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

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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 depositories\(^1\) may engage. The competitive

\(^{1}\) 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

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³. Other federal agencies include the Federal National Mortgage Association, Federal
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. The Comptroller of the Currency was directed to control and regulate the national currency and to supervise national banks. The Federal Home Loan Bank Board was directed to supervise Federal Home Loan Banks. 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, intermediate credit banks, and others—make up a final

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

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.
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.


13. See H. Walgren, supra note 11, at 322.


objectives. The first goal was to finance the Civil War through sub-
stantial government borrowing. The Banking Act's second objec-
tive was to eliminate the myriad state bank paper money certifi-
cates in circulation, many of which were fraudulent.\textsuperscript{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 coun-
try 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.\textsuperscript{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 con-
gressional attack and persists today.

The next substantial reform in the nation's banking system was the passage of the Federal Reserve Act in 1913.\textsuperscript{20} The Act pro-
vided 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 eco-
nomic depression following the stock market crash of 1929. A large number of the banks in the United States failed between 1929 and 1933.\textsuperscript{21} Congress enacted the Banking Act of 1933\textsuperscript{22} and its sequel,

\begin{enumerate}
\item Walgren notes: "Nicholas' Bank Note Reporter, published in 1858, gave 5,400 sepa-
rate descriptions of fraudulent notes in circulation. Only about 7,000 different kinds of genu-
ine notes were in use at the time." H. Walgren, supra note 11, at 324.
\item Federal Reserve Act, ch. 6, 38 Stat. 251 (1913) (codified as amended at 12 U.S.C. §§ 221-522 (1982)).
\item From 1930 to 1933 nearly 9,000 banks failed. H. Walgren, supra note 11, at 334.
\end{enumerate}
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

28. See H. WALGREN, supra note 11, at 335.
30. See Huertas, supra note 12, at 18.
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.  

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. 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. 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 Board and of the Comptroller of the Currency govern how bank holding companies and banks permissibly can expand their business operations. The McFadden Act and the Bank Holding Company Act's Douglas Amendment  

34. 12 C.F.R. §§ 225.1-.43 (1986).
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, to own commercial finance corporations, to operate credit unions, to operate certain computer services, to speculate in futures markets, to deal in credit-related life insurance, and to engage in certain securities brokerage activities. 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. Bank call officer programs are another major force in the market for lending opportunities.

38. M & M Leasing Corp. v. Seattle First Nat'l Bank, 563 F.2d 1377 (9th Cir. 1977).
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).
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
More recently, a flood of "nonbank banks" have entered the financial market. The Bank Holding Company Act defines a bank as an institution that accepts demand deposits and makes commercial loans. 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. In Board of Governors v. Dimension Financial Corporation 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.

In addition to the approximately one hundred 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. The J.C. Penney Company, Dreyfus Corporation, Dean Witter Financial...
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 Revi
on the competition that surely will intensify both from within the banking industry and from outside sources.

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. The Court stated that due process requires "some definite link, some minimum connection, between [the State and] the person . . . it seeks to tax." 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. The Supreme Court noted that its affirmation of the California court's decision did not imply acceptance of the "slightest presence" standard.

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

60. Id. at 561 (quoting Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-345 (1954)).
62. 430 U.S. at 556.
areas of jurisdictional due process 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.

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. 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.

Hanson v. Denckla, 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."

The Supreme Court stated a similar standard in World-Wide Volkswagen Corp. v. Woodson. 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).
66. Id. at 223.
68. Id. at 253.
diction over the corporation would be possible.” The Court recently further attenuated jurisdictional connection requirements in *Burger King Corp. v. Rudzewicz.* 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.

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.

70. *Id.* at 297-298.
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. Bair78 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).
79. See American Refrigerator Transit Co. v. State Tax Comm'n, 395 P.2d 127
rule requires regular, purposeful activity directed toward a market state. Deriving income from a state is not itself sufficient to permit taxation.\\footnote{81}

\section*{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 1864\footnote{82} and successive legislation imposed comprehensive restrictions on state and local taxation of national banks. In 1969, prompted by two Supreme Court decisions,\footnote{83} Congress enacted both a permanent and a temporary amendment to the banking laws that restricted taxation of national banks.\footnote{84} The permanent amendment went into effect in 1976\footnote{85} 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 attempted\footnote{86} 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,\footnote{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 nondiscriminatory franchise tax or other nonproperty tax instead of a franchise tax, imposed on a corporation; and... an estate or inheritance tax.\footnote{88}
The courts will permit neither a tax scheme that taxes interest earned on federal obligations but not the interest earned on state obligations,\(^8\) nor an income tax that includes the income from federal obligations in the tax base.\(^9\) 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*\(^9\) 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.'"\(^9\) 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.\(^9\)

Several states have adopted specific statutory limitations—"negative jurisdiction" statutes—that restrict the state's ability to tax interstate financial activities.\(^9\) 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.\(^9\)

California has adopted a statute that contains a negative juris-

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92. *Id.* at 1521 (quoting Denman v. Slayton, 282 U.S. 514 at 519 (1931)).
93. *See infra* text accompanying notes 101-02.
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).
diction test. Foreign banks that do not maintain a place of business 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. This legislation reflects a clear policy decision. The statute’s purpose is to encourage bank lending activity that, absent some exemption from state taxation, might not be made available within the state. The effectiveness 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 regulation 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 affiliates and commercial corporations and their affiliates are expanding their financial services across state lines. Interstate market penetration by nonbank banks, by mail, telephone, television, and radio, and by computer networks soon will be commonplace.

These developments should lead both the states and their local 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 following: (1) the proper jurisdictional standard, (2) the appropriate taxing 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 jurisdictions in which that bank may be taxed.

A. Jurisdictional Issues

Judicially determined due process and commerce clause standards bind a state or local political subdivision that seeks to tax
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, 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. 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-

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 schemes will cause the Japanese to invest in other states with tax regimes more favorable to foreign-owned economic activity. 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-

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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 subtests 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.

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. 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 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, 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.

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104. See supra text accompanying notes 89-94.
and all of a nondomiciliary institution’s capital as nontaxable. 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, 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.

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.

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.


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.


113. See supra, note 109.

114. See Multi-State Tax Compact Article IV, § 2 reprinted in WASH. REV. CODE § 82.56.010 (1983).
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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{117}

\section{V. Conclusion}

The states must review and revise their methods of taxing the financial industry.\textsuperscript{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

\begin{itemize}
\item \textsuperscript{115} California Franchise Tax Regulation § 25137-4(c)(2) (1985).
\item \textsuperscript{116} Id. at § (c)(1).
\item \textsuperscript{117} New York's newly adopted tax system encompasses a deposits factor in its apportionment formula. 1985 N.Y. LAWS 3434.
\end{itemize}
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.\textsuperscript{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 Relations\textsuperscript{120} 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.

\textsuperscript{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.