§ 47:1967-1972 (West 1950 & Supp. 1986).

103. 105 S. Ct. 1516 (1983). For a further discussion of *First National Bank of Atlanta* see *supra* text accompanying notes 91-94.

104. See *supra* text accompanying notes 89-94.

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and all of a nondomiciliary institution's capital as nontaxable.¹⁰⁵ Particularly in an age of expanding interstate financial activities, this simplistic method is not acceptable.

Transactional taxes, such as document recordation taxes and intangible property taxes, are not flexible enough to serve the demands on a state tax system in an age of expanding interstate financial activity. Transactional taxes trace the source of a particular transaction or a document to one state for tax purposes. Resolution of the sourcing problem is arbitrary and results in an all or nothing approach to taxation.

Sales taxes, use taxes, and gross receipts taxes, although useful in consumer or industrial sales contexts, are not satisfactory in a financial services context. These taxes are economically inelastic,¹⁰⁶ and the taxes often are attributed or allocated on an arbitrary, all or nothing basis. Few states have opted for a gross receipts tax, although the taxes are more popular at the local government level.¹⁰⁷

The income tax does not suffer from these weaknesses. The net income tax is flexible and provides a method for apportioning taxable income among a number of taxing jurisdictions. The tax is sufficiently elastic and responds to fluctuations in a state or national economic cycle. The net income tax is considered equitable because, when imposed progressively, it responds to the taxpayer's theoretical ability to pay. A state can tailor an income tax to accomplish economic goals. For example, legislatures can grant deductions, timing benefits, and tax credits to encourage specifically desired economic activity by financial institutions or other taxpayers. A not insignificant advantage of an income tax is the tax expertise available from the federal income tax community and from the numerous states that presently employ income taxes.¹⁰⁸ Col-

105. See, e.g., IND. CODE ANN. § 6-5-10-3 (Burns 1984), in which a "Bank Tax" is imposed on the deposits, shares, and surplus and profits of banks organized and operating under the laws of the State of Indiana or under the laws of the United States and operating in Indiana.

106. See Report of the 1982 Tax Advisory Council, State of Washington, February 1983 (regarding gross receipt taxes); Report on a Study of the Impact of Washington State Taxes on New Business Creation, Peat, Marwick Mitchell & Co., January 1, 1985; Report of the Tax Advisory Council, *supra*, at 15, (reporting that sales tax elasticity has varied widely over the last three decades but is modestly inelastic over the long run).

107. See, e.g., Los Angeles, California Municipal Code, Article 1, Chapter 2 (4th Edition 1959); Seattle City Code, Chapter 45.44 (19). Only the State of Washington has a full-fledged gross receipts tax. WASH. REV. CODE ANN. § 82.04 (1981). West Virginia is in the process of eliminating its state gross receipts tax. W. VA. CODE § 11-13-2 (1983)

108. Forty-five states impose corporate income taxes. Two of these states, Alaska and

lecting the tax is relatively inexpensive, and interstate associations, such as the Multi-State Tax Commission,¹⁰⁹ already exist to assist the states in extending their income taxes to multistate business entities. Both state taxing authorities and financial industry taxpayers should prefer the imposition of an income tax.

State income taxation of federal obligations held by financial institutions remains an area of uncertainty. The federal statute¹¹⁰ provides that states may levy only nondiscriminatory franchise taxes on interest or principal of federal obligations. Although the elimination in the commerce clause context of the distinction between a franchise tax and an income tax is clear,¹¹¹ it is less clear that the distinction no longer exists for purposes of state taxation of federal obligations. Courts constructed the distinction in the commerce clause context; in the area of state taxation of federal obligations, however, the statute mandates the distinction. Under the analysis in *First National Bank of Atlanta*,¹¹² however, states may include federal interest in their tax base by denying otherwise available deductions for some federal interest. The flexibility that *First National Bank of Atlanta* affords states removes the historical pressure on state and local governments to tax the financial industry with a franchise tax rather than with a direct income tax.

C. Apportionment Issues

The Multi-State Tax Compact¹¹³ (MTC) employs a three-factor formula that traditionally has been applied to the tax apportionment for commercial corporations. The three-factor formula consists of equally weighted sales, property, and payroll factors. The MTC has been made expressly inapplicable to the financial industry.¹¹⁴ Nevertheless, a three-factor formula similar to the MTC formula, or a formula that embraces an additional deposits factor, may provide the most appropriate means for apportioning an institution's income among the states taxing the institution.

Florida, impose no personal income tax. Report of the 1982 Tax Advisory Council, *supra* note 106, at 13.

109. See, e.g., OR. REV. STAT. §§ 305.655 (1983); WASH. REV. CODE § 82.56.010 (1983); W. VA. CODE § 11-10A-1 (1983).

110. 12 U.S.C. § 548 (1982).

111. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

112. 105 S. Ct. 1521 (1985). For a discussion of *First National Bank of Atlanta*, see *supra* text accompanying notes 91-94.

113. See *supra*, note 109.

114. See Multi-State Tax Compact Article IV, § 2 reprinted in WASH. REV. CODE § 82.56.010 (1983).

multistate associations, already exist to assist multistate business and financial industry tax-related tax.

As held by financial institutions under the federal statute¹¹⁵ and regulatory franchise provisions. Although the distinction between the two is less clear,¹¹¹ it is less clear as to the distinction in the taxation of federal income tax. Under the distinction. Under the statute,¹¹² however, states are denying otherwise. The flexibility that moves the historical tax the financial direct income tax.

employs a three-factor formula to the tax apportionment factor formula and payroll factors to the financial industry similar to the additional deposits for apportioning the institution.

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The sales factor of the apportionment formula can be converted easily to a receipts factor. California has mandated this conversion in its regulations dealing with apportionment of bank income.¹¹⁵ The source of each receipts item must be identified to provide the certainty necessary for any apportionment factor. The California rules require this identification.

The apportionment formula's property factor must be modified for application to financial institutions to include an intangibles element, which is contrary to the general approach of the MTC. The source of the intangibles included within the factor must be identified in a manner consistent with the identification of sources for receipts factor purposes. The California rules demand this consistency.¹¹⁶ Identifying the source of a financial institution's payroll will be similar in extent and fashion to payroll source identification in a commercial company.

The final factor, which reflects the bank's deposits, would be unique to taxation of financial institutions. Deposits are the foundation on which a financial institution conducts its economic activity. No bank can make a loan unless it takes in sufficient funds through deposits or other sources to fund that loan. Banks direct a large portion of their advertising budgets and general promotional activities toward raising or maintaining deposits. Because of the significance that deposits have in a bank's operations, a deposits factor in an apportionment formula for application to the financial industry should be seriously considered.¹¹⁷

V. CONCLUSION

The states must review and revise their methods of taxing the financial industry.¹¹⁸ Many states currently employ taxing schemes that neither reflect the economic realities of the financial industry nor take advantage of current legal doctrine on state taxation of multijurisdictional taxpayers. Reasons for the states' failure to update their tax systems are understandable. In times of budgetary constraints most states are pressed to maintain and enforce their present tax schemes. Rarely do states have sufficient resources to expand those schemes in imaginative and economically rational

115. California Franchise Tax Regulation § 25137-4(c)(2) (1985).

116. *Id.* at § (c)(1).

117. New York's newly adopted tax system encompasses a deposits factor in its apportionment formula. 1985 N.Y. Laws 3434.

118. See KOCH, HISTORICAL REVIEW OF STATE TAXATION OF FINANCIAL INTERMEDIARY ACTIVITIES, 10-11 (1984).

ways to tax the rapidly changing financial industry. By contrast, financial institutions have large tax staffs responsible not only for compliance with state and local tax rules, but also for minimizing their employers' administrative reporting burdens and total tax expenditures. For example, Bank of America alone has almost half as many tax staffers as Washington State's Department of Revenue has audit personnel.¹¹⁹ Furthermore, the inability of state taxing authorities to compensate their employees at levels generally comparable to pay scales in the financial industry creates an additional disparity in resources.

In light of this disparity in resources, states cannot be expected to be able to react to changing tax concepts as swiftly or skillfully as the financial industry reacts. Each state, however, should seek to tax each financial institution conducting activity within its borders to the extent required and permitted by law. The states simply cannot achieve this goal unless they grant the authority to establish uniform rules regarding state taxation of financial depositories to some central representational organization or to the federal government. The states will realize only a percentage of the financial industry tax revenues available to them unless an interstate agency like the Multi-State Tax Commission or a federally created agency like the Advisory Commission on Intergovernmental Relations¹²⁰ imposes a tax scheme with uniform jurisdictional rules and apportionment standards.

Because large financial institutions control resources sufficient to respond imaginatively and effectively to any state-imposed tax, these businesses are relatively indifferent to whether state taxation of interstate activity is uniform. States, however, have neither the resources nor the disposition to conduct the same level of effective tax planning. Therefore, the ultimate benefits of a unified local tax planning effort would inure to the states, not to business. Only by agreeing to surrender a limited share of their taxing sovereignty will the states be able to tax the modern financial industry effectively.

119. The Washington Department of Revenue has approximately 170 auditors; the Bank of America has approximately 71 tax personnel. Interviews with John Olson, Chief of Audit Division, Washington State Department of Revenue, and Phillip M. Plant, Assistant Tax Counsel, Bank of America.

120. In 1974, Congress commissioned the Advisory Commission on Intergovernmental Relations (ACIR) to make a study of all pertinent matters that related to state "doing business" taxes on out of state depositories. Pub. L. No. 94-222, 90 Stat. 297 (1974). The ACIR's report is found in State and Local "Doing Business" taxes on Out-of-State Financial Depositories - Report of ACIR (May 1975).

EXHIBIT K: 10

**Edelstein, Haskell "White Paper on the Need for Federal Legislation Placing a
Two Year Moratorium on Nondomiciliary State Taxation of Financial
Institutions", Bank Administration Institute - Multistate Taxation of Banking
(October 19, 1990)**

BANKING INDUSTRY PERSPECTIVE

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FINANCIAL INSTITUTIONS STATE TAX COALITION (FIST)
OCTOBER 19, 1990

WHITE PAPER ON THE NEED FOR FEDERAL LEGISLATION
PLACING A TWO YEAR MORATORIUM ON NONDOMICILIARY
STATE TAXATION OF FINANCIAL INSTITUTIONS

EXECUTIVE SUMMARY

Federal legislation is needed to place a two year moratorium on a new wave of unfair state taxation of out-of-state financial institutions. States in search of tax revenues are aggressively seeking to tax out-of-state financial institutions based on the mere fact that some of their customers live there. Without a moratorium on this type of taxation, unreasonable compliance burdens will be imposed with respect to multistate banking activities and double taxation will result. To the extent capital continues to flow to the residents of these taxing jurisdictions, the increased costs associated with these inequities will be passed on to them in the form of higher interest rate on loans which, in turn, will adversely affect the local economy.

Under settled notions of multistate taxation, a state will not tax an out-of-state business unless it has an office or employees there. Attempted state taxation of lesser contacts such as mail order transactions has been held unconstitutional by the United States Supreme Court. Despite the foregoing, states such as Minnesota, Indiana and Tennessee have enacted laws which tax out-of-state financial institutions based on customer location alone. These state taxing schemes purport to tax only local income; however, they determine this local income in differing and often inconsistent manners. Moreover, they unfairly single out financial institutions while according more favorable tax treatment to general corporations.

The new taxing schemes are totally unnecessary to prevent bank income from escaping state taxation. Banks pay state taxes on all of their income under existing state tax systems. Home states either tax 100 percent of the income of local banks or provide that their income otherwise apportionable to states where the banks are not taxable is reassigned or "thrown back" to the home state. The new taxing schemes, in overriding this established approach, promote double taxation.

In addition to the problems touched upon above, the spread of state taxation based on mere customer location will cause other adverse consequences. These difficulties are summarized below.

FINAL DRAFT - OCTOBER 19, 1990 REVISION

- o Excessive compliance burdens will arise. The new taxing schemes attribute income for tax purposes to the customer location under vague rules (e.g., where a multistate customer is "located" or where the services are "consumed" by the customer). The facts necessary to ascertain this location are often known only to the customer and may be virtually unobtainable. In addition, these facts are likely to change year to year, leaving the taxpayer in a position of uncertainty as to its tax liabilities. Even when the facts can be obtained, it is difficult to program this information on existing computer systems. This difficulty is compounded by variations in customer location rules in each state. Finally, the threshold of contacts giving rise to taxability is so low under these new type systems that tax reporting requirements are triggered in instances where the compliance costs actually exceed the total tax due. All of these taxpayer filing problems will create equally aggravating difficulties for state tax auditors.
- o Double taxation will result. These new state tax systems are incompatible among themselves and with existing laws in other states. Each state selects a method of determining taxable income in a way that maximizes revenue consistent with its own regional attributes. Thus, for example, money center states such as New York will tax income at the headquarters location while market states will tax the same income at the customer location. Multiple taxation of the same income is inevitable under this circumstance.
- o The local economy will be impaired. The excessive compliance burdens, the existence of multiple taxation, and the inability of the financial institution to forecast future tax exposures due to vague and unpredictable apportionment rules will discourage financial institutions from entering financial markets outside their home state. This, in turn, will limit the free flow of capital across state lines and may adversely affect the local economy through increased interest costs and/or reduced capital investment. In those instances where out-of-state banks continue dealing with customers in the new tax system jurisdictions, the increased costs of compliance and double taxation will be passed on to the local customer in the form of higher costs of credit thereby producing the same adverse effect.
- o Financial institutions will be discriminated against. The state tax systems imposing taxes based upon mere customer location generally single out financial institutions as distinct from general corporations. General corporations are protected by Public Law 86-272 from taxability based on customer location even though they have employees in the state soliciting orders from local customers. The financial industry enjoys no such legislative protection. This discriminatory treatment is compounded by the fact that the

banking and financial industry has traditionally been taxed on 100% of its income by its home state. This is because state taxation of out-of-state national banks was banned by federal law up to 1976 and because, even today, banks cannot conduct interstate branching outside their home office state in most instances. The absence of protective legislation combined with the lack of an established history of bank taxation outside the home state, greatly increases the likelihood that differing rules will be used in determining local income as the states select a tax system which maximizes local revenues rather than accurately assesses factors contributing to local profit. For example, Indiana and Tennessee tax general corporations under a three factor approach but, with respect to financial institutions, employ the single factor receipts formula which exaggerates market state values. Similarly, these states source fee income of financial institutions to the customer location rather than the place where the service is performed as with general corporations. Such state taxation is discriminatory and unfairly cripples the ability of financial institutions to compete with non-financial corporations offering similar products. In addition, the competitive disadvantage which out-of-state financial institutions already face because of the inability to conduct interstate branching, will be exacerbated by the imposition of multiple taxation.

o Retaliatory legislation and other adversarial state interactions may result. Insofar as these customer location tax systems result in the taxation of the income of an out-of-state financial institution which has already been taxed by its home state, the home state may take offense and threaten sanctions against the customer location state. This circumstance is particularly likely to arise in instances where smaller border state banks get whipsawed. Such needless divisiveness among taxing jurisdictions is undesirable and increases the adverse effect upon interstate flows of capital.

The federal legislation needed will establish a moratorium upon the taxation of out-of-state financial institutions for a two year period to permit Congress to identify and adopt an appropriate method of preventing unfair and excessive state taxation of out-of-state financial institutions. State taxation of financial institutions having local offices, employees, or having owned or leased tangible personal property used in connection with its local business should nevertheless be permitted. A reasonable approach in this regard was contained in a resolution adopted by the House of Delegates of the American Bar Association. The nexus rules attached, similar to those of American Bar Association Legislative Recommendation 1981-3, would establish minimal jurisdictional standards based on physical presence. These standards would prevent unfair and excessive state taxes and would simplify tax administration for both the financial services industry and the states. The attached

proposed nexus rules are an appropriate approach to address the inequities that will result from further spread of the new taxing schemes.

RE: JURISDICTIONAL RULES FOR STATE TAXATION OF NON-RESIDENT FINANCIAL INSTITUTIONS.

Sec. 1 JURISDICTION TO TAX

(a) No State or political subdivision thereof shall impose either directly or indirectly any tax on a financial institution unless such financial institution has a business location in the State or political subdivision during the taxable year.

(b) No State or political subdivision thereof shall impose directly or indirectly taxes on any financial institution not having its principal office within the State if such taxes (when considered together with taxes imposed by the State in which is located its principal office) are more burdensome than the taxes imposed upon financial institutions transacting similar character of business having their principal office within the taxing State.

Sec. 2 DEFINITIONS

For purpose of section 1, the following definitions shall apply:

(a) **Business Location -**

(1) **General Rule -** A financial institution has a "business location" in a State in a taxable year only if:

(A) such financial institution maintains an office in such State; or

(B) one or more employees of the financial institution has or have a regular presence in such State; or

(C) such financial institution owns or is a lessee of 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 - 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;

(B) participation in loans made by other financial institutions having offices in the State;

(C) solicitation of 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;

(D) investigation for credit purposes and physical inspections and appraisals of real and personal property securing or proposed to secure any loan, or collecting and servicing loans in any manner whatsoever.

(3) De Minimus exception From Business Location - A financial institution shall not have a business location in a nondomiciliary State unless it has (during the taxable year) more than \$10,000,000 of either payroll or property attributable to such State.

(4) General Exceptions From Business Location - Notwithstanding any other provision of this title, a financial institution shall not be deemed to have a business location in a State if the only activities of the financial institution in the State are, or are in connection with, one or more of the following:

(A) maintaining or defending any action or suit;

(B) filing, modifying, renewing, extending or transferring a mortgage, deed of trust, or security interest;

(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;

(D) acting as an 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;

(E) maintaining an office in the State by one or more officers or directors of the financial institution who are not also employees of the financial institution;

(F) meetings of the board of directors of the financial institution;

(G) maintaining an office in the State by one or more independent contractors, whether or not related to the financial institution, performing processing, collection, servicing or other ministerial functions for that financial institution.

(b) Financial Institution - "Financial Institution" means the following:

(1) A holding company;

(2) Any regulated financial corporation;

(3) Any subsidiary of a holding company or of a regulated financial corporation; or

(4) Any other corporation organized under the laws of the United States or organized under the laws of any State or foreign country which is carrying on the business of a financial institution.

(c) Holding Company - "Holding Company" means any corporation 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.

(d) Regulated Financial Corporation - A "regulated financial corporation" is an institution that deposits or accounts of which are insured under SAIF and BIF, any institution which is a member of a Federal Home Loan bank, any other bank or thrift institution incorporated or organized under the law of the United States, a State, or any foreign country which is engaged in the business of receiving deposits or which holds a bank charter, any corporation organized under the provisions of sections 611 to 631 of Title 12 (Edge Act Corporations), any credit union incorporated or organized under the laws of a State or any foreign country, and any agency, branch or subsidiary of a foreign depository as defined in section 3101 of Title 12.

(e) Subsidiary - "Subsidiary" means a corporation whose voting stock is more than fifty percent owned, directly or indirectly, by another corporation.

(f) Business of a Financial Institution - "Business of a Financial Institution" includes the business activities that:

(1) a regulated financial corporation may be authorized to do under state or federal law or the business that its subsidiary is authorized to do by the proper regulatory authorities;

(2) any corporation organized under the authority of the United States or organized under the laws of any State or foreign country does, or has authority to do, which is substantially similar to the business which a corporation may be created to do under any laws governing the creation of banks and trust companies, industrial banks, savings and loan associations, credit unions, and similar institutions or any business which a corporation or its subsidiary is authorized to do by said laws; or

(3) any corporation organized under the authority of the United States or organized under the laws of any State or foreign country does or has authority to do if such corporation derives more than fifty percent of its gross income from activities

(including the discounting of obligations) in substantial competition with the businesses described in subsections (1) and (2) above. For purposes of this subsection, the computation of the gross income of a corporation shall not include income from nonrecurring, extraordinary items.

(g) Employee - Any individual to whom wages are paid within the meaning of section 3401 of Title 26 is an "employee."

(h) Maintains an Office - A financial institution "maintains an office" wherever it has established a regular, continuous and fixed place of business for its employees.

(i) Property Located in a State -

(1) General Rule - Except as otherwise provided in this section, tangible property shall be deemed to be located in the State in which such property is physically situated. Mere ownership of a charge card, credit card or other means utilized to access an account shall not constitute property located in a State.

(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.

(j) 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) the office from which his activities are directed or controlled is located in the State, where a majority of the employee's service is not performed in any one State.

(k) State - Any of the several States of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or any territory or possession of the United States.

(l) 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.

(m) Lease - A lease is a leasing transaction where the financial institution leases the property for its own use and would be treated as owner of the leased property under the provisions of the Internal Revenue Code of 1954 prior to the enactment of the Economic Recovery Tax Act of 1981. All other transactions purporting to be leases shall be treated as loans for purposes of section 2 of this title.

* * *

EXHIBIT K: 11

Edelstein, Haskell, "Multistate Taxation - Internecine Warfare Among the States" (undated outline)

Multistate Taxation - Internecine Warfare Among the States
Haskell Edelstein
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- A. Listening to the states' presentations shows the "jungle" the financial and all other services businesses are living in -- two types of states each want a piece of the profits:
1. Headquarters states say:
 - a. The work is done here.
 - b. The people who perform the services are located here.
 - c. The risks of the business are incurred here.
 - d. We provide the most government services and protections to the service providers.
 - e. We need the revenue.Therefore, we have the right to tax the income derived from services performed in our state.
 2. Market states say:
 - a. Our taxpayers buying the services generate the profits of out-of-state financial and other service businesses.
 - b. We furnish government services by, providing for debt and contract enforcement against our residents.
 - c. The income from services arises where it is paid from and where the benefits of the services are received or used.
 - d. We need the revenue.Therefore, we have the right to tax the income derived from services rendered to residents of our states.
 3. These two viewpoints are essentially in direct conflict and irreconcilable.
 4. These conflicting viewpoints leaves business caught in the middle, and subject to conflicting tax regimes resulting in multiple taxation of the same income.
 - a. The market state approach is politically appealing (taxing "the fellow behind the tree"), but practically, has to result in higher costs to the customers located in the taxing states.
 - b. The market state approach is a money grabbing exercise -- service providers are already paying taxes to the states where the work is performed, so the market states are in effect attempting to take revenue away from the headquarters states.
- B. The business response.
1. Business does not object to paying just and fair taxes, but not twice on the same income.
 2. Business cannot and will not tolerate double taxation of the same income, directly or indirectly.
 3. Business needs rules that can be easily understood, applied and complied with.
 4. Business needs rules that minimize audit disputes and that can be easily auditable.
 5. Within the foregoing parameters, business is not concerned about which states receive the revenue -- a business could simply put a reasonable percentage of its U.S. income into one "pot", and let the states then divide the pot among themselves -- leaving business alone.

6. This fight is among the states -- business is in the middle.
7. Business, if forced, must and will find ways to pass on the extra cost -- e.g., grossing up of taxes, a direct cost to the residents of the market states.
8. As a last resort, services will not be provided. In the case of lending, a loss of access by local business to the nationwide capital markets.

C. What needs to be accomplished.

1. Achieve uniformity (consistency) of rules of all states -- this is imperative to avoid multiple taxation of the same income.
 - a. Can be achieved either voluntarily or mandating by federal legislation.
2. Protection against a headquarters state making up revenue lost by adoption of the market state approach by more heavily taxing the same businesses (multiple taxation in another form).
3. Seek new revenue sources for the market states in the form of transactional taxes on users of services rather than income taxes on providers of services.
4. Understand what is wrong with the market state approach.
 - a. It is bad tax policy.
 - (1) Income taxation by definition seeks to tax income where it is earned -- and income from services is earned where services are performed.
 - (2) Taxation should not be determined on the basis of facts outside the knowledge or control of the taxpayer (i.e., variable customer location).
 - (3) Represents fiscal competition among the states, at the expense of either state revenues or increased business taxation.
 - b. Compliance and auditing is difficult or impossible.
 - c. Business subjected to unexpected tax risks -- not easily determinable when tax liability exists, or the amount of liability.
 - d. Allows states to control the tax revenues of other states, especially where a credit is allowed for taxes paid to other states.
 - e. Seeks simply to reduce or avoid increasing taxes on businesses in-state by taxing out-of-state businesses instead.

D. Business must, out of self-interest and protection against unjust taxation, protect itself!

1. Nexus standards of the market state approach are still highly questionable and will be contested.
2. Voluntary compliance by business is perilous -- if the law is found to be unconstitutional, the tax paid won't be refunded, under current law.
3. Business, should actively seek and recommend, alternative tax approaches that put the additional burden where it belongs -- on the customers using out-of-state services.
4. Change pricing policies to place the economic burdens directly on the customers.
5. Federal legislation may become the only solution if the states don't achieve a uniform solution voluntarily.

EXHIBIT K: 12

Edelstein, Haskell, "State Taxation of Financial Institutions - A Fresh Approach" (July 5, 1991)

State Taxation of Financial Institutions

A Fresh Approach

I. INTRODUCTION

After many years of quietude, states began to rethink the approaches to taxation of banks and other financial institutions beginning in 1986. With the presentation of a proposal by the Multistate Tax Commission, and its almost immediate adoption by Minnesota, a new era commenced. Although the Multistate Tax Commission has not as yet completed work on its draft proposals, a few other states have proceeded to adopt various new approaches to taxing banks, focusing primarily on banks and other financial institutions without physical presence in the state.

The new approach in general seeks to extend income-based taxes to banks whose only connection with the state is having customers located in the state, as borrowers, credit cardholders or users of the banks' services. That is called the "market state" approach, which is distinguished from the "headquarters state" approach which in general views banks as being subject to tax based on income only where they have a physical presence and where they perform their activities.

The new approach has focused on two especially critical tax elements:

- Nexus -** Rules for determining when a state will assert jurisdiction to tax an out-of-state bank.
- a. Traditional rule requires physical presence of an office, branch or the presence of employees, agents or independent contractors.
 - b. The new rule merely requires the bank to have a minimum number of customers or amount of loans to customers located in the state.

July 5, 1991

- Sourcing - Rules for determining the numerators of the apportionment factor elements of receipts and intangible property (loans).
- a. Traditional rules source receipts and loans where the loans are granted and administered.
 - b. The new rule would source both receipts and loans on the basis of where the customer or borrower is located.

In addition, variants on the new approach include:

1. Using only a single factor receipts apportionment formula.
2. Taxing banks domiciled (headquartered) in the state on their entire U.S. income, with a credit for taxes paid to other states; taxing non-domiciled banks on their income apportioned to the state.

These changes in approach to state taxation of banks come at a time when the financial services industry itself is undergoing significant changes. New financial products are being developed and utilized, new competition is arising both from financial institutions which are not banks and banks owned by companies in other types of business, and the existing geographic barriers which presently prevent banks from operating by way of branches across state boundaries are being reconsidered.

Given these changes in both the financial services business and the tax rules, it is imperative to develop a workable and equitable system for taxing financial institutions in order to achieve a tax regime which:

Is fair and equitable to all states;

Prevents two or more states from asserting the right to tax the same income;

Is simple to understand and apply;

Makes compliance and auditing easy to achieve without undue expense to either taxpayer or tax collector; and

July 5, 1991

Contains rules that are determined by the nature of the business or product rather than the character of the institution doing the business.

II. THE NEED FOR A CONCEPTUAL FRAMEWORK

In order to measure the practicality and theoretical justification of a particular approach to taxing financial institutions, a conceptual framework is essential as a measurement tool. In order to develop that tool, the nature of lending money must be examined.

The lending of money can be characterized in several different ways:

1. As a service business - the lender receives interest income from the borrower for taking risks and managing those risks. The work of analyzing the data and making the decision to undertake the risks involved in a loan, as well as the ongoing evaluation and decisions required during the term of a loan, constitute the rendering of a service to the borrower for which the lender is compensated through the payment of interest. See Attachment A.
2. A lender holding a portfolio of loans is acting in the nature of an investor holding an investment in a portfolio of bonds. Under this characterization, lending is equivalent to investment management in that the bank determines first to make the loan investment, and simultaneously or from time to time thereafter determining how and whether to alter the investment portfolio through sales of portions by way of participations, syndications or securitization.
3. A bank or other financial institution acts as a financial intermediary by obtaining and pooling available funds (obtained through deposits or borrowing) for the purpose of investing those funds in loans. The lender gathers funds and on-lends them for a "commission" equivalent to the net spread between the cost of funds and the interest paid by the borrower. Of course, the financial intermediary also takes risks, as described in 1, above, which is also compensated by the net interest spread. This is in essence the providing of a service to both the sources and users of the funds.

4. A bank or other financial institution acts as the lessee of money - the loan of money for interest is the equivalent of renting a car to the user-
lessor.

Several points need to be noted in viewing each of the foregoing characterizations of lending money:

1. The service element is paramount in cases 1, 3, and 4.
2. The customer-borrower is of relatively little importance in case 2, in the sense that any benefit to the borrower is incidental to the creation and management of a portfolio for the benefit of the financial institution itself. Indeed, changes in the loan portfolio will usually change the risks involved, so that the compensation will change depending on the ebb and flow of such risks.
3. Cases 2 and 3 may also be treated and viewed as the activity of investment banking - the lender may not take a position in the loan itself, and is thus essentially rendering the service of arranging for sources of and access to funds.
4. Case 4 suggests the strongest linkage to the location of the customer as an important element in determining where income is derived - *i.e.*, the "location" of the funds "rented" is the basis on which the lender's income is earned.

The foregoing discussion deals only with the activity of lending money, and the role of the financial institution in that process. In addition, financial services involve other activities in the nature of services which may involve taking or accepting risks (either credit or other kinds of risks) without lending money or otherwise creating assets (receivables), or creating assets without credit risks. Some activities involve purely service activities not involving either external risks (*i.e.*, risks due to conditions beyond the control of the financial institution) or the creation of assets on the books of the financial institution. Such activities generally have little element of customer relationship or "contact" with any state other than that of the location of the operations or activities providing the service, although that does not suggest that more substantial contacts with the location of the customer cannot be formulated.

In general, several conclusions can be seen from the use of a conceptual framework:

1. Most formulations of the business of lending money tend to suggest that it is heavily service oriented, thus focusing activity on the location where the service is performed. Since the result would be entirely unfavorable to market states, strict adherence to those formulations may not achieve the needed conclusions.
2. The business of lending should be viewed and treated separately from all other services provided by financial institutions, such as applying different sourcing rules for receipts or different weighing of factors in the apportionment formula.
3. Rendering a service without creating an asset (*i.e.*, an intangible in the form of a loan or receivable) should be treated the same as any other service for tax purposes -- such as travel agent, lawyer, doctor, advertising agency, etc.

III. A MODEST PROPOSAL FOR A FRESH APPROACH

The various ways of characterizing the lending business, as well as the other functions of the financial services business, strongly lean in the direction of service. If the applicable principle of taxing the income of a service business is that income is to be taxed where it is earned, then income from services should be taxed where the service is performed. However, financial services also have two unique characteristics:

1. The undertaking and management of risk, which includes, but is not limited to, credit risk that the customer will fail to repay its loan.
2. Some activities only incidentally involve the providing of services to a customer - *e.g.*, trading in securities, currencies, etc.

Giving recognition to those special elements is appropriate, so that the location of the customer is of more significance in the case of credit risk, while the income resulting from the performance of trading activities should be taxed where those activities occur.

In formulating the following proposal, certain elements were considered critical:

1. Minimize compliance costs and audit issues --
 - a. All rules should be bright-line tests - no rebuttable presumptions should be included, other than an overall authority to modify the rules to prevent evasion or substantial avoidance of tax in egregious cases.
 - b. A standard form of return should apply to each and every state with respect to at least:
 - i. Net income (Federal taxable income)
 - ii. Apportionment formula calculations
 - iii. Nexus determinations
2. Nexus (jurisdiction to tax) must be readily determinable prior to the beginning of a taxable year, based on a point-in-time data.
3. Information needed to comply with the tax rules should be limited to data collected by the taxpayer in the normal course of its business.
4. Apportionment formula elements should be determined by averaging the quarterly amounts during the taxable year.

THE PROPOSAL

NEXUS

1. Determine on the basis of data as of the end of the third quarter of the preceding taxable year, *i.e.*, calendar year 1992 nexus determined as of September 30, 1991.

July 5, 1991

2. Any one of the following will create nexus:
 - a. Physical presence by virtue of a branch office or full-time employees of the taxpayer in the state with an aggregate annual salary rate of at least \$250,000.
 - b. Credit card customers in the state - the greater of (i) more than 5,000 cardholders or (ii) 2% of the total cardholders of the card issuer.
 - c. Other borrowers in the state -- more than 100 (if a borrower is also a credit cardholder, that borrower will be included in each category).
 - d. Loan assets in the state -- more than \$50MM of loans outstanding on the financial records (*i.e.*, excluding written-off loans).
3. Nexus is determined on an individual corporation basis.

COMMENTS:

The nexus rules simply provide *de minimis* standards.

The test in the case of credit cards is intended to eliminate both smaller banks and small segments of large credit card operations, since the revenue affects would be minimal.

Location of loans and location of borrowers would be based on the same criterion -- the mailing address for bills shown on the lender's records.

APPORTIONMENT:

1. Formula -- Three factors:
 - a. Payroll - average annual salary and other compensation as shown on W-2 forms - double-weighted.

July 5, 1991

- b. Property - tangible and intangible (but limited to loans and receivables in the nature of loans).
- c. Deposits and borrowings (including all stock except common and perpetual preferred).

COMMENTS:

The payroll factor, double-weighted, gives proper recognition to the services aspect of the business.

The property factor is easier to deal with than the receipts factor, but serves the same function of representing the customer location element.

The deposits/borrowing factor represents the other side of financial intermediary functions of the business (*i.e.*, the funds gathering function opposite the funds investment lending function). Since deposits are only one course of funding for loans, and are not available to financial service businesses which are not banks, other sources of funds must be taken into account. Since such other funds cannot be traced to their sources (*e.g.*, the holders of marketable securities are usually not easily determinable), such sources must necessarily be attributed to the headquarters location of the borrower.

The traditional receipts factor has not been included for several reasons - the same result and element is reflected in the intangible property factor with regard to loans, and receipts are more difficult to locate and involve fairly complex recordkeeping. In addition, where receipts from loans reflect floating interest rates, they will distort the formula because an increase in receipts really reflects the costs of funds supplied, which is not a function related to the borrower.

2. Sourcing Rules

- a. Payroll - by location of employee's office or where employee is managed in the case of no office.
- b. Property - tangible by physical location; intangibles (loans and receivables) by billing address.

- c. Deposits - by statement mailing address.
- d. Other sources of funds - by location of headquarters.

COMMENTS:

Sources of funds other than deposits cannot practically be traced.

Limiting the intangible property factor to loans and receivables in the nature of loans takes into account that other types of intangibles do not relate to a specific customer (*e.g.* trading assets). Thus loans should encompass all intangibles involving both the creation of a receivable and the presence of a credit risk. Loans should thus include all leasing where the financial institution is the lessor, regardless of the Federal income tax treatment (but only for apportionment purposes).

OPERATIONAL RULES:

1. The throwback rule should apply to income apportioned to a state having no taxable nexus.
2. Every state should allow a loss carryback of at least 5 years.
3. Sourcing of bad debt losses.

In order to overcome the problem identified in Attachment A, taxable income should be apportioned without including bad debts in the calculation of taxable income. Bad debt losses should then be directly allocated to each state and deducted from the pre-bad debt loss taxable income apportioned to the state. These computations should be made without regard to whether or not there is nexus with a state. However, if in the year a bad debt loss is allocable to a state which does not have nexus, the net loss attributable to the state should be thrown back only if there was also no nexus with that state for the preceding five years (the loss carryback period). If there was nexus during any of those carryback years, then a net loss for the current year should be allowed as a carryback to the extent of the net taxable income attributed to the

state in the carryback years. Any excess should then be subject to the throwback rule in the current year.

4. All income, except sales of businesses (including bank branches) and real estate used for business operations, should be business income. The types of income which constitute non-business income in the case of mercantile and manufacturing corporations clearly constitute income from the ordinary business conducted by financial services corporations.
5. Deposits should be generally defined as money paid to the financial institution which is subject to a liability to repay on demand or at a specific time, with or without interest and whose use until then is unrestricted in the hands of the recipient and is not represented by a marketable instrument (except money orders and travelers checks).
6. Unitary - Combination Rules
 - a. Nexus should be determined separately for each corporation.
 - b. Unitary (water's-edge) combination returns should include the parent holding company.
 - c. Intercompany transactions should be eliminated for both nexus and allocation purposes, as well as from taxable income.
7. Nexus should not exist in any case where the corporation is not permitted, under the laws of the state, to conduct business through a branch (in the case of a depository institution) or office located in the state.
8. If the state includes Subpart F income in the tax base, then the controlled foreign corporation should be treated as if it were a branch of its U.S. parent, and therefore its payroll, property and sources of funding (from third parties) should be included in the apportionment formula.

9. In the case of sourcing loans under the intangible property factor of the apportionment formula, all loans are sourced by billing address. In the case of loans acquired by the holder by way of syndications, participations, or other purchases, the billing address should be that of the borrower, even where the loan is administered by another financial institution as agent.

COMMENT:

This approach is consistent with the economic presence theory that a lender has a presence in a state based on where the borrower is located, regardless of how the loan was acquired. On the other hand, it is inconsistent with the economic reality that the lender-taxpayer is merely investing in a portfolio type investment pursuant to the second scenario of the Conceptual Framework described earlier.

ADOPTION AND IMPLEMENTATION:

A major requirement for this, or indeed any, system of state taxation based on income is uniformity of the rules for both nexus and apportionment of income. In order to attain that objective, uniform adoption by the states is imperative. That uniformity can and should be achieved in a manner consistent with the Multistate Tax Compact, which has the same goal in the area of corporate income taxation. The following points, utilizing the "Financial Institutions Tax Compact," should be essential conditions for adoption, ratification and implementation of the final proposal, and for smooth transition into the new tax rules. The Compact will become effective only upon completion of these steps.

1. The Financial Institution Tax Compact must be ratified by a majority of the states (at least 26 states).
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July 5, 1991

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Georgia
Illinois

New Jersey
New York
North Carolina

Texas
Virginia

3. The Financial Institution Tax Compact must be ratified by all of the following states:

Indiana
Iowa
Minnesota

Tennessee
West Virginia

4. The Financial Institution Tax Compact will take effect in all of the member states, provided that conditions 1, 2 and 3 are met, on January 1, 1998.
5. All member states agree that if and when the Compact takes effect, they will collectively petition Congress to enact Federal legislation ratifying the Compact and making it applicable to all states. This will avoid class warfare among states which (1) may apply lower nexus standards and different apportionment ratios to attract revenue and (2) may apply higher nexus standards and more liberal apportionment to attract business.

IV. CONCLUSION

The foregoing proposal seeks to give due consideration to a number of elements, including the nature of the financial services business, the role of both customers and performance of services, and the need for simplicity and certainty of rules. While there may be more precise measurements (such as the gross profitability of each type of financial product), such considerations would only substantially increase complexity and reduce the precision of data, without necessarily improving the quality of the results. Only in the area of bad debt losses has a special exception been made to allocate such losses to avoid an undesirable shift of tax effect among states. In all other respects, the proposal seeks to avoid all distinctions among types of financial services and products except credit cards and pure lending activities.

Hopefully, this can form the basis for a workable system, acceptable to all states while consistent with the nature of the financial services business.

July 5, 1991

State Taxation of Financial Institutions

A Fresh Approach

I. INTRODUCTION

After many years of quietude, states began to rethink the approaches to taxation of banks and other financial institutions beginning in 1986. With the presentation of a proposal by the Multistate Tax Commission, and its almost immediate adoption by Minnesota, a new era commenced. Although the Multistate Tax Commission has not as yet completed work on its draft proposals, a few other states have proceeded to adopt various new approaches to taxing banks, focusing primarily on banks and other financial institutions without physical presence in the state.

The new approach in general seeks to extend income-based taxes to banks whose only connection with the state is having customers located in the state, as borrowers, credit cardholders or users of the banks' services. That is called the "market state" approach, which is distinguished from the "headquarters state" approach which in general views banks as being subject to tax based on income only where they have a physical presence and where they perform their activities.

The new approach has focused on two especially critical tax elements:

- Nexus - Rules for determining when a state will assert jurisdiction to tax an out-of-state bank.
 - a. Traditional rule requires physical presence of an office, branch or the presence of employees, agents or independent contractors.
 - b. The new rule merely requires the bank to have a minimum number of customers or amount of loans to customers located in the state.

July 5, 1991

State Taxation of Financial Institutions
A Fresh Approach
Page 2

- Sourcing - Rules for determining the numerators of the apportionment factor elements of receipts and intangible property (loans).
- a. Traditional rules source receipts and loans where the loans are granted and administered.
 - b. The new rule would source both receipts and loans on the basis of where the customer or borrower is located.

In addition, variants on the new approach include:

1. Using only a single factor receipts apportionment formula.
2. Taxing banks domiciled (headquartered) in the state on their entire U.S. income, with a credit for taxes paid to other states; taxing non-domiciled banks on their income apportioned to the state.

These changes in approach to state taxation of banks come at a time when the financial services industry itself is undergoing significant changes. New financial products are being developed and utilized, new competition is arising both from financial institutions which are not banks and banks owned by companies in other types of business, and the existing geographic barriers which presently prevent banks from operating by way of branches across state boundaries are being reconsidered.

Given these changes in both the financial services business and the tax rules, it is imperative to develop a workable and equitable system for taxing financial institutions in order to achieve a tax regime which:

Is fair and equitable to all states;

Prevents two or more states from asserting the right to tax the same income;

Is simple to understand and apply;

Makes compliance and auditing easy to achieve without undue expense to either taxpayer or tax collector; and

July 5, 1991

Contains rules that are determined by the nature of the business or product rather than the character of the institution doing the business.

II. THE NEED FOR A CONCEPTUAL FRAMEWORK

In order to measure the practicality and theoretical justification of a particular approach to taxing financial institutions, a conceptual framework is essential as a measurement tool. In order to develop that tool, the nature of lending money must be examined.

The lending of money can be characterized in several different ways:

1. As a service business - the lender receives interest income from the borrower for taking risks and managing those risks. The work of analyzing the data and making the decision to undertake the risks involved in a loan, as well as the ongoing evaluation and decisions required during the term of a loan, constitute the rendering of a service to the borrower for which the lender is compensated through the payment of interest. See Attachment A.
2. A lender holding a portfolio of loans is acting in the nature of an investor holding an investment in a portfolio of bonds. Under this characterization, lending is equivalent to investment management in that the bank determines first to make the loan investment, and simultaneously or from time to time thereafter determining how and whether to alter the investment portfolio through sales of portions by way of participations, syndications or securitization.
3. A bank or other financial institution acts as a financial intermediary by obtaining and pooling available funds (obtained through deposits or borrowing) for the purpose of investing those funds in loans. The lender gathers funds and on-lends them for a "commission" equivalent to the net spread between the cost of funds and the interest paid by the borrower. Of course, the financial intermediary also takes risks, as described in 1, above, which is also compensated by the net interest spread. This is in essence the providing of a service to both the sources and users of the funds.

4. A bank or other financial institution acts as the lessee of money - the loan of money for interest is the equivalent of renting a car to the user-
lessor.

Several points need to be noted in viewing each of the foregoing characterizations of lending money:

1. The service element is paramount in cases 1, 3, and 4.
2. The customer-borrower is of relatively little importance in case 2, in the sense that any benefit to the borrower is incidental to the creation and management of a portfolio for the benefit of the financial institution itself. Indeed, changes in the loan portfolio will usually change the risks involved, so that the compensation will change depending on the ebb and flow of such risks.
3. Cases 2 and 3 may also be treated and viewed as the activity of investment banking - the lender may not take a position in the loan itself, and is thus essentially rendering the service of arranging for sources of and access to funds.
4. Case 4 suggests the strongest linkage to the location of the customer as an important element in determining where income is derived - *i.e.*, the "location" of the funds "rented" is the basis on which the lender's income is earned.

The foregoing discussion deals only with the activity of lending money, and the role of the financial institution in that process. In addition, financial services involve other activities in the nature of services which may involve taking or accepting risks (either credit or other kinds of risks) without lending money or otherwise creating assets (receivables), or creating assets without credit risks. Some activities involve purely service activities not involving either external risks (*i.e.*, risks due to conditions beyond the control of the financial institution) or the creation of assets on the books of the financial institution. Such activities generally have little element of customer relationship or "contact" with any state other than that of the location of the operations or activities providing the service, although that does not suggest that more substantial contacts with the location of the customer cannot be formulated.

In general, several conclusions can be seen from the use of a conceptual framework:

1. Most formulations of the business of lending money tend to suggest that it is heavily service oriented, thus focusing activity on the location where the service is performed. Since the result would be entirely unfavorable to market states, strict adherence to those formulations may not achieve the needed conclusions.
2. The business of lending should be viewed and treated separately from all other services provided by financial institutions, such as applying different sourcing rules for receipts or different weighing of factors in the apportionment formula.
3. Rendering a service without creating an asset (*i.e.*, an intangible in the form of a loan or receivable) should be treated the same as any other service for tax purposes -- such as travel agent, lawyer, doctor, advertising agency, etc.

III. A MODEST PROPOSAL FOR A FRESH APPROACH

The various ways of characterizing the lending business, as well as the other functions of the financial services business, strongly lean in the direction of service. If the applicable principle of taxing the income of a service business is that income is to be taxed where it is earned, then income from services should be taxed where the service is performed. However, financial services also have two unique characteristics:

1. The undertaking and management of risk, which includes, but is not limited to, credit risk that the customer will fail to repay its loan.
2. Some activities only incidentally involve the providing of services to a customer - *e.g.*, trading in securities, currencies, etc.

Giving recognition to those special elements is appropriate, so that the location of the customer is of more significance in the case of credit risk, while the income resulting from the performance of trading activities should be taxed where those activities occur.

July 5, 1991

In formulating the following proposal, certain elements were considered critical:

1. Minimize compliance costs and audit issues --
 - a. All rules should be bright-line tests - no rebuttable presumptions should be included, other than an overall authority to modify the rules to prevent evasion or substantial avoidance of tax in egregious cases.
 - b. A standard form of return should apply to each and every state with respect to at least:
 - i. Net income (Federal taxable income)
 - ii. Apportionment formula calculations
 - iii. Nexus determinations
2. Nexus (jurisdiction to tax) must be readily determinable prior to the beginning of a taxable year, based on a point-in-time data.
3. Information needed to comply with the tax rules should be limited to data collected by the taxpayer in the normal course of its business.
4. Apportionment formula elements should be determined by averaging the quarterly amounts during the taxable year.

THE PROPOSAL

NEXUS

1. Determine on the basis of data as of the end of the third quarter of the preceding taxable year, *i.e.*, calendar year 1992 nexus determined as of September 30, 1991.

July 5, 1991

2. Any one of the following will create nexus:
 - a. Physical presence by virtue of a branch office or full-time employees of the taxpayer in the state with an aggregate annual salary rate of at least \$250,000.
 - b. Credit card customers in the state - the greater of (i) more than 5,000 cardholders or (ii) 2% of the total cardholders of the card issuer.
 - c. Other borrowers in the state -- more than 100 (if a borrower is also a credit cardholder, that borrower will be included in each category).
 - d. Loan assets in the state -- more than \$50MM of loans outstanding on the financial records (*i.e.*, excluding written-off loans).
3. Nexus is determined on an individual corporation basis.

COMMENTS:

The nexus rules simply provide *de minimis* standards.

The test in the case of credit cards is intended to eliminate both smaller banks and small segments of large credit card operations, since the revenue affects would be minimal.

Location of loans and location of borrowers would be based on the same criterion -- the mailing address for bills shown on the lender's records.

APPORTIONMENT:

1. Formula -- Three factors:
 - a. Payroll - average annual salary and other compensation as shown on W-2 forms - double-weighted.

July 5, 1991

- b. Property - tangible and intangible (but limited to loans and receivables in the nature of loans).
- c. Deposits and borrowings (including all stock except common and perpetual preferred).

COMMENTS:

The payroll factor, double-weighted, gives proper recognition to the services aspect of the business.

The property factor is easier to deal with than the receipts factor, but serves the same function of representing the customer location element.

The deposits/borrowing factor represents the other side of financial intermediary functions of the business (*i.e.*, the funds gathering function opposite the funds investment lending function). Since deposits are only one course of funding for loans, and are not available to financial service businesses which are not banks, other sources of funds must be taken into account. Since such other funds cannot be traced to their sources (*e.g.*, the holders of marketable securities are usually not easily determinable), such sources must necessarily be attributed to the headquarters location of the borrower.

The traditional receipts factor has not been included for several reasons - the same result and element is reflected in the intangible property factor with regard to loans, and receipts are more difficult to locate and involve fairly complex recordkeeping. In addition, where receipts from loans reflect floating interest rates, they will distort the formula because an increase in receipts really reflects the costs of funds supplied, which is not a function related to the borrower.

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COMMENTS:

Sources of funds other than deposits cannot practically be traced.

Limiting the intangible property factor to loans and receivables in the nature of loans takes into account that other types of intangibles do not relate to a specific customer (e.g. trading assets). Thus loans should encompass all intangibles involving both the creation of a receivable and the presence of a credit risk. Loans should thus include all leasing where the financial institution is the lessor, regardless of the Federal income tax treatment (but only for apportionment purposes).

OPERATIONAL RULES:

1. The throwback rule should apply to income apportioned to a state having no taxable nexus.
2. Every state should allow a loss carryback of at least 5 years.
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In order to overcome the problem identified in Attachment A, taxable income should be apportioned without including bad debts in the calculation of taxable income. Bad debt losses should then be directly allocated to each state and deducted from the pre-bad debt loss taxable income apportioned to the state. These computations should be made without regard to whether or not there is nexus with a state. However, if in the year a bad debt loss is allocable to a state which does not have nexus, the net loss attributable to the state should be thrown back only if there was also no nexus with that state for the preceding five years (the loss carryback period). If there was nexus during any of those carryback years, then a net loss for the current year should be allowed as a carryback to the extent of the net taxable income attributed to the

state in the carryback years. Any excess should then be subject to the throwback rule in the current year.

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COMMENT:

This approach is consistent with the economic presence theory that a lender has a presence in a state based on where the borrower is located, regardless of how the loan was acquired. On the other hand, it is inconsistent with the economic reality that the lender-taxpayer is merely investing in a portfolio type investment pursuant to the second scenario of the Conceptual Framework described earlier.

ADOPTION AND IMPLEMENTATION:

A major requirement for this, or indeed any, system of state taxation based on income is uniformity of the rules for both nexus and apportionment of income. In order to attain that objective, uniform adoption by the states is imperative. That uniformity can and should be achieved in a manner consistent with the Multistate Tax Compact, which has the same goal in the area of corporate income taxation. The following points, utilizing the "Financial Institutions Tax Compact," should be essential conditions for adoption, ratification and implementation of the final proposal, and for smooth transition into the new tax rules. The Compact will become effective only upon completion of these steps.

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2. Eight of the following states must ratify the Financial Institution Tax Compact: *(20 to be listed)*

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July 5, 1991

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IV. CONCLUSION

The foregoing proposal seeks to give due consideration to a number of elements, including the nature of the financial services business, the role of both customers and performance of services, and the need for simplicity and certainty of rules. While there may be more precise measurements (such as the gross profitability of each type of financial product), such considerations would only substantially increase complexity and reduce the precision of data, without necessarily improving the quality of the results. Only in the area of bad debt losses has a special exception been made to allocate such losses to avoid an undesirable shift of tax effect among states. In all other respects, the proposal seeks to avoid all distinctions among types of financial services and products except credit cards and pure lending activities.

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July 5, 1991

EXHIBIT K: 13

**Edelstein, Haskell, "Multistate Taxation of Financial Services - Understanding
the Nature and Dynamics of the Business of Lending"
(January 16, 1991)**

399 Park Avenue
New York, NY
10043

Haskell Edelstein
Senior Vice President and
General Tax Counsel

January 16, 1991

Mr. Dan Bucks
Executive Director
Multistate Tax Commission
444 North Capitol Street, N.W. - Suite 409
Washington, D.C. 20001

Dear Dan:

In our last conversation regarding the MTC's proposed regulations on the sourcing and allocation of income of financial institutions, you expressed interest in the possible implications of the concept that the principal reason why lenders earned income, and were compensated, was because they undertake risks in making a loan.

I have subsequently given more thought to that consideration, and as the result, I have prepared the attached analysis. This analysis leads to the conclusion that the sourcing of income from lending, based on customer location, leads inevitably to distortions and discontinuities over time, and simply fails to take into account how and what a lender does to generate and earn its income.

I would be pleased to discuss this with you further if you wish. Of course, I would appreciate it being treated as a part of my submission to the MTC and included in the record of the MTC's hearings on its proposed regulations.

Sincerely,



Attachment

CC: ✓ Alan Friedman (w/attachment)
General Counsel
Multistate Tax Commission
386 University Avenue
Los Altos, CA 94022

c\ltr.buc

Multistate Taxation of Financial Services Understanding the Nature and Dynamics of the Business of Lending

Taxation, it has been said, is a very practical exercise. Those involved in the process understand that rules of taxation can only be applied and designed based on understanding the nature and operation of the business being taxed. Thus, in determining how to tax the business of lending money, the nature of that business must be understood. That is especially the case in determining "where" the resulting interest income is "earned". It is impossible to answer that question without first knowing how and why interest income is earned (i.e., why does a lender become entitled to receive interest and what is it being paid for).

The key element of the bank's role as "financial intermediary" (between borrowers and suppliers of funds) is that of taking risks. That is obvious if it is remembered that interest rates charged by banks on commercial loans are usually determined by the credit-worthiness of the borrower. The best, most credit-worthy ones pay only base rate or "prime" rate, while those less credit-worthy pay higher rates. But that credit risk is only one of many risks a bank undertakes in making a loan.

A litany of risks encompasses the following:

1. Credit risk - the loan won't be repaid.
2. Interest rate risk - (sometimes referred to as "gapping" - lending long and borrowing short) - the risk that the cost of funds over the term of the loan will exceed the interest charged to the borrower.
3. Liquidity risk - the ability to obtain and/or retain the funds necessary to lend to the borrowers or repay liabilities (including deposits).
4. Event risk - sudden political, military or natural events which prevent the carrying out of the lending and repayment functions.
5. Foreign exchange risk - where funds are lent/obtained in different currencies, the risk is the availability and cost of other currencies utilized in the transaction.
6. Sovereign (country) risk - e.g., expropriation, political and/or governmental action which interdicts the bank's relationships with its customers.
7. Operational risk - defalcations, errors and omissions and other operational errors.

Most important, these items are primarily future oriented, situation specific and unique to each bank and time.

The focus on risk-taking as the primary reason why and how the bank earns its interest revenue points up a number of critical elements.

1. A loan continues for a period of time into the future. The risks do not begin until the loan is made, and continue for as long as the loan is outstanding. That must be distinguished from a sale of goods, where the transaction is generally completed once the goods are delivered.

2. Risk-taking is based on and the sole result of judgments based upon all available relevant information. The judgment process, like the risks themselves, is a continuous one over the time the loan is outstanding. Obviously, the judgmental process is done by people.
3. Compensation for risks may not, and usually does not, coincide with the occurrence of the risk, if and when it should actually happen. For example, compensation for credit risk (if and to the extent actually paid) will invariably be received before a loan borrower fails to pay it back.

This analysis points to a number of conclusions regarding the principles which ought to apply for tax purposes. First and foremost, the taking of risk involves primarily the exercise of judgment, the making of decisions and carrying out of conclusions based upon the analysis of the facts on which the judgments are determined. That is, and can only be, done by people. Thus, interest earned for taking risk 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.

Second, the income earned by accepting and taking risks needs to be sourced at the same place where the risks will impact if they should happen. Among the major implications for taxing the financial services enterprise is the problem of losses. If the lender is earning or entitled to interest as compensation for taking risks, the principal one being risk of credit loss, it ought to follow that the tax effect of that loss be the same as the interest income previously taxed. For example (and for illustration purposes only), assume a state taxes an out-of-state bank on the basis of a single factor receipts formula and the bank, aside from its business in its home state, makes a single \$25MM loan to a customer in that state, for a 5 year term. For the first 3 years, the borrower pays the interest due (no principal payments being required until the end of the term) which are taxed by the state. In the fourth year, the borrower develops severe financial difficulties and ceases to pay interest. The bank finally determines at the beginning of the fifth year that it can and will collect none of the principal of the loan, and charges it off as a bad debt loss. In the fifth year, of course, the bank has no receipts attributable to the state. Therefore, the state has had the benefit of taxing the bank's compensation for taking the credit risk, but has avoided having to give any tax benefit for the loss actually suffered. That result, of course, mirrors the situation in the bank's headquarters state if it has adopted the same apportionment rules: it taxes none of the revenue, but would suffer the full impact of the bank's bad debt charge-off.

Such a result clearly is wrong. While the existence of the erroneous result should be obvious, the reasons why are not so evident. One reason is simply that an absence of any deduction for additions to loan loss reserves (which will result from following the concepts used in determining Federal taxable income) guarantees a mismatching of income and expense. However, even the use of loan loss reserves for tax purposes does not solve the problem, since the bulk of the actual loss will occur and be deducted after the loan goes bad and interest income has ceased. A receipts factor simply does not, and probably cannot, give proper recognition to the reasons why a bank receives interest income in return for or as compensation for taking risk. It is thus important that the interest income and the impact of risks be reflected in the same taxing jurisdiction, whenever those elements occur.

Proper analysis of these considerations leads to the conclusion that sourcing receipts in the form of interest on loans by the location of the borrower distorts unfairly and unrealistically the proper taxation of that income. It simply does not properly reflect where and how the income was earned - by people analyzing data, making judgments and carrying out decisions. It does not, and probably cannot, assure that the consequences of risk-taking (i.e., losses) be reflected and the tax benefits be obtained in the same places that the income was taxed before the risks actually occurred.

Such an analysis inevitably points to the conclusion that the New York State approach to sourcing interest revenue, based on the location of lending decisions and loan management, is the proper basis for sourcing such receipts.

Haskell Edelstein

January 16, 1991

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EXHIBIT K: 14

Edelstein, Haskell, "How Should the Income of Banks with Multistate Operations be Allocated?", The Journal of Multistate Taxation (May/June 1992)

How Should the Income of Banks With Multistate Operations Be Allocated?

The "market state" approach, which several states have adopted and others are considering, will produce distorted results. The author argues for a uniform system accepted by all states that generally taxes income where services are performed but also recognizes market states' demands.

By Haskell Edelstein

In 1986, after many years of quiescence, the states began to rethink approaches to the taxation of banks having multistate business. With the development of a proposal by the Multistate Tax Commission (MTC) and its almost immediate adoption by Minnesota, a new era began. Although the MTC has not yet completed work on its draft proposals, several other states have proceeded to adopt various new approaches to taxing banks, focusing particularly on those without physical presence, but having customers in the state. (See Pickhardt, "Determining Nexus for Banks in Market States," 2 JMT 10 (Mar/Apr 1992).)

The new approach, in general, seeks to extend income-based taxes

to banks when their only connection with the state is having customers located in the state, as borrowers, credit card holders, or users of the banks' services. That is known as the "market state" approach, and it may be distinguished from the "headquarters state" or "money center state" approach, which views banks as being subject to tax based on income only where they have a physical presence and where they perform their activities.

In general, the dispute focuses on which states may tax a transaction when the customer and the location at which the service is rendered are different. In the case of banks, since money is an intangible, a related issue is: Exactly what service is being rendered? In view of most states' need to raise revenue, banks are merely the first target of such legislation. Legislation aimed at other service-based industries, such as travel agencies and law and accounting firms, will likely follow.

At least as applied to financial institutions, these new approaches have focused on two critical elements:

Nexus—extending the taxing juris-

diction of a state from one based on physical presence to one based on the location of a minimum number of customers or dollar amount of loans to customers located in the state.

Sourcing of interest income—changing the sourcing of interest received on a loan from the place where the loan is made and administered to the location of the borrower.

In addition to these changes, a few states have adopted a new apportionment formula based on a single receipts factor, and one state (Indiana) now taxes banks domiciled in that state on their entire U.S. income, with a credit for taxes paid by the bank on that income to other states. (See Stroble, "Indiana Amends Financial Institutions Tax," 1 JMT 39 (Mar/Apr 1991).)

The focus on the location of borrowers, the sourcing of interest income, and the reliance on receipts in the apportionment of income necessitate a clear understanding of the nature of lending in reaching proper conclusions as to how a bank earns interest income and

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where that income is earned. In other words, why is a lender entitled to interest at all?

RISKS INCURRED BY BANKS

The key element of the bank's role as "financial intermediary" (between borrowers and suppliers of funds) is that of *taking risks*. Interest rates charged by banks on commercial loans are usually determined by the creditworthiness of the borrower. The best, most creditworthy borrowers pay only base or "prime" rate, while those less creditworthy pay higher rates. But that *credit risk* is only one of many risks a bank undertakes in making a loan.

A litany of other risks incurred by banks encompasses the following:

1. Credit risk—the risk that the loan will not be repaid.
2. Interest rate risk—the risk that the cost of funds over the term of the loan will exceed the interest charged to the borrower.
3. Liquidity risk—the risk that the bank will not be able to obtain or retain the funds necessary to lend to the borrowers or to repay liabilities, including deposits.
4. Event risk—the risk of sudden political, military, or natural events that prevent the bank from carrying out the lending and repayment functions.
5. Foreign exchange risk—the risk that when funds are lent or obtained in different currencies, the other currencies used in the transaction may not be available or may fluctuate in value.
6. Sovereign (country) risk—e.g., the risk of expropriation or political or governmental action that interdicts the bank's relationships with its customers.
7. Operational risk—the risk of errors, omissions, and other operational failures.

Most important, these items are primarily *future oriented*, situation specific, and unique to each bank and time.

The focus on risk-taking as the primary reason why and how banks earn interest revenue points up a number of critical elements.

A loan continues for a period of time into the future. The risks do not *begin* until the loan is made, and continue for as long as the loan is outstanding. That must be distinguished from a sale of goods, where the transaction is generally completed once the goods are delivered. Risk-taking is based on, and the sole result of, judgments derived from all available relevant information. The judgment process, like the risks themselves, is continuous over the time the loan is outstanding. This judgmental process is done by *people*.

Compensation for risks usually does not coincide with the occurrence of the risk, if and when it should actually happen. For example, compensation for credit risk (if and to the extent actually paid) invariably will be received *before* a borrower fails to pay back a loan.

This analysis points to a number of conclusions regarding the principles that ought to apply for tax purposes. First and foremost, taking risks involves primarily exercising judgment, making decisions, and carrying out conclusions based on the analysis of the facts on which the judgments 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.

Second, the income earned by accepting and taking risks needs to be sourced at the same place where the risks will impact if they should happen. Among the major implications for taxing the financial services enterprise is the problem of losses. If the lender is earning or entitled to

interest as compensation for taking risks, the principal one being risk of credit loss, it follows that the tax effect of the loss should be the same as that of the interest income previously taxed. For example, assume a state taxes an out-of-state bank on the basis of a single-factor receipts formula and the bank, aside from its business in its home state, makes a single \$25 million loan to a customer in that state, for a five-year term. For the first three years, the borrower pays the interest due (no principal payments being required until the end of the term), which is taxed by the state. In the fourth year, the borrower develops severe financial difficulties and ceases to pay interest. The bank determines at the beginning of the fifth year that it can and will collect none of the principal of the loan, and charges off the loan as a bad debt. In the fifth year, the bank has no receipts attributable to the state. Therefore, the state has had the benefit of taxing the bank's compensation for taking the credit risk, but has avoided having to give any tax benefit for the loss actually suffered. That result mirrors the situation in the bank's headquarters state if it has adopted the same apportionment rules: it would tax none of the revenue, but would suffer the full impact of the bank's bad debt charge-off.

Such a result is clearly wrong. Although the existence of the erroneous result should be obvious, the reasons why are not so evident. One reason is simply that the absence of a deduction for additions to loan loss reserves, which results from following the concepts used in determining Federal taxable income, guarantees a mismatching of income and expense. Even the use of loan loss reserves for tax purposes, however, does not solve the problem, since the bulk of the actual loss will occur and be deducted *after* the loan goes bad and interest income has ceased. A receipts factor simply does not, and probably can-

not, give proper recognition to the reasons why a bank receives interest income in return for or as *compensation for taking risk*. It is thus important that the interest income and the effect of risks be reflected in the same taxing jurisdiction, whenever those elements occur.

There is a further circumstance that illustrates the problems generated by the use of a receipts factor in apportioning the interest income of a bank. Many loans are made at

Income from services should be taxed where the services are performed.

floating interest rates—the rate of interest is tied or related to an independent market rate of interest (e.g., U.S. Treasury interest rates, LIBOR—London interbank offered rate, prime rates) and, accordingly, the rate of interest payable changes at regular intervals during the term of the loan. To the extent that the element upon which the interest rate is based reflects the cost of the funds the bank obtains to make the loan, the “spread” (i.e., the difference between the interest received and the interest paid by the bank) remains constant over the term of the loan. In an apportionment formula using only gross receipts, however, shifts in apportionment of income will occur because (1) fixed rate loans will continue to generate the same gross income while (2) gross receipts from floating rate loans go up and down, yet (3) net income (the spread) from the floating rate loans will remain unchanged. Thus, a state’s share of income apportioned on the basis of gross receipts can increase or decrease even though no changes occur either in the manner in which the lending is carried out or in the net income from such activity.

These considerations suggest that although the receipts factor in an apportionment formula is appropriate in the case of a business selling tangible property, the nature of the lending business is such that receipts will be both misleading and distortive, since changes in receipts can occur for reasons unrelated to either the level of income being earned or the way in which the business is conducted. The importance of this conclusion derives from understanding a major purpose of an apportionment formula—to fairly determine the portion of a business’s income that may be attributed to a particular state. One element clearly is where income is earned. In the case of financial services, however, the use of receipts often produces distorted results under those principles.

The changes in state approaches to the taxation of banks, noted above, come at a time when the financial services industry itself is undergoing significant changes. New financial products are being developed and used, new competition is arising both from financial institutions that are not banks and from banks owned by companies in other types of business, and the existing geographic barriers that presently prevent banks from operating by way of branches across state boundaries are being reconsidered.

EQUITABLE SYSTEM REQUIREMENTS

Given these changes in both the financial services business and the tax rules, it is imperative to develop a workable and equitable system for taxing financial, and other service-related, institutions to achieve a tax regime that:

1. Is fair and equitable to all states.
2. Prevents two or more states from asserting the right to tax the same income.
3. Is simple to understand and apply.

4. Makes compliance and auditing easy to achieve without undue expense to either the taxpayer or the tax collector.
5. Contains rules that are determined by the nature of the business or product rather than by the character of the institution doing the business.

To measure the practicality and theoretical justification of a particular approach to taxing financial institutions, a conceptual framework is essential as a measurement tool. To develop that tool, the nature of lending money must be examined. The lending of money can be characterized in several different ways:

1. It can be viewed as a *service* business in which the lender receives interest income from the borrower for taking risks and managing those risks. The work of analyzing the data and making the decision to undertake the risks involved in a loan, as well as the ongoing evaluation and decisions required during the term of a loan, constitutes the rendering of a service to the borrower for which the lender is compensated through the payment of interest.
2. A lender holding a *portfolio* of loans is acting in the nature of an *investor* holding a portfolio of bonds. Under this characterization, lending is equivalent to investment management, in that the bank determines first to make the loan investment, and simultaneously or from time to time thereafter determines how and whether to alter the investment portfolio through sales of portions by way of participations, syndications, or securitization.
3. A bank or other financial institution acts as a *financial intermediary* by obtaining and pooling available funds (obtained through deposits or borrowing) for the purpose of investing

those funds in loans. The lender gathers funds and lends them for a "commission" equivalent to the net spread between the cost of funds and the interest paid by the borrower. The financial intermediary also takes risks, and is also compensated by the net interest spread. This is, in essence, providing a service to *both* the sources and users of the funds.

4. A bank or other financial institution acts as the lessee of money because the lending of money for interest is the equivalent of renting a car to the user-lessee.

Several points need to be noted in viewing each of the foregoing characterizations of lending money:

1. The *service* element is paramount in items 1, 3, and 4.
2. The customer-borrower is of relatively little importance in item 2, in the sense that any benefit to the borrower is incidental to the creation and management of a portfolio for the benefit of the financial institution itself. Indeed, changes in the loan portfolio will usually change the risks involved, so that the compensation will change depending on the ebb and flow of such risks.
3. Items 2 and 3 may also be treated as the activity of investment banking—the lender may not take a position in the loan itself, and is thus essentially rendering the *service* of arranging for sources of and access to funds.
4. Item 4 suggests the strongest linkage to the location of the customer as an important element in determining where income is derived, *i.e.*, the "location" of the funds "rented" is the basis on which the lender's income is earned.

The foregoing discussion deals only with the activity of lending

money, and the role of the financial institution in that process. In addition, financial services involve other activities in the nature of services that may involve taking or accepting risks (either credit or other kinds of risks) without lending money or otherwise creating assets (receivables), or creating assets without credit risks. Some activities involve purely service activities that do not involve either external risks, *i.e.*, risks due to conditions beyond the control of the financial institution, or the creation of assets on the books of the financial institution.

Such activities generally have little element of customer relationship or "contact" with any state other than that of the location of the operations or activities providing the service, although that does not suggest that more substantial contacts with the location of the customer cannot be formulated.

In general, several conclusions can be made from the use of this conceptual framework:

1. Most formulations of the business of lending money tend to suggest that it is heavily service-oriented, thus focusing activity on the location where the service is performed. Since this result would be unfavorable to market states, strict adherence to those formulations may not achieve the required results.
2. The business of lending should be viewed and treated separately from all other services provided by financial institutions, such as by applying different sourcing rules for receipts or different weighting of factors in the apportionment formula.
3. Rendering a service without creating an asset, *i.e.*, an intangible in the form of a loan or receivable, should be treated the same as any other service for tax purposes—such as travel agent, lawyer, doctor, advertising agency, etc.

The various ways of characterizing the lending business, as well as the other functions of the financial services business, strongly lean in the direction of service. If the applicable principle for taxing the income of a service business is that income is to be taxed where it is earned, income from services should be taxed where the service is performed. Financial services also have two unique characteristics:

1. There is an undertaking and management of risk, which includes, but is not limited to, credit risk that the customer will fail to repay its loan.
2. Some activities only incidentally involve providing services to a customer—*e.g.*, trading in securities, currencies, etc.

Giving recognition to those special elements is appropriate, so that the location of the customer is of more significance in the case of credit risk, while the income resulting from the performance of trading activities should be taxed where those activities occur.

PROPOSAL FOR A FRESH APPROACH

In formulating the following proposal, certain elements were considered critical:

1. The rules need to be adopted uniformly by all states, to avoid conflicting rules that can result in multiple taxation of the same income by two or more states.
2. Compliance costs and audit issues need to be minimized. All rules should be bright-line tests. No rebuttable presumptions should be included, other than an overall authority to modify the rules to prevent evasion or substantial avoidance of tax in egregious cases. A standard form of return should apply to each state with respect to at least (a) net income (Federal tax-

able income); (b) apportionment formula calculations; and (c) nexus determinations.

3. Nexus must be readily determinable *prior* to the beginning of a taxable year, based on *point-in-time* data.
4. Information needed to comply with the tax rules should be limited to data collected by the taxpayer in the normal course of its business.
5. Apportionment formula elements should be determined by averaging the quarterly amounts during the taxable year.

These considerations suggest a proposal regarding nexus and sourcing of receipts in the case of banks, other financial institutions, and service-related businesses that could achieve results acceptable to all states. This consideration is the most important, because the application of inconsistent rules by various states can result in a financial institution being taxed on more than 100% of its income by all states in the aggregate. That circumstance must be avoided, as it is unfair to taxpayers who would be taxed on the same income by two or more states. For example, if a bank in State A performed all of its activities there, and had no office elsewhere, State A could claim the right to tax 100% of the bank's income. If State B, where some of the bank's customers were located, claimed the right to tax 20% of the bank's income on the basis of the bank's receipts being sourced by the location of its customers, the bank would, in effect, be taxed on 120% of its income. Thus, the following proposal is intended to be uniformly applicable to avoid such multiple taxation, as well as for practicability in compliance and administration.

Factors Considered

Nexus for a taxable year should be determined on the basis of data

available before the end of the preceding taxable year, and it should consider the following:

1. A physical presence (a branch or other office) in the state.
2. A minimum number of credit card customers located in the state.
3. A minimum number of other borrowers located in the state.
4. A minimum dollar amount of loans to borrowers in the state.

The location of the borrower should be determined on the basis of the mailing address for bills, as shown on the lender's records. Due to the distinction in numbers of customers and volumes in the case of the credit card business, a separate test is appropriate, since credit cards are frequently issued by banks exclusively in that business. Finally, if and when interstate branching by banks is permitted by Federal law, no nexus should exist as to any state if a bank is not permitted by the laws of that state to operate a branch in that state.

Apportionment of income should be determined on the basis of a three-factor formula:

- Payroll—double weighted.
- Property—limited to tangible property and loans, and receivables in the nature of loans.
- Deposits and borrowings (including all stock except common and perpetual preferred stock).

In viewing this proposal, several items should be noted with respect to the reasons for certain aspects of the proposal:

1. The payroll factor, double weighted, gives proper recognition to the *services* aspect of the business.
2. The property factor is easier to deal with than the receipts factor, but serves the same function of representing the cus-

tomers location element. Since loans are the principal property that generates income, and tangible property is a proper element in determining location of activities, both types should be included in the property factor.

3. The deposits-borrowing factor represents the other side of the financial intermediary function of the business (*i.e.*, the funds-gathering function as opposed to the funds-investment lending function). Since deposits are only one source of funding for loans, and are not available to financial service businesses that are not banks, other sources of funds must be taken into account. Since these other funds cannot be traced to their sources (*e.g.*, the holders of marketable securities are usually not easily determinable), these sources must necessarily be attributed to the borrower's headquarters location.
4. The traditional-receipts factor is not included for several reasons; the same result and element is reflected in the intangible property factor with regard to loans, and receipts are more difficult to locate and involve fairly complex recordkeeping. In addition, when receipts from loans reflect floating interest rates, they distort the formula because an increase in receipts really reflects the costs of funds supplied, which is not a function related to the borrower.
5. Sources of funds other than deposits cannot practically be traced, so such other sources are best located where they are gathered and managed.
6. Limiting the intangible property factor to loans and receivables in the nature of loans takes into account that other types of intangibles do not relate to a specific customer (*e.g.*, trading assets). Thus, loans should encompass all intangi-

bles involving both the creation of a receivable and the presence of a credit risk. Loans should thus include all leasing when the financial institution is the lessor, regardless of the Federal income tax treatment (but only for apportionment purposes).

7. All income, except sales of businesses (including bank branches) and real estate used for business operations, should be business income. The types of income that constitute non-business income in the case of mercantile and manufacturing corporations clearly constitute income from the ordinary business conducted by financial services corporations.
8. *Deposits* should generally be defined as money paid to the financial institution that is subject to a liability to repay on demand or at a specific time, with or without interest, and the use of which until then is unrestricted in the hands of the recipient and is not represented by a marketable instrument (except money orders and travelers checks).
9. Nexus should not exist in any case in which the corporation is not permitted, under state law, from conducting business through a branch (in the case of a depository institution) or office located in the state.
10. If the state includes Subpart F income in U.S. taxable income as the tax base, the controlled foreign corporation should be treated as if it were a branch of its U.S. parent, and therefore its payroll, property, and sources of funding (from third parties) should be included in the apportionment formula.
11. In the case of sourcing loans under the intangible property factor of the apportionment formula, all loans should be sourced by billing address. For loans acquired by the holder by

way of syndications or participations, the billing address should be that of the borrower, even when the loan is administered by another financial institution as agent. This approach is consistent with the "economic presence" theory that a lender has a presence in a state based on where the borrower is located, regardless of how the loan was acquired. On the other hand, it is inconsistent with the economic reality that the lender-taxpayer is merely investing in a portfolio-type investment under the second scenario of the framework, discussed above.

CONCLUSION

The foregoing proposal seeks to give due consideration to a number of elements, including the nature of the financial services business, the role of both customers and performance of services, and the need for simplicity and certainty of rules. Although there may be more precise measurements (such as the gross profitability of each type of financial product), these considerations would only substantially increase complexity and reduce the precision of data, without necessarily improving the quality of the results. The proposal seeks to avoid all distinctions among types of financial services and products except credit cards and pure lending activities. It is hoped that this can form the basis for a workable system, acceptable to all states while consistent with the nature of the financial services business. ■

EXHIBIT K: 15

Federal Deposit Insurance Report Package and related documents

Federal Financial Institutions **Examination Council**

FOR COMMERCIAL BANKS:
OMB No. for FDIC: 3064-0052
Expiration Date: 8/31/90
OMB No. for OCC: 1557-0081
Expiration Date: 8/31/90
FOR SAVINGS BANKS:
OMB No. for FDIC: 3064-0054
Expiration Date: 1/31/90



CALL NUMBER 167

FDIC - OCC

SAMPLE

Call Date: March 31, 1989
Report Package for:
Insured Commercial Banks Not
Members of the Federal Reserve
System, National Banks
and Savings Banks

All questions pertaining to the enclosed forms and their completion should be directed to the Call Reports Analysis Unit, telephone toll free (800) 424-5101, or call (202) 898-6607

Federal Deposit Insurance Corporation
Call Reports Analysis Unit
550 17th Street, NW, Room F-574
Washington, DC 20429

Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency

EXHIBIT K: 16

**Federal Deposit Insurance Corporation, "Statistics on Banking 1987"
(on file at MTC headquarters)**

Statistics on Banking 1987



EXHIBIT K: 17

**Ferguson, Fred E., "State Taxation of Financial Institutions", Bank
Administration Institute - Multistate Taxation of Banking
(November 19, 1990)**

STATE TAXATION OF FINANCIAL INSTITUTIONS

Current Developments -- 1990

Bank Administration Institute
Multistate Taxation of Banking
New York, New York
November 19, 1990

Fred E. Ferguson
Director, State Tax Policy



STATE TAXATION OF FINANCIAL INSTITUTIONS

Current Developments -- 1990

Table of Contents

	<u>Page</u>
I. Recent Trends in Bank Taxation	1
A. Market States vs. Money Center States	1
1. Market States	1
a. Minnesota	1
b. Indiana	1
c. Tennessee	1
2. Money Center States	1
a. New York	1
B. Multistate Tax Commission Regulations	1
II. Significant State Banking Developments - 1990	2
Alabama	2
California	2
Florida	3
Hawaii	3
Illinois	4
Indiana	4
Iowa	5
Maryland	5
Massachusetts	6
Montana	7
New York	7
North Carolina	7
Tennessee	8
Utah	8
West Virginia	8

STATE TAXATION OF FINANCIAL INSTITUTIONS

Current Developments -- 1990

I. RECENT TRENDS IN BANK TAXATION

A. Market States vs. Money Center States

1. Market States - Minnesota, Indiana and Tennessee have all recently established aggressive tax policies aimed at taxing the income of out-of-state financial institutions doing business with state residents. Based on the perception that they are market states (financial institutions are not heavily concentrated in the states and the states are net borrowers of capital) rather than money center states (financial institutions are heavily concentrated in the state and the state is a net lender of capital). All three states, in order to generate increased revenues, have chosen to attribute financial institution earnings to the place where the customer resides as opposed to the state from which the lending bank operates. However, different formulas were selected to achieve this result.
 - a. Minnesota - In 1988, Minnesota enacted a weighted three-factor formula of receipts (70%), property including intangibles (15%), and payroll (15%). Receipts are sited to the residence of the borrower or where the property securing the loan is located. Income from services is sited to the place of consumption, not the place of performance. Property is attributed to the state where located, with intangible assets sited to the location of the borrower. Payroll is attributed to Minnesota if the employee is employed with the state, actually working there, or is accountable to an office with the state.
 - b. Indiana - In 1989, Indiana enacted a single factor gross receipts formula for its non-resident taxpayers. Resident taxpayers are taxed on their income from all state operations and granted a limited credit for taxes paid to other states. The situs rules for gross receipts of non-resident taxpayers attribute income to the residence of the customer. For example, interest and fee income from credit card accounts are sited to Indiana if the charges are regularly billed there.
 - c. Tennessee - Earlier this year, Tennessee adopted a financial institutions tax closely modeled on Indiana's 1989 law. The Tennessee tax also imposes a single-factor gross receipts formula, and adds a presumption of nexus based on the existence of at least \$5 million of assets attributable to Tennessee. The legislation also imposes an additional franchise tax on the value of all tangible or intangible property attributed to the state.
2. Money Center States
 - a. New York - New York, in contrast to Minnesota, Indiana and Tennessee, has a heavy concentration of financial institutions and is a net lender of capital. Accordingly, New York's apportionment formula reflects a lending perspective. The state uses a weighted three-factor formula of receipts (40%), deposits (40%), and payroll (20%). Income is attributed to the location where receipts are processed, services are performed, or credit card loans are made. Deposits are sited to the branch where they are maintained, instead of to the state where the depositors reside.

B. Multistate Tax Commission (MTC) Regulations

The conflict between money center states and market states and the ability of the state to tailor its situs rules and apportionment formulas to maximize revenue, illustrates the potential for multiple taxation of financial institutions operating in a multistate environment. In 1989, the MTC proposed draft regulations for the uniform apportionment of income from financial institutions that generally adopt a market state approach. After considering written comments, the proposed regulations were noticed for hearing earlier this year.

The proposed regulations are to apply to income derived from the business in only those states where the taxpayer exercises its corporate franchise or transacts business. This includes states where the taxpayer owns property in the state, makes loans secured by property in the state, has employees in the state, or "engages in regular solicitation" in the state. The regulations provide that a financial institution is

presumed to be engaged in regular solicitation if it: a) has debtor/creditor relationships with 100 or more state residents; b) has an average of \$10 million in assets in the state; or c) has more than \$500,000 in receipts attributable to sources within the state. The presence of certain property in the state (e.g., syndicated loans, REMICs, REITs, money market securities) will not be sufficient to find a taxable nexus if the taxpayer's sole activity in the state is evaluating, acquiring, maintaining and/or disposing of such property.

Hearings on the regulations have been held as follows:

Washington, DC - August 21, 1990
San Francisco, CA - August 23, 1990
Chicago, IL - December 3, 1990
Atlanta, GA - December 4, 1990

II. SIGNIFICANT STATE BANK TAX DEVELOPMENTS - 1990

Listed below is a summary of banking legislation introduced in the states during the 1990 legislative session. Although not exhaustive, the listing contains several proposals that did not pass but are included as indicative of potential future legislation.

ALABAMA, HB 944 **Financial Institutions Excise Tax**

HB 944 amends the definition of "Financial Institution" in Alabama's Financial Institutions Excise Tax to include "regulated financial corporations", which are further defined as banks or thrift institutions incorporated in the United States or any foreign country which are engaged in the business of receiving deposits, or which hold a bank charter.

This legislation would effectively expand the scope of Alabama's Financial Institutions Excise Tax to include business activities conducted in Alabama by both out-of-state national banks and out-of-state state chartered banks. The bill failed to pass.

CALIFORNIA, REGULATION 23183 **Definition: Financial Corporation**

The Franchise Tax Board (FTB) has released a portion of draft regulations with respect to banks and financial institutions. Reg. Sec. 23183, which defines the term "financial corporation," was the subject of a public hearing on October 15, 1990. Notice and hearing schedules for two other regulations, Reg. Sec 23181-23183 (Doing Business-Financials and Banks) and Reg. Sec. 25137 (Apportionment and Allocation of Income with Respect to Banks), have not yet been announced. It is anticipated that these two regulations will be publicly noticed before the end of the year.

CALIFORNIA, REGULATION 25137-10 **Combination Regulation for Financial and Non-Financial Corporations**

California Regulation 25137-10 outlines the use of combined reports for general corporations with financial subsidiaries. Specifically, the regulation provides for the allocation and apportionment of unitary business income where that business consists of a general parent corporation whose predominant activity is other than financial activity, and a unitary subsidiary created to perform financial activities.

The regulation modifies the standard 3-factor apportionment formula by including in the property and sales factors receivables from financial activities (and amounts realized from such receivables) of the general corporation and its financial subsidiary. The regulation applies to taxable years beginning on or after January 1, 1989, and was adopted by the California Franchise Tax Board July 17, 1990.

CALIFORNIA, BARCLAYS BANK CASE **Unitary Combination with Foreign Parent Companies**

The California Appellate Court has scheduled Barclays Bank v. Superior Ct. of County of Santa Clara (Super. Ct. of Cal., Doc. S010394, May 30, 1989), for oral argument on November 12, 1990. This case is of particular importance to those filing combined returns in California with foreign parent companies. The lower court found such filing to be unconstitutional but neither the California Franchise Tax Board (FTB) nor the State Board of Equalization (SBE) has followed this preliminary finding. It is anticipated that the court will render a decision by the end of 1990. It is also anticipated that the California Supreme Court will deny a petition to review the case brought by either party. The losing party is then expected to petition the US Supreme Court for certiorari.

CONNECTICUT, CALLY CURTIS CASE **Minimum Nexus Requirements**

The US Supreme Court has denied certiorari for Cally Curtis Co. v. Groppo (Ct. Sup. Ct., Doc. 13733 March 27, 1990), a case from Connecticut relating to the minimum nexus requirements required for sales and use tax purposes. By taking this action, the Court has validated the lower court decision in favor of the taxpayer. Although the case deals with the presence of video tapes within the state, it may have broad implications, for instance, with respect to credit card nexus for banks.

The lower court in Cally Curtis Co. specifically held that the presence of instructional video tapes in the state, leased by the taxpayer to unrelated entities in the state and shipped using common carriers, did not establish nexus. Cally Curtis is headquartered outside the state, maintains ownership of the individual tapes sent into Connecticut and has no additional presence within the state. By decision of the court, Cally Curtis has no liability for the collection of sales and use tax for the video tapes.

FLORIDA, CS FOR HB 3695 **Intangibles Taxes**

This bill increases Florida's tax on intangibles (stocks, bonds, year-end accounts receivable and mutual funds) from 1 mill to 1.5 mills of value (\$1.50 per \$1000). Banks and savings and loans subject to the intangibles tax are now eligible for a credit against their corporate income tax equal to the lesser of 65% (previously 40%) of their income tax liability or the amount of the intangibles tax. In addition, banks are also granted a new credit against the intangibles tax equal to 33% of the prior year's intangibles tax liability, reduced by the amount of the credit taken against their corporate income tax. These provisions are part of a \$1.3 billion tax and fee increase that became law on June 21, 1990 without the signature of Governor Martinez (R).

HAWAII, HCR 324 **Equitable Tax Policy for Financial Institutions**

House Concurrent Resolution 324 called for a review of financial institutions taxation in Hawaii, and requested the Director of Taxation to formulate an equitable tax policy for financial institutions. HCR 324 notes that financial institutions are treated differently from other corporations under Hawaii tax law due to requirements imposed by federal laws that were repealed in 1976.

The Director of Taxation is requested to review the provisions contained in SB 2439 (below), and submit a report of findings and recommendations, including a draft bill, to the legislature at least twenty days before the convening of the 1991 Regular Session. The concurrent resolution failed to pass.

HAWAII, SB 2439
Taxation of Financial Institutions

SB 2439 proposed to subject banks to the corporate income tax and impose the current franchise tax on state and national banks located and doing business in Hawaii.

SB 2439 failed to pass the Legislature. Sources in Honolulu indicate that industry members are preparing a report for Hawaii's 1991 Regular Session that would recommend changes to the current taxation of financial institutions.

ILLINOIS, PUBLIC INFORMATION HEARING
Taxation of Border Banks by Indiana Bank Tax

An October 17, 1990 meeting was held in Danville, Illinois, by Governor James R. Thompson (R) and a group of border banks in Illinois to discuss hardships caused by the new Indiana tax on financial institutions. Discussions centered around the increased costs of new loans to Indiana customers and the withdrawal of Illinois banks from the Indiana financial market as a result of the tax.

In addition, the Illinois Bankers' Association (IBA) is reportedly conducting a survey of all Illinois banks regarding their cross-border business activities, specifically with respect to Indiana activities. The Community Bankers' Association of Illinois (CBAI) has also sent surveys to Illinois banks recently, and the IBA study is intended to supplement this data.

ILLINOIS, SB 1728
Financial Institutions Tax Act

SB 1728 was a "shell" bill that was meant to carry a retaliatory bank tax intended to counter the taxation of certain Illinois banks by Indiana's newly enacted (1989) bank tax.

The sponsor of SB 1728, Senator Harry "Babe" Woodyard, represents a district on the border between Illinois and Indiana that contains several Illinois banks which may be subject to Indiana's tax on banks. Although SB 1728 was never voted out of the Finance Committee, the Senator has indicated that he will introduce similar legislation during the next Regular Session.

Senator Woodyard participated in a public information hearing on October 17, 1990, which was called by the Governor of Illinois to discuss the impact of the Indiana bank tax on Illinois banks. The "border bank" problem of increased taxes that Illinois banks face due to the new Indiana tax is considered a substantial political issue for the economic future of both states.

INDIANA, REGS. 45 IAC 17
Financial Institutions Tax Regulations

On June 19, 1990, the Indiana Department of Revenue released a proposed draft of Financial Institutions Tax Regulations designed to administer the bank tax enacted last year (HEA 1625). Written comments were accepted through July 25, 1990. The Department held a public hearing on the proposed regulations on September 24, 1990. Since that date, only non-substantive amendments have been made to the regulations. They are expected to be finalized by December 31, 1990.

INDIANA, HB 1395
Amendments to Financial Institutions Tax

HB 1395 contains amendments to 1989 HEA 1625, Indiana's newly-enacted Financial Institutions Tax. The bill provides that members of a unitary group under the new Act must be either a holding company, a regulated financial corporation, a subsidiary of either, or an entity that conducts the business of a financial institution.

HB 1395 also provides that if a taxpayer's average quarterly franchise tax liability for the preceding year exceeds twenty thousand dollars, the taxpayer is to remit payment via electronic funds transfer. This bill was adopted and signed by the Governor on March 15, 1990.

INDIANA, HEA 1625 (1989)
Corporate Income Tax for Banks

Last year, Indiana enacted a corporate income tax for banks and other financial institutions that imposes on each taxpayer a franchise tax measured by net income for the privilege of exercising its franchise or transacting business in Indiana. The new tax consists of a residence-based tax for resident taxpayers (taxed on total net income with credits for taxes paid to other states), and a source-based tax for non-resident taxpayers (taxed on net income apportioned to Indiana using a single receipts factor). The tax applies only to corporations transacting the business of a financial institution in Indiana; however, the definition of transacting business in Indiana is significantly expanded under the Act. Previously, banks in Indiana were subject to a net worth tax on deposits and a tax on income from intangibles.

IOWA, REGS. 701-59.25-28
Regulations for Financial Institutions

The new Iowa regulations are designed to implement existing statutory law with respect to financial institutions doing business in Iowa. Reg. 701-59.25 defines "doing business" and provides a non-exclusive list of activities used to determine when a financial institution is carrying on business in another state, and therefore is able to allocate or apportion its income. Reg. 701-59.26 deals with determining when an affiliated group of financial institutions have a unitary relationship. Reg. 701-59.28 provides apportionment rules for financial institutions that specify the use of a single-factor formula measured by gross receipts, and provide detailed sourcing rules. The rules were adopted December 20, 1989, and are effective for tax years beginning on or after June 1, 1989.

MARYLAND, REPORT
Taxation of Financial Institutions in MD

On April 12, 1990, the Maryland Department of Fiscal Services (under the auspices of the General Assembly) issued a report to members of the General Assembly on the taxation of financial institutions in Maryland. The report highlights changes occurring in the industry and in other states, and analyzes Maryland's financial institutions franchise tax in light of these changes.

MASSACHUSETTS, HB 2211
Income Tax on Financial Institutions

The legislation proposes a new two-factor net income tax for financial institutions, including the following key provisions:

- o Apportionment of income by both in-state and multistate banks, using the receipts and payroll factors.
- o Election to file a combined report.
- o Tax rate is lowered from the current 12.54% to 10.5%.

The bill also imposes a 1.32% gross receipts tax on security brokers. HB 2211 would apply to tax years beginning after October 1, 1990. The bill is currently in the Joint Committee on Taxation.

MASSACHUSETTS, SB 1317
Income Tax on Financial Institutions

SB 1317 proposes a new single-factor income tax on financial institutions, as follows:

- o Multi-state banks apportion income based only on a receipts factor.
- o Massachusetts banks are not allowed to apportion, but a credit is available for tax paid to other states.
- o Unitary combined return is required for unitary groups.
- o Tax rate is 12.54%.

The legislation is effective for tax years beginning after January 1, 1990, and automatically sunsets on January 1, 1997, reverting back to the current system. By 1994, a state commission must be formed to study the taxation of financial institutions, with a final report due by July 1, 1996. The bill is pending in the Joint Committee on Taxation.

SB 1317 and HB 2211, propose a new method of tax for financial institutions and establish a source of funding for low-income housing. Both bills establish a non-profit program to provide revenues for qualified mortgages to be funded by capital contributions of those financial institutions required to file returns under the new income tax. Capital contributions will be required periodically in amounts that are proportional to each taxpayer's share of the state's net income tax. It is not clear whether this portion of either bill will ultimately become law.

MASSACHUSETTS, HB 3431
Income Tax on Financial Institutions

This legislation proposes a new two-factor net income tax for financial institutions, including the following key provisions:

- o Apportionment of income using the receipts and payroll factors
- o Tax rate is lowered from the current 12.54% to 10.5%.

HB 3431 would apply to tax years beginning after October 1, 1988. The bill also establishes the Massachusetts Affordable Housing Assistance Corporation, which is to be funded by taxpayers under the new bank tax.

HB 3431 is one of several proposals for a tax on financial institutions currently under consideration in Massachusetts. HB 2211 and SB 1317 are similar proposals, which were all considered in hearings by the Joint Committee on Taxation on March 20, 1990.

MONTANA
Ballot Initiative

On November 6, 1990, Montana voters considered repealing all existing taxes on residents and business, and replacing them with a "trade charge" on business and financial transactions. This charge would have been levied on every transaction occurring in the state (or partially in-state). The net effect would be a gross receipts tax on all businesses; such a tax may impose an especially onerous burden on financial institutions. The "trade charge" would have been 1% of gross value, beginning on July 1, 1991, and would increase in future years. The referendum was defeated.

NEW YORK, REGS. SEC. 16-2 & 18-2 et seq.
Regulatory Amendment

This regulation amends the combined reporting regulations under the franchise tax on banking corporations. Specifically, this amendment repeals the "safe-harbor" rule that circumvents mandatory combination if all intercorporate transactions are conducted at arm's-length prices. Adopted by the Commissioner July 30, 1990.

NEW YORK, REGS. SEC. 606.1 et seq.
New Procedural Regulation

This new regulation allows the Department of Taxation and Finance to pass through certain costs of audit to financial institution taxpayers only. The Department will assess an additional \$110 per hour of auditor time to banks under audit, beginning immediately. The regulations were finalized on October 22, 1990.

The New York State Bankers Association is reportedly pursuing a challenge to this regulation in the state courts.

NEW YORK, SB 7005
Expense Deduction Disallowance

SB 7005 prohibits financial institutions from claiming a deduction for expenses associated with tax-exempt income. The bill also disallows the bank tax deduction for taxes paid to other states. This legislation would apply existing income tax restrictions to the bank tax. The Governor's staff estimated that SB 7005 would raise \$20 million for the state. The bill failed to pass out of the Finance Committee.

NORTH CAROLINA, INCREASED AUDIT ACTIVITY
Financial Institutions

The North Carolina Department of Revenue has reportedly begun a campaign to audit all financial institutions conducting business in the state. Audits are reportedly proceeding alphabetically, starting at the END of the alphabet (currently auditing "N"). The issues typically under examination include treatment of tax-free municipal bonds and apportionment of income to the state.

TENNESSEE, SB 2515
Financial Institutions Tax

SB 2515 imposes an excise tax on the net income of in-state and out-of-state banks and other financial institutions doing business in Tennessee. The legislation also proposes:

- o A single-factor apportionment formula based on receipts.
- o A unitary business concept for financial institutions.
- o An additional franchise tax based on the value of all tangible or intangible property located in or attributable to Tennessee.
- o A presumption of taxable nexus based on the existence of at least \$5 million of assets attributable to Tennessee.
- o A "throw-back rule" for out-of-state receipts not taxable in the foreign state if the receipts result from business activity carried on within Tennessee.

The legislation is effective for fiscal years ending on or after July 15, 1990. Signed by the Governor.

UTAH, TASK FORCE
Study of Taxation of Financial Institutions

The Utah Tax Commission is reportedly examining the issue of a broad net income tax on financial institutions in order to push for legislation during the 1991 Regular Session. The bill is likely to be very similar to that adopted in Tennessee in 1990. No pre-filed legislation has yet been released.

WEST VIRGINIA, HB 4803
Acquisition of Bank Shares

The purpose of HB 4803 is to prohibit a bank holding company with its principal place of business located outside West Virginia from acquiring, directly or indirectly, five percent or more of the interest in, or assets of, any bank or bank holding company located in West Virginia. HB 4803 was signed by the Governor on March 26.

EXHIBIT K: 18

Fox, William F., "Taxation of Financial Industries in an Era of Change", (research paper prepared for the Arizona Joint Select Committee on State Revenues and Expenditures) (preliminary draft dated March 29, 1989)

- Preliminary Draft -

TAXATION OF FINANCIAL INDUSTRIES IN AN ERA OF CHANGE

A RESEARCH PAPER
PREPARED FOR
THE
ARIZONA JOINT SELECT COMMITTEE ON
STATE REVENUES AND EXPENDITURES

March 29, 1989

*Written by William Fox,
University of Tennessee prof.*

- Preliminary Draft -

**TAXATION OF FINANCIAL INDUSTRIES IN AN ERA OF CHANGE
EXECUTIVE SUMMARY**

The economic environment in which banks and savings and loans do business has been changing rapidly in recent years. A major shift has been the broadening of financial institutions' ability to deliver services outside their state of domicile (legal base). Technological changes, opening of new markets, and legislation have combined to allow this increase in interstate banking. Today, 45 states including the District of Columbia allow some form of interstate banking. Arizona currently allows interstate branching through holding companies only, but will permit full de novo interstate banking effective June 30, 1992. Arizona has been a leader in allowing financial institutions increased powers to diversify the services they offer.

Arizona is one of 23 states which tax financial firms (excluding the insurance industry) under the general corporate tax statutes rather than applying an industry-specific tax structure. Thus, the taxes on financial institutions in Arizona have many of the same problems as the general corporate income tax. But because financial institutions have unique characteristics and differ from other corporations in the way they earn their income, additional factors must be considered when designing a structure to tax them.

There are three major concerns with defining taxable income for financial institutions. If these concerns are not addressed, efficiency, or neutrality, within the financial industry and across industries will be distorted, and Arizona will fail to tax all income earned in the State. The trade-off, however, is that by restructuring taxes to address these neutrality issues, the State could create additional complexity and increase tax administration and compliance costs.

The first neutrality concern is that Congress has prohibited the taxation of interest on federal securities under a corporate income tax. Because this source of income is not taxed in Arizona, the tax base is narrowed and firms' decisions are distorted because they have an incentive to place their assets in federal securities rather than other investments. Since interest on federal obligations makes up a much larger share of total income for banks than it does for other corporations, the failure to tax this income reduces the tax burden of banks relative to other businesses. Congress has allowed states to tax interest on federal securities under a nondiscriminatory franchise tax, which could use net income as a base. So Arizona could enhance tax neutrality by applying a franchise tax, rather than a corporate income tax, to financial institutions.

The second efficiency concern is that the three apportionment factors used in the formula -- sales, payroll, and tangible property -- are poor proxies for how financial income is earned.

Thus, Arizona may not be taxing financial firms on their income earned in the state and, so, may be placing lighter or heavier tax burdens on these businesses than on other businesses. Because the formula does not cater to financial institutions, Arizona may not be capturing its full share of tax revenue. This problem can be addressed by including intangible property in the apportionment formula or by weighting the sales factor more heavily.

The third concern is whether a state can tax a firm which provides financial services without any physical presence in the state, through the issuance of credit cards or the use of automatic teller machines, for example. If these forms of income remain untaxed, firms have incentive to change their business decisions and earn more of their income in this way. Also, if this type of income is not taxed either in Arizona or in the state of domicile, foreign firms offering branchless banking services will have lower taxes and an advantage over Arizona-based firms. Legal scholars have concluded that states can tax income based on the solicitation of business rather than a physical presence. Thus, Arizona could tax the income earned through branchless banking activities.

TAXATION OF FINANCIAL INDUSTRIES IN AN ERA OF CHANGE

The tax structure imposed on the financial industry was developed in an environment where most financial services were offered within the state of residence and where federal legislation placed significant limitations on the states' flexibility in taxing the service. Both the environment and federal legislation have changed radically during the past two decades necessitating new consideration of the tax structure. The purposes of this paper are to describe and evaluate taxation of the financial industry in Arizona given the new environment. The focus is on banks and savings and loans. Firms in other areas of the financial industry, such as brokers, are not included.

This study is separated into four sections. The first is a description of the financial industry in Arizona and of trends towards diversification and interstate provision of services. Second, the legal basis and current taxation of the industry is discussed. Next, an analysis of economic issues related to the tax structure is provided, with emphasis on definition of income and tax neutrality. Finally, a set of options for revising the tax structure is given.

Financial Industry

Arizona's Banks and Savings and Loans

Banks and savings and loans operating in Arizona reported combined assets of \$56.14 billion as of September 30, 1988

(Office of the Superintendent of Banks, 1988a and 1988b). Assets of Arizona banks were 24th highest among the states (including DC) in 1986 and savings and loan assets were 12th in the nation (U.S. Bureau of the Census). In both cases Arizona is the largest among the 8 mountain states.

Arizona has 47 banks which held \$27.31 billion in assets (48.6 percent of total banks and savings and loans) and operated 725 branches as of September 30, 1988 (Office of the Superintendent of Banks, 1988a). Thirty-two of the banks are state chartered, but they only account for \$10.46 billion of the assets and 268 of the branches. The state banks are generally small, as only 7 have assets above \$100 million. Exceptions include The Arizona Bank (\$5.12 billion in assets) and Citibank (\$2.85 billion).

The 15 nationally chartered banks have combined assets of \$16.85 billion and a total of 457 branches. Valley National Bank of Arizona (\$9.61 billion in assets) and First Interstate Bank of Arizona (\$6.60 billion) dominate the national banks, as only one other bank has more than \$100 million in assets.

The state's 13 savings and loans have assets of \$28.83 billion and operate 310 branches. Eight of the savings and loans, with just over one half of the assets have state charters and the remainder have federal charters. The larger savings and loans include Merabank (\$7.43 billion in assets), Western (\$6.38 billion), Great American (\$4.02 billion), Pima (\$3.34 billion), and Southwest (\$2.46 billion).

Trends in Interstate Banking

One of the most important trends among financial institutions has been towards the delivery of interstate financial services. According to the McCarran Act the ability of nondomiciled banks (banks headquartered elsewhere) to branch into a state is determined by the state's banking laws. Savings and loans, credit unions, and other financial institutions are not limited by the McCarran Act and must abide by guidelines of their regulatory agencies. Generally they can engage in interstate branching. Also, banks can undertake many interstate activities without branching, and the McCarran Act only limits their branching activities. For example, banks can solicit customers across state lines or offer services through automatic teller machines (ATM) owned by other institutions without engaging in interstate banking.

Forty-five states including the District of Columbia allow some form of interstate banking. Sixteen states have legislation to permit de nova interstate banking, though it becomes effective at different dates (Table 1). Arizona currently permits interstate banking through holding companies only, but will permit de nova banking effective June 30, 1992. According to Arizona's statutes, banks established after May 1984 must be in operation at least 5 years before they can be acquired. Though no statistics are available to allow a precise measure of the current share of Arizona financial assets owned by out-of-state

STATE INTERSTATE BANKING LAWS

	Nationwide	Regional Reciprocity Trigger to Nationwide	Regional Reciprocity
Alabama			X
Alaska	X		
Arizona	6/92		
Arkansas			1/89
California		X	
Colorado		7/93	
Connecticut			X
Delaware		X	
District of Columbia			X
Florida			X
Georgia			X
Hawaii			
Idaho	X		
Illinois		X	
Indiana		X	
Iowa			
Kansas			
Kentucky	X		
Louisiana		X	
Maine	X		
Maryland			X
Massachusetts			X
Michigan		X	
Minnesota			X
Mississippi			X
Missouri			X

Montana		
Nebraska		1/90
Nevada		7/90
New Hampshire		X
New Jersey	X	
New Mexico	7/92	
New York	X	
North Carolina		X
North Dakota		
Ohio		X
Oklahoma	X	
Oregon		X
Pennsylvania		X
Rhode Island	X	
South Carolina		X
South Dakota	X	
Tennessee		X
Texas	9/2001	
Utah	X	
Vermont		X
Virginia		X
Washington	X	
West Virginia	X	
Wisconsin		X
Wyoming	X	

Dates evidence a change in interstate banking authority as taken from Kincaid and McCray (1988).

Source: Conference of State Bank Supervisors (1988).

holding companies, 46.6 percent of assets were held by banks which were owned by holding companies in 1986 (U.S. Bureau of the Census). Robert Hawkins of the Advisory Commission of Intergovernmental Relations estimated that 65 percent of state chartered banks across the nation are owned by bank holding companies.

Arizona also allows state chartered banks which are not members of the Federal Reserve System relatively broad powers to diversify. For example, Arizona is one of 15 states which permit securities underwriting by banks, one of 19 which allow securities brokerage, and one of 24 which permit banks to engage in real estate development (Table 2).

Current Arizona Tax Structure

Historical Limitations on Taxing Banks

Constitutional restrictions and Congressional action have formed state taxation of financial institutions. Commerce Clearing House (1988) has said it well, "The methods prescribed for the taxation of national banks set the pattern for taxation of all important members of the group." Constitutional restrictions on taxing national banks go back to the case of McCulloch v. Maryland (1819) which limited the ability of one level of government to tax another. The court finding in the McCulloch case has been interpreted to mean that states can only tax national banks to the extent permitted by Congress.

TABLE 2

STATE DIVERSIFICATION LEGISLATION
FOR INTERSTATE BANKING

	Insurance Under- writing	Insurance Brokerage	Real Estate Equity Partici- pation	Real Estate Devel- opment	Real Estate Brokerage	Securities Under- writing	Securities Brokerage/No Under- writing
Alabama		X					
Alaska							
Arizona			X	X		X	X
Arkansas			X	X			
California			X	X		X	
Colorado			X	X			
Connecticut			X	X			X
Delaware	X					X	X
District of Columbia							
Florida			X	X		X	X
Georgia							X
Hawaii							
Idaho							
Illinois							
Indiana		X				X	X
Iowa		X			X	X	X
Kansas						X	X
Kentucky			X	X			
Louisiana							
Maine			X	X		X	X
Maryland							X
Massachusetts			X	X	X	X	
Michigan				X			
Minnesota							X
Mississippi							
Missouri			X	X		X	
Montana						X	
Nebraska		X					X
Nevada			X	X			
New Hampshire			X	X			

TABLE 2 (Continued)

New Jersey		X	X	X	X	X	X
New Mexico							
New York			X	X			X
North Carolina	X	X	X	X	X	X	X
North Dakota							
Ohio			X	X			X
Oklahoma							
Oregon		X				X	
Pennsylvania							
Rhode Island			X	X			
South Carolina	X	X					
South Dakota	X	X	X	X			
Tennessee			X				
Texas							X
Utah	X		X	X			
Vermont							X
Virginia			X	X			
Washington			X	X		X	
West Virginia			X	X		X	X
Wisconsin		X	X	X	X		
Wyoming		X					

Source: Conference of State Bank Supervisors (1988).

Congress made its first step towards reducing immunity of national banks from state taxation in 1864. Numerous other court cases and legislative acts took place in the intervening years until 1969 when Congress acted to unify its position on immunity provisions. Moratoriums on the 1969 legislation prevented its application until 1976. Since 1976 the only limitation on state taxation of banking is that "such taxation must not discriminate against national banks" (McCray 1986). Similar legislation has existed for savings and loans since the 1930s. This does not require that national banks necessarily be taxed using the same structure as state banks, only that there be no discrimination. Administratively though, states have been prone to tax state and national banks using the same structure in order to avoid discrimination. This recent legislation offers states the opportunity to restructure their banking taxes using the added flexibility, though only Minnesota and New York have made significant revisions to date.

Taxation of Arizona's Financial Industry

The Arizona financial industry is taxed under general corporate income tax statutes as opposed to industry specific statutes. The corporate income tax is levied on state chartered banks, national banks, insurance companies, and savings and loans. Credit unions generally have no tax liability because they are exempt from federal income taxes and, thus, pay no Arizona income taxes. Also, insurance companies which are

subject to a premium tax (representing all but title insurance companies) are exempt from the corporate income tax.

Twenty-three states, including Arizona, tax banking in the same manner as other corporations, and 27 do not. Arizona is one of 19 states which use a direct net income tax for the banking industry (Kincaid and McCray, 1988).

Corporate taxable income in Arizona is determined by beginning with the federal definition of taxable income and making numerous subtractions and additions. Examples of additions are interest on the obligations of state and local governments outside Arizona, annuity income, and expenses incurred holding tax exempt debt. Subtractions include dividends from Arizona corporations and federal income tax payments.

Arizona's corporate tax structure has seven tax brackets, with rates ranging from 2 to 10.5 percent. The highest bracket is reached at \$6,000 of corporate income, meaning the higher rate is imposed on almost all corporate income.

Unfortunately, no data are available which separate the tax receipts of financial institutions from those for other industries, so it is not possible to undertake a careful study of the pattern of revenue adequacy and stability for taxes paid by individual industries. The Massachusetts Special Commission Relative to the Taxation of Banks (1987) reported that the income tax reserve for Arizona tax purposes was \$8.4 million in 1980, \$9.6 million in 1981, and \$7.9 million in 1982. These figures indicate what banks put in reserve to pay their taxes, not what

was actually paid. This fluctuation seems to evidence an unstable tax structure across the business cycle, meaning that corporate profits are relatively volatile. They were higher in the expansion year of 1981 than in the recession years of 1980 and 1982. However, these data are for too few years to permit more than anecdotal comments.

Taxation of Multistate Income

State taxation of financial institutions across the U.S. was originally developed to tax the principal office of banks located in the state, since each state was prohibiting interstate banking. As a result, income from the interstate operations of banks was given little consideration in tax legislation by most states. Arizona's approach to defining taxable income appears to have developed in the same manner, though the logical basis for the state's tax structure is better than in most other states. Currently, the taxable income of interstate financial institutions operating in Arizona is based on the income earned in the state, regardless of the state in which the financial institutions are domiciled (headquartered). The method for measuring income is the same for financial institutions as for other corporations.

Arizona's approach to taxing bank income is referred to as "source based" because the goal is to tax income which has its source in Arizona. The alternative is a "residence based" structure, which would tax Arizona domiciled financial

institutions on their income earned, regardless of the state in which it is earned. Nondomiciled firms would not be taxable in Arizona under a residence tax structure. Approximately one-third of the states use a residence based approach (McCray, 1987).

Apportioning Multistate Income

Arizona's share of multistate corporate income is measured by apportioning income into Arizona using the arithmetic average of the proportion of a corporation's tangible and real property, receipts, and payroll which are located in Arizona. Beginning in 1984 a unitary approach under the Uniform Division of Income for Tax Purposes Act (UDITPA) was adopted for defining the total income subject to apportionment. The unitary rules employ a test of the operational linkage between tied businesses to determine if they are to be combined for measurement of income. Many banks have interpreted the rules to mean that out-of-state members of a holding company are not a unitary group for taxation (telephone conversation with Gordon Murphy, Arizona Banker's Association, January 19, 1989). However, the Department of Revenue, through its audit process, is examining this issue with several banks. A water's edge definition is also used in Arizona, which essentially means only domestic corporate income is included.

Despite existence of the apportionment formula, it is unlikely that Arizona generates significant revenue from taxation of nondomiciled banks. One reason is that only domiciled banks can branch in the state, though these banks may be owned by a

nondomiciled holding company. Thus, nondomiciled banks are only operating in the state through branchless means, such as via the mail or telecommunications.

The Arizona Department of Revenue has concluded that nexus exists for tax purposes if a nondomiciled bank (or any bank) earns income and has property in the state. Bank credit cards, which are owned by a bank, represent property and interest earnings are a source for income, so the Department could regard the provision of credit cards to Arizona residents as taxable activity for nondomiciled firms. However, there are probably few nondomiciled firms filing returns and the Department is probably collecting little revenue from these sources.

The revenue lost from apportioning income out of state from domiciled banks probably also is limited. Domiciled banks are branching very little outside the state (though their holding companies may be) so any non-Arizona income earned is likely generated through branchless means. This income may be apportioned outside the state using Arizona's rules, and may be escaping taxation completely. The interest on loans which are repackaged into securities and resold outside the state also may be escaping taxation. (See Appendix)

Evaluation of the Taxation of Financial Institutions

Ultimately, the goals for taxation are accomplished by choosing an appropriate tax base and applying the necessary tax rates. The first topic addressed here is various aspects of

defining taxable income, or in other words, choice of the tax base. The second topic is tax neutrality, which depends on both the base chosen and the tax rates applied. This section is an evaluation of the current Arizona tax structure as applied to financial institutions.

Definition of Taxable Income

Definition of the tax base is the most complex concern in the design of any tax structure, yet it is vitally important because it determines the tax rates which must be imposed to raise a given amount of revenues. It is also the most important determinant of the compliance and administrative efforts which are required to collect the revenues. Generally it is argued that the base should be as broad as possible to permit lower rates. One advantage is that lower rates reduce incentives to evade taxation, defined as not paying taxes that are legally due. A second advantage is that a broad base precludes avoiding taxes through legal means. For example, if all interest income is taxed at a constant rate, there is no incentive for people to place their assets in one instrument versus another because of differences in the tax rate.

The Arizona tax base for financial institutions is defined by the corporate income tax regulations in the same manner as for other corporations. Three aspects of this definition as applied to financial institutions must be considered in evaluating the current tax structure: apportionment, interest on federal

obligations, and branchless banking. The conclusion for each of these is that states are failing to tax the entire income of financial institutions and steps should be taken to revise tax systems accordingly. In some ways Arizona's tax structure is better designed than many, but some restructuring may be appropriate.

Interest on Federal Obligations

A significant omission from the Arizona tax base is the interest which financial institutions earn from holding federal obligations. Kincaid and McCray (1988) estimate that this can represent between 10 and 60 percent of bank income, but is unlikely to be a significant source of income for nonfinancial corporations. This has the effect of reducing the taxation of banks relative to other corporations. There is significant potential to broaden the base by taxing this interest, and thereby creating a tax structure which taxes corporations more evenly. Unfortunately, conditions under which interest on federal obligations can be taxed are set by Congress and the interest cannot be included in the base of a corporate income tax.

Congress has not totally limited the states' ability to tax interest from federal obligations, however. This interest can be taxed if the states use a nondiscriminatory franchise tax or other nonproperty tax as the tax on banks. Many states already use this approach. Thirty-four states and the District of

Columbia currently employ a franchise tax, and of these, 20 measure the franchise tax base with net income, just as one would for a corporate income tax (Kincaid and McCray 1988).

Twenty-five of the total 34 include the income from federal obligations in the tax base. However, states in the western region of the U.S. are much less likely to use a franchise tax than are states in other parts of the U.S.

Arizona could consider the strategy of exempting financial institutions from the corporate income tax and creating a franchise tax structure specific to them. Though this would create a different tax structure from other firms, it would actually result in more even taxation. The tax could be legally imposed on financial institutions in interstate commerce as long as it meets the requirements laid out by the courts in Complete Auto Transit v. Brady. These conditions are that the tax is on an activity with substantial nexus in Arizona, the tax is fairly apportioned, the tax does not discriminate against interstate commerce, and the tax is fairly related to services provided by Arizona (see McCray 1986). None of these conditions poses a serious obstacle.

In the 1983 Memphis Bank & Trust case, the U.S. Supreme Court ruled that a state including federal interest in its base also must include interest on its own obligations and on its political subdivisions. Thus, changing to the franchise tax structure also would require the inclusion of interest from Arizona state and local government obligations in the base. This

is likely to raise fears of higher interest rates for these governments, but any effect should be small.

Additional administrative expenses would arise from adopting a different tax structure for financial and other corporations. New guidelines and new forms would be necessary. A particular definitional problem occurs when a unitary firm includes subsidiaries which produce in financial and other types of industries. For example would General Motors, which has both financial and manufacturing subsidiaries, be taxed as a financial or as a general corporation? Application of the unitary concept would require detailed rules to determine in which industry firms are to be taxed.

Apportionment of Multistate Income

The corporate income tax is intended to tax income which has its source in Arizona. Thus, the income of Arizona domiciled financial institutions arising from operations outside Arizona must be excluded in calculation of their Arizona tax base, and the income of nondomiciled firms arising from operations in the State must be measured as their Arizona tax base. Each of these can be achieved through separate accounting of firms' activities or formula apportionment. This section will review Arizona's current formula and will discuss several reasons why it may be poor when applied to financial institutions. The basic conclusion is that the apportionment formula and situs regulations could be revised to better reflect the way financial

institutions earn income and to shift more of a firm's taxable income to Arizona.

The share of income which is attributed to Arizona depends on the factors in the formula and the situs rules used to measure where the factors are located. The factors included in the formula are intended as proxies for how income is generated and the situs rules are to measure the state in which income is earned. Wide variation exists in how states approach these two issues and compliance by firms would be greatly enhanced if uniformity with regard to apportionment and situs were achieved. These two aspects of the formula will be addressed separately.

Apportionment. Forty-four states use a three factor formula to apportion general corporate income. The factors are the percentage of corporate property, percentage of corporate receipts, and percentage of corporate payrolls which are located in the state. An average of the percentage of each factor in the state is multiplied times corporate income to determine the income earned in the state. This approach was codified in the UDITPA in the late 1950s. In practice the three factor formula is applied in different ways across those states using it. For example, 14 states choose not to give equal weight to the factors when determining their average.

Thirty-two states use an apportionment method of some type for inter-state bank income, though only eleven use the three factor approach (Kincaid and McCray 1988). One reason for treating financial institutions differently is that the UDITPA

agreement specifically excludes bank income. Arizona is one of the states which apply the three factor formula to financial corporations.

Three concerns regarding the use of the three factors must be examined in this regard. These are that the property factor is a poor surrogate for how financial income is earned, the focus on tangible property shifts income to a bank's state of domicile and away from its market states, and the weighting scheme for factors in the formula must be chosen to achieve the desired set of goals.

First, the formula may not be well designed for apportioning financial income because the property factor is a poor representation of how this income is earned. Only tangible property is included in the property factor but financial income is more closely linked to intangible property. Hellerstein (1983) notes that deposits may play the role for banks that factories serve for other producers since they are the basis for making loans. Though this parallel is becoming less true as banks are able to use securitization (repackaging loans for resale to a secondary market) as a mechanism for generating loanable funds, there is still a strong case that intangible assets are a better indicator of where bank income is earned than is tangible property.

Second, it would appear that Arizona's use of the property factor without including intangible assets and without proper situs rules would tend to shift some taxes which could

legitimately be collected in Arizona, to the states in which the firms are domiciled. This may become even more of an issue with de nova banking. As will be described below, careful development of the situs rules and the apportionment formula can shift a greater share of revenues into Arizona.

The problem is not necessarily that income remains untaxed, but that it might not be apportioned to the state where the income is actually earned. The effect of omitting intangibles is to increase the relative amount of property in the state where financial institutions have tangible property. The physical property of most banks is likely to be in the state of domicile. Since Arizona is a market state (a state with few domiciled institutions), its share of the tax revenues is probably reduced by exclusion of intangibles from the property factor.

There is no perfect apportionment formula and one should not be expected since it is merely intended as a proxy, not an identical representation of how financial institutions earn their income. Still it is apparent that if a property factor is included, intangible assets must be used in order to have a good proxy for the method of generating financial income. Other states have begun making adjustments in their formula to account for this distinction between general and financial corporations. New York recently revised its bank income apportionment formula to use all three factors, but replaced the property factor with deposits. Minnesota revised its formula by using both tangible

and intangible property in the property element of the three factor formula.

A difficulty with including intangible assets in the property factor is they are mobile, and banks can move them in a manner which lowers their total tax cost. Thus, careful rules are necessary to ensure their situs is properly determined. Arizona will probably want its situs rules to favor the state where the market is located, because this will increase the state's tax base. Note that both New York and Minnesota use measures of bank revenues as the sales factor and this requires similar rules on situs.

Third, once the factors have been chosen, a decision must be made on how to weight each of them. Again, there is no a priori correct set of weights, and the choice is substantially open to a decision based on goals for the tax system. For example, states often double weight the sales component in their general corporate income tax formula, because this tends to lower the taxes for firms which have a relatively large share of their production capabilities (payroll and property) in the state and to raise taxes for firms which have a relatively large share of their sales in the state.

New York double weights its receipts and deposits factors and reduces the weight on the payroll factor in its bank formula. Minnesota's bank formula adds 70 percent of the share of receipts in the state to 15 percent of the shares of property and payroll to determine the percentage of income earned in the state.

Clearly both states have chosen to reduce the tax for banks which locate a large share of their workers in state as an incentive to choose the state as a location for employment. Both increase the tax on banks which have a significant share of receipts in state.

Arizona could make a similar decision to weight its factors in favor of domestic production, though it has not done so with regards to its general corporate income tax. An advantage of such a weighting system is it would reduce taxes for banks with significant physical presence in the state and this would encourage the location of jobs in Arizona. However, the influence of the apportionment formula's weighting scheme on the location of jobs is probably very small and there is no concrete evidence on this issue. Another potential advantage of unequal weights is they could modestly increase exporting of the tax since the tax burden would be heavier on nondomiciled firms. A disadvantage is that this scheme probably increases the chance that a bank would pay taxes on more than 100 percent of its income.

Situs. The situs rules for the factors can be of equal importance to the amount of income taxable in each state as the factors themselves. Establishing rules for situs is most difficult for receipts and intangible property. The rules are likely to be written such that there is either a bias towards the state of bank domicile or towards the state where the market is located. To increase revenues it is generally best to lean to the bias which a state possesses. For Arizona, this would mean

creating a bias towards the market state. The market state approach appears to be consistent with the rules used for determining sales tax liability, since 40 of 45 sales taxing states use a destination principle for the tax liability.

The market state bias can be created through a variety of mechanisms. For receipts, this can be accomplished by identifying the situs where a credit card is billed, where the property is located which serves as security for a loan, or where the proceeds of loans are to be applied rather than to the situs of the institution making the loan or housing the asset. Deposits can be handled in a similar fashion by identifying their situs at the account's address. Minnesota has adopted these types of situs provisions. At least some aspects of Arizona's situs rules operate in this fashion. Walter E. Heller Western, Inc. vs. Arizona Department of Revenue affirms Arizona's ability to tax interest earned in the state using market oriented rules.

Administrative and compliance burdens imposed by the situs provisions should be given consideration in any final decision. Complicated rules or rules requiring difficult data gathering would be undesirable for tax collectors and payers. Compliance is also enhanced if states use consistent rules. Since few states have acted as yet to revise their bank taxes, the set of rules which minimizes compliance and administration is not certain. Arizona can play a role in formulating the best pattern if it gives early attention to reconsidering its situs rules.

Branchless Banking

Another problem with the definition of taxable income arises because of branchless banking, which refers to the receipt of financial services by Arizona residents from an institution without a physical presence in the state. Examples of branchless banking are financial services offered by an out-of-state bank through an automatic teller machine, the mail, and telephone. Credit cards are probably the major service available to residents which is provided in this manner today. Expansion of these types of services has been very rapid and new telecommunications technology will increase the potential for branchless banking. Currently, Arizona is unlikely to tax the income derived from these services because there is no physical presence in the state, though the Department of Revenue could conclude that nexus exists for credit card interest since the issuer owns the cards.

There are several reasons for Arizona to aggressively seek to tax the income of branchless activities in the state including the fact that the source of branchless income is Arizona, their taxation overcomes any problems with tax neutrality in the state, and their taxation generates additional revenues for Arizona. Each of these deserve a brief explanation. First, the case for Arizona being the source of income rests on following the market approach to situs.

The neutrality concern is that branchless services could go completely untaxed if they are delivered by a financial

institution domiciled in a state which uses a source approach to tax banking income and if Arizona fails to tax the income. If neither the state of domicile or Arizona tax the income, financial institutions either domiciled in or having a physical presence in Arizona are placed at a competitive disadvantage because they must compete in Arizona with financial institutions which are not taxed on the income earned on their Arizona activities. The result would be lower costs for the untaxed firms and this should permit them to offer better rates to attract deposits, offer lower rates on loans, or provide greater return to owners.

Even if no competitive disadvantage existed for any financial institution operating in Arizona, the state loses tax revenues if it fails to tax branchless activities. The amount of revenue loss from failing to collect these taxes is likely to grow rapidly over time as branchless activities expand.

To date only Minnesota has chosen to explicitly extend its tax on financial institutions to branchless services. Minnesota's approach is to use a solicitation basis for defining nexus rather than requiring physical presence. This is accomplished by levying the tax on banks with a physical presence in the state or which regularly solicit for business in the state. Activity must be conducted with at least 20 persons during the tax year or deposits must exceed \$5,000,000 in order for such regular solicitation to have been deemed to occur.

Establishing nexus on the basis of solicitation does not appear to raise a constitutional problem. Hellerstein (1983) concluded that "making regular loans on a continuing basis is sufficient" nexus under the Due Process Clause. McCray (1986) extends this by noting that "an out-of-state bank that has purposefully solicited deposits and loans from a host state and earns income therefrom has created sufficient contacts with that state and its residents upon which to base taxing jurisdiction." She extends this to credit card business as well.

Summary of Defining Taxable Income

In sum, the definition of taxable income for financial institutions must be reevaluated if the goals for the tax system are to be met. The combination of federal legislation and changing industry structure means that traditional approaches to taxing firms in the financial industries are inadequate. The result is Arizona collects less revenue than it should, financial institutions have ready means to avoid taxes, and firms are treated unevenly for tax purposes. Restructuring the taxes can overcome these problems, but likely at the expense of greater administrative and compliance burdens.

Tax Neutrality

This section is a further evaluation of the degree to which Arizona's tax structure is even and the effects of any unevenness. This is couched in terms of tax neutrality and how

the lack of neutrality distorts economic efficiency. The remainder of this section will be an examination of three aspects of tax neutrality: across industries, within the financial industry, and between states.

Interindustry Neutrality

Interindustry tax neutrality means that taxes are imposed such that their incidence on businesses is even across financial and nonfinancial industries. This presumably means that taxes will not make investment in one industry more attractive than in another. Economists assert that such decisions are made by comparing marginal rates of return, so neutrality should be examined in terms of marginal rather than average rates of return.

Attaining neutrality does not require that all industries be taxed using exactly the same structure, only that the effect on marginal returns is the same. However, the information is generally unavailable for setting rates separately for each industry and the administrative problems of doing so are considerable. Thus, the most practical public policy approach to neutrality is probably to impose a tax which generally has the same initial incidence on all industries, unless some very specialized information is available on incidence within an industry.

The above discussion on defining bank income illustrates that the historical approach to taxing financial company income

in Arizona, using the same definitions as for nonfinancial corporations, is likely to leave taxes nonneutral because even if the nominal tax rates are equal the proportion of income subject to the tax is not. Many of the reasons why corporate taxes will not be neutral arise because of unique characteristics of the financial industry. As a result different tax structures are probably necessary for financial and other corporations in order to obtain neutrality. It will be necessary to define the tax base for financial institutions in ways that is more consistent with the interstate practices and means of earning their income. Thus, making reforms in the tax structure as described above may be necessary to achieve a neutral tax structure across industries.

The importance of neutral taxation across industries is growing because the lines between industries have been blurring with recent diversification of nonfinancial firms into financial markets and vice versa. For example, Sears owns Allstate Insurance, Coldwell Banker real estate, Dean Witter Securities, the Discover Card, and Dean Witter and Sears Savings Banks (Waren 1988). General Electric owns the investment banking firm of Kidder Peabody. Diversification increases the risk that investment in industries is at least partially determined by tax differentials as the lines between the industries become less obvious.

Financial Industry Neutrality

Neutrality within the financial industry also requires that marginal tax burdens for individual segments of the industry are even. Practically, this has been applied to mean that all institutions in the industry should be subject to the same tax structure. Arizona's current tax structure is effective for taxing most financial institutions which have physical presence within the state but there are three cases where neutrality may be violated.

First, credit unions generally operate untaxed and yet they compete with other financial institutions for many of the services which they offer. This exemption would appear to have no economic rationale. Credit unions should be taxed whether payment of the corporate income tax is intended as a charge for benefits received from public services or meant to be a hidden consumer tax or simply an administratively acceptable means of generating revenues.

Second, a lack of neutrality may exist between the depository institutions, which are generally the topic of this report, and the nondepositories, such as insurance companies and brokers. In Arizona most of these nondepositories are currently subject to the general corporate income tax structure with the exception of those insurance companies which are taxed with the premium tax. The premium tax is probably a greater share of insurance profits or value added than is the corporate income tax

for other financial institutions. This may indicate the insurance companies bear a heavier tax burden.

Third, intraindustry neutrality is likely to be violated for financial institutions which operate in Arizona without a physical presence. Taxation will be neutral if these branchless banks are domiciled in a state which imposes the same effective tax rate as Arizona and which uses residence based taxation. Also, the taxation would be neutral if they are located in a source based state which uses situs rules that tax the Arizona activities. These conditions are unlikely to be met, and the probable case is that financial institutions with nexus in Arizona are placed at a competitive disadvantage. As described above, Arizona can increase the chance for neutrality by broadening its laws to tax these branchless banking activities. However, Arizona taxes combined with those imposed by other states will not be neutral if the state in which the branchless banks are domiciled also taxes the same income because of the situs rules or the residence based approach.

Interstate Neutrality

Differences in taxation of financial institutions across states is another issue which frequently arises. Interstate neutrality of taxes exists whenever taxes do not influence the behavior of financial institutions in terms of where they locate, where they conduct economic activity, and how they engage in

financial practices. Generally the interstate neutrality of taxes is examined by identifying tax differentials across states.

Two reasons may be posited for why unusually high or low tax rates relative to other states may be a concern for Arizona. First, high (low) taxes may make it difficult (easier) for Arizona domiciled banks to operate in interstate markets. However, this concern is probably of little relevance in Arizona. One reason is that the ability of Arizona banks to compete outside the state probably depends on the banks' good-will, economies of scale, and specialized banking expertise, while taxes are of much less significance (Tannenwald 1988). Further, Arizona taxes will not influence costs of doing business or the profitability of activities outside the state as long as Arizona uses source based taxation, which precludes taxing income generated outside the state.

Second, high taxes are posited as a concern because they may make it difficult for the state to attract the location of specialized activities of nondomiclied banks. Many market related financial services activities must be located near their consumers. However, telecommunications (and other) technologies permit financial institutions some flexibility in locating certain specialized operations in states with low tax rates and future technologies are likely to increase the flexibility. For example, banks may have the potential to offer services, such as their credit card operations, through subsidiaries located far from their place of domicile.

Considerable study has been undertaken on the effects of taxes and other factors on the location of industry. (For a review see Wasylenko, 1985.) Unfortunately, little of this analysis has focused specifically on the factors which enter siting decisions for financial institutions. Wasylenko and McGuire (1985) examine the effect of taxes on employment change in the combined finance, insurance, and real estate industries of states. They found no evidence that corporate tax rates were a factor in the location of employment changes, though they concluded that high personal income tax rates could discourage employment growth in these industries. Though lack of analysis causes current research evidence to be inconclusive on the relationship between taxes and financial industries, the preponderance of studies focused on other industries would indicate that tax differentials would at most have a very modest influence on the location of even the specialized functions of financial firms. Other factors, such as quality and availability of labor and access to quality infrastructure are likely to be much more important.

The extent to which Arizona taxes may be even a modest concern can be determined through a comparison of relative tax burdens with those other states. Arizona's statutory 10.5 percent rate on corporate income (above \$6,000) is only exceeded by Massachusetts, Hawaii, and Connecticut among the 36 states and the District of Columbia which tax bank income in some manner (see Table 3). The median rate across all states in the

TABLE 3
STATUTORY AND EFFECTIVE TAX RATES ON BANK INCOME, BY STATE

State	Tax Rate ^b (1988)	Effective Tax Rate ^c (1980)
Massachusetts	12.54	10.66
Hawaii	11.7	3.99
Connecticut	11.5	8.88
Arizona	10.5	5.31
Nebraska	10.27	n.a.
District of Columbia	10.25	14.49
California	9.6	9.52
Minnesota	9.5	9.49
New Jersey	9.0	4.53
New York ^a	9.0	8.92
Delaware	8.7	4.69
Nevada	8.08	n.a.
New Hampshire	8.0	n.a.
Rhode Island	8.0	9.42
Wisconsin	7.9	7.13
Idaho	7.7	4.99
New Mexico	7.6	4.08
Tennessee	7.59	n.a.
Oregon	7.5	8.16
North Carolina	7.27	n.a.
Alaska	7.0	3.99
Missouri	7.0	2.10
North Dakota	7.0	5.16
Pennsylvania	6.82	n.a.
Mississippi	6.59	n.a.
Kansas	6.375	4.77
Alabama	6.0	4.12
Arkansas	6.0	0.42
South Dakota	6.0	4.35
Florida	5.63	n.a.
Colorado	5.5	1.09
Iowa	5.0	4.63
Oklahoma	5.0	2.23
Utah	5.0	2.98
Virginia	4.52	n.a.
South Carolina	4.5	1.29
Maryland	3.58	n.a.

^a. New York City also taxes the income of banks domiciled within its borders at a statutory rate of 9.0 percent. Banks may deduct their city tax against their state taxable income.

Note: Georgia, Illinois, Indiana, Kentucky, Louisiana, Maine, Michigan, Montana, Ohio, Texas, Vermont, Washington, West Virginia, and Wyoming impose major deposit, share, and other taxes on banks in place of income taxes.

^b. Source, Tannenwald, (1988).

^c. Source, Special Commission Relative to the Taxation of Banks (1987).

n.a. = not available.

table is 7.5 percent. Also, note that Arizona's rate is higher than any neighboring states.

The tax rates described above, however, are statutory rates and fail to reflect the true relative burdens placed on banks in Arizona vis a vis those operating in other states. One reason is that states have differing definitions of taxable income. For example, the Arizona statute which permits banks to subtract federal income tax payments in determination of taxable income will significantly narrow the tax base and thereby reduce the effectiveness of the high rates. It is necessary to consider both the size of rates and breadth of the base in measuring tax burdens. Also, it would be useful to examine the full range of taxes levied by states on the financial industry.

Average effective tax rates, which are measured by dividing actual tax payments by a broad measure of corporate income, are a better indicator of relative tax burdens. A study conducted several years ago by the Massachusetts Executive Office for Administration and Finance sought to measure effective tax rates on bank income for 27 states (see Table 3). A finding of the study was that the effective tax rate on Arizona bank income was 5.31 percent, approximately at the national average rate of 5.32 percent. Thus, Arizona's tax burden is comparable to that imposed by other states. However, only California had a higher effective rate among the nearby states.

Arizona's effective rate is much below the 10.5 percent rate which is legislatively applied against bank income. This means

that taxable bank income is considerably lower than bank income. These differences between nominal and effective tax rates will arise for all Arizona industries, for reasons such as the deductibility of federal taxes. However, there are reasons specific to the financial industry for differences between nominal and effective rates. An example is the exclusion of interest on federal securities from the definition of taxable income for financial industries. This may evidence that neutrality of taxation does not exist between the financial industry and other industries. Similar study of other industries would be necessary to determine the extent of any lack of neutrality.

Several conclusions arise from this section. First, Arizona corporate taxes are near the national norm. Second, financial entities are not unusually disadvantaged by high taxes in Arizona. Finally, the average effective tax rate paid by financial institutions appears to be approximately one-half of the stated nominal tax rate.

Options for Tax Restructuring

This section is a list of policy options which the Committee may want to consider in addressing any potential restructuring of taxation of the financial industry. In considering these options it is appropriate to remember that the financial industries are in a state of considerable adjustment. Thus, whether or not changes are to be recommended now, the tax structure will need to

be reconsidered as additional information becomes available on the shifting industry structure.

Option 1: Exempt financial industries from the corporate income tax and tax them with a franchise tax. The tax base for the franchise tax would be defined by corporate income and the rate would be chosen to allow neutral taxation with respect to nonfinancial firms.

One advantage of this option is that it allows a broader definition of financial income since federal securities could be included in the tax base. This would allow better interindustry and intrafinancial industry neutrality. Additional revenue could be raised from the tax to the degree that financial institutions are failing to pay the same percentage of income in taxes as are other firms.

A potential disadvantage of this option is it would require that Arizona state and local government securities be included in the tax base. Another disadvantage is that very careful rules would be necessary to define when a unified company was to be taxed under the financial industries franchise tax versus the general corporate income tax. Finally, it could raise the average tax burden of Arizona banks relative to banks in other states.

Option 2: Adjust the apportionment formula for multistate financial company income to a) add intangibles to the property factor or b) eliminate property as a factor c) use a receipts factor only.

This option allows a closer linkage between the apportionment formula and the manner in which financial company income is generated. The revenue implications are likely minimal

at present because little income probably is being apportioned in or out of the state. However, it will allow greater revenue in the long term if the state begins combining more holding company income in measurement of taxable income. Also, it will generate more income if the state aggressively seeks to tax branchless banking.

Either Option a, b, or c can be acceptable. Approach c is designed to raise the greatest revenues in a market state, such as Arizona, because it taxes all income associated with revenues generated in the state. Approach b would only use payroll and receipts to determine apportionment and excludes tangible or intangible property. The reason for choosing b is that it is administratively much simpler than approach a, because there is no need for precise rules on the situs of intangible property. However, such rules will be necessary for determining the situs of receipts with either option. All three options would require financial corporations to be treated differently from other corporations. The chosen rule would also deviate from the apportionment formulas used in most other states and this could cause financial institutions to be taxed on more or less than 100 percent of their income.

Option 3: Develop legislation such that jurisdiction for tax purposes is based on solicitation rules rather than physical presence.

Technology which permits electronic banking causes situs and jurisdictional regulations based on physical presence to be outdated. Solicitation rules can replace a physical definition

and permit Arizona to tax the income generated within the state, regardless of the physical location or operational methods of the provider. Legislation could be designed to facilitate taxing credit card activities of financial institutions which have no physical operation in the state. The laws could make a clear statement that branchless activities are taxable wherever it is constitutionally acceptable to do so. Included would be services provided by financial institutions operating through the mail or through electronic means.

Taxing branchless activities may create administrative problems because of the need to identify taxpayers. Much of the burden may be placed on the potential taxpayers by establishing clear legislation requiring that they report their activities in the state. However, some court cases have brought into question the penalties included in the reporting statutes used in other states. New Jersey was sued in the First Family Mortgage case and the court appeared to accept reporting requirements in certain circumstances, but this remains an open issue (Geis 1988). Rules which exclude nondomiciled firms with minimal activities should be developed to limit administrative and compliance problems and to ensure that constitutionality limitations regarding nexus are met.

Option 4: Extend the taxation of financial industries to all competitors, including credit unions.

Credit unions currently have no tax liability because they have no federal taxable income. Their services are offered in

competition with taxed financial institutions and it would improve neutrality if they were taxed. They could be taxed by establishing regulation to define credit union income.

All of these options alter the tax base for financial institutions. Such alterations may be desirable due to the unique and evolving characteristics of financial industries.

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Appendix

In addition to the issues discussed above, interest on securitized loans, though a somewhat technical topic, poses some interesting questions about the tax treatment of financial institutions.

Securitization of Loans

There is a strong trend towards financial institutions making loans and then repackaging these loans for resale to investors through secondary markets. Resale of packaged home mortgages has been done for some years, and auto and other consumer loans are frequently resold as well. This practice is referred to as securitization of loans. The concern with such practices is the difficulty in identifying which state has jurisdiction for tax purposes over interest earned on the securities. With securitization, Arizona retains the ability to tax income from making and reselling loans, but it may lose the ability to tax interest paid on loans. The financial institution selling the loan would no longer receive the interest if the loan were resold, so the institution would pay no tax on the interest. The interest would escape Arizona taxation completely if the security is sold to a firm without nexus in the state. Further, the interest could escape all state taxation unless all tax structures are very carefully designed. This would happen if the situs rules for interest in the state in which the security

purchaser is domiciled considers the interest on a market basis, which presumes Arizona would tax it.

At present the issue of securitization may be of limited importance in Arizona. Nationwide, large banks are engaging in reselling loans, but smaller banks generally are not. Further, banks may be holding relatively little securitized debt as they seek to make loans and resell them. But the issue may be of growing importance.

One approach to taxing the securitized interest is to establish a dual tax structure for financial institutions (see McCray 1988). A residence based system could be levied on in-state domiciled banks and a source based system on out-of-state domiciled banks. The source based part of a dual system would tax out-of-state banks on their Arizona income, just as is done today. The residence based system would tax domiciled banks on their entire income (wherever earned) and allow them a credit for any taxes paid to other states. This could increase tax revenues by raising taxable income for domiciled corporations, and would not place the domiciled firms at a competitive disadvantage in the sale of in-state financial services. Also, it would ensure that Arizona banks operating in states using a residence based system are taxed in Arizona, since these banks would not be taxed by the other residence based state. This system would prevent domiciled firms from escaping taxation on interest from securitized loans.

Finally, the residence based system appears to reduce administrative burdens for domiciled firms because situs rules are unnecessary and since there are no situs rules domiciled banks would be unable to shift their tax burden by relocating intangible assets. Still, situs rules will remain necessary for nondomiciled firms and the potential for them to relocate intangibles remains in place. Further, domiciled institutions must abide by situs rules in other states so there is little compliance savings.

Several potentially undesirable effects of the residence based system should be noted. First, it would effectively tax Arizona domiciled firms operating outside the state at the higher of the Arizona or other state tax structure. This could place the Arizona firms at a competitive disadvantage when operating in other states. It also places Arizona's collections at the mercy of other states, since the value of credits depends on taxation by other states. Thus, revenues become unpredictable as they depend on the tax policies of 49 other states.

A related concern is the effect on Arizona's ability to export. A greater share of taxes could be exported if higher tax costs can be shifted to consumers in another state. However, it would appear unlikely that higher taxes paid only by Arizona domiciled banks could be shifted to residents of other states in which these banks operate, given the competition does not pay the same taxes. Thus, the increased taxes from use of a residence approach probably would be paid by owners of Arizona financial

institutions and potentially by Arizona residents and businesses.

Next, the residence system would raise the tax costs to banks which have their domicile in Arizona and thereby give banks the incentive to be domiciled outside the state. This is unlikely to have a significant effect on the availability of banking services in the state. However, it may reduce the Arizona presence of central office banking positions and may be regarded as a negative for economic development.

A more limited approach to taxing the securitized interest would be to introduce a throwback provision which would allow Arizona to tax the income on securities held by domiciled institutions which is totally untaxed in other states. This would be sufficient to prevent Arizona financial institutions from avoiding taxes through purchasing securitized loans.

However the state seeks to tax interest related to securitization, the decision must be made simultaneously with the state's nexus and situs rules. If the nexus rules follow the market approach it may be difficult for Arizona firms to resell their securities. This issue arose in Minnesota because of the fear that purchase of securitized loans from a Minnesota financial institution would give the purchaser nexus in the state. Of course, this is only of concern for purchasers which have not as yet established nexus in the state. Minnesota adopted the approach of providing safe harbor for a purchaser which had no nexus connection other than ownership of securitized

loans (Geis 1988). Thus, the interest is taxed in the state only if nexus exists for other reasons.

EXHIBIT K: 19

**Ferguson, Fred E., "Comments on behalf of the Financial Institutions State
Tax Coalition, (August 21, 1990)**

COMMENTS OF
FRED E. FERGUSON
PRICE WATERHOUSE
ON BEHALF OF THE
FINANCIAL INSTITUTIONS STATE TAX COALITION

TUESDAY, AUGUST 21, 1990

TO

MULTISTATE TAX COMMISSION

WITH RESPECT TO

REG. IV.18.(i) SPECIAL RULES: FINANCIAL INSTITUTIONS

I AM FRED E. FERGUSON, DIRECTOR OF STATE TAX POLICY FOR PRICE WATERHOUSE. I AM HERE ON BEHALF OF THE FINANCIAL INSTITUTIONS STATE TAX COALITION TO PRESENT SOME CONCERNS OF THE COALITION WITH RESPECT TO THE MULTISTATE TAX COMMISSION PROPOSED SPECIAL RULES FOR FINANCIAL INSTITUTIONS.

THE FINANCIAL INSTITUTIONS STATE TAX COALITION (FIST COALITION) IS AN AD HOC COMMITTEE OF MULTISTATE FINANCIAL SERVICES COMPANIES ORGANIZED TO SUPPORT STATE TAX POLICIES THAT PREVENT MULTIPLE TAXATION BY SUBJECTING FINANCIAL INSTITUTIONS TO STATE TAX LAWS UNDER TRADITIONAL STANDARDS OF DOING BUSINESS (I.E., A NEXUS STANDARD FOR FINANCIAL INSTITUTIONS SIMILAR TO P.L. 86-272) AND BY SOURCING INCOME TO THE STATES USING AN EQUITABLE AND CONSISTENT FORMULA (I.E., BASED UPON WHERE SERVICES ARE PERFORMED). THE MEMBERS OF THE FINANCIAL INSTITUTIONS STATE TAX COALITION ARE:

Bank of America, NT & SA
The Chase Manhattan Bank, N.A.
Citicorp/Citibank, N.A.
The Citizens and Southern Corporation
Dean Witter Financial Services Group, Inc.
First Bank System, Inc.
First Chicago Corporation
First Interstate Bank
NCNB Corporation
Sovran Financial Corporation
Wells Fargo & Company

THE CONCERNS ARE:

1. REGULATIONS ARE OVER-REACHING (UNCONSTITUTIONAL)

Can the states regulate nexus (i.e., can "Jurisdiction To Tax" be adopted by edict)? No - under constitutional nexus standards (e.g., National Bellas Hess), states need more contact with financial services companies than local customers.

CONCLUSIONS:

- 1) Inevitably the regulations will be invalidated, costing the states inordinate amounts of money in protracted litigation and refunds.
- 2) States should not be able to tax the franchise until banks are able to exercise the franchise within their borders.

2. PROBLEMS IN DEALING WITH MTC/UDITPA REGULATIONS

- A. **SHOULD BE STATUTORY CHANGE** - Setting aside the constitutional arguments, the MTC/UDITPA Regulations (Art.IV) are standards for allocation and apportionment, not standards for nexus. State legislatures should adopt nexus standards via statute, not regulate these standards.
- B. **WITHOUT AUTHORITY** - The MTC/UDITPA Regulations Section 2 (Art.IV.2) specifically exclude financial services companies. Since these regulations are not extended to financial services companies, they should require more than a modification.
- C. **WRONG SECTION IS BEING ADDRESSED** - The financial institutions regulations are proposed to amend MTC/UDITPA Regulations Section 18 (Art.IV.18) which is a modification section (i.e., it applies only if other provisions do not fairly reflect income). Section 17 (Art.IV.17) sources income other than the sale of tangible personal property and is the applicable section to deal with service income.

CONCLUSIONS:

- 1) If the MTC perceives a problem with taxing financial services companies, then the MTC should not be seeking modifications to the MTC/UDITPA Regulations, but should be requesting member states to adopt statutes that would establish jurisdictional standards - the same legislative process the states used to address constitutional nexus of mail order sales tax collection (National Bellas Hess) and Indiana and Tennessee used to establish new financial institution taxes.
- 2) If MTC is dead-set that they are going to make MTC/UDITPA Regulations applicable to financial services companies, then they should address Section 2 dealing with applicability and Section 17 dealing with sourcing income from service companies, and not a special rules modification to Section 18.

3. **DOUBLE TAXATION AND DISTORTION**

- A. **NON-UNIFORMITY / MULTIPLE SOURCING RULES** - The MTC Regulations, by not addressing the issue of sourcing income from financial services companies on a uniform basis, promote a double taxation scheme where the proceeds from a loan will be taxable in both the loan origination state and loan proceed states (e.g., given the premise that states will adopt regulations to maximize revenues, New York (production state) and an MTC member state (market state) will not adopt the same rules).
- B. **RECEIPTS FACTOR DISTORTION** - An apportionment formula that uses a receipts-only factor (single or super-weighted receipts factor) has a tendency to distort income. While a receipts only factor may be internally consistent (if uniformly adopted), that is ignoring reality, since a receipts only formula has not been uniformly adopted. Thus, income will be shifted to market states that ignore production factors (property and payroll).
[NOTE: When applying the internal consistency test to an apportionment formula, the Court looks at one state's tax system at a time to determine its Constitutionality. It does not look at the practical aspects of applying several different yet Constitutionally valid state tax systems. State tax policy needs

FINANCIAL INSTITUTIONS STATE TAX COALITION
EXECUTIVE SUMMARY
AUGUST 21, 1990
PAGE 4

to respond to the fairness of the state tax burden on a nationwide basis, and not just the fairness of individual state tax systems.]

CONCLUSIONS:

- 1) Non-uniform rules for sourcing income and apportionment causes certain double taxation of the same income.
- 2) If it is the purpose of the MTC to promote uniform and responsible state tax laws, it is irresponsible for the MTC to adopt rules that promote INCONSISTENCY.
- 3) Banks are especially susceptible to the inconsistency and non-uniform laws due to the absence of an established history of non-domiciliary state taxation.

4. COMPLIANCE BURDEN

- A. **VAGUE RULES** - The destination sourcing rules are illogical, ill-defined and subject to conflicting interpretations.
- B. **INFORMATION LIMITS** - The destination sourcing rules often require information known only to the customer.
- C. **SYSTEMS AND DATA RETRIEVAL COMPLIANCE** - The multiple systems requirements necessary to comply with multiple state tax laws will force duplicate data banks.

CONCLUSIONS:

- 1) There needs to be a two year moratorium until the bankers and states can agree on a central system.

5. EFFECTS ON THE STATES & ECONOMY

- A. **DISCRIMINATES AGAINST BANKS** - Use of jurisdictional thresholds lower than those contained in P.L. 86-272 for companies selling tangible personal property discriminates against financial services companies.

FINANCIAL INSTITUTIONS STATE TAX COALITION
EXECUTIVE SUMMARY
AUGUST 21, 1990
PAGE 5

- B. **PITTING IN-STATE v. OUT-OF-STATE** - Use of non-uniform sourcing rules pits production states (net lending states) against market states (net borrowing states). The financial institutions in the production states are the same institutions the market states need to rely on for loan participation.
- C. **BAD STATE TAX POLICY** - Because the driving force to adopt a state tax policy that focuses on taxing out-of-state financial institutions is increased revenues and not equitable considerations, the result may cause more harm (e.g., confusion, double taxation, etc.) than good (e.g., additional revenues).

CONCLUSIONS:

- 1) Because large lending institutions that participate in loans throughout the U.S. will face a multiplicity of laws and rules there will be restrictions to the flow of capital **AT THE MARGIN**. These institutions will invest to maximize revenues and will undoubtedly make economic decisions accordingly.
- 2) As new and conflicting state tax laws will produce higher interest rates, the real loser is the consumer. Since most small and medium businesses would require capital from without the company and without the state, opportunity exists for higher interest rates.
- 3) The MTC regulations encourage retaliatory legislation.

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EXHIBIT K: 20

**Fox, William F., "The Economic Impact of State Taxation and Regulation on
Banking" (undated)**

THE ECONOMIC IMPACT OF STATE TAXATION AND REGULATION ON BANKING

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Preliminary. Please do not quote without permission of the authors.

Introduction

State tax structures influence the location of economic activity as they change the relative cost of doing business across states. Considerable research has focused on how manufacturing firm locations or employment are affected by tax structures.¹ Other industries, and in particular the banking sector, have received much less attention in the location literature. This paper is focused on the banking sector and the effect of its unique tax structure on the situs of banking activity. Further, we address the effects on bank locations of the broader policy environment by examining effects of branching and interstate banking restrictions.

The banking literature has primarily been concerned with the specification of consumer loan functions [4 and 23], business loan functions [14, 15, 19 and 25], and optimal lending policies [2 and 7]. However, none of the specifications include an explicit recognition of the role played by taxes in the lending decision.² This paper addresses that issue.

This paper is concerned with the impact of various variables, including taxes, on bank lending. As such, it does not specifically address the issue of the appropriate definition of bank output. This is a controversial issue. Studies have used as output earning assets [1], total assets [12], a weighted sum of selected balance sheet items [11] and the number of accounts [13].

¹Wasylenko () provides a good summary of this literature. See also Nadeau [1988].

²Peterson and Ginsberg [1981] do include in their specification a variable representing government regulation. This, however, is a usury ceiling and not an explicit tax variable. Melitz and Pardue employ a scale constant to account for the impact of regulations such as reserve requirements and capital constraints [1973]. See also Goldberg [1981].

In microeconomics, the production process is where inputs are transformed into outputs. As a consequence, to be consistent in banking, the production process would be where inputs - borrowed funds and deposits - are transformed into earning assets. The transformation in terms of value added clearly apply to loans, but do not clearly apply to federal funds sold or to government securities purchased. Therefore, consistent with microtheory, bank output is considered to be loans.

Bank loans consist of consumer loans, real estate loans, and commercial loans. The first two types of loans are often constrained in the market by government regulations. Usury laws that exist in many states distort the operation of the market freely for these loans. However, commercial loans are not so constrained.

The impact of taxes on the lending decision of commercial banks is an acknowledgement that taxes do matter. The question addressed is whether the incidence of taxation has an impact on the amount of financial activity - here lending activity - within a state. It has been shown elsewhere [11] that financial activity of financial institutions within states can be explained by state personal income but not by tax rates. However, it is important to note that Goldberg, et. al. study financial activity, defined as total assets and total deposits in the banks within a state. As such, they are including both assets and liabilities as a measure of total financial activity. This, of course, is double counting. Deposits are an input which are transformed into outputs. Assets, in particular, loans are an output.

This paper does not attempt to estimate standard supply and demand functions. Again, this is an area of dispute, especially regarding the specification of the equations.³

³See Hicks[1980].

In the 1970's environment of limited interstate banking and less extensive alternatives for local banks to access national capital markets, little effect of taxes on the location of banking activity might have been anticipated because banks had no simple options for shifting either assets or employment out-of-state.

Securitization of bank loans, branchless banking, and interstate banking through holding company affiliation have significantly raised the opportunities for banks to reduce their tax liabilities through careful tax planning. Thus, the confluence of a changing regulatory environment, development of new banking products and an emerging tax structure can create a growing effect of bank taxes on situs.

The present timing for a study of the relationship between bank taxes and regulations and economic development is appropriate because of the transitions underway. The regulatory structure for banks has been changing and Congress has increased state powers to tax banks. To date only Indiana, Minnesota, and New York have responded with major tax structure adjustments, so this study can provide input to policymakers on the importance of economic development issues to the tax structure questions.

State Tax Structures

Several aspects of state tax structures have the potential to influence the location of banking activity. The first component is states' selection of the type of bank tax to employ. Historically, the choice of instruments has been influenced by constitutional restrictions which limit the taxation of national banks and which limit the taxation of income from federal securities.⁴ Taxation of national banks has gone through several periods of change, but Congressional legislation which became law in 1976 now allows

⁴See McCray () for a summary of the constitutional and legislative history.

states to tax national banks in any nondiscriminatory manner. The income from federal securities only can be taxed using a nondiscriminatory franchise or other nonproperty tax.

The constitutional limitations frequently have led state taxation of banks to develop independent of other business taxation. Bank taxes usually are structured using some combination of corporate income, franchise, or share taxes. Base definitions for the corporate income tax often are a variant of the federal definition, but the specific characteristics differ by state. The base for share taxes is the value of banking shares, deposits, or another indicator of intangible personal property. Franchise taxes either have a corporate income tax or a share tax base. Thus, state taxes either have an income or an intangible property base, and the franchise tax is a legal distinction rather than a conceptually different tax base. Franchise taxes are popular because of the ability to include the income from government securities in the base.

Seventeen states use a corporate income tax, 34 employ a franchise tax, and 7 have share taxes. Banks are taxed in Michigan using the single business tax. These totals include 12 states which use some combination of income, franchise, and share taxes and 3 states which have no tax on banking firms. Several states have franchise taxes which use both an income and intangibles base.

Tax Rates and Other Structural Characteristics

Tax rates are a second component of the tax structure with possible implications for bank behavior. Tax rates on income (using either an income or income based franchise tax) range from a high of 12.54 percent in Massachusetts (which uses a franchise tax) to 0 percent in 13 states. Rates on assets are harder to compare because the bases often differ, but they range from as high as the 1.5 percent business and occupations tax in Washington

to 0 percent in 31 states. All else equal, banks can be expected to transfer their assets or economic activity to avoid high tax rates.

Several other aspects of the tax structure have the potential to influence bank tax liabilities. One is whether federal income tax obligations are deductible in calculation of the state tax liability, a feature of three states' tax structures. Another is whether income from federal securities or the value of federal securities is included in the tax base. This can change the portfolio which a firm would want to hold in a state.

Finally, whether a state either requires or allows apportionment of bank income can be important. Income for multistate corporations is normally apportioned across states using either separate accounting or formulary apportionment. A common means is a three factor formula which apportions to a state the share of its domestic income which corresponds to the arithmetic average of its percent of the firm's domestic sales, payrolls, and property.⁵ Historically, state tax structures have given less consideration to apportionment of bank income than for firms from other industries, because banks were presumed to earn their income in a single state. Some states, such as Massachusetts, allow no apportionment and require all of their banks' income to be taxed in the state regardless of where it is earned. Other states may permit interstate banks to apportion, but may not have developed explicit rules for bank apportionment. Few states, if any, require unitary treatment of bank holding companies when the apportionment formula is calculated. This potentially offers an opportunity for banks to shift assets across states.

⁵The actual effects of apportionment also depend on the situs rules used to determine where the factors are located.

The Bank Regulatory Environment

Banking has historically been one of the most regulated industries in the United States. However, the atmosphere of regulation changed with the passage of the 1980 Depository Institutions Deregulation and Monetary Control Act. The act is considered by many to be the most significant piece of bank legislation passed since the 1930s. The act simplified many regulations, established uniformity of reserve requirements among institutions of different charters and provided for the abolition of interest ceilings on deposits. Although the regulations that affect banking are numerous, the ones of major interest here are Regulation Q, the McFadden Act, the Glass-Steagall Act and capital requirements.

The high interest rate and inflationary environment of the 1970s and 1980s led to the demise of Regulation Q, the de facto demise of the McFadden Act and Glass-Steagall. That environment and its consequences also motivated a change in the capital requirements of the banking system.

First, Regulation Q which limited interest that banks and savings and loan associations could pay on deposits led to financial disintermediation. Here, savers decreased their holdings of Regulation Q controlled deposits and shifted their funds to certificates, Treasury bills or money market mutual funds. The Depository Institution Deregulation and Monetary Control Act of 1980 provided for the legal demise of Regulation Q.

The McFadden Act required national banks to adhere to the branching laws of the state in which they were located. This was intended to protect local banks from outside competition and effectively gave banks geographic protection. However, banks that wished to expand given local restrictions on branching resorted to establishing multibank holding

companies. Banks that were allowed to branch statewide that wished to offer additional services formed one bank holding companies.

The McFadden Act which initially prevented banks from competing on an interstate basis is effectively ineffective. Banks now have established offices in other states to extend loans or accept deposits. Banks have also been allowed to operate credit card accounts in other states without establishing offices that that state. Technology has created automated teller and electronic funds transfer systems nationwide.

States have passed regional banking acts and some states have passed national banking acts allowing interstate banking.

Two states that have been at the forefront are Delaware and South Dakota. These states have passed legislation to encourage banks to transfer certain operations to Delaware or South Dakota in order to stimulate economic growth and development in those states.

The Glass-Steagall Act separated investment banking from commercial banking. However, Glass-Steagall has effectively been circumvented through the ownership of discount brokerage firms by bank holding companies. Given a declining share by banks in the market for short term credit due to the growth of commercial paper and loan problems due to energy and third world lending, banks are actively seeking a repeal of Glass-Steagall.

Given the current concern over bank failure and the inadequacies inherent in deposit insurance, bank regulators have sought an increase in capital adequacy. The push for increased capital by regulators has led many banks to securitize their loans. This means that the banks will package their loans into securities and sell them to investors. In some cases this could involve the selling of the loans by the bank to a subsidiary of its bank holding company. In so doing the bank can practice regulatory avoidance in that it

acquires addition funds and avoids reserve requirements, capital requirements, and deposit insurance premiums. Moreover, the bank could avoid some taxation as well if it sells the instruments to a subsidiary of its bank holding company located in a state with a smaller tax burden.

Conceptual Framework

In this study we seek to examine the effect of bank tax and regulatory structure on the regional location of banking. The effects can occur through two mechanisms. First, there can be an indirect effect on bank location if the demand for banking services declines in response to a tax induced reduction in overall regional economic activity and if there is a positive correlation between the general and bank tax structures. This effect probably is very small because the quantitative influence of taxes on the regional economy is modest. Second, there is a direct effect if banks respond to taxes or the regulatory structure by shifting certain activities to minimize their costs.

Bank location decisions likely depend on whether retail functions or production and wholesale functions are to be performed.⁶ The production and wholesale decisions can be likened to those made by manufacturing branch plants, which have been the focus of much of the location research of the past decade. Most production and wholesaling functions may not need locations near the market.⁷ Cost related factors may be the key determinant

⁶Bank location decisions should be thought of as including both decisions on where to locate facilities and size of each facility.

⁷The location of banking operations in Delaware and South Dakota are wholesale rather than retail operations. They are limited to operations such as credit cards, commercial lending, and retail credit processing functions and not deposit taking and lending functions. Indeed, the intent of the legislation was to encourage the establishment of out-of-state companies within Delaware and South Dakota while protecting the local banks.

of where firms locate the latter activities, and tax and regulatory factors may be among the greatest cost differences. Retail functions, on the other hand, may need to be physically located adjacent to the market, which means there is a direct link between the regional economy and demand for banking services. The policy environment may have little effect on this activity, though they will matter to the extent that regulatory factors change the concept of retail banking or to the extent that retail banking is price sensitive.

Location is an important consideration. Previous studies have concentrated on the retail side of banking as being the determinant of bank location [Black and Lundsten]. However, given legislative changes and advances in technology, retail considerations have become less important. As Keeley and Zimmerman note, no economic phenomenon can be properly analyzed without first determining the market in which it takes place [p. 25]. State laws constrain banks differently. In some states, a banking organization is allowed to engage in more activities than in other states. As a result, some banks are motivated to locate where their activities can be maximized [see Pozema and Erdevig].

Indeed, the growth of bank holding companies occurred due to the desire to expand the range of banking activities. The reaction of some states was to limit such activities while the reaction of others was to encourage it [Keane and Abel]. However, it has been found that the ability of banks to operate across state lines has not resulted in competitive advantages for those BHCs that have done so [Goldberg and Hanweck].

The two states that first changed their banking laws in order to attract out of state banks were South Dakota and Delaware. As Erdevig notes, South Dakota in 1980 was the first state to alter its laws in order create jobs, expand its economy and increase tax revenues [p. 18]. Delaware enacted similar legislation in 1981. The intent of both states

was to allow for wholesale banking rather than retail banking activities by the new banks. The legislation was constructed to minimize the impact on domestic banks in the two states.

Another development in banking markets has been the growth in securitized loans. Such loans are nothing new having been initiated nationally by the Federal National Mortgage Administration in the 1930s. However, recently financial institutions have securitized credit card receivables and automobile loans. Such securitization could be motivated by regulatory avoidance. An institution through securitization can avoid reserve requirements, capital requirements and deposit insurance premiums [Pavel p. 23]. For example, James points out that the incentives to engage in securitization increase when capital requirements are raised [p. 21]. A bank by selling loans reduces the size of its balance sheet and thereby reduces its capital requirement. Consequently, a bank could avail itself to selling loans to a bank holding company subsidiary and thereby increase the overall return to the BHC. The result of securitization and BHC expansion could be the integration of financial markets. Indeed, Osborne finds that the U. S. banking industry has become less of a collection of local markets and more of an integrated national market [p. 101].

Banks making decisions on wholesaling and production activities can be expected to choose between the set of j potential sets in order to maximize profits. However, a site in j will be selected only if the profit rate exceeds the opportunity cost for at least one site in j . The profit function's value for each site in j can be given by Equation 1. Profits depend on

$$\pi_j = R(L, i, DD, U, E) - C(F, P, w) - t_i A_s - (1 - t_r) [R_s - C_s] \quad \forall j; \quad (1)$$

revenues (R), which are a function of bank lending activity (L), the national rate of interest (i), demand deposits (DD), usury regulations (U), and bank competition (E). Lending activity and demand deposits determine the scale of banking operations and national interest rate, using regulations and competition determine the price. Bank costs (C) are determined by the cost of funds (F), state regulatory practices (R), and local input costs (w).

Regulations which allow greater flexibility in bank structure should lessen bank costs.

Finally, share taxes are the tax rate (t_s) times the intangible property base (A_s) and profits taxes equal the tax rate (t_p) times the profit base. The tax bases are subscripted with an S to reflect the situs rules used by a state for determining what is taxed.

The factors in the revenue function for wholesaling activities are generally determined by the nationwide activities of a bank and are independent of the siting decision. An exception to this is that usury laws can reduce the revenues earned at a particular site. Otherwise, banks can be expected to choose across the j locations by selecting the site which minimizes operating cost and tax factors, and more banking activity would be expected in those states where these factors are more conducive to a high rate of return.

The profit function for bank retail decisions also has the form of Equation 1. However, for wholesaling activities, factors in its revenue function were taken as given by the location. For retail activities, which are more likely to be region specific, it is the profit rate probably given by competitive market conditions. Thus, revenues for retail functions are jointly determined with siting decisions through the selection of L and DD. Higher costs or taxes would be reflected in higher prices for retail banking to maintain profit levels. Therefore, retail banking activity will decline in high tax places only to the

extent that the retail activities have a price elasticity greater than 0. Presumably this is much less responsive than for wholesaling activities.

Equation 1 describes the supply side of the market but both demand and supply factors influence the aggregate banking services provided in a region. The regional demand for banking services depends on the overall level of regional economic activity and the interest rate. Thus, for any given interest rate the retail demand in each state is influenced only by regional economic activity. In the remainder of this paper, the demand for retail banking activity is assumed to be proportional to the regional level of economic activity. This permits the analysis to focus on the supply side and deviations in demand which would arise because the regional interest rate differs from the national rate.

Each firm can evaluate all potential sites and construct an indirect profit function, Π^* which is the envelope of potential profit maximums for each site. Similarly, the analysis can be conducted to determine the magnitude of banking activity at each site. The parameters in the indirect profit function generally are those shown in Equation 2.

$$\Pi^* = \Pi^*(i, V, E, F, R, w, t_r, t_n, S) \quad (2)$$

For banks performing each type of activity the task is to choose a location by maximizing profits subject to the constraints, as illustrated in 3 and where

$$\max_j \Pi^* \text{ s.t. } \bar{R} \text{ over all; for wholesaling activities and} \quad (3)$$

$$\Pi_j \geq \Pi_M \text{ for all activities}$$

Π_M^* is the opportunity rate of return.

Empirical Analysis

Our interest is to measure the influence of state policy on the magnitude of banking activity. Therefore, rather than study the behavior of individual banks and their siting decisions, we analyze the aggregate banking activity in states. This means we have aggregated the profit maximizing decisions of all banks in j , where j represents each of the 50 states.

Determinants of the level of activity which banks will have in each state can be drawn from Equation 3. For empirical analysis, retail and wholesale bank activities must be combined in order to examine how policy variables influence banking in different states. This is illustrated in Equation 3 where S represents the situs rules for taxation and B represents the level of banking relative to economic activity in the state. The cost of funds is omitted under the assumption that this is constant nationwide.

$$B = f(U, P, W, t_i, t_x, S) \quad (4)$$

The location of banking activity is multidimensional so B can be used as a measure of several different banking characteristics. Three types of choices are examined here. Banks can be expected to maximize profits by making three choices on the basis of the factors in Equation 4. The first is situs of real economic activity, which refers to decisions on where banks locate employment and production activities. Second, is bank asset portfolio choice decisions regarding the types of loans which are made. Third, is the related decision on where banks hold their financial assets. Banks may be able to increase their profits by location decisions of each type. The incentives arising from state tax and regulatory policies may differ across these decisions, so it is possible to have different, and even conflicting results on the relationship between policy and these factors. Banks, for example, may have means to alter their tax liability by relocating either their portfolios or

their employment. As a result, tax structures may change the situs of financial assets and therefore state tax revenues while having little influence on the location of real economic activity, such as employment, or vice versa.

There may be situations where aggregate banking activity remains unaltered by tax and regulatory practices, though the distribution of activity may be changed across different types of banks. Thus, a fourth issue is effects on the distribution of banking activity by size of firm, as elements of the tax and regulatory structure favor large versus small banks or the reverse.

The empirical analysis consists of seeking to determine the effects of tax and regulatory policies on the three bank decisions for two points in time, 1978 and 1986. This is accomplished by estimating Equation 3 for several appropriately chosen measures of banking activity. Effects on the size distribution of banks is studied within the context of the three decisions by looking at how large and small banks are affected and comparing this with the effect on all banks. To undertake this analysis, data on appropriate banking characteristics are aggregated for all banks in each state using the FDIC Call and Income Reports. Data on state bank regulatory structures were taken from Amel and Keane (1987). Tax structure data were compiled from Commerce Clearing House (1989) and from direct contacts with state tax departments.

Bank tax structure variables analyzed in this study include the tax rate (t_c) on corporate income, regardless of whether the tax is in a franchise or corporate income form, and the share tax rate (t_s). Factors influencing what enters the tax base (S) are measured using whether the state has a corporate income tax, whether the state has a franchise tax, whether the state permits apportionment of income, and whether federal interest is taxed.

Different tax structures may allow banks to plan their tax liability by

choosing locations. For example, banks would be expected to locate expenses and intangible property in states with income based taxes and to locate income in states with taxes based on intangible values. The ability to move intangible property to avoid taxes should be larger than the ability to move expenses. However, for several reasons it is an empirical question as to which tax has the greatest effect on location. First, moving intangibles may change the liability for both taxes, since income can be claimed to be earned in the state where the intangibles are located. Second, share tax rates often are low so the incentive for relocating the base is limited, but the base definitions often are broad. Further, in many cases these taxes can be reduced by relocating either real or financial assets.

Regulatory practices (R) included are dummy variables which measure whether the state allows in-state multibank holding companies (MBHC), statewide branching and the degree to which interstate banking is permitted. Regulatory practices which allow MBHC, statewide branching, and greater flexibility for interstate banking allow banks to seek a larger size and diversify into additional markets. These can reduce costs to the extent that economies of scale and scope exist and can lower risks through diversification.⁸ Potentially, this could raise the level of banking activity in a state. However, larger sized banks may have greater capacity to shift either real or financial behavior to avoid taxes, so the effect is uncertain.

⁸Hunter and Timme find that for banks with up to \$5 billion in assets no appreciable cost savings accrue from multiproduct production. For banks between \$5 billion and \$25 billion, multiproduct production actually increases production costs [p. 9]. However they do find economies of scale in the \$800 million to \$5 billion range and diseconomies in the \$100 million to \$800 million range.

Erdevig (1988) identified South Dakota and Delaware as the first states to pass legislation designed to attract out-of-state banking activity by eliminating usury laws (U) and other reforms.⁹ A dummy variable was introduced to measure the effectiveness of their legislation. The competitiveness of the banking community is measured by the number of banks which have at least one billion dollars in assets and input costs are proxied with the average wage rate for employees of the Finance, Insurance, and Real Estate sector.

Real Activity

The real economic activity of banks is measured here by their employment and the gross state product arising in the banking sector. The effect of taxes and regulations on the regional location of these real measures can be seen in Table 1. Regressions were estimated using ordinary least squares for the aggregate of all banks in 1978 and 1986.¹⁰ Following the assumption that the demand for banking services bears a fixed relationship to overall economic activity, employment and output in the banking sector were divided by the corresponding value for all sectors in the state's economy prior to the empirical analysis.

Overall, the results evidence that bank taxes and regulations have little effect on the real economy. Tax planning by banks seems to have limited implications for the siting decisions for employment. This is not inconsistent with findings for the influence of taxes

⁹Erdevig identified New York, Pennsylvania, Nebraska, Virginia, and Maryland as other states which have enacted legislation since Delaware and South Dakota. A dummy variable including all states was never statistically significant.

¹⁰Banks were not separated by size class for real activity because separate data on employment.

on manufacturing firms, which though statistically significant generally are found to be quantitatively small. An exception is that the regulatory and tax changes enacted in Delaware and South Dakota led to a statistically significant higher level of employment in these states in 1986, but no employment effect in 1978, before their laws were enacted. The only other policy variable related to employment is the tax rate on income, which has an unexpected positive sign. However, the location of employment may have little relationship with tax liabilities, which could be altered by resiting financial assets and liabilities.

The expected pattern is not found between tax variables and GSP. Delaware and South Dakota, had higher GSP in the banking sector in 1978, before the legislated changes, but not often. This could indicate an inconsistency in the GSP estimates or it may signify that the activity attracted by these states has low value added. Delaware was statistically significant in a separate equation where independent dummy variables were entered for each state. The share tax rate and the income tax rate were statistically significant in the earlier time period, counter to the expectation that tax effects would be growing.

Regulatory practices also had few implications for the real economy. The only exception is the presence of multibank holding companies is found to reduce the value added, perhaps by allowing lower cost banking. More large banks in a state tend to raise the relative employment and output (only in the earlier time period).

One expectation was that the numerous changes in bank practices between 1978 and 1986 would alter the structural relationships contained in the estimated equations. Chow tests were conducted to measure the statistical significance of this behavior. The hypothesis that the structures are the same is rejected as expected for employment; however, we fail to reject the hypothesis for the GSP equations.

Financial Measures

Equation 4 was estimated for total assets and total liabilities within each state in order to measure influences on the location of financial activity. Effects of the basic level of demand are eliminated by estimating equations using assets and liabilities per dollar of gross state product as the regressand.

Taxes also have limited effects on location of total financial assets. Consistent with expectations, assets are greater in states with high taxes on income, though there is little evidence that high share tax rates discourage situs of assets. For liabilities, it is the existence, rather than the rate of an income tax which discourages situs. Statewide branch banking reduces the presence of both assets and liabilities and legislation permitting multibank holding companies and interstate banking reduces liabilities. Delaware and New Jersey have significantly more assets and liabilities both before and after enactment of their banking legislation, providing little support that their legislation was or was not effective. Next, states with more large banks have greater assets, but lower liabilities. Finally, the structure changes between 1978 and 1988 for both assets and liabilities.

Banks were separated into those with more than \$1 billion in assets and those with less than \$1. The regressions were reestimated separately for the aggregate of banks in each size group.¹¹ The regressions were estimated using ordinary least squares. A seemingly unrelated regression technique was considered because of a possible correlation in the error terms for small and large banks within a state. However, no efficiency gain is achieved from the use of seemingly unrelated techniques when the X matrix is identical for

¹¹The size break of one billion dollars was held constant in real terms using \$634.4 million in 1978.

both and small and large banks (see Judge et al. p. 321). Also, the variable for the number of big banks was excluded because the dependent variable was created using the same information. The implications of regulatory practices have been on the size distribution of the banks since noticeable differences arise between effects on the total assets and liabilities of small versus large banks. For example, branch banking leads to greater assets and liabilities in large banks, and lesser ones in smaller banking. Thus, branching appears to shift financial assets from small to large banks, while reducing the overall level. Both interstate banking and multibank holding company legislation reduce the presence of small banks without hurting large banks. Delaware's banking laws initially afforded most favorable treatment to banks which did not compete in domestic markets and this seems to have the intended result since liabilities for both large and small banks are greater in Delaware and South Dakota. Finally, as should be expected, large banks have a greater share of financial assets in states with more large banks.

Portfolio Choices

Three aspects of portfolio selection are examined: federal securities, commercial and industrial loans (C&I), and personal loans all expressed as a share of total assets. Again, OLS is used for estimation purposes since the X matrices are identical. Bank's portfolio choices may be of significant public policy concern to the extent that domestic financial banks are an important source of lending for business development and markets are not smooth. However, few of the public policy variables influence portfolio choice. C&I loans tend to be greater in states which permit MBHC and which use higher income tax rates. The relationship with income tax rates may arise because banks may be better able to apportion C&I loan income out-of-state. States with large banks also locate more assets

in C&I loans. We failed to reject the hypothesis that the structure of the relationships changed between 1978 and 1986.

Delaware and South Dakota hold more consumer loans and less C&I loans. Thus, these states have been effective in attracting more banking activity. However, by design, what they attract is relatively less oriented to local business needs. Prior to the banking law changes, banks in these states held more federal securities. As would be expected, banks in state's using a franchise tax hold fewer assets in federal securities, but surprisingly they hold more federal securities in states which are known to tax the interest. Further, states with more big banks and states which allow statewide branching or multi bank holding companies hold lower bank assets.

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Table 1: Regression Estimates for All Banks, 1986 and 1978

	INTERCEPT	CORINCR	APPORT	SHARERT	MBHC	INTERST	BRANCH	FEDINT	CORPYTAX	FRANTAX	BIGBANK	AVEEARN	OUTLI
1986													
TEMPBK	0.018 *** (15.45)	0.00083 *** (3.62)	-0.0012 (-1.53)	0.00017 (0.43)	0.00014 (0.17)	-0.000079 (-0.14)	-0.00067 (-0.85)	-0.00053 (-0.45)	-0.0013 (-1.34)	-0.0015 (-1.35)	0.00022 *** (4.38)	0.000000024 (0.653)	0.012 *** (6.47)
TGSPBK	0.024 *** (9.02)	0.00011 (0.41)	0.0029 (1.54)	-0.0005 (-0.54)	-0.0065 *** (-3.42)	-0.0012 (-0.87)	-0.0054 *** (-2.89)	-0.0024 (-0.86)	-0.0053 ** (-2.40)	0.00080 (0.30)	-0.000036 (-0.304)	-0.000000032 (-0.37)	0.011 (2.64)
TRC2170	572.25 *** (10.00)	11.10 * (1.86)	-18.85 (-0.47)	-3.60 (-0.18)	-77.61 * (-1.91)	28.09 (0.98)	-85.17 ** (-2.15)	-53.49 (-0.89)	-50.97 (-1.08)	42.68 (0.74)	7.43 *** (2.93)	-0.00026 (-0.27)	1477.64 *** (16.29)
TRC2950	534.92 *** (9.05)	-3.95 (-0.64)	40.40 (0.98)	-3.53 (-0.18)	-80.08 * (-1.91)	-46.80 (-1.58)	-125.35 *** (-3.07)	-39.80 (-0.64)	-70.95 (-1.46)	20.28 (0.34)	-8.42 *** (-3.21)	-0.00027 (-0.14)	1211.87 *** (12.94)
SHFEDAS	19.81 *** (8.78)	-0.11 (-0.46)	0.25 (0.16)	0.52 (0.67)	-3.17 * (-1.98)	-1.11 (-0.98)	-4.67 *** (-3.00)	4.91 ** (2.08)	-0.53 (-0.29)	-3.14 (-1.39)	-0.39 *** (-3.92)	0.000057 (0.78)	-4.29 (-1.20)
SHCIAS	13.23 *** (8.84)	0.40 ** (2.59)	-1.25 (-1.19)	-0.24 (-0.47)	2.24 ** (2.11)	0.84 (1.12)	1.40 (1.36)	-2.00 (-1.27)	0.64 (0.52)	0.031 (0.02)	0.24 *** (3.67)	-0.000031 (-0.64)	-5.16 ** (-2.18)
SHCONAS	15.44 *** (6.26)	-0.64 ** (-2.50)	0.080 (0.05)	-0.027 (-0.03)	1.24 (0.71)	0.96 (0.77)	2.24 (1.31)	2.22 (0.86)	1.06 (0.52)	-1.71 (-0.69)	-0.0061 (-0.06)	-0.00012 (-1.46)	38.92 *** (9.95)
1978													
TEMPBK	0.012 *** (4.51)	0.00023 ** (2.07)	0.00017 (0.29)	0.00024 (0.81)	-0.00015 (-0.24)	-0.00016 (-0.16)	-0.0003 (-0.46)	0.00012 (0.13)	-0.00033 (-0.42)	-0.0013 (-1.55)	0.00019 *** (2.85)	0.000000032 (1.33)	0.0014 (0.95)
TGSPBK	0.011 * (1.74)	0.000076 (0.29)	0.0014 (0.96)	0.00021 (0.31)	-0.0028 * (-1.85)	0.0047 * (1.98)	-0.0017 (-1.07)	0.00030 (0.14)	-0.0013 (-0.73)	0.0011 (0.57)	0.00030 * (1.90)	-0.00000028 (0.51)	0.0055 (1.64)
TRC2170	472.44 ** (2.61)	-0.34 (-0.043)	44.75 (1.09)	-1.76 (-0.089)	-118.67 *** (-2.77)	-27.33 (-0.40)	-34.89 (-3.05)	-18.43 (-0.30)	-10.03 (-0.19)	53.21 (0.95)	10.95 ** (2.43)	0.0011 (0.071)	200.84 ** (2.10)
TRC2950	443.83 ** (2.66)	0.11 (0.016)	40.28 (1.07)	-1.62 (-0.089)	-109.16 *** (-2.76)	-24.42 (-0.39)	-30.09 (-3.00)	-17.81 (-0.31)	-9.44 (-0.20)	47.87 (0.92)	10.36 ** (2.49)	0.00031 (0.021)	184.43 ** (2.09)
SHFEDAS	11.55 ** (2.49)	-0.031 (-0.16)	-1.18 (-1.13)	-0.23 (-0.46)	-1.18 (-1.08)	-1.11 (-0.64)	-1.42 (-1.19)	1.79 (1.13)	-0.55 (-0.41)	-0.67 (-0.46)	-0.21 (-1.82)	0.00020 (0.49)	7.48 *** (3.04)
SHCIAS	10.06 (2.36)	0.18 (0.89)	-0.54 (-0.56)	-0.21 (-0.45)	1.43 (1.41)	2.86 * (1.79)	-1.29 (-1.18)	-1.02 (-0.70)	1.17 (0.95)	-0.40 (-0.30)	0.19 * (1.76)	0.00038 (0.89)	-3.62 (-1.60)
SHCONAS	0.24 *** (4.95)	-0.0026 (-1.27)	0.0049 (0.44)	0.00098 (0.18)	0.015 (1.25)	-0.0035 (-0.19)	0.012 (0.95)	0.015 (0.86)	0.011 (0.74)	-0.0048 (-0.32)	-0.00070 (-0.57)	-0.0000083 * (-1.88)	-0.042 (-1.61)

Table 2: Regression Estimates for Big Banks, 1986 and 1978

	INTERCEPT	CORINCFR	APPDRT	SHARERT	MBHC	INTERST	BRANCH	FEDINT	CORPYTAX	FRANTAX	BIGBANK	AVEEARN	OUTLI
1986													
TEMPBK	0.018 *** (15.45)	0.00043 *** (3.62)	-0.0012 (-1.53)	0.00017 (0.43)	0.00014 (0.17)	-0.000079 (-0.14)	-0.00067 (-0.85)	-0.00053 (-0.45)	-0.0013 (-1.34)	-0.0015 (-1.35)	0.00022 *** (4.38)	0.000000024 (0.65)	0.012 *** (6.47)
TGSPBK	0.024 *** (9.02)	0.00011 (0.41)	0.00029 (1.54)	-0.00050 (-0.54)	-0.0065 *** (-3.42)	-0.0012 (-0.87)	-0.0054 *** (-2.89)	-0.0024 (-0.86)	-0.0053 (-2.40)	0.00080 (0.30)	-0.000036 (-0.30)	-0.000000032 (-0.37)	0.011 ** (2.64)
TRC2170	63.06 (0.98)	12.96 * (1.94)	-77.26 * (-1.72)	15.82 (0.72)	8.10 (0.18)	89.53 *** (2.78)	88.80 * (2.00)	35.18 (0.52)	38.15 (0.72)	-28.51 (-0.44)	18.01 (6.33)	-0.00085 (-1.68)	1260.07 *** (12.39)
TRC2950	62.55 (1.57)	-2.32 (-0.56)	-7.96 (-0.29)	13.47 (0.99)	-0.93 (-0.03)	10.91 (0.55)	31.70 (1.15)	31.79 (0.76)	6.87 (0.21)	-36.16 (-0.91)	1.51 (0.85)	-0.0010 (-0.78)	1013.58 *** (16.07)
SHFEDAS	7.29 ** (2.24)	-0.21 (-0.62)	-3.10 (-1.36)	0.31 (0.28)	-1.37 (-0.59)	1.22 (0.75)	-0.055 (-0.02)	8.77 ** (2.58)	4.07 (1.52)	-3.73 (-1.14)	-0.071 (-0.49)	0.00012 (1.10)	-5.40 (-1.05)
SHCIAS	8.90 ** (2.31)	0.15 (0.38)	-2.27 (-0.84)	0.88 (0.67)	2.74 (1.00)	3.92 ** (2.03)	0.85 (0.32)	4.19 (1.04)	3.77 (1.19)	-3.25 (-0.84)	0.52 (3.04)	-0.000055 (-0.44)	-2.39 (-0.39)
SHCONAS	18.88 *** (4.31)	-0.94 ** (-2.17)	1.17 (0.40)	-0.21 (-0.15)	0.92 (0.32)	0.48 (0.24)	2.93 (1.06)	3.18 (0.69)	-1.16 (-0.34)	-3.82 (-0.84)	-0.15 (-0.82)	-0.000087 (-0.71)	44.77 *** (7.43)
1978													
TEMPBK	0.012 *** (4.51)	0.00023 ** (2.07)	0.00017 (0.29)	0.00024 (0.81)	-0.00015 (-0.24)	-0.00016 (-0.16)	-0.00032 (-0.46)	0.00012 (0.13)	-0.00033 (-0.42)	-0.0013 (-1.55)	0.00019 (2.85)	0.000000032 (1.33)	0.0014 (0.95)
TGSPBK	0.011 * (1.74)	0.000076 (0.29)	0.0014 (0.96)	0.00021 (0.31)	-0.0028 * (-1.85)	0.0047 * (1.98)	-0.0017 (-1.07)	0.00030 (0.14)	-0.0013 (-0.73)	0.0011 (0.57)	0.00030 * (1.90)	0.00000028 (0.51)	0.0055 (1.64)
TRC2170	99.85 (0.54)	16.86 (2.19)	-22.69 (-0.54)	4.53 (0.22)	-48.38 (-1.10)	-24.67 (-0.35)	135.75 *** (2.86)	-2.88 (-0.05)	7.04 (0.13)	-73.05 (-1.27)	29.11 *** (6.31)	-0.0052 (-0.31)	4.84 (0.05)
TRC2950	97.78 (0.57)	15.79 (2.21)	-21.12 (-0.54)	4.30 (0.23)	-45.18 (-1.11)	-23.31 (-0.36)	127.02 *** (2.88)	-2.61 (-0.05)	6.28 (0.13)	-68.97 (-1.29)	27.01 *** (6.31)	-0.0052 (-0.34)	3.52 (0.04)
SHFEDAS	9.83 (1.27)	0.23 (0.71)	-3.12 (-1.78)	-0.51 (-0.61)	0.20 (0.11)	-2.32 (-0.78)	0.83 (0.42)	2.37 (0.90)	0.99 (0.44)	-2.27 (-0.94)	0.33 (1.69)	-0.00031 (-0.45)	6.04 (1.47)
SHCIAS	16.18 (1.42)	0.060 (0.13)	-2.23 (-0.87)	-0.32 (-0.26)	1.10 (0.41)	-5.04 (-1.18)	-2.45 (-0.84)	3.46 (0.89)	2.44 (0.74)	-2.70 (-0.76)	0.78 *** (2.75)	-0.00031 (-0.302)	-9.57 (-1.58)

SHCONAS Model is not full rank.

Table 3: Regression Estimates for Small Banks, 1986 and 1978

	INTERCEPT	CORINCFR	APPORT	SHARERT	MBHC	INTERST	BRANCH	FEDINT	CORPYTAX	FRANTAX	BIGBANK	AVEEARN	OUTL1
1986													
TEMPBK	0.018 *** (15.45)	0.00043 *** (3.62)	-0.0012 (-1.53)	0.00017 (0.43)	0.00014 (0.17)	-0.00079 (-0.14)	-0.00067 (-0.85)	-0.00053 (-0.45)	-0.0013 (-1.34)	-0.0015 (-1.35)	0.00022 *** (4.38)	0.000000024 (0.65)	0.012 *** (6.47)
TGSPBK	0.024 *** (9.02)	0.00011 (0.41)	0.0029 (1.54)	-0.00050 (-0.54)	-0.0065 *** (-3.42)	-0.0012 (-0.87)	-0.0054 *** (-2.89)	-0.0024 (-0.86)	-0.0053 *** (-2.40)	0.00080 (0.30)	-0.000036 (-0.30)	-0.000000032 (-0.37)	0.011 ** (2.64)
TRC2170	509.19 *** (9.39)	-1.86 (-0.33)	58.41 (1.54)	-19.42 (-1.05)	-85.71 ** (-2.23)	-61.43 ** (-2.26)	-173.96 *** (-4.64)	-88.68 (-1.56)	-89.11 * (-1.99)	71.19 (1.31)	-10.58 *** (-4.40)	0.00094 (0.53)	217.57 ** (2.55)
TRC2950	472.37 *** (9.41)	-1.63 (-0.31)	48.36 (1.38)	-16.99 (-0.99)	-79.15 ** (-2.22)	-57.70 ** (-2.29)	-157.05 *** (-4.53)	-71.59 (-1.36)	-77.82 * (-1.88)	56.43 (1.12)	-9.93 *** (-4.46)	0.00074 (0.45)	198.29 ** (2.49)
SHFEDAS	21.92 *** (9.07)	-0.35 (-1.39)	1.39 (0.82)	0.89 (1.08)	-3.90 ** (-2.28)	-1.10 (-0.90)	-4.15 ** (-2.49)	5.63 ** (2.23)	0.12 (0.06)	-3.60 (-1.48)	-0.31 *** (-2.90)	0.000040 (0.50)	3.41 (0.89)
SHCIAS	12.58 *** (8.22)	0.34 ** (2.14)	1.07 (1.00)	-0.63 (-1.21)	1.66 (1.53)	0.37 (0.49)	3.15 *** (2.98)	-4.65 *** (-2.90)	-1.35 (-1.07)	1.23 (0.80)	0.04 (0.61)	-0.0000015 (-0.03)	-9.66 *** (-3.98)
SHCONAS	12.24 *** (3.34)	0.27 (0.70)	-5.25 ** (-2.04)	0.62 (0.50)	1.74 (0.67)	1.18 (0.64)	-0.052 (-0.02)	3.49 (0.91)	2.58 (0.86)	-2.07 (-0.56)	0.24 (1.46)	-0.000015 (1.25)	23.21 *** (4.00)
1978													
TEMPBK	0.012 *** (4.51)	0.00023 ** (2.07)	0.00017 (0.29)	0.00074 (0.81)	-0.00015 (-0.24)	-0.00016 (-0.16)	-0.00032 (-0.46)	0.00012 (0.13)	-0.00033 (-0.42)	-0.0013 (-1.55)	0.00019 *** (2.85)	0.000000032 (1.33)	0.0014 (0.95)
TGSPBK	0.011 * (1.74)	0.000076 (0.28)	0.0014 (0.96)	0.00021 (0.31)	-0.0028 (-1.85)	0.0047 (1.98)	-0.0017 (-1.072)	0.00030 (0.14)	-0.0013 (-0.73)	0.0011 (0.57)	0.00030 * (1.90)	0.000000028 (0.51)	0.0055 (1.64)
TRC2170	372.79 ** (2.06)	-17.20 ** (-2.28)	67.44 (1.65)	-6.29 (-0.32)	-70.29 (-1.64)	-2.66 (-0.04)	-170.65 *** (-3.68)	-15.55 (-0.25)	-17.06 (-0.33)	126.26 ** (2.24)	-18.17 *** (-4.03)	0.0063 (0.39)	195.99 ** (2.04)
TRC2950	346.05 ** (2.08)	-15.68 ** (-2.26)	61.40 (1.63)	-5.92 (-0.33)	-63.98 (-1.62)	-1.11 (-0.02)	-157.11 *** (-3.67)	-15.20 (-0.27)	-15.72 (-0.33)	116.84 (2.25)	-16.86 *** (-4.01)	0.0055 (0.37)	180.91 ** (2.05)
SHFEDAS	10.43 ** (2.50)	-0.12 (-0.66)	-1.25 (-1.32)	-0.34 (-0.74)	-1.92 * (-1.94)	-2.27 (-1.44)	-0.046 (-0.04)	2.29 (1.61)	0.012 (0.01)	-0.087 (-0.07)	-0.069 (-0.66)	0.00038 (1.01)	2.91 (1.31)
SHCIAS	10.73 ** (2.65)	0.47 *** (2.77)	-0.89 (-0.75)	-0.066 (-0.15)	1.63 * (1.70)	3.51 ** (2.30)	-0.67 (-0.64)	-2.58 * (-1.87)	0.12 (0.10)	0.095 (0.08)	-0.00034 (-0.003)	0.00021 (0.57)	-0.61 (-0.29)
SHCONAS	0.29 *** (4.76)	-0.0011 (-0.54)	0.0016 (0.14)	-0.00090 (-0.17)	0.013 (1.10)	-0.00038 (-0.002)	0.0096 (0.78)	0.0061 (0.37)	0.0068 (0.49)	-0.00082 (-0.06)	0.0024 * (1.95)	-0.0000064 (-1.50)	-0.045 * (-1.77)

EXHIBIT K: 21

**Fox, William F., Memorandum re Taxation of Financial Institutions to
Commissioner Joe Huddleston (April 13, 1992)**

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 situated 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 K: 22

Fox, William F., "Draft Alternatives for Modernizing the Massachusetts Bank Tax Structure", State Tax Notes, (July 12, 1993) pp. 96-121

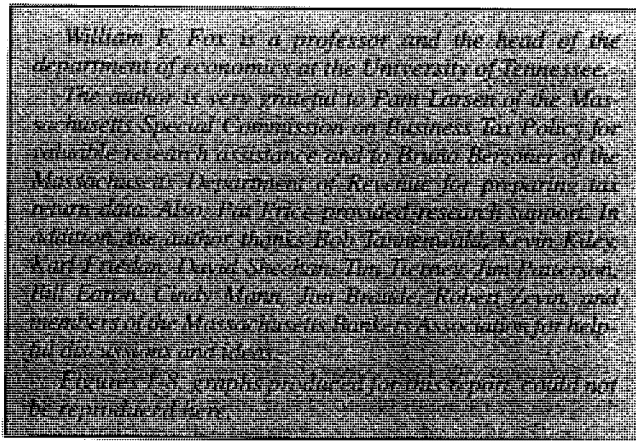
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Special Report / Viewpoint

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Draft: Alternatives for Modernizing The Massachusetts Bank Tax Structure

by William F. Fox, for the Massachusetts Special Commission on Business Tax Policy



1. Introduction

Over the past decade the financial industry has undergone major transitions that will continue through the 1990s. One result has been considerable state-level discussion on the most effective means for taxing financial institutions. In Massachusetts, reports have been prepared and deliberations held by a major tax study commission and numerous others. Outside Massachusetts, major bank tax law changes have occurred in at least five states since 1985, and ongoing analysis and dialogue have been sponsored by the Multistate Tax Commission.

Dramatic changes in banks' procedures and competition have left many state tax structures outdated, and this may be particularly true in Massachusetts. The current Massachusetts bank tax structure can lead to very uneven tax burdens across firms and industries, potentially disadvantaging banks relative to firms in other financial and nonfinancial industries. Specific reasons include the Commonwealth's bank tax rate is the highest in the U.S., all income earned by domiciled banks is taxed and the income of many nondomiciled banks goes untaxed in Massachusetts, and banks are taxed with higher rates than most direct competitors and other businesses in the Commonwealth.

This report is intended as input in the ongoing discussion of Massachusetts bank taxes. Many topics considered here already are on the table, and the greatest contribution may be the synthesis and comprehensive presentation. In addition, the report includes evaluation of alternatives. As appropriate, proposals contained in House Bill 4037 and other bank tax reform bills introduced in prior years are examined here.¹ However,

¹H.B. 4037 is a bank excise tax reform bill which has been submitted by the Massachusetts Bankers Association for the 1993 legislative session. For bank tax reform bills that present alternative approaches to those proposed in H.B. 4037, see S.B. 2087, introduced in the 1989 legislative session.

this report does not prescribe a particular set of tax policy changes.

The report contains seven sections. This introduction includes a brief description of the Massachusetts banking industry. Section 2 examines changes in the banking environment. Section 3 is a short history of bank tax legislation and section 4 is a discussion of the current bank tax structure in Massachusetts and other states. An evaluation of the problems with the Massachusetts bank tax is presented in section 5. The next section examines the relationship between bank taxes and economic development. The final section identifies the major issues that must be addressed in reforming the tax structure and the advantages and disadvantages of alternative solutions.

1.a. Banking Industry in Massachusetts

Two hundred sixty-one banks operated in Massachusetts in 1992 and held a combined \$141.0 billion in assets.² The preceding several years were a period of decline for the banking industry. Total assets in 1992 were 13.2 percent below the 1988 level, and the number of banks was down 18.4 percent. Eleven banks failed in 1990, 15 banks in 1991, and 17 banks in 1992. By comparison only four banks failed between 1986 and 1989. Massachusetts banks lost a combined \$2.3 billion during 1989, 1990 and 1991. Despite the decline in assets and number of banks, 1992 appears to have been a much better year for the industry. Profits totaled \$1.1 billion, just below the 1988 level.

The banking industry accounts for a significant share of Massachusetts' economy. More than 70,200 people were employed by the Commonwealth's banking industry in 1991 (see Table 1). Employment grew relatively steadily from 43,300 in 1970 to 82,700 in 1988, but has declined rapidly since. Employment in 1991 was about the same as in 1985. Some employment losses may be attributable to the national recession, but the Massachusetts banking industry had not evidenced a susceptibility to earlier U.S. recessions (1970, 1974-75, 1980, and 1982). More likely causes are difficulties in the New England banking industry resulting from real estate loan losses, tighter regulatory standards, and other changes.³

The banking industry's share of total Massachusetts employment has risen slowly from the 1.62 percent share in 1969, to 2.0 percent in 1991. Again, the share is lower than in 1988. The percentage of Massachusetts' employment in the banking industry is slightly above the 1.9 percent U.S. average, and is second highest among New England states. However, Massachusetts trails such money center states as Delaware, New

²Data were provided by the Massachusetts Bankers Association.

³See Browne and Rosengren (1992).

Table 1
Massachusetts Employment and Income in Banking and Credit Agencies

Year	Employment	Share of Total Employment	U.S. Share of Total Employment	Income (thousands)	Share of Total Income	U.S. Share of Total Personal Income
1969	43,295	1.62	1.53	315,704	1.32	1.29
1970	45,785	1.71	1.58	363,094	1.41	1.35
1971	46,057	1.74	1.62	386,265	1.41	1.38
1972	46,477	1.73	1.63	405,879	1.37	1.36
1973	48,208	1.73	1.66	444,031	1.38	1.35
1974	49,743	1.77	1.72	492,714	1.41	1.40
1975	49,704	1.83	1.77	541,192	1.46	1.44
1976	50,005	1.82	1.77	583,998	1.45	1.46
1977	50,928	1.80	1.78	620,553	1.42	1.45
1978	52,454	1.77	1.80	673,094	1.39	1.45
1979	54,631	1.78	1.85	748,210	1.38	1.46
1980	57,341	1.82	1.91	862,835	1.41	1.49
1981	60,124	1.92	1.95	981,788	1.44	1.49
1982	62,044	1.98	1.98	1,121,397	1.52	1.58
1983	64,173	2.00	2.01	1,248,252	1.56	1.65
1984	67,055	1.97	2.00	1,379,145	1.54	1.64
1985	70,134	1.99	2.01	1,550,802	1.61	1.65
1986	76,637	2.12	2.05	1,837,264	1.76	1.73
1987	81,276	2.19	2.06	2,095,406	1.86	1.75
1988	82,654	2.17	1.99	2,367,332	1.92	1.76
1989	81,489	2.16	1.96	2,440,095	1.86	1.70
1990	77,667	2.12	1.93	2,447,709	1.81	1.67
1991	70,263	2.00	1.88	2,312,576	1.68	1.63

York, Illinois, and California. Massachusetts' banking industry represents 2.7 percent of total banking employment in the United States, slightly above the Commonwealth's 2.4 percent share of the U.S. population.

More than \$2.3 billion in personal income was earned in the Massachusetts banking industry in 1991 (see Table 1).⁴ The percentage of personal income earned in banking was somewhat smaller than the percentage in employment, but still stood at 1.7 percent. Again, the share of personal income is slightly larger for the Commonwealth than for the U.S., but Massachusetts is below other large money center states. As with employment, the percentage of personal income earned in banking has grown steadily since 1969, evidencing the industry's growing importance. Massachusetts experienced an 11.2 percent annual growth rate in income from the banking industry between 1970 and 1991, which is about the same growth rate as that for U.S. banking as a whole. The growth compares favorably with the 6.0 percent rate of inflation during the same time period. Only Maine has grown more slowly among New England states.

⁴Personal income includes wages, salaries, other labor income (which includes fringe benefits), and proprietor's income. Personal income data reported here and for SIC 60 (depository institutions) and SIC 61 (non-depository credit institutions).

2. Current Banking Environment⁵

Bank taxes were developed in an era when financial institutions were presumed to operate wholly within one state. Three major trends are altering the continued validity of this structure: interstate banking, branchless banking, and growth of nontraditional financial service providers. Each trend is addressed below.

2.a. Interstate Banking

The 1980s began with the banking system strongly regulated and technological innovations for delivering banking services not fully developed. Federal legislation, state legislation, and shifts in banking practices, many of which were already underway, have left banks' interstate practices substantially altered.

Four federal statutes have increasingly permitted branching and interstate banking during the past several decades. The McFadden Act, which was passed in 1927 and amended in 1933, restricted the in-state branching powers of national banks to those of state-chartered banks. Three subsequent acts have expanded the potential for interstate banking. The Douglas Amendment to the Bank Holding Company Act of 1956 determined that states have the final authority on branching within their borders and in determining whether an interstate acquisition will be allowed. The Garn-St. Germain Act facilitated

⁵This section draws heavily on Fox and Kelsay (1992).

Table 2

State Laws Allowing Interstate Banking as of January 1, 1991

Nationwide Entry Without Reciprocity	Nationwide Entry With Reciprocity	Regional or Contiguous State Entry w/Reciprocity	Entry Not Allowed
Alaska	Connecticut	Alabama	Hawaii
Arizona	California	Arkansas ²	Kansas
Colorado	Delaware	District of Columbia	Montana
Idaho	Kentucky	Florida	North Dakota
Maine	Illinois	Georgia	
Nevada	Louisiana	Indiana ³	
New Hampshire	Massachusetts	Iowa	
New Mexico	Michigan	Maryland	
Oklahoma ¹	Nebraska	Minnesota	
Oregon	New Jersey	Mississippi	
Texas	New York	Missouri	
Utah	Ohio	North Carolina	
Wyoming	Pennsylvania	South Carolina	
	Rhode Island	Virginia	
	South Dakota	Wisconsin	
	Tennessee		
	Vermont		
	Washington		
	West Virginia		

¹Bank holding companies from states not granting reciprocal entry to Oklahoma banking organizations must wait four years before making additional acquisitions.

²Entry into Arkansas is contingent on submission, approval, and compliance with an extensive plan guaranteeing certain levels of community service and investment.

³This state is scheduled to convert to nationwide entry as follows: Indiana — July 1, 1992.

Source: *Banking Studies*, Division of Bank Supervision and Structure, Federal Reserve Bank of Kansas City, 1990 Annual. Categorization of Massachusetts based on Amel (1991).

interstate banking by authorizing banking institutions to acquire failing banks and thrifts in states other than the one where they are domiciled. Finally, the Edge Act of 1978 provided for limited interstate banking through international banking provisions.

Despite limitations imposed by these statutes, banks have been able to expand their interstate operations. One way is through chain banking agreements in which individuals, rather than corporations, own banks in multiple states. These agreements circumvent the Bank Holding Company Act which limits corporations, but not individuals, from ownership of multistate banks. Another way has been to purchase noncontrolling interest in an out-of-state bank, with an option to purchase control of the firm when permitting legislation is put in place. Also, a bank in one state can purchase a failed bank in another state through provisions of the Garn-St. Germain Act. In some cases, federal regulators have permitted the out-of-state bank to set up the failed bank as a branch, rather than as a subsidiary bank. In recent years, out-of-state banks have acquired at least four failed Massachusetts banks and have set them up to operate as branches. Further, banks have created nonbank subsidiaries in other states, such as loan production offices.⁶

⁶In 1989 the Community Bank Coalition for Tax Rate Reform reported there were loan production offices from 17 nondomiciled banks operating in the Commonwealth.

State legislation also has facilitated rapid increases in interstate banking. Maine's 1975 legislation was the first to authorize interstate banking. Since then at least 45 other states plus the District of Columbia have passed legislation permitting some form of interstate banking (see Table 2). Nonetheless, the bank holding company structure remains the major means by which financial institutions are able to expand interstate operations. Massachusetts allows holding companies domiciled in other states to locate a subsidiary in the Commonwealth if the state where the holding company is domiciled allows a reciprocal arrangement for Massachusetts domiciled holding companies. The Massachusetts Bankers Association currently is supporting legislation that would authorize nationwide interstate banking.

2.b. Branchless Banking

Banks are now able to deliver a large volume of services to places where they have no branches, thanks largely to technological advances in the collection, storage, and transmission of information. Examples of modern-day "branchless banking" include transactions conducted through point of sale terminals, automated clearing houses, automated teller machines, and electronic funds transfer systems. The development of high-speed computers has facilitated banking transactions conducted through the mail. All of these innovations have permitted banks to expand the scope of financial services they provide and the span of geographic markets they serve.

The data processing revolution has enabled the rapid expansion of loan securitization, perhaps the most important form of branchless banking today. Securitization has a long history, dating back to the Federal National Mortgage Administration (Fannie Mae) in the 1930s. However, securitization became an extensive practice only after development of high speed information systems and deregulation of the financial industry. An evidence is that mortgage backed securities grew 11-fold during the first half of the 1980s.⁷

Securitization has expanded recently into many other markets including automobile loans, credit card receivables, small business loans, home equity loans, computer leases, affiliate notes and many others (Lerner, 1990). For example, Chase Manhattan Bank is reported to have securitized more than \$7 billion in credit card receivables, and to have placed \$600 million in one deal in 1989. Marine Midland Bank has originated about \$2 billion in automobile receivable-backed securities over the past five years. Ford Motor Credit, the largest issuer of asset-backed securities in 1989, brought \$5.2 billion in automobile-backed securities to market.

2.c. Growth of Nontraditional Financial Service Providers

A number of industries that directly or indirectly compete with banks have developed or grown rapidly during the past several decades. Frequently the banking industry operates at a competitive disadvantage relative to these industries. Among the reasons are firms in these industries often are subject to lesser or different regulatory structures and to different tax regimes than are banks.

The Division of Banking has some regulatory responsibility for many nontraditional service providers and its listings allow a comprehensive review of these competitors. As of March 31, 1993, in Massachusetts there are 110 companies that make small loans, such as Beneficial Massachusetts, Inc., Chase Manhattan Personal Finance Services, and Sears Consumer Financial Corp.; 112 sales finance companies such as General Electric Capital Corp. and Whirlpool Acceptance Corp.; 82 automobile financing firms such as Chrysler First Financial Services Corp., General Motors Acceptance Corp., and Toyota Motor Credit Corp.; 177 mortgage lending firms such as Citicorp Mortgage, Inc., New Hampshire Colonial Mortgage Co., and Sears Mortgage Corp.; 351 mortgage broker firms such as Assurance Mortgage Corp., First Boston Mortgage Corp., and Primeamerican Financial Services. In addition, there are 149 credit unions, 187 collection agencies, 419 foreign transmittal agencies, and 149 insurance premium finance agencies. Note that the list includes subsidiaries of many large U.S. nonbank and bank corporations.

The nonbank competitors often are of extraordinary size. General Motors Acceptance Corporation, the largest nonbank finance company, held \$102.9 billion in assets in 1991 (D'Arista and Schlesinger). General Electric Capital Corp. and Ford Motor Credit Company each had more than \$50 billion in assets and another eight finance companies had more than \$10 billion in assets in 1991.

Bank and nonbank firms compete in three ways. The first two are cases where nonbank financial service firms have entered traditional banking markets and the third is where banks have been allowed greater authority. First, nearly every nonbank competitor seeks to make loans by issuing credit cards, making home mortgages, or giving personal or business loans. During the first quarter of 1993, 20 of the top 45 mortgage lenders in Massachusetts were nonbanks, 20 were banks and 5 were bank owned mortgage companies.⁸ More striking, is that 76 of the top 100 mortgage lenders in Massachusetts were banks in 1986. Only 47 were banks during the first quarter of 1993. The number of nonbank mortgage companies in the top 100 grew from 20 to 43 during this time period.

Commercial bank assets have increased 197.3 percent since 1980. Data prepared by Momingstar reveal that mutual funds in the U.S. held \$228.9 billion in assets in 1992, a 1228.9 percent increase in one decade. Money market mutual funds alone had assets of \$72.3 billion in 1992. Assets of finance companies have grown 325.5 percent since 1980.⁹

In Massachusetts as of June 30, 1992 state-chartered credit unions held \$5.8 billion in assets, and federally chartered credit unions held \$3.8 billion, for a total of \$9.6 billion. Assets in Massachusetts-chartered credit unions grew 146.0 percent between 1982 and 1992, versus 64.5 percent in state chartered savings banks and 56.5 percent in state chartered cooperative banks.¹⁰ In fact, since 1990 assets in Massachusetts' banks have declined while credit union assets have risen dramatically. Five of the largest 100 mortgage companies during the first quarter of 1993 were credit unions, up from one in 1986.

Second, banks and other financial institutions compete for deposits. Though banks' competitors (except credit unions) often are termed nondepositories because they do not accept deposits, the competitors raise capital through mutual funds, tax deferred annuities and other alternatives to deposits in banks. Much of the growth in nonfinancial institution's assets has been funded through means that compete with bank deposits.

Third, many states have relaxed regulations which limited-markets banks can enter. For example, banks in Massachusetts are permitted to engage in securities underwriting, securities brokerage, and other brokerage services. Thus, banks are competing in industries from which they were formerly excluded.

3. History of State Bank Taxes¹¹

The structure of state bank taxes across the U.S. has been driven by judicially imposed restrictions on the ability of states to tax national banks and by Congressional legislation. These constraints arose because in times past national banks were regarded as instrumentalities of the U.S. government. They issued currency, served as fiscal agents, and acted as depositories of public monies. Given restrictions on taxation of national banks, states have limited their taxation of state-chartered banks to what was permissible for national banks, so that the state banks were not placed at a competitive disadvantage. As

⁸Banker and Tradesman Monthly Mortgage Report, 1993, Issue 3.

⁹D'Arista and Schlesinger.

¹⁰Data provided by Massachusetts Bankers Association.

¹¹This section is drawn from McCray (1990), Symons (1984), and Symons and Strauss (1987).

⁷United States League of Savings Institutions, Savings Institutions Sourcebook, Chicago, IL, 1988, pp. 65-67.

a result, many states impose a tax regime on banks that differs from the regime they impose on nonbanking corporations.

Judicial restrictions on states' ability to tax national banks began with the 1819 U.S. Supreme Court finding in *McCulloch v. Maryland*.¹² The ruling held unconstitutional all state taxes on national banks other than a real property tax and a bank share tax. However, in this ruling Congress was seen as having the power to permit any form of taxation it deemed appropriate. The authority given in *McCulloch v. Maryland* for states to levy a real property tax and a bank share tax was clearly specified by Congress in the National Bank Act of 1864.¹³ Congress limited the rate of tax on real property to that imposed on other property owners. The share tax rate on national banks was limited to the rate levied on "other moneyed capital." The courts interpreted the maximum share tax rate described in the 1864 Act to be no higher than the rate imposed on other corporations involved in banking or the rate incident on the intangible personal property of individuals involved in the banking business. The latter interpretation required states to impose taxes on a wide range of intangible property.

The goals states sought to achieve during this era included to collect substantial revenues from taxation of banking and to impose taxes which could be administered in a realistic fashion. One result was that over time the effective tax rate on banks increased relative to that imposed on other forms of intangible personal property. Banks began to sue on the premise that they were overtaxed compared to "other moneyed capital." In 1923, after the Supreme Court ruling in *Merchant's National Bank v. Chmond*,¹⁴ Massachusetts' banks accepted a compromise of \$3 million as compensation for excess collection of past taxes.

Congress acted in 1923 in response to the difficulty of defining taxes that did not discriminate against banks and to the problems states were having maintaining sufficient revenues from taxation of banks. One change from this legislation was that the definition of "other moneyed capital" was restricted in order to limit the potential of bank taxes being seen as discriminatory. Also, options for state taxation of banks were extended to include a tax on net income at a rate not to exceed that on other corporations and a tax on dividends received by shareholders at a rate no higher than that on net income from "other moneyed capital." These alternatives likely would have generated less revenue than the share tax already imposed by states because interest from federal, state, and local securities was not taxable under either of the newly permitted taxes. Thus, in 1926 Congress enacted a third alternative. An excise (or franchise) tax was permitted where net income from all sources was allowed as the tax base.

The difficulty of assessing taxes on banks in a nondiscriminatory manner remained even after the 1926 legislation. A major issue was the set of taxes that should be used to compare tax liabilities for banks and other corporations. Non-bank corporations often were subject to a series of taxes while banks were subject only to a franchise, share or income tax. States began to build up the bank tax rate so the tax burden on banks would be similar to that imposed on other corporations.

Difficulties of setting the appropriate tax rate developed anew across the states.

Once again Congress responded, this time passing legislation in 1969 that eventually became effective in 1976. The major constraint imposed by this most recent legislation on state taxation of banks is as follows: "For the purpose of any tax law enacted under authority of the United States or any State, a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located."¹⁵

The 1976 legislation represented two significant changes in federal policy on taxation of national banks. First, states are permitted to impose any type of tax on banks without the necessity of obtaining congressional approval, as long as the taxes do not discriminate against national banks. Second, whether taxes discriminate against national banks is measured by comparing the taxes on national banks with the taxes on state banks, rather than with nonbanking corporations. Thus, the only limitation in existing legislation is that a state must tax national banks in the same manner as it taxes banks chartered in the state. Relaxation of prior restrictions is appropriate because the original purpose for such restraints on taxation — protecting the issuance of currency and the other fiscal services performed by national banks — is no longer needed in today's environment. Today, these functions are performed primarily by the Federal Reserve System.

A limitation on state taxation of interest from federal securities also remains. Specifically, "Stocks and Bonds of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or, both, to be considered in computing a tax, except

1. a nondiscriminatory franchise tax or another non-property tax instead of a franchise tax, imposed on a corporation; and
2. an estate or inheritance tax."¹⁶

Thus, the total income of a bank, including interest from federal securities, may be in the tax base as long as the state tax is a franchise tax, but the interest on federal securities cannot be included in a corporate income tax. The reason for the difference is a franchise tax normally is levied on the privilege of doing business in a state or of being a corporation, and is not a direct assessment on the income earned. A corporate income tax is a direct assessment against corporate income.

4. Massachusetts' Bank Tax Structure¹⁷

Massachusetts' bank tax history is long and varied because of the changing federal policies. The Commonwealth passed its initial tax on incorporated banks in 1812, prior to the first judicial ruling. The tax was a one percent assessment on the value of capital stock. Later, Massachusetts, like other states responded to the National Bank Act of 1864 by enacting a tax on the shares of national banks at the location where the share owners resided. Massachusetts quickly reacted to the 1926 congressional action by legislating an excise tax on banks

¹²17 U.S. 316 (1819).

¹³13 Stat. 100-118 (1864).

¹⁴256 U.S. 635 (1921).

¹⁵12 U.S.C. 548 (1969).

¹⁶31 U.S.C. Section 3124(a) (1982).

¹⁷See M.G.L., Chapter 63.

domiciled in the Commonwealth, with the base being federal taxable income with several adjustments.

Massachusetts has maintained its basic bank tax structure since the excise tax was imposed in 1926.¹⁸ The tax is imposed as a franchise tax. The privilege of operating in the Commonwealth is valued using bank net income, which includes interest on federal securities. Net income is defined as "the gross income from all sources, without exclusion, for the taxable year, less the deductions, but not credits, allowable under the provisions of the Federal Internal Revenue Code." However, certain deductions allowed by the U.S. are not permitted by the Commonwealth, including for intercorporate dividends received, for losses sustained in previous years, and for income, franchise or stock taxes imposed by other governments. In addition interest earned on state and local government debt is taxable in the Commonwealth but not by the U.S. government.

Massachusetts formerly calculated the tax rate on banks by adding the nonbank corporate tax rate (currently 9.5 percent) and a rate to account for the corporate net worth tax (currently \$2.60 per \$1000 of value) with the intent of equalizing the bank and nonbank tax burdens. The practice of setting the bank rate to equalize burdens ceased when the new federal tax legislation became effective in 1976. The 12.54 percent rate which was imposed at that time is still in effect today.

Massachusetts does not allow bank members of a holding company to file combined returns, though nonbank members can file combined returns. Each bank member of a holding company is taxed independently of other corporations that are in the same holding company.¹⁹

The Massachusetts bank tax structure has been described as residence based.²⁰ One reason is domiciled banks are taxed on their entire income wherever earned.²¹ No deduction is allowed for income earned outside the Commonwealth by Massachusetts-domiciled banks, even if the income is taxed in the

state where it is earned. This differs from the Massachusetts nonbank tax structure and from the way many states tax banks. A second reason is the tax is not levied on banks domiciled in other states even if they earn income in the Commonwealth. Again, this differs from the Massachusetts nonbank tax structure, where firms are permitted to apportion income. As a rule, states have not been aggressive in taxing nondomiciliary banks through apportionment or other means. However, the number of states taxing nondomiciliary bank income is growing rapidly and includes Minnesota, Tennessee, Indiana, New York, and California.

4.a. Defining a Bank

The Commonwealth has been compelled to define banks for tax purposes because a unique tax structure is imposed on banks. The definition is structured both by the tax law and the regulatory definition of a bank. A firm is taxed under the bank tax law only if it has a charter, and it only is required to obtain a charter (at least in Massachusetts) if it accepts deposits and makes loans. Massachusetts General Law, Section 63 says banks, including both thrifts and commercial banks, are chartered by the U.S. government, Massachusetts, or a foreign country. For regulatory purposes, a firm must accept insured deposits and make loans to be chartered as a bank in Massachusetts.

Two assumptions, both invalid in today's banking environment, appear to have been implicit in the original definition. First, banks were presumed to operate in markets that were independent of nonbank competition. Thus, many firms in the financial services industries are not subject to the bank tax even though they directly compete with banks.²² For example, loan companies, stock brokers, and insurance companies are not subject to the bank tax because they do not accept insured deposits. Similarly, credit card companies such as Sears' Discover Card and American Express are not included. Even bank holding companies and credit card subsidiaries of the holding companies are not classified as banks for tax purposes since they do not accept deposits and therefore, do not need bank charters.

The second assumption implicit in defining a bank for tax purposes appears to have been that banking services only would be provided by domiciled banks. Thus, the Massachusetts bank structure, as in most states, was developed to tax domiciled banks.²³ However, the changes in bank interstate practices that were described above allow banks to operate in a state without a domiciled presence. Nondomiciled banks operating in Massachusetts without a domiciled subsidiary bank generally are not taxable under the bank structure, though they may be taxable through the corporate tax framework. For example, a loan production office is taxable under the excise tax structure. Branchless banking is untaxed in the Commonwealth.

4.b. Bank Tax Contribution to State Tax Revenues

Bank taxes historically have been a significant source of revenues in Massachusetts (see Table 3). Revenues rose from \$28.4 million in 1970 to \$229.2 million in 1987, a 13.1 percent compound annual growth rate. However, revenues have declined markedly during the past five years. Inflation-adjusted

¹⁸An out-of-state bank seeking to acquire a financial institution located in the Commonwealth is required "to make ninety-hundredths of one percent of its assets in the Commonwealth available for call . . ." by the Massachusetts Housing Partnership Fund for ten years (M.G.L., Chapter 107 section 38). The Fund is used to finance housing purchases by low income households. Contributions to the fund are repaid at cost, but may not include an opportunity cost so a tax may be implicit in this set aside. A total of \$66.1 million has been committed-to-date and three additional acquisitions are pending.

¹⁹The implications of this feature are discussed in detail in section 5.c. Multibank Financial Corporation is an example of a bank holding company. It is headquartered in Dedham and owns three banks in the Commonwealth: South Shore, Mechanics, and Multibank West. Multibank Financial corporation also owns a leasing company located outside the commonwealth.

²⁰See McCray, 1990. The intent appears to have been development of a residence based tax structure in a regulatory framework. However, three current exceptions to the residence structure should be noted. First, foreign chartered banks operate in Massachusetts through branches and are taxed with an apportioned system based on a single factor receipts formula. Second, federal regulations have permitted certain out-of-state banks to establish branches in the Commonwealth. These banks are apportioning income into Massachusetts. Third, Section 63 states that nationally chartered banks doing business in the Commonwealth are taxable. The section does not explicitly require that national banks be domiciled in the Commonwealth, so non-domiciled national banks may be subject to the tax.

²¹The First National Bank of Boston sued the Commonwealth arguing that taxing 100 percent of foreign sourced income without apportionment or consideration of taxes paid to other jurisdictions is unconstitutional. A settlement was reached for tax years 1976 through 1990 whereby Massachusetts paid \$37 million to the bank. However, the constitutional question remains unsettled.

²²See Section 2.c. for a listing of many nonbank financial institutions.

²³In the past, when nondomiciled banks operated in the Commonwealth they did so only after setting up a subsidiary in Massachusetts, and the subsidiary could be taxed as a domiciled bank or in some cases as a nonbank.

Table 3
Massachusetts Bank, Corporate, and Tax Revenue

Fiscal Year	Bank Tax Revenue (Thousands)	Corporate Tax Revenue (Thousands)	Total Revenue (Thousands)	Bank Tax Revenue as Percent of Cor- porate Tax Revenue	Bank Tax Revenue as Percent of Total Revenue
1970	28,387	201,909	1,313,132	14.06	2.16
1971	32,610	184,481	1,411,455	17.68	2.31
1972	33,749	213,934	1,718,693	15.78	1.96
1973	35,435	236,209	1,949,058	15.00	1.82
1974	33,077	262,168	2,098,576	12.62	1.58
1975	39,627	222,996	2,083,320	17.77	1.90
1976	37,768	271,145	2,608,536	13.93	1.45
1977	44,111	324,821	2,811,344	13.58	1.57
1978	44,195	333,080	3,178,544	13.27	1.39
1979	55,433	400,640	3,488,057	13.84	1.59
1980	70,455	438,860	3,831,122	16.05	1.84
1981	76,504	441,922	4,193,971	17.31	1.82
1982	70,204	498,055	4,637,363	14.10	1.51
1983	113,980	506,108	4,989,326	22.52	2.28
1984	106,598	569,265	5,653,992	18.73	1.89
1985	138,319	666,423	6,411,230	20.76	2.16
1986	193,351	802,558	7,484,159	24.09	2.58
1987	229,165	814,082	8,102,373	28.15	2.83
1988	219,074	771,806	8,270,855	28.38	2.65
1989	223,471	887,059	8,816,655	25.19	2.53
1990	110,744	698,408	8,519,334	15.86	1.30
1991	48,051	612,244	8,994,641	7.85	0.53
1992	60,156	643,755	9,482,505	9.34	0.63

1992 revenues were below the revenues generated in 1970. Bank tax revenues fell much more sharply during the recession years than nonbank corporate tax revenues. Nonbank corporate revenues are 21 percent below the 1987 level, and bank tax revenues are 73.7 percent lower. Much of the bank revenue decline appears to be the result of troubles in the New England banking industry and the U.S. recession. Also, the decline may be partially attributable to banks' increasing awareness of tax avoidance possibilities.²⁴ Revenues will rebound less in a stronger economy to the extent that banks have become more astute in their tax planning. Revenues in fiscal 1993 may be about \$150 million, still well below the 1987 peak.²⁵

Bank tax revenues have usually represented between 1.5 and 2.5 percent of the Commonwealth's total tax receipts (see Table 3). However, bank taxes have contributed less than two-thirds of one percent during the past two years. Bank taxes ranged between 12 and 18 percent of nonbank corporate tax receipts from 1970 through 1982. Revenues then rose sharply to 28.4 percent and have declined back to 9.3 percent.

²⁴In the tax literature, the term "tax avoidance" is used to connote the legal use of existing tax statutes to reduce the taxpayer's overall tax burden. This differs from "tax evasion" which refers to illegal steps to reduce tax burdens.

²⁵This 1993 estimate is based on collections through January and the average share that revenues from July through January have represented of the entire fiscal years' collections.

The share of revenues provided by Massachusetts bank taxes generally has been large relative to many states. Massachusetts' bank taxes were a larger percentage of nonbank corporate taxes than in money-center states New York, Delaware, California, and Pennsylvania between 1983 and 1988. Massachusetts bank taxes were generally a higher share of total tax receipts as well during this time period.

The income elasticity is an effective means for evaluating the long term performance of a tax. The income elasticity is calculated as the percent growth in tax revenues divided by the percent growth in personal income. Acceptability of the long term performance of bank tax revenue depends on whether the years 1990 through 1992 represent a short term fluctuation or a significant reduction in the tax's long term performance. The elasticity calculations show the bank tax performed very poorly if the tax is evaluated through 1991, but performed well if evaluated through 1989.²⁶ The bank tax was approximately unit elastic from 1970 through 1989 and from 1983 to 1989 (years between the two recessions). Unit elastic means revenues grow at the same rate as personal income, and is usually regarded as a desirable characteristic for a tax structure. In both time periods, bank taxes performed better than corporate income taxes. The corporate taxes grew about 0.85 times as fast as personal income. Growth in revenue at rates below that for income can make funding of services very difficult. However,

(Text continued on page 105.)

²⁶Personal income data only are available through 1991.

Total	National	Trust	Savings	Cooperative Bank	Federal Savings & Loan	International Banks	Total
Net Income	-1,296,918,924	-20,829,203	-173,497,703	-9,903,154	-184,946,596	-1,511,829	-1,686,095,581
State and municipal bond income	80,829,039	75,402,191	2,895,405	5,914,273	18,883	1,291,558	165,059,791
Foreign, state, or local taxes	8,795,580	23,620,804	24,393,136	4,006,790	661,161	307,306	61,477,472
Loss carry-over used	3,372	0	-1,574,288	1,272,708	0	0	-298,208
Dividends received	48,054,128	364,211	-1,773,489	-663,231	19,201	1,170	46,000,820
Other income	-2,531,846	9,989,291	103,158	-2,512,250	25,403	0	5,073,756
Total adjusted taxable income	-1,161,768,648	88,547,294	-149,453,786	-1,884,864	-184,221,948	88,201	-1,408,781,952
Total excise	8,113,799	24,145,722	23,782,722	4,273,022	996,039	353,185	61,311,303
Number of Banks	43	54	144	98	12	8	351
Average per Bank							
Net Income	-30,160,905	-385,726	-1,204,845	-101,053	-15,412,216	-188,979	-4,803,691
State and municipal bond income	1,879,745	1,396,337	20,107	60,350	1,574	161,445	470,256
Foreign, state, or local taxes	204,548	437,422	169,397	40,886	55,097	38,413	175,149
Loss carry-over used	78	0	-10,933	12,987	0	0	-850
Dividends received	1,117,538	6,745	-12,316	-6,768	1,600	146	131,056
Other income	-58,880	184,987	716	-25,635	2,117	0	14,455
Total adjusted taxable income	-27,017,876	1,639,765	-1,037,874	-19,233	-15,351,829	11,025	-4,013,624
Total excise	188,693	447,143	165,158	43,602	83,003	44,148	174,676
Total assets ¹	1,645,005,811	827,894,531	325,799,202	80,408,080	N/A	52,688,000	

Source: Massachusetts Department of Revenue.
¹Assets are for banks included in Table 5.

	Less Than \$50 Million	\$50 Million to \$100 Million	\$100 Million to \$500 Million	\$500 Million to \$1 Billion	\$1 Billion to \$1.5 Billion	\$5 Billion and Above	Total
1. Net Income	115,477	-152,048	-558,167	-3,880,731	-16,376,862	-247,848,088	-5,561,699
2. State and Municipal Bond Income	5,693	73,135	134,719	704,478	1,913,684	19,631,246	711,730
3. Foreign, State or Local Taxes	32,629	46,015	164,066	461,162	597,297	3,815,046	206,636
4. Loss Carry Over Used	87	-737	2,101	281	-214,907	0	-10,101
5. Dividends Received	760	2,221	-34,664	2,330	38,972	9,612,065	282,894
6. Other Income	2,593	-41,737	-22,769	12,050	-446,704	2,804,597	31,751
7. Total Adjusted Taxable Income	149,580	-85,729	-338,378	-2,878,707	-14,337,144	-213,309,062	-4,684,900
8. Total Excise Tax	33,246	48,120	172,789	429,184	609,546	3,943,534	213,111
9. Number of Banks ¹	66	63	127	23	17	5	301

Source: Massachusetts Department of Revenue.
¹Assets were not available for all banks included in Table 4.

Table 6: State Taxation of Banks

	Corporate Income Tax Rate	Franchise Tax Rate	Share Tax Rate	Apportion Bank Tax Liability	Franchise Tax Based on Income	Interest from Government Securities Taxable		
						Federal	State's Own Bonds	Other States' Bonds
AL (q)	0.0	6.0	1.0	Y	Y	Y	N	Y
AK (h,l)	9.4	0.0	0.0	Y	N/A	N	N	N
AZ (h)	9.3	0.0	0.0	Y	N/A	N	N	Y
AR (l)	6.5	0.27	0.0	Y	N	N	N	Y
CA (h)	0.0	11.107	0.0	Y	Y	Y	Y	Y
CO (h,l)	5.1	0.0	0.0	Y	N/A	N	N	Y
CT (h)	0.0	11.5	0.0	Y	Y	Y	Y	Y
DE	0.0	8.7	0.0	N	Y	Y	N	Y
DC	0.0	10.25	0.0	Y	Y	N	N	Y
FL (c,h)	0.0	5.5	0.15	Y	Y	Y	Y	Y
GA (c,d)	6.0	0.25	0.0	Y	N	N	N	Y
HI	0.0	11.7	0.0	N	Y	Y	N	Y
ID (h)	8.0	0.0	0.0	Y	N/A	N	N	Y
IL (h)	7.3	0.25	0.0	Y	N	N	Y	Y
IN	0.0	8.5	0.25	Y	Y	N	N	Y
IA	0.0	5.0	0.0	Y	Y	Y	Y	Y
KS (l)	0.0	6.625	0.0	Y	Y	Y	N	Y
KY (c,e)	0.0	0.001	0.95	Y	N	N	N	Y
LA (c,m)	0.0	0.0	0.0	N	N/A	N	N	Y
ME (a,h)	0.0	1.0	0.14	Y	Y	Y	N	Y
MD	0.0	7.0	0.0	Y	Y	Y	N	Y
MA	0.0	12.54	0.0	N	Y	Y	Y	Y
MI (j)	0.0	0.0	0.0	Y	N/A	N	N	Y
MN (h,n)	0.0	9.8	0.0	Y	Y	Y	Y	Y
MS (f,h,l)	5.0	0.25	0.0	N	N	N	N	Y
MO (h,r)	5.0	7.0	0.05	N	Y	Y	N	Y
MT (h)	0.0	7.329	0.0	Y	Y	N	Y	Y
NE (o)	0.0	0.469	0.0	N	N	N	N	Y
NV	0.0	0.0	0.0	N	N/A	N	N	N
NH (i)	8.0	1.0	0.0	N	N	N	N	N
NJ (h)	0.0	9.375	0.0	Y	Y	Y	Y	Y
NM (b,l)	7.6	0.0	0.0	Y	N/A	N	N	Y
NY (h)	0.0	10.35	0.0	Y	Y	Y	Y	Y
NC	7.905	0.003	0.0	Y	N	Y	N	Y
ND (h)	0.0	7.0	0.0	Y	Y	Y	N	Y
OH (c,h)	0.0	1.5	0.0	Y	N	N	N	N
OK (h)	6.0	0.125	0.0	Y	N	N	Y	Y
OR (h)	0.0	6.6	0.0	Y	Y	Y	Y	Y
PA	0.0	0.0	1.25	N	N/A	N	N	N
RI (h)	0.0	8.0	0.0	N	Y	N	N	Y
SC (g)	0.0	4.5	0.0	N	Y	Y	N	Y
SD (h)	0.0	6.0	0.0	Y	Y	Y	Y	Y
TN (i)	6.0	0.25	0.0	Y	N	Y	Y	Y
TX (p)	0.0	0.25	0.0	N	N	N	N	N
UT (h)	0.0	5.0	0.0	Y	Y	Y	Y	Y
VT	0.0	0.000040	0.0	N	N	N	N	Y
VA	0.0	1.0	0.0	Y	N	Y	N	Y
WA (k)	0.0	0.0	0.0	Y	N/A	N	N	N
WV (h)	9.0	0.75	0.0	Y	N	N	Y	Y
WI (h)	0.0	8.3345	0.0	Y	Y	Y	Y	Y
WY	0.0	0.0	0.0	N	N/A	N	N	N

(Table 6 continued on next page.)

(Table 6 continued.)

<i>Notes:</i>
N/A not applicable.
a. The share tax is a franchise tax levied on assets.
b. Levies a \$50 franchise tax.
c. Levies an intangible property tax.
d. The tax listed as a franchise tax is a gross receipts tax on depository institutions.
e. The tax listed as a franchise tax is an intangibles tax on deposits. There is also an intangibles tax of 1.5% on accounts receivable, notes, bonds, credits, etc.
f. Levies a share tax, but it is a credit against the personal property tax.
g. This tax is an income tax, but not the corporate income tax.
h. Minimum tax is levied in the event no income is earned.
i. The capital stock and dividends tax paid can be credited against the income tax.
j. Levies the Single Business Tax (2.3% of the adjusted tax base).
k. Not all state and local government interest is taxable.
l. This is the highest marginal tax rate levied on income.
m. All property, including intangibles, is taxed at a rate equal to the aggregate of all lawful levies and is assessed at a percentage of fair market value or use value.
n. There is an additional franchise tax equaling the excess of 5.8% of minimum alternative taxable income over the basic tax imposed.
o. The Nebraska Bank Franchise Tax equals 12.3 times 48.8% of the maximum corporate tax rate, expressed in cents, multiplied by the amount of average deposits of the financial institution in thousands of dollars.
p. The tax is the greater of 4.5% of net taxable earned surplus and 2.5% of net worth.
q. The tax listed as a share is a tax on capital stock and can be credited against the excise tax.
r. Banks may credit taxes paid under the corporate income tax against the bank franchise tax.
<i>Source:</i> Commerce Clearing House State Tax Guide, 1993; Alabama State Franchise Tax Board; Connecticut Department of Revenue; Delaware Office of the Bank Commissioner; Mississippi Tax Commission; Missouri Franchise Tax Board; North Dakota Tax Commission; Oregon Department of Revenue; Rhode Island Department of Administration; South Carolina Tax Commission; Vermont Department of Banking and Insurance; Virginia Department of Revenue.

(Text continued from page 102.)

bank revenues grew only 0.35 times as fast as personal income from 1970 through 1991. The elasticity was negative for the 1983 to 1991 time period (a full business cycle).

Massachusetts banks also made significant payments to the Division of Banking for fees and examinations. Commercial, cooperative, and savings banks paid \$4.7 million in examination fees and another \$6.3 million in asset based charges during 1992. The Division of Banking spends about one-half of its receipts for operations, meaning more than \$5.0 million in fee and examination revenue was available for the general fund.

Data from the combined 1990 returns of all banks are provided in Table 4 by type of bank charter and in Table 5 by bank size.²⁷ Table 4 includes data summed across banks and both Tables 4 and 5 provide data for the average bank. Line 1 of the bank tax return, called net income, is taken from line 28, Federal Form 1129 of the federal income tax return. The sum of all banks had negative net income in 1990, most of which was the result of poor performance by national banks.²⁸ A total of 118 of the 351 banks had negative net income in 1990, and by category, only banks with assets of less than \$50 million had positive net income. Lines 2 through 6 in the tax return (and tables) are adjustments required by Massachusetts. The adjustments generally are deductions or exclusions that the federal

government allows in calculation of taxable income, but which Massachusetts does not. The largest adjustments are for interest earned on state and municipal debt; foreign, state or local taxes deducted on the federal return; and dividends received. The net effect of adjustments is to raise bank taxable income relative to net income, as shown in line 7. Both international and trust banks had positive adjusted taxable income, though their net income was negative. Those banks earning positive income paid taxes, so a substantial tax liability was incurred despite the negative combined income of banks. Note, as measured by assets, national banks are much larger than the other bank groups, followed by trust, savings, cooperative, and international banks.

4.c. Bank Taxes in Other States

Many states continue to impose different tax structures on bank and nonbank corporations. Only about 23 states use the same structure for both, though even in these states the tax code may have different features for the two types of corporations.²⁹ Given the history of federal legislation, states normally use share, franchise, or income taxes. The share taxes likely remain from the 1800s, when share taxes were the only federally permissible tax structure. Though termed share taxes, the bases differ widely and include value of banking shares, deposits, or another indicator of intangible personal property. The base definition for corporate income taxes is normally a variant of federal taxable income, though as noted above, interest from

²⁷The data in Tables 4 and 5 are for the banks' 1990 tax year, not for the Commonwealth's fiscal years, as reported in Table 3.

²⁸Data from 1990 tax returns is reported because they were available. The data are not representative of an average year.

²⁹See Fox and Kelsay (1992).

federal securities is not taxable under this structure. The base for franchise taxes is either a measure of income (like an income tax) or the value of intangible property (like a share tax). Thus, franchise taxes have bases which are similar to either an income or a share tax.

Fifteen states impose an income tax, 40 have a franchise tax, and 7 use share taxes (see Table 6). These state totals include 15 states that use more than one form of taxation. Also, a number of states impose franchise taxes using both an income and a share base. Banks are taxed with the single business tax in Michigan. Louisiana, Nevada, and Wyoming have no statewide tax on banking.

Tax rates on income (using either an income- or franchise-based tax) range from 12.54 percent in Massachusetts to 0 in 12 states. Rates on assets (using either a share tax or a franchise tax) are more difficult to compare because of the widely different bases. The business and occupations tax in Washington has the highest rate (which is actually levied on receipts) at 1.5 percent and 31 states with a 0 rate have the lowest.

5. Evaluation of Massachusetts' Bank Tax Structure

The Special Commission on Business Tax Policy has been asked to evaluate the Commonwealth tax structure according to the criteria of equity, efficiency and simplicity. Most economists agree that these criteria are most likely to be met when all bank and nonbank corporations are taxed at the same effective tax rate.

Economists normally argue that taxes are efficient, or neutral, when they are imposed so that any influence on economic decisions of people and businesses is minimized. The reason is the economy's production and people's well-being are at their highest level when taxes do not distort decisions. The best practical rule for limiting tax distortions is to impose the same effective tax rate on all firms.³⁰ An even or neutral rate means that tax rates will not make investment in one industry more attractive than investment in another.³¹ Unless taxes are imposed at the same rate, firms have an incentive to shift resources

³⁰In theory taxing all firms at the same rate may not be the best strategy. The reason is that a corporate income tax cannot be neutral, since even if it does not distort the return to investment in different industries it will distort decisions regarding the use of capital versus labor and decisions on whether to incorporate. Given these distortions (or nonneutralities), the best tax structure probably would imply different rates across industries, with the highest tax rates on those industries that are least able to adjust their relative use of capital versus labor in response to tax rates. However, available data are too limited to reveal how rates should vary across industries to achieve maximum efficiency. Consequently, imposing the same effective rate on all industries is likely to produce the least distortion.

³¹Neutrality does not require that all industries and all firms be taxed using exactly the same structure, only that the effect on marginal rates of return be the same. Thus, the fact that nonbank corporations and banks are taxed with different structures in Massachusetts does not on the face make the taxes nonneutral.

Detailed analysis of neutrality requires examination of the tax structure facing every industry and the supply and demand conditions in every industry that the ability to shift taxes to consumers, employees, or other resource holders can be determined. No studies of this detail have been performed for Massachusetts and such analysis is beyond the scope of this manuscript. Thus, this study relies solely on analysis of the initial incidence of taxes rather than on the final incidence (after considering the ability to shift taxes to others) and the assumption is that equal tax burdens result in equal effective tax rates.

from production in industries with the highest tax rates and to industries with the lowest tax rates.

Equity is a difficult concept to apply to business taxes in the same way that it is applied to personal taxes, since we often are uncertain whether business taxes are shifted forward to consumers, backwards to labor, or are borne by shareholders. Business taxes can be evaluated more effectively in terms of the benefit principle, which proposes that firms pay taxes in relationship to the benefits they receive from public services. Again, the best means for achieving equitable taxation is imposition of an even tax rate on all firms.³²

Similarly, administrative and compliance costs should be lower with an even tax rate, and particularly when the same tax structure is imposed on all firms. Differential rates require decisions on which rates to set for each industry and in which industry firms should be categorized. These decisions entail greater effort in auditing firms and in determining what rate should be imposed.

The Massachusetts bank tax structure leads to very different tax burdens across industries. Therefore, the existing bank tax structure fails to achieve the goals of equity, efficiency, and simplicity laid out for the Commission. In fact, the Massachusetts tax structure encourages banks to shift the production of financial services outside the Commonwealth. The Massachusetts structure does not tax the financial industry in a neutral or even fashion for the following reasons:

1. Taxes are levied on a residence basis so that domiciled banks pay taxes to the Commonwealth and nondomiciled banks do not pay bank taxes;
2. Massachusetts banks are less competitive in other states because they are taxed on some income earned outside the Commonwealth;
3. The tax structure requires each bank member of a holding company to be treated as a separate entity for tax purposes;
4. Failure to include the entire financial industry in the bank tax structure so that banks pay higher taxes than firms in most other financial industries;
5. Banks and nonfinancial corporations are taxed with different structures;
6. Imposition of the highest tax rate in the country on banks and of a tax rate which is higher than that imposed on many other corporations in the Commonwealth.

The remainder of this section contains a description of how each issue causes uneven taxes, and a discussion of the resulting problems.

5.a. Tax Treatment of Domiciliary and Nondomiciliary Banks

The residence based structure places Massachusetts-domiciled banks at a competitive disadvantage on their operations in the Commonwealth and in their efforts to sell services in other states. This sub-section addresses the problems created in Mas-

³²Nonetheless, the corporate income tax is not the optimal mechanism for taxing firms according to the benefits received from public services. One important reason is that non-profitable firms and unincorporated businesses pay no taxes but both groups of firms benefit from public services. Oakland (1992) argues that a state value added tax would be a much better proxy as a benefit tax.

sachusetts, and the next sub-section examines the problems outside the Commonwealth.

Both domiciled and nondomiciled banks provide financial services in the Commonwealth. Domiciled banks have higher costs than nondomiciled banks since only domiciled banks are subject to the Commonwealth's bank taxes.³³ This means domiciled banks must accept lower rates of return on their investment or they must find ways to raise the interest rates they charge or to increase other fees for consumers.

An example can illustrate how two hypothetical banks, one domiciliary and one nondomiciliary, are treated (Box 1). Assume each earns \$1 million during a particular year making loans in Massachusetts, with the domiciliary bank having all of its property and workers in Massachusetts and the nondomiciliary bank having all of its property and workers in its home state.³⁴ The domiciliary bank pays \$125,400 ($\$1,000,000 \times 0.1254$) in taxes to Massachusetts. The nondomiciliary bank has no Massachusetts bank tax liability.³⁵

The nondomiciliary bank may have taxable income in its home state, depending on the particular tax law in effect.³⁶ A common approach when a nonbank corporation earns income in several states is to apportion the income across states for tax purposes using a three factor formula. The formula is based on a simple average of the percent of receipts, payroll, and property in each state.³⁷ The home state for the nondomiciled bank would have all of the payroll and all of the property in this example, so it would be able to tax two-thirds of the income. Exactly how receipts would be handled in the formula is less obvious since the other state could either attribute them to itself or to Massachusetts, depending on where the loan was made and the specific attribution rules. Here we will presume the receipts are attributed to Massachusetts. In this case the nondomiciled firm will pay taxes on \$666,667 ($\$1,000,000 \times 0.6667$) because the apportionment formula allows it to tax two-thirds of the income. The median tax rate for corporate taxes in the U.S. is 7 percent (in North Carolina, for example), so the tax liability in the median state would be \$46,667 ($\$666,667 \times .07$).

The conclusion of the example is the Massachusetts domiciled bank pays \$125,400 in taxes and the nondomiciled bank pays \$46,667 in taxes, but not to Massachusetts. The total tax liability for some nondomiciled banks could be zero, depending on the apportionment formula in the state where the bank is domiciled and on whether the state has a tax on bank income. The differential tax liability arises because Massachusetts has a very high marginal rate on bank income,

because Massachusetts' lack of apportionment rules may lead to some nondomiciled bank income going untaxed, and because the tax is structured on an origination basis.³⁸

Box 1			
Assumptions:			
1. Bank A domiciled in Massachusetts.			
2. Bank B domiciled is another state.			
3. Both banks earn \$1,000,000 operating in Massachusetts			
4. Two-thirds of the nondomiciled bank's income is taxable in the other state.			
5. The other state imposes a 7-percent tax rate on bank income			
Bank	Taxable Income	Tax Rate	Tax Liability
Massachusetts Tax Liability			
A	\$1,000,000	0.1254	\$125,400
B	0		0
Other State Tax Liability			
A	0		0
B	666,667	0.07	\$46,667
Total Tax Liability			
A			\$125,400
B			\$46,667

Credit card activity is a good example of Massachusetts' problem in taxing nondomiciliary banking services. The Massachusetts Bankers Association reports that 86 percent of the credit card market is not taxed by the Commonwealth, because the credit card services are sold through branchless means.³⁹ Banks delivering credit card services to the other 14 percent of the market are taxed in Massachusetts and will pay much higher taxes than their competition. Securitization of loans is another example. Loans can be made in the Commonwealth, and then packaged and resold as securities to nondomiciliary financial institutions. Taxes paid on interest earned by the nondomiciliary firm will be lower than for a loan held by a domiciliary banks.

One implication of the tax structure is that a nondomiciled bank minimizes its tax burden by continuing to sell services from outside the Commonwealth, rather than by opening a Massachusetts bank. Alternatively, a nondomiciled holding company can keep its tax burden low by opening a small Massachusetts bank and delivering most services from nondomiciled subsidiaries.

5.b. Failure To Recognize Income Earned Outside the Commonwealth

A second problem with the residence based tax structure is domiciled banks pay taxes to the Commonwealth on income earned in other states. As a result, Massachusetts banks are disadvantaged on their operations outside the Commonwealth because they are taxed at Massachusetts' high rate. In addition the Commonwealth's banks may pay taxes to the other state.

³³Nondomiciled bank holding companies may open bank subsidiaries in Massachusetts. These subsidiaries are domiciled in Massachusetts and are taxed as any other domiciled bank.

³⁴Thus, the nondomiciliary bank is selling financial services through branchless means or through a nonbank firm.

³⁵Some tax liability could exist under the Massachusetts corporate excise tax if the nondomiciled bank operated through a separate nonbank company, whether headquartered in the Commonwealth or elsewhere.

³⁶Legislation in many states allows apportionment, but banks in few states appear to be actually apportioning at this time. Thus, the entire income of the nondomiciliary bank may be taxed in the home state. Banks in California, West Virginia, New York, Tennessee, and Minnesota may be exceptions.

³⁷Use of the three factor formula for bank income is much less common than for other corporations. The advantages and disadvantages of alternative formulas are addressed in Sections 7.a.2., 7.a.3., and 7.a.4.

³⁸The actual cost of taxes to corporations also depends on the federal corporate tax liability. The differential between the banks would be lower as state taxes are deducted in calculation of federal corporate income taxes.

³⁹Testimony of the Massachusetts Bankers Association in Support of H 2378 and H 2568 relative to bank taxation and competitive equality, March 31, 1992.

The following example illustrates the problem (Box 2). Suppose a Massachusetts domiciled bank earns \$1,000,000 on loans made to businesses located in North Carolina and a North Carolina bank also earns \$1,000,000 on activity in North Carolina. The Massachusetts bank pays \$125,400 ($\$1,000,000 \times 0.1254$) in taxes to the Commonwealth and the North Carolina bank pays \$70,000 ($\$1,000,000 \times 0.07$) in taxes at home.⁴⁰ The Massachusetts bank is competitively disadvantaged because it must pay \$55,400 more in taxes, yet the two banks must obtain capital from the same national capital market. Competition prevents the Massachusetts bank from charging higher interest rates on loans outside the Commonwealth. Thus, the Massachusetts tax would be expected to lower the amount of loans that could be made by domiciled banks and the tax is likely to be borne by factors located in Massachusetts. The result is lower wages and rents earned by Massachusetts residents and property.⁴¹

Box 2			
Assumptions:			
1. Bank A domiciled in Massachusetts.			
2. Bank B domiciled in North Carolina.			
3. Both banks earn \$1,000,000 operating in North Carolina.			
4. None of Bank A's income is taxable in North Carolina.			
Bank	Taxable Income	Tax Rate	Tax Liability
Massachusetts Tax Liability			
A	\$1,000,000	0.1254	\$125,400
B	0		0
North Carolina Tax Liability			
A	0		0
B	\$1,000,000	0.07	\$70,000
Total Tax Liability			
A	\$1,000,000		\$125,400
B	\$1,000,000		\$70,000

The problem for Massachusetts' banks is exacerbated if North Carolina apportions corporate income for tax purposes (Box 3). The Massachusetts bank continues to pay \$125,400 in taxes to the Commonwealth. Assume North Carolina uses a three factor formula based on payroll, property and receipts to apportion corporate income and the Massachusetts bank has all of its payroll and property at home. The Massachusetts bank would pay \$23,333 in taxes to North Carolina ($\$1,000,000 \times 0.333 \times 0.07$).⁴² Thus, the total tax burden for the Massachusetts bank is \$148,733 ($\$125,400 + 23,333$) versus \$70,000 for the North Carolina bank. Note that in total the Massachusetts bank is taxed on 133 percent of its income (\$1,333,333), since all income is taxed at home plus one-third of income is taxed in North Carolina.

⁴⁰North Carolina banks also pay a franchise tax using a share tax base, so the tax differential is not as great as the illustration suggests.

⁴¹The demand in Massachusetts for bank employees and other inputs used by banks will decline with banking activity, meaning wage rates and other input prices may fall in Massachusetts.

⁴²The Massachusetts bank is presumed to have nexus in North Carolina. The Massachusetts bank pays tax on a simple average of its share of payroll, property, and receipts in North Carolina. In this case, the bank has 100 percent of the receipts and 0 percent of the property and payroll in North Carolina. These three percentages are summed and divided by 3 to determine the 33.3 percent share taxed in North Carolina.

Box 3			
Assumptions:			
1. Bank A domiciled in Massachusetts.			
2. Bank B domiciled in North Carolina.			
3. Both banks earn \$1,000,000 operating in North Carolina.			
4. One-third of Bank A's income is attributed to North Carolina.			
Bank	Taxable Income	Tax Rate	Tax Liability
Massachusetts Tax Liability			
A	\$1,000,000	0.1254	\$125,400
B	0		0
North Carolina Tax Liability			
A	\$333,333	0.07	\$23,333
B	\$1,000,000	0.07	\$70,000
Total Tax Liability			
A			\$148,733
B			\$70,000

Box 4			
Assumptions:			
1. Bank A domiciled in Massachusetts.			
2. Bank B domiciled in Tennessee.			
3. Both banks earn \$1,000,000 operating in Tennessee.			
4. All of Bank A's income is attributed to Tennessee.			
Bank	Taxable Income	Tax Rate	Tax Liability
Massachusetts Tax Liability			
A	\$1,000,000	0.1254	\$125,400
B	0	0	0
Tennessee Tax Liability			
A	\$1,000,000	0.06	\$60,000
B	\$1,000,000	0.06	\$60,000
Total Tax Liability			
A			\$185,400
B			\$60,000

The Massachusetts bank is taxed on 200 percent of its income (\$2,000,000) if it operates in Tennessee rather than North Carolina (Box 4). Tennessee uses a single receipts-based factor to apportion income.⁴³ The bank pays \$125,400 to Massachusetts and \$60,000 to Tennessee ($\$1,000,000 \times 0.06$) at Tennessee's 6 percent tax rate, resulting in a total tax burden of \$185,400. Few states are apportioning the income of non-domiciled banks at this time, so the potential for double taxation is limited, but the likelihood of double taxation is growing.

5.c. Taxing Each Member of a Holding Company Separately

In Massachusetts, each bank member of a holding company is treated as a separate taxpayer, resulting in potential advantages and potential disadvantages for Massachusetts banks. The disadvantage for banks can be illustrated with a holding company that has one bank member that earns \$100,000 and one that loses \$100,000 during a particular year. Under

⁴³Tennessee is used in this example because it is the only state with a totally destination based tax structure. The box illustrates how a Massachusetts bank would actually be taxed in Tennessee.

Massachusetts' bank tax law the profitable bank pays \$12,540 in taxes and the unprofitable bank pays zero. However, the holding company would have zero income and zero tax liability if it was treated as a unitary being. Members of a nonbank holding company are permitted to file a combined return and would have zero tax liability.

The advantage for banks is this rule, in combination with Massachusetts relatively high tax rate and its taxation of banks on a residence principle allows (and encourages) domiciled bank holding companies to avoid Massachusetts' bank taxes by producing services outside the Commonwealth. The holding company can offer retail bank services, such as accepting deposits, through a domiciled member of the holding company. Then, a nondomiciled member of the holding company can be established in a state with low or no taxes on bank corporations. The nondomiciled member can offer credit card services to residents of the Commonwealth, operate as the major source of loans for the holding company, or buy loans from the domiciled member of the holding company and pay much lower taxes to another state. The Commonwealth raises less tax revenue and has lower bank employment as a result. The other state is beneficiary of the employment and depending on its apportionment rules, may enjoy an increase in its tax revenue.

To illustrate this incentive, consider two bank structures (Box 5). One is a bank that operates solely in Massachusetts, earns \$1,000,000 of net income, and pays \$125,400 in taxes. The second is a bank holding company that is domiciled in Massachusetts and owns a Massachusetts bank that earns \$500,000 in net income and a nondomiciliary bank that earns \$500,000 based on loans made in Massachusetts.

Box 5			
Assumptions:			
1. Bank A domiciled in Massachusetts.			
2. Bank B is a holding company domiciled in Massachusetts.			
3. Bank B has a Massachusetts (M) and a non-Massachusetts (NM) subsidiary.			
4. Bank A earns \$1,000,000 operating in Massachusetts.			
5. Bank B earns \$500,000 through its M subsidiary and \$500,000 through its NM subsidiary, both on operations in Massachusetts.			
6. B is illustrated as the sum of M and NM.			
7. Two-thirds of the NM income is attributable to another state.			
Bank	Taxable Income	Tax Rate	Tax Liability
Massachusetts Tax Liability			
A	\$1,000,000	0.1254	\$125,400
B	\$500,000	0.1254	\$62,700
M	\$500,000	0.1254	\$62,700
NM	0	0	0
Other State Tax Liability			
A	0		0
B	\$333,334	0.07	\$23,333
M			
NM	333,334	0.07	\$23,333
Total Tax Liability			
A	\$1,000,000		\$125,400
B	\$833,334		\$86,033
M	\$500,000		\$62,700
NM	\$333,334		\$23,333

The holding company pays \$86,033 in taxes to the two states in which the banks are headquartered. This tax liability is the result of \$62,700 in taxes due to Massachusetts (\$500,000 x 0.1254) plus \$23,333 in taxes to the state where the second bank is domiciled (\$500,000 x .667 x 0.07).⁴⁴ Further, the bank holding company could increase its after tax profits, by lowering its total tax burden, as it shifts more of its activity to the non-Massachusetts subsidiary.

In addition, treatment of each bank affiliate as a separate taxpayer provides an incentive for affiliates to sell each other assets and services and price these intracompany sales in ways that minimize their taxable income in states with a high bank tax rate, such as Massachusetts. For example, if one bank sells loans to an affiliate, the price of the loans appears as a cost on the books of the buyer and as receipts on the books of the seller. By law, affiliated companies in all industries are required to price sales and transfers among themselves "at arm's length" — according to the prices of comparable transactions occurring among independent firms. In practice, comparably priced transactions among independents are difficult to identify. With such little objective guidance available to either tax enforcers or taxpayers, a Massachusetts bank has an incentive to set a low price for loans sold to affiliates located in states with a lower bank tax rate than the Commonwealth's. The low price reduces the taxable income of the Massachusetts bank and raises the income (by lowering the costs) of the non-Massachusetts affiliate.

Banks lacking nondomiciled subsidiaries are not able to benefit from the imprecision of pricing inter-affiliate transactions. The treatment of affiliates as separate taxpayers may result in unevenness between small banks, that may be less able to establish affiliates, and large banks.⁴⁵

The first three points have evidenced that Massachusetts has structured its bank tax in a very nonneutral fashion. Despite the discouragement of some economists, other states often create nonneutral taxes as well, but normally with the intent of attracting jobs and other economic activity.⁴⁶ However, Massachusetts has designed a nonneutral bank tax which achieves the reverse — banks are encouraged to shift their economic activity outside the Commonwealth.

5.d Several Tax Structures for Financial Institutions Taxes

Credit unions, insurance companies, credit card companies, loan companies, and other nonbank financial institutions are taxed with different structures than banks and probably face nonneutral taxation relative to banks. Even bank holding companies are taxed with a different structure than the banks they own. With the possible exception of insurance companies, banks appear to pay greater taxes than their direct competitors.

⁴⁴The nondomiciliary bank is assumed to be taxable on 100 percent of its property and 100 percent of its payroll and zero percent of its receipts in the home state. The bank is taxable at home on the simple average of these percentages, or 66.7 percent.

⁴⁵Small banks, like large banks, may resell loans through a secondary market, so they have some means to avoid Massachusetts' high taxes.

⁴⁶Double weighting the sales factor when apportioning corporate income, as is done by Massachusetts and a number of other states, is one example of a structural characteristic that is intended to attract economic activity (See Maury and Graeser, *State Tax Notes*, Feb. 1, 1993, p. 227, for a review). Tax credits for job creation are another example of non-neutralities in the tax structure that are intended to encourage economic development (see Fox and Murray, 1993).

Table 7

**A Comparison of the Massachusetts Tax Burden of a Representative Bank With
That of a Representative Nondepository Credit Institution**

	Bank (1)	Nondepository Credit Institution (2)
1. Net income before federal, state, and local taxes	\$10,000,000	\$10,000,000
2. Federal taxable income	5,797,029	6,586,677
3. - Deduction for dividends permitted under Massachusetts law	Not permitted	588,494
4. + Federal deduction for dividends received	147,652	435,933
5. + Federal deductions for net loss carryovers	1,751,922	n.a.
6. + Federal deduction for taxes paid	1,418,885	1,087,801
7. + Federal exclusion for interest on state and local obligations	732,326	943,376
8. Equals: Estimated Massachusetts taxable income	9,847,764	8,465,293
9. Estimated Massachusetts income tax	1,234,910	804,203
10. Net Worth	n.a.	72,864,214
11. - Property taxable at local level	n.a.	14,543,628
12. + Mortgage indebtedness	n.a.	98,960
13. Equals: Estimated taxable net worth	n.a.	58,418,946
14. Estimated net worth tax	n.a.	151,889
15. Total Massachusetts income and net worth taxes as a percent of net income (tax burden) [(row 9 + row 14)/row 1] X 100.	12.35%	9.6%
n.a.: not applicable.		
<i>Sources:</i> Calculations by the staff of the Massachusetts Special Commission on Business Tax Policy and U.S. Internal Revenue Service, <i>Corporation Source Book</i> .		
<i>Statistics of Income</i> , 1987, 1988, and 1989.		

The greater tax burden on banks raises their costs relative to their competitors and presumably makes it more difficult for banks to be profitable and to attract business.

A quick review can illustrate the different ways that financial institutions are taxed. Credit unions are not taxable under either the bank tax or the corporate income tax. A justification for leaving credit unions untaxed is that though Congress has given states authority to tax federal banks, it has not sanctioned states to tax federally chartered credit unions. Federally chartered credit unions only can be taxed on their real and tangible personal property. States have approached the exemption in a variety of ways, but generally exempt all credit unions from income, franchise and share taxes. Nonetheless, state chartered credit unions are taxable in several states including Rhode Island, Alabama, and Nebraska. The exemption gives credit unions a tax advantage, but the lack of neutrality cannot be fully overcome without congressional legislation. Massachusetts should consider pushing for congressional approval to tax credit unions. H. B. 4037 extends the bank tax to state credit unions.⁴⁷

The major tax levied on insurance companies is assessed as a percentage of premiums, and is a gross receipts rather than an income tax.⁴⁸ Research in other states has concluded that

⁴⁷Also, the Massachusetts Bankers Association is supporting legislation to require credit union members to have a "common bond." A common bond is required for federally chartered credit unions and in some states for state chartered credit unions. The idea is to limit credit union expansion unless they are subject to the same regulatory and tax regimes as banks.

⁴⁸Insurance companies and banks compete in a number of markets. For example, the savings component of many insurance policies competes with saving options at banks.

gross receipts taxes on insurance companies are a greater percentage of their net income than the income tax which is imposed on banks and other firms.⁴⁹ However, the final conclusion on whether banks or insurance companies face the greater tax burden depends on the assumption about which has the greater ability to shift taxes to consumers, labor, or others. Also, the high bank excise tax rate in Massachusetts will make bank and insurance company taxes much closer.

Loan companies, credit card companies and others are taxed through the nonbank corporate tax structure and are subject to the net worth tax of \$2.60 per \$1000 and the 9.5 percent corporate income tax. Bank holding companies can choose to be taxed through a 0.33 percent levy on gross income in lieu of the nonbank tax structure. Bank holding companies adopt this option relatively infrequently.

Tannenwald (1988) estimated the tax liability for a representative nondepository credit institution such as a loan company, and compared the tax burden with a representative bank. His fictitious, representative nonbank credit institution was created using data for all profitable nonbank institutions. Thus, the firm represented the average characteristics of all such firms and the tax burden was the average tax liability.

The Tannenwald study was updated by Special Commission Staff using data for 1987, 1988, and 1989 (see Table 7). The tax burden for the representative nondepository is comparable to a 9.6 percent tax rate on net income versus an average of 12.35

⁴⁹See Fox (1991).

percent for banks.⁵⁰ Thus, the tax burden on banks is estimated to be 28.6 percent greater than the burden placed on non-depositaries.

The example of a bank earning \$1,000,000 can be used to compare the tax liability of depository and nondepository financial institutions (Box 6). Bank A pays \$123,500 in taxes and a nondepository financial institution with the same \$1,000,000 in income pays only \$96,000 ($\$1,000,000 \times 0.096$) in Massachusetts taxes, even though both firms may be delivering the same financial service. Further, the differential tax structure gives banks the incentive to form subsidiaries which are taxable as nonbanks. For example, the bank can reduce its tax liability from \$123,500 to \$109,750 if it can move one-half of its income into a nonbank subsidiary. The bank would owe \$61,750 in taxes on income taxed as a bank ($\$500,000 \times 0.1235$) plus \$48,000 on its nonbank income ($\$500,000 \times 0.096$). A bank owned mortgage company is one form of a nonbank subsidiary.

Box 6			
Assumptions:			
1. Bank A domiciled in Massachusetts.			
2. Firm B is a nonbank financial institution headquartered in Massachusetts.			
3. Bank A and Firm B both earn \$1,000,000 making loans in Massachusetts.			
4. The effective tax rate on nonbank financial institutions' income is 9.6 percent and for banks is 12.35 percent.			
Bank	Taxable Income	Tax Rate	Tax Liability
A	\$1,000,000	0.1235	\$123,500
B	\$1,000,000	0.096	\$96,000

The nonbank subsidiaries of nondomiciled multi-state financial institutions which operate in Massachusetts may be taxable under the corporate excise tax, but their tax liability likely is very small. For example, loan production offices, though taxable through the corporate excise tax will have very little taxable presence because interest is not included in the receipts factor and payroll and property are very limited for a loan production office.

5.e. A Different Tax Structure for Nonbank Corporations

This section further considers differences between bank and nonbank tax structures. In Massachusetts, nonfinancial corporations also pay the 9.5 percent corporate income tax and the \$2.60 per \$1000 net worth tax rate. A study by the Executive Office of Administration and Finance found the effective tax rate on banks is 10 to 20 percent higher than for other corporations.⁵¹ The analysis reported in Table 5 suggests the differences could be even greater. However, actual liability as a percent of corporate income for individual firms depends on a corporation's net worth relative to its profitability. Only relatively unprofitable firms would have a greater tax liability with

the nonbank structure than with the bank structure. Specifically, firms having net income of less than 8.6 percent of worth would have greater tax liability with the nonbank structure.⁵²

Several other differences between the bank and nonbank tax structures complicate comparison of the tax burdens.⁵³ One example is that nonbank corporations are permitted to apportion income across states using a three factor formula. Thus, Massachusetts taxes the share of income corresponding to the average of the corporations' payroll, property, and double weighted sales which are located in the Commonwealth. Apportionment allows domiciled nonbank corporations to pay taxes on only a share of total corporate income while domiciled banks must pay on 100 percent of income. On the other hand, nondomiciled corporations must apportion a share of income to Massachusetts but nondomiciled banks, including members of Massachusetts holding companies, are not required to apportion income to the Commonwealth. Failure to apportion the income of nondomiciled banks makes it easier for both domiciled and nondomiciled banks to avoid taxes. Other differences in the bank and nonbank tax structures include treatment of loss carryforwards and availability of special tax credits.

Structural differences in the bank and corporate taxes raise some uncertainty whether a bank holding company, viewed as a single business, will pay more or less taxes than a unified nonbank corporation. But it seems very likely that businesses will have widely different tax burdens while using these disparate tax systems.

5.f. Massachusetts Imposes a High Marginal Tax Rate

Banks domiciled in Massachusetts pay higher tax rates on each additional dollar of income than do banks in other states (see Table 4). High tax rates on domiciled banks are an important reason for the problems identified in points 5.a through 5.e.

6. Massachusetts' Bank Tax and Economic Development

Increasing the rate of economic growth is a primary goal for most state governments, and tax systems frequently are designed with this goal in mind. This section examines effects which the Commonwealth's bank tax structure can be expected to have on economic growth.

Bank taxes can influence economic development directly and indirectly. Taxes have a direct influence through impacts on employment and income generation in the banking industry. Bank taxes have indirect influences on other industries through multiplier effects and through access to credit.

6.a. Situs of Banking Activity

The best way to evaluate economic development implications of bank taxes is to begin with consideration of what banks

⁵⁰The tax burden for nondepositories is lower than the 10.4 percent Tanenwald found in the initial study, substantially because of the loss carry-forward provision available for nonbanks.

⁵¹This is the most recently available study, despite having been undertaken in 1984.

⁵²The total tax liability is greater for nonbank corporations when the net worth tax burden as a share of corporate income is greater than the corporate and bank income tax rate differentials. The net worth tax is a greater burden when net worth is 11.7 times or more greater than net income (calculated as the difference between the bank and nonbank income tax rates divided by the net worth tax rate). A company's value is more than 11.7 times greater than its income when its rate of return on net worth is less than 8.6 percent.

⁵³See section 7.d.

do. In a simplistic sense, the functions performed by banks can be categorized in two groups. First, banks undertake retail functions, such as making loans and accepting deposits. Second, banks perform production and wholesaling activities such as clearing checks, operating credit card processing centers, and reselling and holding loans. The importance of the distinction between retail and wholesale activities is that retail functions often must be located near the financial market, but wholesaling functions can be located almost anywhere in the U.S. Retail functions offered through branchless banking, also can be produced almost anywhere.

Tax structures may have little implication for location of market oriented retailing functions. These activities will be located near the consumer and the only effect of taxes may be to raise the price at which services are sold to consumers. However, taxes may be of importance to where production, wholesaling, and branchless banking services originate.

As has been described above, Massachusetts levies a higher marginal tax rate on bank income than any other state and imposes bank taxes using a residence based system. High tax burdens raise costs of doing banking business in Massachusetts vis-a-vis other states and can place the Commonwealth's banks at a relative disadvantage. However, taxes are only one factor influencing where banking activity occurs. Other factors include wage costs, availability of appropriately skilled labor, state bank regulations, and telecommunications infrastructural capabilities. Thus, whether taxes actually affect location decisions of banks is an empirical question.

Banks can engage in tax avoidance in three general ways. First, they can shift where they hold assets. For example, banks can reduce their tax liability on loans made in Massachusetts by securitizing the loans and reselling them to a member of the holding company domiciled in another state. Second, banks can change their portfolios to hold different types of assets. For example, banks could hold higher risk, higher return assets in high tax jurisdictions or they could hold federal bonds in states that do not tax the interest from such bonds. Third, banks can locate some of their economic activity, such as employment, in low tax areas and sell services into high tax states like Massachusetts. Thus, Citibank has located its credit card facility in South Dakota rather than New York, and the credit card activity of all but one of Massachusetts' largest banks has been sold to out-of-state firms.⁵⁴ Location of banking activity, including situs of employment and earned incomes, is the major concern of most state policymakers and the issue addressed further here. Resiting of assets and altered portfolio decisions, though not directly affecting economic activity, can reduce bank tax revenues.

6.b. Do Banks Avoid Massachusetts' Taxes?

Considerable research has been undertaken on the effects of state and local government taxes on business location, though most of the work has focused on manufacturing or on the entire economy.⁵⁵ Synthesis of the location research leads to the

⁵⁴Letter from Alan Morse, U.S. Trust Co. to Jonathan F. Light, Massachusetts Department of Revenue, December 28, 1990. The sale of credit and securities probably has occurred because the Massachusetts business climate for credit card activity, which includes effects of high taxes, is very poor. A recent DRI/McGraw Hill study concluded that Massachusetts is the least attractive state for credit card firms.

⁵⁵For surveys of the literature see Fox and Murray (1993), Wasylenko (1991), and Bartik (1991).

conclusion that high taxes reduce manufacturing and total employment in a state, but the effects of taxes are modest and may be of limited public policy importance.

Taxes may be more important in the location of production and wholesaling activities of banks than in the location of manufacturing facilities. The reason is that transportation costs for inputs and outputs, which frequently dominate location decisions for manufacturing firms, are much less important for banking activity.

Little research has examined defendants of where banking activity occurs. The sparse research identifies a limited, but growing effect of states' fiscal structures on the location of banking activity. Fox and Black (1993) found some evidence that tax structures are important determinants of the siting of banking activity, and that the trend is towards a greater effect of taxes on situs. Also, they conclude that Delaware and South Dakota have been effective in attracting banking through a combination of favorable regulatory policies and low taxes. Unfortunately, influences of the tax and regulatory environment cannot be disentangled. Finally, allowing interstate banking is consistent with more banking activity in a state. Wasylenko and McGuire (1985) found no evidence that state corporate income tax rates were important determinants of the percentage growth in the Finance, Insurance, and Real Estate industry. Their results indicated that high individual income tax rates for upper income residents discourage development of the industry, but subsequent work has failed to support this finding.

Research detects a smaller influence of taxes on the location of banking activity than was anticipated a priori, but several important observations should be noted. First, the most likely reason that research has uncovered little effect of taxes is that banks have only recently enjoyed the technological capability and regulatory leeway to alter such behavior easily. Interstate banking, branchless banking, and new banking technologies all have emerged very recently. Larger effects of taxes can be expected as banks become more astute at resiting their activities in response to tax differentials.

Second, the Wasylenko and McGuire research evidences that unusually high tax burdens have a much more than proportionate influence on location of economic activity than do small tax differences. Thus, the Massachusetts banking industry may be at a disadvantage even if the negative economic consequences of taxes normally are very small because Massachusetts tax burdens appear to be above national norms. Third, though Delaware and South Dakota have succeeded in attracting banking activity, other states seeking to emulate these two have been much less successful.

6.c. Nonbank Economic Effects

Bank taxes can influence nonbank employment and income generation in two ways. Incomes earned by employees and suppliers of the banking industry result in additional job creation as the incomes are spent and respent in Massachusetts. This process, often termed the multiplier effect, can be of considerable importance. The multiplier's size depends on many factors, but a reasonable rule of thumb, based on research with state econometric models, is that the state level multiplier is around 2 for banking services produced for sale outside the Commonwealth. This means about as many jobs and as much income is created in other industries as in the banking and supplier industries. Thus, banking lost because of high taxes has important effects on other industries.

Also, the Commonwealth's economy is diminished to the extent that taxes discourage banking, and less banking means less available credit. The extent of economic loss depends on two linkages: the effect of taxes on the presence of banking and the relationship between banking and availability of credit. These linkages are difficult to measure making the extent of economic effects hard to quantify. A reasonable expectation is that most lending activity would continue in the Commonwealth even with a reduced banking sector. Insurance companies, nondomiciled banks, and other substitute lenders would provide funds. Still, small-and medium-sized firms and emerging local businesses may be harmed by a reduced local banking sector in Massachusetts. Less available credit for these firms could be detrimental to the overall economy, since small and new firms have been the source of much U.S. job creation in recent years.

7. Alternatives for Restructuring Massachusetts Bank Tax

The above sections have illustrated that the Commonwealth's tax system is very uneven, at least in part because the regulatory based definition of banks and the tax structure that developed were designed for a time when interstate banking did not occur. The changing banking environment has made the current definition of banks and the current tax structure inappropriate for today. Firms in the banking industry are likely to pay a greater percentage of profits in taxes than are firms in many other industries. The higher tax burdens on banks mean taxes are not equitable since they bear no relationship to benefits from public services. Second, the tax structure is inefficient, making investment in the banking industry look less attractive than investment in other industries. Third, production of banking services in Massachusetts (whether for consumption inside or outside the Commonwealth) is taxed more heavily than banking services produced in other states. This discourages production of banking services in Massachusetts. Finally, large multi-state banks may be advantaged relative to small, single state banks.

This section identifies specific components of the tax system that must be restructured to offset existing disadvantages including: the geographic distribution of income, definition of tax base, level of tax rates, definition of the taxable entity, and definition of nexus. Alternative means for restructuring the tax system are identified and examined in terms of their strengths and weaknesses. Criteria for examining alternatives for the tax system are neutrality, equity, simplicity, and revenue impacts. Specific recommendations are not made.

7.a. Geographic Distribution of Income

A reasonable mechanism must exist for determining where the income of multistate and multinational corporations is to be taxed. Determination of where income is taxed is important to banks with multistate and multinational operations and to banks that have placed loans in another state or have other means of earning income outside the Commonwealth. The current Massachusetts tax structure has addressed the issue of geographic distribution of income in the simplest of ways. In general terms, bank taxes are imposed on all income earned by domiciled banks and on no income earned by nondomiciled banks. As described above, this residence based system differs from that used in nearly every state and that used by the Commonwealth for other industries.

Two major alternatives exist for the banking industry: a dual tax system and an apportioned system.⁵⁶ Each will be considered in succession.

7.a. 1. Dual Tax Structure

The dual tax structure has a separate framework for domiciled and nondomiciled corporations.⁵⁷ Domiciled corporations are taxed on a residence basis, meaning they must pay taxes on 100 percent of their income regardless of where it is earned, just as with the current system. The major difference from the existing system for domiciled banks is the dual structure allows a credit for taxes paid to other states.⁵⁸ With the dual structure, nondomiciled banks are taxed in the Commonwealth on an apportioned share of their income instead of the existing system which leaves nondomiciled state banks untaxed.

Apportionment of nondomiciled bank income makes the tax burden for domiciled versus nondomiciled banks more equitable and more neutral. Thus, the dual structure reduces incentives to produce banking activity outside of Massachusetts for sale in Massachusetts.

The dual tax structure is non-neutral in two important ways. First, banks still would be taxed at higher rates than nonbank corporations unless bank tax rates are lowered.

Second, the disadvantage of producing banking services in Massachusetts for sale to residents of other states is not eliminated with the dual structure. The dual structure effectively taxes domiciled banks at the higher of the Massachusetts and the other state's rate. An example can illustrate the problem. Suppose a Massachusetts bank earns \$1,000,000 operating in Tennessee (Box 7).⁵⁹ Tennessee charges the bank \$60,000 ($\$1,000,000 \times 0.06$) in corporate excise tax based on its 6-percent tax rate. Massachusetts gives the bank a credit for taxes paid to Tennessee, and this prevents the bank from being taxed more than once on the income. However, the residence based system leads to \$125,400 in taxes owed to the Commonwealth ($\$1,000,000 \times 0.1254$) less the \$60,000 paid in taxes to Tennessee. In total the bank pays Tennessee \$60,000 and Massachusetts \$65,400 ($\$125,400 - \$60,000$) for a tax liability of \$125,400. Other banks operating in Tennessee, regardless of their domicile, would have only a \$60,000 tax burden. Thus, the dual system effectively leaves domiciled banks paying taxes at the higher Massachusetts rate on their out-of-state activities, continuing to discourage production of banking services in the Commonwealth.

Administrative and compliance costs with a dual tax system are greater than with the current system because more banks pay taxes and because apportionment factors must be calculated. However, these compliance costs are not overly burdensome relative to costs imposed on nonbanking corporations. The dual tax system would have little impact

⁵⁶Separate accounting for the income earned in each state is frequently discussed as well, but is excluded here since the use of apportionment formulas has been much more common across the U.S.

⁵⁷See McCray (1990) for a complete discussion of the dual structure. Indiana has adopted a dual structure for taxing banks.

⁵⁸Taxes paid on income earned in foreign countries has not been effectively addressed with the dual structure.

⁵⁹Tennessee is an appropriate example because it taxes one hundred percent of the income that the Massachusetts bank earns.

nonadministrative and compliance costs for domiciled banks. Note that domiciled banks are not protected from calculating apportionment factors because the factors likely will be used in determining taxable income in other states.

Box 7				
Assumptions:				
1. Bank A domiciled in Massachusetts.				
2. Bank B domiciled in Tennessee.				
3. Both banks earn \$1,000,000 on operations in Tennessee.				
4. Bank A receives a credit in Massachusetts for taxes paid in Tennessee.				
5. All of Bank A's income is attributed to Tennessee.				
Bank	Taxable Income	Tax Rate	Tax Credit	Tax Liability
Massachusetts Tax Liability				
A	\$1,000,000	0.1254	\$70,000	\$55,400
B	0		0	
Tennessee Tax Liability				
A	\$1,000,000	0.07		\$70,000
B	\$1,000,000	0.07		\$70,000
Total Tax Liability				
A				\$125,400
B				\$70,000

The dual tax system is anticipated to raise additional revenue. Estimates are that domestic banks would receive credits of only \$1 to \$2 million for taxes paid to other states, but apportionment of nondomiciled bank income would yield \$5 to \$7 million.⁶⁰ However, this is a short run calculation. Revenues could be decreased or actually could decline if domiciled banks shift their activity to avoid Massachusetts' taxes. Further, revenues with the dual tax system may be less predictable than the current tax structure, since the credit for domiciled banks is determined by tax rate and tax base decisions in other states.⁶¹

7.a.2. Apportioned Income

Apportioned tax structures allocate a share of domiciled and nondomiciled bank income to the Commonwealth based on a proxy for where banks earn their income. An apportioned system would treat nondomiciled banks the same as the dual system, but differs from the dual system for domiciled banks, because the residence based system would be replaced with apportionment.

The major advantage of an apportioned structure is the tax system is neutral for banks producing financial services for consumption inside or outside the Commonwealth.⁶² The neutral tax burden means no disincentive to produce bank services in Massachusetts. Taxes on banking services would be determined by the tax laws where banking services are sold

⁶⁰Letter from Commissioner Stephen W. Kidder, Massachusetts Department of Revenue, to Senator Patricia McGovern, Chairman, Senate Committee on Ways and Means, June 4, 1990.

⁶¹Revenue losses could be limited by setting the maximum tax credit equal to the other state's tax rate times the Massachusetts tax base. However, administrative burdens rise when the credit is set at any value other than the actual tax liability.

⁶²Neutrality only exists to a full extent with a destination based formula. The structure will be less neutral with a source based formula or to the extent that administrative problems prevent a true destination tax. See section 7.a.4.

rather than where they are produced.⁶³ Thus, Massachusetts banks would be in a better position to produce banking services for sale inside and outside (including overseas) of the Commonwealth. For example, in Box 7 a Massachusetts' bank would pay \$60,000 to Tennessee if \$1,000,000 of its income was apportioned to Tennessee. The bank would owe no tax liability to Massachusetts based on this portion of its income.

Massachusetts banks selling services in states that are using source tax rules, like New York, would have little or no tax burden in the other state and would pay no tax to Massachusetts. The income could be thrown back or thrown out of the formula (see Section 7.a.5.) so that it is taxed.

Both domiciled and nondomiciled banks would pay \$125,400 in taxes to the Commonwealth if they earn \$1,000,000 operating in Massachusetts. In addition, the tax burden for domiciled and nondomiciled banks would be even so that tax equity would be achieved between the banks. However, a nondomiciled bank headquartered in New York could be taxed at the source, in New York, and at the destination, in Massachusetts, meaning a nondomiciled bank could be taxed twice on the same income.

Administrative burdens should be similar to the dual system. Domiciled banks will apportion income for Massachusetts' tax purposes, but little change in total compliance costs should result because domiciled multi-state banks may be required to apportion income when calculating tax burdens in other states.

Massachusetts may lose some revenues with an apportioned structure. Little data are available for estimating the revenue losses with an apportioned structure, so there is a risk that estimates are substantially in error. The Department of Revenue estimated that \$6 to \$9 million in revenue, primarily paid to Massachusetts by domiciled banks, would be lost by apportioning income, though \$5 to \$7 million would be gained from the ability to tax nondomiciled banks.⁶⁴ Any revenue loss may be modest because most Massachusetts banks have engaged in interstate banking by establishing subsidiary banks in other states, and these subsidiaries are not taxable in the Commonwealth.

Box 8	
Different Factors in Formulas	
Tax formulas normally have one, two, or three factors. A wide selection of factors could be chosen, but the following examples illustrate factors usually considered. The one factor formula is calculated as:	
Share of taxable income _{MA}	$= \frac{\text{Receipts}_{MA}}{\text{Nationwide receipts}}$
The two factor formula is calculated as	
Share of taxable income _{MA}	$= \frac{1}{2} \cdot \frac{\text{Receipts}_{MA}}{\text{Nationwide receipts}} + \frac{1}{2} \cdot \frac{\text{Payroll}_{MA}}{\text{Nationwide payroll}}$
The three factor formula is calculated as	
Share of taxable income _{MA}	$= \frac{1}{3} \cdot \frac{\text{Payroll}_{MA}}{\text{Nationwide payroll}} + \frac{1}{3} \cdot \frac{\text{Property}_{MA}}{\text{Nationwide property}} + \frac{1}{3} \cdot \frac{\text{Receipts}_{MA}}{\text{Nationwide receipts}}$

⁶³The apportionment rules are an important aspect of the degree to which this is true. The rules are discussed in Section 7.a.5.

⁶⁴Letter from Commissioner Stephen W. Kidder, Massachusetts Department of Revenue, to Senator Patricia McGovern, Chairman, Senate Committee on Ways and Means, June 4, 1990.

7.a.3. Apportionment Formulas

Both the dual and apportioned systems require an apportionment formula. There are two important aspects to any formula: the factors included in the formula and the siting of these factors. This section is a lengthy discussion of important issues in developing apportionment formulas.

The apportionment formula uses proxies for how firms earn income to determine the share of corporate income that should be taxed in Massachusetts. Income can be thought of as earned on the source or supply side, or on the destination or demand side. Traditionally, corporate income taxes have been source based. Sales taxes, on the other hand, are destination based in 40 of 45 states where they are imposed. The insurance premiums taxed is also destination based.

The specific formula for the banking industry and whether it is to follow source or destination principles should be determined after consideration of the goals for the tax system: equity, efficiency, and simplicity. In addition, consideration must be given to whether Massachusetts' formula should be similar to that imposed in other states.

7.a.4. Apportionment Factors

Selection of apportionment factors involves two decisions. First is the number of factors in the formula. Second is weights applied to the factors. These will be considered separately.

Number of factors. No perfect apportionment formula exists since the formula is merely intended as a proxy for, not an identical representation of how financial institutions earn their income. Considerable controversy has surrounded the appropriate set of factors for the banking industry. Usually, analysts make their recommendations for the banking industry after examining a one-factor, a two-factor receipts and payroll formula, or the standard three-factor formula (see Box 8). The one-factor formula is based on gross receipts and normally attributes receipts to the market where they are earned. Receipts include interest and other revenues but not repayment of loan principal.

Conceptually the two- and three-factor formulas are similar. The two-factor formula is sometimes proposed in place of the three-factor formula, because some people believe the payroll and property factors are nearly identical, so little is gained by using a three-factor formula.⁶⁵ The American Bar Association and H.B. 4037 propose a two-factor receipts and payroll based tax.⁶⁶ The conceptual distinctions are discussed here by comparing the three-factor and one-factor formulas. Calculations with tax formulas are illustrated in Box 9.

Three-factor formula. Nonbank corporate income is apportioned using the three-factor formula in 44 of the 47 states with corporate income taxes. The three-factor formula apportions income based on the percentage of payrolls, percentage of property, and percentage of sales which a corporation has in a state, with the specific weights applied to these factors varying by state.⁶⁷ However, the agreement that led to widespread use of the three-factor formula explicitly excluded the financial industry. Only 11 states use the three-factor for-

mula, though at least 32 of the 40 states taxing bank income have legislation allowing some type of apportionment for banks (Kincaid and McCray, 1988, p. 22). Further, apportionment appears to be occurring in only a few states, despite its legal basis.

Box 9

Apportionment formulas are used to calculate the share of a corporation's income that is taxable in a state. The first step is to determine the percentage of each factor located in a state. Then the factors are averaged to yield the percentage of income taxable in the state. For example, the traditional three factor formula is calculated as

$$\text{Share of taxable income}_{MA} = \frac{1}{3} \cdot \frac{\text{Payroll}_{MA}}{\text{Nationwide payroll}} + \frac{1}{3} \cdot \frac{\text{Property}_{MA}}{\text{Nationwide property}} + \frac{1}{3} \cdot \frac{\text{Receipts}_{MA}}{\text{Nationwide receipts}}$$

Thus, the firm pays the taxes in the Commonwealth on 10 percent of its income if Massachusetts has 10 percent of a firm's national payroll, 5 percent of the nationwide property, and 15 percent of the nationwide receipts.

$$10\% = \frac{1}{3} \cdot 10\% + \frac{1}{3} \cdot 5\% + \frac{1}{3} \cdot 15\%$$

This percentage is multiplied by the firm's nationwide income. Massachusetts would tax \$100,000 of income (\$1,000,000 x 0.10) for a firm with taxable income of \$1,000,000.

The formula is altered only slightly if the factors are not weighted equally. For example, a formula with double weighting on sales (as with the Massachusetts excise tax) is as follows:

$$\text{Share of taxable income}_{MA} = \frac{1}{4} \cdot \frac{\text{Payroll}_{MA}}{\text{Nationwide payroll}} + \frac{1}{4} \cdot \frac{\text{Property}_{MA}}{\text{Nationwide property}} + \frac{1}{2} \cdot \frac{\text{Receipts}_{MA}}{\text{Nationwide receipts}}$$

Using the numerical data, Massachusetts would tax 11.25 percent of the corporation's taxable income

$$11.25\% = \frac{1}{4} \cdot 10\% + \frac{1}{4} \cdot 5\% + \frac{1}{2} \cdot 15\%$$

Massachusetts would impose taxes on \$112,500 (\$1,000,000 x 0.1125) for the firm earning \$1,000,000 in taxable income.

The standard three-factor formula can be thought of as sharing a corporation's taxable income between the source state and the market state (or country).⁶⁸ Property and payrolls normally are attributed to the state where they are located and are thought of as source factors. Sales normally are attributed to the state or country where the market is located and give the formula a destination factor.

Proper treatment of property within the three-factor bank formula has been controversial. First, some argue that deposits should be substituted for the property factor, as New York has done. The deposits factor is justified because receiving deposits

⁶⁵See Hellerstein (1983) for a discussion.

⁶⁶"Multistate Taxation of Depositories: An Analysis of Legislation Proposed by the American Bar Association," *St. John's Law Review* vol. 58, 1984.

⁶⁷See Maury and Graeser, *State Tax Notes*, Feb. 1, 1993, p. 227.

⁶⁸The degree of this depends on the situs rules.

and making loans are the major functions of a depository institution. Hellerstein observed that deposits may play the

role for banks that factories serve for other products, though this parallel is becoming less true as banks are able to use securitization as a mechanism for generating loanable funds.⁶⁹ Another justification is that the deposits factor is more distinct from the payroll factor than is the property factor. Perhaps the major concern with a deposits factor is it cannot be used if banks are defined to include nondepositories, and the discussion below indicates a broader definition may be appropriate. Also, the deposits factor is source-based and does not belong in a destination formula.

Second, arguments have been made that the property factor should include intangible property. Most believe intangible property belongs in the property factor for banks because intangibles are so important in generating bank income. The Multistate Tax Commission proposal includes intangibles in the property factor. Minnesota uses both tangible and intangible property in the property factor. California has replaced real property with intangibles in its formula. A major problem with using intangibles is that their situs can be very easily manipulated, which makes the formula subject to easy avoidance mechanisms. Careful rules are necessary to ensure their situs is properly determined.

Evaluation of one versus three factors. Evaluation of the relative strengths of the one- versus three-factor formula can be summarized as follows. The greatest strength of the three-factor formula is its familiarity, while a single-factor receipts-based formula appears to be a new approach. The Multistate Commission⁷⁰ has supported a three-factor formula because of its familiarity and the desire to reach a compromise between the money center (source) and market states.⁷¹ The major conceptual distinction is the one-factor formula makes the income tax a destination tax and the three-factor formula makes the tax closer to an origination tax.⁷² The one-factor, destination formula is superior in neutrality and potential for making the Commonwealth a more attractive situs for producing financial services. The three-factor formula may or may not generate more revenues in the Commonwealth in the near term, but is more likely to cause a revenue loss in the long term, because of avoidance techniques. Both the one- and three-factor formulas will cause some additional compliance costs until banks have adjusted to market state attribution for the receipts factor. Which formula is more equitable is unclear. These topics are addressed in detail in the following discussion.

Neutrality. A three-factor formula emphasizes taxation at the source, since the property and payroll factors are based on where income is produced. A source based tax is nonneutral

and has similar, though less extreme, economic incentives to a residence based tax. Banks can practice tax avoidance by shifting employment and property to states where tax rates and tax structures are favorable.⁷³ An apportioned tax structure with a source based (three-factor) formula provides less incentive to relocate production of financial services than the current residence based structure. But greater tax burdens would remain on financial services produced in the Commonwealth versus those produced outside the Commonwealth.

Consider the example of a firm that offers mutual funds for sale from a location in Massachusetts. Also, assume income is apportioned using a two-factor receipts and payroll formula. The firm would be taxed on one-half of its U.S. income if all of its employees are located in the Commonwealth, even if none of the mutual funds were purchased by Massachusetts residents. The tax provides an incentive to relocate the mutual fund outside Massachusetts.

The single-factor formula creates neutral taxation for all financial services sold in the Commonwealth.⁷⁴ Both domiciled and nondomiciled banks would pay the Massachusetts tax rate on income earned from services sold in the Commonwealth, regardless of whether the services are produced in or out of Massachusetts. The mutual fund company described above has tax liability in Massachusetts only to the extent that mutual funds are purchased by Commonwealth residents. Similarly, Massachusetts domiciled banks pay taxes where financial services are delivered and will not be taxed in the Commonwealth on services delivered elsewhere. Thus, the single-factor formula provides no disincentive to produce financial services in the Commonwealth and in this regard is preferable to either a three-factor formula or the existing residence based structure. Given the growing potential for banks to alter location of their assets or productive activities to avoid taxes, the single-factor formula may offer a strong advantage in the long term.

McClure (1984, p. 252) made the same point when he argued that "... source-based taxes probably distort the locational allocation of resources more than do similar differentials in destination-based taxes. If the states are to continue to levy a tax that is inappropriate for subnational levels of government, they might at least do it in a way that does as little harm as possible."

Revenues. The three-factor formula has been said to generate more revenues for a money center state and a single-factor formula to generate more for a market state. Assertions have been made that money center states will select a three-factor formula and market states a one-factor formula merely to maximize their respective revenues. However, the three-factor formula only need generate more revenue for a money center state if banks do not engage in tax avoidance. Money center states with high tax rates stand to lose employment, income generation, and tax revenues to the extent that banks can respond to high tax rates by moving the production of financial

⁶⁹See Hellerstein (1983), p. 673.

⁷⁰Alan Friedman of the Multistate Tax Commission reports that a full meeting of participants of various study groups "seemed to gel" around a basic three-factor formula. Multistate Tax Commission Review, Volume 1992, Number 1, December 1992.

⁷¹A money center state is a relative center for producing banking services. Thus, it can be thought of as a state that is a net exporter of financial services to other states. A market state is a net importer of financial services. Note that these definitions refer to the export or import of financial services, not of financial capital.

⁷²H.B. 4037 mixes the destination and origination structures since both a payroll and a receipts factor are included. Still, the two-factor formula has a stronger destination bias than the standard three-factor formula.

⁷³Charles McClure (1986) has pointed out that in the extreme, an apportioned corporate income tax can be interpreted as three taxes: one on property, one on payroll, and one on receipts. The taxes on property and on payroll provide an incentive to relocate these production type activities to states where the rate of tax is lower.

⁷⁴Following McClure's (1986) argument, a single-factor formula is similar to a sales tax on financial services, with the rate varying according to the profitability of each bank.

services outside the state. Even a money center state with a large market, such as New York, ultimately could generate less revenue from the source based tax as domiciled banks relocate production of services to subsidiaries outside the state and then sell the financial services back into the state.

It is difficult to make a clear statement regarding whether Massachusetts is a money center state. The banking industry data in section 1 suggest the Commonwealth is a net exporter of banking services to a limited degree. To the extent the Commonwealth is a money center state, it would gain more revenues in the short term with a three-factor formula and if it is a market state it would gain more from a one-factor formula. In either event, the Commonwealth is less likely to gain revenue in the long term with a three-factor formula.

Equity. The equity across states of a one-factor versus a three-factor formula depends on one's perspective, remembering that the one-factor formula attributes income to the state where a firm's market is located and the three-factor formula shares the income between the market and source states. Maury and Graeser (1993) assert that a destination based tax is less equitable as a benefit tax, but the following example illustrates that an argument can be made that either is more consistent with a benefit based tax. Consider a loan to finance housing in Massachusetts which is made by a New York bank and sold to a Delaware bank. Under a source based tax the interest income probably would be taxed in Delaware, though it is neither the originating nor the market state.⁷⁵ Perhaps the strongest case can be made that a destination tax, meaning Massachusetts taxes the income, is more equitable.

Different formulas across states can result in corporations being taxed more than once on their income. For example, the same receipts could be in the numerator of the receipts factor for a destination taxing state and a production taxing state. An illustration was included in Box 4 where income is taxed once in the destination state and once in the producing state. This problem may become increasingly important as more states move to destination taxes. However, the potential for double taxation should not be exaggerated because much bank income already may be escaping taxation through avoidance mechanisms.

Weighting the factors. A decision must be made on what weights should be applied to each factor if a two- or three-factor formula is to be used as the proxy for how income is earned. The simplest approach is to weight each factor evenly but many states impose different weights. New York double weights its receipts and deposits factors and thereby reduces the relative impound of the payroll factor. Minnesota's bank formula adds 70 percent of the share of receipts to 15 percent each of the property and payroll shares. As an incentive to recruit workers, both states' formulas reduce taxable income for banks which locate a large share of the bank's labor force in their borders. In essence both increase the tax on banks that have a significant share of receipts in the state. As a result, both states increase the destination rather than source base of the tax.

Massachusetts may want to weight receipts heavily for banks, as it has for nonbank corporations, if a 2- or 3-factor formula is selected. The goal would be to attract more bank

employment, though weighting in the apportionment formula probably has a very small effect on the location of jobs. A disadvantage is that special weighting schemes increase the chance that a bank would pay taxes on more than 100 percent of its income because unique formulas lead to different proportions of income being taxed. For example, exactly 100 percent of a bank's income is taxed if all states use the first formula in Box 9 and design tax structures that reach all of bank income. However, 101.25 percent of bank income is taxed if Massachusetts alone chooses to use the double weighted receipts formula shown in the second formula in Box 9.

7.a.5. Attribution Rules

The attribution rules for where the factors are located are of equal importance to the factors themselves. Attribution rules determine what portion of a factor is located in Massachusetts versus other states. Little disagreement is likely to exist for attributing real property and payroll. These are source based facts and siting will follow where the property and employment are physically located. The siting of intangible property (and some types of personal property) is much more difficult and can follow either source or market state rules.

Also, receipts can be attributed to the market state or the source state. The equity and neutrality advantages of a single-factor destination tax structure that were described above are based on market attribution rules. Both the one- and the three-factor formulas make the tax more like a source tax if source based rules are used for attribution purposes. Source state attribution means interest from loans is sited where they are booked, credit card interest where the bank offering the service is located, and so forth. Market (destination) attribution means interest from loans is sited where the property used as collateral for the loan is located, where credit card interest is billed, or where the loan proceeds are applied. Tennessee follows market attribution rules. Receipts are attributed to Tennessee from lease or rental of its property if the property is located in Tennessee; from loans secured by property in Tennessee; from unsecured consumer loans if the consumer is a resident of Tennessee; from unsecured commercial loans if the loan proceeds are applied in Tennessee; from credit card transactions if the consumer is in Tennessee; and so forth. H. B. 4037 uses destination rules that are similar to Tennessee's, though several of the specific rules have a source basis to them.

Attributing receipts to the market, regardless of whether a one-factor or three-factor formula is used, will cause some compliance costs for the bank industry. Fox and Kelsay (1992) examined the compliance issue and concluded that only small incremental increases in processing costs should result at the institutional level. They determined many financial institutions already have extensive loan tracking systems, which, by and large, are necessary to respond to regulatory rather than tax requirements. Further, the enormous scale economies present in data processing and other information systems for the banking sector permit costs of implementing system changes to be spread over a large customer base.

Allocation formula problems. Income earned in Massachusetts by foreign banks and by Massachusetts banks operating in other countries potentially presents problems. A properly designed destination tax allows Massachusetts to tax an appropriate share of income if the worldwide income of multinational firms is allocated. However, the corporate excise tax only apportions the U.S. income of corporations. Separate

⁷⁵Further, under current tax law in many states the income could lie outside the rules for defining taxable income.

accounting must be used to measure U.S. income versus income earned in other countries if a similar structure is adopted for the bank tax. Separate accounting can provide an accurate measure of taxable income when transfer prices for transactions between U.S. and foreign branches are set at arm's length. However, many analysts have bemoaned difficulties with separate accounting and argue for apportioning worldwide income as well.⁷⁶

Another problem is receipts from certain transactions cannot be situated using destination principles and to a lesser extent source rules. Alternative means must be found to prevent the income from going untaxed. Examples are interest from unsecured working capital loans made to multistate corporations, from U.S. Government securities, and from some securitized loans.⁷⁷

The dual tax structure ensures that all income is taxed because by definition the domicile state begins by taxing all income. Two other approaches normally are used for ensuring that all income is taxable in some state. First, receipts that cannot be situated can be "thrown out" of the denominator of the apportionment formula. In effect, the approach is to apportion unsituated income to each state according to the share of receipts where factors can be situated. Second, the receipts can be "thrown back" to the state of domicile, so they enter the numerator for the domicile state's receipts factor. The second approach is a pure residence-based mechanism for that part of income where factors can be situated. The throwback rule would appear to be most beneficial to money center states.

H.B. 4037 follows a different, source-based rule for determining situs. The share of unsituated income that is taxable in the Commonwealth is calculated as the percentage of the bank's deposits owned by residents and other entities in Massachusetts.

A method similar to one of those described here must be used to ensure that all income is taxed. Each method is arbitrary and not conceptually consistent with the apportioned tax structure. The throw-out rule or the method in H.B. 4037 both share the unsituated receipts across states and therefore would have less harmful effects on incentives to relocate assets. On the other hand, the dual approach and throwback rule would raise more revenues for the state of domicile.

7.b. Definition of the Taxable Entity

Two major issues arise in defining the taxable entity. The first is determining what firms are banks or financial institutions. This issue is important to the extent that Massachusetts wants to continue separate treatment of banks or other financial institutions versus nonbank institutions. The second issue is whether combined reporting of banks is to be required.

⁷⁶*State Tax Notes*, Apr. 19, 1993, p. 918, has summaries of testimony before the Senate Governmental Affairs Committee in support of an apportioned rather than separate accounting method for taxing multinational income. The testimony was by Philip Aldape (Idaho State Tax Commission), Benjamin Miller (California Franchise Tax Board), and Dan Bucks (Multistate Tax Commission).

⁷⁷States may choose not to tax interest from securitized loans if the financial institution has no presence in the state other than ownership of the securities. Further, though nexus obviously exists in the source state, receipts would not be attributable to the source state under destination principles. See Section 7.f.

7.b.1. Defining a Financial Institution or Bank

Massachusetts defines banks for tax purposes on a regulatory basis, in terms of how they are chartered, rather than on economic grounds (see Section 4.1.). The regulatory definition may have been appropriate during times when banks performed certain narrowly determined functions and were protected from the competition of nonbank institutions. Today the definition of a bank is a significant limitation to imposing a neutral tax structure on financial institutions.

A neutral structure requires all firms competing in similar markets be subject to the same effective tax rates. Thus, a tax structure that is defined broadly enough to include all financial institutions is the best means to neutral taxation.⁷⁸

Neutral taxation requires that the definition include credit card companies, loan production offices, banks, leasing companies, mortgage companies, finance companies, credit unions, bank holding companies and many other types of firms. California, Tennessee, and West Virginia have developed broad definitions of financial institutions. California has defined financial institutions to include any firm which receives "more than 50 percent of its gross income from the use of its capital in substantial competition with other moneyed capital."⁷⁹ Tennessee defines a financial institution as "a holding company, any regulated financial corporation, a subsidiary of a holding company or regulated financial corporation, or any corporations organized under the laws of the United States or any other taxing jurisdiction that is carrying on the business of a financial institution."⁸⁰ Insurance companies are explicitly exempted in Tennessee. West Virginia also defines financial organizations broadly as ones that are engaged in earning income from loans, leasing, operating a credit card business, rendering estate or trust services or handling deposits. H.B. 4037 specifically defines banks as financial institutions but also broadens the definition to "any other corporation . . . carrying on the business of a financial institution." The definition of the business of a financial institution includes, "if such corporation derives more than 50 percent of its gross income. . . in substantial competition with a bank."

7.c. Nominal Tax Rate

Data presented in Sections 5.d and 5.e indicate that bank tax rates must be lowered if the tax burdens are to be equalized across banks, other financial corporations, and nonfinancial corporations.⁸¹ H.B. 4037, for example, would lower the bank rate to 10.5 percent. The tax structure's equity and neutrality would be enhanced if the bank tax rate was reduced to equalize corporate tax burdens. However, tax revenues will fall with a lower rate. Peat Marwick (1985) estimated the Commonwealth would lose \$11.25 million if banks were made subject to the regular corporations tax.⁸² This loss would have represented

⁷⁸While it is possible to impose the same effective tax rates without subjecting banks and other financial institutions to the same tax structure, differences in tax codes and industry practices make this difficult in a practical sense.

⁷⁹McCray (1990), p. 50.

⁸⁰Tennessee Code Annotated 67-4-804, p. 63.

⁸¹The need to equalize tax burdens is lessened somewhat if all financial institutions are brought under the same bank tax structure, but neutrality is violated until all businesses are subject to the same effective tax rate.

⁸²These estimates are the most current available, despite being ten years old.

about 10 percent of tax collections in 1983, the year for which the calculations were made. The Executive Office for Administration and Finance (1984) estimated a \$9.6 million revenue loss in 1982 from moving banks to the regular corporate tax structure, comparable to about 14 percent of revenues. As described above, additional revenue losses could result as the net effect of apportioning income into and out of the Commonwealth.

7.d. Defining Taxable Income

Neutrality is affected by differential tax rates, as discussed above. Neutrality also is affected in the Commonwealth by the way that taxable income is defined. Massachusetts has bypassed many decisions involved in defining bank taxable income by beginning the calculation with gross income from all sources, less certain deductions allowed by federal law. In a general sense federal definitions may be acceptable, but some adjustments are necessary to define a tax base that is consistent with Massachusetts' objectives. One example is the federal government does not allow either banks nor nonbanks a deduction for the cost of holding state and local government debt.

Further, Massachusetts has legislated several differences in calculation of taxable income and tax liability for nonbanks versus banks. These include: ability to carry losses forward, tax credits intended to encourage certain types of activities, and ability to apportion income. Each of these special treatments for nonbanks is likely to distort the relative tax rates facing banks versus other corporations. All are most likely to result in greater taxation of banks. Differences in terms of apportioning income have been treated at length above but each other topic is addressed in this section.

7.d.1. Costs of Holding State and Local Government Debt

Both the bank and nonbank taxes are net income taxes, which means the tax base is calculated as business revenues minus business costs. The treatment of state and local government debt is a case where the bank and corporate tax structures fail to follow the principles of a net income tax. Massachusetts requires firms to add interest earned on state and local debt to federal taxable income in calculation of Massachusetts taxable income.⁸³ Massachusetts' tax structure should allow a deduction for the cost of holding the debt in order to be consistent with a net income tax, but no deduction is allowed.⁸⁴ Without the deduction the tax structure essentially operates as a gross income tax on earnings from state and local government debt, rather than as a net income tax. One result is to discourage the holding of state and local debt. H.B. 4037 would permit the deduction.

Neither bank nor nonbank firms are permitted the deduction for costs associated with holding state and local debt and in this sense neutrality and equity between the financial and nonfinancial industries may not be violated. However, banks are more likely to hold state and local debt than are most nonfinancial

corporations, so failure to allow the deduction may raise the relative tax burden on banks.

Lost tax revenues is the major negative consequence of allowing a deduction for the costs of holding state and local debt. Banks earned \$165.1 million in interest on state and local government debt during 1990 (Table 4).⁸⁵ Banks' taxable income would have been reduced by \$82.6 million, if the costs of holding debt were only one-half as great as the interest earnings.⁸⁶ Larger banks appear to hold a greater percentage of their assets in state and local government securities (Table 5).

7.d.2. Loss Carryforwards

Nonbank corporations, including many financial service providers, are permitted to carry losses forward and deduct them against future income for up to five years, while banks are not allowed any loss carryforward. H.B. 4037 would extend the five year loss carryforward to banks. Tax equity and neutrality require equal tax burdens over the long term (not merely for one year) on firms with the same profits. Loss carryforwards are necessary to ensure that the same aggregate profits over several years leads to the same tax liability. For example, consider two firms with the same investment, one of which earns \$100,000 per year for six years and the other of which loses \$100,000 every other year and earns \$300,000 in alternating years. Unless losses can be carried forward, the firm earning a consistent profit is taxed on a total of \$600,000 over the six years and the firm with erratic income is taxed on \$900,000 over the six years. These firms have different tax burdens for the combined six years without loss carryforwards, even though the before-tax return on firm investment is the same.

Ability to carry losses forward can be most important for new firms, which often experience losses for several years before becoming profitable, and for firms whose profits vary across economic cycles. Loss carryforwards could have been an important means of smoothing bank tax liabilities during the difficult years of 1989 through 1991. Nonetheless, the reduction in bank tax liabilities resulting from loss carryforwards means less revenue for the Commonwealth. A Massachusetts Bankers Association internal evaluation indicated that banks losing money in 1990 and 1991 would have paid \$57.4 million less in taxes in 1992 with a loss carryforward similar to that available under the excise tax. These banks would have carried \$405.2 million in losses beyond 1992.⁸⁷

7.d.3. Tax Credits

Massachusetts allows nonbank corporations two separate forms of tax credits: (1) a three percent investment tax credit (ITC) and (2) a research and development (R&D) tax credit. The credits are intended to encourage corporations to invest and to undertake R&D in the Commonwealth. Neither credit is available for banks, raising their burden relative to nonbanks. Again, the equity and neutrality criteria are violated by differential treatment. However, lost revenues would be a consequence of allowing banks the credits.

⁸³The federal government does not permit a deduction for the cost of holding state and local government debt because the federal government does not include state and local government interest as a revenue.

⁸⁴For banks the cost of holding state and local government debt is the interest paid to holders of certificates of deposit, to passbook accounts, or to alternative means of raising capital. Similarly, the costs to nonbanks of holding state and local government debt are the costs of raising capital.

⁸⁵Department of Revenue calculations.

⁸⁶The revenue loss would be less than the value of the deduction times the tax rate (\$82.6 million x 0.1254) because many banks had negative profits in 1990 and paid no tax.

⁸⁷Memo from Stuart Ryan to Kevin Kiley, April 15, 1993.

An additional concern about the credits is they are so small that any effect on investment or R&D may be limited. The biggest effect of the credits is to lower the tax burden on business, but the goal of reducing business tax burdens could be more effectively achieved with across-the-board tax relief (for example, lower tax rates) rather than with credits that affect firms unevenly.

7.e. Combined Reporting

Defining the taxable entity involves two major issues. First, determination must be made as to whether the taxable entity is each individual corporation or the combination of all affiliated members of a unitary group. In other words, should affiliated firms file a combined tax return or separate returns? Second, if companies are to file as a combined unit, a determination must be made regarding what firms constitute the unitary group. These issues are considered in order.

7.e.1. Should Combined Reporting Be Required?

Massachusetts currently treats banks and nonbank corporations differently with regards to combined reporting. Combined reporting is not permitted for bank members of a holding company or any other bank group. The corporation income tax allows companies the option of filing a combined return, except for security corporations and trusts with transferable shares.

The policy concern is an inappropriate share of income may be taxed when members of an affiliated group are taxed separately on their income. First, as described in Section 5.c, total profit may be overstated for affiliated groups, comprised of both profit and loss members. Second, the Commonwealth may be unable to tax the appropriate share of income, because, through transfer pricing choices corporations can engage in planning to avoid the tax. Consider the case of a Delaware holding company with a subsidiary in Massachusetts. The holding company may charge an excessive management fee to its subsidiary, resulting in lower corporate profits in Massachusetts and higher profits in Delaware. In many cases it may be theoretically possible to determine the appropriate tax liability by separating the holding company's income from the subsidiaries, but practically it can be very cumbersome to determine if transactions have been at arm's length. McClure observes (1986, p. 68) "... substantial transactions between affiliated firms can make it administratively difficult and perhaps impossible, to verify that transfer prices are not being manipulated to shift income between affiliated firms, and therefore between jurisdictions." In other cases the activities of affiliated companies may be so intertwined that it is impossible to separate income because of shared costs, other economies of scale, and economies of scope. Third, the Commonwealth may be unable to tax the appropriate share of income because a portion of the holding company's income may be due to activities by the Massachusetts subsidiary, but nexus rules may not make the holding company taxable as a separate being in Massachusetts.

Three options are available for the Commonwealth, the third of which maintains existing law. Affiliated bank members of a company can be required to file a combined return, can be allowed to file a combined return, or can be prevented from filing a combined return. The criteria for a good tax system provide the basis for making a decision about which option to select.

Only the provision that requires firms to file a combined return seems to be consistent with a neutral tax system, a tax

system that is equitable from a benefits perspective, and a tax system that allows Massachusetts an acceptable share of corporate revenues. Allowing firms the option to file a combined return means that firms are free to engage in tax planning, but leaves the firms free to file combined returns when it is favorable for them. For example, the Massachusetts subsidiary may want to file a combined return with the Delaware holding company when the subsidiary has a profitable year and the holding company does not, but they will file separate returns in other years. On the other hand, prohibiting combined returns maintains the neutrality and equity problems with the current law.

H.B. 4037 allows the Commissioner of Revenue to require consolidated returns and permits firms the option of filing a combined return. This approach is a compromise to the positions described in the previous paragraph. However, the bill allows each member bank to apportion separately prior to combination and this defeats some benefits of combined reporting. Nonbank corporations also apportion and then combine under the excise tax law.

7.e.2. What Firms Are in an Affiliated Group?

If a decision is made to require (or allow) combined reporting, a determination must be made as to which affiliates constitute a combined entity. The combined entity, or unitary being, should be defined as the set of companies that form an economic unit. McClure says (1986, p. 68) that, "For costs to justify a finding of unity the costs must be substantial enough that how they are allocated between firms could seriously affect the calculation of profits of the various corporate entities sharing them."

The affiliated group could be drawn only from firms which individually have nexus in Massachusetts or from all affiliated companies, regardless of whether nexus would exist independently in the Commonwealth. Again, requiring all affiliated companies to combine, regardless of whether they independently have nexus is the approach that is consistent with the goals of neutrality and equity. Worldwide combination is most consistent with these goals but also offers implementation difficulties. A comprehensive discussion of worldwide unitary is beyond the scope of this paper.

McCray (1990, p. 60) observes that the Supreme Court has allowed combined reporting as long as at least 50 percent common ownership exists between firms and there is a "flow of value" between firms. Tennessee has determined that a unitary business "means business activities or operations of financial institutions that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution." Centralized management is seen as one evidence that a combined entity exists as it notes that, "Unity is presumed whenever there is unity of ownership, operation and use evidenced by centralized management or executive force The absence of these centralized activities does not, however, necessarily evidence a nonunitary business . . ." ⁸⁸ The last statement allows a combined company to be construed more broadly than centralized management.

A dividend-received deduction should be included in the tax law if combined reporting is allowed or required. Firms should be permitted a deduction for most or all of dividends received from firms in which they have a substantial ownership interest. Non-

⁸⁸Tennessee Code Annotated 67-4-804, p. 64.

bank corporations are permitted a deduction for 95 percent of dividends received from companies of which they own at least 15 percent while under current law banks are permitted no deduction.

7.f. Nexus

Nexus refers to the minimum presence necessary for taxation. Nexus rules must be designed to follow the intent of the tax structure. Broad, creative nexus rules are unnecessary if the intent is to continue taxing few nondomiciled banks. Branchless banking activity, credit card issuers, and out-of-state lenders only can be taxed with a broader definition of nexus than has traditionally been used in most state tax structures. Taxation of banks operating in the Commonwealth without physical presence is necessary to impose a destination-based tax, which is appropriate for achieving neutrality and equity.

Minnesota and Tennessee have defined nexus on a solicitation rather than on a physical presence basis in order to tax branchless banking activity. These states define nexus to exist for banks which either have a physical presence in the state or which regularly solicit for business in the state. Both states have de minimus rules that exclude from taxation financial institutions with limited connections to the state. In Minnesota, activity must be conducted with at least 20 persons during the tax year or deposits must exceed \$5,000,000 in order for regular solicitation to be deemed to have occurred. Tennessee presumes a financial institution is doing business in the state when the sum of the bank's assets and the absolute value of its deposits within the state total \$5,000,000 or more.

H.B. 4037 defines nexus on a solicitation basis. A de minimus rule is included, presuming presence if banking activities are conducted with more than 100 residents or if the bank has \$25 million or more in assets attributable to Massachusetts.

Establishing nexus on a solicitation basis does not appear to raise a constitutional problem. Hellerstein (1983, pp. 664-665) concluded that "making regular loans on a continuing basis is sufficient" nexus under the Due Process Clause. McCray (1986, pp. 305-306) extends this by noting that "an out-of-state bank that has purposefully solicited deposits and loans from a host state and its residents therefrom has created sufficient contacts with the state and its residents upon which to base taxing jurisdiction." She extends this to credit card business as well (pp. 310-311).⁸⁹

A significant issue in Minnesota and Tennessee was whether financial institutions establish nexus solely because they purchase securitized loans which use collateral in the state. Establishing nexus on the basis of purchasing securities creates the potential that financial institutions would avoid purchasing securities that are collateralized in states where the financial institutions do not already have nexus. A two-tiered market for securitized assets of local banks could develop and work to the disadvantage of local industry. Both Minnesota and Tennessee have chosen not to extend nexus to firms whose only relationship with the state is holding securities. However, the income from securities is taxable if firms otherwise have nexus in the state. Means to limit tax avoidance if nexus rules are not "extended" to some holders of securitized assets are discussed in section 7.a.5.

⁸⁹Arizona asserts that credit card interest is taxable in the state, even though its nexus laws do not follow solicitation principles in the same way as Tennessee and Minnesota.

8. Issues And Options

The most important issues missed in section 7 are listed in this section. Several ways to handle these issues are given as well. Maintaining the status quo is not listed as an option under each issue, although no change obviously is an alternative.

ISSUE 1: How should the income of multistate banks be allocated across states?

Option 1: Impose a dual tax structure

Option 2: Apportion income across states

ISSUE 2: What factors should be in the formulas that are necessary with both the dual and apportioned structures?

Option 1: A one-factor receipts formula

Option 2: A two-factor receipts and property formula

Option 3: A three-factor receipts, property, and payroll formula

ISSUE 3: What types of property belong in the property factors?

Option 1: Real and personal property only

Option 2: Intangible property only

Option 3: Real, personal, and intangible property.

ISSUE 4: Should deposits replace property in the formula?

Option 1: No

Option 2: In a two-factor formula

Option 3: In a three-factor formula

ISSUE 5: What conceptual framework should attribution factors follow?

Option 1: On an origination basis

Option 2: On a destination basis

ISSUE 6: How should receipts be treated that cannot be situated with a destination approach?

Option 1: A throwout approach

Option 2: A throwback approach

Option 3: Apportioned according to deposits

ISSUE 7: How broad should bank definition of banks be?

Option 1: Only include regulated financial institutions

Option 2: Include all firms that do the business of a financial institution

ISSUE 8: Should the tax rate be changed?

Option 1: Lowered to the same effective rate as imposed on other industries

Option 2: Lowered to the median tax rate on financial institutions in other states

ISSUE 9: Should the cost of holding state and local government debt be a deduction in calculating taxable income?

ISSUE 10: Should banks be able to carry losses forward as a deduction against future income?

ISSUE 11: Should the tax credit for research and development and the investment tax credit be extended to banks?

ISSUE 12: Should the members of an affiliated group file as a combined company?

Option 1: Banks required to file a unitary return

Option 2: Banks allowed to file a unitary return

ISSUE 13: How should nexus be set for banks?

Option 1: On a physical presence basis

Option 2: On the basis of soliciting business in Massachusetts

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EXHIBIT K: 23

**Huddleston, Joe B., Commissioner, Tennessee Department of Revenue,
"How Tennessee Approaches the Taxation of Financial Institutions" (undated)**

HOW TENNESSEE APPROACHES THE TAXATION OF FINANCIAL INSTITUTIONS

JOE B. HUDDLESTON
COMMISSIONER
DEPARTMENT OF REVENUE
STATE OF TENNESSEE

FRANCHISE, EXCISE TAXATION OF FINANCIAL INSTITUTIONS IN TENNESSEE

I. Recent developments in financial industry

A. Primary changes in the way financial institutions conduct business

1. State and federal authorization of interstate banking
2. Increase in branchless banking
3. Participation in securitized loan transactions

B. Primary effects of changes on state taxation

1. Impact on generation of revenue
2. Disparate treatment between in-state taxpayers and out-of-state concerns

II. Analysis of Tennessee's Financial Institutions Act, 1990 Tenn. Pub. Acts Ch. 1087

A. Nexus concepts

1. Creation with or without actual physical presence in-state
2. Exceptions to the definition of doing business in Tennessee

B. Development of apportionment formula applicable to financial institutions

1. Traditional concept of apportionment of income
2. Calculation of Tennessee's single factor apportionment formula

C. Combined reporting

During the past few years, many states have begun to review how financial institutions are taxed in light of the recent changes in this industry. In 1990, Tennessee joined Indiana, Minnesota and New York in enacting legislation which significantly alters the franchise, excise taxation of financial institutions. In particular, the new legislation responds to three basic changes which have occurred in the banking industry in the past decade - the development of interstate banking, the presence of an increased flexibility in the types of services and products offered, and the appearance of what is referred to as branchless banking. All these factors impact on the nature of the business environment in which a bank or other institution operates and generates taxable income. The changes also affect the way in which these institutions now compete with other types of industries.

Until recently, banks generally operated only within their state of domicile with all income allocated to that state for taxation. Issues involving apportionment of income in Tennessee, for example, were virtually nonexistent. Now, most states allow some degree of interstate banking - either regionally or nationwide. Effective January 1, 1991, Tennessee statutes permit reciprocal interstate banking. In addition, not only are geographic limitations being relaxed, but there is a significant increase in the offering of interstate banking services exclusively by telephone, wire or other means of communication. No longer is it necessary for a bank to physically enter a state in order to compete within the state's markets. For example, entire loan transactions may be handled between the lender and the borrower by wire transfer or telephone. However, the most notable example of branchless banking occurs in the credit card industry. Credit card companies - located usually in South Dakota, Delaware or Nevada - solicit credit card customers by mail or

telephone from all fifty states. Under traditional tax structures, interest paid on credit card balances is taxed only by the state in which the lending bank is domiciled. Therefore, although these companies systematically and regularly avail themselves of the markets provided by other states, the debtor's state has often been unable to tax the income received by the lender.

Another challenge to the way a state taxes financial institutions is caused by the sale of securitized loans, an activity which is gaining popularity. Securitized loans are loans which have been packaged together by the originating bank and then sold to other banks or lenders on the secondary market. Loan selling is often inadequately addressed by current tax laws because the originator of the loan and the final owner are severed by the transaction. Under traditional tax methods, the originator's state loses its ability to tax the interest income from the packaged loans since the originator is no longer the owner of the underlying loan even though the collateral may be located in that state and even though the originator may continue to service the loan.

The impact of these changes on most states' current tax structure is twofold. First, without a re-analysis of the types of activities conducted by banks within a state which will trigger tax liability, a significant amount of revenue will be lost even though the state has provided the market in which the income is earned. Secondly, and closely tied with the first consideration, the failure to tax out-of-state financial institutions causes the state's tax burden to be unfairly distributed between its in-state industries and the out-of-state corporations. The end result is to place domiciled institutions at a substantial disadvantage when offering the same services and products as out-of-

state banks and other members of the financial community which incur no tax liability.

The appearance of recent legislation in Tennessee, Indiana and Minnesota represents an attempt to realign the tax responsibilities of financial institutions. Note that not only are banks or other corporations which are regulated either by federal or state law classified as financial institutions under this legislation, but corporations which derive more than 50% of their business from activities involving the extension of credit will also be considered a financial institution for franchise, excise tax purposes.

In general, the Tennessee Act provides that a financial institution will be deemed to be conducting business in the state for tax purposes if it maintains an office, employees or representatives in the state or owns or leases property located in Tennessee - traditional nexus concepts. However, the Act goes further and provides that an institution will be deemed to be doing business in Tennessee if it, among other things, solicits business, sells products or services or extends credit within the state even if the corporation conducts all these activities exclusively through the mail or by telephone without establishing a physical presence in Tennessee. While some have argued that these rules push nexus concepts to an impermissible limit, the newer nexus concepts which focus on the degree to which a corporation regularly and systematically avails itself of a particular local market has found support from recent case law developments in not only this area but other corporate business practices as well.

Not all business activities conducted by financial institutions in Tennessee,

however, will trigger tax liability. The act creates specific exceptions to the definition of "doing business" in Tennessee. Generally, the purchase of an ownership interest, by itself, in certain investment-related assets which are attributed to Tennessee such as loan-backed securities or interests in securitized loans or securities will not cause the institution to be subject to tax. In addition, amendments to the financial institutions act have recently been proposed which would include the purchase of interest in demand deposit clearing accounts, federal funds, certificates of deposit and other similar secondary instruments issued by one financial institution to another within the list of excepted transactions. In essence, then, secondary market and bank to bank transactions, by themselves, will not trigger tax liability in Tennessee. However, if the institution conducts any activity within Tennessee beyond those excepted by statute, all of its business earnings, both investment and credit related, will be subject to apportionment.

Once a financial institution has sufficient contacts with Tennessee to subject it to tax, its net income is apportioned in accordance with a single factor formula based on gross receipts. Traditionally, the apportionment formula used by most corporate taxpayers is based on three factors - property, payroll and sales. For manufacturing companies, this formula has proved to be a workable method. However, the standard formula when applied to financial institutions falls short in achieving a fair ratio for two reasons. First, as noted above, a significant amount of bank services are provided within a state without the bank physically entering the state. Therefore, the numerator of the payroll factor will be nominal for these corporations, if existent at all. Secondly, a financial institution's business earnings are more closely connected with the ownership of intangible, rather than tangible, property. However, the standard

method for determining the property factor of the formula totally disregards ownership of intangible property and, therefore, is not a fair indicator of the value of a bank's assets. For these reasons, Tennessee, like Indiana, has adopted a single-factor apportionment formula based on the taxpayer's gross receipts which are generated by lending, leasing and credit related activities.

Unlike the standard apportionment formula, however, the types of gross receipts reflected in the numerator, by statute, do not include all receipts or income which may be earned by the institution. Only receipts relating to the extension of credit or loan activities are plugged into the numerator. Income generated by a bank's investment activities is not considered. For example, income received from governmental securities, secondary market transactions or bank to bank investment transactions is eliminated from the calculation of the numerator. However, the apportionment formula is merely the method by which a bank's income is divided among the various states for taxation and is not a reflection of the way in which an institution may derive taxable revenues. For example, credit-related services occupy only a portion of the business activities of many financial institutions. The ability to extend credit is dependent upon the institution's maintenance of income-producing assets acquired through investment of deposits and other receipts. Once a financial institution has availed itself of a state's benefits and protection through the conduct of credit-related business within its borders, all net taxable income, whether credit-related or investment-related, which is generated in the institution's regular course of business is subject to tax as measured by the single-factor apportionment formula.

The way in which a bank's income is attributed to the numerator of Tennessee's

apportionment formula reflects Tennessee's position as a market state for financial services. That is, states which consider themselves market states generally have few financial institutions domiciled within their border and, therefore, depend heavily on access to out-of-state credit sources to fulfill borrowing needs. As an importer of capital and financial services, then, income for tax purposes is attributed to either the residence of the debtor, the location of the collateral or other property, or where the proceeds are applied. In contrast, states such as New York which represent money centers still attribute the majority of a bank's income to the state where the services are performed or receipts received - traditionally the state of the bank's domicile.

One other major change for Tennessee banks implemented by the new legislation is the ability of related financial institutions to file a combined franchise/excise tax return. Historically, Tennessee has followed separate entity taxation whereby each corporation is considered to stand on its own for the purpose of determining its franchise/excise tax liability - even if the taxpayer joins its parent in the filing of a consolidated return for federal tax purposes. Corporations other than financial institutions will continue to file returns on a separate basis. However, in order to alleviate the consequences of asset or profit shifting, a financial institution which is a member of a unitary group is required to pay tax based on the net earnings of all members which conduct financial institution activities even if some of those members would not be subject to Tennessee's tax.

Tennessee's Financial Institutions Act has recently come under review again by our legislators. After consideration of proposals submitted by both the

Department of Revenue and the banking community, recommendations for amendments to the legislation were approved on January 4, 1991 by Tennessee's Joint Business Tax Study Committee for submission to the Tennessee legislature.

Among the changes is the exemption of insurance companies which are subject to the gross premiums tax in Tennessee from the definition of a "financial institution". These companies will continue to pay franchise, excise tax as before passage of the new bill. Secondly, as noted above, the types of activities which will not be deemed to be doing business in Tennessee have been expanded to include bank to bank transactions and basically all secondary market activities.

Certain changes to the single factor apportionment formula have also been suggested. First, income resulting from investment in Tennessee securities or its political subdivisions will not be reflected in the receipts used for purposes of calculating the numerator of the formula. Secondly, the apportionment formula as passed in 1990 provides that the denominator shall include not only credit related income but all income from all business activities carried on by the institution. As a result, while investment income such as interest from securitized loans or federal obligations is excluded from the numerator, this type of income is required by Chapter 1087 to be added to Tennessee's denominator. The amendments recently proposed would change the apportionment formula to provide that the denominator as well as the numerator will include only an institution's credit and rental income which is specifically attributed by statute. This amendment will bring Tennessee's single factor apportionment formula into line with that used by Indiana.

The proposed amendments also clarify the way net operating losses are calculated for unitary groups filing on a combined basis for the first time in Tennessee. In general, net operating losses which were incurred by any member of the group before July 15, 1990, the effective date of the Act, will be allowed on the combined return, but only if the member's loss was already apportioned to Tennessee during those early years. Finally, a proposed amendment has been presented which clarifies the way interest income from secured loans is attributed in the event the collateral is located both within Tennessee and in other states. In this situation, the amount of interest which will be attributed to the numerator of the apportionment formula will be determined by a ratio based on the value of the Tennessee collateral as to the total value of the collateral. Lenders and creditors filing a UCC-1 or other document evidencing a secured debt with the Tennessee Secretary of State's office are currently required to state on the document the value assigned to collateral located in Tennessee for the purpose of calculating the amount of recordation tax due. In determining the value of Tennessee collateral for the attribution of interest income for franchise, excise tax purposes, a financial institution may use the value of collateral stated on the face of its recorded document. It is felt that this approach will ease both administrative and compliance burdens.

If passed by the Tennessee 1991 General Assembly, these changes will apply to fiscal years ending after July 15, 1991.

EXHIBIT K: 24

Hunter, William J., "An Economic Analysis of the Market State Approach for the Taxation of Income Earned by Out-of-State Banks" (undated)

**AN ECONOMIC ANALYSIS
OF THE
MARKET STATE APPROACH FOR THE TAXATION
OF INCOME EARNED BY OUT-OF-STATE BANKS**

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INTRODUCTION

The revolution in computer technology of the last two decades has vastly improved competition and the delivery of services in the banking industry. Automatic teller machines have freed the average banking customer from the limits that normal business hours place on her ability to conduct routine financial transactions. Computer technology has also provided firms and individuals of even modest means with the ability to "shop" nationally for the most favorable rates available for both deposits and loans. While the benefits of enhanced interstate competition might seem so obvious that they scarcely need to be enumerated, they are perhaps too obvious in that they are taken for granted in the current policy debate over state taxation of the earnings of out-of-state banks. Yet these taxes portend such a serious threat to interstate competition that the potential economic consequences should be the focal point of the debate.

The rationale for states taxing of out-of-state banks seems to rest on the assumption that financial transactions conducted

by non-resident institutions constitutes "market exploitation."¹ This theory seems to imply that the benefits of competition such as greater consumer access to credit, new and innovative financial services and the geographic spreading of risk are in some way exploitative and as a consequence require state corrective action through some form of taxation. From an economic perspective the merit of such a theory is highly suspect for it completely ignores the benefits that free markets provide to consumers as well as producers.² Certainly the exploitation assertion provides no basis for the evaluation of state tax policy. However, state taxation of out-of-state banking can and should be evaluated through commonly accepted economic principles of good tax policy.

In contrast to the exploitation hypothesis, economic analysis of state taxation of non-domiciliary financial institutions raises a variety of cautionary flags. Indeed, the full cost of this tax to a state and its residents may far outweigh the benefits brought to the state through higher tax revenues. Careful evaluation of market state taxation of non-resident banks raises several concerns as to whether this form of taxation constitutes good policy. Problems arise in the areas of excessive compliance costs, the potential for market

¹ Sandra B. McCray, "State Taxation of New Banking Procedures," Tax Notes (June 4, 1990) p. 1231.

² Roger S. Cohen, "State Taxation of New Banking Procedures: A Reply," Tax Notes (July 30, 1990) pp. 631-32.

discrimination and the possibility the tax would constitute a barrier to trade. In addition, the excess burden of the tax -- economic jargon for the value of the change in consumer and firm behavior as a result of the tax -- may place a formidable cost on a state and its residents. The excess burden of state taxes on non-residents banks include the reduction in financial options for consumers and the loss of some inter-regional loans. In this respect the excess burden of the tax translates into greater financial market instability for states employing market based taxation, particularly during regional business cycles, and higher levels of risk for state financial systems.

POLICY EVALUATION - TAXATION OF NON-DOMICILIARY BANKS

State taxation of the income non-resident banks derive from transactions within that state raises several questions as to whether such taxes constitute reasonable tax policy. In particular, these taxes may violate several commonly accepted criteria for evaluating taxes. Specifically, market state based taxes can impose burdensome compliance costs on firms, are discriminatory in nature and reduce inter-state transactions. While the violation of any one of these criteria is sufficient to raise questions of the appropriateness of the tax, the potential impact of market based taxes on the efficiency of financial markets is cause for serious concern. The excess burden, measured in reduced availability of credit, adverse influence on state economic development and higher levels of financial market risk,

may be sufficiently great to caution against any policy which includes this form of taxation.

Compliance cost. It is generally accepted by economists and policy analysts that taxes should be imposed in a manner which tends to minimize compliance costs.³ However, the high compliance costs has been the uniform experience among the states that tax the earnings of out-of-state banks. These costs can be excessive, especially for smaller financial institutions. First, the tax requires banks to alter their accounting procedures so as to be able to identify and track the location of their loans and other accounts contrary to the way they otherwise conduct business. Second, given individual state tax laws, banks will be required to use different accounting methods to calculate taxes due in each state. Indeed, even among the three states currently taxing the income generated by non-resident banks a variety of differences exist. For example, Tennessee and Indiana use a different apportionment factor for calculating taxable income than does Minnesota. All three states employ apportionment factors which are at variance with the Multistate Tax Commissions proposals. Since banks by changing their accounting systems incur relatively high fixed costs, small institutions will be particularly disadvantaged by this tax. Individuals and small firms will see higher borrowing costs as banks would be required

³ Advisory Commission on Intergovernmental Relations, State Taxation of Banks: Issues and Options (December 1989) p. 7.

to spread these fixed accounting costs over a relatively small loan amounts.

In addition, there is the complicating factor of debt purchased on secondary markets. Financial institutions frequently sell debt, especially home mortgages, to other institutions or individuals. Typically these loans are "bundled" together and a bundle may contain debt instruments from a variety of locations. Should secondary debt be included in a state's definition of taxable base even higher compliance cost would result. Indeed, it is quite possible that the holders of this secondary debt may not even be aware of the tax liability attributable to particular debt bundles. Markets are likely to adjust to these conditions by developing a two tier system. The secondary market which would evolve from this arrangement would cause residents of market base tax states to experience higher borrowing costs.

A final element of the high compliance costs in taxing non-resident banks arises from the possibility of double taxation. If states fail to provide home banks and financial institutions with tax credits for taxes paid to other states, firms would be liable for taxes in two states on the income generated from a single source. Given the low nexus standards currently in place for the states utilizing this tax, it is quite probable that the cost of compliance, especially for small banks and those institutions with minimal exposure in these states, is far in excess of tax liability.

Discrimination. A second commonly accepted element of good tax policy is that the imposition of a tax should not discriminate among different lines of business.⁴ However, state taxation of out-of-state financial institutions on income earned from in-state transactions is in itself discriminatory because it sets a different standard for financial institutions compared to retailers and manufacturers who are subject to the conditions set forth in P.L. 86-272.

In addition, there is the potential for discrimination in the treatment of business conducted through secondary markets. As was noted above the compliance cost associated with secondary market activity may be particularly onerous. Perhaps in consideration of this fact, Minnesota which initially included secondary debt in its tax of out-of-state banks later provided it an exemption, as does Indiana. (The Tennessee situation is less clear but it seems that the state has not exempted most secondary market transactions from their tax.⁵) Yet exempting secondary market transactions sets a double standard for taxing identical sources of income. For example, the secondary market exemption would imply that a out-of-state bank would not liable for taxes on income produced by a mortgage it purchased from an in-state

⁴ Ibid.

⁵ Joe Huddleston, Commissioner, Tennessee Department of Revenue to Timothy L. Amos, General Counsel, Tennessee Bankers Association, correspondence dated July 17, 1990.

bank. However, the out-of-state institution would be liable for taxes if it originated the very same mortgage loan itself.

Taxes as a source of trade barriers. A third criteria for the evaluation of state tax policy is that a tax should not form an effective trade barrier by unduly hindering interstate markets or commerce.⁶ However, states utilizing market state taxation run a real risk of erecting significant barriers to their local markets which will subsequently present problems for the national market. These barriers result, in part, from the high compliance costs discussed above and will cause some out-of-state banks to avoid conducting business in states which levy such taxes. In particular, these taxes are apt to substantially inhibit or even eliminate many smaller firms from participating in that state's financial markets. The loss of these firms, even though they may be small, can have a serious negative effect on the competitiveness of a state's financial markets. Indeed, the benefits of competition, lower borrowing costs and greater access to credit, will be reduced simply by the influence of the tax in dissuading outside banks even from considering an initial entry into that state's markets.⁷

Excess burden. Perhaps the most important criteria in the evaluation of tax policy is that taxes should be selected and

⁶ Idem, Advisory Commission on Intergovernmental Relations.

⁷ See William J. Baumol, John C. Panzar, and Robert D. Willig, Contestable Markets and the Theory of Industry Structure (San Diego: Harcourt Brace Jovnovich, 1982).

levied in a way which minimizes the distortions (excess burden) they imposed on society.⁸ It should be noted that every tax introduces some distortion because individuals and firms always alter their behavior in response to taxes. For example, a tobacco excise tax will cause the price of cigarettes to rise and consumers will make fewer purchases. The excess burden of the tobacco tax is the value to consumers and producers of the cigarettes not purchased. This excess burden may be quite large for a state that enacts a tax which is substantially different from that of surrounding jurisdictions. For example, it has been estimated that cigarette taxes in the State of Washington, which are higher than surrounding states, caused a decrease of 13% in state retail sales in the early 1970's.⁹

Similarly, the excess burden associated with state taxation of out-of-state banks is the reduction in the bank loans and the resulting higher credit costs for individuals and firms. The reduction in credit is a direct consequence of the imposition of the tax which reduces the rate-of-return earned by the taxed institutions. Bank profits are reduced not only by the amount of the tax itself but also by the added compliance costs, which for some firms can easily exceed their total tax obligation. Banks and other financial institutions will respond to this loss in

⁸ See Robin W. Boadway and David E. Wildasin, Public Sector Economics (Boston: Little, Brown and Company, 1984) Chapter 9.

⁹ Paul Manchester, "Interstate Cigarette Smuggling," Public Finance Quarterly (1976), 225-37.

profit in one of two ways. First, banks may simply refrain from conducting business within the taxing jurisdiction. This cessation of business is most likely to occur among small banks or banks with minimal exposure within the state because these banks are particularly susceptible to high compliance costs. Second, financial institutions who remain active in the market will offset their lower profits by reducing their exposure to that market. Either response translate into fewer loans and a reduced availability of credit within the taxing jurisdiction.

The existence of the excess burden associated with taxing income of out-of-state financial institutions is undeniable. What is not known, however, is the magnitude of this burden. For state policy makers there are several important questions which need to be answered before considering the implementation of this tax. First, by how much will the tax raise the cost of borrowing within the state? Second, what impact will the tax have on the availability of credit for resident firms and individuals? Unfortunately, due to the newness these taxes there is little information available to provide direct estimates of the impact of the tax on state credit markets. However, studies of the impact state usury laws may provide some insight into the response of out-of-state banks to the imposition of state taxation. Usury laws were passed with the intention of helping borrowers but they had the opposite effect. Usury restrictions limit credit and ultimately raise borrowing cost for many individuals, just as market state taxation is likely to do.

While usury laws and state taxation are mechanically different, they each have the same impact on the banks subject to their conditions, both reduce lender rates-of-return. Usury restrictions lower profits through interest rates which restrict gross margins. Taxes reduce lender profit through the imposition of higher tax levies and compliance costs. Since the effects on financial institutions of both usury laws and taxation are the same, lower bank profits, usury studies can provide some insight into the potential impact of the market state approach to taxation on credit markets.

Usury studies indicate that financial institutions consistently respond to state imposed reductions in their rates of return in several ways. The most common response is for banks to move credit out of restricted markets by either shifting credit to other (non-usury) states or by switching to loans of a type not subject to interest rate control. This reaction is consistent with what would be the expected response of banks to states enacting market based income taxes. Banks will simply shift loans to states which do not have market based taxes.

The most disturbing aspect of the usury studies, and one which bodes ill for market based taxation of bank income, is the magnitude of the changes in credit availability attributable to state controls. For example, one study of Tennessee found its usury limit of 10% interest caused a thirty percent reduction in finance company loans during the period August 1977 to March

1978.¹⁰ In total the decline in Tennessee based finance company loans outstanding was \$150 million during this time period. Tennessee consumers also responded by transferring their business to neighboring states. For example, Tennessee experienced a sharp reduction in bank auto loans while auto loans made by banks in neighboring Alabama and Georgia rose sharply.¹¹ Even small changes in bank rates of return can lead to substantial amounts of credit loss. During the first four months of 1974 the States of Missouri and Mississippi had an 8% interest limit on home mortgages loans when FHA loan rates averaged about 8.78%. This small reduction in gross returns (less than 10%) lead to an 18% greater decline in residential loan contracts in Mississippi and Missouri than in neighboring states without the 8% limit.¹² Banks made up for their lower levels of local consumer loans by shifting funds out of state, particularly through loans to the Federal funds market.¹³

The evidence provided by usury studies suggest that states should act prudently when contemplating the imposition of the market state approach for taxing income from out-of-state banks. The impact of these taxes on state credit markets will be

¹⁰ Robert E. Keleher and B. Frank King, "Usury: The Recent Tennessee Experience," Economic Review: Federal Reserve Bank of Atlanta (July/August 1978) p. 75.

¹¹ Ibid., p. 76.

¹² Norman N. Bowsher, "Usury Laws: Harmful When Effective," Review: Federal Reserve Bank of St. Louis (August 1974) p. 19.

¹³ Ibid., p. 22.

negative and, as indicated by a variety of usury studies, may be substantial. The possibility that the market state approach to taxation may seriously hamper state financial markets is not surprising for it merely reflects the flip side of the technology that has fostered the high level of interstate transactions. Technology has significantly reduced the cost to banks of entering out-of-state markets. That same technology means that banks can just as easily exit state markets when conditions dictate. Tax laws which reduce profits by imposing unreasonable high compliance costs on banks are likely to effect just such a market condition. Exiting a market may be so costless to out-of-state banks the overall impact on state credit markets could be substantial.

THE EFFECT OF MARKET STATE TAXATION ON STATE CREDIT MARKETS.

The magnitude of changes in state credit markets brought about by the imposition of a market state approach in taxing the earnings of out-of-state banks and financial institutions will be influenced by several factors. The first is the degree to which out-of-state firms participate in the state's markets. Greater participation indicates a potential for significant reductions in the availability of credit within the taxing state. The second element is the level of tax burden, including the compliance costs, which falls on individual banks. Again the greater the cost incurred by a bank, relative to their income earned within the state, the higher the probability it will retreat from the

market. While the impact of the market state approach taxes on credit availability awaits empirical analysis, the types of changes states may expect in their credit markets are clear. Taxed induced changes in state credit markets will have a predictable influence on:

1. market competition and consumer costs,
2. state economic development,
3. regional business cycles, and
4. the level of risk undertaken in state financial markets.

Each of these conditions will be discussed in turn.

Market competition and consumer costs. State bank regulations are highly restrictive and only eleven states permit non-reciprocal nationwide banking.¹⁴ Thus in the majority states, most out-of-state banks are prohibited from a brick and mortar presence. Indeed it is often in response to state restrictions that banks are forced to conduct business as a non-domiciliary institution. Yet, these banks can represent a significant competitive force in their out-of-state markets. Often out-of-state banks provide innovative products or services which may not be commonly available from local institutions. The motive for the out-of-state bank is enhanced profits which can only be accomplished when it provides value to local customers. Consequently, the more a state's financial markets are open to non-domiciliary institutions, the more local consumers benefit.

¹⁴ Idem, Advisory Commission on Intergovernmental Relations, Table 1.

State imposed taxes on non-domiciliary banks will reduce market competition by forcing out-of-state to reduce their tax liability by limiting their market exposure. Financial markets in these states will become more concentrated as out-of-state banks either leave the state entirely or reduce their business volume. Consumers will suffer in several ways when local credit markets become more concentrated. First, a reduction in the number of out-of-state banks means that residents will have fewer credit options and are therefore likely to face higher borrowing costs. Some services provided by out-of-state banks may be eliminated entirely. Second, non-domiciliary banks may refuse to take on small loans in order to compensate for the higher fixed cost associated with compliance. Lower income individuals and new business ventures are most likely to be affected by this change in loan policy.

State economic development. During the decade of the 1980's states and even cities committed billions of tax dollars to support private firms in an effort to promote and enlarge business development and employment opportunities. Tax dollars have been used to subsidize business plant and equipment, to provide interest subsidies for capital expansion, to provide venture capital for new businesses and to fund employee training. While these government efforts have committed billions of dollars to the cause of economic development, they pale in comparison to amount of private sector investments, in which banks play a major

role. Indeed commercial banks provide some \$600 billion in commercial and industrial loans alone.

State taxation of the income earned by out-of-state banks hinders economic development by reducing the amount of funds these banks will commit to state credit markets. Consequently there will be fewer private funds available for direct capital investment. Interestingly, on the one hand states may commit billions of dollars in public funds to encourage private capital formation while simultaneously discouraging private investment through higher tax levies on out-of-state banks.

Regional business cycles. Generally the business cycle is thought of as a national phenomenon but regional impacts are often far more pronounced. It is not uncommon for one part of the country to be in an economic expansion while other regions languish in recession. The regional business cycle visits different credit needs and credit market conditions on states in each phase of the cycle. In general credit is readily available in states benefitting from an economic expansion. Although state firms need capital during expansions, strong revenue streams make it likely that they will be able to finance their continued growth through internally generated funds. In addition, rising personal income adds to bank deposits and provides additional resources to state credit markets. In contrast credit markets in states undergoing a recessionary phase of a regional business cycle are generally tighter because the recession induced decline in personal income

reduces the growth in bank deposits as individuals draw down savings for living expenses.

As businesses move out of recession they need credit to expand and build inventory but the depressed local credit market may not be able to accommodate their needs. Out-of-state banks may be an excellent source of credit in this critical time when local markets are hard pressed to fulfill credit needs. In effect banks by loaning outside of their region act to reduce the economic consequences of regional recessions by shifting some funds from healthy states to moving out of distress. By taxing the earnings of out-of-state banks, state may be erecting a barrier to this flow which could ultimately exacerbate local economic conditions. In effect market based state taxes could dampen total tax revenues by restricting the flow of an important source of business credit needed to lift the state out of recession.

Risk undertaken in state financial markets. Banks and other financial institutions are subject to a variety of risks. First, there is the risk inherent in any loan for ultimately some borrowers may not be able to repay the loan. Second, there is risk contained in an entire loan portfolio which is often sensitive to macroeconomic factors outside the control of the bank. For example business failures tend to rise during periods of economic recession. A deep recession can threaten a large portion of business loans held by individual banks.

As an offset to this risk banks diversify their loan portfolios by including loans made to a variety of industries or purposes. Banks can further reduce risk through a geographical diversification of their loans. Such diversification provides banks with additional safety, because even the depths of a severe national recession, many states and regions individually experience reasonably good economic conditions.

Market state based taxation encourages portfolio risk by inhibiting banks from making out of state loans. The impact of this is not merely limited to the portfolios of out-of-state banks alone but may cause local credit markets to incur more risk as well. The reason for the local market impact is simple. When a state discourages out-of-state banks from local lending, it forces its business firms to be more dependent on instate banks for credit. Local firms will have less access to credit, particularly when they need to offset the effects of the business cycle and will therefore, be more dependant on local banks for business loans. As a consequence state bank loans will be more locally concentrated than would otherwise be the case. The reduced access to out-of-state markets in combination with local concentration of loans made by state banks carries with it a higher degree of market risk than would otherwise occur. Market based state tax policy can have a significant effect on the risk inherent in local financial markets.

CONCLUSION

States which enact a market state approach for taxing the income earned by out-of-state banks will reduce the availability of credit to its residents and businesses. Owing to the newness of this form of taxation there is little direct evidence to determine the magnitude of this credit loss. However, economic theory suggests that states which enact this tax could experience a substantial loss of out-of-state bank credit. Theory implies that the tax could reduce financial market competition, raise borrowing costs, hinder state economic development and make state economies more susceptible to regional business cycles. All this suggests that states should act prudently by putting off the implementation of this tax until such time its full effects on markets are known.

EXHIBIT K: 25

Jagiela, John S. and Culhane III, Martin A., "A Taxing Situation for Out-of-State Financial Institutions: Minnesota Sets the Stage by Adopting MTC Proposed Regulations", Journal of State Taxation (Spring/Summer 1989) pp. 35-69

A Taxing Situation for Out-of-State Financial Institutions: Minnesota Sets the Stage by Adopting MTC Proposed Regulations

JOHN S. JAGIELA*
AND
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In response to the explosion of interstate banking and financial activities of large nationwide financial institutions, Minnesota has recently adopted comprehensive nexus and apportionment statutes designed to capture a share of out-of-state financial institutions' revenues derived from Minnesota. Provided that nexus exists, so-called market states, such as Minnesota, are free to impose a nondiscriminatory tax on out-of-state financial institutions, including national banks, in the same manner as other business corporations.¹

The expansion of permissible interstate activities of financial institutions during the last several years, as well as the deterioration of constitutional and statutory restrictions on state taxation of out-of-state financial institutions, has created new revenue-raising incentives for states to reex-

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amine their methods of taxing financial institutions.² The Multistate Tax Commission (MTC) has provided additional impetus for reform by promulgating comprehensive proposed regulations for the attribution of income of financial institutions.

This article first gives an overview of Minnesota's statutory scheme. It reviews the definition of a "financial institution" and describes the nexus and apportionment analyses. It then reviews, in some detail, exemptions for secondary markets, which Minnesota enacted in response to perceived difficulties with the legislation as originally enacted. Finally, it explains other considerations for out-of-state financial institutions, including combined reporting, alternative minimum tax, and Minnesota Business Activity Reports.

Overview of Minnesota's Statutory Scheme

Amendments to the Minnesota corporate franchise tax that were enacted by the Minnesota legislature during its 1987 regular session at Chapter 268 (1987 Minnesota Tax Act), and modified by the 1988 Minnesota legislature's regular session at Chapter 719 (1988 Minnesota Tax Act), have resulted in a substantial redraft and clarification of the Minnesota taxation of financial institutions. Further modifications, primarily of a technical nature designed to clarify identified ambiguities in the current statute, are expected to be adopted by the 1989 Minnesota legislature, which will have concluded its current session in May 1989.

Financial institutions falling within Minnesota's taxing jurisdiction are now subject to the corporate franchise tax and taxed in the same manner as other nonfinancial corporations.³ In addition, the 1987 Minnesota Tax Act adopted comprehensive statutory provisions governing the determination of when nonresident taxpayers, including out-of-state financial institutions, have sufficient nexus with Minnesota to be subjected to Minnesota's taxing jurisdiction. Finally, with respect to apportionment of income, the 1987 Minnesota legislature, borrowing heavily from the MTC proposed regulations, adopted a weighted three-factor apportionment formula that applies only to financial institutions. Application of this new statutory apportionment formula will often result in a determination that financial institutions based outside of Minnesota, which derive income or receive deposits from Minnesota sources or customers, are subject to Minnesota's franchise tax.⁴

Assuming an out-of-state financial institution has nexus with Minnesota for franchise tax purposes, the net income from its business carried on partly within and partly without Minnesota is apportioned to Minnesota under a weighted apportionment formula that financial institutions must use.⁵ This three-factor apportionment formula consists of a gross receipts

factor (weighted 70%), a property factor (weighted 15%), and a payroll factor (weighted 15%).⁶

Out-of-state financial institutions obtaining Minnesota deposits, investing in Minnesota loans, or holding other assets with Minnesota connections are likely to have at least two of the three Minnesota apportionment factors. First, the Minnesota receipts factor numerator will include interest income and other receipts from assets in the nature of loans that are related to Minnesota.⁷ Second, the Minnesota property factor numerator includes as intangible property assets in the nature of loans as well as other intangible assets that are related to Minnesota.⁸ It is also possible that an out-of-state financial institution will have a positive Minnesota payroll factor to the extent that its employees may be viewed as performing services in Minnesota. Once the apportionment factor is calculated, it is applied to an out-of-state financial institution's overall taxable net income, which, in general, will be its federal taxable income after certain Minnesota adjustments. The franchise tax is currently imposed at the rate of 9.5% on Minnesota taxable income.⁹

Definition of a Financial Institution

Since the changes in the statute discussed in this article are directed specifically toward financial institutions, a comprehensive definition of the term financial institution is included in the Minnesota Statutes.¹⁰ The term financial institution is broadly defined to include:¹¹

1. A holding company;
2. Any regulated financial corporation; or
3. Any other corporation that is carrying on the business of a financial institution.

These terms are further defined in the statute. For example, "regulated financial corporation" means:¹²

1. An institution whose deposits or accounts are insured under the Federal Deposit Insurance Act or by the Federal Savings and Loan Insurance Corporation;
2. Any institution that is a member of the Federal Home Loan Bank;
3. Any other bank or thrift institution incorporated or organized under the laws of any state or any foreign country that is engaged in the business of receiving deposits;
4. Any Edge Act corporation; and
5. Any agency of a foreign depository.

The definition of financial institution is intentionally drafted broadly enough to include many so-called nonbank banks.¹³ It includes not only

holding companies and regulated financial corporations but also any other corporations that carry on the "business of a financial institution," which includes the business:

1. That a regulated financial corporation may be authorized to do under state or federal law or that its subsidiary is authorized to do by the proper regulatory authorities;
2. That any corporation is authorized to do that is substantially similar to the allowable business of a corporation or its subsidiary doing business under Chapters 46 to 55 of the Minnesota Statutes;¹⁴ and
3. Of any corporation that derives more than 50% of its gross income from lending activities (including discounting obligations) in substantial competition with the business of those regulated financial institutions described in (1) and (2).¹⁵

The Nexus Statute—Minnesota's Claimed Jurisdiction

Minnesota has broadly defined the limits of its taxing jurisdiction with respect to out-of-state financial institutions. Minnesota's codification of the breadth of its taxing jurisdiction over nonresidents is set forth in the Minnesota Nexus Statute.¹⁶ The Nexus Statute, as enacted in 1987 and modified by the 1988 Minnesota Tax Act, claims a broad jurisdiction over many financial instruments and transactions that are connected in some manner with Minnesota. The original Nexus Statute provided limited exemptions for certain financial instruments. Modifications made by the 1988 Minnesota Tax Act, which are effective retroactively to the inception of the Nexus Statute, created additional limitations on Minnesota's claimed jurisdiction over financial instruments and transactions. These modifications were made in direct response to substantial problems identified by practitioners with respect to the breadth of the original Nexus Statute. The 1988 legislature enacted a broad secondary market exemption from nexus consideration for holders of certain financial instruments and other assets with Minnesota connections. The 1989 legislature is also likely to adopt certain further clarifications to the secondary market exemption. The secondary market exemption is discussed in detail below.

Activities Deemed to Create Sufficient Nexus

The Minnesota Department of Revenue (Department of Revenue) will view out-of-state financial institutions that acquire financial instruments connected with Minnesota, or that engage in transactions touching Minnesota, as having nexus with Minnesota, unless their activities fall within

one of the specific nexus exemptions. The Nexus Statute, as modified by the 1988 Minnesota Tax Act, clearly provides that the following physical contacts will subject a taxpayer to Minnesota taxation:¹⁷

1. Conducting a trade or business that has a place of business in Minnesota;
2. Regularly having employees or independent contractors conducting business activities in Minnesota on the taxpayer's behalf; or
3. Owning or leasing real or tangible personal property located in Minnesota.

The Nexus Statute further provides that an entity that does not have any physical contacts with or presence in Minnesota, as described above, will still be viewed as having nexus with Minnesota if it either obtains or regularly solicits business from within Minnesota.¹⁸ Consequently, merely obtaining business from within Minnesota will trigger application of the first part of the "without regard to physical presence" nexus standard. There is no requirement that Minnesota business actually obtained be regularly or systematically obtained from within Minnesota. The second part of the nexus standard will be satisfied if there is regular solicitation of business from within Minnesota, regardless of whether Minnesota business is actually obtained. The statutory "solicitation as nexus" concept was adapted from the nexus provisions enacted concurrently with respect to the application of Minnesota's sales tax to out-of-state entities lacking physical contacts with or presence in Minnesota.¹⁹ For purposes of the income tax Nexus Statute, "solicitation" is broadly defined.²⁰ This is to be expected given the sales tax genesis of the statutory language.

Business From Within Minnesota: Out-of-state financial institutions without physical contacts with or presence in Minnesota will be particularly concerned with the creation of statutory nexus if business is merely obtained from within Minnesota. The Nexus Statute defines "business from within Minnesota" as including, but not limited to:²¹

- (1) sales of products or services of any kind or nature to customers in Minnesota who receive the product or service in Minnesota;
- (2) sales of services which are performed from outside Minnesota but the benefits of which are consumed in Minnesota;
- (3) transactions with customers in Minnesota that involve intangible property and result in income flowing to the person from within Minnesota [as determined under the attribution and apportionment statute discussed below] . . . ;
- (4) leases of tangible personal property that is located in Minnesota [as defined] . . . ;
- (5) sales and leases of real property located in Minnesota; and
- (6) if a financial institution, deposits received from customers in Minnesota.

Particularly important are factors (3) and (6) above, as will become evident in the discussion relating to the attribution and apportionment methodology used to compute Minnesota gross receipts and the broadly defined concept of Minnesota deposits. The nexus exemption provisions, however, mitigate to some extent the broad scope of the statutory nexus factors set forth in the Nexus Statute.

Rebuttable Presumption of Nexus

Minnesota's Nexus Statute creates a rebuttable presumption that nexus exists for certain out-of-state financial institutions meeting the statutory criteria. The 1988 Minnesota Tax Act modified the statutory presumption of nexus so that it now applies only to financial institutions. As modified, the Nexus Statute provides that a person is presumed, subject to rebuttal, to be obtaining or regularly soliciting business from within Minnesota if it is a financial institution and either:²²

1. It obtains or regularly solicits business with 20 or more persons within Minnesota during any tax period; or
2. The sum of its assets and the absolute value of its deposits attributable to sources within Minnesota equals or exceeds \$5 million.

Limiting the "20 or more transactions" test solely to financial institutions was unintended, and the 1989 legislature is expected to make the test applicable to all corporations.

Thus a financial institution that meets either the "20 or more transactions" test or the "\$5 million in Minnesota assets and deposits" test will be presumed, subject to rebuttal, to have nexus with Minnesota. Conversely, these statutory provisions delineate a clear safe harbor for out-of-state financial institutions that do not fall within either of the statutory presumptions and that do not have any physical contacts with Minnesota (i.e., no place of business, employees or independent contractors, or real or personal property located in Minnesota). Such financial institutions will not be subject to any of the taxes imposed by Chapter 290 of the Minnesota Statutes.²³

Of particular concern to out-of-state financial institutions is the rebuttable presumption that an out-of-state financial institution has nexus with Minnesota if the sum of its assets and the absolute value of its deposits attributable to Minnesota exceeds \$5 million. Attribution of assets and deposits is to be made under the comprehensive apportionment provisions discussed below, which attribute a wide variety of assets to Minnesota. Therefore, the activity of holding a loan that is in excess of \$5 million and fully secured by Minnesota real property, for example, will result in a presumption that an out-of-state financial institution has nexus with Min-

nesota. Also, a financial institution that makes 21 unsecured consumer loans to Minnesota borrowers will trigger the nexus presumption, regardless of the aggregate amount loaned.

Planning Observation: Although the statutory presumption of nexus is rebuttable, the level of Minnesota business activity in which an out-of-state financial institution may engage and nonetheless successfully rebut the statutory presumption is not clear. The scope of activities in which taxpayers can engage while successfully rebutting the presumption will probably be determined only on an ad hoc basis as taxpayers challenge proposed audit adjustments made by the Department of Revenue.

As discussed immediately below, a number of financial instruments and activities are exempt from consideration for nexus purposes and, therefore, will not enter into the determination of whether the \$5 million or 20 or more transactions statutory presumptions have been met. However, direct loans with Minnesotans, which were not acquired in a secondary market transaction, do not fall under any of the categories of exempt assets, and such direct loans exceeding \$5 million or involving 20 or more Minnesotans will trigger the rebuttable statutory presumption that nexus exists.

Exempt Financial Instruments and Activities

One of the key provisions in the Nexus Statute involves certain exempt financial instruments and activities that are not to be considered or factored into the determination of whether the owner of the assets or the performer of the activities is subject to tax under Chapter 290 of the Minnesota Statutes.²⁴ These provisions allow out-of-state financial institutions to purchase the enumerated financial instruments without fear that the mere holding of such financial instruments will, in and of itself, subject the holder to Minnesota taxation.

The following statutory language, which may be further clarified by the 1989 Minnesota legislature, sets forth in full Minnesota's basic nexus exemption:²⁵

Ownership of an interest in the following types of property (including those contacts with this state reasonably required to evaluate and complete the acquisition or disposition of the property, the servicing of the property or the income from it, the collection of income from the property, or the acquisition or liquidation of collateral relating to the property) shall not be a factor in determining whether the owner is subject to tax under this chapter:

- (1) an interest in a real estate mortgage investment conduit [REMIC], a real estate investment trust [REIT], or a regulated investment company [RIC], as those terms are defined in the Internal Revenue Code of 1986, as amended . . . ;

- (2) an interest in a loan-backed, mortgage-backed, or receivable-backed security representing either: (i) ownership in a pool of promissory notes, mortgages, or receivables or certificates of interest or participation in such notes, mortgages, or receivables, or (ii) debt obligations or equity interests which provide for payments in relation to payments or reasonable projections of payments on the notes, mortgages, or receivables, and which are issued by a financial institution or by an entity substantially all of whose assets consist of promissory notes, mortgages, receivables, or interests in them;
- (3) an interest in any assets described in [the property factor attribution and apportionment rules, discussed later in this article] and in which the payment obligations embodied in such assets were solicited and entered into by persons independent and not acting on behalf of the owner;
- (4) an interest in the right to service or collect income from any assets described in [the property factor attribution and apportionment rules, discussed later in this article] and in which the payment obligations embodied in such assets were solicited and entered into by persons independent and not acting on behalf of the owner;
- (5) an interest of a person other than an individual, estate, or trust, in any intangible, tangible, real, or personal property acquired in satisfaction, whether in whole or in part, of any asset embodying a payment obligation which is in default, whether secured or unsecured, the ownership of an interest in which would be exempt under the preceding provisions of this subdivision, provided the property is disposed of within a reasonable period of time; or
- (6) amounts held in escrow or trust accounts, pursuant to and in accordance with the terms of property described in this subdivision.
If the person is a member of the unitary group, [this] paragraph does not apply to an interest acquired from another member of the unitary group.

The 1987 Minnesota Tax Act, which originally adopted the Nexus Statute, did not contain the exemptions set forth in items (3) through (6) above, including the final unnumbered paragraph. The 1988 Minnesota Tax Act enacted such provisions, effective retroactively to taxable years beginning after December 31, 1986, the original effective date of the Nexus Statute. The exemption provisions included in items (3) through (6) above are considered in detail below under the discussion of the secondary market exemption from nexus consideration. The 1989 legislature is expected to further clarify this language to provide a retroactive exemption for an interest in money market instruments or securities, as discussed in more detail below. Without this modification, simply holding these instruments may create nexus if an out-of-state financial institution had Minnesota

deposits, because of the operation of the Minnesota Apportionments Statute. Furthermore, proposed 1989 legislation would enact an exemption for interests in funded or unfunded agreements to extend or guarantee credit. The 1989 Minnesota legislature may also modify the secondary market exemption embodied in items (3) and (4) above and revise the limitation on transfers among members of a unitary group. These potential modifications are discussed in more detail below.

The exemptions numbered (1) and (2) above were included in the original legislation enacted by the 1987 Minnesota Tax Act. The exemption in item (2) above was, however, expanded retroactively by the 1988 Minnesota Tax Act to include a broader class of asset-backed securities than was provided in the original statute. These exemptions are designed to protect holders of an interest in a REMIC, REIT, or RIC, and the holders of certain loan-backed, receivable-backed and mortgage-backed securities. Thus, the statutory exemption assures the owner of "securitized" assets, whether in the nature of a pass-through, debt, or equity interest, that simply holding such assets will not create Minnesota nexus. Unless such an exemption were in place, the owner of a \$10 million "securitized" pool of loans with Minnesota real property as collateral would be presumed to have nexus with Minnesota solely by virtue of holding the interest in the Minnesota loan pool.

It should be noted that the exemptions for financial instruments described in items (1) and (2) above do not hinge on obtaining such interests from persons that are independent and not acting on behalf of the owner. By contrast, the secondary market exemptions for certain assets provided under items (3) and (4) above condition the availability of these exemptions upon a showing that neither the holder nor an agent of the holder participated in any origination activities related to the assets. Possible changes in the exemption for secondary market transactions, effective for taxable years beginning after December 31, 1988, are under consideration by the 1989 Minnesota legislature and are discussed below. The new exemptions under items (5) and (6) above apply equally to all of the exempt assets covered by items (1) through (4), and allow direct ownership of property acquired upon a default in a qualifying financial instrument (provided that disposition of the property occurs within a reasonable period of time) as well as the maintenance of an escrow or trust account related to otherwise exempt property.

The last, unnumbered paragraph of the exemption statute, providing that the exemption will not be available to interests acquired from another member of the taxpayer's unitary group, is probably drafted more broadly than necessary to implement its original intent. It is believed that the language was designed to prevent (1) one member of a unitary group from

originating assets, such as loans secured by Minnesota property, and then transferring the assets to another member of the unitary group that would attempt to rely on the secondary market exemption and (2) a Minnesota-based financial institution from rearranging its investment portfolio through intercompany transfers in an attempt to manipulate the apportionment and attribution provisions so as to reduce its Minnesota tax liability. This provision with respect to unitary groups, when read literally, could be construed as removing the nexus exemption when an otherwise exempt asset is transferred between members of the same unitary group. Thus, under the literal statutory language, an interest in a REMIC transferred from one member of a unitary group to another member would lose the protection from Minnesota nexus consideration. It is not believed that this result was intended in circumstances in which the original owner in the unitary group held an exempt asset, and the 1989 legislature is expected to revise this provision to clarify its intended operation.

Purchase Exemption: In addition to the general exemption provisions set forth above, the Nexus Statute contains a provision that is designed to encourage the purchase of tangible personal property or intangible property (subject to the secondary market exemption for intangible property, e.g., loans and other financial instruments) or services by non-Minnesota persons from Minnesota vendors. Purchases from Minnesota vendors will not be taken into account in determining whether an out-of-state entity has nexus "except for services involving either the direct solicitation of Minnesota customers or relationships with Minnesota customers after sales are made."²⁶ Out-of-state financial institutions are given additional statutory protection from nexus consideration.

First, no contact with any Minnesota financial institution by any non-Minnesota financial institution with respect to otherwise exempt transactions, or with respect to deposits received from or by a Minnesota financial institution, will be taken into account in making a nexus determination. Thus, an out-of-state financial institution's contacts with a Minnesota financial institution related to the acquisition of assets qualifying for the secondary market exemption will not be a factor in determining whether the out-of-state financial institution has nexus with Minnesota.²⁷

Second, the inclusion of a Minnesota financial institution in a transaction with an out-of-state financial institution and an out-of-state borrower is not taken into account in determining whether the out-of-state financial institution is subject to Minnesota's taxing jurisdiction.²⁸ Therefore, a Minnesota financial institution will be entitled to enter into a loan participation or co-lending arrangement with non-Minnesotans without tainting the transaction and subjecting an out-of-state financial institution to Minnesota's taxing jurisdiction. As is the case for exempt financial instru-

ments, these additional nexus exemptions will not apply to transactions between or among members of the same unitary group.²⁹

Constitutional Concerns

Two potential constitutional infirmities exist in the current Nexus Statute. First, the broad jurisdictional net of the Nexus Statute may result in taxation of nonresident entities that have little or no Minnesota contact other than holding an intangible asset with some relationship to Minnesota. Subjecting a nonresident to Minnesota taxation when such nonresident does not have certain minimum contacts with Minnesota is, of course, prohibited by the Due Process Clause of the U.S. Constitution.³⁰

The imposition of Minnesota taxation is clearly justified for those nonresident entities that:

1. Have a place of business in Minnesota;
2. Have employees or agents in Minnesota;
3. Own or lease tangible personal or real property located in Minnesota;
or
4. Sell products or services directly to, or solicit business or deposits directly from, Minnesota customers.

In such cases, the out-of-state businesses clearly compete head-on with Minnesota businesses, and imposition of the Minnesota franchise tax is justified to ensure fairness. On the other hand, imposition of Minnesota franchise taxation on an out-of-state entity with no contacts with Minnesota other than, for example, its ownership of a loan secured by Minnesota real property, or its ownership of an unsecured commercial loan in which the proceeds were applied in Minnesota, may well be outside of the permissible constitutional limits of Minnesota's taxing jurisdiction.

Minnesota's assertion of jurisdiction over an out-of-state financial institution, simply because the institution makes or acquires a loan or holds other assets with some relationship to Minnesota, may extend beyond the permissible limits of a state's taxing jurisdiction under the Due Process Clause of the U.S. Constitution. For example, *Chemical Realty Corp. v. Taxation Div. Director*³¹ involved a wholly owned subsidiary of Chemical New York Corporation, a registered bank holding company, that challenged New Jersey's assertion of income tax based on its involvement in certain loan participations that were secured by New Jersey real property. In finding for Chemical Realty, the New Jersey Tax Court determined that Chemical Realty's nexus with New Jersey was insufficient under the Due Process Clause to justify New Jersey's taxation of Chemical Realty's income from the participation loan transactions. Other companies lending funds to New Jersey residents, and carrying out loan servicing activities in New Jersey,

have not been as successful as Chemical Realty in avoiding New Jersey taxation.³²

The possibility that Minnesota could successfully defend its new Nexus Statute if a taxpayer with the same circumstances as Chemical Realty were to challenge the statute should not be underestimated. For example, in a nontax but related context, U.S. Supreme Court precedent such as *Burger King v. Rudzewicz*³³ has broadly defined the power of a state to exercise personal jurisdiction over a nonresident even if the nonresident is not physically present in the forum state but merely engages in commercial efforts "purposefully directed" toward residents of the state.³⁴

Unreasonable Classification Issue: A second constitutional problem with the Nexus Statute is that it may be viewed as creating unreasonable classifications among similar financial instruments. This classification problem creates not only due process concerns but also concerns over possible violations of the Equal Protection Clause of the U.S. Constitution and the Uniformity Clause of the Minnesota Constitution.³⁵ For example, an out-of-state financial institution holding a "securitized" investment or an interest in a REMIC, REIT, or RIC would not be subject to Minnesota franchise taxation as long as it had no other contacts with Minnesota. This would be the case even if the sole collateral for the investment were mortgages secured by Minnesota real property (which would cause the investment to be attributable to Minnesota). In contrast, direct ownership of an asset, such as a loan, that is secured by Minnesota real property, and that was not acquired in a secondary market transaction, is not currently excluded from nexus consideration. Therefore, an out-of-state financial institution holding such an asset would be exposed to Minnesota's franchise tax simply as a result of holding such an investment. Indeed, nexus would be presumed if the principal balance of the direct loan was \$5 million or more. An entity that acquired the same loan in a qualifying secondary market transaction, however, would not be viewed to have nexus with Minnesota as a result of owning such investment.

Constitutional problems are created by the statutory distinction between (1) "securitized" and secondary market loans and assets and (2) "nonsecuritized" direct loans or assets. Any direct loan can be "securitized" merely by placing it into a pass-through entity or corporation if a party is willing to incur the increased transaction costs. Clearly this legal formality cannot rise to the level of constitutional significance necessary to support a separate, constitutionally appropriate classification. Consequently, the net effect of the statute is merely to increase the cost of borrowing for Minnesota residents engaging in direct borrowing transactions with out-of-state lenders without any offsetting benefit to either the borrower or the state. To the extent that an out-of-state lender makes direct loans into Min-

nesota, an incentive exists for the lender/originator of the loan to sell the loan in the secondary market so that the purchaser of the loan can obtain the statutory umbrella of protection from Minnesota taxation afforded by the secondary market exemption.

Apportionment—A New Comprehensive Treatment

The apportionment factor applicable to financial institutions is weighted. The factors, and their weighting, are as follows:³⁶

1. *Receipts Factor*: The ratio that receipts from Minnesota (that is, gross income, including net taxable gain on the disposition of certain assets, including securities and money market instruments) bear to the taxpayer's total receipts. The weight is 70%.
2. *Property Factor*: The ratio that the total tangible property used by the taxpayer and the intangible property attributable to Minnesota bears to the taxpayer's total tangible and intangible property. The weight is 15%.
3. *Payroll Factor*: The ratio that the portion of the taxpayer's payroll paid or incurred in Minnesota (or paid in respect to labor performed in Minnesota) bears to the taxpayer's total payroll. The weight is 15%.

Calculation of the Receipts Factor

The Minnesota statute sets forth comprehensive rules for determining the receipts factor for financial institutions.³⁷ The receipts factor will allocate or apportion³⁸ in some manner all gross income of the financial institution, including income from money market instruments³⁹ and securities,⁴⁰ as broadly defined in the statute. In addition, receipts from the lease or rental of real or tangible personal property, whether earned under finance or true leases, are attributable to Minnesota if the property is located in Minnesota.⁴¹ Movable property is attributed to Minnesota if either it is used entirely within Minnesota or the principal base of operation of the property is within Minnesota.⁴²

Minnesota's method of attributing interest income and service fee income to Minnesota is set forth in detail in Exhibit 1 (on the following page).⁴³ For example, loans secured by real property are attributed to Minnesota if the security property is located in Minnesota. Unsecured commercial loans are generally attributable to the state where the loan proceeds are applied. Fiduciary and service fee income is attributable to the state where the benefits of the fees or services are consumed. Credit card interest income and service fees are attributable to Minnesota if they are billed to a Minnesota address.

Exhibit 1
Computation of the Gross Receipts Factor:
Interest Income and Service Fee Income
Attributable to Minnesota

<i>Nature of Income Source</i>	<i>Attribution Method</i>
Loans secured primarily by real estate or tangible personal property.	Attributable to Minnesota if the security property is located in Minnesota.
Unsecured consumer loans whether made at a place of business, by a traveling loan officer, by mail, by telephone, or by other means.	Attributable to Minnesota if loan is made to Minnesota resident.
Commercial loans and installment obligations that are unsecured (or secured by intangible property under pending 1989 modifications).	Attributable to Minnesota if proceeds of the loan are to be applied in Minnesota (if not determinable, attributed to state in which there is located the office of the borrower from which the loan application would be made in the regular course of business, otherwise thrown out of apportionment formula).
Interest income from a financial institution's portion of a participation loan (or syndication loan under pending 1989 modifications).	Utilize above criteria, depending on nature of underlying loan (but secondary market exemption may apply).
Credit card interest income, receivables, and service fees.	Attributable to state to which card charges and fees are regularly billed.
Merchant discount income on credit card transactions.	Attributable to state of merchant's location (or place of sale for multistate merchants).
Fiduciary and other services.	Attributable to state where benefits of the fees or services are consumed.
Income from traveler's checks or money orders.	Attributable to state where checks or money orders are purchased.
Receipts from investment in securities of Minnesota or Minnesota's subdivisions, agencies, and instrumentalities.	Wholly attributable to Minnesota.

Exhibit 1 shows that the Minnesota Apportionment Statute relies heavily on the MTC proposals and attempts to apportion income to the market states from which income is generated. It should be noted, however, that the Apportionment Statute differs somewhat from the draft of the current MTC proposed regulations, dated January 1989. Like the MTC proposed regulations, the Apportionment Statute is not concerned with the principal physical location of the income's recipient. Also, the same general methodology as described in Exhibit 1 is used in computing the Minnesota property factor. The sources of interest and certain fee income under the receipts factor are considered intangible assets of the financial institution and, therefore, are attributable or apportionable property.

The apportionment method for financial institutions with respect to receipts from non-Minnesota securities differs from that set forth in Exhibit 1. Subdivision 7 of the Apportionment Statute is designed to cover securities and money market instruments, including, but not limited to, U.S. Treasury securities, obligations of other states and political subdivisions, repurchase obligations, commercial paper, certificates of deposit, and similar instruments that would not fall within the general category of financial instruments attributable to Minnesota.⁴⁴ If the 1989 proposed modifications are enacted, money market instruments and securities will be considered exempt from nexus consideration as subdivision 3(b) assets, and the income therefrom will be apportioned under the provisions of subdivision 6(o), which may limit application of subdivision 7 to certain out-of-state financial institutions.

Deposits Ratio: Subdivision 7 provides that income from such non-Minnesota investments is to be apportioned to Minnesota based on the ratio that the financial institution's total deposits from two sources—(1) Minnesota residents (including any business with an office or other place of business in Minnesota) and (2) Minnesota political subdivisions, agencies, and instrumentalities—bear to the total deposits of the financial institution obtained from all other states. For purposes of computing the receipts factor, all deposits made by Minnesota residents or the state of Minnesota or its political subdivisions are attributable to Minnesota whether or not the deposits are accepted or maintained within Minnesota.

Since many financial instruments held by out-of-state financial institutions will be considered non-Minnesota securities, Minnesota will attempt to apportion income from these investments to Minnesota according to the relationship that Minnesota deposits maintained at an out-of-state financial institution bear to the institution's total deposits. In the case of an unregulated financial institution that may not accept deposits, apportionment of receipts from non-Minnesota securities and money market

instruments is computed based on the ratio that its gross business income from Minnesota bears to its gross business income from all states.⁴⁵

Consistent with the earlier discussion of jurisdiction to tax, an out-of-state regulated financial institution with no deposits attributable to Minnesota would have no income from *non-Minnesota* securities apportionable to Minnesota. However, when such entities invest in Minnesota securities (such as securities issued by Minnesota or its political subdivisions, agencies, or instrumentalities), income from the instruments is wholly attributable to Minnesota for purposes of the receipts factor (regardless of the absence of Minnesota deposits), but not for purposes of the property factor.⁴⁶

The Apportionment Statute provides an extremely broad definition of "deposit" that includes, among other items, normal commercial, checking, savings, time, or thrift accounts, as well as trust funds, escrow funds, funds deposited as advances, outstanding drafts (including cashier's checks and money orders), and money held as a credit balance by a financial institution on behalf of its customers (but not interinstitution fund transfers).⁴⁷ Thus, in analyzing its exposure to Minnesota's franchise tax, an out-of-state financial institution must not only review its loan portfolio and sources of fee income, but also carefully analyze the nature of its deposits and determine what percentage of its total deposits is attributable to Minnesota sources.

Calculation of the Property Factor

Because of the significant impact that holding intangible property has on the operations of financial institutions, the property factor in the apportionment computation includes both tangible and intangible property. The definition of tangible property is the same for both nonfinancial institutions and financial institutions; however, intangible property (except for goodwill) is also specifically includible in the apportionment computation for financial institutions and includes:⁴⁸

1. Coin and currency located in Minnesota.
2. Lease financing receivables to the extent the leased property is located within Minnesota.
3. Secured commercial and consumer loans, unsecured loans, participating loans, credit card receivables, and other receivables that are attributable to Minnesota based on the market state concept in a manner similar to that used to compute the receipts factor discussed above at "Calculation of the Receipts Factor" and as outlined in Exhibit 1.

4. All securities and money market instruments that are apportioned to Minnesota based on the ratio of Minnesota deposits to total deposits (unregulated financial institutions utilize gross business income).⁴⁹

Calculation of the Payroll Factor

The payroll factor is determined identically for nonfinancial institutions and financial institutions.⁵⁰ Basically, this amount includes all payroll paid or accrued to residents of Minnesota or amounts attributable to payments made for services performed in Minnesota.

There are two considerations in determining where an employee's compensation is assigned: (1) the location of the employee's services and (2) the location of the office with which the employee is identified or to which he or she is assigned or accountable. The statute appears to provide that an employee's compensation will be assigned to Minnesota if either (1) all or a portion of his or her services are performed in Minnesota or (2) he or she is identified with or assigned or accountable to a Minnesota office. There is no provision for allocating the compensation of an employee attached to a non-Minnesota office who works both within and without Minnesota; the statute appears to require that an employee's entire compensation be assigned to Minnesota if he or she performs any services within Minnesota. Presumably, there is some *de minimis* level of Minnesota services below which the assignment of such an employee's compensation to Minnesota would not be required, but the statute does not suggest what that level may be.

Exclusion of Exempt Assets

Modifications to the Minnesota Apportionment Statute made by the 1988 Minnesota Tax Act allow certain financial instruments to be excluded from the apportionment factor calculation if the instruments are exempt from nexus consideration under subdivision 3(b) of the Nexus Statute. If a financial instrument is exempt under the nexus provisions (for example, interests in a REMIC, REIT, or RIC, "securitized" loan transactions, or loans or other assets acquired on the secondary market), the holder of such an instrument will be entitled to exclude such exempt instruments from the numerator and denominator of the receipts and property factors provided the holder is engaged solely in permissible activities associated with such instruments.⁵¹ However, if an out-of-state financial institution is subject to Minnesota tax because of its other contacts with Minnesota, its property interest in and its receipts from such exempt property are apportion-

able to Minnesota in the same manner as securities or money market instruments.⁵²

The Secondary Market Exemption

Recognizing that the Nexus Statute, as well as the Apportionment Statute as originally enacted, failed to give adequate consideration to the broad secondary market existing with respect to the resale of financial instruments, the Minnesota legislature adopted a relatively liberal secondary market exemption from the nexus rules in the 1988 Minnesota Tax Act. Legislation proposed in 1989 will, if enacted, further clarify the scope of the secondary market exemption. Therefore, holding certain financial instruments, which under the original statute would have created statutory nexus, will not now be viewed as a factor in determining whether the owner has nexus with Minnesota. Removal of the Minnesota taint from these financial instruments gave Minnesota-based financial institutions relief from the resistance they experienced in attempting to resell financial instruments to out-of-state financial institutions that had considered the potential Minnesota tax consequences of their investment and balked at purchasing financial instruments with Minnesota connections.

Perceived Problems With Original Statute

As the first market state to fully adopt the MTC proposed regulations as law, Minnesota discovered that it had, in effect, created an island on which out-of-state financial institutions hesitated to land. Except for the preexisting nexus exemption applicable to REMICs, REITs, RICs, and loan-backed "securitized" investments, other acquisitions of Minnesota-sourced assets could trigger a statutory presumption of nexus for out-of-state financial institutions. Indeed, to the extent that Minnesota assets (the property factor numerator) plus the absolute value of Minnesota deposits exceeded \$5 million, Minnesota nexus was presumed. A number of the identified problems are attributable to Minnesota's unique position as the only state adopting the comprehensive apportionment rules advocated by the MTC. The authors believe that many of these problems would not exist if all states adopted similar provisions. Of course, widespread enactment of the MTC proposed regulations may never occur.

After enactment of the original Nexus and Apportionment Statutes under the 1987 Minnesota Tax Act, effective generally for taxable years beginning after December 31, 1986, Minnesota practitioners faced many questions regarding the applicability of the provisions to existing as well as contemplated financial transactions. It soon became apparent that the broad nexus provisions of the new statute went beyond practitioners' prior

understanding of the requisite contacts with Minnesota required to subject an out-of-state financial institution to Minnesota's taxing jurisdiction.⁵³ The Department of Revenue's view is that the new law merely codified its existing administrative position. Since the Nexus Statute and Apportionment Statute do not contain any provisions that would grandfather preexisting transactions, financial institutions are properly concerned that transactions, such as secured loans, that they entered into many years before the effective date of the statute would now clearly subject them to Minnesota taxation. The secondary market exemption will, in some cases, provide relief to concerned taxpayers.

Practical Problems: Minnesota practitioners identified a number of practical problems created for Minnesota businesses as a result of the broad statutory reach of the original nexus provisions.

First, an out-of-state financial institution that had not purposefully directed its activities toward Minnesota, and that neither solicited Minnesota deposits nor otherwise directly solicited business from Minnesota, would be unwilling to lend funds to a Minnesota resident that sought out its financial services because the transaction might trigger nexus for the out-of-state financial institution. Moreover, the financial institution could not simply mark up the loan for the estimated amount of Minnesota taxation; it would have to factor into its analysis the overall impact of becoming subject to Minnesota's taxing jurisdiction, including consideration of the expense involved in making the complex attribution and apportionment calculations.

Second, for many of the same reasons, Minnesota-based financial institutions currently engaged in investment banking and in commercial paper sales and remarketing activities found substantial resistance from potential out-of-state customers when they attempted to sell financial products on a nationwide or worldwide scale. Properly advised prospective purchasers that analyzed the Minnesota tax consequences associated with purchasing certain investments found that simply purchasing such investments would in many instances result in a statutory presumption of nexus. Prospective out-of-state investors considering two identical competing securities avoided Minnesota-based securities because of the potential for the imposition of the Minnesota franchise tax. Indeed, because of the inability of the out-of-state financial institution to quantify the actual tax liability and concomitant compliance costs, the out-of-state entity would often forgo investment in the Minnesota-based securities when fungible alternative investments were available.

Third, Minnesota-based financial institutions, and their customers, were deprived of a source of new funds when "nonsecuritized" loans could not be remarketed. The original statute virtually forced Minnesota-based origi-

nators of loans to either "securitize" loans in order to take advantage of the original statutory nexus exemption or hold direct "nonsecuritized" loans in their own portfolios because purchasers were unwilling to acquire them.

Fourth, the broad reach of the original Nexus Statute arguably attempted to tax any party to a financial transaction that was only tangentially involved with Minnesota. For example, prospective out-of-state borrowers utilizing the advisory services of a Minnesota-based financial institution were concerned that any contact with Minnesota, including contacts where their borrowing needs were simply remarketed to other out-of-state financial institutions, would expose the parties to the transaction to Minnesota franchise taxation. Thus, Minnesota financial intermediaries lost potential advisory fee income that would otherwise have been available upon arranging a transaction between two or more out-of-state entities.

Finally, it was widely believed that the broad reach of the Nexus Statute discouraged out-of-state financial institutions holding financial instruments that arguably created nexus pursuant to a literal application of the statute from engaging in any additional contacts with Minnesota. It was believed that by relying upon the potential constitutional limitations discussed above, these institutions would in many cases take a return filing position that they were not subject to Minnesota franchise taxation. To support their filing position, it was believed that such out-of-state financial institutions would scrupulously avoid any contacts with Minnesota through employees, agents, or independent contractors, including use of Minnesota counsel, accountants, investment advisors, or other professionals. It was feared that, for example, out-of-state counsel would be routinely retained to issue opinions with respect to Minnesota law, possibly resulting in inconsistent interpretations of the Minnesota statutes across the country and causing similarly situated out-of-state financial institutions to take conflicting positions with respect to their obligation to pay Minnesota franchise tax.

Adoption of a Nexus Exemption

In an effort to address these perceived problems, the 1988 Minnesota legislature adopted a secondary market exemption for certain financial instruments and activities. The modifications to the Nexus Statute and the Apportionment Statute with respect to secondary market activities are retroactively effective for taxable years beginning after December 31, 1986.⁵⁴ Pending 1989 legislation is expected to include certain retroactive clarifications to the secondary market exemption, as well as adopt a new safe harbor that is intended to provide some amount of certainty that an

acquired asset is an exempt subdivision 3(b) asset, effective for assets acquired in taxable years beginning after December 31, 1988.

Prior to legislative action, an ad hoc advisory group of Minnesota attorneys, bankers, accountants, and other interested parties had met to consider the problems with the original statute and draft legislation that would attempt to alleviate these problems. The group met with representatives of the Department of Revenue. Philosophical differences between the parties were resolved and a middle ground consensus was reached. This resulted in the current secondary market exemption. The Department of Revenue believed that providing an exemption for only secondary market instruments and activities adequately addressed the perceived problems discussed above, yet retained the integrity of the taxation system with respect to out-of-state financial institutions with substantial contacts with Minnesota. The same advisory group and representatives of the Department of Revenue have formulated the pending 1989 modifications.

Current Enumerated Exemptions: The six enumerated nexus exemptions set forth above, under the heading "Exempt Financial Instruments and Activities," now provide a clear safe harbor for secondary market purchasers of Minnesota-based or Minnesota-related assets. As exemptions (3) and (4) from the current version of the Nexus Statute indicate, ownership of assets attributable to Minnesota or of an interest in the right to service or collect income from such assets will no longer be considered in determining whether the owner has nexus with Minnesota.⁵⁵ The secondary market nature of the exemption is provided by allowing the exemption only in the case where "the payment obligations embodied in such assets were solicited or entered into by persons independent and not acting on behalf of the owner."⁵⁶ The statute does not elaborate on these independency or agency concepts.

Modifications by the 1989 Legislature: Legislation proposed in 1989 will expand to eight the list of exempt subdivision 3(b) asset categories by including:

1. "Money market instruments" and "securities," as defined by the statute, irrespective of whether these financial instruments were acquired on a secondary market; and
2. Interests acquired on the secondary market in a funded or unfunded agreement to extend or guarantee credit whether conditional, mandatory, temporary, standby, secured or otherwise.

The first modification, if enacted, will be retroactive to taxable years beginning after December 31, 1986. The second will probably be effective only for taxable years after December 31, 1988. Furthermore, the proposed 1989

legislation will make a wholesale revision to the vague secondary market notion of "independency" by replacing this provision with an objective three-part test, discussed in detail below, measured with respect to certain characteristics of the person from whom the owner acquired the asset, effective for taxable years beginning after December 31, 1988.

Reasonable Contacts: Also incorporated into the exemption statute is a broad provision allowing out-of-state financial institutions to engage in contacts with Minnesota that are "reasonably required to evaluate and complete the acquisition or disposition of [exempt] property, the servicing of the property or the income from it, the collection of income from the property, or the acquisition or liquidation of collateral relating to the property. . . ."⁵⁷ Thus, purchasers of exempt financial instruments on a secondary market basis or holders of instruments otherwise exempt, such as an interest in a REMIC or a loan-backed or mortgage-backed security, will be allowed to engage Minnesota professionals to render opinions with respect to the transaction as well as to assist in due diligence activities. Agents or employees of the out-of-state financial institution may also engage in due diligence and other activities in Minnesota. Contacts with Minnesota that would be required on a continuing basis as a result of the ownership of the property, such as contacts related to the servicing or collection of income from an asset, are allowed. Also allowed are those contacts with Minnesota that are reasonably required with respect to the acquisition or liquidation of related collateral. Out-of-state financial institutions, as a result of this activity exemption, should now have no hesitation about using Minnesota professionals when acquiring assets that fall within the nexus exemption.

Ownership Through Default: The modifications made under the secondary market provisions also allow a person (other than an individual, estate, or trust) to obtain direct ownership of Minnesota intangible, tangible, real, or personal property that is acquired in satisfaction of a default upon an otherwise exempt financial instrument.⁵⁸ Thus, direct ownership of Minnesota property is allowed in certain limited circumstances under the condition that the property is disposed of within a reasonable period of time.⁵⁹ The statute does not elaborate on the period of time that would be considered reasonable. Finally, any funds that an out-of-state financial institution holds in an escrow or a trust account will not be viewed as Minnesota deposits if the funds relate to otherwise exempt property. This provision should lessen the possibility that a nexus presumption would arise if a deposit or escrow amount of \$5 million or more were placed in an out-of-state financial institution with respect to the acquisition or disposal of Minnesota-based property or as additional security for an asset held by the financial institution.⁶⁰

Summary: The modifications made under the 1988 Minnesota Tax Act offer substantial relief for out-of-state financial institutions concerned with the broad reach of the original Nexus and Apportionment Statutes. The new legislation has broadened the transactions and activities that Minnesota will disregard for purposes of determining nexus and has thereby created a wide safe harbor, which will significantly reduce, if not eliminate, many of the concerns of out-of-state financial institutions considering the acquisition of securities or financial instruments with Minnesota connections. Given the infinite variety of financial transactions, it is likely that the statutory exemptions have not addressed every conceivable secondary market transaction. It is expected that additional fine tuning of the statute will be required to ensure that transactions that are truly made in the secondary market are not hindered by the application of Minnesota's Nexus or Apportionment Statutes, and the proposed 1989 legislation is an example of this ongoing process.

Proposed 1989 Modifications to Secondary Market Provisions: Under the existing statute, an asset with Minnesota connections, such as a loan secured by Minnesota real property, may qualify as an exempt secondary market asset only if the payment obligations the asset embodies were originated by persons independent and not acting on behalf of the owner. The independency and agency concepts embodied in this statutory language provide a standard that is too vague for out-of-state taxpayers that hold what they believe to be exempt secondary market assets. Accordingly, proposed 1989 legislation would eliminate the original independency and agency concepts for a more objective test that would be effective for assets acquired in taxable years beginning after December 31, 1988.

The 1989 proposed modifications cannot simply be viewed as a "safe harbor," but rather are new substantive operating procedures to determine whether certain assets are entitled to the secondary market exemption. The proposed bright-line test would require the owner and seller of an asset to meet three tests before secondary market protection applies:

1. At the time of the acquisition of the assets, the owner of the asset must not directly or indirectly own 15% or more of the outstanding stock (15% or more of the capital or profits interest in the case of a partnership) of the entity from which the owner originally acquired the asset. The proposed legislation also includes attribution rules designed to measure the extent of indirect ownership. This attribution rule would provide that an owner is deemed to own all of the stock, capital interest, or profits interest owned by another person if the owner directly owns 15% or more of the stock, capital interest, or profits interest in that other person. Furthermore, the owner is deemed to own all stock, capital interest, and profits interest directly

- owned by any intermediary parties in the transaction, to the extent a 15% or more chain of ownership of stock, capital interest, or profits interest exists between the owner and any intermediary party.
2. The entity from which the owner acquired the asset must regularly sell, assign, or transfer interests in these assets to three or more persons during the full 12-month period immediately preceding the month of acquisition.
 3. The entity from which the owner acquired the asset must not sell, assign, or transfer 90% or more of its exempt assets to the owner during the full 12-month period immediately preceding the month of acquisition.

The practitioner should remember that this three-part test does not apply to all of the categories of exempt assets. Accordingly, owners of interests in assets such as "securitized" loans, money market instruments, or securities will not have to consider the applicability of the three-part test should this legislation be enacted.

The proposed 1989 legislation also clarifies that an interest in the types of assets or credit agreements qualifying for the secondary market exemption is deemed to exist at the time the owner becomes legally obligated (conditionally or unconditionally) to fund, acquire, renew, extend, amend, or otherwise enter into the credit arrangement. Finally, the 1989 proposed legislation would clarify the tax consequences of the transfer of certain exempt assets among members of a unitary group. Although the proposed 1989 legislation discussed herein has been drafted by the Department of Revenue and reviewed by the advisory group, there can be no assurance that the legislation will be enacted or will not be further modified until after the Minnesota legislature concludes its work in May 1989.

Impact on Apportionment Factors

To the extent that an out-of-state financial institution holds an asset that is exempt from consideration under the nexus provisions, and the financial institution is not otherwise subject to Minnesota's taxing jurisdiction (for example, its activities are limited to those specific activities allowed under the Nexus Statute), the gross receipts from the exempt property are excluded from both the numerator and the denominator of the receipts factor.⁶¹ If a financial institution is otherwise subject to Minnesota's taxing jurisdiction (for example, because it owns property in Minnesota, has employees in Minnesota, or conducts business from a Minnesota office), its interest in assets that are considered exempt property under the Nexus Statute is included in the receipts factor; however, the normal attribution methodology discussed above is not used.⁶² Instead, these assets are

included in the receipts factor in the same way as securities or money market instruments.⁶³

Therefore, provided that these assets are not viewed as an investment in securities of the state of Minnesota or its political subdivisions, agencies, or instrumentalities, the gross receipts therefrom will be attributed in the manner provided for nonstate securities.⁶⁴ This methodology requires apportionment of receipts based on the ratio that the financial institution's total deposits from Minnesota bear to its total deposits from everywhere. For unregulated financial institutions, receipts are apportioned to Minnesota based on the ratio that its gross business income earned from Minnesota bears to its gross business income from everywhere.⁶⁵ Thus, even for those out-of-state financial institutions that are subject to Minnesota's taxing jurisdiction, a special apportionment methodology will apply to exempt instruments that are held by such out-of-state financial institutions.

A similar adjustment must be made to compute the out-of-state financial institution's property factor. An out-of-state financial institution that is not subject to Minnesota's taxing jurisdiction will exclude exempt assets from the numerator and denominator of its Minnesota property factor.⁶⁶ To the extent that the holder is subject to Minnesota's taxing jurisdiction, otherwise exempt assets are included in the apportionment base, again based on the deposits ratio for regulated financial institutions and on the gross business income ratio for unregulated financial institutions.⁶⁷

Transactions Not Clearly Within the Safe Harbor

Despite the enactment of the broad secondary market exemption in response to specific problems identified with the original Nexus and Apportionment Statutes, certain financial transactions either have been excluded from the secondary market exemption or do not clearly fall within the exemption. As practitioners begin to apply the modified statutes to real-world transactions, many more examples of such grey-area transactions will probably be uncovered.

In considering transactions not covered by the secondary market exemption, one should remember that the statute is intended to subject the holder of a direct loan with Minnesota borrowers, such as a commercial loan secured by Minnesota real property, to Minnesota's taxing jurisdiction. Thus, origination of a loan secured by Minnesota real property, in and of itself, will be presumed to subject the originator to Minnesota's taxing jurisdiction if it exceeds \$5 million,⁶⁸ since a loan secured by Minnesota real property is attributed to Minnesota and considered a Minnesota asset.⁶⁹

As mentioned previously, it may be possible to "securitize" such a transaction in an effort to use the exemption for loan-backed or mortgage-backed securities. Alternatively, the originator of the loan may simply sell off the loan, although the Department of Revenue would probably view gain or loss from the transaction as Minnesota-source income. In any event, regardless of the nature of the transaction (for example, regardless of whether the borrower or lender solicited the business), a "nonsecuritized" loan of \$5 million or more, using Minnesota real property as collateral, will subject the owner that originated and continues to hold the intangible asset to Minnesota's claimed taxing jurisdiction. This result does not seem appropriate, especially when an out-of-state lender is approached by the Minnesota borrower and the lender does not purposefully direct its conduct toward Minnesota.

Another difficulty occurs when neither the borrower nor the lender to a secured lending transaction is a resident of Minnesota, but the parties engage in a lending transaction where a *portion* of the property securing the loan is Minnesota real property. The issue is whether the inclusion of a single parcel of Minnesota real property in the pool of collateral will taint the entire loan transaction and subject the lender to Minnesota's taxing jurisdiction.

Example: A New York lender makes a \$100 million secured loan to a Massachusetts corporation that offers a \$100 million pool of corporate assets located across the country as security for the loan. If a \$10 million Minnesota warehouse is included in the pool of properties, the question is to what extent, if any, the New York-based lender becomes subject to Minnesota's taxing jurisdiction, simply as a result of the loan transaction with the Massachusetts borrower.

This type of lending transaction should be bifurcated in such a manner that, in the above example, the loan would be viewed for Minnesota purposes as a \$10 million loan secured by Minnesota real property, with the balance of the loan being considered unrelated to Minnesota. The property factor would seem to require this result since a loan is attributed to Minnesota only "to the extent that the security property is located within [Minnesota]."⁷⁰ On the other hand, the statute setting forth the computation of the receipts factor does not contain the phrase "to the extent that the security property is located within [Minnesota]."⁷¹ Therefore, a literal reading of the statute would require Minnesota attribution of the entire gross receipts of the \$100 million loan posited in the above example. Such a result would be clearly unreasonable and it appears proper to attribute gross receipts to Minnesota only to the extent that the loan is secured by Minnesota real property. Informal discussions with the Department of Revenue indicate that it agrees with a position that would bifurcate such

a loan. The MTC has modified its proposed regulations in this area by providing that a loan secured by real property in more than one state is apportioned to the state having "the greatest property value."

►**Planning Pointer:** Since there is no clear statutory or regulatory authority for a bifurcation position, at this juncture the parties may be better advised to substitute other collateral for the Minnesota property if the out-of-state lender wants to avoid any possibility of Minnesota taxation. Moreover, even if the bifurcation concept were accepted (thus limiting Minnesota tax exposure to only a small fraction of the loan transaction), the transaction would still trigger a substantial compliance burden for the out-of-state lender that would be newly subject to Minnesota's taxing jurisdiction as a result of the loan transaction.

Clearly, difficulties with direct loans and variations thereof, as well as with loans partially secured by Minnesota property, will cause continuing concern for out-of-state financial institutions not otherwise obtaining or regularly soliciting business from Minnesota.

Other Considerations

Unitary Businesses and Combined Reporting

An out-of-state financial institution that is determined to be part of a unitary business will be required to join together with other members of its unitary group having nexus with Minnesota and file a combined report to determine its franchise tax liability.⁷² The combined report will compute the out-of-state financial institution's Minnesota franchise tax liability in a manner similar to that described above; however, all corporations that are members of the same unitary group are treated as a single unitary business for purposes of making the net income and apportionment calculations.⁷³ Additionally, in the case of a unitary business, the alternative minimum tax (AMT) computation is computed on an amount reflecting the apportionment factors of all businesses in the unitary group.⁷⁴ In order to compute exposure to Minnesota taxation accurately, one must determine whether an out-of-state financial institution will be viewed as a member of a unitary group and, if so, how the income and activities of the other corporations included in the group will affect its net tax liability.

Minnesota's Alternative Minimum Tax

The 1987 Minnesota Tax Act adopted a highly controversial corporate AMT. An out-of-state financial institution will be subject to AMT to the extent that AMT exceeds the regular tax. AMT is imposed at the rate of

.001 times the "alternative minimum tax base." The AMT base simply equals the sum of the numerators of the gross receipts, property, and payroll apportionment factors, less any available exemption amount.⁷⁵ A corporation that operates as a financial institution as its sole or primary business activity is not allowed any exemption amount from AMT.⁷⁶ However, intangible property is not included in the definition of Minnesota property for purposes of AMT.⁷⁷ Thus, intangible assets, such as loans, will not be included in the AMT base.

Generally, for the first five taxable years during which a corporation is subject to taxation in Minnesota, the amount of its Minnesota property and payroll for AMT purposes is deemed to be zero. However, the 1988 Minnesota Tax Act retroactively amended this exemption, effective for taxable years beginning after December 31, 1986, to exclude financial institutions from qualification for the benefits of this provision.⁷⁸ The factors-based AMT as computed above is effective only for taxable years beginning prior to January 1, 1990. For taxable years beginning after December 31, 1989, Minnesota's AMT is scheduled to switch to a "piggy-back tax" of 40% of the corporation's federal AMT.⁷⁹ The 1989 legislature is considering repealing the factors-based AMT for taxable years beginning after December 31, 1988. Prospects for repeal are not clear because repeal would create an annual revenue loss of approximately \$55 million.

Business Activity Report

The Minnesota Business Activity Report is a one-page information form that certain nonresident corporations with minimal contacts with Minnesota must file with the Department of Revenue, although they do not file Minnesota income tax returns and are not qualified to do business in Minnesota.⁸⁰ Every nonexempt corporation that obtains any business from within Minnesota must file the Business Activity Report annually on Form M-4R.⁸¹ The report must be filed on or before the fifteenth day of the fourth month after the close of the corporation's calendar or fiscal accounting year. Therefore, a calendar-year corporation must file on or before April 15 of the following year.

Of primary concern to out-of-state financial institutions (especially lenders holding assets with Minnesota property as collateral) is the statutory provision penalizing failure to timely file the Business Activity Report by preventing "the use of the courts in this state [except with respect to activities and property exempt from nexus consideration] for all contracts executed and all causes of action that arose at any time before the end of the last accounting period for which the corporation failed to file a required report."⁸² Moreover, the statute provides that a nonexempt cor-

poration does not have any cause of action upon which it may bring suit under Minnesota law unless the Business Activity Report has been filed.⁸³

The court in which the issues arise has the power to excuse a corporation for its failure to file a report when due and to restore the corporation's cause of action under the laws of Minnesota.⁸⁴ The court may exercise this discretion only if the corporation has (1) paid all taxes, interest, and civil penalties due to the state for all periods or (2) provided for payment of such amounts by adequate security or bond approved by the Commissioner of Revenue.⁸⁵ Proposed 1989 legislation would make reinstatement mandatory if the corporation had provided for any outstanding Minnesota tax liability. Concern has arisen that the statute could trigger a protracted dispute with the Department of Revenue over proper tax liability, during which the statute of limitations on the underlying cause of action (for example, a foreclosure action) would continue to run.⁸⁶

Not every out-of-state corporation is required to file the Business Activity Report. For example, out-of-state financial institutions that engage only in secondary market activities will be exempted from the Business Activity Report filing requirements. The statute also contains several exceptions that will apply to many out-of-state corporations. An out-of-state corporation need not file a Business Activity Report if it satisfies any of the following criteria:

1. It has obtained a certificate of authority to do business in Minnesota by the end of the accounting period for which it was otherwise required to file a Business Activity Report;
2. It has filed appropriate tax returns with Minnesota;
3. It is a tax-exempt corporation making a proper information filing;⁸⁷
4. It is a nonresident corporation qualifying for the secondary market exemption from the nexus rules, provided that all of the corporation's activities, or the interests in property that it owns, are exempted from taxation under the exemptions set forth in the Nexus Statute; or
5. It is exempt from Minnesota nexus because its involvement in Minnesota financial transactions resulted in less than \$5 million in assets and deposits and fewer than 20 transactions with Minnesota customers.

Proposed 1989 legislation would repeal exemption (5) above, effective for taxable years beginning after 1988, and add a new exemption for S corporations effective retroactively to taxable years beginning after December 31, 1986.

Out-of-state financial institutions that fail to meet any of the exemptions will be required to file the Business Activity Report only if they obtained any business from within Minnesota.⁸⁸ The meaning of the phrase

"obtained any business" is determined by reference to the Nexus Statute.⁸⁹ Since the Business Activity Report looks only to business obtained by a corporation (that is, completed transactions), it appears appropriate to ignore the listing of items considered as merely solicitation of business, but the Department may disagree with this interpretation.⁹⁰

► **Planning Pointer:** With the modifications made by the 1988 Minnesota Tax Act, exemptions from filing the Business Activity Report are intended to dovetail with exemptions from nexus for out-of-state financial institutions. Thus, entities engaging only in secondary market activities are not required to file Business Activity Reports. Moreover, even if such entities inadvertently become subject to the Business Activity Report filing requirement, but fail to file timely reports, they will still be entitled to use Minnesota's courts to enforce rights in assets qualifying for one of the exemptions from nexus consideration.⁹¹ It has been noted that the filing of a Minnesota Business Activity Report by an out-of-state financial institution may, therefore, be tantamount to an admission of conduct falling within the Nexus Statute.⁹²

Conclusion

Assuming that out-of-state financial institutions have, in prior years, taken the position that income they received from financial instruments with Minnesota connections was not attributable to Minnesota (even, for example, in the case of financial instruments issued by the state of Minnesota or its political subdivisions), the comprehensive Nexus and Apportionment Statutes adopted by Minnesota require these financial institutions to reconsider whether any of their income or assets are attributable or apportionable to Minnesota. If the out-of-state financial institution has no Minnesota deposits, and the financial institution does not transact any lending or service business within Minnesota, only gross receipts from Minnesota securities are attributable to Minnesota. In such a situation, however, the out-of-state financial institution would probably be entitled to rely on the safe-harbor provision that excludes an out-of-state financial institution from Minnesota taxation if its assets and deposits attributable to Minnesota are less than \$5 million, because the absence of Minnesota deposits would result in a determination that the Minnesota securities are not considered Minnesota property. Moreover, assuming pending 1989 legislation is enacted, money market instruments and securities would be excluded as possible sources of nexus. The 1988 Nexus Statute now provides a clear safe harbor for transactions not meeting the statutory nexus presumption of 20 or more transactions with Minnesotans or \$5 million or more in Minnesota assets or deposits. In contrast, an out-of-state finan-

cial institution engaged in large-scale direct lending or in activities generating service fees within Minnesota will probably fall within Minnesota's claimed taxing jurisdiction, since it will be viewed as deriving substantial income from within Minnesota.

The broad new secondary market exemption enacted in 1988, but effective retroactively, will allow out-of-state financial institutions to acquire assets with Minnesota connections from certain independent originators that are not acting on their behalf and to avoid any possibility that simply holding such assets would be considered a factor in determining nexus. (Proposed 1989 legislation would adopt an objective bright-line test for measuring independency using a three-part test.) Moreover, direct ownership of Minnesota property will not trigger nexus if property is acquired pursuant to a default in an otherwise exempt asset and disposed of within a reasonable period of time.

Out-of-state financial institutions that aggressively solicit Minnesota deposits or transact business with a number of Minnesota customers will now more clearly be subject to Minnesota tax, especially if such entities previously took positions that their income was not generally attributable or apportionable to Minnesota under statutory provisions such as Minnesota's qualifying-to-do-business statute. In those situations, it is likely that the nexus and apportionment provisions adopted in the 1987 and 1988 Minnesota Tax Acts will result in an increase in Minnesota taxes for such out-of-state financial institutions.

1. McCray, "State Taxation of Interstate Banking," 21 *Ga. L. Rev.* 283, 284-285 (1986).

2. McCray, *supra* note 1; McCray, "Constitutional Issues in State Income Taxes: Financial Institutions," 51 *Albany L. Rev.* 895 (1987); Judson & Duffy, "State and Local Taxation of Financial Institutions: An Opportunity for Reform," 39 *Vand. L. Rev.* 1057 (1986); Hellerstein, *State Taxation* ¶10.5 (1983 & Supp. 1987). See also Hellerstein, "Federal Constitutional Limitations on State Taxation of Multistate Banks," App. 11 to Board of Governors of the Federal Reserve System, *State and Local Taxation of Banks*, Report of a Study under P.L. No. 91-156 for the Senate Comm. on Banking, Housing & Urban Affairs, 92d Cong., 1st Sess. (Dec. 1971).

3. Minn. Stat. §290.02 (1988). The 1987 Minnesota Tax Act redesignated the corporate excise tax as a franchise tax and repealed the excise tax imposed on national and state banks under Minn. Stat. §290.361 (1986). Thus, national and state banks are subject to the same substantive franchise tax measured by net income as other corporations.

4. The pre-1987 Minnesota tax rules did not contain a separate apportionment formula for banks or other financial institutions. Therefore, in the past, out-of-state financial institutions, in some circumstances, may have determined that they had no income apportionable to Minnesota. Under the detailed apportionment provisions now codified in the Minnesota Statutes, these same institutions are now more clearly subject to taxation in Minnesota.

5. Minn. Stat. §290.191, subd. 1 (1988).

6. Minn. Stat. §290.191, subd. 3 (1988). Note that it is no longer possible to use a non-weighted numerical average apportionment formula in Minnesota.

7. Minn. Stat. §290.191, subd. 6 (1988).
8. Minn. Stat. §290.191, subd. 11 (1988).
9. Minn. Stat. §290.06, subd. 1 (1988).
10. Minn. Stat. §290.01, subd. 4a (1988).
11. Minn. Stat. §290.01, subd. 4a(a) (1988).
12. Minn. Stat. §290.01, subd. 4a(c) (1988).
13. The nonbank rules have been used by both financial and nonfinancial corporations to offer various financial services on a nationwide basis. See Judson & Duffy, *supra* note 2, at 1065-1067.
14. Chapters 46 to 55 of the Minnesota Statutes generally included the following entities: banks, savings banks, trust companies, bank and trust companies, building and loan associations, savings and loan associations, credit unions, industrial loan and thrift companies, investment and loan companies, and safe deposit companies.
15. Minn. Stat. §290.01, subd. 4a(d)(3) (1988).
16. Minn. Stat. §290.015 (1988).
17. Minn. Stat. §290.015, subd. 1(a) (1988).
18. Minn. Stat. §290.015, subd. 1(b) (1988).
19. See Minn. Stat. §297A.21, subd. 4(a) (1988).
20. Minn. Stat. §290.015, subd. 1(d) (1988) provides that "solicitation" includes, but is not limited to: (1) the distribution, by mail or otherwise, without regard to the state from which such distribution originated or in which the materials were prepared, of catalogs, periodicals, advertising flyers, or other written solicitations of business to customers in Minnesota; (2) the display of advertisements on billboards or other outdoor advertising in Minnesota; (3) advertisements in newspapers published in Minnesota; (4) advertisements in trade journals or other periodicals, the circulation of which is primarily within Minnesota; (5) advertisements in a Minnesota edition of a national or regional publication (or a limited regional edition of a broader regional or national publication in which Minnesota is included), which are not placed in other geographically defined editions of the same issue of the same publication; (6) advertisements in regional or national publications in an edition that is not by its contents geographically targeted to Minnesota, but that is sold over the counter in Minnesota or by subscription to Minnesota residents; (7) advertisements broadcast on a radio or television station located in Minnesota; or (8) any other solicitation by telegraph, telephone, computer database, cable, optic, microwave, or other communication system.
21. Minn. Stat. §290.015, subd. 1(c) (1988).
22. Minn. Stat. §290.015, subd. 2(a) (1988).
23. Minn. Stat. §290.015, subd. 2(b) (1988).
24. Although referred to herein as "exempt" financial instruments, it should be noted that such financial instruments are not exempt for any purpose other than determining whether the owner has nexus with Minnesota.
25. Minn. Stat. §290.015, subd. 3(b). Subd. 3(a) of the Nexus Statute recognizes the protection from Minnesota taxation afforded sellers of tangible personal property by P.L. No. 86-272 (15 U.S.C. §§381-384) and specifically allows tangible personal property to be stored in a state licensed warehouse without concern that nexus is triggered.
26. Minn. Stat. §290.015, subd. 4(b) (1988).
27. Minn. Stat. §290.015, subd. 4(c) (1988).
28. *Id.*
29. *Id.*
30. U.S. Const. amend. XIV, §1.
31. 5 N.J. Tax 581 (Tax Ct. 1983), *aff'd*, 6 N.J. Tax 448 (N.J. Super. Ct. App. Div. 1984).
32. In *The Tuition Plan of New Hampshire*, 4 N.J. Tax 470 (1982), a New Hampshire bank made student loans to residents of New Jersey. The bank had no New Jersey contacts except salaried employees who called on school administrators to obtain names of prospective borrowers. The New Jersey Tax Court found such contacts justified the exercise of New Jersey's taxing jurisdiction. See also *AVCO Fin. Servs. Consumer Discount Co. One, Inc. v. Taxation Div. Director*, 100 N.J. 27, 494 A.2d 788 (1985) (Pennsylvania consumer loan corporation that had offices bordering New Jersey and made loans to New Jersey residents engaged in

New Jersey collection efforts and utilized New Jersey courts to enforce borrowers' obligations was subject to New Jersey taxation); CIT Fin. Servs. Consumer Discount Co. v. Taxation Div. Director, CCH ¶¶201-026 (N.J. Tax Ct. 1982) (Pennsylvania consumer loan operation taxable in New Jersey, New Jersey sister corporations viewed as alter ego of Pennsylvania corporation).

33. 471 U.S. 462.

34. 471 U.S. at 472-473.

35. U.S. Const. amend. XIV, §1; Minn. Const. art. 10, §1.

36. Minn. Stat. §290.191, subd. 3 (1988). Minnesota did not adopt a fourth factor, the deposits factor, which was originally advocated by the MTC.

37. Minn. Stat. §290.191, subds. 6, 7, and 8 (1988).

38. Allocable income is income that is assignable to a particular jurisdiction on the basis of a factor such as the domicile of the taxpayer, the location of the property from which the income is derived, or the place in which the income is deemed to have been earned. Apportionable income is income that is not considered assignable to a particular jurisdiction and therefore is attributed in part to each jurisdiction in which it is considered to have been earned on the basis of a formula including one or more factors that are considered to have produced the income. Business income is typically treated as apportionable income if the business is conducted in more than one state.

39. "Money market instruments" means federal funds sold and securities purchased under agreements to resell, commercial papers, banker's acceptances, and purchased certificates of deposit and similar instruments to the extent that the instruments are reflected as assets under generally accepted accounting principles. Minn. Stat. §290.191, subd. 6(c) (1988).

40. "Securities" means U.S. Treasury securities, obligations of U.S. government agencies and corporations, obligations of state and political subdivisions, corporate stock and other securities, participations in securities backed by mortgages held by U.S. or state government agencies, loan-backed securities, and similar investments to the extent the investments are reflected as assets under generally accepted accounting principles. Minn. Stat. §290.191, subd. 6(d) (1988).

41. Minn. Stat. §290.191, subd. 6(e) (1988).

42. *Id.*

43. Minn. Stat. §290.191, subds. 6(f) to 6(n) (1988).

44. See Minn. Stat. §290.191, subds. 6(c) and 6(d), *supra* notes 39 and 40.

45. Minn. Stat. §290.191, subd. 7 (1988).

46. Compare Minn. Stat. §290.191, subd. 6(n) (receipts factor), with subd. 11(l) (property factor).

47. Minn. Stat. §290.191, subds. 8(a) to 8(g) (1988).

48. Minn. Stat. §290.191, subds. 11(d) to 11(l) (1988).

49. Note that for purposes of the property factor, Minnesota securities are apportioned in a manner that is identical to non-Minnesota securities, thus avoiding the possibility that simply investing in Minnesota securities, without other contacts, could trigger the rebuttable presumption of jurisdiction to tax. By computing the property factor for Minnesota securities by reference to a financial institution's Minnesota deposits, an out-of-state financial institution with no Minnesota deposits (or no Minnesota gross business income in the case of an unregulated financial institution) will not have any property factor numerator and will not likely trigger the statutory nexus presumption, even if \$5 million or more of such Minnesota securities are held by the financial institution. Moreover, 1989 modifications, which will be retroactive if enacted, will exempt money market instruments and securities as subdivision 3(b) assets, causing attribution pursuant to subdivision 11(m), which may result in the exclusion of such assets from the property factor.

50. Minn. Stat. §290.191, subd. 12 (1988).

51. Minn. Stat. §290.191, subds. 6(o) and 11(m). See text accompanying *infra* notes 63-67.

52. *Id.*

53. With respect to direct lending activities to Minnesota borrowers where the loan was secured by Minnesota property, prior to enactment of the Nexus Statute, practitioners commonly relied on Minn. Stat. §303.03, which addresses when a foreign corporation is required

to qualify to do business in Minnesota. In particular, the qualifying-to-do-business statute does not require out-of-state entities that make, participate in, or invest in loans, whether as borrower or lender, or that otherwise acquire indebtedness or mortgages or other security interests in Minnesota real or personal property, to qualify to do business in Minnesota. Minn. Stat. §303.03(f). Moreover, activities in Minnesota resulting from securing or collecting debts or enforcing any rights in property securing such debts do not result in the holder being required to qualify to do business in Minnesota. Minn. Stat. §303.03(g). The nexus provisions adopted by the 1987 Minnesota Tax Act are much broader than the provisions that determine whether a corporation must qualify to do business in Minnesota. Even after the modifications made in the Nexus Statute with respect to secondary market instruments and activities, the Nexus Statute is still broader than the qualifying-to-do-business statute. Any uncertainty with respect to the continued utilization of the qualifying-to-do-business statute to determine tax jurisdiction has been rejected by the Minnesota legislature since the 1988 Minnesota Tax Act has amended the statute to specifically state that such statute is not to be utilized as a guide in determining whether an out-of-state entity is subject to Minnesota's taxing jurisdiction. See Minn. Stat. §303.03 (1988).

54. 1988 Minn. Laws, ch. 719, Article 2, Section 57.
55. Minn. Stat. §290.015, subd. 3(b) (1988).
56. Minn. Stat. §290.015, subs. 3(b)(3) and 3(b)(4) (1988).
57. *Supra* note 55.
58. Minn. Stat. §290.015, subd. 3(b)(5) (1988).
59. *Id.*
60. Minn. Stat. §290.015, subd. 3(b)(6) (1988).
61. Minn. Stat. §290.191, subd. 6(o) (1988).
62. *Id.*
63. See Minn. Stat. §290.191, subs. 6(n) and 7 (1988).
64. See *supra* note 45.
65. *Id.*
66. Minn. Stat. §290.091, subd. 11(m) (1988). See also text accompanying *supra* notes 51-52.
67. *Id.*
68. A clear safe-harbor exemption exists for a single loan of less than \$5 million when there are no other contacts with Minnesota. See Minn. Stat. §290.015, subd. 2(b) (1988).
69. See Minn. Stat. §290.191, subd. 11(f) (1988).
70. Minn. Stat. §290.191, subd. 11(f) (1988) (emphasis added).
71. Minn. Stat. §290.191, subd. 6(f) (1988).
72. Minn. Stat. §290.34, subd. 2; see also Minn. Rules §8019.0300, subd. 2.
73. Minnesota's unitary business principle, including definition of the term unitary business and situations where unity is presumed, is codified at Minn. Stat. §290.17, subd. 4 (1988); see also Minn. Rules ch. 8019.
74. Minn. Stat. §290.092, subd. 4(d) (1988).
75. Minn. Stat. §290.092, subd. 3 (1988).
76. *Supra* note 74.
77. Minn. Stat. §290.092, subd. 4(b) (1988).
78. Minn. Stat. §290.092, subd. 4a(5) (1988).
79. Minn. Stat. §290.092, subd. 5 (1988).
80. The information report is simply a device the Department of Revenue will use to identify nonresident corporations that are taking a position that they are not subject to Minnesota's taxing jurisdiction. In practice, it can be expected that those corporations filing the Minnesota Business Activity Report will be targeted for future inquiry to ascertain their qualification for exemption from Minnesota tax.
81. Minn. Stat. §290.371, subd. 1 (1988).
82. Minn. Stat. §290.371, subd. 5(b). (Note that subd. 5 may be renumbered as subd. 4 by the Revisor of Statutes because of the repeal of former subd. 2 under the 1988 Minnesota Tax Act.)
83. Minn. Stat. §290.371, subd. 5(a) (1988).
84. Minn. Stat. §290.371, subd. 5(c) (1988).

85. Minn. Stat. §290.371, subd. 5(c) (1988). There are no monetary penalties for failure to file the Business Activity Report.

86. Litigants in Minnesota courts, and in U.S. District Court actions based on diversity jurisdiction, are expected to routinely raise the issue of whether out-of-state litigants have complied with the Business Activity Report filing requirements or are otherwise exempt. A special exemption from the tax return confidentiality rules has been enacted that will allow parties to a civil action to make a written information request with the Commissioner of Revenue to ascertain whether a timely report has been filed. See Minn. Stat. §290.371, subd. 5(d) (1988).

87. Corporations that are exempt from tax pursuant to Minn. Stat. §290.05, subd. 1, or that file appropriate information returns pursuant to Minn. Stat. §290.05, subd. 4, are not required to file a Business Activity Report. This exemption includes corporations exempt under Subchapter F of the Internal Revenue Code, such as Section 501(c) tax-exempt organizations, as well as corporations engaged in the business of mining or producing iron ore or other ores that are subject to the occupation taxes imposed by Minn. Stat. ch. 298.

88. *Supra* note 81.

89. See Minn. Stat. §290.015, subd. 1(c) (1988). See also text accompanying *supra* notes 17-20.

90. See Minn. Stat. §290.015, subd. 1(d) (1988). See also *supra* note 20.

91. See Minn. Stat. §290.371, subd. 5(b) (1988).

92. Parties concerned with the constitutionality of the Business Activity Report filing requirement should be aware of a recent case considering the constitutionality of a similar New Jersey statute requiring the filing of a Business Activity Report. See *First Family Mort. Corp. of Fla. v. Durham*, 108 N.J. 277, 528 A.2d 1288 (1987), *cert. dismissed by agreement of the parties*, 108 S. Ct. 2860 (1988). In *First Family Mort.*, a Florida corporation whose principal place of business was in Illinois failed to file a Notice of Business Activities Report pursuant to N.J. Stat. §14a:13-15. First Family Mortgage was prevented by the statute from foreclosing on a home mortgage loan in New Jersey until it filed a Business Activities Report on income earned in New Jersey and paid any taxes due. The Supreme Court of New Jersey upheld against both a Commerce Clause and Supremacy Clause challenge the requirement that certain nonresident corporations must file Business Activity Reports before having access to New Jersey courts. The court, however, struck down the portion of the statute that would have permanently denied access to the state's courts for any cause of action accruing during the period for which the report was not filed. Furthermore, national banks and their subsidiaries may wish to take a position that they are not subject to the Business Activity Report filing requirements since the statute may be in conflict with the National Bank Act. See, e.g., *New York Guardian Mortgage Corp. v. Davis*, 193 N.J. Super. 443, 474 A.2d 1101 (1984).

EXHIBIT K: 26

Judson, C. James and Giseburt, Dirk (Davis Wright Tremaine), "State Taxation of Banks and Other Financial Institutions" (November 1, 1990)

STATE TAXATION OF BANKS AND OTHER
FINANCIAL INSTITUTIONS

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State taxation of banks and other financial institutions has a long history. Both the federal government and the individual state governments have exerted substantial power over the activities of banks and other financial intermediaries. Likewise, the federal government has from time to time placed restrictions on the ability of the state and local taxing authorities to tax the activities or assets of banking institutions. The states themselves have voluntarily restricted their own abilities to tax these institutions and have required their governmental subdivisions to adhere to the same rules.

This introduction will explore briefly the regulatory history of the banking industry and then the history of taxation of the industry. We will then discuss in some detail a number of taxation concepts which are unique or unusual for this particular industry.

I.

BANK REGULATORY HISTORY

When the United States was formed, the banking system then in existence was chartered and regulated at the colony level; under both the Articles of Confederation and the Constitution as initially adopted, the substantial portion of the banking system

was state controlled. The First National Bank was chartered by the federal government in 1791. A Second United States Bank was chartered in 1816. Political turmoil surrounding the relative roles of the federal and state governments in general and acutely divisive political goals in the financial area placed both the First and Second Banks of the United States in constant legislative jeopardy. In an era of easy money, neither institution was viewed by the voters as a substantial benefit. For almost a hundred years, our banking system was essentially a state banking system. The intrusion of the First and Second Banks of the United States into the financial scene was both short lived and minimally effective.

All this changed with the financial demands of funding the Civil War. Congress utilized two methods to restrict the freedom of the state banking system and to create out of whole cloth a strong national banking system. The first leg of the strategy was to create a system whereby national banks could be chartered by the Comptroller of the Currency upon application from an individual citizen or citizens. The second leg of the strategy was to issue and impose a tax on notes which were then commonly issued by state banks. The combination of financial disadvantages created by the tax on state bank notes and the ready availability of charter under the National Bank Act drove many state banks to recharter as a national bank. Other state banks reacted in a different fashion. They simply stopped issuing bank notes (to escape tax) and were coerced into

retaining state charters by new state legislation which greatly expanded their powers. In place of the mechanism of issuing bank notes the state banks adopted a time deposit funding mechanism, creating a pool of capital with which to conduct their lending activities. As a result of the Civil War legislation, two viable and competing banking systems were brought to substantial maturity.

The banking system created in 1864 and 1865 continued largely unchanged until 1916 with the creation of the Federal Reserve System. In substantial part, the Federal Reserve System was the Congressional reaction to banking difficulties which occurred periodically during the fifty years between the Civil War situation and the Federal Reserve Act. After additional banking difficulties, the Federal Deposit Insurance Corporation was created in 1933. When the Federal Reserve System was created, Congress permitted state banks to elect not to become a member of the system and to avoid regulation by the Federal Reserve Board.

The regulatory climate today is one of expansiveness. Both state and federal regulatory systems are anxious to grant to their chartered institutions the right to conduct activities which are presently of questionable legality or clearly forbidden. Interstate banking began in the middle 1970's with state legislation which permitted branching across state lines in certain circumstances. In part, the state legislation was driven by the need to shore up the depleted capital of banking

institutions in the newly-liberal admitting state. Typically, interstate branching or acquisition is permitted only on a reciprocal basis: the state of the acquiring institution must grant banks of the target institution the ability to conduct similar activities in the acquiring bank's state. While today most states still do not have legislation which permits interstate branching or nationwide banking, federal legislation has sponsored regional interstate branching in the Northeast and other areas, and interstate branching will spread in the very near future.

In Washington State, for example, the five largest banking institutions are owned out of state, four by California parents and one by a Portland, Oregon parent. In California, in contrast, obstacles against nationwide banking have resulted in foreign ownership of a majority of the top ten.

Even as the states and federal regulatory agencies have granted expanded powers to banks to conduct activities across state lines, legislative and regulatory authority to conduct nontraditional banking activities is proceeding apace. Insurance underwriting, real estate investment, real estate brokerage, travel agency, insurance agency and a number of other nontraditional banking activities are currently the subject of active marketing by state institutions particularly and frequently by federally chartered institutions. Securities underwriting is an area where substantial market and legislative attention has been focused. The Glass-Steagel Act prohibited to

national banks the underwriting of securities. State banks which are members of the Federal Reserve System are similarly forbidden to engage in securities underwriting activities. A state bank which is not a member of the Federal Reserve System is exempted from the prohibition and may (and many presently do) engage in securities underwriting activities. A state bank which engages in a securities business must, however, do so through a subsidiary that insulates its bank parent from liability for the subsidiaries losses or actions. A few states allow their banks to conduct securities activities of one kind or another.

As banks and other financial institutions look toward continued expansion of their powers and broadening of their markets, the states have begun to examine their traditional taxing system to more aggressively tax those new and different activities.

II.

BANK TAXING HISTORY

Banks have historically been exempt from most state and local taxation outside states where they have full banking offices. The National Bank Act of 1864 and its successors imposed comprehensive restrictions upon the taxation of national banks by state and local governments. The restrictions were designed to limit the power of state governments to levy taxes on national banks in retaliation for taxes levied by the federal government on state banks. States could tax national banks only

on their shares of stock and on bank-owned real estate. Although the share tax was in theory assessed on the shareholder of the bank, in most states the collection mechanism contemplated a payment by the financial institution of an amount equal to the tax and reducing otherwise dividend distributions to the shareholders to compensate for that payment. In addition to limiting states to two different methods of taxing national banks, the National Bank Act also limited the tax rate in an attempt to avoid discriminatory treatment of national banks when compared to other state-chartered financial activities.

Congress in 1923 expanded the ability of the states to tax nationally chartered domestic banks. Four methods of tax were permitted. In addition to the shares tax and the real estate tax, a tax was permitted on dividends received by shareholders as well as a net income tax. The latter option was later expanded to permit states to impose a franchise tax on banks which was measured by net income. The purpose of the later amendment was to permit states to tax interest on federal obligations in a nondiscriminatory fashion. The 1923 legislation also required that the rate of tax be no higher than on similar financial activities.

Prompted by two U.S. Supreme Court decisions, Congress in 1969 reassessed its position. It enacted a permanent amendment to the banking laws, which places national banks on the same footing as state banks for state tax purposes. This means that the states are free to impose any tax, including a tax on

intangibles, on any bank having taxable nexus within the state, subject only to the requirement of equal treatment of national and state banks within the same state.

The effective date of the permanent amendment lifting the restrictions on state and local taxation of national banks was delayed until January 1, 1973, in order to permit the Federal Reserve System to conduct a study to determine the impact of the amendment on the banking system and to investigate other relevant issues. The permanent amendment was in effect for approximately eight months when, on August 16, 1973, Congress passed another extension. In order to allow time to develop uniform and equitable methods for determining jurisdiction to tax and for dividing the tax base among the states, Congress imposed a moratorium on the imposition by any state or local government of any tax measured by income or receipts or any other "doing business" tax on any insured depository not having its principal office within such state. The moratorium terminated September 12, 1976. The moratorium provided by Pub. L. 93-100 having lapsed, 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.

Congress also commissioned the Advisory Commission on Intergovernmental Relations (ACIR) to make a study of all pertinent matters relating to the application of state "doing business" taxes on out-of-state depositories.

ACIR made six recommendations in its study mandated by Congress:

(a) Jurisdiction to tax should be limited to those institutions which have a substantial physical presence in the state.

(b) Jurisdiction should be denied with respect to banks that enter a state merely to protect security interests in the case of default on loans secured by property in the state.

(c) Federal legislation should not adopt a standardized definition of taxable income or mandatory apportionment/allocation guidelines.

(d) The public debt law should be amended to authorize states to include income from federal government obligations in the measure of direct net income taxes.

(e) Federal legislation should prevent states from practicing "discriminatory taxation" against out-of-state institutions.

(f) Where a bank is subject to taxation in more than one state, the home office state should allow credit for similar taxes paid to other states.

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. S. 1900, introduced in the 95th Congress, is 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.

Senator Cranston (D. Cal.) with Senator Heinz (R. Pa.) and Senator Lugar (R. Ind.) introduced S. 719 in the 95th Congress. S. 719, in summary form, contains the following elements:

(a) Title I of S. 719 provides a jurisdictional standard under which any state or political subdivision may tax a depository if it maintains a "business location" within the state or subdivision. A business location is defined as an office location; the regular presence of employees; the leasing of tangible personal property to others (although jurisdiction would extend only to leasing activities); or the ownership and use of an electronic funds transfer facility.

(b) Title II of the bill contains an optional maximum uniform apportionment formula. The formula serves to establish a ceiling as to the amount of the applicable tax base of a depository which may be taxed by a state which has jurisdiction to tax such depository. This approach allows each state to adopt or continue to apply its own apportionment formula or any other division of tax base rule, while providing a depository protection from taxation of more than 100% of its state tax base. The two-factor formula of payroll and receipts reflects the major elements contributing to depository operations and profitability.

The property factor provided in the traditional three-factor formula is omitted because tangible property of depositories is heavily weighted to the home office state and would tend to be duplicative of the payroll factor (unless leased property is a substantial portion of the bank's assets). Intangible personal property is excluded as a factor because it would tend to be duplicative of the receipts factor. Throwback rules are provided to protect against the assignment of tax base to a state which does not have jurisdiction to tax a depository, thereby providing full accountability for revenue.

(c) Rules for combined reporting are provided which generally allow a state to continue its practices as to its own depositories. There are limitations as to the combination of depositories and nondepositories in nondomiciliary states which do not change existing practices and which protect depositories from the extension of state reporting requirements based on the unrelated activities of already taxable nondepository affiliates.

(d) S. 719 would allow individual states to select their method of doing business taxation - whether measured by income, receipts, or capital values or a combination thereof. Generally the states are free to define their own tax base except that income acquired from a branch or agency located outside the United States is excluded from the tax base.

(e) The bill contains a provision which provides for nondiscrimination between domiciliary and nondomiciliary

depositories and between state and federally chartered institutions.

The Multistate Tax Commission 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 go in taxing interstate activities of the expanding banking industry. The proposed regulation has been drafted and redrafted on a number of occasions. It is not expected to be promulgated in final form until mid-1991.

III.

WHAT IS A BANK?

There exist a number of somewhat conflicting definitions of the term "bank." Black's Law Dictionary describes a bank as:

An institution . . . whose business it is to receive money on deposit, cash checks or drafts, discount commercial paper, make loans, and issue promissory notes payable to bearer. . . ."

The Supreme Court has defined a bank in the following terms:

Strictly speaking, the term "bank" applies a place for the deposit of money, as that is the most obvious purpose of such an institution. Originally the business of banking consisted only in receiving deposits, such as bullion, plate and the like, for safekeeping until the depositor should see fit to draw it out for use, but the business, in the progress of events, was extended, and bankers assumed to discount bills and notes and to loan money upon mortgage, pawn or

other security, and at a still later period to issue notes of their own intended as a circulating currency and a medium of exchange instead of gold or silver.

The National Bank Act of 1964 defines a bank in terms of its powers. A national bank is permitted:

To exercise 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 securities; and by obtaining, issuing, and circulating notes according to the provisions of this chapter.

For federal tax purposes, the term "bank" has been defined to include a bank or trust company:

(a) Incorporated in doing business under the laws of the United States (including laws relating to the District of Columbia) or any state,

(b) A substantial part of the business of which consists of (i) receiving deposits and making loans and discounts or (ii) of exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and

(c) That is subject by law to supervision and examination by state or federal authority having supervision over banking institutions. The term "bank" also encompasses a domestic building and loan association.

State regulatory definitions are often more streamlined.

RCW 30.04.010 defines "bank" in the following language:

Any corporation organized under the laws of a state engaged in banking, other than a trust company or a mutual savings bank.

"Banking" is defined as including "the soliciting, receiving or accepting of money or its equivalent on deposit as a regular business." The regulatory definition goes on to differentiate among the following kinds of institutions: commercial bank; savings bank; trust company; foreign or alien bank; mutual savings bank; industrial loan company; consumer finance company; credit union; crop credit associations; develop credit corporations; industrial development corporation. Although many of these institutions have specific tax rules in most states, they are all roughly comparable in their activities and might logically be (and usually are) taxed in an integrated fashion.

Newly redrafted California Reg. § 23183 (copy attached) defines a financial corporation as one which predominantly deals in money or monied capital in competition with the business of national banks. A copy of the section is attached to this article as Exhibit 1.

IV.

CURRENT STATE TAX SCHEMES

Reliable data concerning the current posture of the several states as they struggle with taxation of out-of-state banks have been difficult to come by. The Advisory Commission on Intergovernmental Relations has been engaged in a substantial study of state taxation of banks, some initial data from which was published in the November 28, 1988 issue of Tax Notes. Among the data there reported are the following:

*Thirty-five states reported that their primary mechanism for taxing banks is a franchise tax. The advantage of the franchise tax, of course, is that a state may tax interest on federal obligations if they utilize a "nondiscriminatory franchise" tax.

*Twenty states measure their franchise tax by a bank's net income.

*Nineteen states utilize a direct net income tax (and therefore do not tax federal interest).

*Seven states impose a bank shares tax.

*Four states utilize a gross receipts tax.

*Six states have a taxing scheme which is not in any of the above categories.

The ACIR survey reported several curious practices. While in the other regions of the country, approximately 75% of the states levy a franchise tax on banks, only 42% of the states in the West utilize a franchise tax in their bank tax schemes. Fifty-four percent of the states in the West utilize a direct net income tax, as compared to only 22% of the states in the Northeast and 18% of the states in the Midwest. No states in the West utilize a bank shares tax, but 33% of the eastern states do utilize this tax.

Twenty-seven states do not tax banks under the same scheme utilized in the taxation of general business corporations. The remaining 23 states utilize the same tax for both banks and the general business corporations. Western states tend to utilize the same tax for banks and other business corporations.

Midwestern and eastern states tend to use a special bank tax for the banks.

The ACIR asked the states to describe their policies with respect to the taxation of income which is earned by out-of-state banks. The table reflected below summarizes the responses:

Categories of Interstate Bank Interest Income
Potentially Subject to State Taxation

Does state tax . . . ? (Income category)	Percent of Responding States		Leading Tax Region
	Yes	No	
1. Interest income from loans made by an out-of-state bank which has no office, employees or representatives in state to a resident of the state and secured by personal property located in state.	22%	78%	50% Midwest
2. Interest income from credit cards issued to state residents by an out-of-state bank which has no office or employees in state.	21%	79%	39% West
3. Interest income from loans to residents in state made by an out-of-state bank which has no office, employees or representatives in the state and secured by real property located in the state.	24%	76%	50% Midwest
4. Interest income from loans solicited by in-state representatives of out-of-state banks (e.g., call programs).	40%	60%	60% Midwest
5. Interest income from loans solicited at loan production offices located in state but closed at the out-of-state home office of the soliciting bank.	67%	33%	80% Midwest South

Thirty-two states indicated that they have either a statute or a regulation which provides for the apportionment of income of a bank which has business activities in more than one state. A UDITPA three-factor formula or variance thereof is utilized by 11 of these states. The remaining 21 states use a variety of methods in apportioning, allocating or separately accounting for

the income of an institution which has business activities across the state lines.

V.

JURISDICTION TO TAX

States have historically had a restrictive view of their ability to tax the activities of banks which are not locally domiciled. In the past, the regulatory focus of most states was limited to regulating banks domiciled in the local jurisdiction and presenting nondomiciliary banks from engaging in as many local activities as possible. At the same time that federal legislation prohibited taxation of nondomiciliary national banks, taxation of domiciliary national banks was severely limited. Many states placed voluntary restrictions on their taxation of locally-chartered banks in order to achieve a sort of equality between the two classes of banks.

A second reason for the limited view of tax jurisdiction was for certain states the preservation of taxing prerogatives with respect to substantial local banking activities. States such as New York regarded themselves in a position only to lose taxing revenue under an expanded tax jurisdiction scheme. New York has a very substantial portion of the nation's banking business in its domiciliary banks. The reluctance of the New York taxing authorities to expand jurisdiction to tax out-of-state activities and thus be in a moral if not legal position to permit its domiciliary banks to claim taxability in other states and a

corresponding out apportionment of revenue base is understandable.

The residence-based tax scheme of New York and other money center states is represented in both the jurisdiction and the apportionment areas. New York has historically extended its tax jurisdiction only to its domestic banks. It was not until 1985 that the presence of a loan production office of an out-of-state bank would support the imposition of jurisdiction to tax. At the same time, the apportionment concept employed by New York contemplated that virtually all of the income of a domiciliary bank would be subject to New York tax with only limited out-apportionment of banking activity clearly located in another jurisdiction.

The expanding activities of banks and other financial intermediaries has, in the minds of most taxing authorities greatly changed the focus of state taxation of banks.

The Multistate Tax Commission regulations and the states of Indiana, Minnesota and Tennessee exemplify how far a state can go in asserting jurisdiction to tax the interstate activities of nondomiciliary institutions. As reported earlier, the MTC has promulgated draft rules which define the conduct of local activities which give rise to state taxation. The MTC proposed regulations define the term "exercising a corporate franchise or transacting business in the state" in the following fashion:

A financial institution is exercising a corporate franchise or transacting business in this state if:

(a) it has a place of business in this state;

(b) it has employees, representatives or independent contractors conducting business activities in its behalf in this state; or

(c) it engages in regular solicitation in this state (whether a place of business, by traveling loan officers or other representatives, by mail, by telephone or other electronic means), and the solicitation results in the creation of a depository of direct debtor/creditor relationship with a resident of this state. For purposes of this regulation, mere processing or transfer through financial intermediaries of checks, credit card receivables, commercial paper and the like does not create a debtor/creditor relationship.

A financial institution is presumed, subject to rebuttal, to be engaged in regular solicitation within this state if it has entered into any of the relationships listed in subsection (c) above with 100 or more residents of this state during any tax period or if it has \$5,000,000 or more of assets attributable to sources within this state at any time during the tax period.

The first two legs of the jurisdictional stool are traditional and noncontroversial. The third leg, although controversial, seems clearly to represent the direction in which the courts are leading, although at this writing there is no state or federal supreme court case clearly defining the rule as contained in the MTC proposed regulation.

The Minnesota jurisdiction rules parallel the MTC proposed regulations. Adopted in 1987, the Minnesota tax scheme provides that a bank is subject to tax if it "conducts a trade or business

which . . . regularly solicits business from within [Minnesota] . . . " The statute then defines solicitation in the following fashion:

- (a) Distribution by mail or otherwise of catalogs, periodicals, advertising fliers, or other written solicitations or of business to customers in Minnesota;
- (b) Display of advertisements on billboards or other advertising in Minnesota;
- (c) Advertising in Minnesota newspapers; and
- (d) Advertising on Minnesota radio or television.

Further paralleling the MTC proposed regulations, the statute contains a presumption that there is jurisdiction to tax if the bank conducts activities with 20 or more persons within Minnesota during a tax year or if the sum of its assets and deposits attributable to Minnesota sources equals or exceeds \$5,000,000.

The courts have taken diverse analytical positions with respect to jurisdictional rules as they apply to financial entities. For example, three states have sought to tax the service charge income of the J. C. Penney Company earned in connection with J. C. Penney Company credit cards. J. C. Penney Co. v. State of Washington; J. C. Penney Co. v. Daily; J. C. Penney Co. v. Department of Revenue.

In each case, J. C. Penney Co. had a number of retail stores in the taxing state. It maintained a credit office in an adjacent state. The credit office administered all credit activities with respect to the retail stores located in the

taxing state and in other states surrounding the taxing state. Credit activities conducted at each retail outlet were minimal. They included such things as telephone contacts between the store and the credit office to ascertain whether a particular credit card is still valid, making available of credit card applications to local customers, and the like. In each case the State Department of Revenue sought to tax service charge income (interest income) earned by J. C. Penney Company from local residents on the ground that sufficient credit activities were located within the taxing state to permit taxation of this income. The trial courts in each of the three states held that the service charge income was not taxable for the reason that the J. C. Penney Company's credit service activities occurred at the regional credit office, rather than within the taxing jurisdiction. In Washington State, the Board of Tax Appeals and the trial court concluded that there was insufficient nexus in a due process sense for the state to tax the service charge income. The Washington Supreme Court overruled the trial court and held that there was sufficient nexus for the state to tax the income. The Indiana Supreme Court held that there was insufficient nexus and upheld the trial court on this basis. The West Virginia Supreme Court overturned the West Virginia trial court, holding that sufficient business contacts did exist for the state to constitutionally tax the service charge income.

In First Federal Savings and Loan v. Abbot, the Supreme Court of Georgia held that the state could not impose an

intangibles recording tax on long-term notes secured by Georgia real estate unless the taxable situs of the notes was in Georgia. In that case the institution holding the notes had no place of business in Georgia and had no agents doing business in Georgia. The fact that its promissory note was secured by Georgia real estate did not provide a sufficient connection with the state to allow the intangible recording tax to be imposed. Compare United States Sugar v. Gay.

The "taxable situs" concept was also at issue in Columbia Bank for Cooperatives v. Blackmon, in which the Georgia Supreme Court held that Georgia could tax objects located beyond the state borders (i.e., long term notes) if ownership of the property resulted from business conducted in the state. In this case the out-of-state lending institution had sent officers and agents to Georgia to solicit loans which were eventually closed in Georgia. The court found that the conduct of such business in Georgia furnished a sufficient nexus to require the lender to pay the intangibles tax on long term notes secured by Georgia real estate.

The Tax Court of New Jersey held that an out-of-state consumer finance company's contact with the State of New Jersey was insufficient to support the imposition of an income tax where the taxpayer had 60 consumer loan offices in Pennsylvania but no offices in New Jersey. However, many consumer loans were made to New Jersey residents, although all arrangements are made through the Pennsylvania offices. Under the facts, the Tax Court held

that there was insufficient nexus to support the imposition of an income tax.

In a similar case, the Wisconsin Tax Appeals Commission held that an out-of-state corporation which engaged in leasing trucks and trailers in the State of Wisconsin was not "doing business" in the state and was therefore not subject to the state franchise tax.

Sandra B. McCray has argued convincingly that jurisdictional test described in the MTC proposed regulations and the Minnesota statutory scheme are a correct statement of the constitutional rule as they apply to state taxation of interstate financial activities. There is as of this writing no case which conclusively resolves this issue. It seems likely that the Minnesota rules will be tested administratively and then through the state and federal court systems. An answer to the question should soon follow.

VI.

STATE JURISDICTIONAL STATUTORY PROVISIONS

The question of statutory taxing authority is extremely important. A number of states have recognized the legislative wisdom of narrowing the jurisdiction of the state to tax interstate financial activities from the constitutional maximums described above. Several states have adopted specific statutory limitations which permit limited interstate banking activities without the necessity of qualifying to do business or paying business taxes. These statutes are so called "negative

jurisdiction" statutes. Other states have determined to define their taxing statutes in a broad way, nevertheless containing an affirmative requirement that the taxpayer have some defined minimum local business activity before taxing jurisdiction is established. These are so-called "affirmative jurisdiction" tests.

California and Alaska are among the states which have adopted negative jurisdiction statutory tests. California statutes provide that certain activities, if conducted by an out-of-state lending institution, will not be considered doing business within the state for tax purposes. These activities include the purchase or acquisition of loans with a California situs; inspection or appraisal by a nonresident employee of California real or personal property securing a loan; enforcement of loans through judicial process; engaging of a nonaffiliated firm to make collections or service loans in California; the acquisition of title to California real or personal property securing loans pending the orderly sale and disposition thereof.

Alaska's Model Foreign Bank Loan Act exempts foreign banks which do not maintain a place of business in the state for receipt of deposits, from licensing requirements and the imposition of certain taxes otherwise imposed for doing a banking business in the state. The banks must limit their activities to make and servicing loans and to transactions designed to provide security for the loans. To take advantage of the exemption, foreign banks must file a statement with the Commissioner of

Commerce prior to engaging in any of the permitted transactions.

The Attorney General of New Jersey has ruled that out-of-state banks conducting limited functions permitted by N.J.S.A. 17:9A-316 are not subject to taxation under two statutory schemes. The first is the Corporation Business Act, which subjects banks in New Jersey to a tax based on net worth and net income. The second is the Corporation Income Tax Act, which imposes an income tax on corporations which are not subject to the Corporation Business Tax Act. The Corporation Business Activities Reporting Act, provides that every foreign corporation which carries on any activity or owns or maintains any property in the state, must annually file a Notice of Business Activities Report with the Division of Taxation of New Jersey. Failure to file such a report disqualifies such corporation from filing any action in any court in New Jersey until it files such a report. Certain activities would make a foreign corporation subject to the Act (at least on the face of the Act) including:

- i. The maintenance of an office or place of business;
- ii. The maintenance of personnel;
- iii. The ownership of real or tangible personal property;
- iv. The ownership of tangible personal property which is used by other (i.e., rental property);
- v. Receiving payments from persons residing in the state aggregating in excess of \$25,000; and

vi. The derivation of income from any source in the state.

There is no recent case law regarding the effectiveness of the Act in barring access of national bank to the courts.

Another important area of statutory involvement in the question of taxing jurisdiction is represented by the Washington J. C. Penney Co. case. Washington's statute reaches out to tax only activities of the taxpayer conducted within the State of Washington. The statute does not seek to tax income derived from sources within Washington, but only income derived from Washington activities. The Board of Tax Appeals concluded that the service charge income was not subject to Washington taxation

and does not fall within the terms or intent of RCW 82.04.290 . . . for the reason that such income was not derived from appellant's activities within the State of Washington.

The Indiana trial court entered a similar legal conclusion in the Indiana J. C. Penney Co. case. The issue was largely ignored by the West Virginia Supreme Court in the West Virginia J. C. Penney Co. case. The New Jersey Attorney General Opinion dated August 31, 1978, supra, is based on similar reasoning.

In Levin-Townsend Computer Corp. v. Town of Stratford, the Connecticut court held that the leasing of tangible personal property by a leasing corporation not qualified to do business in the State of Connecticut, where the lessee used the property in Connecticut, was not "doing business" so as to justify the imposition of the Corporation Business Tax on the lessor. the

court stated that in the absence of an office, bank accounts and a traditional sales force in the state, the lessor's entering into three leases of personal property to a Connecticut lessee would not be treated as "doing business" for tax purposes.

These cases point out an important principle frequently applicable in the area of interstate taxation of financial depositories. Many states do not tax the privilege of deriving income from that state, but instead tax the privilege of engaging in local business activities. Because financial depositories are frequently restricted in the extent to which they can extend their business activities to a state other than their home state, depositories may frequently not be permitted by corporation and banking law from conduct in enough business to be subject to an out-of-state "business activities" tax. Although financial depositories are not subject to the protection of Pub. L. 86-272, the federal negative jurisdiction tax barrier which applies to mercantile companies, they still may be protected from taxation in at least some states by the "business activities" statutory taxation scheme.

VII.

STATE REPORTING MECHANISMS

Broad jurisdictional rules such as those espoused by Indiana, Minnesota and Tennessee raise a corrolary problem: how does the state ascertain which financial institutions are conducting activities which might give rise to taxation? With the increased sophistication of financial transactions, the

ability of a bank to engage in a transaction of substantial size but short duration and minimal contact with the state has increased. As more banks conduct activities within the jurisdictional definitions, the potential for protracted litigation rises geometrically. The logical response by the states to this difficulty is a reporting scheme. The goal of the reporting scheme is to require reporting in virtually all situations where an out-of-state bank may have some activity which affects the state. The goal is to require reporting of virtually all activities because the constitutional prohibitions against taxation typically do not operate in the context of a reporting-only statutory scheme. While all of the activities reported may not give rise to taxation, the state nevertheless has a clear idea of the extent activities of a nondomiciliary institution and can pick and choose among those activities for purposes of taxation.

Minnesota has a notice scheme which applies not only to banks, but to standard business corporations. A Notice of Business Activities must be filed with the tax authority if a nonresident corporation meets any of the following tests:

- (a) it has a place of business or personnel (including independent contractors) in the state;
- (b) It has real or tangible personal property in the state;
- (c) It receives payments in excess of \$25,000 from sources within the state; or

(d) "It derives income from sources within the state."

New Jersey and California have similar statutes. White Dragon Productions holds that the contractual agreements of a corporation which has failed to qualify to do business in California are voidable because of the corporation's failure to comply with State Franchise Tax Law provides that a contract is voidable if it is entered into by a corporation while the corporation's powers, rights and privileges are suspended by the Secretary of State for failure to comply with Franchise Tax requirements. In addition, the California courts have previously held that contracts entered into during the period of suspension are subject to the same rule notwithstanding a subsequent requalification by the suspended company. White Dragon applies the same principle in holding that a corporation's subsequent compliance with the tax laws does not deprive the other party to contracts arising prior to compliance of the right to declare such contract void. A.B. 2773 will provide for retroactive cure of voidability upon payment of penalties, and should become law soon.

On the other hand, in First Family Mortgage Corp., the New Jersey Supreme Court struck down a similar penalty. The New Jersey statute contained a prohibition against lawsuits with respect to "all contracts executed and all causes of action that arose . . . prior to the [filing of a report]". First Family Mortgage Corp., acquired some mortgages on New Jersey real

property. It was clearly covered by the reporting requirements of the New Jersey statute but did not file a report. One of the obligors on the mortgages defaulted and First Family began foreclosure proceedings. The mortgagor defended on the grounds that because First Family had not met the requirements of the reporting statute it could not litigate in the courts of New Jersey. First Family alleged that the statute violated the commerce clause by prohibiting access by First Family to the state's courts. The New Jersey Supreme Court agreed with First Family and struck down the penalty portion of the reporting scheme.

VIII.

APPORTIONMENT SCHEMES

As reported by the ACIR, a substantial block of states use a UDITPA-based free factor formula in apportioning the income of banks and other financial institutions. Some states require the inclusion of intangible personal property in the property factor of a UDITPA-like formula. The "location" of intangibles of course is extremely uncertain. The U.S. Supreme Court has vacillated on the topic, holding sometimes that the situs of intangible is the residence of the debtor and other times that it is at the domicile of the creditor. Sourcing of intangibles for purposes of a three factor formula is a matter of increasing importance as the activities of most banks increasingly cross state lines.

The MTC formula in the present draft is a destination or market-state based formula in which sourcing rules are defined so as to establish the right to tax primarily by states where the proceeds of a financial transaction are utilized rather than where they originate. This is understandable constitutionally and politically. It is understandable constitutionally in that one of the goals of the MTC regulations is to define the outer limits of state taxation of interstate activity. It is understandable politically in that the substantial majority of members of the MTC are so-called market states rather than money center states. A rule which attributes financial income to the source of the funding rather than the use of the funding is inconsistent with the revenue goals of those member states.

The New York rules, of course, are different. The New York rules are substantially domiciliary. The New York factors result in the apportionment to the State of New York of substantially all of the income of domiciliary banks. Loans, for example, are attributed to New York if the greater portion of income-producing activity relating to the loan occurs in New York. Because the current regulatory environment requires that most loans be approved and administered in the domiciliary state, and because for most New York banks the substantial body of their personnel is located in New York, it is likely that virtually all New York bank loans (other than I.B.F. loans) will be sourced to New York for apportionment purposes.

The Minnesota rules, just as the MTC proposed regulations, contemplate attribution of substantial income to the market state. A loan, for example, is attributed to Minnesota if it is secured by property located in Minnesota or if the proceeds of the loan are to be utilized in the state.

California is presently in mid-stride in redefining its apportionment formula.

In Pacific First Federal Savings & Loan Association v. State of Washington, the State of Washington attempted to impose a gross receipts tax upon income generated by the investment of liquid assets by a savings and loan association. The savings and loan association was headquartered in Washington but had branches in Oregon. Part of the funds which were invested by the Washington head office of the association were transferred from its Oregon branches and generated there from Oregon depositors.

The taxpayer argued that the income from the investment should be allocated between Washington and Oregon using a weighting procedure to make the allocation.

The Board of Tax Appeals held for the Department of Revenue that the relevant activity was the investment of funds and that this activity took place solely in the State of Washington. Apportionment was not required because furnishing the funds for investment is not the "performance of a service" which is rendered outside the state and which contributed to the earning of income by the Washington office.

The taxpayer appealed the decision of the Board of Tax Appeals to the Superior Court of Thurston County, which reversed the BTA. The court found that the transmission of funds to Washington and their later investment constituted a single business activity which could not be divided. Therefore the income derived from the investment was subject to apportionment.

The Washington Supreme Court decided the case solely on a statutory ground. The court noted that the rule allows

apportionment if an out-of-state office of a multi-state business "contributes to the performance of" the service which is taxed . . . if the word "contributes" is focused upon, the taxable incident does not occur entirely in Washington. . . . In the instant case, Pacific's Oregon branches "contribute" to the performance of the service (short term investment) by supplying approximately one-half the funds employed. We hold that . . . Pacific is entitled to apportion its income from liquid fund investments.

The State of Washington having no specific statutory authority for a particular apportionment formula, the Supreme Court did not determine the nature of the apportionment required, and remanded the case for consideration of various alternative apportionment formulas in light of the Supreme Court's ruling.

IX.

APPORTIONMENT ISSUES

In Hess Realty Corporation, the Tax Court held that the non-bank taxpayer was allowed to use a three factor apportionment formula even though the corporation did not have a "regular place of business" without the state of New Jersey. The state statutes

permitted apportionment only where the taxpayer maintained a regular place of business outside the state. The Tax Court focused on the ability of the Director of Taxation to mitigate unfair tax results in an interstate context. The Court indicated that since the corporation was clearly taxable in a variety of other states, the fact that it had no regular place of business there did not detract from the requirement of mitigation.

This case may well be helpful in a banking context, particularly in light of the proposed Multistate Tax Commission regulations on interstate nexus and apportionment. The MTC regulations would clearly provide for nexus in situations where there is no substantial contact with a state and clearly where no office is present. This New Jersey case suggests domiciliary states may be required to out-apportion notwithstanding their general policy of requiring a branch or some other substantial office in the out-apportionment state.

In a trial court decision dated March 10, 1989, J.C. Penney was held taxable by Tacoma on 100% of its interest income earned on sales at its Tacoma store. No apportionment was allowed. The decision was clearly wrong.

X.

UNITARY PRINCIPLES

The application of the unitary principle to the financial industry has been expansive. In part because of the regulatory environment, most financial institutions have limited their operations to finance-related activities. Because a typical

financial holding company and its subsidiaries are a group which constitute a "functionally integrated" business operation, the states have generally held that all substantially owned entities which are affiliates of a financial operation must be included in the unitary or combined reporting group. Some states limit combinations to those unitary affiliates doing business within their borders (e.g., New York); other states require a combined report include unitary affiliates not doing business in the state as well (e.g., California). These latter states must address the further issue of whether they require the inclusion of local values in the numerator of the apportionment of these entities' formulae (Finnigan) or not (Joyce). The regulatory framework can best be summarized by reference to federal law. A bank holding company may not own a subsidiary which is not engaged in activities which are not "closely related to banking or managing or controlling banks." National banks may only engage in activities which are "incidental to the business of banking."

Several examples may prove illuminating. The Oregon statutes require "a unitary group of affiliated corporations to file a combined report covering the unitary operation of the group." The statute defines an affiliated corporation as one more than 50% owned by other members or the corporation and defines the concept of a "unitary group" as a group of corporations whose business activities are integrated with and dependent upon or which contribute to the business activities of the group as a whole, and the business activities of the group

are carried on and taxable in more than one state. The Department of Revenue, in turn, has declared that a unitary group exists where a Washington subsidiary of a Washington bank leases computer equipment in the state of Oregon, and that therefore the unitary group must report its Oregon net income on a combined report basis and pay tax on that portion of its income attributable on a three-factor formula basis to Oregon. On the other hand, a leasing subsidiary has been held by Oregon to be subject to the corporation excise tax of 6% rather than the higher rate required from banking institutions when combined reports are filed breaking down the activities of the unitary business in Oregon.

California has found that a group of corporations engaged in the making of small loans were conducting a unitary business where it was established that there was central procurement of money, centralized accounting and supervision, centralized employee training programs and common employee benefit plans which contributed to the earnings for all members of the group. In reponse to the recent decision in Mole-Richardson v. Franchise Tax Board, the Franchise Tax Board reviewed their diverse regulations but ultimately decided to leave the presumption of regulation 25120(b) intact.

New York provides for mandatory combined reporting of 80% or more owned affiliates doing business in New York. Combination of 65% owned affiliates is permitted or required in the discretion of the Tax Commission. Prior application must be made to the

Commission for permissive combination and if approved, binds the group until permission to change is granted.

EXHIBIT K: 27

**Kaltenborn, Marilyn M., "Is New York's Bank Tax Ready for the 1990s?,"
Journal of State Taxation (Fall 1985) pp. 225-234**

Is New York's Bank Tax Ready for the 1990s?

MARILYN M. KALTENBORN*

Chapter 298 of the Laws of 1985 significantly revises the New York State franchise tax on banking corporations (hereinafter referred to as the bank tax) imposed by Article 32 of the New York State Tax Law.¹ The purpose of Chapter 298 is to make the bank tax analogous to the New York State franchise tax on general business corporations. This is appropriate since banks are now competing, directly or indirectly, with other sectors of the financial community, such as investment bankers, stock brokers, and finance companies, all of which are taxed as general business corporations.² Although Article 32 was enacted in 1972, it remained essentially the same as its predecessors,³ which were enacted in 1926. In 1972, the types of business that banks engaged in were more limited than they are today, and the fields of international and interstate banking were in their infancies.⁴

Prior to the enactment of Chapter 298, Article 32's treatment of commercial banks was different from its treatment of thrifts (savings banks and savings and loan associations).⁵ Because of the many changes that have occurred in the manner in which thrifts are organized and the types of business in which they may engage, the constitutionality of this discriminatory treatment was recently questioned.⁶

These developments led to a realization that a change in the bank tax was desirable. Chapter 298 was drafted to meet three primary goals:

1. To tax banks more like general business corporations;
2. To make the treatment of commercial banks and thrifts similar; and
3. To make the calculation of the tax more predictable and less likely to be the subject of adjustment upon audit.⁷

This article discusses in general terms the most significant changes that Chapter 298 made in the bank tax as a result of an evaluation of these goals.

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Corporations Subject to the Bank Tax

Section 1451 of the New York Tax Law imposes a franchise tax on every banking corporation for the privilege of exercising its franchise or doing business in New York in a corporate or organized capacity.

Before the enactment of Chapter 298, a banking corporation was defined in such a manner as to exclude banks that were not *doing a banking business* in New York, even though they may have been *doing business* in New York.⁸ Therefore, an out-of-state bank that had only a loan production office or a representative office in New York was not classified as a banking corporation and was not subject to the bank tax. Such a corporation was not subject to the franchise tax imposed on general business corporations either.⁹ Chapter 298 amends the definitions of "banking corporation" and "banking business" so that an out-of-state corporation that is doing a banking business anywhere and that is doing business in New York is subject to the bank tax;¹⁰ that is, an out-of-state bank with only a loan production office or a representative office in New York will be subject to the bank tax.

Another change in the definition of "banking corporation" concerns subsidiaries of banks and of bank holding companies. Before the enactment of Chapter 298, only certain 80%-or-more owned subsidiaries of a commercial bank, of a corporation subject to Article 3-A of the New York Banking Law (a bank holding company), or of a corporation registered under the Federal Bank Holding Company Act of 1956 were classified as banking corporations. For the subsidiary to be classified as a banking corporation it had to be principally engaged in a business that might be lawfully conducted by a commercial bank. Now the 80%-stock-ownership test has been reduced to a 65% test, and a subsidiary of a thrift or of a corporation registered as a savings and loan holding company (but excluding a diversified savings and loan holding company) under the Federal National Housing Act may also be classified as a banking corporation. The subsidiary must now be principally engaged in a business that might be lawfully conducted by a commercial bank or that is so closely related to banking or managing or controlling banks as to be a proper incident thereto, as set forth in section 4(c)(8) of the Federal Banking Holding Company Act of 1956.¹¹

The result of these changes is that several corporations that were taxable under other franchise taxes will now be taxable under the bank tax instead. However, certain of these corporations may elect not to be taxed under the bank tax. Section 1452(d) of the New York Tax Law provides that any corporation that in 1984 was taxable under the franchise tax on general business corporations may make a one-time election to continue to be taxable under that tax in lieu of the bank tax.

While section 1451 of the New York Tax Law imposes the bank tax on banking corporations, and section 1452 defines the term banking corpo-

ration without including bank holding companies in the definition, bank holding companies may, nevertheless, be subject to the tax. Section 1462(f) provides that under specific circumstances, certain bank holding companies are to be included in a combined return with other banking corporations or bank holding companies. This provision, along with section 1452(d), makes bank holding companies that are included in a combined return subject to the bank tax rather than the franchise tax on general business corporations. This was essentially the rule before the enactment of Chapter 298. Previously, however, only bank holding companies subject to Article 3-A of the New York Banking Law or corporations registered under the Federal Bank Holding Company Act of 1956 could be subject to the bank tax; now, a corporation registered as a savings and loan holding company (but excluding a diversified savings and loan holding company) under the Federal National Housing Act can be subject to the bank tax.

Computation of the Bank Tax

Before the enactment of Chapter 298, Article 32 imposed a tax on thrifts that was the highest of 12% of the portion of entire net income,¹² allocated to New York, with certain exceptions and limitations, 1.6% of the interest or dividends credited to depositors or shareholders; or \$250. For all other taxpayers, the tax was the highest of 12% of the portion of entire net income allocated to New York; 1.6 mills upon each dollar of the taxpayer's issued capital stock allocated to New York; or \$250.¹³

Chapter 298 reduces the 12% rate to 9%, and permits a taxpayer to exclude from entire net income the following income from subsidiary capital:¹⁴ 17% of the interest income, 60% of the dividend income, and 60% of the gains and losses. A taxpayer may also exclude from entire net income 22½% of the interest income it receives from obligations of New York State or any of its political subdivisions, or the United States.¹⁵

The taxes measured by issued capital stock and interest or dividends are replaced by taxes measured by assets and alternative entire net income. However, these taxes apply to all taxpayers uniformly; a distinction is no longer made between commercial banks and thrifts.¹⁶ Therefore, for all taxpayers the bank tax is now the greatest of the following four alternative measures: entire net income, alternative entire net income, assets, or \$250.

The asset tax is imposed at the rate of one-tenth, one twenty-fifth, or one-fiftieth of a mill, depending on the taxpayer's net-worth-to-assets ratio and the percentage of its loans secured by certain types of mortgages. However, if a taxpayer has an outstanding net-worth certificate issued to the Federal Deposit Insurance Corporation (FDIC) or to the Federal Savings and Loan Insurance Corporation (FSLIC) pursuant to the Federal

Garn-St. Germain Depository Institutions Act of 1982 (Garn-St. Germain),¹⁷ it is not subject to the asset-based tax.¹⁸ In addition, any cash or other assistance a taxpayer receives from the FDIC or the FSLIC pursuant to Garn-St. Germain is excluded from assets subject to tax and from entire net income and alternative entire net income.¹⁹

The tax measured by alternative entire net income is imposed at the rate of 3%. Alternative entire net income is the same as entire net income except that it includes *all* income from subsidiary capital and all government bond income.²⁰

Allocation

One of the most significant changes made by Chapter 298 is that the portion of entire net income, alternative net income, and assets that is attributable to business done in New York is to be determined by formula apportionment.²¹ Previously, in most cases entire net income was allocated pursuant to the principles of separate accounting.²² Under separate accounting, each item of income and expense is specifically identified as attributable to business done either in New York or outside New York. In formula apportionment, entire net income (or other tax base) is multiplied by an allocation percentage.

The bank tax allocation percentage consists of three factors: receipts, deposits, and payroll. The receipts factor is the ratio of receipts earned within New York to receipts earned everywhere. The receipts factor for all tax bases includes only those receipts that are included in the computation of alternative entire net income. Therefore, in allocating entire net income, the receipts factor includes all income from subsidiary capital and all government bond income, even though a portion of such income is excluded from entire net income. The deposits and payroll factors are similarly computed, except that for purposes of allocating entire net income and assets, the numerator of the payroll factor is limited to 80% of the payroll paid to New York employees. The allocation percentage for entire net income and assets is determined by adding the three factors together, giving *double weight* to the receipts and deposits factors, and dividing the result by *five*. The allocation percentage for alternative entire net income is determined by adding the three factors together and dividing the result by three.²³

The law contains specific rules for determining whether receipts from such things as loans, leases, credit cards, traveler's checks, and investment activities are earned within New York.²⁴ The most interesting rule concerns *loans*. In general, income from a loan is earned within New York if the greater portion of income-producing activity related to the loan

occurred within New York. However, if a taxpayer attributes income from a loan to a branch outside New York, the attribution will be deemed to be proper unless the State Tax Commission can demonstrate that it is improper. If the Tax Commission so demonstrates and if the taxpayer had a branch in New York at the time the loan was made, the income from the loan is then presumed to be earned within New York. The taxpayer may rebut this presumption by showing that the greater portion of income-producing activity associated with the loan did not occur within New York. When a loan is recorded on the books of a place outside New York that is not a branch, it is presumed that the income from the loan was earned within New York if the taxpayer had a branch within New York at the time the loan was made. The taxpayer may also rebut this presumption.

The statute contains a provision that if the allocation percentage does not properly reflect the taxpayer's activity in New York, the State Tax Commission is authorized to add or delete factors or use a different method to properly reflect the taxpayer's activity within New York.²⁵

International Banking Facilities

Before the enactment of Chapter 298, a taxpayer that had an international banking facility (IBF)²⁶ in New York could reduce its entire net income by the adjusted eligible net income earned by its IBF.²⁷ Now, a taxpayer may elect to either reduce its entire net income by this amount or treat the IBF as if it were located outside of New York when computing its entire-net-income allocation percentage.²⁸

The election made for purposes of computing entire net income is binding for purposes of computing alternative entire net income and the taxpayer's allocation percentage.²⁹ Therefore, if a taxpayer elects to reduce its entire net income and alternative entire net income by the adjusted eligible net income earned by its IBF, the payroll, deposits, and receipts of the IBF are excluded from both the numerator and denominator of each factor when allocating entire net income and alternative entire net income.³⁰ If a taxpayer does not elect to reduce its entire net income and alternative entire net income by the adjusted eligible net income earned by its IBF, the numerator of each factor does not include IBF elements, but the denominator of each factor does.³¹ This results in a lower allocation percentage.

IBF assets are always in the asset-based tax, and a New York IBF is treated as being in New York when computing the asset allocation percentage.³² The payroll, deposits, and receipts of a New York IBF are always in both the numerator and denominator of the factors when computing the asset allocation percentage.³³

Combined Returns

Before the enactment of Chapter 298, a group of affiliated corporations could be permitted or required to compute its tax on a *consolidated* basis. Under this approach, each corporation calculated its own entire net income and determined the portion of such income allocable to business done in New York. If the tax for the consolidated group was measured by entire net income rather than issued capital stock, a "differential tax" was also imposed.³⁴

Chapter 298 provides that a group of affiliated corporations is to compute its tax on a *combined* basis, which is the method used by general business corporations.³⁵ Under this method, each corporation is treated essentially as a division of a single corporation. The group computes combined entire net income, combined alternative entire net income, and combined assets, eliminating all intercorporate transactions. Combined allocation percentages are also computed.³⁶

Although the combined reporting method under the bank tax is generally the same as under the tax on general business corporations, there are some interesting differences between the combined reporting provisions of the bank tax and those of the tax on general business corporations. Under the tax on general business corporations, a combined report may be permitted or required if the following three criteria are met:

1. One corporation owns or controls 80% or more of another corporation or the corporations are both 80% or more owned or controlled by the same interests;
2. The corporations are engaged in a unitary business; and
3. There would be a distortion of the income, capital, activities, or business of a corporation if it filed on a separate basis.³⁷

Under the bank tax, if the 80%-or-more stock-ownership requirement is met, the corporations *must* file on a combined basis, unless the taxpayer or the State Tax Commission can show that the inclusion of an 80%-or-more owned or controlled corporation fails to properly reflect the tax liability of the corporations, that is, it creates a distortion. However, if such a corporation does not have nexus with New York, it will not be included in a combined report, unless the Tax Commission deems the inclusion to be "necessary in order to properly reflect the tax liability under [the bank tax], because of intercompany transactions or some agreement, understanding, arrangement or transaction. . . ."³⁸

If the corporations meet a 65%-or-more stock-ownership requirement, then a combined return *may be permitted or required* if the State Tax Commission deems that a combined return is necessary in order to properly reflect the tax liability of one or more of the corporations.³⁹

While under the bank tax statute there is no separately stated unitary business requirement, it would appear that corporations that are affiliated

with banks or bank holding companies and that are subject to the bank tax are likely to be engaged in a unitary business.

Under the tax on general business corporations, a corporation that is incorporated under the laws of another country (an alien corporation) may not be included in a combined report.⁴⁰ Under the bank tax, an alien corporation may file a combined report, but only with another alien corporation.⁴¹

Before the enactment of Chapter 298, only commercial banks, their holding companies, and certain of the subsidiaries of either of them could be included in a consolidated return.⁴² Now, thrifts, certain of their holding companies, and certain of the subsidiaries of thrifts or their holding companies can also be included in a combined return.⁴³

Miscellaneous Provisions

Chapter 298 takes effect with respect to taxable years beginning on or after January 1, 1985, and all provisions, except those that apply to thrift institutions, expire for taxable years beginning on or after January 1, 1990.⁴⁴

The Administrative Code of the City of New York is similarly amended by Chapter 298. The major difference is that alien banks still have as a basis of tax the tax measured by issued capital stock rather than the asset tax.⁴⁵

Chapter 298 requires that New York State and New York City promulgate regulations regarding certain provisions of the bank tax by December 1, 1985. In addition, the state and the city are authorized to enter into an agreement to provide for a single audit and examination of the books of any taxpayer that is subject to both the state and city bank tax, or, where appropriate, a consistent determination and conclusion with respect to factual matters and interpretations of law whenever such determinations and conclusions relate to substantially identical provisions.⁴⁶

A temporary state commission has been created to study the bank tax and the changes made to it by Chapter 298. The commission is to submit reports by December 1, 1988, and December 1, 1989, and is to recommend whether the amendments made by Chapter 298 should be continued for taxable years beginning on or after January 1, 1990.⁴⁷

Conclusion

As mentioned in the beginning of this article, Chapter 298 was drafted with three goals in mind: to tax banks more like general business corporations; to make the treatment of commercial banks and thrifts similar; and to make the calculation of the tax more predictable and less likely to be the subject of adjustment upon audit.

With respect to taxing banks more like general business corporations, the statute achieves this goal in three ways: by requiring the portion of a tax base that is attributable to business done in New York to be determined by formula apportionment; by requiring combined reporting rather than consolidated reporting; and by imposing as one of the alternative measures of tax an asset-based tax.⁴⁸ However, the bank tax still contains many provisions that differ from those of the tax on general business corporations, the most significant of which are:

- Entire net income does not include a portion of the income from subsidiary capital tax, but no separate tax is imposed on subsidiary capital as is the case under the tax imposed on general business corporations;
- Entire net income does not include a portion of the income from certain government obligations;
- The numerators of the payroll factors of the entire-net-income and asset allocation percentages contain only 80% of New York payroll;
- A deposits factor is used rather than a property factor;
- Combined reporting is mandated in certain cases unless it can be shown to be distortional; and
- Combined reporting is allowed for certain corporations that meet a 65%-or-more (but less than 80%) ownership test.⁴⁹

These differences may be justified in light of the fact that banks are still subject to regulatory requirements and are not yet indistinguishable from general business corporations.⁵⁰

The statute appears to achieve the goal of treating commercial banks and thrifts similarly. However, it is too soon to know whether the goal of making the calculation of the tax more predictable and less likely to be the subject of adjustment upon audit has been achieved.

The question of whether New York's bank tax is ready for the 1990s cannot be answered at this time. It will be up to the temporary state commission created to study the bank tax to make that determination.

1. 1985 N.Y. Laws 298, was signed by the governor on July 10, 1985.
2. See Memorandum in Support of Ass. Bill No. 3434-A (1985) [which was enacted as 1985 N.Y. Laws 298] at 2, 9, and 10.
3. Before the enactment of Article 32, Article 9-B imposed a franchise tax on state banks, trust companies, financial corporations, and savings and loan associations, and Article 9-C imposed a franchise tax on national banking associations and production credit associations.
4. Memorandum in Support, *supra* note 2, at 10.
5. See, e.g., N.Y. Tax Law §1455(b) prior to the enactment of 1985 N.Y. Laws 298.
6. See Savings Bank of Utica v. State Tax Commission, 107 A.D.2d 205, 485 N.Y.S.2d 903 (4th Dept. 1985), appeal docketed.
7. Memorandum in Support, *supra* note 2, at 10.
8. N.Y. Tax Law §§1452(a) and (b) prior to the enactment of 1985 N.Y. Laws 298.

9. See Central Park Plaza Corp. v. Bates, 278 A.D. 607, 102 N.Y.S.2d 77 (3d Dept. 1951), *aff'd*, 303 N.Y. 694, 103 N.E.2d 57 (1951).

10. N.Y. Tax Law §§1452(a) and (b).

11. *Id.* §1452(a)(9). Paragraph nine also excepts from the bank tax subsidiaries that do business with any entity other than a member of its affiliated group, if the subsidiary is principally engaged in a type of business that is subject to a tax other than one measured by net income.

12. Entire net income is federal taxable income with certain modifications. See N.Y. Tax Law §1453.

13. N.Y. Tax Law §1455 prior to the enactment of 1985 N.Y. Laws 298.

14. In general terms, subsidiary capital is investments in the stock of, or loans to, a more-than-50%-owned corporation. See N.Y. Tax Law §1450(d) and (e). Before the enactment of Chapter 298, all income from subsidiary capital was included in entire net income pursuant to N.Y. Tax Law §1453(b)(1).

15. N.Y. Tax Law §§1453(e)(11) and (12).

16. *Id.* §1455(b).

17. Pub. L. No. 97-320.

18. N.Y. Tax Law §1455(b)(1).

19. *Id.* §§1455(b)(1)(v)(A), 1453(e)(9) and (10), 1453(g), and 1453-A(a).

20. *Id.* §1453-A.

21. *Id.* §1454.

22. Before the enactment of 1985 N.Y. Laws 298, N.Y. Tax Law §1454 provided that the method for allocating entire net income was to be prescribed by the State Tax Commission. Regulations promulgated under the predecessor articles to Article 32 state that separate accounting is the preferred method for allocating entire net income.

23. N.Y. Tax Law §1454.

24. *Id.* §1454(a)(2).

25. *Id.* §1454(a)(6).

26. An international banking facility (IBF) is a segregated set of accounts set up in compliance with certain New York banking or Federal Reserve Board requirements. An IBF is exempt from certain regulatory restrictions and requirements, and is created primarily to receive deposits from and lend money to non-U.S. persons. To the extent a New York IBF receives deposits from and lends money to non-U.S. persons, it receives beneficial New York tax treatment. To the extent it receives deposits from and lends money to U.S. persons, it is treated as any other New York branch of the taxpayer. For purposes of this article, it is assumed that a New York IBF receives deposits from and lends money to only non-U.S. persons.

27. N.Y. Tax Law §1453(f). Section 1453(f) also provides that if adjusted eligible net income is a loss, such loss must be added to entire net income.

28. N.Y. Tax Law §§1453(f) and 1454(b)(2).

29. *Id.* §§1453-A(b) and 1454(c)(2).

30. *Id.* §1454(a)(4).

31. *Id.* §§1454(b)(2) and (c)(2).

32. *Id.* §§1455(b)(1)(v)(A) and 1454(d).

33. *Id.* §1454(d).

34. See N.Y. State Dept. of Taxation and Finance, Form No. CT-32A, Consolidated Franchise Tax Return for Banking Corps. (1984), for details on how to compute the tax on a consolidated basis.

35. See N.Y. Tax Law §§211(4) and 1462(f).

36. *Id.* §1462(f)(3).

37. *Id.* §211(4) and N.Y. Admin. Code tit. 20, §6-2.2 (1962).

38. N.Y. Tax Law §1462(f)(2)(i).

39. *Id.* §1462(f)(2)(ii) and (iii).

40. N.Y. Admin. Code tit. 20, §6-2.5(b).

41. N.Y. Tax Law §1462(f)(4).

42. N.Y. Tax Law §§1462(f) and 1452(a)(9) before the enactment of 1985 N.Y. Laws 298.

43. N.Y. Tax Law §§1462(f) and 1452(a)(9).

44. 1985 N.Y. Laws 298, §51.
 45. *Id.* §§30-45.
 46. *Id.* §§47, 48.
 47. *Id.* §50.
 48. N.Y. Tax Law §210(3) contains the formula apportionment method for general business corporations; §211(4) contains the combined reporting provisions for such corporations; and §210(1)(a)(2) imposes as one of the alternative measures of tax on such corporations a tax on business and investment capital.
 49. *See id.* §208(9) for calculation of entire net income under the tax on general business corporations; §210(1)(b) for imposition of the tax on subsidiary capital; §210(3)(a) for calculation of the three-factor business allocation percentage; and §211(4) and N.Y. Admin. Code tit. 20, Subpart 6-2 (1962), for rules concerning combined reporting.
 50. Memorandum in Support, *supra* note 2, at 10.

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EXHIBIT K: 28

Kaltenborn, Marilyn M. and Friedman, Alan H. Outline of Presentation to Federation of Tax Administrators", The Apportionment of Income and from Financial Institutions" (June 10, 1992)

Multistate Tax Commission



FEDERATION OF TAX ADMINISTRATORS

60th ANNUAL MEETING

Atlantic City, New Jersey

June 10, 1992

THE APPORTIONMENT OF INCOME FROM FINANCIAL INSTITUTIONS

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NOTE: THE FOLLOWING OUTLINE WAS PREPARED PRIOR TO THE U.S. SUPREME COURT DECISION IN NORTH DAKOTA V. QUILL CORPORATION (U.S. SUPREME COURT DOCKET NO. 91-194) ENTERED ON MAY 26, 1992. TIME LIMITATIONS FOR THE PREPARATION AND COPYING OF THIS OUTLINE DID NOT PERMIT A WRITTEN DISCUSSION OF THAT OPINION HERE. THE OPINION WILL BE DISCUSSED IN DETAIL DURING THE SESSION.

THE APPORTIONMENT OF INCOME FROM FINANCIAL INSTITUTIONS

I. INTRODUCTION.

Income apportionment concepts with respect to general business that is conducted in interstate commerce have been with us for at least 70 years. See, Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920). It is because national banks, until very recently, fell within a Congressionally protected class, that the issue of formulary apportionment of their interstate business activities is currently being raised.

The emerging policy issues can be expressed in the following terms

"Should banks or other types of financial institutions that do business in interstate commerce continue to be treated differently from all other commercial enterprises that derive income from selling services in interstate commerce?"¹

"If banks that do business in interstate commerce should

¹. At least two banking representatives have suggested that "[b]anks should not be singled out for special or discriminatory tax treatment compared to general corporations." H. Reumpler and J. Ames, "Multiple State Taxation: Will Your Bank Be Hit By Out-of-State Levies?", Banking Expansion Reporter, Vol. 9, No. 18 (9/17/90), p.1, 2.

be treated similarly to other businesses that engage in interstate commerce, what, if any, factors are prevalent in the banking context that warrant differential tax treatment by the states?"

These questions, as well as subsidiary ones, have increasingly been addressed by the states. Some states, such as Indiana, Minnesota, New York, Tennessee and West Virginia have recently adopted various approaches to the taxation of financial institutions doing business in their states. These issues are also currently the subject of public proceedings being held on the Multistate Tax Commission's proposed Regulation IV.18.(i) addressed below. But, the more recent development in this area is the development of a cooperative, working relationship between state and financial institution industry representatives, here referred to as State/Industry Meeting, with its working subcommittees referred to as State/Industry Financial Working Group (S/IFWG).

II. THE APPORTIONMENT FORMULA.

A. The Standard Formula.

Statutory provisions for the attribution of income earned by general corporations by some type of formula presently exist in 45 states and the District of Columbia with respect to general business enterprises. Of those states, 32 either require or permit at the taxpayer's election the application of the standard, equally-weighted three-factor formula based upon Article IV. of the Uniform Division of Income for Tax Purposes Act (UDITPA):

$$\frac{\text{In-state Sales} + \text{In-state Property} + \text{In-state Payroll}}{\text{Sales Everywhere} + \text{Property Everywhere} + \text{Payroll Everywhere}}$$

Three (3)

5

B. Statutory Variations to the Standard Formula.

The number of states applying a double-weighted or greater sales factor as to all or a sizeable segment of the taxpaying population totals thirteen (13).² Several other states offer a variation on the standard apportionment approach.³ And, of course, Indiana and Tennessee have applied a single sales factor apportionment approach to the income of non-domiciliary banks.

C. MTC Proposed Regulation.

The M.T.C.'s Proposed Regulation IV.18.(i) (Financial Institutions) is attached to this outline as Attachment A. This proposal is the product of the Multistate Tax

². Double-weighted or greater sales factor states:

Connecticut (double-weighted sales for manufacturers and sellers of tangible personal property; single sales factor for others), Florida, Illinois, Kentucky, Massachusetts, Minnesota, Mississippi (for retailers, but not wholesalers), Nebraska, New Hampshire, New York, North Carolina, Ohio, Oregon, Texas (franchise tax), West Virginia, and Wisconsin.

³. Other state formula varieties:

Colorado - taxpayer may elect between a two-factor (property and sales) or the standard three-factor.

Hawaii - two-factor (property and payroll) for manufacturers or standard three-factor applied to gross receipts if seller of tangible personal property.

Iowa - single factor (sales).

Missouri - taxpayer may elect between single sales factor (includes 50% of sales delivered outside of Missouri) and standard three-factor.

Nebraska - phasing in of a single (sales) factor.

6

Commission's Uniformity Committee effort and has been tempered with a substantial amount of industry input to this point. Its principal provisions include -

• **Application:**

1. Holding companies.
2. Regulated financial corporations.
3. Any corporation carrying on the "business of a financial corporation". This category includes corporations that conduct activities that are substantially similar to the ones authorized under the state's laws governing financial institutions; and any corporations that derive more than 50% of their gross income from lending activities.
4. State chartered credit unions.

• **Jurisdiction or nexus:**

The proposed regulation sets forth the activities that render the financial institution subject to apportionment of income:

1. In-state ownership of property.
2. Direct loans secured by in-state property.
3. In-state presence of employees or contractors.
4. Regular solicitation of in-state loans or deposits by mail, telephone or electronic means. "Regular solicitation" is presumed to exist if the bank (i) has

4

debtor/creditor relationships with 100 or more residents;
(ii) has \$10,000,000 of assets or deposits in the states;
or (iii) has in excess of \$500,000 in receipts from in-
state sources.

- Participation and syndication loans and other secondary market activities do not, alone, create nexus; but if nexus is otherwise established, income from these activities will be subject to apportionment.

- **Apportionment:**

Net income from the bank's activities is determined by the application of the standard, equally-weighted three-factor formula, modified to reflect more accurately the manner in which the income of a financial organization is earned.

- Receipts Factor. The sourcing of receipts from interest or fees to the place where the services are consumed by the bank's customer.

Receipts from rentals and from secured loans sourced to the location of the property or security.

Receipts from unsecured consumer and commercial loans and

8

fees sourced to state of residence of debtor.

Receipts from credit card interest and fees sourced to residence of cardholder.

Deposit or loan related fees that are pooled may, at the bank's election, be attributed (i) to the state of residence of the borrowers or depositors or (ii) to the state based upon the ratio that total deposits (or total interest) sourced to that state bears to total deposits (or total interest) from all sources.

Receipts from a bank's purchase of securities or money market instruments sourced based upon the ratio that in-state deposits bear to deposits from all sources.

Receipts attributed to a state in which the bank is not taxable is attributed pursuant to the laws of the state of commercial domicile.

- Property Factor. Includes real, tangible and intangible property. Sourced to states in a comparable fashion as receipts are sourced.

- Payroll Factor. Standard provisions used - compensation paid to employees in the state.

- (9)
- Relief Provision. If the application of the regulation can be shown to represent the bank's income-producing activities unfairly in the state, then the bank may petition or the tax administrator may require the use of another apportionment methodology.

D. EXAMPLE OF ONE NEWER APPROACH TO THE TAXATION OF FINANCIAL INSTITUTIONS - TENNESSEE'S APPROACH.

Tennessee now imposes an excise tax on net earnings and a franchise tax upon financial institutions doing business in Tennessee. The law, effective as to corporate fiscal years commencing on or after July 15, 1990, follows the single factor apportionment approach.

- **Application:**

1. Holding companies.
2. Regulated financial corporations.
3. Any corporation carrying on the business of a financial corporation, excluding (i) corporations that derive less than 50% of their gross income from lending activities, (ii) federal and state credit unions, (iii) regulated investment funds or companies holding not less than 75% of its assets in government bonds, and (iv) corporations organized for lodge purposes.

- **Jurisdiction or nexus:**

Under Tennessee's new law, a financial institution is presumed to be doing business in Tennessee if it has -

1. assets and deposits attributable to Tennessee sources totalling more than \$5,000,000 (excludes federal and non-Tennessee government obligations); or

- 10
2. an employee, representative or independent contractor conducting business in the state; or
 3. regularly sells products or services to customers in the state that receive such products or services in the state; or
 4. regularly solicits business from potential customers in the state; or
 5. regularly performs services outside the state that are consumed in the state; or
 6. regularly engages in transactions with customers in the state that involve tangible property, including loans, and which result in receipts flowing to the taxpayer from within the state; or
 7. owns or leases property located in the state; or
 8. regularly solicits and receives deposits from customers in the state.

As with the M.T.C. proposed regulation, as well as the Minnesota and Indiana statutes, the secondary loan market is carved out of the conduct that, by itself, creates nexus. See T.C.A. Sections 67-4-806(e) and 67-4-903(g).

• **Apportionment:**

Business earnings of both foreign and domestic banks are apportioned to Tennessee based upon a single factor - gross receipts derived from in-state loan activities.

III. THE M.T.C. REGULATION PROCESS.

The M.T.C. proposed financial institutions regulation has been developed by the Commission's Uniformity Committee and has been the subject of four public hearings, one held in Washington, D.C. on August 21, 1990, one in San Francisco on August 23, 1990, one in Chicago, Illinois on December 3, 1990 and one in Atlanta, Georgia on December 4, 1990. The hearings were open to the public and anyone interested in providing either written or oral input was invited to do so.

In the normal course of proceeding, after the public hearing process is closed, the Hearing Officer submits his Report of Hearing Officer to the M.T.C. Executive Committee, the seven-member board that directs the activities of the Commission. The Report is to contain a synopsis of the proceedings, as well as specific recommendations as to what, if any, regulation or other action is necessary in the interest of achieving uniformity in the area of apportionment of income derived from financial institutions. It was originally anticipated that the Report of the Hearing Officer would be submitted to the Executive Committee before the end of June of 1991. However, on November 9, 1990, the Executive Committee, upon recommendation of the Hearing Officer, directed that further Committee action upon the proposed Regulations be deferred until it directs otherwise.

In the ordinary course of the regulatory process, the Executive Committee reviews the Final Report of Hearing Officer and may then refer the Report, accepting in whole or in part the recommendations of the Hearing Officer, to the full membership of the Multistate Tax Commission for action. Under a Bylaw of the Commission, the Executive Committee may not refer the matter to the full Commission for its consideration unless it receives commitments from at least a majority of Commission member states that are affected (states with an income or franchise tax) that they will consider the recommendations for adoption in their respective states.

12

Should the uniformity recommendation of the Hearing Officer not receive the majority vote described above, or on its own motion, the Executive Committee may decide to terminate all further proceedings, return the matter to either the Hearing Officer or its Uniformity Committee for further development, or take such other action as it deems appropriate. If finally adopted by the Commission, the proposed regulation becomes a regulation of the Commission and is then referred to the member states for their consideration pursuant to their respective rule-making or legislative processes.

In this specific matter, the banking industry has suggested that a Congressionally established two-year moratorium be sought "upon the taxation of out-of-state financial institutions based on mere customer location (traditional nexus rules would not be affected) until such time as a proposal can be drafted which minimizes the costs to banks and states, reduces the instances of double taxation, but provides a reasonable nexus for state taxation within constitutional limits."⁴ While not agreeing to any moratorium, the Commission's Executive Committee agreed to engage in a cooperative process with the Federation of Tax Administrators and industry representatives in order to develop a fair and administrable apportionment regulation. Section V. below provides detail regarding the current status of that effort.

IV. THE ISSUE OF NEXUS.

The states have been asked to justify their requiring certain non-domiciliary banks to register and pay franchise or income taxes when the banks maintain no physical presence in the state. As noted in section II. of this outline, the

⁴. Testimony of Paul Claytor on behalf of the American Bankers Association, August 21, 1990.

13

proposed M.T.C. regulation is founded primarily on traditional nexus concepts - the presence of property interests and/or representatives. See the definition of "Exercising a Corporate Franchise of Transacting Business in a State" set forth in Reg. IV.18.(i)(B)(5)(a)-(c). The reliance on traditional, as well as newer nexus concepts, is also evident with respect to the Indiana, Minnesota, Tennessee and West Virginia approaches.

It is primarily subsection (d) of Reg. IV.18.(i)(B)(5) that reflects something other than the traditional notions of nexus-creating activity. That subsection provides that nexus exists if the out-of-state bank regularly solicited business in the state (presumed, subject to rebuttal, to exist from either 100 or more direct debtor/creditor relationships, \$10,000,000 in assets and deposits, or \$500,000 in receipts). This basis for nexus - regular solicitation - is derived from United State Supreme Court case law that support personal jurisdiction and tax jurisdiction in modern commercial contexts. The basis for this approach to nexus should be addressed by the United States Supreme Court decision in Quill v. North Dakota (S.Ct. Dkt. No. 91-194) due to be issued any moment.⁵

The newer nexus principles relied upon by the states in Quill suggest that Due Process and Commerce Clauses to the United States Constitution may be satisfied by either traditional nexus-creating activities or by regular or systematic solicitation of banking business in the state. The physical presence of the non-resident bank is no longer required before a state may impose a reasonable tax burden.

⁵. The Quill case was decided on May 26, 1992, not in time to provide a thoughtful analysis here. The opinion will be discussed in detail during the session. However, the bottom line, in this writer's opinion, is that the states' position with regard to establishing nexus over financial institutions that engage in the interstate marketing of financial services was substantially strengthened.

This position finds its footing in the following principles:

- National Bellas Hess was limited to use of U.S. Postal Service and common carrier for delivery of the goods. It did not involve the use of in-state facilities such as telephones or 1-800 numbers, banking or credit cards, or any type of advertising other than that sent through the mails.

- National Bellas Hess was decided before the change in U. S. Supreme Court jurisprudence relating to the ability of the states to tax interstate commerce; and before a major shift in the Court's decisions in the area of personal jurisdiction.

- More recent U.S. Supreme Court personal jurisdiction and tax cases can be reasonably read to support a finding of nexus for use tax collection purposes for the "regular", "continuous", "systematic", or "purposeful" conduct of the out-of-state marketers' solicitation and conducting of business with the in-state market base.

- "Governmental jurisdiction in matters of taxation, as in the exercise of the judicial function, depends upon the power to enforce the mandate of the State by action taken within its borders, either in personam or in rem" Shaffer v. Carter, 252 U.S. 37, 49 (1920).

- "..... [Holmes'] argument ignores, however, [its] significant economic presence in Louisiana, its many connections with the State, and the direct benefits it receives from Louisiana in conducting its business. D.H. Holmes Co., Ltd. v. McNamara, 486 U.S. 24 (1988) (emphasis supplied).

15

• We believe that only two States have a nexus substantial enough to tax a consumer's purchase of an interstate telephone call. The first State is a State like Illinois which taxes the origination or termination of an interstate telephone call charged to a service address within that State. The second is a State which taxes the origination or termination of an interstate call billed or paid within that State. Cf., Goldberg v. Sweet, ___ U.S. ___, 109 S.Ct. 582 (1989).

• "Jurisdiction in these circumstances may not be avoided merely because the defendant did not physically enter the forum State..... [I]t 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. So long as a commercial actor's efforts are "purposefully directed" toward residents of another State, [the Court] ha[s] consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there." Burger King, 471 U.S. at 473, quoting World-Wide Volkswagen, 444 U.S. at 297-298.

• "[T]he crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." Tyler Pipe Industries, Inc. v. Washington Dept. of Rev., 483 U.S. 232, 250 (1987).

• "[One who] has placed goods in the stream of commerce benefits economically from the retail sale of the final product in the forum State, and indirectly benefits from the State's laws that regulate and facilitate commercial activity." Asahi Metal Industry Co. v. Superior Court, 480

16
U.S. 102, 117 (1987) (Brennan, Jr., concurring in part and concurring in the judgment).

• An appropriately apportioned corporate net income or franchise tax which does not discriminate against out-of-state banks and is imposed upon an activity or non-resident bank that has a substantial nexus with the taxing state is constitutional. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

• While reversed on statutory construction grounds, Alabama Circuit Judge William Gordon relied wholly on the Complete Auto and Goldberg cases to suggest that the state could constitutionally impose its excise tax on non-domiciliary financial institutions that conducted credit card operations by mail. See, Memorandum Opinion and Judgment, State of Alabama v. Credit Card Companies, No. 88-288-G, Fifteenth Judicial Circuit (3/7/90), reversed sub. nom., Siegelman v. Chase Manhattan Bank (USA), National Association, No. 89-1024, -1104, ___ So.2d ___ (Ala. 1991).

V. THE STATE/INDUSTRY FINANCIAL WORKING GROUP PROCESS.

The current MTC/FTA effort that is being pursued is one in which representatives of several large financial institutions and trade associations have agreed to support an effort to draft a fair, administrable and widely adopted apportionment formula. This process will be the major focus of the discussion during our session and is best described by Attachments B and C to this outline. These documents set forth the background, the state efforts at coming up with an agreed upon formula and the current status of the process. We refer you to those documents for this portion of the outline. However, it is important that you not tarry too long with regard to the suggestion that a five-factor apportionment formula (payroll, property, source of funds and two receipts factors) be developed. That suggestion has since been set

17

aside in an effort to limit the number of factors to no more than three.

Needless to say, the process being pursued is a delicate one, given the uniqueness of such a broad involvement of industry and state representation. The process, while presently being supported by a wide range of interested state and industry representatives, is open to additional state monitoring or involvement.

VI. CONCLUSION.

The state taxation of financial institutions offers substantial challenges to the states. Some of these challenges are:

- Can a sufficient number of states agree to a uniform, minimum nexus threshold that produces fair taxation?
- Can a sufficient number of states agree to a uniform apportionment methodology that make sense in today's global and national economy?
- Can the headquarter-states accommodate newly-adopted apportionment methods in a manner that protects their domiciliary financial institutions from actual over-taxation?
- Can all of these challenges be met without creating administrative nightmares in which Freddy Krueger⁶ would be certain to appear?

Should the current S/IFWG effort reach a successful conclusion, a uniform approach that is acceptable to both market

⁶. For those unfamiliar with Freddy Krueger, see "Nightmare on Elm Street".

18.

and money center states will be the result. If successful, it is anticipated that the financial institutions will support and work for the widespread adoption of the uniform approach decided upon by the participating states. On the other hand, should the S/IFWG effort not reach such a successful result, the MTC regulatory process will likely be re-activated and concluded.

ATTACHMENT A

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MULTISTATE TAX COMMISSION PROPOSED REGULATION
ATTRIBUTING INCOME FROM THE
BUSINESS OF A FINANCIAL INSTITUTION

Reg. IV.18.(i). Special Rules: Financial Institutions.

The following special rules are established with respect to the attribution of income derived from the business of a financial institution.

(A) **Application of Regulation.** This regulation shall apply to attribute the income derived from the business of a financial institution to only those states in which the taxpayer either exercises its corporate franchise or transacts business as defined hereunder. Except as may be specifically limited by this regulation, it is the intention of this regulation to subject to taxation all of the income of a financial institution that is within the constitutional power of this state to tax.

(B) **Definitions and General Provisions.** Except as specifically defined herein, all terms used in this regulation shall have the same meaning as such terms have under [here include your State citation to the Multistate Tax Compact or other applicable state law] and the rules and regulations promulgated thereunder.

- (1) "Borrower" means the individual or entity who is primarily liable on a debt instrument. If more than one individual or entity is primarily liable on a debt instrument, each such individual or entity shall be considered the borrower to the extent of its interest in the debt instrument. For purposes of this regulation, a partnership shall be treated as a separate entity.
- (2) "Business of a Financial Institution" includes the business activities, including finance leasing, that:
 - (a) a regulated financial corporation may be authorized to do under state or federal law or the business that its subsidiary is authorized to do by the proper regulatory authorities;
 - (b) any corporation organized under the authority of the United States or organized under the laws of this state or any other state or country does, or has authority to do, which is substantially similar to the business which a corporation may be created to do under [insert citations of state's laws governing the creation of banks and trust companies, industrial banks, savings and loan associations, credit unions, etc.] or any business which a corporation or its subsidiary is authorized to do by said laws; or

52

(c) any corporation organized under the authority of the United States or organized under the laws of this state or any other state or country does or has authority to do if such corporation derives more than fifty percent of its gross income from lending activities (including the discounting of obligations) in substantial competition with the businesses described in subsections (a) and (b) above. For purposes of this subsection, the computation of the gross income of a corporation shall not include income from nonrecurring, extraordinary items.

(3) "Deposit" means:

- (a) the unpaid balance of money or its equivalent received or held by a financial institution in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to a commercial, checking, savings, time, or thrift account whether or not advance notice is required to withdraw the credited funds, or which is evidenced by its certificate of deposit, thrift certificate, investment certificate, or certificate of indebtedness, or other similar name, or a check or draft drawn against a deposit account and certified by the financial institution, or a letter of credit or a traveler's check on which the financial institution is primarily liable; provided, that, without limiting the generality of the term "money or its equivalent," any such account or instrument must be regarded as evidencing the receipt of the equivalent of money when credited or issued in exchange for checks or drafts or for a promissory note upon which the person obtaining any such credit or instrument is primarily or secondarily liable or for a charge against a deposit account or in settlement of checks, drafts, or other instruments forwarded to such bank for collection;
- (b) trust funds received or held by such financial institution, whether held in the trust department or held or deposited in any other department of such financial institution;
- (c) money received or held by a financial institution, or the credit given for money or its equivalent received or held by a financial institution in the usual course of business for a special or specific purpose, regardless of the legal relationship thereby established, including, without being limited to, escrow funds, funds held as security for an obligation due the financial institution or

23

others (including funds held as dealers reserves) or for securities loaned by the financial institution, funds deposited by a debtor to meet maturing obligations, funds deposited as advance payment on subscriptions to United States Government securities, funds held for distribution or purchase of securities, funds held to meet its acceptances or letters of credit, and withheld taxes; provided that there shall not be included funds which are received by the financial institution for immediate application to the reduction of an indebtedness to the receiving financial institution, or under condition that the receipt thereof immediately reduces or extinguishes such an indebtedness;

- (d) outstanding drafts (including advice or authorization to charge a financial institution's balance in another such institution), cashier's checks, money orders, or other officer's checks issued in the usual course of business for any purpose, but not including those issued in payment for services, dividends, or purchases or other costs or expenses of the financial institution itself;
 - (e) money or its equivalent held as a credit balance by a financial institution on behalf of its customer if such entity is engaged in soliciting and holding such balances in the regular course of its business.
- (4) "Deposit Related Fees." For purposes of the receipts factor, deposit related fees include all fees associated with the administration of deposit accounts.
- (5) "Exercising a Corporate Franchise or Transacting Business in a State." Except as may be specifically provided for in this regulation, a financial institution is exercising a corporate franchise or transacting business in this state if it:
- (a) owns, leases or otherwise has an interest in any real or tangible personal property located in this state or maintains an office or other place of business in this state;
 - (b) makes any direct loan secured by any real or tangible personal property located in this state;
 - (c) has an employee, representative or independent contractor conducting business activities in its behalf in this state; or,
 - (d) engages in regular solicitation in this state (whether at a place of business, by travelling loan

officer or other representative, by mail, by telephone or other electronic means), and the solicitation results in the creation of a depository or direct debtor/creditor relationship with a resident of this state. For purposes of this subsection, mere processing or transfer through financial intermediaries of checks, credit card receivables, commercial paper and the like does not create a debtor/creditor relationship.

A financial institution is presumed, subject to rebuttal, to be engaged in regular solicitation within this state if, during the tax period, it:

- (i) has entered into direct debtor/creditor relationships with one hundred (100) or more residents of this state; or
- (ii) has an average during the tax period of ten million dollars (\$10,000,000) or more of assets and deposits attributable to sources within this state; or
- (iii) has in excess of five hundred thousand dollars (\$500,000) in receipts attributable to sources within this states.

(e) Notwithstanding any other provision contained in this subsection to the contrary, a financial institution is not considered to be either exercising a corporate franchise or transacting business in this state if its sole and exclusive activities in this state are limited to evaluating, acquiring, maintaining and/or disposing of any of the following property, including any security or collateral relating to such property:

- (i) any participation or syndicated loans;
- (ii) a real estate mortgage investment conduit, a real estate investment trust, or a regulated investment company as those terms are defined by the Internal Revenue Code of 1986, as amended;
- (iii) money market instruments or securities;
- (iv) loan-backed, mortgage-backed, or receivable-backed security representing either: ownership in a pool of promissory notes, mortgages, or receivables or certificates of interest or participation in such notes, mortgages, or receivables, or debt obligations or equity interests which provide for payments in relation to payments or reasonable projections of payments on notes, mortgages, or receivables;

(v) any interest in a loan or other asset or property attributed to this state under subsection (D)(2)(a) through (h) and in which the payment obligations were solicited and entered into by an independent person not acting on behalf of the taxpayer;

(vi) any interest in the right to service or collect any income from any loan, asset or other property attributed to this state under subsection (D)(2)(a) through (h) and in which the payment obligations were solicited and entered into by an independent person not acting on behalf of the taxpayer;

(vii) a funded or unfunded agreement to extend or guarantee credit, whether conditional, mandatory, temporary, standby, secured or otherwise;

(viii) an interest of a person other than an individual, estate, or trust, in any intangible, real, or tangible personal property acquired in satisfaction, whether in whole or in part, of any asset embodying a payment obligation which is in default, whether secured or unsecured, provided the property is disposed of within a reasonable period of time.;
or

(ix) property or funds held in an escrow or trust account that is maintained in connection with the property described in this subsection (B)(5)(e).

(6) "Finance leasing" or "finance lease" shall mean any type of capital lease to which a financial institution is a party, including sales-type, leveraged, and direct financing leases, that involves the transfer to the lessee of substantially all of the risks and burdens of ownership in the property subject to the lease. A "finance leasing" or "finance lease" is further evidenced by the lessee reporting such lease as an asset and a liability for financial accounting purposes. To the extent that it cannot be determined whether a capital lease falls within this definition of "finance leasing" or "finance lease", reference shall be made to the classification of leases set forth in Statement of Financial Accounting Standards No. 13, "Accounting for Leases", in effect as of the date of the adoption of this Regulation.

(7) "Financial Institution" includes the following:

(a) A holding company.

(b) Any regulated financial corporation.

(c) Any other corporation organized under the laws of the United States or organized under the laws of this state or any other state or country which is carrying on the business of a financial institution.

(8) "Holding Company" means any corporation subject to [insert citation of the state law governing the creation of bank holding companies] 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.

(9) "Independent person not acting on behalf of the taxpayer" means, for purposes of subsections (A)(5)(e)(v) and (vi) as follows:

(a) At the time of the acquisition of the asset, loan or property, the taxpayer must not directly or indirectly own fifteen percent (15%) or more of the outstanding stock or, in the case of a partnership, fifteen percent (15%) or more of the capital or profits interest, of the entity from which the taxpayer originally acquired the asset, loan or property. In determining indirect ownership, the taxpayer is deemed to own all of the stock, capital interest, or profits interest owned by another person if the taxpayer directly owns fifteen percent (15%) or more of the stock, capital interest, or profits interest in that other person. In addition, the taxpayer is deemed to own all stock, capital interest, and profits interest directly owned by any intermediary parties in the transaction, to the extent a fifteen percent (15%) or more chain of ownership of stock, capital interest, or profits interest exists between the taxpayer and any intermediary party;

(b) the entity from which the taxpayer acquired the asset, loan or property must regularly sell, assign, or otherwise transfer interest in such assets, loans or property to three (3) or more persons during the full twelve (12) month period immediately preceding the month of acquisition; and

(c) the entity from which the taxpayer acquired the asset, loan or property must not sell, assign or otherwise transfer ninety percent (90%) or more of its exempt assets, loans or property to the taxpayer during the full twelve (12) month period immediately preceding the month of acquisition.

(10) "Loan Related Fees." For purposes of the receipts factor, loan related fees include all fees associated with the generation and administration of loans, including loan servicing fees.

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- (11) "Loan Servicing Fees." For purposes of the receipts factor, loan servicing fees include fees charged by a financial institution that sells, assigns or otherwise transfers loans to a purchasing financial institution in instances in which the transferring financial institution continues to process the loan payments.
- (12) "Money Market Instruments" mean Federal funds sold and securities purchased under agreements to resell, commercial paper, banker's acceptances, and purchased certificates of deposit and similar instruments to the extent that such instruments are reflected as assets under generally accepted accounting principles.
- (13) "Participation Loan" means an arrangement in which a financial institution makes a loan to a borrower and thereafter sells, assigns or otherwise transfers all or a portion of the loan to a purchasing financial institution.
- (14) "Presumption." A presumption subject to rebuttal, as provided in this regulation, shall be rebuttable by clear and convincing proof established by [the party seeking to oppose the application of the presumption.][either the financial institution or [here include title of your State taxing agency].
- (15) "Property Located in this State".
- (a) Tangible Property: General Rule. -- Except as otherwise provided in this section, real and tangible personal property which is security for a loan or property subject to a lease shall be considered to be located in the state in which such property is physically situated. It shall be presumed, subject to rebuttal, that the property is physically situated in the same state as the billing address of the borrower or lessee.
- (b) Moveable tangible property. -- Tangible personal property which is characteristically moving property, such as motor vehicles, rolling stock, aircraft, vessels, mobile equipment, and the like shall be considered to be located in a state if:
- (i) the operation of the property is entirely within the state; or
- (ii) 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.

It shall be presumed, subject to rebuttal, that the location of operation of the property and the principal base of operations from which the property is sent out shall be in the same state as the billing address of the borrower or lessee.

- (16) "Receipts" for the purpose of the receipts factor means gross income, including net taxable gain on disposition of assets (including securities, loans, personal and real property and money market transactions) when derived from transactions and activities in the regular course of the taxpayer's trade or business.
- (17) "Regulated Financial Corporation" means any 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 the United States or any State which is engaged in the business of receiving deposits or which holds a bank charter, any corporation organized under the provision of 12 U.S.C. 611 to 631 (Edge Act Corporations); any credit union incorporated or organized under the laws of any State; and any agency, branch or subsidiary of a foreign depository as defined in 12 U.S.C. 3101.

It is presumed, subject to rebuttal, that any subsidiary and any holding company of a regulated financial corporation shall be a financial institution for the purpose of this regulation.

- (18) "Resides/Residence/Resident." A person shall be considered to reside or make his or her residence in or be a resident of a state if, in the case of an individual, he/she resides there for 183 or more days of the relevant tax period. For purposes of this regulation, corporations and partnerships shall be treated as residents of their states of commercial domicile. An individual, a partnership or a corporation shall be presumed, subject to rebuttal, to reside at (i.e., be a resident of, make his residence at) the address to which the statement of account is regularly mailed.
- (19) "Securities" means United States Treasury securities, obligations of United States Government agencies and corporations, obligations of State and their political subdivisions, corporate stock and other corporate securities, participations in securities backed by mortgages held by United States or State government agencies, loan-backed securities and similar investments to the extent that such investments are reflected as assets under generally accepted accounting principles.

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- (20) "State" means a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or any territory or possession of the United States or any foreign country.
 - (21) "Subsidiary" means a corporation whose voting stock is more than 50% owned, directly or indirectly, by a financial institution.
 - (22) "Syndication Loan" means a multi-financial institution loan transaction in which all of the lenders are named as parties to the loan and have privity of contract with the borrower.
 - (23) "Taxable" and "Taxable in another State." For the purpose of the receipts factor, a taxpayer is taxable in another state if: (a) in that state, he is 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 tax, or (b) that State has jurisdiction to subject the taxpayer to such a tax regardless of whether, in fact, the State does or does not.
 - (24) "Taxpayer" means a financial institution which is subject to taxation in a state because it is exercising its corporate franchise or is transacting business in a corporate or organized capacity in the state and has gross income attributable under this regulation to sources within this state.

(C) **Business Income.** All income (taxable under the laws of this State) which arises from the business of a financial institution shall be deemed derived from transactions in the regular course of the taxpayer's business and subject to apportionment under this regulation. All such income which arises from activities of a financial institution which are not the business of a financial institution as defined in this rule shall be apportioned or allocated in accordance with the rules set forth in [here include your State citation to UDITPA or the Multistate Tax Compact].

(D) **Apportionment of Business Income.**

(1) **General Method.**

- (a) If a financial institution is carrying on the business of a financial institution both within and without this state and if, by reason of such business activity, it is taxable in another state, the portion of the net income (or net loss) arising from such business which is derived from sources within this state shall be determined by apportionment in accordance with this regulation.

(b) The tax applicable to financial institutions whose net income (or net loss) is apportionable according to the rules in this section shall be determined by multiplying the tax base by a fraction the numerator of which is the sum of the receipts factor, the property factor, and the payroll factor as defined in this regulation and the denominator of which is three. If any factor(s) is missing, the remaining factors are added together and the sum is divided by the number of remaining factors. A factor is missing if both its numerator and denominator are zero, but it is not missing merely because its numerator is zero.

(2) Receipts Factor. In general. -- The receipts factor is a fraction the numerator of which is the receipts of the taxpayer within this state during the tax period and the denominator of which is the total receipts of the taxpayer wherever earned during said tax period. The numerator of the receipts factor shall include, in addition to items otherwise assignable under [here include your State citation to the Multistate Tax Compact or other applicable state law]:

- (a) Receipts from the lease or rental of real or tangible personal property (including both finance leases and true leases) if the property is located in this state.
- (b) 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 located in two or more states, it shall be deemed to be located in the state having the greatest property values.
- (c) Interest income and other receipts from consumer loans not secured by real or tangible personal property that are made to residents of this state (whether at a place of business, by travelling loan officer, by mail, by telephone or other electronic means or otherwise).
- (d) Interest income and other receipts from commercial loans and installment obligations not secured by real or tangible personal property if and to the extent that the borrower or debtor is a resident of this State.
- (e) Interest income and other receipts from a financial institution's portion of loans, including syndication and participation loans, under the rules set forth in subsections (a) through (d) above.

- (f) 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 to the extent that the borrower or debtor is a resident of this State.
- (g) 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.
- (h) Receipts from the performance of services 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 non-recurring 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 bear 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 decedent for

27

whom the estate relates 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 in this state; or if performed both in and outside this state and a greater proportion of the service is performed in this State than in any other State, as determined on the basis of the cost of performance.
 - (i) Receipts from the issuance of travelers checks and money orders if such checks and money orders are purchased in this state.
 - (j) Receipts from investments of a financial institution in securities and from money market instruments, based upon the ratio that total deposits from this state, its residents, its political subdivisions, agencies and instrumentalities bear to the total deposits from all states, their residents, their political subdivisions, agencies and instrumentalities. For purposes of this subsection, deposits made by this State, its residents, its political subdivisions, agencies and instrumentalities shall be attributed to this state regardless of whether or not such deposits are accepted or maintained by the taxpayer at locations within this state.
- In the case of an unregulated financial institution subject to this regulation, such receipts shall be apportioned to this state based upon the ratio that its gross business income earned from sources within this state bears to the gross business income earned within all States.
- (k) All receipts allocated by this rule to a state in which the taxpayer is not taxable shall be attributed pursuant to the laws of the state of the taxpayer's commercial domicile.
- (3) Property Factor. In general. -- The property factor is a fraction the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in, and intangible property attributed to this state during the tax period and the denominator of which is the average value of all of the taxpayer's real and tangible personal property owned or rented and used in, and intangible property attributed to all states during the tax period.

For purposes of this regulation, the value of property owned by the taxpayer shall be its original cost; the value of real or tangible personal property rented by the taxpayer shall be eight times its net annual rental rate. The net annual rental rate for any item of rented property is the annual rate paid by the taxpayer for such property less the aggregate annual subrental rates paid by subtenants of the taxpayer. Goodwill shall not be included in the property factor.

The numerator of the property factor shall include, in addition to items otherwise assignable under [here include your State citation to the Multistate Tax Compact or other applicable state law], the following:

- (a) Coin and currency located in this state.
- (b) Lease financing receivables if and to the extent that the property is located within this state.
- (c) Assets in the nature of loans which are secured by real or tangible personal property if and to the extent that the security property is located within this state. In the event that such security property is located in two or more states, it shall be deemed to be located in the state having the greatest property values.
- (d) Assets in the nature of consumer loans and installment obligations which are unsecured or secured by intangible property, if the loan was made to a resident of this state.
- (e) Assets in the nature of commercial loans and installment obligations which are unsecured or secured by intangible property, if the borrower is a resident of this state.
- (f) Funds deposited by this state, its agencies, instrumentalities, political subdivisions and residents shall be attributed to this state regardless of whether or not such deposits are accepted or maintained by the taxpayer at locations within this state.
- (g) A financial institution's portion of a participation or syndication loans, under the rules set forth in subsections (b) through (e) above.
- (h) A financial institution's credit card and travel and entertainment credit card receivables to the extent that the borrower or debtor is a resident of this State.

- 34
- (i) Assets in the nature of securities and money market instruments, based upon the ratio that total deposits from this State, its agencies, instrumentalities, political subdivisions and residents bear to the total deposits from all States, their residents, their political subdivisions, agencies and instrumentalities.

In the case of an unregulated financial institution subject to this regulation, such assets shall be apportioned to this state based upon the ratio that its gross business income earned from sources within this state bears to the gross business income earned within all States.

All intangible property located by this rule in a state in which the taxpayer is not taxable shall be attributed pursuant to the laws of the state of the taxpayer's commercial domicile.

- (4) Payroll Factor. In general. -- The payroll factor is a fraction the numerator of which is the total amount paid by the taxpayer for compensation during the year, and the denominator of which is the total amount of compensation paid in every state.

(E) Special Rules. If the allocation and apportionment provisions of this regulation do not fairly represent the extent of the taxpayer's activity in this state, the taxpayer may petition for or the 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.

ATTACHMENT B

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Heidi Heitkamp
COMMISSIONER

STATE OF NORTH DAKOTA

OFFICE OF STATE TAX COMMISSIONER

STATE CAPITOL

600 E. BOULEVARD AVE., BISMARCK, NORTH DAKOTA 58505-0599 701-224-2770

(27)

TO: ALL STATE TAX ADMINISTRATORS

**FROM: HEIDI HEITKAMP, NORTH DAKOTA TAX COMMISSIONER
CHAIR, MTC/FTA WORKING GROUP ON FINANCIAL INSTITUTIONS**

**SUBJECT: APRIL 29-30TH MEETING WITH INDUSTRY ON
TAXATION OF FINANCIAL INSTITUTIONS**

DATE: APRIL 1, 1992

As you may be aware, a joint MTC/FTA effort, of which I have been acting as discussion leader for the MTC states, is exploring alternative methods for the apportionment of net income earned by banks and other financial institutions. Representatives of several interested state tax administrators have been meeting with industry representatives and among themselves in an effort to develop a fair, uniform, administrable approach for income apportionment among the states. An important second meeting with several industry representatives is now set for April 29-30, 1992 in New York. At that meeting, state representatives will describe to the industry where the states are in this process and seek their comments on the alternative approaches that have been developed thus far.

A brief history of this effort may be of some assistance here, and a more extensive review of past events is contained in the enclosed Report. During the mid-1980s, the Multistate Tax Commission had explored the development of a uniform regulation that would apportion the income received from financial institutions. A proposed regulation from that process has been reviewed at several public and regional meetings with affected parts of the industry. Since the introduction of the MTC proposed regulation, four states - Minnesota, Indiana, Tennessee and West Virginia - have adopted somewhat differing approaches to the apportionment of financial industry net income.

In April of 1991, the American Bankers Association and a coalition of banks agreed to work cooperatively with the states in the development of such a regulation in an effort to achieve some uniformity among the potential conflicting state approaches. While the banking industry's Congressional efforts during the last Congressional session have focussed on obtaining authority to branch nationwide, it is clear that should a sufficient number of states fail in their effort to agree upon a uniform income apportionment method, the industry will not hesitate to seek one by federal legislation.

NAI

In October of 1991, the MTC and FTA sponsored a Financial Institutions Business Workshop in Washington, D.C where 23 states were represented. From that meeting a "Subcommittee on Apportionment of Income from Financial Services" was organized. This Subcommittee is comprised of the following persons:

Convener:

Alan Friedman, Multistate Tax Commission

Subcommittee Members:

Michael Boekhaus (Bill Lunka)	MN	Keith Larson	WV
Eric Coffill	CA	John Malach	IL
Anne Dougherty	TN	Jonathan Robin	NYC
Marilyn Kaltenborn	NY	Harley Duncan (monitoring for Mary Jane Egr	FTA)

The Subcommittee has now completed its initial effort to reach an agreed upon uniform method of apportionment. The Subcommittee met on four occasions for several hours by teleconference, and a smaller group of the Subcommittee met in New York for an additional one and one-half days in order to further refine the states' respective positions and seek a single, uniform approach. Copies of the Subcommittee agendas were earlier made available to you.

The Subcommittee has now reported on its efforts and I am sending you a copy of its memorandum report dated March 30, 1992 incorporating the Minutes of the meeting held in New York on March 9-10, 1992 in New York. The Minutes reflect the discussions held and the position thus far reached by the Subcommittee members. In this regard, your attention is directed to Attachment 4 to the Minutes. That attachment represents a suggestion for the states' consideration in an effort to reach a consensus between the money-center and market state approaches.

Please review these materials and distribute them to your interested staff members. Your state's input at this or any later stage of the process is welcome and needed if we are to reach any semblance of uniformity in our tax approach to the financial services industry.

Lastly, several state tax administrators have now responded to the prior invitation to attend the April 29-30 New York meeting with the American Bankers Association and other industry representatives. If your state has not yet responded, please let us know of your intentions by completing the enclosed form and faxing it to Bill Six, Administrative Officer, Multistate Tax Commission, fax # 202-624-8819. Further details concerning the meeting will be sent to those states indicating their participation.

ATTACHMENT C

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TO: HEIDI HEITKAMP, NORTH DAKOTA TAX COMMISSIONER
 CHAIR, MTC/FTA WORKING GROUP ON FINANCIAL INSTITUTIONS

FROM: ALAN H. FRIEDMAN, CONVENER, SUBCOMMITTEE ON APPORTIONMENT
 OF INCOME FROM FINANCIAL SERVICES

RE: REPORT OF SUBCOMMITTEE ON APPORTIONMENT OF INCOME FROM
 FINANCIAL SERVICES

DATE: MARCH 30, 1991

During the April 17-18, 1991 Banking Conference that was sponsored by the American Bankers Association in Chicago, industry representative stated that they were willing to work with the Multistate Tax Commission in its effort to develop a uniform apportionment method to apply to income derived from activities of financial institutions. Following that meeting, representatives of various states and financial institution industry members met to discuss together the possibility of reaching a uniform method among the states for the apportionment of income from financial institutions. On July 15-16, 1991, approximately 35 state and industry representatives met in San Francisco to discuss the various issues involved in trying to reach some uniform apportionment method short of one being Congressionally mandated.

One result from the initial meeting in San Francisco was the recognition by the state representatives present the additional commitment by the states to seek additional information concerning how financial institutions operated before attempting to address the apportionment issues. To this end, a two-day "Financial Institutions Business Workshop" was organized by the Multistate Tax Commission and the Federation of Tax Administrators for October 8-9, 1991. The Workshop was held in Washington, D.C. at which representatives of 23 states attended.

Immediately following the Workshop, this Subcommittee was formed to carry forward with the effort of developing fair, uniform and administrable apportionment formulae for the financial institutions industry. The membership of the Subcommittee is as follows:

Convener:

Alan Friedman, Multistate Tax Commission

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Subcommittee Members:

Michael Boekhaus (Bill Lunka)	MN	Keith Larson	WV
Eric Coffill	CA	John Malach	IL
Anne Dougherty	TN	Jonathan Robin	NYC
Marilyn Kaltenborn	NY	Harley Duncan (monitoring for Mary Jane Egr	FTA)

Due to fiscal problems faced by most of the states, the Subcommittee met principally via telephone conference calls, most of which were of several hours duration. For background purposes, each of the Subcommittee members was provided with the following materials:

1. Paper by Jim Judson entitled "State Taxation of Banks and Other Financial Institutions"
2. Paper submitted Haskell Edelstein of Citicorp entitled "State Taxation of Financial Institutions - A Fresh Approach"
3. Letter dated January 21, 1991 from Fred Ferguson detailing major and minor drafting problems contained in the MTC draft proposal
4. Letter dated April 8, 1991 from Phil Plant of the Bank of America
5. California's definition of a "financial corporation".

Between conferences, various suggested apportionment approaches were circulated among the Subcommittee members.

The first three teleconferences were held on January 24, February 11, and February 27, 1992. Agendas for these meetings are available should any state representative wish to review them. At the outset, the Subcommittee agreed on several points:

- A. Nexus issues were not on table for formal discussion or action at this time, the assumption being that nexus would have to exist before apportionment could be applied.
- B. Uniformity of state tax bases was not to be addressed.
- C. Joint-state administrative possibilities were to be discussed after consensus was reached on an

apportionment formula.

- D. The initial drafting efforts were to be focussed on traditional banking activities.
- E. Foreign owned banks were to be included in any proposal.
- F. The suggestions put forth by the industry by F.I.S.T. and Haskell Edelstein's "A Fresh Approach" were considered and were to be the subject of further discussion after the states' efforts were concluded.

During these first three teleconferences, the division between the two principal approaches - the money-center and the market approaches - were set forth and discussed. Attachment 1 sets forth the money-center state suggested compromise resolution and Attachment 2 describes one market state suggested compromise resolution. Attachment 3 combines in one document the money-center vs. market outlines of their respective positions. During the February 27th conference call, it became apparent that both the market and money-center state positions were staked out fairly firmly and that the only real possibility for reaching additional consensus required a face-to-face meeting of representatives of the two positions. That meeting was held in New York on March 9-10, 1992.

Attachment 4 sets forth the Minutes of the meeting held in New York on March 8th and 9th and presents the most comprehensive description of the various issues that were addressed by the Subcommittee as a whole. During this meeting, representatives of the differing approaches fully discussed and clarified their respective positions. Both money-center state and market state representatives expressed their desire to reach some sort of uniform approach; but, other than the compromises represented in Attachments 1 and 2, no one at the table was able to move off his or her respective state approach.

Toward the end of the New York meeting, another formula approach emerged for consideration. While no state representative will take credit for the suggestion and no state representative has yet to commit to recommend its adoption, the Subcommittee offers this approach for consideration because it represents one potential for compromise. The suggested approach, more definitively set forth in the Minutes, is for the application of a five-factor apportionment formula. The five factors would consist of: (1) a traditional payroll factor, (2) a property factor that would include intangibles, (3) a receipts factor sourced on a market state basis, (4) a receipts factor sourced on a money-center basis, and (5) a source of funds factor that consisted of deposits only and no other borrowing. No weighing of the factors has been settled upon as yet.

44

Lastly, the Subcommittee identified several other issues that require addressing once an apportionment formula has been agreed upon. The major issues that the Subcommittee identified in this regard are:

- A. Entities to be included within scope of definition of financial institution.
 - 1. Nonbank banks?
 - 2. Credit Unions?
 - 3. Brokerage houses?
 - 4. Insurance companies?
 - 5. Others?
- B. Weighing of factors once they are identified and agreed upon.
- C. Development of definitions for unique terms.
- D. Unitary/combination/Finnigan issues.
- E. Reduction of record keeping and other administrative burdens on bank and audit staffs.
- F. Possible joint-state administrative mechanisms.

In order to provide the industry with sufficient time to prepare for the April 29-30 meeting, the Subcommittee recommends that this Report be distributed to industry representatives at the same time that it is distributed to the states.

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PROPOSED FACTORS (OTHER THAN PAYROLL)

SOURCE OF FUNDS FACTOR

BORROWINGS - Rebuttable presumption that all borrowings are attributable to headquarters. This recognizes that some borrowings may be as a result of the creditor dealing with another office of the bank, e.g., an LPO or representative office. The degree of contact with the LPO or other office that will result in a borrowing being attributed there must be developed.

Borrowings do not include anything in the equity section of the balance sheet and in the repo setting are to be net of repo assets. As a result, only net repo liabilities, if any, would be included in the factor.

Fed. funds borrowings and discount window borrowings would be attributable to the headquarters only. No rebuttable presumption because this activity is done by the headquarters as part of managing the bank's assets and liabilities, overall. It is not done by any one branch or as a result of the bank's accessing any particular market.

Study Federal Home Loan Bank Board (or its successor's) advances to S & Ls.

DEPOSITS - Small Account - If the account has less than \$X, it is attributable to the address of the depositor. This is not a presumption and may not be rebutted.

Medium Account - If the account has between \$X and \$Y, it is attributable to the branch where booked. This is not a presumption

and may not be rebutted. The branch must be a real branch with employees in full time attendance. The employees must have the authority to approve loans, accept loan repayments, disburse funds and conduct one or more other functions of a banking business. This is to eliminate allocation to "shell" branches. If the deposit is booked at a "shell" branch, then it is attributable to the headquarters.

Large Accounts - If the account has over \$Y, it is attributable to the branch which has the most contact with the deposit. The criteria for determining where the most contact has occurred must be developed, but SINAA (see receipts factor for large loans) would be a good place to start.

RECEIPTS FACTOR

Credit Cards - Interest - billing address; merchant discount - merchant's address; service fee - billing address.

Leases (non-finance) - Where tangible or real property located.

Small Loans (under \$Z) - If collateralized, where collateral is. If no collateral, application address.

Large Loans (\$Z and over) - Presumed at branch where booked, rebutted by SINAA (solicitation, investigation, negotiation, approval and administration). Note that first 3 elements of SINAA may well occur in a market state.

Syndication Loans (A loan made by several banks in the first instance; that is, several banks are named as lenders in the loan agreement.) - Treat the same as large loans. Any servicing fees earned by the lead bank are situated where the service is performed.

Participation Loans - (A loan that is made by one (or several) banks who then assign some or all of the loan to another bank(s). The new bank(s) receive the same interest payments that the original bank(s) would have received. The assignment can be with or without recourse.) Treat participations as a loan made by the new bank(s) to the original bank(s) and determine the situs of this loan in the same way as large loans are treated. Loan by original bank treated as a large loan. Receipts factor to include only the net interest income retained by the original bank(s). Servicing fees are to be situated to the place where the service is performed.

PASS-THROUGH CERTIFICATES - (Typically many small loans are sold to a corporation or, more likely, a trust, which then sells pass-through certificates which entitle the holders to receive their pro-rata share of principal and interest.) The original bank has sold loans which result in a gain or loss. Should the receipts factor reflect this gain or loss? A bank which buys a pass-through certificate has purchased an investment and the investment and trading income rules apply. Open question on servicing fees, should they follow rules for the direct loan (e.g. credit cards) or should they be situated where service is performed?

INVESTMENT AND TRADING INCOME (Including government bonds) -
Study IRS ideas on 24 hour global trading (see Tax Notes, 8/27/90,
p. 1143).

SERVICES - Where performed.

NEW YORK

ACTIVITY	RECEIPT ATTRIBUTED
Credit Cards	Billing Address
Merchant Discount	Merchant Address
Credit Card Service Fee	Billing Address
Leases (non-finance)	Location of Tangible or Real Property
Collateralized Small Loans (<\$Z)	Location of Collateral
Unsecured Small Loans (<\$Z)	Borrower's Address on Application
Large Loans (> or = \$Z)	Branch (Rebuttable-SINAA)
Syndication Loans	Branch (Rebuttable-SINAA)
Syndication Loan Service Fee	Where Service is Performed
Participation Loan-Orig. Bank	Branch (Rebuttable-SINAA); Net Amount
Participation Loan-New Bank	Branch (Rebuttable-SINAA w/Original Bank)
Participation Loan-Service Fee	Where Service is Performed
Pass-Through Certificates - Seller	Reflect Gain or Loss?
Pass-Through Certificates - Purchaser	Investment & Trading Income Rules
Pass-Through Certificates - Service Fee	Where Service is Performed or Investment Rules
Investment & Trading Income	Study?
Other Services	Where Performed

51

NEW YORK

ACTIVITY	SOURCE OF FUNDS ATTRIBUTED
Small Deposits (< \$X)	Depositor's Address
Medium Deposits (between \$X and \$Y)	Branch Where Booked (if shell then throwback to headquarters)
Large Deposits (> \$Y)	Branch (SINAA)
Fed Funds	Headquarters
Discount Window	Headquarters
Net Repo Liabilities	Headquarters (Rebuttable)
Other Borrowings	Headquarters (Rebuttable)
Advances to S&Ls	Study?

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MINNESOTA Department of Revenue**Appeals, Legal Services and Criminal Investigations Division**

Phone (612) 296-1022

Memo

To: Bank Apportionment Subcommittee
From: Mike Bockhaus
Subject: KISS Compromise
Date: February 24, 1992

RIGHT (5E)

This is what I have come to think of as the KISS Compromise, which basically follows my philosophy for tax system management: keep things simple enough so that I can explain it to a legislator from the northlands who has better things to do than worry about theories of taxing banks.

The basic premise of this proposal is the splitting of the attribution of the income from intangible property and the intangible property interest between the market and the money-center. Bill Lunka put together the attached spreadsheet that shows the general outline of the proposal. Please note that this is a draft for discussion purposes only.

The concept is relatively simple and is predicated on the traditional three-factor formula designed for manufacturing/mercantile corporations. In the manufacturing context, the plant/property is attributed to its location. The income derived from the plant is attributed to the location of the customers purchasing the products.

What we are attempting to do with the intangible property is similar. The property interest is attributed to the state where the facility that created the property is located, the money center. The income from that property is assigned to the location of the customers/borrowers, the market state.

There are three basic reasons for advancing this alternative. First of all, it fits within the traditional, judicially approved three-factor formula. This is important not only from a judicial standpoint, but also from the legislatures' views as well. Whatever is settled on has to pass legislative muster before the constitutional test. My experience is that it is much easier to pass variations on a common theme, than it is to offer something completely new and different.

KISS Compromise

Page Two

Secondly, it attempts to minimize the compliance problems by, in most cases, using information readily available to the banks as attribution rules. Based on the experience of Minnesota's auditors and long discussions with the industry, the banks can administer these attribution rules with minimal effort. From the tax administration standpoint, states won't have to adopt extensive complex regulations to administer. There also won't be the expense inherent in administering a complex new system.

Finally and most importantly, it is a compromise between the market and the money-center approaches that we have seen so far. It recognizes the fact that we all are going to have to give up something or the U.S. Congress may take all of it away, leaving us no flexibility (Remember the Railroads!).

As to the proposal itself, I stress that this is only a work-in-progress for our discussion. I am aware of the need for some refinements to make it work. What I am looking for is some agreement that this is the route we want to follow in putting together a fair (for the states and banks), simple and administrable formula. That should be the first order in our discussion before we spend time picking away at the details.

Now for the details. The spreadsheet is pretty much self-explanatory. We didn't have time to include attribution rules based on the size of the loan, but the concept merits further discussion.

There are three issues that I'd like to highlight. First of all, you will note that investments and securities have been excluded from the property and receipts factors. This is our version of a punt. The current market formulas attribute this property and associated income based on deposits. The theory for the current rule is that deposits are the source of funds for purchasing these instruments. But deposits aren't the sole source of funds available to a bank, as our previous telephone conference made painfully obvious. All of the income, deposits and borrowings of a bank can be used to purchase securities. The complexity of a source of funds rule solely to attribute this income did not seem feasible. The alternative of attributing this income and property to a bank's principal place of business puts everything in the money-center and nothing in the market.

Therefore, the proposal excludes investments and securities on the theory that the other measures of business activity will arrive at a fair approximation of the business activity within a state. That proportion would in turn be a fair approximation of the investments and securities attributable to activity in that state. This is the same result in many states for investments and securities held by manufacturers.

The second issue is income from services. Let me be up front about the fact that Minnesota has committed to attributing services for all corporations based on consumption. This is an issue that goes beyond banking for us. That said, there are two areas of contention about services. The banks and money-centers argue that consumption is difficult and expensive to administer. A good argument that can be ameliorated by a majority of states adopting the concept (which is essentially what occurred when states adopted the destination sales rule for manufacturers). The market/single factor states argue that the alternative of where the services are performed duplicates the payroll and distorts the formula. Also, a good argument. A possible compromise may be to use some rebuttable presumption looking at the location of the customer for whom the services are performed to attribute this income, either by billing address or principal place of business. This would give the income a market orientation, yet ease the administrative burden on the banks. Market states would have to include a payroll factor to reflect business activity occurring in the money-center.

The final issue is the toughest: unsecured commercial loans. This would probably be a good area to use some attribution rules based on the size of the loans. The proposal situates the income based on where the funds are used as a general principal. Here again, we could use a rebuttable presumption to attribute the income and require a higher degree of care in determining where the funds are applied based on the size of the loan. Smaller loans are more numerous and less subject to manipulation. Larger loans present an opportunity for "tax planning." All of the property interest is essentially attributed to the money-center.

Syndication and participation loans are not specifically addressed. The attribution of income and property arising out of syndication and participation loans should be determined by the type of loan that is being syndicated or participated in. The issue for participation and syndication loans is

**KISS Compromise
Page Four**

more properly addressed in the nexus context. Does the fact that a bank participates in a loan that attributes income to a state create nexus in that state?

Finally, I just want to tease you with this thought: what about interstate branching? This proposal could allow us to create property attribution rules for when a bank has a branch within the state and when it doesn't. This would address the banks' complaint about taxing them when they can't branch into a state. A bank would be taxed more or less, depending on whether it had a branch in the state. Just a thought.

Talk to you all on Thursday.

Enclosure

Proposed Financial Institution
Apportionment Formula

Activity	Property Attributed	Payroll Attributed	Receipts Attributed
Coin and Currency	Where Physically Located	N/A	Where Physically Located
Goodwill	Excluded from Formula	N/A	Excluded from Formula
Lease Financing	Where Tangible Property Is Located	N/A	Where Tangible Property Is Located
Loans Collateralized by Tangible Property	Where the Main Office of the Original Lender is Located	N/A	Where the Collateral is Physically Located
Unsecured Consumer & Installment Loans	Where the Customer Regularly Sends Their Payment	N/A	Where the Customer Resides
Credit & Travel Entertainment Cards	Where the Customer Regularly Sends Their Payment	N/A	Where the Customer Is Regularly Billed
Unsecured Commercial Loans	Where the Main Office of the Original Lender is Located	N/A	Where the Funds Are Used
Investments & Securities	Excluded from Formula	N/A	Excluded from Formula
Employees	N/A	Where Employee is Employed	N/A
Merchant Discount Income	N/A	N/A	Where the Merchant Is Located
Fiduciary and Other Services	N/A	N/A	Where the Benefits of The Services Are Consumed
Travelers Checks & Money Orders	N/A	N/A	Where the Travelers Check or Money Order was Purchased
Tangible Property	Where Property is Sitused	N/A	N/A

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PROPOSED FINANCIAL INSTITUTION APPORTIONMENT FORMULA - NYS/NYC

Activity	Source of Funds Attributed	Payroll	Attributed	Receipts	Attributed
Borrowings (General)	Headquarters 1	N/A			N/A
Borrowings (Repo's)	Headquarters 2	N/A			N/A
Borrowings (Fed. Funds)	Headquarters	N/A			N/A
Borrowings (Discount Window)	Headquarters	N/A			N/A
Borrowings (Fed. Home Loan Bank Board)	?	N/A			N/A
Deposits < \$X	Depositor's Address	N/A			N/A
Deposits \$X - \$Y	Branch Where Booked 3	N/A			N/A
Deposits > \$X	Branch Per SINAA 4	N/A			N/A
Credit Cards (Interest)	N/A	N/A		Billing Address	
Credit Cards (Merchant Discount)	N/A	N/A		Merchant's Address	
Credit Cards (Service Fee)	N/A	N/A		Billing Address	
Leases (non-finance)	N/A	N/A		Location of property	
Collateralized Loans < \$X	N/A	N/A		Location of collateral	
Uncollateralized Loans < \$X	N/A	N/A		Address of borrower	
Commercial Loans > \$X	N/A	N/A		Branch where booked 1	
Loans (Syndication)	N/A	N/A		Branch where booked 2	
Loans (Participation)	N/A	N/A		Branch where booked 3	
Pass-Through Certificates	N/A	N/A		?	
Investment/Trading Income 1	N/A	N/A		?	
Services	N/A	N/A		Where performed	
Employees	N/A	Where employee employed			N/A

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62

PROPOSED FINANCIAL INSTITUTION APPORTIONMENT FORMULA - MINNESOTA

Activity	Property Attributed	Payroll Attributed	Receipts Attributed
Coin and currency	Where physically located	N/A	Where physically located
Goodwill	Excluded from formula	N/A	Excluded from formula
Lease financing	Where tangible property located	N/A	Where tangible property located
Loans collateralized by tangible property	Main office of original lender	N/A	Where collateral physically located
Unsecured consumer & installment loans	Where customer sends payment	N/A	Where customer resides
Credit & travel cards	Where customer sends payment	N/A	Where customer billed
Unsecured commercial loans	Main office of original lender	N/A	Where funds used
Investments and securities	Excluded from formula	N/A	Excluded from formula
Employees	N/A	Where employee employed	N/A
Merchant discount income	N/A	N/A	Where merchant located
Fiduciary and other services	N/A	N/A	Where benefits of services consumed
Travelers checks and money orders	N/A	N/A	Where travelers checks or money orders purchased
Tangible property	Where property situated	N/A	N/A

(64)

FOOTNOTES:

Property Attributed:

1. Rebuttable presumption.
2. Net of Repo assets; only net Repo liabilities included.
3. If branch determined to be "shell," then attributed to headquarters.
4. SINAA—Solicitation, Investigation, Negotiation, Approval and Administration.

Receipts Attributed:

1. Rebuttable per SINAA.
2. Rebuttable per SINAA; servicing fees earned by lead bank attributed where performed.
3. Treated as loan by new bank(s) to original bank(s); Rebuttable per SINAA; includes only net interest income retained by original bank(s); servicing fees attributed where performed.

Activity:

1. Includes government bonds

Bank

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TO: MEMBERS OF SUB-SUBCOMMITTEE ON APPORTIONMENT OF INCOME
FROM FINANCIAL SERVICES: (MARILYN KALTENBORN, JONATHAN
ROBIN, BILL LUNKA/MIKE BOEKHAUS)

FROM: ALAN H. FRIEDMAN

RE: MINUTES OF NEW YORK SUB-SUBCOMMITTEE MEETING

DATE: MARCH 18, 1992

I have attached my draft of the minutes regarding our meeting in New York on March 9 and 10, 1992 for your review and comment at our next teleconference on Thursday, March 19, 1992 at 1:30 PM (Eastern). You all know the drill - call in to 202-296-3132 at the designated time.

The agenda for this call is solely to correct my version of the minutes of the New York meeting so that an accurate and fair version can be sent to the full Subcommittee on Friday or next Monday. Another teleconference will be scheduled for next week for the full Subcommittee to have its input. As soon thereafter as possible, a memorandum reflecting our progress will be sent to the Tax Administrators of all states seeking a bit of feedback and additional suggestions for a workable and fair formula.

Last Thursday, I was present at the FTA Board meeting in D.C. when this topic was discussed. The Board agreed to stick with the April 29-30 meeting with the industry in New York. Our efforts will be provided to industry representatives in advance of that meeting, most likely in a format similar to the one that was provided to the Tax Administrators.

I suggested to the FTA Board that, while the Subcommittee has made substantial progress, it is unlikely that we could get much additional movement towards one uniform formula acceptable by both money-center and market states without the involvement of the Tax Administrators and others in the states that have more final policy-making authority than we now have at the table. There appeared to be agreement with this observation.

P.S.: Thanks, again, to Jonathan and New York City for the hospitality. It is rare that one has the pleasure of working in an environment that is so conducive to beating meeting participants into submission. It will be hard to forget the effect of the fragrance of the garbage that was set out in front of the elevators, the soothing sound of the alarm system, and the chain on the men's room key that was enough to give one a hernia if he is not prepared to carry it.

TJ

171

MINUTES OF THE SUB-SUBCOMMITTEE ON APPORTIONMENT OF INCOME FROM
FINANCIAL SERVICES

March 9-10, 1992
New York City

The Sub-Subcommittee on Apportionment of Income from Financial Services met for the better part of two days on March 9-10, 1992 in the office of the New York City Department of Finance, One Centre Street, New York, NY. Members of the Sub-Subcommittee were:

Marilyn Kaltenborn	New York State Tax Department
Jonathan Robin	New York City Department of Finance
Bill Lunka	Minnesota Department of Revenue

Others present were:

Alan Friedman	Multistate Tax Commission
Richard Garrison	New York State Tax Department
Jerry Rosenthal	New York City Department of Finance
Kathy Barnett	" " "

For the purpose of simplicity, with the exception of a few particular references, these minutes will not identify who made what particular point during the two-day meeting. At other times, the minutes will use the terms "money-centered" or "domicile" state to reflect certain expressions of that bias and the term "market" state to reflect that bias. Some of the suggestions are not attributed to either bias, but evolved from the group dynamic and are owned by neither money-center nor market state representatives.

The meeting opened with Jonathan Robin describing an analysis that had been conducted of several of New York's largest domiciliary and alien (non-U.S.) banks with reference to the size of their New York allocation factors. Robin expressed some surprise at the results in that the selected domiciliary banks (on an aggregated basis) had assigned to New York only 50.57% of their net income. The range on an individual bank basis ran from 30%-60% New York apportionment factor, with the remaining percentage being attributed primarily to the banks' overseas activities. The apportionment percentage attributed to New York by alien banks (based on "effectively connected" income) was 57.73% on an aggregated basis, with approximately 86% attributed to trading and investment activity located in New York. A brief check of foreign

(domestic, non-New York banks) reflected a 2.66% apportionment factor for New York. Robin suggested that these preliminary numbers reflected that the states were laboring under a misconception that New York was sweeping in close to 100% of their domiciliary banks' income into the New York tax base.

Robin and Kaltenborn then briefly described the New York state and City apportionment formula which included:

An 80% payroll factor - for business location and development

A double-weighted receipts factor

A double-weighted deposits factor (using the FDIC definition of deposits)

Both Robin and Kaltenborn remained committed throughout the meeting to including a "Source of Funds" element in the factors. While they believed that all liabilities comprising the sources of a bank's funding of its activities are an important measure of that activity for apportionment purposes, they could envision supporting a formula that just included deposits as an approximate measure of that activity.

Lunka expressed Minnesota's opposition to using a source of funds or deposits factor in place of a property factor. He suggested that he could envision supporting a more traditional looking three-factor formula that reflected assets, payroll and receipts. He added that the receipts factor is the proxy for the market states and intangible assets should be included in the property factor which will act as the proxy for the money-centered states.

Based upon the positions taken, the market and money-centered approaches were stuck at the following bidding with regard to the number and type of the factors:

FACTORS

MONEY-CENTER STATE	MARKET STATE
Payroll factor	Payroll factor
Receipts factor	Receipts factor
Property factor (open issue)	Property factor
Source of funds or deposits factor	No source of funds or deposits factor

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The Sub-Subcommittee, setting aside its differences as to the number and kind of factors, then worked at developing the factors in terms of the types of items or activities included and their attribution.

PAYROLL FACTOR

The Payroll Factor was the least controversial and one which was fully agreed upon by the representatives. Included in this factor would be all employees, including general executive officers with company-wide responsibility (currently excluded from New York's payroll factor) and deferred compensation. This agreement is represented by the following chart:

PAYROLL FACTOR

Activity: Employees		
ITEM ATTRIBUTED	MONEY-CENTER STATE	MARKET STATE
Payroll	Place of employment include officer 's comp. and deferred comp.	Same

RECEIPTS FACTOR

There was no disagreement expressed between the money-center and market approaches with regard to the specific items to be included in a receipts factor and such items are noted in the chart below. With regard to the attribution of receipts from these items, the money-center vs. market state differences are based upon differing economic philosophies. Money-centers generally believe that the service activities of a financial institution should be attributed to the place of performance of the services (normally the headquarter state). Market states generally believe that such receipts should be attributed to the location of the borrower of such services, irrespective of where the actual services might be considered to have been performed. Minnesota has thrown in a rather unique twist in that it would attribute income from services based upon the place of consumption of the services and not, necessarily, the state of residence of the borrower.

This basic conflict dominated most of the meeting and created

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the "rub" which neither side was willing or able to smooth out when addressing receipts on an item-by-item basis. Although, the money-center approach was willing to flex somewhat on the basis of distinguishing between "retail" and "wholesale" banking activities, the treatment of large loan items became a sticking point. The flexibility that the money-center states might find possible is the attribution of "small" collateralized loans (\$ limit not yet defined) to the location of the collateral (real and tangible personal property). A rebuttable presumption attributing "small" uncollateralized loans to the address of the borrower as stated on the loan application was also suggested by the money-center state. The market state approach would require both "large" and "small" collateralized loans to be attributed to the location of the collateral. Both sides suggested that loans that were collateralized by intangible property be treated as uncollateralized loans are treated.

Despite this difference in approach, some agreement was initially reached regarding the attribution of some receipts in the market state numerator that arise from certain types of loan or other service income. *Credit card interest income* and *merchant discount income* was agreed to be assigned on a credit card holder address and merchant address basis under any scenario. An early concession by the money-center, based upon the "retail/wholesale" dichotomy, was that *credit card service fee income* would also follow the attribution of credit card income (state of card holder). However, this latter money-center state concession was withdrawn when a five-factor (with double receipts) approach, that will be set out later in these minutes, was presented.

Operating (non-finance) leases were agreed to be assigned to location of the property (with no presumptions regarding the location of the property, eg., that the property is located at the billing address of the lessee). It was also agreed to treat *finance leases* the same as collateralized loans; but, again, the treatment of said loans remained in flux due to the possible use of the double receipts factor approach discussed below. Should the double receipts factor not be accepted by a sufficient number of states, it is assumed that the money-center "retail/wholesale" approach would result in the "small" collateralized loans being attributed to the location of the collateral and the "large" collateralized loans being situated to the branch to which they are properly booked.

One possibility suggested would be to attribute any size of loan to the state in which the loan funds are used to acquire property from third parties or improve the collateralized property located in that state. Another suggestion was to attribute to the market and money-center states a certain set percentage of income from loans based upon the bank's and the borrower's contacts regarding the loan, such as the bank's office of original loan application, location of borrower, etc.

Currently, New York presumes the proper attribution of any

loan to be at the branch where the loan was booked. But, on a loan-by-loan analysis of several factors, referred to as "SINAA", New York may re-attribute a loan to another and more appropriate location. SINAA is the acronym for "Solicitation", "Investigation", "Negotiation", "Approval" and "Administration". If a sufficient number of these factors are shown on audit with respect to a given loan to be at another branch (but not an office), the loan may be taken from the place booked by the bank and attributed to a more appropriate location.

Large uncollateralized loans fell into the same two camps that collateralized loans fell into. Market state approach would source them to the state of the borrower (commercial domicile of corporations) or place of consumption in MN's case; money-center approach would source them based on the office of the bank which had the most contacts with the loan under SINAA. The group briefly discussed the effect interstate branching would have on, eg., New York's receipts factor which uses SINAA. It was agreed that New York's numerator would decrease, but which states' would have an increase is not known.

Interest income from syndicated loans would be attributed the same as the money-center or market state would treat the underlying loan. If collateralized or uncollateralized, the market state approach would be to assign the income to the state of the collateral or borrower; the money-center would either apply the "small" loan approach to a collateralized loan or booking office (subject to a SINAA adjustment). *Loan origination and loan service fees from syndicated loans* would be attributed to the state of the collateral or borrower by the market state and, by the money-center state to the state in which the services were performed.

Interest and fee income from participation loans would follow the same choice of attribution patterns followed for the syndicated loans. The market state takes the position that involvement by an out-of-state bank in either a participation or syndication loan will not, by itself, create nexus over the bank. However, if nexus otherwise exists, the income from such loans will be attributed as discussed above. The money-center position is that the second or purchasing bank in a participation loan situation has nothing to do with the original borrower and, therefore, no income attribution to the state of the borrower is supportable. This assumption - that there is an insufficient contact between the borrower and the second bank - needs to be confirmed before this assumption is relied upon. The money-center position is that there is a separate, second, loan where the first bank is borrowing from or selling an interest in a loan asset to the second bank. This transaction is a separate and distinct transaction from the loan by the first bank to the original borrower.

One suggestion with regard to the participation loan interest income is to attribute to the market state of the borrower the gross receipts from the loan, even though the bank collecting the proceeds remits a portion of the proceeds to the second or

72

participating institution. Not allowing the deduction from gross receipts by the originator of the loan is consistent with the "gross receipts" requirement of UDITPA and should work to prevent the originating bank from exporting all of the interest receipts to out of the market state. With regard to the treatment of the numerator of the receipts factor of the participating bank, the money-center approach would treat the receipts as receipts from a loan to the originating bank using SINAA situsing rules. The market state approach would continue to view this as a loan to the original borrower.

The Sub-Subcommittee wrestled with a very difficult issue of the possible conversion of loan instruments into securities and the big swing in income attribution that depended upon this issue. It should be noted that there is currently an issue whether participation loans sold by banks are "securities", no longer maintaining the characteristics of a loan. See, Banco Espanol de Credito v. Security Pacific National Bank, et al., 763 F.Supp.36 (S.D.N.Y. 1991), currently on appeal to the Second Circuit Court of Appeals, which held loan participations did not lose their classification as loans for SEC disclosure purposes. See also, FFIEC Supervisory Policy Statement, Fed. Reg. Vol. 57, No. 22 (February 3, 1992), possibly permitting the classification of some loan participations as instruments that are required to be assigned to a bank's trading or held for sale accounts, as opposed to its investment account (loan account).

A discussion was held regarding the practice of banks to engage in trading and investment activities that are treated differently for bank regulatory purposes depending upon whether the security or loan is intended to be held as a long term "investment" or short term "trading" or "held for sale" activity. The Sub-Subcommittee referenced the newly adopted Supervisory Policy Statement on Securities Activities for financial institutions adopted by the Federal Financial Institutions Examination Council (Federal Register, Vol. 57, No. 22, February 3, 1992) for a detailed explanation of the different accounting treatment for loans and securities held in a bank's investment account and those held for sale or trading. In this area, New York would treat "pass throughs" (eg., mortgages or bundles of credit card receivables sold to a trust that in turn sells pass through certificates in the trust to investors) as securities, if are held in the bank's trading or held for sale account. Receipts generated by these assets would be attributed by New York to the state in which they were held and managed, and would not attribute these receipts simply on a branch location basis.

A discussion was also had of the "24-Hour Book" in which an institution will trade on a 24 hours basis by passing the Book from its London office to its New York office and then to its Tokyo office. The receipts derived by this taxpayer needs to be apportioned among the activities of its three offices. Today, New York accomplishes this by attributing to its receipts factor that portion of the 24-hour Book receipts based upon the ratio that

trading and investment assets in New York bear to such assets everywhere. One suggestion made was to apportion such receipts by the ratio that the payroll attributable to the 24-hour Book in the state bears to total payroll for such Book everywhere. There was a concern that since we already had a payroll factor this might not be desirable. It was then suggested that the number of traders might be a more appropriate measure of in-state activity. Currently, MN and the MTC regulation proposal would use a deposits factor to apportion the receipts from this activity. An article explaining the 24-Hour Book has been written by a Charles Plambeck in the August 27, 1990 publication of Tax Notes. It was agreed that we needed to study this area more to address the apportionment issues raised by such activities.

With regard to other services, such as trust services, merger and acquisition advisory services, economic forecasting, data processing, transfer agency services, payment of municipal bond interest through banking services, and the like, the same issues exist as to where the services were performed v. where the customer is located or the services consumed issues were raised and left undecided. The group agreed that states should use the same receipts situsing rules for these service fees as they use for general business corporations. It is to be noted that, absent any special rule adopted to the contrary, UDITPA would situs such services to the state in which the majority of the cost of performance of the service were incurred. See, UDITPA, Section 17. However, many states are moving away from this all or nothing approach with respect to certain service industries. New York, for example, in the advertising media area, apportions receipts from advertising upon a proportionate audience or readership basis. See, also MTC Regulations IV.18.(h)(Television and Radio Broadcasting and IV.18.(j)(Publishing) to the same effect.

At this point in the discussion a suggestion to break the market state/money-center state impasse was raised. *Two receipts factors were suggested - one accommodating the money-center activities and one accommodating the market state activities.* Thus, a five-factor formula was placed on the table that included a property factor (including tangible and intangible property), a payroll factor, a market state receipts factor, a money-center receipts factor, and a source of funds factor (deposits only). All agreed that this suggestion deserved review by the full Subcommittee. The two receipts factors are set forth in a combined fashion on the following chart:

TWO RECEIPTS, FACTORS

Activity	Market State	Money-Center State
Credit cards interest	Billing address	Same
Merchant discount	Merchant address	Same
Credit card fees	Billing address	Where service performed
Leases (non-fin.)	Location of tangible or real property	Same
Collateralized loans-interest*	Location of collateral	Branch booked (rebuttable-SINAA)
Collateralized loans-service fees	Location of collateral	Where service performed
Unsecured loans-interest*	Debtor's address (commercial dom.)	Branch booked (rebuttable-SINAA)
Unsecured loans-service fees	Debtor's address (commercial dom.)	Where service performed
Trading income** (in 24-Hour Book)	Trader's ratio***	Same
Trading income** (not in 24-Hour Book)	Where asset is held, managed, and controlled	Same
Other services	Where service is performed****	Same

- *Loans = debt instruments in Investment Account (FFIEC)
- **Trading income = income from the Trading Account and Held for Sale Account (FFIEC); the 24hr Book included income from only assets reflected by the Trader's Ratio; include at net if distortive.
- ***Trader's ratio = U.S. domestics: number of Traders (no Mgrs.) within/everywhere (worldwide)
= Alien's: number of Traders (no Mgrs.) within/everywhere (effectively connected)
- ****To be treated the same as services are treated under state's general business corporation approach.

NOTE: Trading income currently attributed by a Trading Asset ratio in NY and by a Deposits ratio in MN and under proposed MTC reg.

In the newly suggested 5-factor approach, a property factor would be included that would have as its primary component intangible property (mainly loan and investment assets). While it was noted that the same situsing conflict exists between the market and money-center states, it was suggested that only one property factor should be used, instead of constructing a market and money-center property factor as was done with respect to the receipts factor. No charting of the property factor is included here as no common situsing rules were agreed to. However, it was understood that the relative weighing of the various factors could be used to reach a consensus among the competing interests.

Lastly, New York presented its "Source of Funds" factor which was limited to deposits only, with no other borrowing included, as this was viewed less weighted toward the money-center. This will be especially true if and when interstate branching becomes a reality. The money-center would divide deposits into "small" (under \$100,000) and "large" (\$100,000 and over), with small deposits being sitused to the address of the depositors and large deposits sitused to the branch where properly book (with SINAA to be applied where not properly booked). The market state, while not agreeing to a deposits factor, would source one based upon depositors' addresses irrespective of the size of the deposit. Chart-wise, the deposits factor suggested would be as follows:

DEPOSITS FACTOR

Activity	Market State	Money-Center State
Deposits (less than \$100,000)	Depositor's address	Same
Deposits (more than \$100,000)	Depositor's address	Branch booked (SINAA adjustment available)

The full Subcommittee is requested to review the progress made by the Sub-Subcommittee, think about the remaining areas of disagreement, consider the 5-factor approach or any additional approach that might resolve the conflict between market and money-center states, and arrive at your recommendation. Since the next meeting with the industry is set for April 29-30, 1992, it is requested that the Subcommittee decide upon its recommendations no later than April 3, 1992, so that further direction could be received from the Tax Administrators by April 21st.

In order to accomplish the foregoing, our next teleconference call is set for Thursday, March 26th at 1:30 PM (Eastern). You are invited to join that teleconference by your calling 202-296-3132 at the scheduled time. Your recommendations will be sought, so please be prepared to make your Subcommittee position known at that time. I would anticipate our discussion lasting 1 and 1/2 to 2 hours.

MINUTES OF THE SUB-SUBCOMMITTEE ON APPORTIONMENT OF INCOME FROM FINANCIAL SERVICES

March 9-10, 1992
New York City

The Sub-Subcommittee on Apportionment of Income from Financial Services met for the better part of two days on March 9-10, 1992 in the office of the New York City Department of Finance, One Centre Street, New York, NY. Members of the Sub-Subcommittee were:

- Marilyn Kaltenborn New York State Tax Department
- Jonathan Robin New York City Department of Finance
- Bill Lunka Minnesota Department of Revenue

Others present were:

- Alan Friedman Multistate Tax Commission
- Richard Garrison New York State Tax Department
- Jerry Rosenthal New York City Department of Finance
- Kathy Barnett " " "

For the purpose of simplicity, with the exception of a few particular references, these minutes will not identify who made what particular point during the two-day meeting. At other times, the minutes will use the terms "money-centered" or "domicile" state to reflect certain expressions of that bias and the term "market" state to reflect that bias. Some of the suggestions are not attributed to either bias, but evolved from the group dynamic and are owned by neither money-center nor market state representatives.

The meeting opened with Jonathan Robin describing an analysis that had been conducted of several of New York's largest domiciliary and alien (non-U.S.) banks with reference to the size of their New York allocation factors. Robin expressed some surprise at the results in that the selected domiciliary banks (on an aggregated basis) had assigned to New York only 50.57% of their net income. The range on an individual bank basis ran from 30%-60% New York apportionment factor, with the remaining percentage being attributed primarily to the banks' overseas activities. The apportionment percentage attributed to New York by alien banks (based on "effectively connected" income) was 57.73% on an aggregated basis, with approximately 86% attributed to trading and investment activity located in New York. A brief check of foreign (domestic, non-New York banks) reflected a 2.66% apportionment

factor for New York. Robin suggested that these preliminary numbers reflected that the states were laboring under a misconception that New York was sweeping in close to 100% of their domiciliary banks' income into the New York tax base.

Robin and Kaltenborn then briefly described the New York state and City apportionment formula which included:

An 80% payroll factor - for business location and development

A double-weighted receipts factor

A double-weighted deposits factor (using the FDIC definition of deposits)

Both Robin and Kaltenborn remained committed throughout the meeting to including a "Source of Funds" element in the factors. While they believed that all liabilities comprising the sources of a bank's funding of its activities are an important measure of that activity for apportionment purposes, they could envision supporting a formula that just included deposits as an approximate measure of that activity.

Lunka expressed Minnesota's opposition to using a source of funds or deposits factor in place of a property factor. He suggested that he could envision supporting a more traditional looking three-factor formula that reflected assets, payroll and receipts. He added that the receipts factor is the proxy for the market states and intangible assets should be included in the property factor which will act as the proxy for the money-centered states.

Based upon the positions taken, the market and money-centered approaches were stuck at the following bidding with regard to the number and type of the factors:

FACTORS

MONEY-CENTER STATE	MARKET STATE
Payroll factor	Payroll factor
Receipts factor	Receipts factor
Property factor (open issue)	Property factor
Source of funds or deposits factor	No source of funds or deposits factor

The Sub-Subcommittee, setting aside its differences as to the number and kind of factors, then worked at developing the factors in terms of the types of items or activities included and their attribution.

PAYROLL FACTOR

The Payroll Factor was the least controversial and one which was fully agreed upon by the representatives. Included in this factor would be all employees, including general executive officers with company-wide responsibility (currently excluded from New York's payroll factor) and deferred compensation. This agreement is represented by the following chart:

PAYROLL FACTOR

Activity: Employees		
ITEM ATTRIBUTED	MONEY-CENTER STATE	MARKET STATE
Payroll	Place of employment include officer 's comp. and deferred comp.	Same

RECEIPTS FACTOR

There was no disagreement expressed between the money-center and market approaches with regard to the specific items to be included in a receipts factor and such items are noted in the chart below. With regard to the attribution of receipts from these items, the money-center vs. market state differences are based upon differing economic philosophies. Money-centers generally believe that the service activities of a financial institution should be attributed to the place of performance of the services (normally the headquarter state). Market states generally believe that such receipts should be attributed to the location of the borrower of such services, irrespective of where the actual services might be considered to have been performed. Minnesota has thrown in a rather unique twist in that it would attribute income from services based upon the place of consumption of the services and not, necessarily, the state of residence of the borrower.

(82)

This basic conflict dominated most of the meeting and created the "rub" which neither side was willing or able to smooth out when addressing receipts on an item-by-item basis. Although, the money-center approach was willing to flex somewhat on the basis of distinguishing between "retail" and "wholesale" banking activities, the treatment of large loan items became a sticking point. The flexibility that the money-center states might find possible is the attribution of "small" collateralized loans (\$ limit not yet defined) to the location of the collateral (real and tangible personal property). A rebuttable presumption attributing "small" uncollateralized loans to the address of the borrower as stated on the loan application was also suggested by the money-center state. The market state approach would require both "large" and "small" collateralized loans to be attributed to the location of the collateral. Both sides suggested that loans that were collateralized by intangible property be treated as uncollateralized loans are treated.

Despite this difference in approach, some agreement was initially reached regarding the attribution of some receipts in the market state numerator that arise from certain types of loan or other service income. *Credit card interest income* and *merchant discount income* was agreed to be assigned on a credit card holder address and merchant address basis under any scenario. An early concession by the money-center, based upon the "retail/wholesale" dichotomy, was that *credit card service fee income* would also follow the attribution of credit card income (state of card holder). However, this latter money-center state concession was withdrawn when a five-factor (with double receipts) approach, that will be set out later in these minutes, was presented.

Operating (non-finance) leases were agreed to be assigned to location of the property (with no presumptions regarding the location of the property, eg., that the property is located at the billing address of the lessee). It was also agreed to treat *finance leases* the same as collateralized loans; but, again, the treatment of said loans remained in flux due to the possible use of the double receipts factor approach discussed below. Should the double receipts factor not be accepted by a sufficient number of states, it is assumed that the money-center "retail/wholesale" approach would result in the "small" collateralized loans being attributed to the location of the collateral and the "large" collateralized loans being situated to the branch to which they are properly booked.

One possibility suggested would be to attribute any size of loan to the state in which the loan funds are used to acquire property from third parties or improve the collateralized property located in that state. Another suggestion was to attribute to the market and money-center states a certain set percentage of income from loans based upon the bank's and the borrower's contacts

82

regarding the loan, such as the bank's office of original loan application, location of borrower, etc.

Currently, New York presumes the proper attribution of any loan to be at the branch where the loan was booked. But, on a loan-by-loan analysis of several factors, referred to as "SINAA", New York may re-attribute a loan to another and more appropriate location. SINAA is the acronym for "Solicitation", "Investigation", "Negotiation", "Approval" and "Administration". If a sufficient number of these factors are shown on audit with respect to a given loan to be at another branch (but not an office), the loan may be taken from the place booked by the bank and attributed to a more appropriate location.

Large uncollateralized loans fell into the same two camps that collateralized loans fell into. Market state approach would source them to the state of the borrower (commercial domicile of corporations) or place of consumption in MN's case; money-center approach would source them based on the office of the bank which had the most contacts with the loan under SINAA. The group briefly discussed the effect interstate branching would have on, eg., New York's receipts factor which uses SINAA. It was agreed that New York's numerator would decrease, but which states' would have an increase is not known.

Interest income from syndicated loans would be attributed the same as the money-center or market state would treat the underlying loan. If collateralized or uncollateralized, the market state approach would be to assign the income to the state of the collateral or borrower; the money-center would either apply the "small" loan approach to a collateralized loan or booking office (subject to a SINAA adjustment). *Loan origination and loan service fees from syndicated loans* would be attributed to the state of the collateral or borrower by the market state and, by the money-center state to the state in which the services were performed.

Interest and fee income from participation loans would follow the same choice of attribution patterns followed for the syndicated loans. The market state takes the position that involvement by an out-of-state bank in either a participation or syndication loan will not, by itself, create nexus over the bank. However, if nexus otherwise exists, the income from such loans will be attributed as discussed above. The money-center position is that the second or purchasing bank in a participation loan situation has nothing to do with the original borrower and, therefore, no income attribution to the state of the borrower is supportable. This assumption - that there is an insufficient contact between the borrower and the second bank - needs to be confirmed before this assumption is relied upon. The money-center position is that there is a separate, second, loan where the first bank is borrowing from or selling an interest in a loan asset to the second bank. This transaction is a separate and distinct transaction from the loan by

the first bank to the original borrower.

One suggestion with regard to the participation loan interest income is to attribute to the market state of the borrower the gross receipts from the loan, even though the bank collecting the proceeds remits a portion of the proceeds to the second or participating institution. Not allowing the deduction from gross receipts by the originator of the loan is consistent with the "gross receipts" requirement of UDITPA and should work to prevent the originating bank from exporting all of the interest receipts to out of the market state. With regard to the treatment of the numerator of the receipts factor of the participating bank, the money-center approach would treat the receipts as receipts from a loan to the originating bank using SINAA situsing rules. The market state approach would continue to view this as a loan to the original borrower.

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85

A discussion was also had of the "24-Hour Book" in which an institution will trade on a 24 hours basis by passing the Book from its London office to its New York office and then to its Tokyo office. The receipts derived by this taxpayer needs to be apportioned among the activities of its three offices. Today, New York accomplishes this by attributing to its receipts factor that portion of the 24-hour Book receipts based upon the ratio that trading and investment assets in New York bear to such assets everywhere. One suggestion made was to apportion such receipts by the ratio that the payroll attributable to the 24-hour Book in the state bears to total payroll for such Book everywhere. There was a concern that since we already had a payroll factor this might not be desirable. It was then suggested that the number of traders might be a more appropriate measure of in-state activity. Currently, MN and the MTC regulation proposal would use a deposits factor to apportion the receipts from this activity. An article explaining the 24-Hour Book has been written by a Charles Plambeck in the August 27, 1990 publication of Tax Notes. It was agreed that we needed to study this area more to address the apportionment issues raised by such activities.

With regard to other services, such as trust services, merger and acquisition advisory services, economic forecasting, data processing, transfer agency services, payment of municipal bond interest through banking services, and the like, the same issues exist as to where the services were performed v. where the customer is located or the services consumed issues were raised and left undecided. The group agreed that states should use the same receipts situs rules for these service fees as they use for general business corporations. It is to be noted that, absent any special rule adopted to the contrary, UDITPA would situs such services to the state in which the majority of the cost of performance of the service were incurred. See, UDITPA, Section 17. However, many states are moving away from this all or nothing approach with respect to certain service industries. New York, for example, in the advertising media area, apportions receipts from advertising upon a proportionate audience or readership basis. See, also MTC Regulations IV.18.(h) (Television and Radio Broadcasting and IV.18.(j) (Publishing) to the same effect.

At this point in the discussion a suggestion to break the market state/money-center state impasse was raised. Two receipts factors were suggested - one accommodating the money-center activities and one accommodating the market state activities. Thus, a five-factor formula was placed on the table that included a property factor (including tangible and intangible property), a payroll factor, a market state receipts factor, a money-center receipts factor, and a source of funds factor (deposits only). All agreed that this suggestion deserved review by the full Subcommittee. The two receipts factors are set forth in a combined fashion on the following chart:

86

TWO RECEIPTS FACTORS

Activity	Market State	Money-Center State
Credit cards interest	Billing address	Same
Merchant discount	Merchant address	Same
Credit card fees	Billing address	Where service performed
Leases (non-fin.)	Location of property	Same
Collateralized loans-interest*	Location of collateral	Branch booked (rebuttable-SINAA)
Collateralized loans-service fees	Location of collateral	Where service performed
Unsecured loans-interest*	Debtor's address (commercial dom.)	Branch booked (rebuttable-SINAA)
Unsecured loans-service fees	Debtor's address (commercial dom.)	Where service performed
Trading income** (in 24hr Book)	Trader's ratio***	Same
Trading income** (not in 24hr Book)	Where asset is held, managed, and controlled	Same
Other services	Where service is performed****	Same

- *Loans = debt instruments in Investment Account (FFIEC)
- **Trading income = income from the Trading Account and Held for Sale Account (FFIEC); the 24hr Book included income from only assets reflected by the Trader's Ratio; include at net if distortive.
- ***Trader's ratio = U.S. domestics: number of Traders (no Mgrs.) within/everywhere (worldwide)
= Alien's: number of Traders (no Mgrs.) within/everywhere (effectively connected)
- ****To be treated the same as services are treated under state's general business corporation approach.

NOTE: Trading income currently attributed by a Trading Asset ratio in New York and by a Deposits ratio under MN and proposed MTC reg.

87

In the newly suggested 5-factor approach, a *property factor* would be included that would have as its primary component intangible property (mainly loan and investment assets). While it was noted that the same situsing conflict exists between the market and money-center states, it was suggested that only one property factor should be used, instead of constructing a market and money-center property factor as was done with respect to the receipts factor. No charting of the property factor is included here as no common situsing rules were agreed to. However, it was understood that the relative weighing of the various factors could be used to reach a consensus among the competing interests.

Lastly, New York presented its "*Source of Funds*" factor which was limited to deposits only, with no other borrowing included, as this was viewed less weighted toward the money-center. This will be especially true if and when interstate branching becomes a reality. The money-center would divide deposits into "small" (under \$100,000) and "large" (\$100,000 and over), with small deposits being sitused to the address of the depositors and large deposits sitused to the branch where properly book (with SINAA to be applied where not properly booked). The market state, while not agreeing to a deposits factor, would source one based upon depositors' addresses irrespective of the size of the deposit. Chart-wise, the deposits factor suggested would be as follows:

DEPOSITS FACTOR

Activity	Market State	Money-Center State
Deposits (less than \$100,000)	Depositor's address	Same
Deposits (more than \$100,000)	Depositor's address	Branch booked (SINAA adjustment available)

The full Subcommittee is requested to review the progress made by the Sub-Subcommittee, think about the remaining areas of disagreement, consider the 5-factor approach or any additional approach that might resolve the conflict between market and money-center states, and arrive at your recommendation. Since the next meeting with the industry is set for April 29-30, 1992, it is requested that the Subcommittee decide upon its recommendations no later than April 3, 1992, so that further direction could be received from the Tax Administrators by April 21st.

EXHIBIT K: 29

Kiely, Rep. Patrick J. and Loftus, Joseph E., "Indiana's New Franchise Tax on Financial Institutions: Justification for the Statutory Change" (undated)

INDIANA'S NEW FRANCHISE TAX
ON FINANCIAL INSTITUTIONS:
JUSTIFICATION FOR THE STATUTORY CHANGE

by

Representative Patrick J. Kiely
Co-Chairman
Indiana House Ways and Means Committee
Indiana House of Representatives
Anderson, Indiana

and

Joseph E. Loftus, Attorney
Indiana House Ways and Means Committee
Indiana House of Representatives
Indianapolis, Indiana

TABLE OF CONTENTS

Indiana's New Franchise Tax
On Financial Institutions:
Justification for the
Statutory Change. Rep. Patrick J. Kiely
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	<u>Page Number</u>
I. Overview of HEA 1625.	1
II. Justification for HEA 1625.	3
A. The Interstate Banking Environment.	5
B. Policy Objectives	9
1. Simplification of Existing Tax Structure.	10
2. Eliminate the Competitive Disadvantage of Indiana Financial Institutions	12
a. Taxpayer Defined.	13
b. Exemption From Gross Tax.	14
c. Personal Property Tax Exemption Eliminated.	18
d. Government Obligation Interest Exemption Eliminated	19
3. Fairly Tax Nonresident Financial Institutions and Corporations Transacting the Business of a Financial Institution	21
C. The Dual System of Taxation	22
III. Summary	24

I. OVERVIEW OF HEA 1625

On May 9, 1989, with Governor Evan Bayh's signature to House Enrolled Act 1625, Indiana changed significantly its method of taxing financial institutions. This Act, among other things, adds a new article to the Indiana Code providing a new net income tax for financial institutions.¹ Its provisions, effective January 1, 1990, impose on each taxpayer² a franchise tax measured by net income for the privilege of exercising its franchise or transacting business in Indiana. The tax rate is 8.5%.

The structure of the new financial institutions tax is unique because it consists of a residence-based tax for resident taxpayers³ and a source-based tax for non-resident taxpayers.⁴ Resident taxpayers are taxed on all net income subject to a full or partial credit for taxes paid to other states.⁵ The amount of the credit is limited to the amount that would have been paid under Indiana's tax. Nonresident taxpayers are taxed on net

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1. IC 6-5.5-1-1 et. seq.
 2. IC 6-5.5-1-17(a).
 3. IC 6-5.5-1-13.
 4. IC 6-5.5-1-12.
 5. IC 6-5.5-2-5.

income apportioned to Indiana using a single receipts factor.⁶

The new tax applies only to corporations that are transacting the business of a financial institution in Indiana.⁷ However, the statute significantly expands Indiana's taxing authority by:

- (1) taxing nonresident institutions formerly untaxed or lightly taxed by Indiana;
- (2) setting up broad tests for determining when nonresident institutions do business in Indiana;
- (3) extending the tax not only to regulated institutions such as banks, but to nonregulated corporations whose primary business is lending money and extending credit; and
- (4) changing the rules for attributing nonresident institution income, so that interest and earnings from loans and other transactions with Indiana residents are attributed to and taxed by Indiana.

Other important aspects of HEA 1625 include:

6. IC 6-5.5-2-3.

7. IC 6-5.5-1-17(d).

- (1) the creation of a Financial Institutions Tax Fund for the distribution of a portion of the revenue from the new tax to local taxing units;
- (2) the amendments which "source" income under Indiana's adjusted gross income tax in a manner comparable to the attribution rules under the new tax; and
- (3) the requirement that every corporation that carries on any business activity or owns or maintains property in Indiana for a taxable year file a business activity report with the Department of Revenue, unless it files an Indiana tax return or qualifies to do business in Indiana.

Financial institutions subject to the new financial institutions tax are exempted from the Indiana gross income tax, supplemental net income tax, bank tax, savings and loan tax, and production credit association tax.

II. JUSTIFICATION FOR HRA 1625

Not since 1933, when the legislature enacted the Intangibles

Tax Act,⁸ has there been such a major restructuring of Indiana's taxation of financial institutions. The enactment of HEA 1625 was the culmination of many years of effort by the Indiana League of Savings Institutions to restructure the tax on financial institutions to a net income tax to alleviate the severe impact of the gross income tax on savings institutions. In addition to these efforts, the Commission on State Tax and Financing Policy⁹ studied issues concerning the taxation of all financial institutions in separate studies in 1982, 1987 and 1988.

While the Indiana League was the primary proponent of the restructuring, HEA 1625 is more than a change from a gross to a net income tax. It represents an attempt by the General Assembly to enact a tax structure better suited to the current interstate banking environment for all financial institutions and meeting several other public policy objectives. To meet these objectives, HEA 1625 creates a "dual system" tax structure consisting of residence-based taxation with a credit for domiciliary financial institutions and source-based taxation for nondomiciliaries, broadens the taxpayer base, and creates for the first time substantial taxation of nonresident financial

8. Acts of 1933, Chapter 83.

9. IC 2-5-3-1 et. seq.

institutions.

A. The Interstate Banking Environment

The interstate banking environment in 1989 is significantly different than it was even in the near past. Commentators have suggested that the most important changes involve:

- (1) emergence of interstate branch banking;
- (2) growth of sophisticated bank technology that allows for interstate branchless banking through electronic devices such as automated teller machines;
- (3) extensive and growing solicitation of banking services by computer-driven mail;
- (4) out-of-state accounting and administration of loans, deposits and withdrawals; and
- (5) elimination of a clear distinction between traditional banking services and other areas of commerce.¹⁰

With respect to interstate banking, most state legislatures, including the Indiana General Assembly, have passed legisla-

10. See generally Sandra B. McCray, State Taxation of Banks: Issues and Options, Advisory Commission on Intergovernmental Relations, (draft report), May 1989.

tion permitting interstate banking.¹¹ By the end of 1988, forty-seven states allowed interstate acquisitions for at least some of their banks. To put the growth in the number of states permitting interstate banking in perspective, a recent study by the Federal Reserve Bank of Atlanta revealed that between 1983 and 1988 the number of offices of banking organizations existing outside the home state of organization grew from 7,492 offices to 14,651 offices or an increase of 95.5%.¹² Similarly, the number of these offices permitted to offer all banking services increased from 1,406 to 7,492 or an increase of approximately 433%.¹³ This same study also predicted that this growth trend is likely to continue since more interstate banking laws are becoming national in scope.¹⁴

With respect to technological developments, the use of automated teller machines and other electronic banking devices has made traditional physical presence jurisdiction rules obsolete. For instance, the Second Circuit Court of

11. IC 28-2-16-1 et. seq.

12. See B. Frank King, Sheila L. Tschenkel, and David D. Whitehead, Interstate Banking Developments in the 1980's, Federal Reserve Bank of Atlanta, Economic Review, May/June 1989, p. 39.

13. Id.

14. Id. at p. 42.

Appeals in Independent Banker's Ass'n v. Marine Midland Bank,¹⁵ upholding a ruling of the Comptroller of the Currency, held that a bank that effects loan, deposit, and withdrawal transactions with its customers electronically through an automatic teller machine does not engage in branch banking. Consequently, banks and nonbank entities can easily circumvent state branch banking limitations and by that method extend their activity nationwide.¹⁶

The solicitation of banking services through the mail results in jurisdictional problems similar to those regarding technological developments. Today, many banks and nonbank entities offer loans and other services and solicit deposits from out-of-state residents through computer-driven mail. For instance, according to a recent survey in the American Banker, one-third of the top 100 banks had at least 30% of their credit card accounts with individuals outside the domicile state of the bank.¹⁷

The elimination of the clear distinction between traditional

15. See 757 F. 2d 453 (2nd Cir., 1985); Cert. denied, 106 S. Ct. 2929 (1986).

16. McCray, *Supra* note 11, at 26.

17. See, Credit Card Business Mushrooms at Large Banks, *American Banker*, August 14, 1986, p. 1, 6.

banking services and other areas of commerce is illustrated by the efforts of banks to acquire new powers in the areas of securities, insurance and real estate. Currently, twenty-five states allow their state-chartered banks to engage in some securities activities,¹⁸ seventeen states allow banks to underwrite insurance and/or act as an insurance agent or broker,¹⁹ and twenty-six states permit state banks to invest in and develop real estate and/or act as a real estate broker.²⁰ Banks have sought additional powers in these areas to counter the growth in the number of nonbank entities that have begun to encroach on areas that traditionally have been reserved for banks. For instance, banks face increased competition from unregulated entities such as companies affiliated with automobile manufacturers (e.g., GMAC) that provide financing, retailers (e.g., Sears) that issue credit cards, and securities firms (e.g., Merrill Lynch) that attract deposits through money market accounts.

The preceding discussion, while not at all exhaustive of the

18. See, Conference of State Bank Supervisors, State of the State Banking System, 1989.

19. Id.

20. Id.

changes, provides some indication of the rapid evolution of the interstate banking environment and the interstate flow of credit. Because Indiana's financial institutions tax structure was a product of an era predating interstate banking and the growth of nonbank entities, it effectively placed Indiana financial institutions at a competitive disadvantage relative to nonresident financial institutions and other nonbank entities transacting the business of a financial institution in Indiana. As a result, the legislative efforts in adopting HEA 1625 were directed at modernizing Indiana's method of taxing financial institutions by enacting a tax structure that, among other things, would eliminate the competitive disadvantage of Indiana financial institutions and fairly tax nonresident financial institutions and corporations transacting the business of a financial institution in Indiana. These policy objectives along with the desirability of simplifying the financial institution structure are discussed below.

B. Policy Objectives

The principal policy objectives underlying the enactment of HEA 1625 are:

- (1) to simplify the existing tax structure;
- (2) to eliminate the competitive disadvantage

of Indiana domiciled financial institutions; and

(3) to tax fairly nonresident financial institutions and corporations transacting the business of a financial institution in Indiana.

1. Simplification of Existing Tax Structure

The need to simplify the existing tax structure was obvious to most legislators. Under that structure (effective until January 1, 1990), the major regulated financial institutions in Indiana are subject to four taxes. Banks and trust companies, savings and loan associations, industrial loan companies and production credit associations are liable for the corporate gross income tax,²¹ the corporate supplemental net income tax,²² and one of three financial institutions excise taxes: the bank tax,²³ the savings and loan association tax,²⁴ or the production credit association tax.²⁵

21. IC 6-2.1-1-1 et. seq.

22. IC 6-3-8-1 et. seq.

23. IC 6-5-10-1 et. seq.

24. IC 6-5-11-1 et. seq.

25. IC 6-5-12-1 et. seq.

Further, savings associations are liable for local personal property taxes. Federally-chartered credit unions pay real property taxes, while state-chartered credit unions pay the corporate gross income tax in addition to real and personal property taxes.

Complicating the current tax scheme is the unique application of the existing taxes. Bank and savings and loan taxes are paid locally in each county and are distributed on the basis of where the principal office or branch of a bank or savings association is located. Gross income taxes, on the other hand, are paid to the state. State-chartered banks and savings associations pay the gross tax and take a credit for that amount against their excise tax. National banks, on the other hand, take a credit for the bank tax against the gross income tax. Savings associations also pay a personal property tax, while banks and credit unions do not. Although savings associations receive a credit for personal property taxes paid against their excise tax, this credit is of no value because the gross tax credit

is large enough to offset the excise tax liability.²⁶

As a result of the various credits available under the current tax structure, a county's financial institution tax revenue is determined not by the total amount of taxable financial resources located in the county, but by the type of financial institutions and their location in a county. A study conducted by the Legislative Services Agency found that Indiana's current tax structure resulted in a substantial inequitable distribution of tax revenue.²⁷

As enacted, HEA 1625 will greatly simplify the taxation of financial institutions in Indiana. Beginning January 1, 1990, all financial institutions will be subject to a single franchise tax based on net income and exempted from the existing array of Indiana taxes.

2. Eliminate the Competitive Disadvantage of Indiana Financial Institutions

26. See generally, John Sylvia, Indiana's Current Taxing Policy of Its Financial Institutions, Legislative Services Agency staff report, prepared for the Commission on State Tax and Financing Policy. October 1987.

27. Id. at 15, 16.

The most important objective in adopting HEA 1625 was to eliminate the competitive disadvantage that the current tax structure imposed on Indiana financial institutions compared to their resident and nonresident competitors. Particularly in light of the changes within the interstate banking environment, the maintenance of a tax structure that differentiated and discriminated among resident and nonresident financial institutions, and between financial institutions and other corporations engaged in the business of a financial institution, cannot be justified. Additionally, it was difficult to defend a tax structure that subjected Indiana financial institutions to much higher levels of taxation than their counterparts in the immediately surrounding states and in the U.S. as a whole. In an effort to eliminate the competitive disadvantage of Indiana financial institutions, several critical provisions were included in HEA 1625.

- a. **Taxpayer Defined** -- Taxpayer is broadly defined to expand the scope of the Act to include not only traditional regulated financial institutions but also other corporations "transacting the business of

a financial institution".²⁸ For nontraditional, nonregulated institutions that term includes any corporation if 80% or more of its gross income is derived from one or more of the following activities: (1) making, acquiring, selling or servicing loans or extensions of credit; (2) leasing or acting as an agent, broker or advisor in connection with "finance leases" of real or personal property; and (3) operating a credit card business.²⁹ As such, the following types of corporations will be subject to Indiana's financial institutions tax, in addition to traditional financial institutions, if they meet the 80% gross income test: consumer lenders; affiliates of automobile manufacturers making loans and leases; affiliates of retailers making credit card loans; corporations in the credit card business; commercial loan companies; companies engaged in lease financing for real and personal property; and mortgage brokers.

b. Exemption From Gross Tax -- The existing tax

28. See IC 6-5.5-1-17(a).

29. See IC 6-5.5-1-17(d)(2).

structure is replaced with a uniform franchise tax measured by net income. As a result, financial institutions subject to the new franchise tax are exempted from the gross income tax, the adjusted gross income tax, the supplemental net income tax, the bank tax, the savings and loan tax and the production credit association tax. This provision, while also important to the objective of simplification, is essential to eliminating the competitive disadvantage of Indiana financial institutions.

Of particular significance is the exemption from the state's gross income tax. Although the gross income tax provides a relatively stable source of income for the state, it does not reflect over time a financial institution's current operating structure. For example, a company operating at a loss will still have gross receipts to be taxed. While the corporate income tax is burdensome to an otherwise healthy financial institution, it can significantly exacerbate the difficulties of a financially troubled financial institution. The importance of the change to a net tax for these institutions lies

in the sensitive and direct effect on their earnings and net worth, as contrasted with many other industries, of volatile interest rates.

The effect of the gross income tax on Indiana domiciled financial institutions was illustrated in a study prepared for the Commission on State Tax and Financing Policy by the Legislative Services Agency.³⁰ With respect to the savings and loan industry, the LSA report noted that in 1981 and 1982, years when Indiana savings and loans suffered net losses of \$96 million and \$148 million respectively, the industry's gross tax liability exceeded \$13 million annually.³¹ In addition, in 1983, after two consecutive years of losses, the savings and loan industry reported net income of \$16.3 million and paid approximately \$14.5 million in gross income tax or 89% of their total net income.³² The LSA study also reported that state banks were also adversely affected by the gross tax. Specifically, the study noted that the net income of

30. See *Supra*, note 26.

31. *Id.* at 3.

32. *Id.*

state banks declined by 48% from 1979 to 1982 while state banks' gross tax liability increased by 46% during the same period.³³

As a result of the existing tax structure, financial institutions in Indiana are taxed at a higher rate than in the surrounding states and, in the case of savings and loan associations, at rates higher than any other state in the United States. Specifically, a Purdue University study compared the Indiana tax liability of a representative Indiana savings and loan institution and the taxes that would have been paid on the same business under the tax statutes of the forty-nine other states.³⁴ The results of the study indicated that the Indiana tax liability was the highest among the fifty states. With respect to the surrounding states, the Indiana tax was 73.9% higher than the Illinois tax, 54.5% higher than the Ohio tax, 73.5% higher than the Michigan tax and

33. Id.

34. See James A. Papke, The Taxation of Indiana Savings and Loan Institutions: The Case for Competitive Equity, paper presented at the Ninety-Sixth Annual Convention of the Indiana League of Savings Institutions, Inc., Lexington, Kentucky, June 21, 1988, p. 14, 15.

46.1% higher than the Kentucky tax.³⁵ In a similar study prepared by George S. Olive & Co. for the Indiana Banker's Association, the tax on Indiana banks was found to be 85% higher than the Illinois tax, 20% higher than the Ohio tax, 50% higher than the Michigan tax and 50% higher than the Kentucky tax.³⁶

c. **Personal Property Tax Exemption Eliminated** -- The discriminatory application of the personal property tax to savings and loan associations was eliminated. Under existing law, savings and loan associations, but not banks, were liable for the personal property tax. In an effort to mitigate this obvious disparity, savings and loan associations were allowed to credit these taxes against their excise tax liability. However, this credit was of little or no value because the gross income tax credit usually eliminated substantially all of the excise tax liability of a savings and loan association. Under HEA 1625 all financial institutions will be

35. Id.

36. See Anthony G. Ressino and Mark R. Hannah, Should Indiana Change How It Taxes Financial Institutions, Hoosier Banker, November 1988, p. 8, 9.

liable for personal property taxes.

d. **Government Obligation Interest Exemption Eliminated**

-- The exemption for interest on government obligations was eliminated. Because income earned on government obligations comprise a large percentage of a bank's income, the failure to tax this income results in a significant revenue shortfall. This was illustrated in the Legislative Services Agency study which found that because of the exemption for government obligations, banks had a significantly lower percentage of taxable gross receipts than did savings and loan associations. Specifically, the LSA report noted that "for savings associations, 90 to 95 percent of their gross receipts is taxable under the gross tax, while for state banks the percentage is 70 to 75 percent".³⁷

Taxation of the income from federal securities is, however, invalid unless the income from state and municipal securities is also taxed under the requirements of 31 U.S.C. 3124 which provides:

All stocks, bonds, Treasury notes, and other obligations of the United States,

37. See Supra, note 26.

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.³⁸ (Emphasis added.)

Accordingly, for the state to tax the income from government securities, two tests must be met: (1) the tax must be a franchise or other non-property tax, and (2) the tax must not be discriminatory. The new financial institutions tax -- franchise tax measured by net income -- clearly meets the first test. The second test can only be satisfied if the state taxes the income from state and local governmental obligations as well as federal obligations.³⁹ Consequently, under the provisions of HEA 1625, income earned on all government

38. See 31 U.S.C. sec. 3124(a).

39. See Memphis Bank & Trust Company v. Riley C. Garner, Shelby County Trustee, 103 S. Ct. 692 (1983). In Memphis Bank & Trust, the U.S. Supreme Court struck down as discriminatory a Tennessee statute which imposed a tax that included interest received on obligations of the United States but excluded interest earned on the obligation of Tennessee and its political subdivisions. Thus, according to Memphis Bank & Trust, a state can use a franchise tax measured by net income and include in the tax base income from federal obligations provided the state also taxes its own obligations and the obligations of its political subdivisions.

obligations -- federal, state and local -- are included in the taxable income of financial institutions.

3. Fairly Tax Nonresident Financial Institutions and Corporations Transacting the Business of a Financial Institution in Indiana

The objective to fairly tax nonresident financial institutions and corporations transacting the business of a financial institution is directly linked to the objective of eliminating the competitive disadvantage of Indiana financial institutions. Of particular relevance to this objective are the provisions broadening the definition of "taxpayer" (discussed above), and the provisions concerning the business transaction rules. The business transaction rules contained in HEA 1625 include both the traditional physical presence test and a "regular solicitation" or "regular engaging" in loan transaction test which does not rely on an in-state physical presence.⁴⁰ The broad jurisdictional standard explicitly recognizes the fact that nonresident financial institutions and corporations transacting the business of a financial institution can and do conduct

40. IC 6-5.5-3-1(5).

business in the state of Indiana without having a physical presence here. Since these nonresident institutions operate in direct competition with Indiana financial institutions and because they derive substantial revenue from their Indiana activities, a tax policy that extends Indiana tax jurisdiction to these financial institutions is justified. This contrasts with the existing structure where nonresident banks are exempted from the adjusted gross income tax and where all interest from loans made by any nonresident are not considered as earned or sourced in Indiana.

C. The Dual System of Taxation

HEA 1625 adopts a dual system of taxation of financial institutions. The dual system was selected because it combines the advantages of a residence-based tax structure for domiciled financial institutions with the advantages of a source-based tax structure for nondomiciled financial institutions.

Under the residence-based component of the tax, the entire income of a domiciled financial institution is subject to the tax regardless of the source of the income. However, a

credit is provided for taxes paid to other states. The amount of the credit is limited to the amount that would have been paid under Indiana's tax. Under the source-based component of the tax, nondomiciled financial institutions will be taxed on net income apportioned to Indiana using a single receipts factor.⁴¹

A pure residence-based tax was not desirable because nondomiciliary financial institutions would pay no tax even though they may have earned income from their activities within Indiana. On the other hand, while a pure source-based tax would have led to the taxation of a nondomiciliary's apportioned income, multistate financial institutions domiciled in Indiana would have been able to reduce their tax liability by apportioning some of their income to another state regardless of whether that income was taxable by the other state. The ability of a multistate domiciled financial institution to apportion income to other state branches or affiliates provides those institutions with a competitive advantage relative to smaller community-based banks. Such a result is logically inconsistent with the

41. The single factor receipts formula in combination with the rules for attributing receipts stated in IC 6-5.5-4-1 et. seq. will maximize the income attributed to the state by nonresident taxpayers.

policy objective to eliminate competitive disadvantages of Indiana financial institutions.

Given the weaknesses of a residence-based tax with respect to nondomiciled institutions and of a source-based tax with respect to domiciled institutions, the General Assembly adopted the dual system.

III. SUMMARY

The enactment of HEA 1625 significantly changes the way Indiana taxes financial institutions; not since the early 1930's had there been such a major restructuring of the financial institutions tax obligations. Beginning January 1, 1990, financial institutions transacting business in Indiana will be subject to a franchise tax measured by net income. The new tax is unique because of the "duality" of its structure. Resident taxpayers are taxed on all net income subject to a full or partial credit for taxes paid to other states. Nonresident taxpayers are taxed on net income apportioned to Indiana using a single receipts factor.

The impetus for the enactment of HEA 1625 was the realization by the General Assembly that the existing tax structure was

obsolete. The obsolescence of the existing tax law is directly attributable to the changes in the banking environment that have occurred over the last several years. The changes of particular significance include: (1) the emergence of interstate banking; (2) the growth of sophisticated bank technology; (3) the solicitation of banking services by computer driven mail; (4) the use of out-of-state accounting and administration of loans, deposits and withdrawals; and (5) the elimination of a clear distinction between traditional banking services and other areas of commerce.

In enacting a tax structure to address the evolving banking environment, the General Assembly attempted to meet three major policy objectives. These policy objectives are to: (1) simplify the existing tax structure; (2) eliminate the competitive disadvantage of Indiana financial institutions; and (3) fairly tax nonresident financial institutions and corporations transacting in Indiana the business of a financial institution. These goals were accomplished by utilizing the "dual system" of taxation which combines the advantages of a residence-based tax structure for domiciled financial institutions and a source-based tax structure for nondomiciled financial institutions with the other changes in taxing mechanics set out in this paper.

EXHIBIT K: 30

Kincaid, John and McCray, Sandra B., "State Taxation and the Rise of Interstate Banking: A Survey of States", Intergovernmental Perspective, (Fall 1988) pp. 18-22

State Bank Taxation and the Rise of Interstate Banking: A Survey of States

John Kincaid and Sandra B. McCray

Tremendous changes are occurring in the U.S. banking system. One of the changes has been the rise of interstate banking. Bank holding companies and banks are branching out into other states by (1) locating subsidiary banks throughout the nation and (2) soliciting deposits and offering loans to customers across the country by mail and through electronic means in a form of "branchless banking." A person living at one end of the country can now do most or all banking through mail and electronic transfers with a bank located at the other end of the country. Increasingly, in fact, citizens do business, directly and indirectly, with many banks, both in state and out of state.

Interstate banking poses a number of tax and regulatory challenges to the states. Forty-six states have enacted interstate banking laws as a first response to these challenges (see Table 1). The ACIR has been conducting research on state taxation and regulation of banks and will issue its first report, entitled *State Regulation of Banks in an Era of Deregulation*, in October 1988. The second phase of

the research involves an examination of the principal issues and options in state taxation of banks.

The challenges faced by states include: (1) the adoption of jurisdiction rules that create tax parity between domiciliary banks (i.e., banks that are chartered by or are headquartered in one's own state); and nondomiciliary banks (i.e., banks that are chartered by or are headquartered in another state but conduct business in one's own state) and (2) the search for an apportionment formula for taxation that reflects how and where multistate banks earn income.

Basically, the spread of interstate banking poses three tax problems for the states: (1) the in-state activities of nondomiciliary banks may escape taxation, thus putting domiciliary banks at a competitive disadvantage, (2) state taxation of nondomiciliary branchless banks may result in double taxation, thus putting out-of-state banks at a competitive disadvantage, and (3) the use of differing and conflicting formulas by states to apportion bank income can create administrative burdens and overlapping taxation. Accordingly, interstate banking is causing states to reexamine their bank taxes and, in some cases, to experiment with new tax formulas. New York and Minnesota, for example, recently enacted changes in their bank tax laws.

The ACIR has undertaken a study of state taxation of banks in order to examine the issues involved in the taxation of interstate banking and the options available to states. One element of this research was a survey of existing state tax practices, the summary results of which are reported here.

In April 1988 a questionnaire was mailed to bank-tax administrators in all 50 states and the District of Columbia. A follow-up mailing was made to states that did not respond to the first mailing. This survey was conducted jointly with the Federation of Tax Administrators, which FTA provided close cooperation and valuable support, especially in handling the mailings of the questionnaire. Usable responses were received from 49 states plus the District of Columbia.

State Taxes Levied on Banks

The most widely used bank tax is a franchise tax, levied by 69 percent of the responding states and the District of Columbia. The popularity of the franchise tax is due largely to two factors.

First, a franchise tax has significant revenue advantages for states. According to federal law, states cannot include the value of or income from federal obligations in their tax base unless they adopt a "nondiscriminatory franchise or other nonproperty tax." Because federal obligations ordinarily comprise a large fraction of a bank's assets and income, failure to use a franchise tax for banks can be costly for states.

Table 1
State Interstate Banking Laws and Effective Dates

Nationwide ¹	Regional ² Reciprocity Required/ Trigger to Nationwide	Regional ³ Reciprocity Required	States without Interstate Banking
Alaska 7/82	California 7/87	Alabama 7/87	Hawaii
Arizona 10/86 ⁶	Colorado 7/88 ^{6, 8}	Arkansas 1/89 ⁹	Iowa
Idaho 1/88	Delaware 1/88	Connecticut 6/83 ⁵	Kansas
Kentucky 1/86 ⁴	Illinois 7/86	District of Columbia 11/85	Montana
Maine 1/78 ⁵	Indiana 1/87	Florida 7/85	North Dakota
New Jersey 1/88 ^{4, 5}	Louisiana 7/87 ¹⁰	Georgia 7/85	
New Mexico 1/90 ⁶	Michigan 1/86 ⁵	Maryland 7/85	
New York 6/82 ^{4, 5}	Nebraska 1/90	Massachusetts 7/83 ⁵	
Oklahoma 7/87	Nevada 7/85 ^{6, 8}	Minnesota 7/86	
Rhode Island 1/88 ^{4, 5}	Ohio 10/85 ⁵	Mississippi 7/88	
South Dakota 2/88 ^{4, 5}	Oregon 7/86 ⁷	Missouri 8/86	
Texas 1/87 ⁶	Pennsylvania 8/86 ⁵	New Hampshire 9/87 ⁵	
Utah 1/88	Vermont 1/88 ⁵	North Carolina 1/85	
Washington 7/87 ⁴		South Carolina 7/86	
West Virginia 1/88		Tennessee 7/85	
Wyoming 5/87		Virginia 7/85	
		Wisconsin 1/87	

Source: Conference of State Bank Supervisors, August 1988.

¹Any out-of-state bank holding company can acquire an existing and/or new (de novo) host-state bank.

²An out-of-state bank holding company can acquire a host-state bank only if (1) the principal place of business of the holding company is in one of the states named in the host state's statute, and (2) the other state accords equivalent reciprocal privileges to the banks of the host state. After a certain date, set forth in the statute, any out-of-state bank holding company can acquire an existing and/or new (de novo) host-state bank.

³An out-of-state bank holding company can acquire a host-state bank only if (1) the principal place of business of the holding company is in one of the states named in the host state's statute, and (2) the other state accords equivalent reciprocal privileges to the banks of the host state.

⁴Reciprocity requirement.

⁵De novo entry permitted.

⁶De novo entry permitted after specified time period—Arizona (6/30/92), Colorado (7/1/93), Nevada (7/1/90), New Mexico (7/1/92), and Texas (9/1/2001).

⁷Oregon law has no reciprocity requirement.

⁸States which drop reciprocity requirement after trigger—Colorado and Nevada.

⁹Effective date 1/89, unless determined otherwise according to statutory specifications.

¹⁰After 7/1/94, an out-of-state bank holding company may open any new bank or acquire a nonestablished LA bank if the acquirer has an established LA bank.

Second, the use of a franchise tax for banks tends to increase the neutrality and fairness of a state's tax system. States that choose a direct net income tax for banks, for example, must exempt the value of and/or income from federal obligations from their bank tax base. This exemption can cover from 10 to 60 percent of a bank's income. By contrast, federal obligations typically constitute an insignificant percentage of the assets and income of nonbank corporations. Therefore, unless states offer a comparable reduction in the tax base of competing nonbank institutions, the use of a direct net income tax will generally favor banks over nonbank corporations.

Of the 35 states that reported using the franchise tax, 20 states (61 percent) measure the tax by a bank's net income. In addition to, or instead of, a franchise tax, 19 of the responding states (38 percent) levy a direct net income tax,

7 (14 percent) impose a bank shares tax, 4 (8 percent) levy a gross receipts tax, and 6 (12 percent) impose another type of tax on banks. Judicial interpretations of the U.S. Constitution probably account for the use of a direct net income tax alone or in conjunction with a franchise tax. According to its interpretations of the commerce clause in the early part of this century, the U.S. Supreme Court ruled that states could not tax businesses operating in interstate commerce by means of a franchise tax, but they could do so with an apportioned direct net income tax. The court's rulings led many states to adopt either a straight, direct, net income tax or a system by which the in-state business of banks was subject to a franchise tax while their interstate business was subject to a direct net income tax.

Interestingly, there are regional differences in bank tax practices. Fully 81 percent of the responding states in

the South, 73 percent in the Northeast, and 70 percent in the Midwest levy a franchise tax as opposed to only 42 percent of the states in the West.¹ In contrast, 54 percent of the responding states in the West and 41 percent in the South levy a net income tax, as opposed to only 22 percent of the states in the Northeast and 18 percent of the states in the Midwest. No northeastern state reported using a gross receipts tax, although this tax is used by one midwestern, one southern, and two western states. None of the responding states in the West reported using a bank shares tax, which is levied by 33 percent of the eastern states, 9 percent of the midwestern states, and 18 percent of the southern states. Although these percentages do not directly reveal it, the total number of states using a bank shares tax has been dwindling in recent years.

The bank shares tax was more widely used prior to 1983 because an 1864 federal law restricted state taxation of national banks to a real property and/or bank shares tax. The 1983 Supreme Court decision in *American Bank & Trust Co. v. Dallas County*, however, hastened the demise of the bank shares tax by severely limiting its revenue-raising capability. In its ruling, the court struck down a Texas bank shares tax because the tax, which the court found to be a property tax, included the value of federal obligations in its base in violation of federal statutory law. Currently, only seven states use a bank shares tax, and at least two of those states are reviewing that tax for possible changes.

Another finding from the survey is that in taxing banks, 32 states (64 percent) include the value of, or income from, state obligations (e.g., bonds), and 25 states (50 percent) include the value of, or income from, federal obligations. Federal law prohibits a state from including the value of, or income from, federal obligations in the measure of its tax unless it uses a *nondiscriminatory* franchise (or other nonproperty) tax. A state franchise tax is deemed discriminatory and in violation of federal law if it includes the value of or income from federal obligations in the base while exempting the value of or income from its own state or municipal obligations. Thus, every state that taxes federal obligations must also tax its own state obligations. Because states are usually loathe to tax the obligations of their own government while exempting those of the federal government, the federal law has the effect of creating a partial tax parity among state and federal obligations. No federal statute or judicial decision prohibits a state from taxing the income from the obligations of other states while exempting the income from its own obligations, how-

¹Regions were defined in accordance with official Census categories: Northeast—Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut, New York, New Jersey, and Pennsylvania; Midwest—Ohio, Indiana, Illinois, Michigan, Wisconsin, Iowa, Missouri, Nebraska, Kansas, Minnesota, North Dakota, and South Dakota; South—Delaware, Maryland, Virginia, West Virginia, North Carolina, South Carolina, Georgia, Florida, Kentucky, Tennessee, Alabama, Mississippi, Arkansas, Texas, Oklahoma, and Louisiana; West—Montana, Wyoming, Colorado, Utah, Idaho, Arizona, Nevada, New Mexico, California, Oregon, Washington, Alaska, and Hawaii.

ever. This fact apparently accounts for the finding that more states tax state obligations than tax federal obligations; the state obligations being taxed are those of other states.

Banks Versus Other Firms

Twenty-seven of the responding states (54 percent) do not tax banks in the same manner as they tax general (non-financial) business corporations. The remaining 23 states (46 percent) do tax general business corporations in the same manner as banks. The use of an industry-specific bank tax by most states appears to be the result of two historical forces. First, until 1976, federal law restricted the methods by which states could tax national banks. Second, until the 1980s, most banks occupied a narrow niche in the business of financial intermediation. The business of banking was confined to soliciting deposits and making short-term commercial and consumer loans. Today, however, federal law provides that states are free to tax banks in any manner they choose, as long as the tax does not discriminate against national banks. Also, banks now engage in a wider variety of business activities, such as securities, insurance and real estate, thus competing directly with non-bank entities in these areas. The number of states that question the continued use of an industry-specific bank tax in this new competitive environment may well increase in the near future.

Again there are regional differences. Fully 77 percent of the states in the West and 53 percent in the South tax banks in the same manner as they do other business corporations. Only 20 percent of the states in the East and 25 percent in the Midwest reported doing so.

Forty of the states (80 percent) tax savings and loan institutions in the same manner as banks. Here there are no marked regional differences, although slightly fewer states in the South (67 percent) tax savings and loan institutions in the same manner as banks.

State Constitutional Limits

In the vast majority of states, there are no constitutional limits on state taxation of banks. Forty-six (96 percent) of the responding states reported no constitutional limits on state taxation of domestic banks and savings and loan institutions. The two responding states with such limits are located in the South and West.

Except for three states—one each in the Midwest, South, and West—45 of the responding states (94 percent) have no constitutional limits on state taxation of out-of-state banks or savings and loan institutions. Similarly, except for one state in the South and three in the West, 44 of the responding states (92 percent) have no constitutional limits on state taxation of income from state or municipal obligations.

Taxation of Interstate Bank Income

The survey results presented in Table 2 indicate that, with one exception, most states do not have statutes that permit them to tax major categories of income earned by out-of-state banks that do not have a physical presence in the state. Nevertheless, some states report that they do tax such income by administrative practice. Generally, the

greater the physical presence of an out-of-state bank, the more likely a state is to tax that in-state operation.

The fact that large numbers of states do not tax a fraction of the income of out-of-state banks that conduct their in-state activities without a physical presence (i.e., banks that conduct their business solely by mail or through electronic means) is due primarily to past judicial interpretations of the commerce clause. According to its interpretation of the commerce clause in the early part of this century, the U.S. Supreme Court invalidated all state taxes on multistate corporations, holding that such taxes created multiple taxation and thereby burdened interstate commerce. Gradually, however, the court changed its interpretation of the commerce clause. If the multistate corporation had an office in the taxing state, the court often upheld the state's tax against a commerce clause challenge, finding that the tax fell on a local business rather than on interstate commerce. Later, the court found the existence of an in-state employee to be sufficient to sustain a state's tax. Still later, the court announced a general rule allowing states to tax an apportioned share of the income of a nondomiciliary corporation. The court found that the use of an apportionment formula solved the problem of multiple taxation.

Some observers argue, however, that a remaining impediment to state taxation of interstate business can be found in the Supreme Court's 1967 decision, *National Bellas Hess v. Department of Revenue of the State of Illinois*, which prohibits *unapportioned* state sales taxes on mail-order sellers. Other observers maintain that this decision does not apply to apportioned net income taxes, and that, therefore, states are free to broaden their tax jurisdiction rules as interstate branchless banking becomes more prevalent.

There are also some regional differences in state taxation of interstate bank income. Generally, states in the

Midwest more often tax interstate bank income than do states in other regions. For Category 1 in Table 2, the Midwest at 50 percent is well ahead of other regions (20 percent in the South, 10 percent in the Northeast, and 9 percent in the West). For Category 2, the West at 39 percent is ahead of other regions (27 percent in the Midwest, 17 percent in the South, and 10 percent in the Northeast). For Category 3, the Midwest at 50 percent is again ahead of other regions (20 percent in the South, 18 percent in the West, and 10 percent in the Northeast). Similarly, a larger percentage of states in the Midwest (60 percent) tax the interest income in Category 4 than do states in the West (42 percent), South (43 percent), and Northeast (20 percent). For Category 5, however, the Midwest and the South are tied at 80 percent, although the West (70 percent) is close behind, but far ahead of the Northeast (30 percent). In all categories, except Category 1, the Northeast has the smallest percentage of states taxing interstate bank interest income.

The results displayed in Table 2 also point up the problem of equity in interstate bank taxation. The ACIR does not advocate increased bank taxation or a particular bank tax policy, but it should be noted that states that do not assert tax jurisdiction over the kinds of interstate bank income listed in Table 2 need to examine whether they are placing their domiciliary banks at a competitive disadvantage. At the same time, a state that bases its taxation on the entire net income of its domiciliary banks needs to determine whether other states are taxing the out-state portions of that same income, thereby subjecting domiciliary banks to double taxation.

Licensing Out-of-State Bank Operations

The survey results displayed in Table 3 show that most states are not active in registering or licensing the loan and

Table 2
Categories of Interstate Bank Income Potentially Subject to State Taxation

Does state tax . . . ? (Income category)	Percent of Responding States		Leading Tax Region*
	Yes	No	
1. Interest income from loans made by an out-of-state bank which has no office, employees or representatives in state to a resident of the state and secured by personal property located in state.	22	78	Midwest 50
2. Interest income from credit cards issued to state residents by an out-of-state bank which has no office or employees in state.	21	79	West 39
3. Interest income from loans to residents in state made by an out-of-state bank which has no office, employees or representatives in state and secured by real property located in state.	24	76	Midwest 50
4. Interest income from loans solicited by in-state representatives of out-of-state banks (e.g., call programs).	40	60	Midwest 60
5. Interest income from loans solicited at loan production offices located in state but closed at the out-of-state home office of the soliciting bank.	67	33	Midwest & South 80

*Region with highest proportion of states reporting a tax on each category of interstate bank income. Table shows name of region and percentage of states in the region levying a tax.

Table 3
State Registration or Licensing of Out-of-State Bank Operations

Does state license . . . ? (business activity)	Percent of Responding States		Leading Region*
	Yes	No	
1. Require the agent or representative of an out-of-state bank who solicits loans or deposits in state to register or apply for a license.	21	79	West 40
2. Require an out-of-state bank which solicits loans or deposits in state through an agent or representative to register or apply for a license.	38	62	West 44
3. Require an out-of-state bank which solicits loans or deposits in state through a loan production office to register or apply for a license.	54	46	West 80

*Region with highest proportion of states reporting a requirement in each category. Table shows name of region and percentage of states in the region imposing the requirement.

deposit activities of out-of-state banks. Only where an out-of-state bank operates a loan production office do more than half of the states require registration or a license. Again there are regional differences. States in the West are more active in registering or licensing out-of-state banking operations than are states in other regions. In Category 1, 31 percent of southern states, 10 percent of midwestern states, and none of the responding northeastern states require a license. Requirements are imposed in Category 2 by 38 percent of the states in the South, 40 percent in the Midwest, and 25 percent in the Northeast. In Category 3, requirements are imposed by 60 percent of midwestern states, 38 percent of southern states, and 25 percent of northeastern states. Thus, as in the taxation of interstate bank income (Table 2), fewer states in the Northeast than in other regions require registration or licensing of out-of-state bank activity.

Tax Apportionment Formulas

Thirty-two (64 percent) of the responding states said that they have a statute, regulation, or administrative procedure that governs the apportionment of the income (or other tax measure used) of a multistate bank. Of the 32 states that use an apportionment formula, 11 (or 22 percent of the 50 states) have adopted the three-factor "Massachusetts" formula consisting of property, payroll, and sales.

The Massachusetts three-factor formula was developed to apportion the income of multistate manufacturing companies and was later codified (with some modifications) in the Uniform Division of Income for Tax Purposes Act (UDITPA). However, the UDITPA formula specifically excludes financial institutions from its provisions. The formula is not well suited for apportioning the income of financial institutions because it does not include intangible property, which comprises most of the assets of a financial institution, in the property factor. For this reason, the states that have recently revamped their bank taxes have either dropped the property factor entirely or have changed the make-up of the property factor to include intangibles.

No commonality exists among the 21 states that use an apportionment formula other than the UDITPA. The lack

of uniformity among state apportionment formulas can lead to overlapping taxation of bank income because state formulas that assign particular pieces of interstate bank income to specific states are likely to clash.

Future Plans

In terms of the immediate future, 30 states (60 percent) responding to the survey have no plans to change the formula currently used to apportion the income of banks for tax purposes. The remaining 16 states (32 percent) expect changes to be made in their formula. (Eight percent did not answer this question.)

Similarly, 34 of the responding states (68 percent) indicated no plans to broaden state jurisdictional rules in order to tax the income that out-of-state banks receive from banking transactions with in-state residents solely by mail or through electronic means. Again, 8 percent did not respond to this question, leaving 12 states (24 percent) with reported plans to broaden jurisdictional rules.

Conclusion

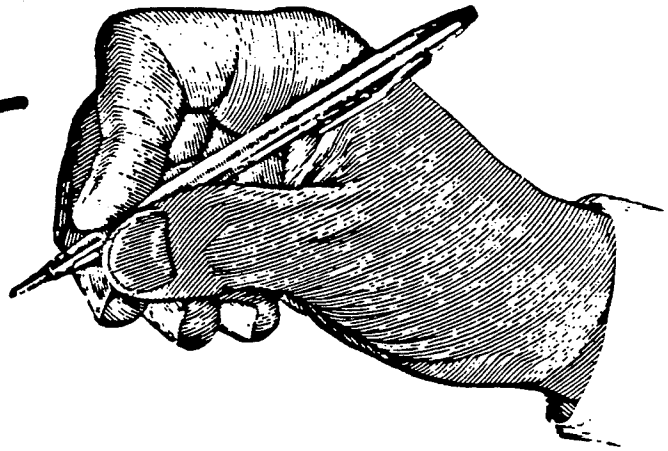
The results of the ACIR/FTA survey show that a number of states are beginning to meet the tax challenges posed by interstate banking. For example, 10 states reported that they have broadened their tax jurisdiction rules to allow them to tax the in-state activities of out-of-state branchless banks, thereby creating greater tax parity between in-state and out-of-state banks. Nevertheless, much remains to be done. For example, states have made scant progress toward finding a uniform rule to apportion the income of multistate banks. The states have, however, entered a period of experimentation that may lead to the identification of the most effective method for taxing banks in the new world of interstate banking—a method that would promote uniformity among state bank taxes and equity for in-state and out-of-state banks.

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EXHIBIT K: 31

**King, B. Frank, Tschinkel, Sheila L. and Whitehead, David D., "Interstate
Banking Developments in the 1980's," Economic Review (May/June 1989)
p. 32-51**

F.F.I.



Interstate Banking Developments in the 1980s

B. Frank King, Sheila L. Tschinkel, and David D. Whitehead

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.¹ 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.²

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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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 1 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, Nonwest 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*

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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

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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.

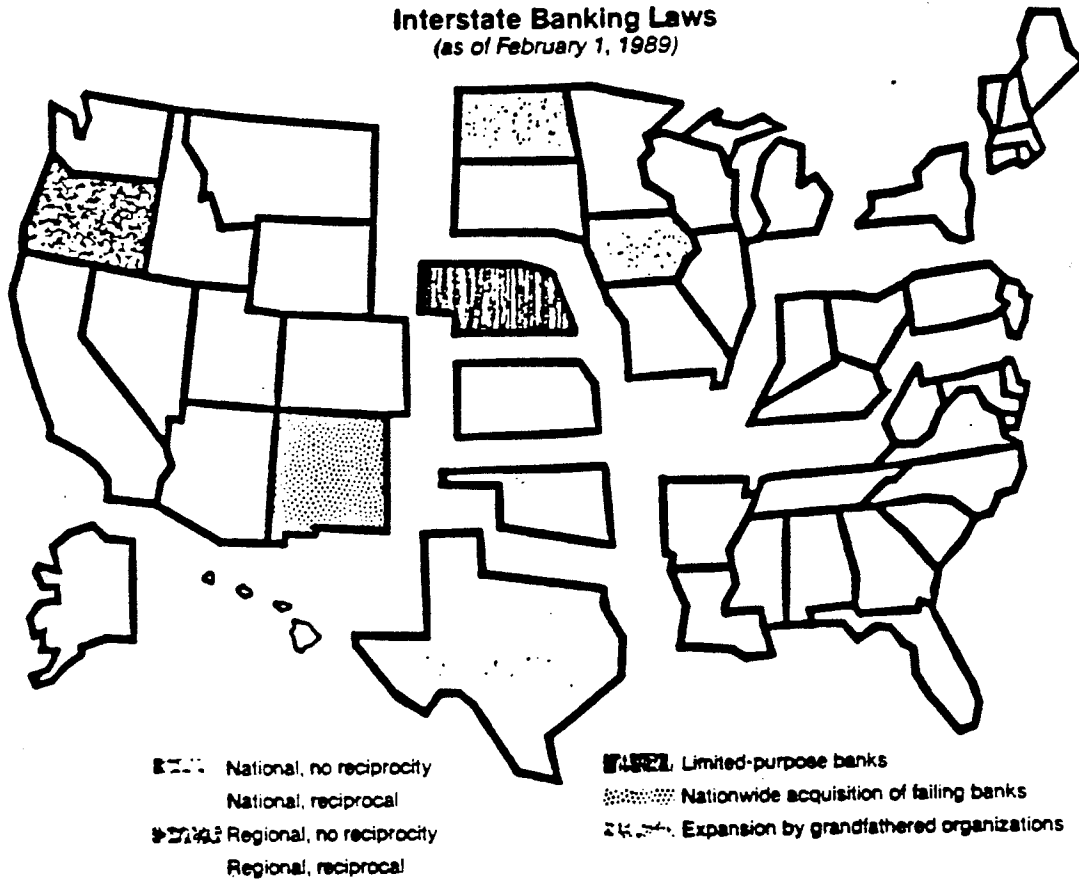
Nonbank Offices. Another way banking organizations innovated around limits to geographic

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
Total Bank Offices	7,492	1,406	6,086	433
Offices of Foreign Banks	302	241	61	25
Domestic Edge Act Corporations	79	143	-64	-45
Total Offices for Foreign Transactions	381	384	-3	-1
Section 4(c)(8) Offices	6,446	5,500	946	17
Loan Production Offices	332	202	130	64
Total Nonbank Offices	6,778	5,702	1,076	19
Total Offices of Banks	14,651	7,492	7,159	95
Thrift Institutions	1,616	N.A.		
Total Interstate Offices	16,267	N.A.		

Sources: See Appendix 3 and David D. Whitehead, *A Guide to Interstate Banking*, Federal Reserve Bank of Atlanta, 1983.

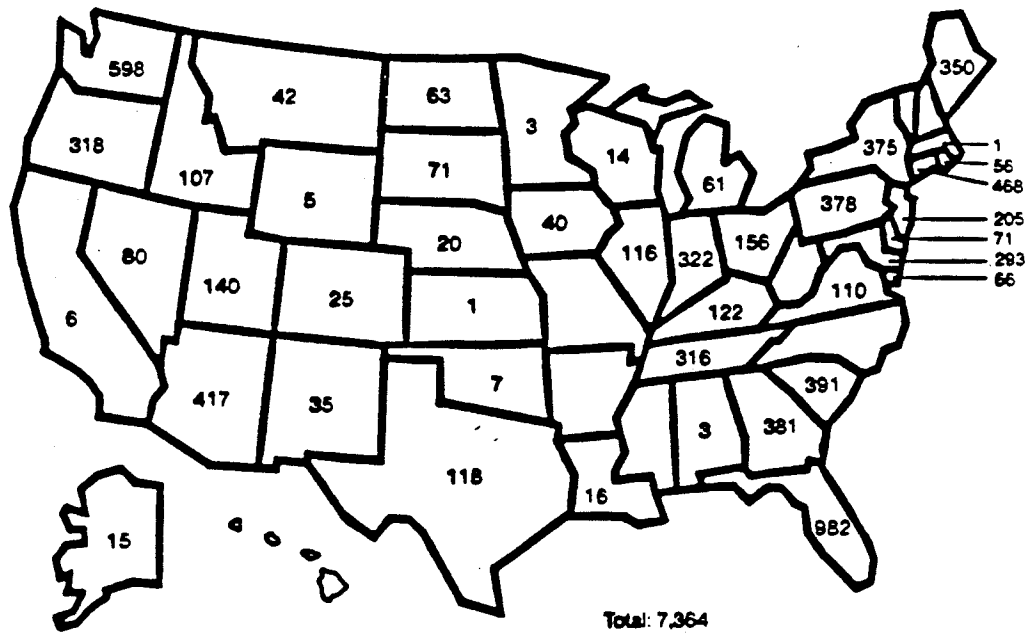
found a rather large network of interstate offices, relatively few of which were permitted to offer a full range of banking services. All these full-service offices were in grandfathered banks. The vast majority of interstate offices were nonbank offices such as 4(c)(8) subsidiaries; loan production 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.

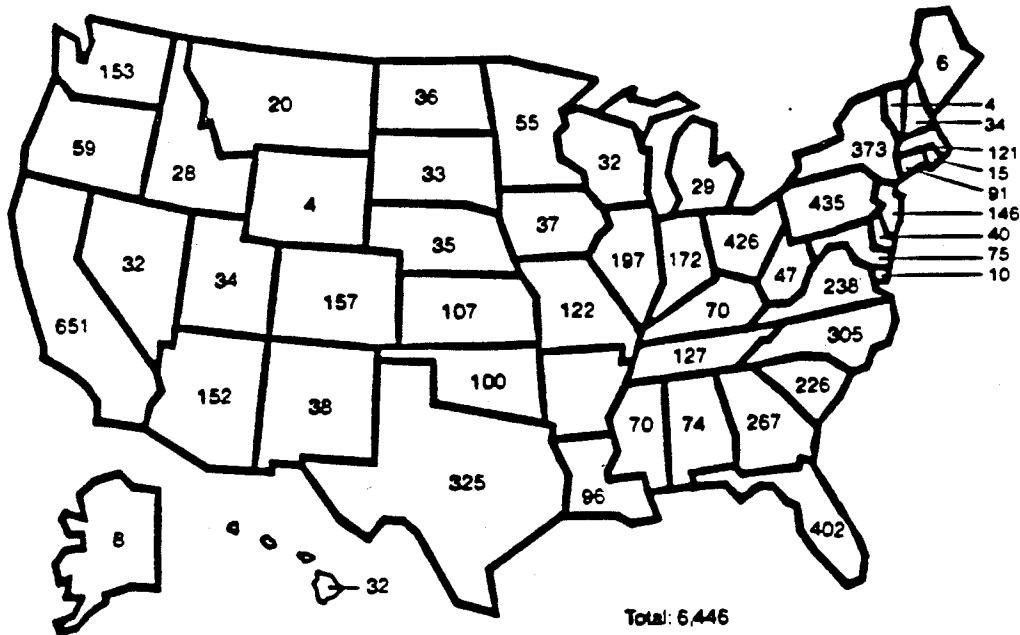
Clearly, the length of time since enabling legislation was enacted to permit interstate banking has also affected the pattern. Developments in the New England compact's states illustrate this effect. Out-of-state banks have made substantial penetration into Connecticut and Rhode Island, whose regional 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.¹ 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 II. 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

¹The 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 1 continued

State	Bank Officers										Officers Limited to International Transactions					Nonbank Officers		
	Domestic					Foreign					Domestic Filer Act Corporations	Loan Production Officers	Offices of 1413B Subsidiaries	Total Officers of Banking Organizations	Savings and Loans	Total Increase Offices		
	Out-of-State Banking Organizations Represented	Out-of-State Banking Organizations Represented	Out-of-State Banking Organizations Represented	Out-of-State Banking Organizations Represented	Out-of-State Banking Organizations Represented	Agency	Filer	Branch										
Montana	3	42												20	62	6	68	
Nebraska	3	20												35	95	8	95	
Neveda	3	80												32	119		121	
New Hampshire	2	205												34	37	30	37	
New Jersey	1	35												146	364		364	
New Mexico	4	375	8	39	16	2	43	20						38	77	74	77	
New York	3	63	1	19										373	896	1	970	
North Carolina	3	156												305	931		932	
North Dakota	3	7												36	99		99	
Ohio	3	318												426	992	131	723	
Oklahoma	3	378												108	109	10	119	
Oregon	4	378												99	368	85	473	
Pennsylvania	3	36												495	828	13	841	
Rhode Island	3	391												15	72		72	
South Carolina	3	71												226	621	1	622	
South Dakota	7	316												33	104	4	108	
Tennessee	6	118												177	451	11	462	
Texas	5	140												325	512	78	590	
Utah	7	110												34	174	11	185	
Vermont	6	948												4	5		5	
Virginia	3	14												4	5		5	
Washington	3	5												238	356	22	378	
West Virginia	6	14												153	717	55	812	
Wisconsin	3	14												47	47	2	49	
Wyoming	3	5												32	48		48	
TOTAL														7,364	16,651	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

¹David 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.

²David D. Whitehead, "Interstate Banking: Probability or Reality?" Federal Reserve Bank of Atlanta *Economic Review* 70 (March 1985): 6-19.

EXHIBIT K: 32

Kramer, Jörg-Dietrich, "German Court Reverses Decision on Taxation of Interest Income of German Branch of U.S. Bank", Tax Notes International, (November 29, 1993)

Tax Treaties

German Court Reverses Decision on Taxation of Interest Income of German Branch of U.S. Bank

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Jörg-Dietrich Kramer

Introduction

In 1985, the BFH (*Bundesfinanzhof*—Federal Finance Court) decided that interest received by the German branch of a U.S. bank from German branches of U.S. corporations is exempt from taxation in Germany under article XIV(2) of the U.S.-Germany tax treaty of 1954 (DBA-USA 1954/1966).¹ This was an extremely controversial decision because the taxation of a German branch of a foreign corporation is regularly left to Germany, as, for instance, under the new U.S.-Germany tax treaty of 1989 (DBA-USA 1989).²

The BFH decided that Germany is entitled to tax the interest income of the German branch of a U.S. banking corporation, even if the interest is paid by another U.S. corporation.

Because the decision was so unusual, the German tax administration would not accept it. After discussions with the U.S. Internal Revenue Service, which also rejected the BFH's interpretation, the Federal Finance Minister issued a "nonapplication decree."³ Under such a decree, the administration does not apply a court decision beyond the individual case decided by the court. In a decision of January 20, 1993,⁴ the BFH abandoned its former

opinion and decided that Germany is entitled to tax the interest income of the German branch of a U.S. banking corporation, even if the interest is paid by another U.S. corporation.

Court Decisions Under the Old Treaty

The facts in both the 1985 and 1993 cases were as follows: a U.S. bank had a branch situated and registered in Germany. It granted a loan to a U.S. corporation, which also had a branch in Germany. The claims for interest and repayment of the loan belong to the business assets of the German branch of the bank. The U.S. bank requests an exemption of the interest income from German corporation tax.

The 1985 Decision

The decision of October 9, 1985, was based on article XIV(2) DBA-USA 1954/1966. This provision reads as follows:

[I]nterest paid by a United States corporation shall be exempt from tax by the Federal Republic where the recipient is not a resident or company of the Federal Republic.

The Federal Finance Minister had joined the procedure, pursuant to section 122 FGO,⁵ which provides that:

if an important question of federal law is involved, the Federal Minister may join the procedure and give his opinion. The court may ask the Minister to join the procedure.

The minister told the court that article XIV(2) was not applicable and that its application would make no sense because it was created for different cases. He also told the court that the U.S. government would not apply the provision to cases like the one before the court. He said that article XIV(2) was created only to establish symmetry with article XIV(1), under which certain interest that was considered to be U.S.-source income under U.S. law should be exempt from U.S. tax.

¹BFH (*Bundesfinanzhof*)—Federal Finance Court), decision of Oct. 9, 1985, I R 128/80, RIW 1986, 235. For prior coverage, see *Taxes International*, March 1986 (issue 77), page 33.

²Convention of Aug. 29, 1989, BGBI. II 1991, 355 = BStBl. I 1991, 94 (DBA-USA 1989), in force since Aug. 21, 1991 (BGBI. II 1992, 235 = BStBl. I 1992, 262). (For the full text of the treaty, see *Doc 93-31206 (101 pages)*, or 90 *TNI* 26-48.)

³BMF (*Bundesminister der Finanzen*—Federal Finance Minister), letter of Sept. 22, 1988, IV C 5 - S 1301 USA - 51/88, BStBl. I 1988, 410. For prior coverage, see 1 *Tax Notes Int'l* 277 (September 1989).

⁴BFH, decision of Jan. 20, 1993, I R 54/92, BStBl. II 1993, 483; *Der Betrieb* 1993, 1454.

⁵*Finanzgerichtsordnung*—Finance Tribunals' Rules of Procedure.

The minister said that his position was based on a long-standing tradition under which branch income is taxed in the state in which the branch is located. He cited a 1982 decision of the U.S. Court of Claims⁶ to show that the U.S. took the same position and that under U.S. practice, article XIV(2) and corresponding provisions were not construed to create a tax exemption in similar cases.

The tax exemption was warranted under a literal reading of article XIV(2) since the corporation that paid the interest was a U.S. corporation and the bank that received the interest was a branch.

The BFH, however, in an extremely thorough and accurate decision, pointed to the clear wording of article XIV(2) of the treaty and declared that its application to cases like the one at hand was appropriate. The tax exemption was warranted under a literal reading of article XIV(2), according to the court, since the corporation that paid the interest was a U.S. corporation and the bank that received the interest was neither a company of the Federal Republic nor a resident in that country, but only a branch. The more general provisions of the tax treaty that seemed to cover the facts—such as articles III and VII—did not apply, according to the BFH, because they were excluded by the special provision of article XIV(2).

In looking to the purpose of article XIV(2), the BFH said that this provision had to be construed to cover the instant case; otherwise, it would have no purpose at all. Although the German and American delegations that negotiated the treaty did not intend for article XIV(2) to have an any effect of its own, this intention had not been expressed in the treaty itself. The BFH said that without application of the provision, unrelieved double taxation could result. The BFH believed that the U.S. Internal Revenue Service might deny a foreign tax credit for a German tax on the interest income on the ground that the income was U.S.-source, not German-source, since the interest was paid by a U.S. corporation.

The 1993 Decision

Because of the administration's nonapplication decree, the BFH had the opportunity to reconsider its opinion. In the new decision, which is much shorter than the 1985 decision, the court found that article XIV(2) DBA-USA 1954/1966 did not apply to the type of case at issue and that it actually did not apply in any of case because the tax from which exemption is granted by

⁶Great-West Life Assurance Co. v. U.S., No. 114-79T (Cl. Ct. May 5, 1982), 82-1 U.S. Tax Cases, paragraph 9374 CCH 1982. For previous coverage, see *Tax Notes*, May 31, 1982, p. 766.

article XIV does not exist in Germany. The BFH determined that the provision was intended to eliminate a form of extraterritorial taxation, i.e., the levying of a withholding tax on payments made by a U.S. corporation to a creditor who is not resident in Germany. Germany does not, however, levy any such tax.

Since article XIV(2) of the 1954 treaty does not apply, the more general provisions of the treaty are applicable. Article XII(2) DBA-USA 1954/1966 provides that Germany shall exempt from tax "interest on . . . any other form of indebtedness . . . derived by a resident or corporation . . . of the United States." This provision, however, is not applicable by virtue of article VII(3), which provides:

. . . paragraph (2) of this article shall not apply if the recipient of the interest has a permanent establishment . . . in the Federal Republic, for purposes of paragraph (2), and the debt-claim giving rise to the interest is effectively connected with such permanent establishment.

Since article VII(2) DBA-USA 1954/1966 does not apply, article III, which regulates the taxation of "industrial or commercial profits," does. Although article III(5) of the treaty provides that the term "industrial or commercial profits" does not include "interest," the reference to "interest" in article III(5) is only to interest in the sense of articles VII(2). The interest paid by the U.S. corporation to the German branch of the U.S. bank is interest in the sense of article VII(3) because the debt claim of the bank was effectively connected with the German branch. Thus, although article III(5) refers the case to article VII, article VII(3) refers it back to article III.

Germany has a right to tax the interest income attributed to the German branch of the U.S. bank, and the U.S. will grant a foreign tax credit with respect to that tax.

Since, after all, article III(1) applies, the result is evident: Germany has a right to tax the interest income attributed to the German branch of the U.S. bank, and the U.S. will grant a foreign tax credit with respect to that tax according to article XV(1)(a) DBA-USA 1954/1966.

The Case Under the New Treaty

For a variety of reasons, foreign banks often do business in Germany through branches instead of subsidiaries. This is also true for U.S. banks. Therefore, the question arises of how the interest income of these branches is treated under the new U.S.-Germany tax treaty of 1989.⁷

⁷See note 2 *supra*.

According to domestic German law, a U.S. bank that has neither its seat nor its place of management, but only a branch, in Germany is subject to limited corporation tax liability if it derives income from domestic sources.⁸ Interest income realized by the German branch of a foreign corporation qualifies as income from domestic sources.⁹ Consequently, the U.S. bank is subject to tax on the interest income realized in its German establishment.

The new treaty confirms Germany's right to tax the interest income attributable to the German branch of the U.S. bank.

The new treaty confirms Germany's right to tax the interest income attributable to the German branch of the U.S. bank: since the branch qualifies as a permanent establishment,¹⁰ the income attributable to the branch may be taxed in Germany.¹¹

⁸Section 2 No. 1 KStG (*Körperschaftsteuergesetz*—Corporation Tax Act).

⁹Section 8(1) KStG and section 49(1) No. 2a) EStG (*Einkommensteuergesetz*—Income Tax Act).

¹⁰Article 5(2)(b) DBA-USA 1989.

¹¹Article 7(1) DBA-USA 1989.

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Germany's right to tax is not precluded by article 11 of the new treaty, which generally provides that only the United States has the right to tax interest income derived by a U.S. resident.¹² There is an exception to this rule, however,

if the beneficial owner of the interest (being a resident of the U.S.) carries on business in (Germany) through a permanent establishment situated therein . . . and the debt claim in respect of which the interest is paid forms part of the business property of such permanent establishment. . . . In such a case the provisions of article 7 . . . shall apply.

Double taxation will be avoided through a tax credit granted by the United States against the U.S. tax on income.¹³ ♦

¹²Article 11(1) DBA-USA 1989.

¹³Article 23(1) DBA-USA 1989.



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