

State Taxation of Banks: Issues and Options



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Preface and Acknowledgments

This is the second report in a two-part study of state regulation and taxation of banking. Sandra B. McCray is the principal author of both reports.

The first report, *State Regulation of Banks in a Era of Deregulation (A-110)*, was published in September 1988. That study focused on the complex issues facing the present dual system by which the states and the federal government regulate banks and banking activities.

This study focuses on the complementary issue of state taxation of banks in an era of regulatory and technological change. With the advent of the recent and rapid blurring of the lines of business between banking and other commercial activities, combined with the relaxation of restraints on interstate banking, state policymakers are faced with a range of issues and policy alternatives for structuring bank tax systems.

The move toward reform of state bank tax laws is well under way. Major reforms of the tax structure have been enacted in New York, Minnesota, and Indiana. Other states have initiated reform on a smaller scale by amending formulas for apportioning multijurisdictional receipts through rulemaking.

The purpose of this report is to inform policymakers and practitioners of the range of available policy options. The report begins with an historical review of the constitutional and legal underpinnings of the present debate, and then discusses the key issues to be resolved by the nation's legislatures.

Specific topics that are addressed in the report include the goals and objectives of bank tax policy, the difficulties of defining a taxable entity, the nature of alternative methods of defining the bank net income tax base, and the policy tradeoffs that must be made when states select among the several methods for apportioning income from multistate activity.

The report concludes with a review of administrative and other policy aspects of tax reform, and a survey of the current status of state bank tax practice among the 50 states and the District of Columbia.

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Final responsibility for the contents of the report rests with the Commission and its staff.

John Kincaid
Executive Director

Robert D. Ebel
Director, Government Finance

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The Birth of the Federal Tax Immunity Doctrine

In 1819, in *McCulloch v. Maryland*,¹ the U.S. Supreme Court first announced its doctrine of federal tax immunity.² The case involved the constitutionality of a Maryland law that imposed a tax on bank notes issued by any bank or branch not chartered by Maryland. Maryland state-chartered banks were not subject to the same tax or a similar tax. When branches of the Second Bank of the United States refused to comply with Maryland's tax statute, the state brought suit to recover the tax and penalties. In a sweeping opinion in which Chief Justice John Marshall uttered his famous statement that the "power to tax involves the power to destroy,"³ the Court held unconstitutional almost all state taxes levied on a federal governmental instrumentality, such as the national bank.⁴ The necessary and proper clause⁵ and the supremacy clause⁶ formed the constitutional bases for the Court's holding.

In 1829, the Court applied its federal tax-immunity doctrine to strike down a property tax imposed by the City of Charleston, South Carolina, on stock issued by the Bank of the United States and held by a private individual.⁷ Like the Maryland law in *McCulloch*, the Charleston ordinance exempted from the tax all stock issued by the state of South Carolina. According to the Court, the tax violated the borrowing clause of the Constitution⁸ because it was "a tax on the power to borrow money on the credit of the U.S. . . ."⁹

These two decisions set the stage for complete congressional domination of state taxation of national banks and federal obligations that continues today: states cannot tax either national banks or federal obligations without the permission of the Congress. The effect of congressional restrictions on state taxation of the income from federal obligations has been much less dramatic, however, than that of federal restrictions on state taxation of national banks.

Federal constraints on state taxation of the income from federal obligations have remained virtually unchanged since the latter half of the 19th century.¹⁰ Today, state taxation of such income is limited by federal statutory law, which provides:

All stocks, bonds, Treasury notes, and other obligations of the United States shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations.¹¹

In contrast, congressional restrictions on state taxation of national banks have changed considerably over the century and a half since the *McCulloch* decision.

The Evolution of State Taxation of National Banks

The history of congressional limits on state taxation of national banks is long and tortured. In 1864, the Con-

gress passed the *National Currency Act*,¹² which codified *McCulloch* by limiting state taxation of national banks to bank real estate and shares¹³—the two options left open by the decision.¹⁴ Section 41 of the act specifically granted the state in which a national bank was located the right to tax the shares of stock in such bank. The actual tax was levied on the individual or corporate shareholder, but most states assessed and collected the tax from the bank. Assessment at the source facilitated collection of the tax. If, for example, the shareholder was a nonresident, the bank could be used as an agent of the stockholder to collect the tax. The bank then reimbursed itself from the dividends or other income distributed to the stockholder.¹⁵ Section 41 also limited the rate of the state tax imposed on national bank shares to the lower of (1) the rate assessed on “other moneyed capital” in the hands of individual citizens of such state or (2) the rate imposed on the shares in any state-chartered bank.¹⁶

Although the Congress could dictate the conditions under which states could tax national banks, it could not control how states and the judiciary interpreted those conditions. For example, the limitation on the rate of bank share taxation to one no greater than the rate assessed on “other moneyed capital”¹⁷ generated decades of litigation. The purpose of this restriction was to prevent states from discriminating against national banks by favoring their competitors.¹⁸ The statute did not specify, however, how states should calculate a nondiscriminatory rate, and states adopted various methods. Moreover, because the Supreme Court had previously held that the rate of taxation includes the entire process of valuation and assessment,¹⁹ national banks accused states of setting discriminatory rates when they applied different rules of valuation as well as when they used different percentages in computing the taxes on fixed valuations.

The high Court was called on numerous times to determine which inequalities would constitute discrimination in violation of the *National Currency Act*. Time and again, the Court scrutinized mind-numbing differences in state assessments and valuation of investments in order to determine whether national banks had been treated in a discriminatory manner. For example, in 1874, the Court considered whether a state that had assessed bank shares at market value and bonds and mortgages at par or nominal value had thereby discriminated against national banks.²⁰ On other occasions, the Court found that the following state practices did *not* discriminate against national banks: (a) denying shareholders the right to deduct from the value of their national bank shares the amount of their capital invested in real property situated outside the state,²¹ (b) exempting from state taxation deposits in savings banks or funds of charitable institutions, provided that the exemption was for reasons of public policy,²² and (c) allowing holders of “credits” in unincorporated banks to deduct their debts from their taxable credits, while denying the same right to shareholders of national banks.²³ Conversely, the Court found that many state practices did discriminate against national banks, including: (a) exempting from property taxation the income from loans and securities of real estate firms, partnerships, and cor-

porations while subjecting national banks to property taxation;²⁴ and (b) taxing the investments of individuals in bonds and notes at a lower rate than that imposed on national bank shares.²⁵

Although plentiful, cases regarding state tax rates on national banks constituted only a small fraction of the litigation generated by Section 41 of the *National Currency Act*. Most of the litigation involved the meaning of the phrase “other moneyed capital.” In its interpretations of this phrase, the Supreme Court frequently used the legal method of exclusion and inclusion. For example, in separate holdings, the Court found that investments in the following entities were excluded from the disputed phrase: trust and insurance companies;²⁶ manufacturing, mining, and railroads;²⁷ and telephone companies.²⁸ States were free, therefore, to set their rates on those entities without regard to their rates on national banks. In another line of reasoning, the Court also began to develop an affirmative definition of the phrase “other moneyed capital,” which, unfortunately, often conflicted with its holdings in the assessment cases. For example, in *Hepburn v. The School Directors*,²⁹ the Court found that securities (both stocks and bonds) might be considered “other moneyed capital,” while in *Mercantile Bank v. New York*,³⁰ the Court upheld a state tax on national bank shares that was higher than the state’s tax on the stock of railroads and certain corporations.³¹

Later, the Court began to focus its interpretation of “other moneyed capital” more narrowly, finding that “the true test of the distinction [between investments that come within the meaning of the disputed phrase and those that do not] . . . can only be found in the nature of the business in which the corporation is engaged.”³² This new interpretation led to another round of litigation in which the Court described the business of banking and compared that business with various others in which individuals and banks might invest to determine whether such investments constituted “other moneyed capital.” Again, a rash of conflicting opinions followed, causing litigants and scholars to charge the Court with gross inconsistency.³³

Finally, in 1923, the Congress amended the law in an attempt to bring some order into the chaos. Under the new law, now referred to as section 5219, a state could choose any one of three methods (in addition to a real estate tax) to tax a national bank: (1) a bank shares tax; (2) a tax on the dividends received by the owners or holders of the bank’s stock; or (3) a net income tax.³⁴ In 1926, a fourth option was added: a state could choose a franchise or excise tax according to or measured by the entire net income of the national bank.³⁵ This option enabled states to include interest on federal obligations (otherwise exempt from state taxes) in the tax base. Because the income from governmental obligations represents a large fraction of the income of commercial banks, the addition of this method of taxation conferred a significant revenue benefit on states.³⁶

These amendments, too, contained several conditions. For example, if a state chose the income or franchise tax option, the law directed it to set the rates of the income and franchise taxes on national banks no higher

than its rate on other financial corporations or mercantile, manufacturing, and business corporations. States that chose the dividend option were instructed to tax dividends from general business also. States that selected a bank shares tax were still required to assess such shares at a rate no higher than the rate on "other moneyed capital." To clarify the meaning of that phrase, the Congress instructed states to tax shares of national banks

at a rate [no greater] than is assessed upon other moneyed capital in the hands of individual citizens of such State coming into competition with the business of national banks; Provided, that Bonds, notes or other evidences of indebtedness in the hands of individual citizens not employed or engaged in the banking or investment business and representing merely personal investments not made in competition with such business, shall not be deemed moneyed capital. . . .³⁷

Far from solving the problem of state taxation of national banks, these amendments with their numerous conditions set the stage for more litigation and conflicting interpretations. The law did not indicate, for example, how states that adopted the income or franchise tax option should compare the tax rates on general business corporations with those on national banks in order to meet the mandate of nondiscriminatory treatment. That omission left states free to choose their own techniques of comparison. Some states chose to compare effective tax burdens rather than nominal tax rates. By comparing effective tax rates, states sought to overcome the inequity created by the congressional prohibition against levying sales and personal property taxes on national banks, two taxes regularly assessed against general business corporations. In order to equalize the effect of taxes on the two kinds of entities, states combined the net income, personal property, and sales taxes paid by general business corporations and calculated a composite rate, which was then contrasted with the nominal tax rate on national banks. During the period from 1926 to 1969, national banks frequently litigated the question of how states should calculate the effective tax rate on general business corporations. Also during this period, litigation of the phrase "other moneyed capital" continued, despite the congressional attempt at clarification.³⁸

In the mid-1950s, a new issue arose—state taxation of the interstate activity of *state banks*. Although banks did not maintain offices outside of their domiciliary state, they frequently did make loans to residents of other states by sending personnel there or by using the services of correspondent banks located in other states. Unlike the situation with state taxation of national banks, which was limited by the Congress to taxation of domiciliary banks, states were free to tax the interstate activities of state banks so long as such taxation was consistent with the due process and commerce clauses.

In 1959, after a long history of interpreting the commerce and due process clauses to ban state taxation of the interstate activities of corporations, the Supreme Court changed its interpretation and upheld state taxation of nondomiciliary corporations that do business with their

residents. In *Northwestern States Portland Cement Co. v. Minnesota*,³⁹ the high Court validated a state net income tax on a nondomiciliary (general business) corporation that had an office in the taxing state. In another case—*Brown-Forman Distillers Corp. v. Collector of Revenue*⁴⁰—the U.S. Supreme Court declined to overturn a decision of the Louisiana Supreme Court upholding the state's tax on a nondomiciliary corporation whose contacts with Louisiana consisted solely of personnel soliciting orders there.

The effect of these decisions was limited, however, by immediate congressional action. In 1959, the Congress passed P.L. 86-272,⁴¹ which prohibited states from taxing foreign corporations whose only activity within the state was the solicitation of orders by the seller or its representative. Because P.L. 86-272 covered only the solicitation of orders for tangible personal property, the activities of financial institutions were not subject to its prohibitions.

As a result of the above Supreme Court decisions and the earlier congressional restrictions against state taxation of nondomiciliary national banks, states were free to tax nondomiciliary *state* banks but not out-of-state *national* banks. Some states took advantage of their expanded taxing power to tax nondomiciliary state banks, creating an inequity between state and national banks. Over time, therefore, the congressional restrictions on state taxation of national banks, originally intended to prevent state discrimination against national banks, had created a tax scheme that favored national banks.

Congressional Resolution of the Problem

In the early 1960s several bills were introduced in the Congress to correct the imbalance that federal law had created between state and national banks. All failed to pass. In 1968, however, the Supreme Court unknowingly dealt the final blow to the congressional statutory scheme by carrying it to its logical absurdity.⁴² In *First Agricultural National Bank v. State Tax Commission*,⁴³ the Court struck down a state sales tax levied on a national bank's purchase of tangible personal property for its own use. Three justices dissented with language that moved the Congress to act: "[t]he Constitution of its own force does not prohibit [a state] from applying its uniform sales and use taxes to, among other things, [a bank's] wastebaskets."⁴⁴

In 1969, the Congress repealed prior restrictions on state taxation of national banks, bringing to an end more than a century of congressional tax preferences granted to national banks.⁴⁵ According to the new law: "a national bank shall be treated as a bank organized and existing under the laws of the State or other jurisdiction within which its principal office is located."⁴⁶ Thus, the only remaining restriction on state taxation of national banks was that such taxes must not discriminate against national banks. The Congress delayed the effective date of the new law to January 1, 1973, in order to provide time for a study and report by the Federal Reserve Board on how state taxes on out-of-state national banks would affect the economic efficiency of the banking system and the mobility of capital.

In 1973, the Congress, still uneasy about prospective state taxation of out-of-state depositories, extended its

prior moratorium on state taxation of national banks. From 1973 to 1976, the new moratorium, set forth in P.L. 93-100, prohibited states from imposing any tax measured by income or receipts or any other "doing business" taxes on federally insured out-of-state depositories. In the same law, the Congress directed ACIR to undertake a "study of all pertinent matters relating to the application of State 'doing business' taxes on out-of-state commercial banks, mutual savings banks, and savings and loan associations." The ACIR study was to include recommendations for legislation that would provide equitable state taxation of those entities.⁴⁷

The 1975 study accomplished this and more. Nearly two years in the making and over 1,000 pages long, the study examined in depth the depository business, multi-state taxation of general business corporations, the question of federal legislation, and alternative approaches to state taxation of depositories. The study concluded with five basic policy choices, framed in terms of alternative recommendations for the Commission to consider. Briefly, the choices were:

No federal statutory limitations on state and local taxation of out-of-state depositories (beyond existing statutory requirements for like treatment of federally chartered and state-chartered depositories).

A federal statute prescribing negative guidelines; i.e., specifying jurisdictional tests and division-of-base rules that may not be used by the states as a basis for taxing out-of-state depositories.

A federal statute prescribing positive guidelines which bind the states in their taxation of out-of-state depositories; i.e., affirmatively prescribing certain jurisdictional standards and division-of-base rules to which states must conform if they tax out-of-state depositories.

A federal statute permitting only the state of domicile (the state of the principal or home office) to tax depositories, and prohibiting net income or other "doing business" taxes upon out-of-state depositories.

A federal statute to compel standardization by substituting a federally collected, state-shared surcharge on depository institutions for state income or other "doing business" taxes on depositories, or allowing a credit for qualified state taxes against the federal tax.

The Commission recommended a policy of negative federal guidelines. Impressed by the precedent of P.L. 86-272, which set negative jurisdictional thresholds for state taxation of interstate businesses, the Commission favored a similar, but higher, tax jurisdiction threshold for banks, as well as a congressional "declaration of policy" as to the appropriate division of the taxable base.⁴⁸ According to the Commission's recommendations, a state would have jurisdiction to tax out-of-state depositories only if they had a "substantial physical presence" within the tax-

ing state, such as a regular office location, the regular presence of employees or agents, or the ownership or use of tangible property, including property involved in lease-financing operations.

Other recommendations included:

"No congressional action which would require states to adopt a standardized definition of taxable income in the taxation of out-of-state financial depositories";

Amendment of federal law "to authorize states to include, in the measure of otherwise valid direct net income taxes, income realized by financial depositories from federal government obligations";

Federal safeguards against discriminatory taxation;

Federal legislation requiring a domiciliary state that taxes the entire income of the depository to allow the depository a credit for taxes paid to nondomiciliary states; and

A reservation of power to the states to resolve any disagreements between them and taxpayers.

Congress failed to act, however, and, in 1976, the language as originally drafted in the 1969 statute became law. Thus, today the only restriction on state taxation of national banks is that such taxes must not discriminate against national banks.

Summary and Comment

In 1819, the U.S. Supreme Court held in *McCulloch v. Maryland* that a Maryland stamp tax levied on the Bank of the United States was unconstitutional. The *McCulloch* decision set the stage for congressional domination of state taxation of national banks and federal obligations that continues today. States cannot tax either national banks or federal obligations without statutory permission from the Congress.

The Congress began exercising its control over state taxation of national banks with the passage of the *National Currency Act* in 1864. The act codified the *McCulloch* holding by permitting states to tax the real property and shares of national banks. One section of the act limited state taxes on national bank shares to a rate no greater than the rate assessed on "other moneyed capital." This first congressional foray into the business of regulating state taxation of national banks through specific statutory directives and limitations signaled the beginning of over a century of litigation involving a bewildering array of differences in state calculations of their rates of taxation and interpretations of the phrase "other moneyed capital."

By 1969, the Congress had recognized that neither further amendments, which merely led to a new round of litigation, nor judicial mediation, which produced a large body of inconsistent and conflicting opinions, could bring order or clarity to state taxation of national banks. Moreover, the federal restrictions, which were originally intended to prevent state discrimination against national banks, had over time created a tax scheme that favored national banks. Finally, in 1976, the Congress revised the

law and removed all prior conditions and limitations on state taxation of national banks and passed legislation requiring only that states tax national banks in the same manner as they tax their state-chartered banks.

The history of congressional restrictions on state taxation of national banks contains valuable lessons for proponents of federal intervention in state taxing powers.

First, congressional intervention in state taxation, which is effected through specific statutory limitations and/or directives, is subject to differing interpretations by the states. Years of litigation are unlikely to bring either order or clarity to state tax systems. Judicial opinions are, by their nature, piecemeal and narrow. Issues that are suitable for judicial resolution involve questions of wheth-

er a state has interpreted a given law reasonably or whether a certain state or federal statute violates the U.S. Constitution. The judiciary does not have the power to analyze and revamp entire state tax systems. As the Supreme Court itself has recognized on numerous occasions, sporadic and unrelated instances of litigation cannot afford an adequate basis on which to create consistent rules in the area of state taxation.⁴⁹

Second, laws that contain specific directives and limitations often have unintended consequences brought about by changing judicial interpretations and by new business practices. In an area of law like tax jurisdiction, which must respond to technological advances,⁵⁰ and in a business like banking, which is currently highly innovative, such unintended consequences are inevitable.

Goals and Objectives for Tax Policy

The 1975 ACIR study identified eight goals and objectives as guides for national policy regulating state taxation of multistate business generally. Those goals remain valid today:

1. Preservation of the autonomy of the states;
2. Simplification of the tax system;
3. Standardization or uniformity of taxes on multistate business;
4. Reduction of compliance burdens and enforcement costs;
5. Provision of certainty and regularity for taxpayers and administrators;
6. Promotion of competitive equality or neutrality between domestic and out-of-state firms;
7. Avoidance of discrimination among different lines of business;
8. Avoidance of trade barriers.

Like the situation with state regulation of banks and bank holding companies,⁵¹ the public policy objectives for state taxation of banks and bank-like entities are sometimes complementary and at other times contradictory. For example, the goal of preserving the autonomy of the states may conflict with the objective of creating a uniform and simple tax system. As noted in an earlier ACIR report:

Differences in the tax structures of states and subdivisions have long been viewed as wasteful by many critics—and certainly by spokesmen for multistate taxpayers. Taxpayers' compliance problems and state administration of the taxes are more complicated than they would be if taxes were uniform. Also these differences hinder the free exchange of trade and commerce across jurisdictional lines. Elimination or reduction of local diversities is seen as promoting simplicity in the entire tax system, an objective long sought by taxpayers and legislators in all the states, as well as on the national level.

On the other side, interstate differences arise from the distinctive policies and needs of the individual state or local communities—from the special needs of agricultural or mining communities compared with those where economic activities are primarily manufacturing, mercantile, or service-oriented; from the differing needs and taxpaying capacities (or customs) of states that are predominantly urban or rural; from the differences between market states and producing states, or between border states and interior states; and from the differing political philosophies of voters and their elected representatives in states with a conservative tradition and those with a recent populist or frontier outlook. The special characteristics of tax laws and administration in each state are a product of the efforts of policymakers and legislators to reflect the partic-

ular heritage of that state. Special adjustments and differing tax forms are provided to accommodate and preserve local interests. The price of simplification may in fact include a sacrifice of some of the special essence of each state. For those who value regional distinctions, these diversities are the core and justification of our federal system. They may view pressures for homogeneity and simplicity in state tax systems as threats to all the other valued differences.

Others argue that some proposals for simplification, such as general acceptance of a standard formula apportionment for the entire net income of each taxpayer, could result in inequitable or inappropriate division of the tax base among states.⁵²

Because the different objectives of a sound tax policy are frequently contradictory, one cannot design a single tax system that will satisfy all of the goals. Implementation of any bank income tax will require compromise and trade-offs among goals.

Environmental Considerations

Any new state bank tax should be evaluated not only by reference to the tax policy objectives cited above but also within the context of the changes taking place in the business of banking. The interstate banking environment today is vastly different than it was in 1975, the date of the prior ACIR report. The most important changes involve interstate branch banking, the growth of sophisticated bank technology, the expansion of bank products and services, and the advent of loan securitization.

Interstate Branch Banking

Proof of the proposition that changes in the bank regulatory laws of one state can influence the regulatory policy of all states is found in interstate branch banking laws. In 1982, Massachusetts was the first state to pass a regional reciprocal interstate banking law.⁵³ Other states soon followed with reciprocity laws, and, today, 46 states allow some form of interstate banking. Twenty-six states permit regional or regional reciprocal interstate banking (nine of these state laws contain a nationwide trigger, that is, a date by which the state will allow nationwide interstate banking), and 20 states allow nationwide interstate banking.⁵⁴ A summary of the current status of interstate banking legislation is provided in Table 1. The vast majority of states that allow interstate banking do so through the bank holding company mechanism (i.e., they enact laws permitting out-of-state banks to enter only after their parent bank holding company applies for and receives permission to establish or acquire a subsidiary or to merge with a bank in the host state). Entry through a bank holding company gives a state maximum control over the new bank. A legislative grant of entry through direct branching makes it difficult for the host state to exercise control over the branch, even if it is a state bank branch, because the chartering state remains the primary regulator and super-

visor of the branch. Some commentators believe that the future viability of the dual banking system requires that states allow interstate banking only through the holding company mechanism.⁵⁵

Because most state laws no longer prohibit out-of-state bank holding companies from operating subsidiary banks across the nation, and because banks solicit loans through loan production offices located in several states, it is difficult today to pinpoint the "source" of a loan for purposes of state apportionment formulas. The Congress noted the problem of finding the actual "source" of bank loans during the debates on the *Tax Reform Act of 1986*. According to the Congress, "The lending of money is an activity that can often be located in any convenient jurisdiction, simply by incorporating an entity in that jurisdiction and booking loans through that entity, even if the source of the funds, the use of the funds, and substantial activities connected with the loans are located elsewhere."⁵⁶

Technological Developments: Branchless Banking

The judicial branch, too, has contributed to the expansion of interstate banking. A recent U.S. Circuit Court of Appeals opinion, which interpreted the federal banking laws, paved the way for banks and bank-like entities to engage in de facto interstate branch banking. By interpreting the terms "branch" and "bank" narrowly, the opinion limited state authority to regulate interstate branch banking. For example, in *Independent Bankers Association v. Marine Midland Bank*,⁵⁷ the Second Circuit Court of Appeals held that a bank that effects loan and deposit transactions with its customers electronically through a shared use automatic teller machine (ATM) does not thereby engage in branch banking. According to the court, federal law does not deem an ATM to be a "branch" of a bank if the bank is a mere user, as opposed to an owner, of the machine.

This decision allows banks and bank-like entities to circumvent the remaining state regulatory restrictions on interstate branch banking by delivering their services through electronic devices located across the nation in a form of "branchless banking." Today, it is legally and technologically possible for banks to enable their customers to make a deposit in an out-of-state bank through an in-state shared-use ATM without thereby engaging in branch banking.

Several banks currently operate nationwide through branchless banks. For example, in January 1986, the New England Federal Savings Bank of Wellesley, Massachusetts, opened for business.⁵⁸ The bank has no walk-in place of business. Customers make their deposits by mail, by telephone, or via automatic teller machines. Within the first six months of operation, the bank had 422 depositors hailing from most of the 50 states. The bank is a full-service bank that makes home mortgage loans and commercial real estate loans; provides MasterCard, Visa, and American Express card services; and offers individual retirement accounts and Keogh accounts. Many other banks engage in some form of branchless banking. For ex-

Table 1
Interstate Banking Legislation by State
(as of February 1, 1989)

State	Effective Date	Area	Number of Partner States
Alabama	Currently	Reciprocal, 12 states and DC (AR, FL, GA, KY, LA, MD, MS, NC, SC, TN, VA, WV).	13
Alaska	Currently	National, no reciprocity.	50
Arizona	Currently	National, no reciprocity.	50
Arkansas	Currently	Reciprocal, 16 states and DC (AL, FL, GA, KS, LA, MD, MS, MO, NE, NC, OK, SC, TN, TX, VA, WV). Reciprocity hinges on commitments to community reinvestment.	17
California	Currently 1/1/91	Reciprocal, 11 states (AK, AZ, CO, HI, ID, NV, NM, OR, TX, UT, WA). National, reciprocal.	11
Colorado	Currently	Reciprocal, 7 states (AZ, KS, NE, NM, OK, UT, WY).	5
Connecticut	Currently	Reciprocal, 5 states (MA, ME, NH, RI, VT).	5
Delaware	Currently 6/30/90	Reciprocal, 5 states and DC (MD, NJ, OH, PA, VA). Special-purpose banks permitted. National, reciprocal.	6
DC	Currently	Nationwide, no reciprocity if community development commitments are made.	50
Florida	Currently	Reciprocal, 11 states and DC (AL, AR, GA, LA, MD, MS, NC, SC, TN, VA, WV). Under a 1972 law, NCNB and Northern Trust Corporation are grandfathered and can make further acquisitions.	12
Georgia	Currently	Reciprocal, 10 states and DC (AL, FL, KY, LA, MD, MS, NC, SC, TN, VA).	11
Hawaii	None		0
Idaho	Currently	National, no reciprocity.	50
Illinois	Currently 12/1/90	Reciprocal, 6 states (IA, IN, KY, MI, MO, WI). Nationwide, organizations may acquire failed institutions if the failed institution is larger than \$1 billion in assets. Under a 1981 law, General Bancshares Corporation is grandfathered and can make further acquisitions in the state. National, reciprocal.	6
Indiana	Currently 7/1/92	Reciprocal, 11 states (IA, IL, KY, MI, MO, OH, PA, TN, VA, WI, WV). National, reciprocal.	11
Iowa	1972	Under a 1972 law, Norwest Corporation is grandfathered and is permitted to acquire banks in Iowa.	0
Kansas	None		0
Kentucky	Currently	National, reciprocal.	31*
Louisiana	Currently	National, reciprocal.	29*
Maine	Currently	National, no reciprocity.	50
Maryland	Currently	Reciprocal, 14 states and DC (AL, AR, DE, FL, GA, KY, LA, MS, NC, PA, SC, TN, VA, WV) and special-purpose banks.	15
Massachusetts	Currently	Reciprocal, 5 states (CT, ME, NH, RI, VT).	5
Michigan	Currently	National, reciprocal.	20*
Minnesota	Currently	Reciprocal, 11 states (CO, IA, ID, IL, KS, MO, MT, ND, SD, WA, WY).	11
Mississippi	Currently 7/1/90	Reciprocal, 4 states (AL, AR, LA, TN). Reciprocal, 13 states (AL, AR, FL, GA, KY, LA, MO, NC, SC, TN, TX, VA, WV).	4

Table 1 (cont.)
Interstate Banking Legislation by State
 (as of February 1, 1989)

State	Effective Date	Area	Number of Partner States
Missouri	Currently	Reciprocal, 8 states (AR, IA, IL, KS, KY, NE, OK, TN)	8
Montana	None		0
Nebraska	Currently 1/1/90 1/1/91	Special-purpose banks. Reciprocal, 10 states (CO, IA, KS, MN, MO, MT, ND, SD, WI, WY). National, reciprocal.	0
Nevada	Currently	National, no reciprocity.	50
New Hampshire	Currently	Reciprocal, 5 states (CT, MA, ME, RI, VT).	5
New Jersey	Currently	National, reciprocal.	21*
New Mexico	Currently 1/1/90	Nationwide acquisition of failing banks. National, no reciprocity.	50
New York	Currently	National, reciprocal.	19*
North Carolina	Currently	Reciprocal, 12 states and DC (AL, AR, FL, GA, KY, LA, MD, MS, SC, TN, VA, WV).	13
North Dakota	Currently	A grandfathered interstate banking organization is permitted to sell its North Dakota banks to out-of-state bank holding companies.	0
Ohio	Currently	National, reciprocal.	23*
Oklahoma	Currently	National, no reciprocity.	50
Oregon	Currently 7/1/89	8 states, no reciprocity (AK, AZ, CA, HI, ID, NV, UT, WA). National, no reciprocity.	8
Pennsylvania	Currently 3/4/90	Reciprocal, 7 states and DC (DE, KY, MD, NJ, OH, VA, WV). National, reciprocal.	8
Rhode Island	Currently	National, reciprocal.	23*
South Carolina	Currently	Reciprocal, 12 states and DC (AL, AR, FL, GA, KY, LA, MD, MS, NC, TN, VA, WV)	13
South Dakota	Currently	National, reciprocal and special-purpose banks.	21*
Tennessee	Currently	Reciprocal, 13 states (AL, AR, FL, GA, IN, KY, LA, MO, MS, NC, SC, VA, WV).	13
Texas	Currently	National, no reciprocity.	50
Utah	Currently	National, no reciprocity.	50
Vermont	Currently 2/1/90	Reciprocal, 5 states (CT, MA, ME, NH, RI). National, reciprocal.	5
Virginia	Currently	Reciprocal, 12 states and DC (AL, AR, FL, GA, KY, LA, MD, MS, NC, SC, TN, WV).	13
Washington	Currently	National, reciprocal. Failing institutions may be acquired by organizations from any state.	21*
West Virginia	Currently	National, reciprocal.	29*
Wisconsin	Currently	Reciprocal, 8 states (IA, IL, IN, KY, MI, MN, MO, OH).	8
Wyoming	Currently	National, no reciprocity.	50

* Does not count the two states where nationwide entry by acquisition of failing banks is possible.

Source: Compiled by the Federal Reserve Bank of Atlanta, and reported by B. Frank King, Sheila L. Tschinkel, and David D. Whitehead, "Interstate Banking Developments in the 1980s," *Economic Review*, May/June, 1989, pp. 32-51.

ample, of the 30,000 depositors of Colonial National Bank of Wilmington, Delaware, only 10,000 come from Wilmington walk-in trade.⁵⁹ The remaining 20,000 depositors live in all 50 states and do business by telephone, mail, and nationwide automatic teller machines, and use debit and credit cards and checks. Chemical Bank of New York offers a branchless banking service called "Premium Banking" to residents of Connecticut.⁶⁰ The service works as follows: (1) Connecticut customers call a New York toll-free number staffed seven days a week by Chemical Bank personnel; (2) customers receive instant access to credit lines; and (3) customers who need cash immediately can make withdrawals at any automatic teller machine linked to the New York Cash Exchange.

The effect of these developments is significant. The advent of electronic banking has rendered obsolete state jurisdiction rules based on physical presence and has greatly increased the mobility of bank assets and deposits, making it difficult to locate such assets and deposits in one state.

Expansion of Bank Products and Services

Another important change in the banking environment involves the definition of the business of banking. The prior barriers between banking and commerce are falling. Three new products and services are of particular interest to banks: securities, insurance, and real estate. Both state and national banks have pushed for new powers in these areas, arguing that allowing them to offer these products and services will benefit everyone: consumers, who will enjoy reduced prices as a result of the increased competition; businesses, which will enjoy improved access to capital markets; state and local governments, which will likely pay lower interest rates on issues of municipal revenue bonds; banks, which will become more efficient and profitable through diversification and economies of scope; and the FDIC, which will face less exposure as banks become stronger.

In many states, banks have convinced legislators of the merit of expanding bank powers. Currently, 25 states allow their state-chartered banks to engage in some securities activities,⁶¹ 17 states allow banks to underwrite insurance and/or act as an insurance agent or broker,⁶² and 26 states permit state banks to invest in and develop real estate and/or act as a real estate broker.⁶³ In addition to their contention that the expanded powers will benefit consumers, businesses, and state governments, banks argue that the new powers are necessary to create a level playing field between banks and the growing number of nonbank entities that are free to engage in banking services. As evidence of the lack of a level playing field, banks cite the increasing competition that they face from unregulated entities, such as retailers that issue credit cards, securities firms that attract deposits by offering cash management accounts, and automobile manufacturers that provide financing for new cars.

Given this blurring of the lines between bank and nonbank financial institutions, state tax laws that are

based on a traditional regulatory definition of a bank may no longer be appropriate.

Loan Securitization

A corollary to the expansion of bank securities powers is the increased securitization of bank assets. This phenomenon is changing the entire nature of the banking business. Traditionally, commercial banks solicited deposits in order to make loans that were held in their portfolios until they were paid off. Recently, however, banks have begun making loans that are subsequently pooled and packaged for sale as securities in the financial markets to institutional (bank and nonbank) and individual investors. The packaging and distribution of securitized loans is usually done by investment banks or large money-center banks. Because securitization offers significant benefits to the lending bank (i.e., allowing it to remove the loans from its books, thereby reducing capital requirements and improving liquidity), loan securitization is likely to continue.⁶⁴

Potentially, banks can securitize and sell all classes of loans.⁶⁵ Typical securitized loans today include those for mortgages, credit cards, cars, and boats.⁶⁶ It is easy to see that a securitized loan does not have a traditional "home" for purposes of state taxation; it can be sold to another bank, insurance company, pension fund, or individual investor anywhere across the nation.

The advent of securitized loans creates a profound dilemma for states that apportion the income of their domiciliary banks. When a loan is securitized, the unity between the originator of the loan and the recipient of the interest income from the loan is severed. The dissolution of this relationship creates conditions for potentially widespread tax avoidance. Assume, for example, that Bank A, which is domiciled in State A, has packaged and sold some of its secured loans to an out-of-state investor. After the sale, State A will lose jurisdiction over the interest income from the loans, even though they are secured by property located in State A.

Suppose, now, that Bank B, which is domiciled in State B, purchases the securitized loans from Bank A. State B will apply its apportionment formula to determine how much of the interest income from the securitized loans it can tax.⁶⁷ Typically, state apportionment formulas attribute the interest income from loans to the state in which the loan originated (i.e., where the loan solicitation, negotiation, and/or administration occurred)⁶⁸ or to the state in which the property securing the loan is located.⁶⁹ If either of these rules is used to apportion the interest income from the securitized loans held by Bank B in State B, none of the interest income from those instruments will be attributed to State B because Bank B (1) was not involved in the solicitation, negotiation, or administration of the underlying loans, and (2) none of the property securing the underlying loans is located in State B. Thus, the interest income from the securitized loans will be apportioned out of State B, even though no other state has jurisdiction to tax that income.

Alternatively, State B might apportion the interest income from the securitized loans according to special rules for income from securities.⁷⁰ In this case, some of the income may be attributed to State B. Nevertheless, much of the income would again be attributed out of state, and may thereby escape taxation by any state.

This dilemma cannot be solved fully through the use of an apportionment formula, although some commentators have suggested a partial solution in the form of a throwback rule.⁷¹ The rule would allow the domiciliary state to throw back and tax the receipts from securities not taxed by any other state. As currently construed by the courts, however, the throwback rule does not allow the domiciliary state to reach either the property or payroll associated with those receipts. Alternatively, the dilemma can be solved fully through the use of the dual system, which is discussed in greater detail below.

Summary and Comment

It is not possible yet to describe all the contours of the “best” bank tax. In addition to the conflicts among the goals of a good tax policy, two other factors contribute to the difficulty of formulating a single bank tax system at this time. First, states have only recently begun to amend their bank tax laws to take advantage of the lifting of prior congressional restraints on state taxation of banks; therefore, one cannot measure the relative effectiveness of the different new state bank taxes. Second, the business of banking is changing rapidly, requiring states to maintain a flexible approach to bank taxation. The bank tax that is appropriate during this evolutionary period may not be suitable once the contours of the business become settled. For these reasons, this report will focus on alternative tax systems, evaluating each against the above goals and the changing nature of banking.

The Options

According to a recent survey conducted jointly by ACIR and the Federation of Tax Administrators, a majority of states use some form of a net income tax for banks (i.e., either a franchise tax measured by net income or a direct net income tax).⁷² The findings from the survey, which provide a wide range of information regarding the status of state bank taxation are presented in Appendix A. Because of the prevalence of net income taxation, this report will focus on that method of taxation.

The Tax Base

The starting point for most state corporate net income tax measures is the federal taxable income base.⁷³ Federal law prohibits states from including the income from federal obligations in the net income tax base unless they comply with the requirements of 31 U.S.C. sec. 3124. According to that statute, a state tax on the income from federal obligations must meet two tests: (1) it must be a nondiscriminatory tax, and (2) it must be a franchise or other nonproperty tax. In *Memphis Bank & Trust v. Garner*,⁷⁴ the U.S. Supreme Court invalidated as discriminatory a Tennessee franchise tax that included interest received on federal obligations but excluded interest earned on the obligations of Tennessee and its political subdivisions.⁷⁵

According to *Memphis Bank & Trust*, a state can use a franchise tax measured by net income and include in such tax base the income from federal obligations if and only if the state taxes its own obligations (and those of its political subdivisions) as well as federal obligations.⁷⁶ Currently, 25 states include the value of, or income from, federal obligations in their bank tax base.⁷⁷

Because federal obligations comprise a large percentage of the income of a financial institution, the failure to use a franchise tax will result in a significant tax break for banks. To create neutrality and fairness across industries, then, a comparable income exemption should be granted to nonfinancial entities.

Alternative Methods of Income Taxation

Four models of corporate income taxation exist: (1) pure residence-based taxation, (2) pure source-based taxation with separate accounting, (3) pure source-based taxation with formula-based apportionment, and (4) a dual system consisting of residence-based taxation coupled with a credit for domiciliary entities and source-based taxation for nondomiciliaries.

A pure residence-based income tax applies only to domiciliary banks and operates on the entire income of the domiciliary bank without regard to the source of that income. Thus, all banks domiciled in the taxing state—state banks that received their charter there and national and foreign banks that are incorporated there—pay tax on their total taxable income base regardless of where the income is earned; and all nondomiciliary banks—state banks chartered out-of-state and national and foreign banks incorporated in another state or country—pay no tax at all even if they have earned income from activities within the host state.

A pure source-based tax attempts to measure the amount of income of a multistate entity that is earned within a given taxing state. For this purpose, a state uses either separate accounting or formula-based apportionment. Pure source-based taxation with formula-based apportionment is used by nearly all of the states for their general business corporations.

A state that uses a dual system levies its tax, in the first instance, on the entire net income of its domestic banks. Then, it allows those banks a tax credit for taxes paid to other states. The amount of the credit is limited to the amount that would have been paid under the domiciliary state's tax. Out-of-state or nondomiciliary banks are taxed according to source principles; that is, an apportionment formula to measure what fraction of the income of an out-of-state bank is earned within the host state.

Pure Residence-Based Tax

Until very recently, most states taxed banks using residence-based tax principles, a system of taxation not used with other businesses.

A pure residence-based tax system meets many of the objectives of a good tax. It is simple, provides certainty and regularity for taxpayers and administrators, has minimal compliance burdens and enforcement costs, and avoids trade barriers. In addition, when freely chosen by states, it preserves their autonomy. One can fault a residence-based tax, however, for failing to promote competitive equality between domestic and out-of-state firms, with discriminating among different lines of business, and with creating the potential for multiple taxation.

The lack of competitive equality between in-state and out-of-state banks, which occurs with the use of a pure residence-based tax, comes from the differences in state tax rates and bases. For example, assume that two banks, Bank A and Bank B, are doing business in State Y. Bank A is domiciled in State Y, which has a 9 percent tax rate; and Bank B is domiciled in State Z, which has a 7 percent tax rate. Bank A, domiciled in State Y, will pay an income tax at a 9 percent rate to State Y regardless of where it earned that income. Bank B, domiciled in State Z, but doing business in State Y in competition with Bank A, will pay a tax at a 7 percent rate to State Z, its domiciliary state. The use of a pure residence-based tax in this situation may have the effect of encouraging Bank B to do business in State Y, where it has a tax advantage over State Y domiciliary banks. State Y, however, has two reasons to complain about this situation. First, State Y fails to collect any tax revenue from Bank B, although Bank B does business there. Second, State Y's domiciliary banks are placed at a tax rate disadvantage vis-a-vis the banks from State Z because State Z banks compete with State Y banks for business but pay a lower tax rate.

In practice, a pure residence-based tax also discriminates against different lines of business within a state. Nearly every state uses source principles to tax its multistate general business corporations. Source-based taxation requires general business corporations to apportion their income among the states in which they do business. Unlike the situation with residence-based taxation, a state

applies its source-based tax to both in-state and out-of-state firms so that each will pay tax at the same rate and base on the fraction of income earned within the taxing state. Thus, competing in-state and out-of-state general business corporations are not subject to different tax bases and rates, as are domiciliary and nondomiciliary banks in the example above.

Unless adopted by every state, a pure residence-based tax also creates a problem for banks that do business in more than one state. Suppose that a bank does business in several states and one of those states, using source principles with an apportionment formula, taxes the income it earns there. Then, the bank may become subject to multiple taxation. Consider, for example, the following situation:

States Y and Z have the same income tax rate and base. State Y taxes its domestic banks on their entire income. Bank A is domiciled in State Y. Bank A does 70 percent of its business in State Y and 30 percent in State Z; it conducts its activities in State Z solely by mail and electronic means. State Z uses source-based taxation to tax foreign banks transacting business there, whether or not the bank has a physical presence within the state.⁷⁸ Bank A will pay tax to its domiciliary state on 100 percent of its income and tax to State Z on 30 percent of its income. Thus, 130 percent of its income will be subject to tax.

This problem, negligible today, will become more acute as prior restraints on interstate banking continue to dissolve, as the technology for delivering bank services electronically becomes more sophisticated, and as states amend their bank tax laws to reflect these changes. The constitutionality of a pure residence-based tax is doubtful when used in such an interstate environment.⁷⁹

Pure Source-Based Tax: Separate Accounting

In theory, a pure source-based tax system permits states to divide the tax base of a multistate corporation among the states in which such corporation conducts its business activities in a manner that approximates the corporation's level of business activity in each state. One way in which a state can use a pure source-based tax to accomplish this goal is through the use of separate accounting.

When used to assign income of a multistate business to a given state for tax purposes, the separate accounting method deems the in-state operations of a corporate branch or subsidiary as a taxable entity unconnected to its out-of-state parent. The income of the branch or subsidiary is isolated as if the entire business operations were conducted in the taxing state.⁸⁰ The U.S. Supreme Court recognized the limitations of this method very early. If, for example, a multistate manufacturing business is a vertically or horizontally integrated group of entities, its operations are not conducted in any single state separately. Instead, the income of the business is earned "by a series of multistate transactions beginning with manufacturing profit in one state and ending with sales profit in other states."⁸¹ Such was in fact the finding of the Supreme

Court in the case of *Underwood Typewriter Co. v. Chamberlain*.⁸²

Two methods of separate accounting exist to isolate the net income of a multistate business in a given state. A state can either:

(1) Ascertain the actual cost of manufacturing and add a reasonable profit, determined by reference to such standards as the profit made by other corporations and the opinions of businessmen. The manufactured goods are then deemed to have been sold by the manufacturing department to the selling department at the price indicated. Specific costs of each department are computed, and overhead, administrative, and other general expenses are charged to the various departments.

or

(2) Ascertain the price at which the articles manufactured may be purchased from other manufacturers in the categories and quantities desired. Utilize this figure as the cost of goods, and otherwise proceed as indicated in (1) above.⁸³

Commentators have criticized separate accounting as “fearfully expensive,” “impracticable,”⁸⁴ “arbitrary,” and “uncertain.”⁸⁵ Few states use the method today, and at least one state that purports to do so allows a multistate business to isolate its in-state income by means of applying formula-based apportionment.⁸⁶

Pure source-based taxation with separate accounting scores low in the criteria of simplicity and reduction of compliance burdens and enforcement.

Pure Source-Based Tax: Formula-Based Apportionment

Another way to use pure source-based taxation to accomplish the goal of dividing the tax base of a multistate corporation is through formula-based apportionment. The apportionment formula is designed to measure the fraction of a multijurisdictional taxpayer’s income that should be attributed to a given state by comparing the taxpayer’s in-state income-producing activities with its activities everywhere. Therefore, the particular formula chosen must reflect how and where the taxpayer earns its income: the factors represent how the taxpayer generates its income, and the “situs rules” govern where the income is earned.

As a general rule, an apportionment formula should comply with two principles: (1) the factors should bear a reasonable relationship to the income being apportioned, and (2) the situs rules should represent the location of the activities or property of the taxpayer by reference to the benefits and protections that the taxing state offers to the taxpayer’s property and/or activities.⁸⁷ To date, neither federal statutory law nor judicial decisions impose any particular formula or situs rules on states.⁸⁸ Thus, states are free to adopt any apportionment formula and situs rules they choose, as long as they comply with the above general fairness rules. The freedom to choose among apportionment formulas allows states autonomy in adminis-

tering state taxes on multistate corporations. Each state can adopt its statutes, rules, and policies without regard to whether another state applies different rules. Conflicts among state statutes, rules, and policies are deemed irrelevant to the taxing state, which administers its laws as if it were the sole taxing state.

If the freedom in their choice of apportionment formulas maximizes the autonomy of states, it greatly increases the compliance burden for multistate corporations, which must comply with a wide variety of formulas and situs rules. With the use of pure source-based taxation and formula-based apportionment, states have made scant progress toward the goal of uniformity.

The problems with formula-based apportionment can be illustrated by reviewing briefly the long history of state uses of formulas to apportion the income of multistate general business corporations. Today, there is little disagreement among the states as to the appropriate factors for a manufacturing firm. Most states use the so-called Massachusetts formula, an equally weighted three-factor formula consisting of property (plant, machinery, etc.), payroll (employees), and receipts (from the sales of goods produced by the plant, machinery and employees). Thus, most states have agreed that the fraction of income of a manufacturing company that should be attributed to a given state can be measured by the following formula:

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

Forty-five out of the 46 states (including the District of Columbia) that levy corporate taxes measured by net income have adopted the three-factor formula.⁸⁹ In 1957, the formula—consisting of property, payroll and sales, and detailed situs rules—was codified in the *Uniform Division for Tax Purposes Act* (UDITPA).⁹⁰ Currently, 23 states use some version of the UDITPA formula.⁹¹ Yet, because many of the states that use the Massachusetts formula (with or without adopting UDITPA) have modified it, there is little uniformity among the states.⁹² According to Jerome Hellerstein, a leading scholar of state taxation, states vary as to (1) what items should be included in each factor, (2) how to value the items that are included, (3) the relative weights assigned to the three factors, and (4) the definition of terms used in the formula.⁹³

For example, state laws differ as to the propriety of including the following elements in the property factor: rented property, inventory in transit between the taxing state and other states, mobile property, and property under construction. State laws also differ on the proper manner in which to value property that is included in the property factor: some states use fair market value, others use book cost less accrued depreciation, and still others employ undepreciated original or book cost.⁹⁴ Similar

conflicts in state rules occur in connection with the payroll and receipts factors.⁹⁵

Although the original formula gave identical weight to each of the three factors, 12 states have modified the relative weights.⁹⁶ States do this in order to accomplish two goals: to increase the amount of net income assigned to the state and/or to favor domiciliary corporations. Typically, states modify the evenly weighted formula by "double-weighting" the sales factor, according it twice as much value as either of the other two factors.⁹⁷ The effect of double-weighting the sales factor is to favor domiciliary multistate corporations, which commonly have more property and payroll than sales in their home state, over out-of-state corporations, which commonly have more sales than property and payroll in the host state.⁹⁸

There is little uniformity among state situs rules.⁹⁹ This diversity has an effect similar to double-weighting the sales factor, rendering the "standard" three-factor formula even less authoritative. The situs rules control which elements go into the numerator of the three-factor formula, thereby increasing or decreasing the amount of income attributed to a given state. The choice carries important revenue considerations. Many states will seek to increase their tax revenue by adopting situs rules designed specifically for that purpose.

Even when situs rules appear to be similar, differences may arise because states apply different definitions to specific words in the rules. For example, although 40 of the 45 states that use a sales or receipts factor use a "destination" situs rule for that factor, attributing it to the numerator of the state to which merchandise or property is shipped or delivered, the laws do not necessarily agree as to the meaning of "delivered" or "shipped."¹⁰⁰ Some states also use the throwback rule to change the situs of the receipts factor from destination to "origin" (i.e., the state from which the merchandise is shipped) if the state of destination does not tax the corporation.¹⁰¹ In sum, after over a half-century of experience with apportionment of the income of general business corporations, there is still little uniformity among state situs rules.

There is reason to believe that state laws for apportioning bank income may differ even more than those respecting the income of manufacturing and merchandising corporations.¹⁰² Banks and other financial institutions earn income primarily from intangible property that, unlike real or tangible personal property, has no natural physical location. For this reason, the U.S. Supreme Court has interpreted the due process clause of the U.S. Constitution to require a situs rule based on the relationship between the intangible property and the taxing state. According to the Court, the required relationship is found at the domiciliary state of the creditor, the domiciliary state of the debtor, or the state in which the intangible debt has a business situs.¹⁰³

Because the due process clause does not prohibit double taxation,¹⁰⁴ all three states could include income from intangibles and the intangibles themselves in the numerators of their receipts and property factors.

The differences in state apportionment formulas and situs rules can increase the total tax burden of multistate

corporations, including banks. Consider the following example:

Assume that State X is the domiciliary state of Bank A. Bank A does business in States X, Y and Z. The tax rate of all three states is 7 percent. According to the situs rules of State X, Bank A has earned 80 percent of its income there. States Y and Z apportion 20 percent and 10 percent to themselves. Bank A pays State X \$56,000 ($\$1,000,000 \times 80\% = \$800,000 \times 7\% = \$56,000$); State Y \$14,000 ($\$200,000 \times 7\% = \$14,000$); State Z \$7,000 ($\$100,000 \times 7\% = \$7,000$). Bank A would pay tax on 110 percent of its income for a total tax of \$77,000.

The Supreme Court has upheld differing state apportionment formulas, reasoning that a particular formula need produce only a rough approximation of the income of a multistate corporation that is attributable to a given state.¹⁰⁵ Therefore, the overlapping taxation that is caused by conflicting formulas and situs rules is not likely to be deemed unconstitutional.¹⁰⁶

States that use pure source-based taxation have difficulty formulating situs rules that are "fair" (i.e., neutral between in-state and out-of-state businesses) and uniform because there is an irreconcilable conflict between the taxation of domiciliary and nondomiciliary banks. In an interstate environment, the home state of a domiciliary bank is also the host state of a nondomiciliary bank. States cannot, with one set of situs rules, reconcile the conflict created by this dual role. The situs rules that will attribute the most income from domiciliary banks to the home state will also attribute the least income from nondomiciliary banks to the host state, as the following example illustrates.

Bank A is domiciled in State Y and makes loans in States Y and Z. Bank B is domiciled in State Z and also makes loans in States Z and Y. Assume that State Y has situs rules that allow it to include in the numerator of its receipts factor all interest and fee income from loans if the loans are made by a bank domiciled in State Y. This situs rule will have the effect of attributing all of the receipts from loans made by Bank A (and other domiciliary banks) to State Y. The rule will also have the effect of attributing none of the income of nondomiciliary Bank B to State Y, although Bank B makes loans there. A similar conflict arises if State Y has a situs rule that directs all banks doing business there to include in the numerator of their receipts factor all interest and fee income from loans if such loans are made to residents of State Y. This rule will increase significantly the amount of the income of Bank B (and other nondomiciliary banks) attributed to State Y, but it will also decrease the amount of income of Bank A (and other domiciliary banks) that is attributed to State Y.¹⁰⁷

This problem is particularly troublesome when an apportionment formula is used in connection with *branchless* banks. For example, suppose that a branchless bank operates in a state that uses a formula that includes payroll, real and tangible personal property, and receipts fac-

tors.¹⁰⁸ Because a branchless bank, by definition, has no payroll or (real or tangible personal) property in its market states, the numerators of those two factors in the market states will be zero, thus significantly reducing the amount of income attributed there, and potentially giving it an unfair advantage over home state banks that must operate with a physical presence in the state.

The home state/host state dilemma also decreases the possibility of states agreeing on a uniform apportionment formula. For example, a state that is the domicile of many large banks ("money center") can increase its revenue by choosing situs rules that attribute most of the income and assets to the home state. Conversely, a state that is the home of relatively small banks may be better able to increase its revenue by choosing situs rules that attribute bank income and assets to the host (or market) state. The implementation of a voluntary uniform apportionment formula would require states to agree not to use apportionment formulas to: (1) seek to increase their revenue, (2) favor domiciliary corporations, or (3) engage in interstate tax competition.

In addition to the problems created by the use of an apportionment formula for both domiciliary and nondomiciliary banks, the use of pure source-based taxation with formula-based apportionment in connection with securitized loans creates the potential for widespread tax avoidance, as described above.

Finally, the use of pure source-based taxation with formula-based apportionment has a discriminatory effect on community-based banks because the system gives multistate banks a significant state tax advantage. In the present environment, large multistate banks have the option to move their assets and profits to jurisdictions with low tax rates or no tax at all, thereby reducing their overall tax burden. Smaller, community-based banks cannot take advantage of such mobility in order to obtain tax breaks.

In short, a pure source-based tax with formula-based apportionment scores low on several tax policy goals, including: simplification of tax systems;¹⁰⁹ reduction of compliance burdens; fairness; provision of certainty and regularity for taxpayers; uniformity of taxes on multistate businesses; and exportability, a goal pursued by many states.

Despite its low score in some of the elements of a good tax, a pure source-based tax ranks high in avoiding discrimination among different lines of business. The reason for this is simple: nearly every state has adopted pure source-based taxation with formula-based apportionment for its general business corporations. Yet, significant differences between general business corporations and banks and bank-like entities may dictate different tax treatment for financial institutions. For example, the drafters of UDITPA exempted financial institutions from the act.¹¹⁰ Manufacturing and mercantile corporations produce and/or market a tangible product that is both visible and allocable to one state. Banks, on the other hand, deal in intangibles that are neither visible nor assignable to only one state, and bank assets are very mobile. With a pure source-based tax, a domiciliary bank can shift its assets and/or profits to a branch in a state that has a low tax

rate or no tax, thereby escaping its home state tax. With residence-based taxation, however, the bank has no incentive to do so because its home state retains taxing jurisdiction over all of its assets/profits. Because a pure source-based tax is the most easily manipulated of the alternative methods of taxation, the use of that system with banks and bank-like entities, which can readily move assets among jurisdictions, may have adverse revenue consequences for states. For these reasons, neutrality in the methods of taxing corporations that do business in a significantly different manner may be neither possible nor desirable. Substantial neutrality—neutrality in both rate and base—is, of course, possible.

Dual System: Residence-Based and Source-Based Tax

The dual system rests on a different theoretical base than does the pure source-based tax. Source-based taxation permits states to adopt and administer tax laws without regard to the differing and/or conflicting laws of other states. The dual system of residence and source taxation requires states to recognize the interaction of tax systems in the growing interstate and international environment.

The United States international tax system is a dual system. The U.S., using residence principles, taxes the worldwide net income of its domestic multinational corporations, allowing domestic multinational corporations a credit for the net income taxes they have paid to the foreign countries in which they do business (to solve the multiple taxation problem). The amount of the credit is limited: foreign income taxes can be credited only to the extent of the U.S. tax allocable to the taxpayer's "foreign source" income. Expressed as a fraction, the maximum allowable credit is:

$$\text{U.S. income tax (on world-wide income, before credit)} \times \frac{\text{foreign source taxable income}}{\text{U.S. consolidated income}}$$

The effect of the foreign tax credit limitation is that U.S. multinational corporations pay taxes on their foreign source income at the higher of the foreign tax rate or the U.S. rate. Foreign multinationals that do business in the U.S. are taxed only on the income earned there.

States can use such a dual tax system, too.¹¹¹ At least 42 states do so with their personal income taxes.¹¹² Alabama does so with its general business corporations, and Rhode Island and Indiana do so with their bank taxes.¹¹³ The dual tax system appears to be consistent with the directives of the due process and commerce clauses.¹¹⁴

The domestic bank component of the dual system consists of a residence-based tax coupled with a credit, and meets many of the same objectives of a good tax as does a pure residence-based tax. Although not as simple as a pure residence-based tax, it is relatively easy to administer. First, a domiciliary state taxes its domestic banks on their entire income, regardless of where it is earned. Domiciliary banks that are subject to this residence-based tax include (1) state banks licensed under the law of the taxing state, (2) foreign banks¹¹⁵ operating in the taxing

state under a state license, (3) national banks that have designated the taxing state as their principal place of business in their charter, and (4) foreign banks operating in the taxing state under a federal license as a "federal branch" or a "federal agency."¹¹⁶ The domiciliary state grants such banks a credit for income taxes paid to other states. There are only two circumstances under which a domiciliary state will grant a credit: (1) for activities conducted by a branch of a domiciliary bank, which is located out of state and taxed by the state in which it is doing business; and (2) for branchless banking activities, which are conducted by a domiciliary bank out of state and are taxed by the state in which the activities are conducted.¹¹⁷

States will not face the administrative and compliance burdens of the system that the United States uses to tax international income.¹¹⁸ Unlike the wide variety of tax bases used by foreign countries, nearly every state that imposes a corporate income tax uses a net income base that conforms broadly to the measure of the federal income tax.¹¹⁹ Therefore, a state could define a creditable tax as a net income tax, a franchise tax measured by net income, or a tax in lieu of a net income tax (i.e., an alternative minimum tax).

States can bypass yet another difficulty in the application of the United States tax on multinational corporations—the calculation of the foreign tax credit limitation. As noted, the U.S. limit is expressed by a formula, the numerator of which is the bank's "foreign source" taxable income and the denominator of which is the U.S. consolidated income. The Internal Revenue Code requires that foreign source income be defined by U.S. tax law rather than by foreign law. To calculate its foreign tax credit limit, therefore, a U.S. multinational must first "re-source" its foreign income according to the extremely complex source rules in sections 861-864 of the Code. These source rules are necessary in the international arena because no constitutional limits exist to prevent foreign countries from overreaching in their definitions of foreign source income. Within the national arena, however, the due process and commerce clauses limit state definitions of the source of income. Thus, states have no need for complex source rules; they can simply limit the amount of their credit by reference to their own rate. The use of effective state tax rates rather than nominal rates will remove any distortions caused by the differences in state net income tax bases.

Unlike the pure residence-based tax, a residence-based tax coupled with a credit does not have the defect of multiple taxation. A simple example will illustrate this proposition.

Assume that Bank A, domiciled in State X, does business in and is taxed by three states: X, Y and Z. Assume further that Bank A has \$1,000,000 of net income for fiscal year 1 and that all three states would calculate the corporation's income in the same manner. All three states have a 7 percent tax rate. Bank A earned income in all three states. State Y determined that 20 percent of the income was earned there and apportioned \$200,000 to itself. State Z determined

that 10 percent of the income was earned there and apportioned \$100,000 to itself. State X assesses its tax on the entire net income of Bank A, but gives a credit for the taxes the corporation pays to States Y and Z. Given these rules, Bank A would pay a \$14,000 income tax to State Y ($\$200,000 \times 7\% = \$14,000$); \$7,000 income tax to State Z ($\$100,000 \times 7\% = \$7,000$); and \$49,000 income tax to State X ($\$1,000,000 \times 7\% = \$70,000 - \$21,000 \text{ tax credit} = \$49,000$). Thus, Bank A pays tax on 100 percent of its income, and its total tax liability is \$70,000.

Because most states use pure source-based taxation with formula-based apportionment for general business corporations, the use of residence-based taxation with a credit for taxes paid to other states can create some tax disparity between banks and general business corporations. On the one hand, the total tax burden on Corporation A will be the same under formula-based apportionment and a system of tax credits as long as State A has a tax rate that is *equal* to that of all other states taxing the corporation, as the following example illustrates:

Assume that Bank A, domiciled in State X, does business in and is taxed by three states: X, Y, and Z. Assume further that Bank A has \$1,000,000 of net income for fiscal year 1 and that all three states use formula-based apportionment to determine the tax liability of Bank A. According to the states' formulas, 70 percent of the company's income is attributable to its activities in State X, 20 percent to those in State Y, and 10 percent to those in State Z. If all three states had the same 7 percent tax rate, Bank A would pay \$49,000 income tax to State X ($70\% \times \$1,000,000 = \$700,000 \times 7\% = \$49,000$); \$14,000 tax to State Y ($20\% \times \$1,000,000 = \$200,000 \times 7\% = \$14,000$); and \$7,000 tax to State Z ($10\% \times \$1,000,000 = \$100,000 \times 7\% = \$7,000$). Thus, Bank A pays tax on 100 percent of its income and its total tax liability is \$70,000, which is the same tax liability that the bank would have under a residence-based tax coupled with a credit.¹²⁰

On the other hand, Bank A's aggregate tax burden will be *greater* if the domiciliary state uses a credit system and a tax rate that is *higher than* that of the host states that tax the bank, as the following example shows:

State X, the domiciliary state, has a tax rate of 9 percent, State Y's rate is 8 percent, and State Z's rate is 7 percent. State X taxes the entire net income (\$1,000,000) of Bank A, and States Y and Z tax 20 percent and 10 percent respectively. Bank A's aggregate tax burden is \$90,000. It pays State X \$67,000 ($\$1,000,000 \times 9\% = \$90,000 - \$23,000 = \$67,000$); State Y \$16,000 ($\$200,000 \times 8\% = \$16,000$); State Z \$7,000 ($\$100,000 \times 7\% = \$7,000$). In effect, the bank has paid tax on \$1,000,000 at the rate of 9 percent.¹²¹

Compare the result under formula-based apportionment with the same 9 percent, 8 percent, 7 percent tax rates:

Bank A's aggregate tax burden would have been \$86,000 rather than \$90,000. It would have paid

\$63,000 to State A ($\$700,000 \times 9\% = \$63,000$), \$16,000 to State Y, and \$7,000 to State Z.

(This example assumes, however, that the situs rules of the three states are identical. If, as was described in the preceding section, the situs rules of the three states differ, overlapping taxation will exist under formula-based apportionment, increasing the corporation's overall tax burden).

The residence-based tax with a credit need not, however, create tax disparity among *competitive* lines of business. For example, as described below, some states have adopted a broad definition of a "bank" in order to subject all competing entities to the same tax.

The residence-based tax with a credit also scores high in creating neutrality between small, community-based banks and large multistate banks in that both are taxed under the same rules. With a pure source-based system, multistate banks, which have the option of moving their assets and profits to low-tax or no-tax jurisdictions and reducing their overall tax burden, have a significant state tax advantage. Under the residence-based tax with a credit, however, the multistate banks would still pay a state tax up to the rate of its domiciliary state, just as community banks do.

The out-of-state or nondomiciliary bank component of the dual system is a source-based tax with an apportionment formula. In order to treat domiciliary and nondomiciliary banks equally, states that choose the dual system would want to use a formula tailored for nondomiciliary banks just as the residence-based portion of the tax is tailored for domiciliary banks. States can do this by adopting a uniform single-factor receipts formula for nondomiciliary banks. The proof of this proposition requires an understanding of which banks are taxed as out-of-state or nondomiciliary banks under the dual system.

Most interstate banking occurs through a merger between an out-of-state bank and an in-state bank, an acquisition of an in-state bank by an out-of-state bank, or de novo entry by a bank holding company. Interstate banking through any of the above methods will create an in-state bank (i.e., a bank that is taxed as a domiciliary). A bank that engages in interstate branchless banking (electronically or by mail) in a host or market state is an out-of-state bank (i.e., a bank that will be taxed as a nondomiciliary). A bank that engages in interstate banking through a *branch* is also an out-of-state bank for purposes of the dual system (i.e., a bank that will be taxed as a nondomiciliary). It is easy to see that it makes sense for the host or market state to choose a single-factor receipts formula to apportion the income of a branchless bank. By definition, a branchless bank has no place of business and no employees in the taxing state. Even in the case of a branch bank (whether state-chartered, national, or foreign), a single-factor receipts formula with market state situs rules will generally attribute the most income to the nondomiciliary state. The reasons for the superiority of the single-factor receipts formula are: (1) attribution rules for a property factor (intangible) typically duplicate those for the receipts factor; and (2) the addition of a payroll factor would attribute more revenue to the host state than a receipts formula only if the receipts-to-payroll ratio of the branch in the

host state is less than the average in the entire corporation.¹²² This condition would require that the branch earn less revenue per employee than the average of the entire corporation, an unlikely event because the branch presumably would be able to take advantage of many services provided by the home-office employees of its parent corporation rather than hiring separate branch employees.

The dual system may help to create uniformity among state tax systems. There is little reason for a state to modify the apportionment formula for nondomiciliary corporations under the dual system. As noted, there are two reasons for a state to modify its apportionment formula: to increase the amount of revenue assigned to the state and/or to favor their domiciliary corporations. With a dual system, the reasons for altering an apportionment formula disappear. First, because the formula is used only for nondomiciliary banks, a state will not change the formula to benefit its domiciliary corporations, either by modifying the weight of a given factor or by altering situs rules. Second, a uniform single-factor receipts formula with market-state situs rules will nearly always attribute the most income to a taxing state.

Also, the use of the dual system will solve the serious dilemma, described previously, which is created by the increasing securitization of loans, and which cannot be remedied fully under a pure source-based tax. Under the dual system, a domiciliary state would levy its tax on the entire interest income received by a domestic bank from the securitized loans, thereby closing the tax avoidance problem described previously.

The dual system suffers from two political handicaps, however. First, it requires states to adopt a method of taxation that is different from the one currently used by most states. Second, the dual system would close many of the tax loopholes that now exist with pure source-based taxation and that allow multistate banks to move their assets and profits to low-tax rate or no-tax jurisdictions. The familiar experience of the federal government with tax reform illustrates the difficulties involved in plugging tax loopholes.

Summary and Comment

Four methods exist for the taxation of the income of banks: pure residence-based taxation, pure source-based taxation with separate accounting, pure source-based taxation with formula-based apportionment, and a dual system consisting of residence-based (with a credit) and source-based taxation. None of the four alternatives will satisfy all eight policy goals set forth in the 1975 ACIR study.

A pure residence-based tax receives the highest marks for simplicity, low compliance and enforcement burdens, certainty, and avoidance of trade barriers. Yet, a pure residence-based tax has several flaws, including discrimination between different lines of business, the failure to promote competitive equality between in-state and out-of-state banks, and the potential for multiple taxation. The last two flaws are particularly serious in light of the increased interstate banking activity originating from legislative and judicial actions and technological progress.

A dual system consisting of a residence-based tax with a credit for domiciliary banks and a source-based tax for nondomiciliary banks scores high in the elements of neutrality, fairness, simplicity, and exportability. Under the dual system, small community banks and large multistate banks are taxed under the same rules. The use of the dual system would also solve two serious problems that cannot be remedied under a pure source-based tax system. First, because the dual system requires the use of an apportionment formula only for nondomiciliary banks, no home state/host state dilemma exists. Instead, a state can adopt a formula that is tailored to apportion the income of nondomiciliary banks. Second, the dual system prevents the tax avoidance created by the increasing securitization of bank loans. Under the dual system, a domiciliary state would levy its tax on the entire interest income received by a domestic bank from the securitized loans. The goal of creating a uniform apportionment formula should be attainable under a dual system. Conversely, the dual system suffers from political handicaps.

Viewed from a national perspective, the pure source-based tax ranks low in the criteria of simplicity, uniformity, provision of certainty and regularity for taxpayers, and reduction of compliance burdens. The use of pure source-based taxation with formula-based appor-

tionment in an interstate environment causes several problems for states. Because of the home state/host state conflict in situs rules, pure source-based taxation with formula-based apportionment scores low in exportability and competitive equality between domiciliary and out-of-state banks. This problem is particularly acute in the case of branchless banks. Also, the use of pure source-based taxation with formula-based apportionment in connection with securitized loans creates the potential for widespread tax avoidance, also decreasing the fairness of the tax. Finally, the use of pure source-based taxation with formula-based apportionment has a discriminatory effect against community-based banks. With a pure source-based system, multistate banks have a significant state tax advantage over community banks. In the present environment, large multistate banks have the option to move their assets and profits to jurisdictions that have a low tax rate or no tax at all, thereby reducing their overall tax burden considerably. Smaller, community-based banks cannot take advantage of such tax breaks. Conversely, because most states today use formula-based apportionment, that method ranks high on avoidance of discrimination between banks and general (nonfinancial) businesses.

Formulas and Jurisdiction

Source-Based Taxes: Alternative Apportionment Formulas

States that adopt a pure source-based tax must select among several possible factors and situs rules. Many states also will alter the respective weights that they assign to the factors chosen in order to increase their revenue and/or favor their domiciliary corporations.

The purpose of an apportionment formula is to measure what fraction of the income-producing activity of a multijurisdictional taxpayer takes place within a given state. Therefore, the particular factors chosen should reflect in general how the taxpayer generates its income. The situs rules then spread the income of the corporate taxpayer among the states having jurisdiction to tax it. Within general fairness guidelines, states have wide latitude in the selection of apportionment formulas.¹²³

Banks earn income by soliciting deposits, which in turn permits them to create loans and investments that generate interest and fee income. Banks also earn a significant amount of income from dealings in intangibles other than loans (i.e., securities and money market instruments) and by providing a variety of services. Thus, in the case of bank income, payroll receipts, intangible property, and deposits are all potential factors. No existing federal laws or judicial decisions require states to choose any one or any combination of these potential factors. No empirical evidence exists that suggests that any factor is better than any other or that any combination will produce a better result when used for both domiciliary and market states.

Moreover, any uniform apportionment formula would require significant compromises; that is, states would have to agree not to use apportionment formulas to (1) seek to maximize their revenue, (2) favor domiciliary corporations, or (3) engage in interstate tax competition, an event that appears unlikely given the experience with state formulas for multistate general business corporations. Although presently it is not feasible to describe the best formula for banks, it is possible to evaluate the formulas now in use.

UDITPA Formula

The UDITPA formula contains a property factor (real and tangible personal property), a sales factor, and a payroll factor. Given the importance of intangibles as an income-producing item for banks, the failure of the UDITPA to include intangible property in its property factor makes that formula unsuitable for bank income; in fact, the act specifically exempts financial institutions. While the omission of intangible property may not rise to the level of a constitutional flaw, it changes significantly how the income of a bank is spread among the states in which it transacts business. For example, the situs of real and tangible personal property is attributed to the state in which the property is physically located. In most cases, such property will be found in the domiciliary state of a financial institution. Consequently, an apportionment formula that uses only real and tangible property will benefit only the domiciliary state. If, as is true in the case of UDITPA,

the formula also contains a payroll factor, the balance will be tipped even further in favor of the domiciliary state because most employees will be located there, too.

Moreover, the use of the UDITPA formula may have a discriminatory effect. Real and tangible personal property (such as machinery and equipment) is likely to comprise a large percentage of the assets of a general business (nonfinancial) corporation, while intangible property will represent a small fraction of its assets. This situation is reversed in the case of a financial institution. Typically, financial institutions have very little real and tangible personal property, whereas intangible property, such as loans and securities, constitute their entire business. Thus, use of the UDITPA formula excludes most of the property of financial institutions, but not that of general business corporations.

Despite these flaws, approximately 11 states use the three-factor UDITPA formula.¹²⁴ Typically, these states have not attempted to design a formula that is tailored for banks, but have simply borrowed the UDITPA formula. A few states include intangible property in the property factor of their apportionment formula.¹²⁵ Unlike the situation with real property or tangible personal property, the legal situs of intangible property can exist in more than one state,¹²⁶ namely, the domicile of the creditor, the domicile of the debtor, and/or the state in which the intangible has a business situs.¹²⁷ The inclusion of intangible property in the property factor coupled with a situs rule based on the residence of the debtor would benefit market states.

New State Apportionment Formulas

Recognizing the defects of the UDITPA formula, some states have adopted new formulas specifically tailored to banking. The new laws of New York and Minnesota represent two different approaches to the problem of apportioning the income of multijurisdictional banks.

The New York Law. In 1985, New York completely revised its bank tax to make it similar to the tax on general business corporations, that is, the state uses a pure source-based tax for banking corporations. The factors chosen to apportion the income of banking corporations are receipts, deposits, and payroll. The numerator of the payroll factor is 80 percent of in-state wages, salaries, and other personal services compensation.¹²⁸ The receipts and deposits factors are double-weighted.

The receipts factor consists of the ratio of receipts earned within New York to receipts earned everywhere. It includes all income from loans, financing leases, rents; service charges, fees and income from bank, credit, travel, and entertainment cards; net gains from trading and investment activities; fees from the issuance of letters of credit and traveler's checks; and all income from government bonds, although a portion of such income is excluded from the tax base.

The regulation contains separate "situs" rules for each receipt. The rules have a strong domiciliary state bias. Consider, for example, the following receipts' situs rules.

1) The situs of income from loans other than credit card loans is in New York if the loan is "located in New York."¹²⁹ A loan is deemed located in New York if the greater portion of income-producing activity relating to the loan (i.e., solicitation, investigation, negotiation, approval, and administration) takes place in the state. The definitions of these terms make it clear that in most cases all of the income-producing activity will be deemed to take place in the state in which the lending bank is located.¹³⁰

2) The situs of income from bank, credit, travel, entertainment and other card operations is the state of domicile of the credit card holder.¹³¹

3) The situs of receipts for services performed by the taxpayer's employees regularly connected with or working out of a New York office is New York if such services are performed within New York.

The deposits and payroll factors also exhibit a domiciliary state bias. The deposits factor is the ratio of the average value of deposits maintained at branches within New York to the average value of all deposits maintained at branches within and outside of New York.¹³² Deposits made by an out-of-state individual or business are deemed to exist in the state in which the deposit is maintained. The payroll factor is the ratio of 80 percent of in-state wages, salaries, and other personal services compensation to total wages, salaries, and other personal services compensation.

The Minnesota Law. Minnesota revised its bank income tax law in 1987 and 1988. The factors selected by Minnesota—payroll, property, and receipts—are similar to those in the UDITPA formula. The similarity between the two formulas ends there, however. Two differences are particularly important. First, the Minnesota formula includes intangible as well as tangible and real property in the property factor.¹³³ Second, the three factors are not weighted evenly. The formula apportions income to Minnesota by comparing 70 percent of the receipts in-state to receipts in all states, 15 percent of the property in-state to property in all states, and 15 percent of the payroll in-state to payroll in all states.¹³⁴

The Minnesota situs rules, which have a distinctly market state flavor, differ significantly from the New York rules, as the following examples illustrate:

1. Receipts from Loans. The situs of income and other receipts from loans secured by real estate or tangible property is in Minnesota if such property is located in the state. The situs of income and other receipts from unsecured commercial loans is in Minnesota if the proceeds of the loan are to be applied in the state.¹³⁵ The situs of income and other receipts from unsecured consumer loans is in Minnesota if the borrower is a resident of Minnesota.¹³⁶

2. The situs of income and other receipts from credit card and travel and entertainment cards is in Minnesota if the card charges and fees are regularly billed there.¹³⁷

3. The situs of receipts from the performance of services is in Minnesota if the benefits of the services are con-

sumed in the state, regardless of where the services are performed.¹³⁸

The state's situs rules for the property factor track those of the receipts factor.¹³⁹ Payroll is attributed to Minnesota if an employee is (a) employed within the state, (b) actually working within the state, or (c) accountable to an office within the state.¹⁴⁰

Summary and Comment

To date, two states—New York and Minnesota—have completely revamped their state bank tax laws using pure source-based principles. Each state has chosen very different situs rules. The differences reflect the states' perception of their status as a home state or a host state. For example, New York, which is a money center state, has chosen situs rules that locate most bank receipts and deposits in New York. The New York receipts and deposits factors are double-weighted. Minnesota, which deems itself to be primarily a host state, has selected situs rules that have a market state bias: receipts and intangible property are located in the state of the borrower. According to the Minnesota situs rules, receipts are weighted more heavily than either property or payroll.

Although these differences in state apportionment formulas do not appear to raise a federal constitutional question,¹⁴¹ they do cause overlapping taxation. As more states pass new bank tax laws, the lack of uniformity will produce more tax overlap and greater administrative burdens for banks operating across state lines.

Definition of Taxable Entities: What Is a Bank?

Until recently, most states defined a "bank" in harmony with the regulatory definition of a bank. Consequently, a "bank" was defined as an entity regulated by the state's Department of Banking. Many states that used this definition taxed banks differently than they taxed other depositories, such as savings and loan institutions. Now, however, states are beginning to enlarge their narrow definition of a bank in order to create tax parity among like institutions. The use of a definition of the taxable entity that includes all or most competing institutions will go a long way toward creating a neutral and fair tax system. State experiments in this area range from an expanded regulatory definition of a "banking corporation" to an open-ended definition of a "financial institution." The laws of New York, Michigan, and California illustrate the possibilities.

The New York Definition

The New York law applies to every "banking corporation" that is exercising its franchise or is doing business in New York. In general, a "banking corporation" is defined as:

- a) Any corporation that is organized under the laws of New York, any other state, or country (U.S. or foreign) and that is doing a banking business, or

- b) Any corporation the stock of which is 65 percent or more owned or controlled by a bank, thrift, or bank holding company and that is engaged in a business that can be conducted lawfully by a commercial bank, or is engaged in a business that is so closely related to banking or managing or controlling or managing banks as to be a proper incident thereto.

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

The law makes the task of revenue authorities and taxpayers easier because it defines which entities are subject to the tax. This is done by regulations that give specific examples of the kinds of entities that are banks, thrifts, or bank holding companies and then by referencing the federal regulations that specifically list the subsidiaries of bank holding companies that are banking corporations under (b) above.

The Michigan Definition

Michigan defines a "financial organization" for the purpose of its single business tax as a "bank, industrial bank, trust company, savings and loan association, bank holding company . . . credit union . . . and any other association, joint stock company, or corporation at least 90 percent of whose assets consist of intangible personal property and at least 90 percent of whose gross receipts income consists of dividends or interest or other charges resulting from the use of money or credit."¹⁴² According to Michigan tax officials, many nonbank institutions that compete with banks for automobile, mortgage, and other loans come within this definition.¹⁴³ Other entities that some commentators deem to be competitors of banks, such as securities brokerage and investment firms and insurance companies, are excluded from the Michigan financial organization tax.¹⁴⁴

By focusing on the unique aspects of banks and financial institutions (i.e., institutions whose assets consist primarily of intangible property and whose income is generated through the use of money and credit), the Michigan statute creates a significant degree of tax parity among competing entities.

The California Definition

California's financial institutions law contains a very broad definition of a taxable entity. The law provides for the apportionment of the income of banks and "financial institutions." Case law defines a financial institution as an entity that deals in "moneyed capital" in substantial competition with national banks. By administrative policy, the California Franchise Tax Board applies a "more than 50 percent of gross income" test. Thus, a financial institution is an entity that receives more than 50 percent of its gross income from the use of its capital in substantial competition with other moneyed capital. Thus, entities engaged in

consumer financing, including automobile financing, come within the definition of a financial institution.¹⁴⁵ Although California has not issued regulations implementing the vague case law, the state has published legal rulings that give examples of the kinds of entities that will be deemed financial institutions.

Use of the Unitary Business Principle

States developed the unitary business principle to counter the problem of tax avoidance through interstate profit shifting by general business corporations.¹⁴⁶ Because they deal in intangibles, banks can shift assets and profits among taxing jurisdictions much more easily than can general business corporations. According to the unitary business principle, the apportionable tax base of multistate Corporation A that is doing business within State X includes the combined income of all members of Corporation A's unitary group, which consists of the parent and any of its controlled (i.e., related by more than 50 percent common ownership) subsidiaries that are engaged with it in a "functionally integrated" enterprise.¹⁴⁷ The amount of the combined unitary base that is attributable to Corporation A's activities in State X is determined by multiplying the base by the state's apportionment formula. The numerators of the factors will include the property, payroll, and receipts of Corporation A, while the denominator of the formula must include the gross receipts, property, payroll, etc., of the entire unitary group.

Corporate taxpayers have criticized the states' use of the unitary business principle, claiming that a clear and economically valid definition of a unitary business is lacking. The U.S. Supreme Court has stated that "the prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not flow of goods."¹⁴⁸ Taxpayers assert that because the unitary method is based on such a nebulous and indefinite concept, states can and do use the method to require the combination of affiliates that are engaged in entirely unrelated businesses, thereby causing distortions in their tax liability.

Fortunately, the question of unrelated businesses seldom arises with banks and bank-like entities.¹⁴⁹ Federal law prohibits banks and bank holding companies from controlling any subsidiaries that are not engaged in activities "incidental to the business of banking" in the case of national banks¹⁵⁰ or "closely related to banking or managing or controlling banks" in the case of bank holding companies.¹⁵¹ Hence, no bank or bank holding company subsidiary can engage in a business unrelated to that of banking, thus removing the major impediment to the use of the unitary business principle.

An important application of the unitary business principle in connection with state taxation of banks is the protection of the integrity of a state's franchise tax. As noted, many states have adopted a franchise tax measured by net income for banks because that tax provides the only method by which states can include the income from federal securities in a bank's tax base. Yet, because not every state has a franchise tax and because bank assets are very mobile, the franchise tax is easily avoided through "tax planning" techniques, such as the following:

Assume that Bank X is a domiciliary bank of State A. State A has a franchise tax and taxes federal securities. Bank X can avoid the tax on federal obligations by transferring its federal securities to Subsidiary Y located in State B, a state that does not have a bank franchise tax and cannot, therefore, tax the income from such securities.

The use of the unitary business principle would allow State A to combine the income of Subsidiary Y with that of Bank A for purposes of its state tax.

The unitary business principle is compatible with both the pure source-based and dual tax systems. A residence-based tax can be translated easily into the source-based tax that is necessary for combined reporting. A residence-based tax can be represented by an apportionment formula that attributes 100 percent of the factors (i.e., gross receipts, intangible property, etc.) to the domiciliary state. Once the residence-based tax is transformed into an apportionment formula, the factors of all of the members of the unitary group can be combined to determine what fraction of the combined apportionable income base is attributable to the taxing state. The actual tax is then calculated by applying the rate to the base and subtracting the credit. As described earlier, the use of a single-factor receipts formula will, in most cases, attribute the most income to the taxing state.

Jurisdiction Rules

As noted, banks can and do conduct business in many states without having a physical location there. Many banks regularly make loans and solicit deposits by mail, telephone, or electronic means. As electronic communications systems become more sophisticated, interstate branchless banking will increase. Such an environment renders jurisdiction rules based on a physical presence obsolete.

Branchless banking can create tax avoidance and tax discrimination between in-state and out-of-state banks. Consider, for example, the following common situation. Company A is a credit card subsidiary of a full-service bank. Its only brick-and-mortar place of business is in State A. Company A solicits its credit card customers solely by mail in all 50 states. Through these mail-order operations, Company A makes loans to consumers in every state, earning interest and fee income from their residents.

Even if we assume that one of these states, State B, has a source component, it normally will not tax Company A on the interest and fee income it receives from residents of State B because Company A, which is domiciled in State A, does not have a brick-and-mortar presence there. Even with the use of the unitary business principle, State B will not be able to tax its apportioned share of the interest and fee income from Company A's credit card subsidiary unless Company A has a taxable affiliate located in State B. The domiciliary banks in State B, on the other hand, may also issue credit cards to residents of State B. Unlike Company A, State B's domiciliary banks will pay taxes on the interest and fee income to State B.¹⁵²

In spite of the fact that branchless banking may result in tax avoidance and discrimination against domiciliary banks, most states still have tax jurisdiction rules that prevent them from taxing out-of-state banks that regularly solicit business from their residents by mail, telephone, or electronic means. It is unlikely that the U.S. Constitution will be interpreted to prevent states from adopting broader income tax jurisdiction rules for nondomiciliary banks that make loans to their residents.¹⁵³ As the U.S. Supreme Court has noted in upholding a state's exercise of judicial jurisdiction over an out-of-state defendant who had no office or other physical presence in the state asserting jurisdiction, "it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a state in which business is conducted."¹⁵⁴ Two states, Indiana and Minnesota, have broadened their tax jurisdiction rules by statute. Similar legislation is pending in Massachusetts. According to the 1988 ACIR survey, 11 other states do so by administrative policy.

The New York Jurisdiction Rules

According to the New York rules, foreign banking corporations "doing business" in New York apportion their income according to a three-factor formula. A banking corporation is deemed to be "doing business" in New York if, within the state, it operates a branch, a loan production office, a representative office, or a bona fide office.¹⁵⁵

The Minnesota Jurisdiction Rules

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

1. Distribution by mail or otherwise of catalogs, periodicals, advertising flyers, or other written solicitations of business to customers in [Minnesota];
2. Display of advertisements on billboards or other outdoor advertising in [Minnesota];
3. Advertising in Minnesota newspapers;
4. Advertising on Minnesota radio or television [stations]. . . .¹⁵⁶

A financial institution is deemed to have "regularly" solicited business from within the state if it "conducts activities with twenty or more persons within [Minnesota] during any tax period, or the sum of its assets and deposits attrib-

utable to Minnesota sources equals or exceeds \$5,000,000."¹⁵⁷

Reporting Requirements

Broad jurisdiction rules allow a state to tax an out-of-state branchless bank, but they do not provide a mechanism for identifying which entities are taxable. Assuming that it is possible for a state to detect the existence of a branchless bank, it still cannot tax such an entity unless the activities of the branchless bank have met the constitutionally required threshold. An attempt to assert tax jurisdiction over a branchless bank without some proof of the extent of its activities within the taxing state would lead inevitably to protracted litigation over the constitutionality of the tax. The issue may have to be litigated again with each separate branchless bank because the nature and extent of the activities of each such entity may vary.

To overcome this problem, some states have turned to reporting statutes. Typically, such statutes require all foreign corporations that have not received a license to do business in the state or that have not filed a tax return for the year in question to file a Notice of Business Activities. Because a reporting statute does not in itself subject the foreign corporation to tax, the use of a reporting statute solves the problem of case-by-case litigation over the taxability of each branchless bank.¹⁵⁸

Minnesota has such a statute. According to the Minnesota statute, every corporation that during the calendar year obtained any business from within Minnesota must file a Notice of Business Activities Report with the state's tax commissioner unless

- 1) It is a financial institution that conducts activities with less than 20 persons within Minnesota during the tax year and the sum of its assets and deposits attributable to Minnesota sources is less than \$5,000,000;
- 2) It is engaged solely in secondary market activity in Minnesota as defined by Minnesota law;¹⁵⁹
- 3) It has a certificate of authority to do business in Minnesota;
- 4) It has filed a timely Minnesota corporate franchise tax return; or
- 5) The corporation is tax-exempt.¹⁶⁰

Under this law, a corporation must file the notice even if it does not have a physical presence in Minnesota.

Because the Minnesota reporting statute is based on a similar statute in New Jersey, the recent litigation over the New Jersey penalty provisions may affect the Minnesota law. According to both statutes, the failure to file the required business activities report results in certain penalties, including the loss of access to the state's courts. Section 13A:13-20(b) of the New Jersey statute provides that:

The failure of a foreign corporation to file a timely report shall prevent the use of the courts in this state for all contracts executed and all causes of action that arose at any time prior to the end of

the last accounting period for which the corporation failed to file a timely report.¹⁶¹

The validity of this section is in doubt. Recently, the New Jersey Supreme Court reviewed *First Family Mortgage Corp. v. Durham*,¹⁶² a case that presented a challenge to the reporting statute. First Family Mortgage Corporation, a Florida corporation that was not authorized to do business in New Jersey, acquired 54 mortgages on New Jersey homes. Although it came squarely within the terms of the New Jersey law, First Family failed to file an activities report. When Linda Durham, the owner of one of the homes mortgaged, defaulted on her mortgage payments, First Family initiated a foreclosure action in a New Jersey court. Durham moved to dismiss the case on grounds that First Family did not comply with the reporting statute. First Family challenged the statute claiming that by prohibiting access to the state's courts, the statute violated the commerce clause of the U.S. Constitution.

Although the New Jersey Supreme Court upheld the state's reporting statute in general, it found that the above section violated the commerce clause because it did not

give the offending corporation the right to regain access to the courts by filing the required report and paying any taxes, interest, or penalties due. In order to preserve the constitutionality of the statute, therefore, the New Jersey Supreme Court interpreted section 14A:13-20(b) as being subject to the general "cure" provisions in section 14A:13-20(c)(1)-(2). The latter section allows a court to excuse the failure to file if:

- 1) The failure to file a timely report was done in ignorance of the requirement to file, such ignorance was reasonable in all circumstances; and
- 2) All taxes, interest, and civil penalties due the state for all periods have been paid, or provided for by adequate security or bond approved by the director, before the suit may proceed.

The Minnesota law (which has not been challenged) does not contain an "ignorance" requirement; that is, a taxpayer can regain access to the courts simply by filing and paying any taxes, penalties, and interest due.

Conclusion

The 1819 decision of the Supreme Court in *McCulloch v. Maryland* set the stage for congressional domination of state taxation of national banks and federal obligations that continues today. States cannot tax either national banks or federal obligations without statutory permission from the Congress.

The Congress began exercising its control over state taxation of national banks with the passage of the *National Currency Act* in 1864. The act codified the *McCulloch* holding by permitting states to tax the real property and shares of national banks. One section of the act limited state taxes on national bank shares to a rate no greater than the rate assessed on "other moneyed capital." This first congressional foray into the business of regulating state taxation of national banks through specific statutory directives and limitations signaled the beginning of over a century of litigation involving mind-numbing differences in state calculations of their rates of taxation and interpretations of the phrase "other moneyed capital."

By 1969, the Congress had recognized that neither further amendments, which merely led to a new round of litigation, nor judicial mediation, which produced a large body of inconsistent and conflicting opinions, could bring order or clarity to state taxation of national banks. In a final revision of the law, the Congress removed all prior conditions and limitations on state taxation of national banks and passed legislation that directed states to tax national banks in the same manner as they tax their state banks. The new law became effective in 1976.

Given the long history of congressional control over the methods by which a state could tax national banks, it is not surprising that most states have not yet revised their laws to reflect either the changes in federal law or the changes in the business of banking. For example, some states still tax their domestic banks using pure residence-based taxation, even though that system fails to promote competitive equality between in-state and out-of-state banks and creates the potential for multiple taxation. Approximately 32 states apportion the income of multistate banks. About 11 of those states apportion the income of in-state and out-of-state banks using the UDITPA three-factor formula, which was designed for manufacturing companies. By failing to take account of intangible property, such as loans and government securities, the UDITPA formula misallocates income among the states when used for banks. There is no commonality among the apportionment rules in the remaining 21 states. Also, most states still use jurisdiction rules based on a physical presence, although such rules appear obsolete in an era in which loans are made and deposits solicited interstate by mail, telephone, and other electronic means.

It is not possible yet to describe all the contours of the "best" bank tax. States have only recently begun to amend their bank tax laws to take advantage of the lifting of prior congressional restraints; therefore, one cannot measure the relative effectiveness of the new taxes. The three states that have recently revamped their laws—Minnesota, New York, and Indiana—have adopted very different approaches to the taxation of bank income. Both Minne-

sota and New York choose pure source-based taxation. Yet, Minnesota has broad jurisdiction rules and an apportionment formula with a market state bias, while New York requires an office location in the state in order to establish tax jurisdiction and has adopted an apportionment formula with a domiciliary state bias. Indiana adopted the dual system of taxation, whereby domestic banks are taxed using a residence-based tax with a credit and out-of-state banks are taxed by means of a single-factor receipts formula. Several other states are in the process of amending their bank tax laws, and eventually every state that has a pure residence-based tax may have to amend its law in order to eliminate multiple taxation.

States are still searching for a system that will satisfy the criteria of a good tax and interstate uniformity. At least in the case of general business corporations, the goal of uniformity has proved elusive. In order to settle on a uniform apportionment formula with a pure source-based tax, states will have to make significant compromises. Specifically, states would have to agree *not* to use apportionment formulas to (1) seek to maximize their revenue, (2) favor domiciliary corporations, or (3) engage in interstate tax competition.

A promising possibility that meets many of the criteria of a good tax is the dual tax system, whereby domiciliary banks are taxed on their entire income, with a credit for taxes paid to other states, while nondomiciliary banks are taxed according to source principles.

Although it is not yet clear what the best bank tax will be, it is imperative to monitor and evaluate the new bank taxes as they are adopted by the states. Such efforts will help states to identify the most effective method for taxing banks, and thereby promote uniformity among state bank taxes.

Notes

- ¹ 17 U.S. (4 Wheat.) 315 (1819).
- ² An excellent and detailed discussion of the federal immunity doctrine can be found in Paul J. Hartman, *Federal Limitations on State and Local Taxation* (New York: The Lawyers Cooperative Publishing Company, 1981).
- ³ 17 U.S. at 429.
- ⁴ A national bank holds a federal rather than a state charter. A national bank is a governmental instrumentality because it is created by the Congress.
- ⁵ US Const. Art VI, sec. 2. Because a national bank was necessary and proper, the decision of the Congress to incorporate such banks was part of the supreme law of the land.
- ⁶ *Weston v. Charleston*, 27 U.S. 448 (1829).
- ⁷ US Const. Art I, sec. 8, cl. 27.
- ⁸ US Const. Art I, sec. 8, cl. 27.
- ⁹ *Weston*, 27 U.S. 469.
- ¹⁰ In 1862, the Congress codified the prohibitions of the *Weston* decision in an act that provided that, "All stocks, bonds and other securities of the United States held by individuals, corporations, or associations . . . shall be exempt from taxation by or under State authority." This *per se* prohibition was rendered ineffective, however, by two later decisions of the Supreme Court that upheld bank shares taxes, measured by the value of all bank assets, including federal obligations (*Home Insurance Co. v. New York*, 134 U.S. 594, 1890), and franchise taxes measured by the entire net income of corporations, including the income from federal obligations (*Society for Savings v. Coite*, 73 U.S. 594, 1867).
- ¹¹ 31 U.S.C. sec. 3124 (a). This restriction has led many states to adopt for banks a franchise tax measured by net income instead of a direct net income tax. With a franchise tax, a state can include the income from federal obligations in the tax base. This is an important advantage because the income from federal and state securities comprises a significant fraction of the income of banks.
- ¹² 13 Stat. 112. Earlier, the Congress had passed the Currency Act of 1862, which exempted from state taxation "all stocks, bonds, and other securities of the United States held by individuals, corporations or associations within the United States." 12 Stat. 346.
- ¹³ 13 Stat. 112.
- ¹⁴ *McCulloch*, 17 U.S. at 435.
- ¹⁵ John B. Woosley, *State Taxation of Banks* (1935), reproduced in Board of Governors of the Federal Reserve System, *State and Local Taxation of Banks, Report of a Study under Public Law 91-156*, Before the Senate Committee on Banking, Housing, and Urban Affairs, 92nd Congress, 1st Session (Committee Print, 1971).
- ¹⁶ Section 41 also permitted a state to tax the real estate of national banks to the same extent that it taxed other real estate.
- ¹⁷ The second limitation was dropped in an 1868 amendment to the Act. 15 Stat. 34.
- ¹⁸ Woosley, *State Taxation of Banks*.
- ¹⁹ *People v. Weaver*, 100 U.S. 539 (1879).
- ²⁰ *Hepburn v. The School Directors*, 90 U.S. (23 Wall.) 480 (1874). The Court found no discrimination in this practice. Typically, these suits were brought by national banks, although the actual tax was levied on the shareholder.
- ²¹ *Commercial Bank v. Chambers*, 182 U.S. 556 (1901).
- ²² *Aberdeen Bank v. Chehalis County*, 166 U.S. 440 (1897); *Mercantile Bank v. New York*, 121 U.S. 138 (1887); *Davenport Bank v. Davenport Board of Equalization*, 123 U.S. 83 (1887); *Bank of Redemption v. Boston*, 125 U.S. 60 (1888).
- ²³ *First National Bank of Wellington v. Chapman*, 173 U.S. 205 (1899).
- ²⁴ *First National Bank of Hartford v. City of Hartford*, 237 U.S. 548 (1927).
- ²⁵ *National Bank of Richmond v. City of Richmond*, 256 U.S. 635 (1921).
- ²⁶ *People v. Commissioners*, 71 U.S. (4 Wall.) 244 (1866); *Mercantile Bank v. New York*, 121 U.S. 138 (1887); *Bank of Redemption v. Boston*, 125 U.S. 60 (1888); *Aberdeen Bank v. Chehalis County*, 166 U.S. 440 (1897).
- ²⁷ *Mercantile Bank v. New York*, 121 U.S. 60 (1888); *Talbot v. Silver Bow County*, 139 U.S. 438 (1891).
- ²⁸ *Bank of Redemption v. Boston*, 125 U.S. 60 (1888).
- ²⁹ 90 U.S. at 484 (1874).
- ³⁰ 121 U.S. 138 (1887).
- ³¹ Woosley, p. 241.
- ³² *Mercantile Bank v. New York*, 121 U.S. 138, 154 (1887).
- ³³ Woosley, p. 239.
- ³⁴ 42 Stat. 1499.
- ³⁵ 44 Stat. 223.
- ³⁶ See text, page XX (note 11), for statutory limitations on state taxation of federal obligations.

- ³⁷ 44 Stat. 223.
- ³⁸ Woosley, p. 288.
- ³⁹ 358 U.S. 450 (1959).
- ⁴⁰ 101 So.2d 70 (1958), appeal dism'd and cert. denied, 359 U.S. 28 (1959).
- ⁴¹ 15 U.S.C. sec. 381 (1959).
- ⁴² See Jerome R. Hellerstein, *Tax Law Review* 30 (1975): 155, 156. (1975)
- ⁴³ 392 U.S. 339 (1968).
- ⁴⁴ 392 U.S. at 348.
- ⁴⁵ See Hartman, p. 376.
- ⁴⁶ 12 U.S.C. sec. 548 (1982).
- ⁴⁷ Advisory Commission on Intergovernmental Relations (ACIR), *State and Local "Doing Business" Taxes on Out-of-State Financial Depositories, Report of a Study under Public Law 93-100*, Before the Senate Committee on Banking, Housing, and Urban Affairs, 94th Congress, 1st Session (Committee Print, 1975), p. v.
- ⁴⁸ ACIR, *State and Local "Doing Business" Taxes*, pp. 48-49.
- ⁴⁹ Cf. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 476; *McCarroll v. Dixie Greyhound Lines, Inc.*, 309 U.S. 176, 188-189 (1940).
- ⁵⁰ See e.g. *Burger King v. Rudzewicz*, 471 U.S. 462 (1985). In upholding jurisdiction over an out-of-state defendant who had no office or other physical presence in the state asserting jurisdiction, the high Court noted that "it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a state in which business is conducted."
- ⁵¹ See ACIR, *State Regulation of Banks in an Era of Deregulation* (Washington, DC: ACIR, 1988).
- ⁵² ACIR, *State and Local "Doing Business" Taxes*, pp. 374-375.
- ⁵³ The Massachusetts law provided that an out-of-state bank holding company with its principal place of business in one of five New England states (Connecticut, Maine, New Hampshire, Rhode Island, and Vermont), which is not directly or indirectly controlled by another corporation with its principal place of business located outside of New England, may establish or acquire a Massachusetts-based bank or bank holding company, provided that the other New England state accords equivalent reciprocal privileges to Massachusetts banking organizations. Massachusetts Gen. Laws Ann., ch. 167A, sec.2.
- ⁵⁴ See Conference of State Bank Supervisors, *State of the State Banking System* (Washington, DC: the Conference, 1989). For a complete description of state regulation of interstate banking, see, ACIR, *State Regulation of Banks in an Era of Deregulation*.
- ⁵⁵ See e.g. Douglas H. Ginsburg, "Interstate Banking," *Hofstra Law Review* 9 (1981): 1133.
- ⁵⁶ House Report. No. 99-426, 99th Congress, 1st Session (1986), p. 393.
- ⁵⁷ 757 F.2d 453 (2nd Cir., 1985); cert. denied, 106 S.Ct. 2926 (1986).
- ⁵⁸ "New England Bank without Walls Depends on US Mail to Bring Deposits Offering Investors Higher Rates," *American Banker*, June 23, 1986, p. 24.
- ⁵⁹ "TSO Welcomes Long-Distance/Nationwide Customers with System that Could Make Walk-in Banking Passe," *American Banker*, August 4, 1986, back page.
- ⁶⁰ "Chemical Enters Connecticut Consumer Market with Phone and Mail Premium Banking Service," *American Banker*, December 17, 1985, p. 23.
- ⁶¹ See Conference of State Bank Supervisors, *State of the State Banking System*, 1989.
- ⁶² *Ibid.*
- ⁶³ *Ibid.*
- ⁶⁴ According to regulatory accounting practices, only loans that are sold without recourse can be removed from the institution's balance sheet. Once the loans are sold without recourse, banks have no legal or contractual obligation to buy back the assets. Nevertheless, some regulators maintain that loan securitization is not risk-free. For example, one official at the Office of the Comptroller of the Currency has warned that "cultural forces morally obligate banks to buy back sour assets . . . you honor what the market perceives to be your commitment, and that is to back up the assets you sell." "Regulator Cites Risks of Asset Securitization," *American Banker*, March 30, 1989, p. 3.
- ⁶⁵ See e.g. "Securitization: What Will They Package Next," *American Banker*, January 7, 1987, p. 1; and "Securitization May Soon Extend to Commercial Loans," *American Banker*, December 16, 1987, p. 16.
- ⁶⁶ *Ibid.*
- ⁶⁷ Unless the state considers the securitized loans nonbusiness income, an unlikely event.
- ⁶⁸ See 1985 New York Tax Law, sec. 1454; 20 NYCRR 19-6.2(d)(1)-(5).
- ⁶⁹ See Minnesota Stat. Ann. sec. 290.191, subd.6.
- ⁷⁰ For example, see New York Tax Law 1454 (a)(2)(E); and Minnesota Stat. Ann. 290.191, subd.7.
- ⁷¹ In a July 7, 1989, memorandum to the Bank Working Group of the U.S. Advisory Commission on Intergovernmental Relations, William Fox argues that a source-based approach with direct allocation to the home state of all bank income not taxed elsewhere will avoid a non-neutrality inherent in the dual approach, whereby "banks will be placed at a disadvantage when operating in any state that has a lower effective rate than their state of domicile because they will pay their home state's higher rates (on their total income)." This non-neutrality does not occur in reverse, however, because a bank domiciled in a low-tax state will pay the high-state's tax rate only on income earned in that state. A state also can attempt to allocate to itself all of the income received by its domiciliary banks from securities. Because the income from securitized loans is surely "business income," however, it may not be possible for a domiciliary state using source-based taxation with formula-based apportionment to allocate the income from securities to itself.
- ⁷² John Kincaid and Sandra B. McCray, "State Bank Taxation and the Rise of Interstate Banking: A Survey of States," *Intergovernmental Perspective* 14 (Fall 1988): 18. Seven states reported that they use a bank shares tax, four levy a gross receipts tax, and six impose another type of tax on banks.
- ⁷³ Jerome R. Hellerstein, *State Taxation* (Boston: Warren, Gorham, & Lamont, 1983), p. 266.
- ⁷⁴ *Memphis Bank & Trust Company*, 103 S.Ct. 692 (1983).
- ⁷⁵ Hartman, *Federal Limitations on State and Local Taxation*, Cumulative Supplement 237.
- ⁷⁶ For a discussion of state franchise taxes on banks, see Sandra B. McCray, "State Taxation of Interstate Banking," *Georgia Law Review* 21 (1986): 283. A state that imposes a franchise tax measured by net worth can also include the value of federal

obligations in the computation of net worth. *Werner Machine Co. v. Director of Taxation*, 350 U.S. 492 (1956).

⁷⁷ Kincaid and McCray, "State Bank Taxation and the Rise of Interstate Banking: A Survey of States."

⁷⁸ See e.g. 1988 Minnesota Statutes 290.01. Such a tax jurisdiction rule should be constitutional. See e.g. McCray, "State Taxation of Interstate Banking."

⁷⁹ See Sandra B. McCray, "Constitutional Issues in State Apportionment of Income: Financial Institutions," *Albany Law Review* 51 (1987): 895. If State A taxes its domiciliary Bank A on 100 percent of its net income and State B taxes Bank A on its income from loans made to residents of State B, multiple taxation will result. In such a case, it is likely that the residence-based tax of State A will fail. See *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980).

⁸⁰ Hartman, *Federal Limitations on State and Local Taxation*, p. 522.

⁸¹ *Ibid.* See *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 120.

⁸² 254 U.S. 113 (1920).

⁸³ Hellerstein, *State Taxation*, p. 323.

⁸⁴ *Ibid.*, p. 325

⁸⁵ Hartman, *Federal Limitations on State and Local Taxation*, p. 523.

⁸⁶ In its response to the ACIR survey, Alabama reported that it allows banks to use the UDITPA apportionment formula to calculate their separate tax liability within the states.

⁸⁷ See generally *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).

⁸⁸ "States have wide latitude in the selection of apportionment formulas. . ." *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 274 (1978).

⁸⁹ Hellerstein, *State Taxation*, p. 495.

⁹⁰ 7A U.L.A. 331 (1957).

⁹¹ See Hellerstein, *State Taxation*, pp. 496-498, for charts listing jurisdictions that have adopted UDITPA.

⁹² *Ibid.*, pp. 495-536.

⁹³ *Ibid.*, pp. 572-600.

⁹⁴ *Ibid.*, p. 577.

⁹⁵ *Ibid.*, pp. 578-600.

⁹⁶ Those states are: Connecticut, Florida, Illinois, Kentucky, Massachusetts, New York, Ohio, West Virginia, Wisconsin, Minnesota, Nebraska, and North Carolina.

⁹⁷ The resulting formula looks as follows:

$$\frac{1}{4} \frac{\text{payroll in state}}{\text{payroll in all states}} + \frac{\text{tangible property in state}}{\text{tangible prop. in all states}} + 2x \frac{\text{sales in state}}{\text{sales in all states}}$$

⁹⁸ The following examples illustrate the effects of double-weighting the sales factor.

Situation 1. Effect of a Double-Weighted Sales Factor on Domiciliary Corporations—Assume that 60 percent of a taxpayer's property, 60 percent of its payroll, and 25 percent of its sales were in State X. If State X weighted each of those factors evenly, then, the average of those three factors would be 145 percent/3 or 48.33 percent. With an evenly-weighted formula, 48.33 percent of the taxpayer's apportionable income would be attributed to State X for corporate income tax purposes. Now suppose that State X modifies its formula to

double-weight the sales factor. The effect would be to reduce the percentage of income attributed to State X to 42.5 percent $[(.60 + .60 + 2x.25)/4 = .425 = 42.5\%]$. The bias in favor of domiciliary corporations with a double-weighted sales factor is even greater if the taxpayer has a greater portion of its property and payroll in the state and still makes a major portion of its sales to out-of-state buyers. Suppose that the mix is 90 percent property, 90 percent payroll, and 15 percent sales in-state. The evenly-weighted formula will attribute 65 percent of the taxpayer's income to State X $[(.90 + .90 + .15)/3 = 65\%]$. The same mix will produce a percentage of only 52.5 percent under the double-weighted sales factor formula $[(.90 + .90 + 2x.15)/4 = 52.5\%]$.

Situation 2. The Effect of a Double-Weighted Sales Factor on Out-of-State Corporations—Assume that the out-of-state taxpayer has only 5 percent of its property and 5 percent of its payroll within State X but makes 20 percent of its sales into State X. The evenly-weighted three-factor formula attribute 10 percent of the taxpayer's income to State X $[(.05 + .05 + .20)/3 = 10\%]$. The double-weighted sales factor will increase that percentage to 12.5 percent $[(.05 + .05 + 2x.20)/4 = 12.5\%]$.

The examples are based on those given by Eugene Corrigan of the Multistate Tax Commission in *Multistate Tax Review* 2 (June 1987): 9. For a thorough discussion of the effects of the double-weighted receipts factor, see Gerald Pomp, "Reforming a State Corporate Income Tax," *Albany Law Review* 51 (1987): 383, 570.

⁹⁹ See generally Hellerstein, *State Taxation*, pp. 582-600.

¹⁰⁰ *Ibid.*, pp. 583-588.

¹⁰¹ *Ibid.*, pp. 588-594. Other differences in state rules, too numerous to list here, appear in Hellerstein, *State Taxation*, Tables 9-2 through 9-5, pp. 618-629.

¹⁰² According to Hellerstein, "The selection of the situs to which to attribute intangible property is fraught with exceptional complications." Hellerstein, *State Taxation*, p. 573.

¹⁰³ In fact, the Court has recognized three different places at which the situs of a debt might be fixed: the domicile of the owner (creditor) (*State Tax on Foreign Held Bonds*, 15 Wall. 300 (1872); *Kirtland v. Hotchkiss*, 100 U.S. 491 (1879), the domicile of the debtor (*Blackstone v. Miller*, 188 U.S. 189 (1903) (*ovrd. Farmer's Loan Co. v. Minn.*, 280 U.S. 204 (1929)); and, the state in which the debt has a business situs, i.e. where the debt originated in the course of business transacted in a state (*New Orleans v. Stempel*, 175 U.S. 309 (1899), *Bristol v. Washington County*, 177 U.S. 133 (1900), *Metropolitan Life Insurance Co. v. New Orleans*, 205 U.S. 395 (1907)). According to the Court, each of those states offered the taxpayer the benefits and protections of its laws. See generally McCray, "State Taxation of Interstate Banking," p. 283. As pointed out by Paul Hartman, Professor Emeritus at Vanderbilt University Law School, it is somewhat anomalous to speak of the "situs" of intangibles. Citing *State Tax Commission v. Aldrich*, 316 U.S. 174, 178, Hartman notes that the "situs" of intangibles is just a judicially approved taxable "relationship" between persons, natural or corporate. Correspondence from Paul Hartman, August 4, 1988.

¹⁰⁴ *Curry v. McCanness*, 307 U.S. 357 (1939). Of course, the commerce clause does prohibit multiple taxation.

¹⁰⁵ *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 273 (1978).

¹⁰⁶ See McCray, "Constitutional Issues in State Apportionment of the Income of Multistate Businesses: Financial Institutions."

¹⁰⁷Both states have a legitimate claim to include the interest and fee income from the loan in the numerator. Both states have the necessary nexus to do so. See note 103.

¹⁰⁸This is the UDITPA formula, which is used by approximately 11 states to apportion the income of banks; see text, page 22 (note 125).

¹⁰⁹Viewed from a nationwide perspective, formula-based apportionment is far from simple. See text, pages 15-16 (notes 86-100).

¹¹⁰7A U.L.A. sec.2, at 340 (1957).

¹¹¹It is important to recognize that a special set of potentially difficult problems may occur if states try to conform fully to the federal model. Key issues would arise, for example, regarding whether the states decided to embrace federal concepts, such as sourcing and allocation rules, that have been developed in the international context.

¹¹²Commerce Clearing House, *All States State Tax Guide*, 1523. Seven states are not represented in the CCH Tables.

¹¹³Alabama Code, sec. 40-18-21; Rhode Island G.L., secs. 44-14-11 and 44-14-13. The Rhode Island law allows domestic banks a deduction, but not a credit, for taxes paid to other states. The tax was recently upheld by the Rhode Island Supreme Court in *Commercial Credit Consumer Services v. Norberg*, 518 A2d 1336 (R.I. 1986). Indiana H.B. 1625 was passed by the Indiana legislature in the 1989 legislative session and signed by the Governor in May 1989.

¹¹⁴The due process clause does not preclude the state of domicile from taxing the entire income of its citizens, *Lawrence v. State Tax Commission*, 286 U.S. 276 (1932); *New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937). Nor does the due process clause prevent the state of domicile from taxing the entire income of its domestic corporations, *Matson Navigation Co. v. State Board of Equalization*, 297 U.S. 441 (1936); *Cream of Wheat v. County of Grand Forks*, 253 U.S. 325 (1920); *G. Altman & F. Keesling, Allocation of Income in State Taxation* (2d ed. 1950), p. 31. Recently, the high court has indicated that a tax credit will satisfy the "fair apportionment" requirement of the Commerce Clause. See *Tyler Pipe Indus. v. Washington Dept of Revenue*, 107 S. Ct. 2810, 2819-21; *D.H. Holmes Co. Ltd. v. McNamara*, 108 S. Ct. 1619 (1988). And see McCray, "Constitutional Issues in State Apportionment of Income."

¹¹⁵For the definition of a "foreign bank" see 12 U.S.C. 3101 (7), (8).

¹¹⁶See 12 U.S.C. 3103 et seq.

¹¹⁷If the domiciliary bank is part of a bank holding company that operates in several states through separately chartered subsidiaries, each such subsidiary is by definition a domiciliary bank of the state which it has designated as its principal place of business.

¹¹⁸Many commentators have noted the complexity of the U.S. system, particularly the calculation of the foreign tax credit and the application of the source rules. For example, the Internal Revenue Code ("Code") gives a tax credit only for "net income taxes" paid to foreign countries. This provision has proved difficult to administer. Many foreign countries levy "taxes" that bear little resemblance to the U.S. net income tax, and the Internal Revenue Code does not permit multinationals to claim a credit against such charges. For this reason, the Internal Revenue Code contains intricate rules that control which foreign charges are creditable.

¹¹⁹Hellerstein, *State Taxation*, p. 266.

¹²⁰Given the same facts, Bank A would pay a total tax of \$70,000 under formula-based apportionment, calculated as follows:

\$49,000 to State X ($\$1,000,000 \times 70\% = \$700,000 \times 7\% = \$49,000$), \$14,000 tax to State Y ($20\% \times \$1,000,000 = \$200,000 \times 7\% = \$14,000$); and \$7,000 tax to State Z ($10\% \times \$1,000,000 = \$100,000 \times 7\% = \$7,000$). The total tax burden on Bank A will also be the same under the dual system and formula-based apportionment if its domiciliary state has a tax rate which is less than that of all other states taxing the bank.

¹²¹Because the disparity is inherent in the differing rate structures, not in the tax credit system itself, the system is not constitutionally infirm. A state tax system that is internally consistent, as is the dual system, is not unconstitutional simply because the tax scheme of another state increases the aggregate tax burden on a multistate corporation. *Armco, Inc. v. Hardesty*, 467 U.S. 638, 644-45 (1984); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); McCray, "Constitutional Issues in State Apportionment of Income."

¹²²The following calculation illustrates this proposition. Define R, P, and B as the total receipts, payroll, and apportionable base, respectively, of the entire corporation, and R_b and P_b as the receipts and payroll of the branch in Indiana. If a single-factor formula is employed, the taxable income attributable to Indiana is given by the formula $T_1 = [R_b/R]B$. If instead Indiana employs a two-factor formula, the taxable income attributable to Indiana is given by the formula

$$T_2 = [1/2][R_b/R + P_b/P]B.$$

It will be advantageous for the market state to use the two-factor formula only if $T_2/T_1 > 1$, or $[1/2][R_b/R + P_b/P][R/R_b] > 1$. A little algebra shows that this equation is tantamount to the equation $R_b/P_b < R/P$.

¹²³*Moorman Manufacturing Co. v. Bair*, 437 U.S. 267.

¹²⁴Kincald and McCray, "State Bank Taxation and the Rise of Interstate Banking: A Survey of States."

¹²⁵New York, California, and Minnesota are three such states.

¹²⁶Such property is also easily moved from state to state or even outside the United States. The Congress recently grappled with this problem in the *Tax Reform Act of 1986*. According to the House Committee report, "The lending of money is an activity that can often be located in any convenient jurisdiction, simply by incorporating an entity in that jurisdiction and booking loans through that entity, even if the source of the funds, the use of the funds, and substantial activities connected with the loans are located elsewhere." See House Report No. 99-426, 99th Congress, 1st Session (1986), p. 393.

¹²⁷See note 103.

¹²⁸The numerator of the payroll factor was limited to 80 percent to encourage banks to maintain a large employee base in New York. See Kalttenborn, "Is New York's Bank Tax Ready for the 1990's?" *Journal of State Taxation* 4 (1985): 225.

¹²⁹1985 New York Tax Law, sec. 1454; 20 NYCRR 19-6.2(a). 1985 New York Tax Law, sec. 1454; 20 NYCRR 19-6.2(a).

¹³⁰Consider, for example, the following definitions of the terms "solicitation," "investigation," "negotiation," and "administration." According to the regulation, "active solicitation" occurs when an employee of the banking corporation initiates the contact with the customer. Such activity is located at the office where the bank's employee is regularly connected, regardless of where the services of such employee were actually performed. "Passive solicitation" occurs when the customer initiates the contact with the taxpayer. If the customer's initial contact was not at an office of the taxpayer, the office where the passive solicitation is deemed to occur is determined by the facts in each case. "Investigation" is located at the office where the taxpayer's employees are regularly connected, regardless of where the services of such employee were actually performed. "Negotiation" and "approval" are located accord-

ing to the rule for investigation above. "Administration" is located at the office that oversees the activity of bookkeeping, collecting the payments, corresponding with the customer, and proceeding against the borrower if it is in default. 20 NYCRR 19-6.2 (d) (1)-(5).

¹³¹ 1985 New York Tax Law, sec. 1454; 20 NYCRR 19-6.6.

¹³² 1985 New York Tax Law, sec. 1454; 20 NYCRR 19-7.8.

¹³³ Minnesota Stat. Ann., sec. 290.191, subd.3.

¹³⁴ Ibid.

¹³⁵ Minnesota Stat. Ann., sec. 290.191, subd.6.

¹³⁶ Ibid.

¹³⁷ Ibid.

¹³⁸ Ibid.

¹³⁹ Minnesota Stat. Ann., 290.191, subd.11.

¹⁴⁰ Minnesota Stat. Ann., sec. 290.191, subd.12.

¹⁴¹ *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267; and see McCray, "Constitutional Issues in State Apportionment of Income."

¹⁴² Michigan Stat. Ann., 7.558 (10).

¹⁴³ Phone conversation with Fred Lynch, Administrator, Michigan Single Business Tax, August 16, 1988.

¹⁴⁴ Ibid.

¹⁴⁵ Phone conversation with Benjamin Miller, Counsel for Multistate Tax Affairs, California Franchise Tax Board, September 7, 1988.

¹⁴⁶ Because the law treats parent corporations and their subsidiaries as isolated entities, a group of related corporations doing business across state lines can practice tax avoidance through interstate profit shifting. Consider, for example, the following situation. Corporation A, a manufacturing company, is located in and doing business in State A, a state with a high state income tax rate. Corporation A has a wholly owned subsidiary, Corporation B, which is located in State B, a state that does not have an income tax. Company A manufactures widgets and company B assembles and sells the widgets throughout the United States, but not in State A. The two companies are clearly integrated economically. In such a situation, it is relatively easy for Company A to avoid State A's income tax by arranging to have the bulk of the profits from the sale of the widgets fall in State B. Company A merely charges Company B an artificially low price for the widgets, so that it receives little income in State A. Company B then sells the widgets at their normal retail price and receives all of the profits in State B, which has no income tax. Multistate Tax Affairs, California Franchise Tax Board, September 7, 1988.

¹⁴⁷ Corporation A may file a combined report in State X. After eliminating intercorporate transactions (because the transactions between Corporation A and the members of its unitary group cannot produce a real economic profit or loss, income is recognized for tax purposes only when the entire process of production and sale is completed, i.e., on the ultimate sale to third parties), the total gross receipts and total deductions for the entire economic enterprise are itemized and netted to produce the apportionable base. This base is then apportioned

among the jurisdictions in which the unitary group conducts its activities according to a formula that measures the contribution of such activities in each state to the profit of the whole.

¹⁴⁸ *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 178 (1983).

¹⁴⁹ California, a pure source-based income tax state, has, however, recently begun dealing with the application of the unitary business principle to unitary enterprises that are engaged in both general businesses and financial businesses. The first case to be litigated in California involved Sears (a general business under California law) and Sears Roebuck Acceptance Corporation (a financial business under California law). The Franchise Tax Board is in the process of drafting regulations that would require "preapportionment" of the income of such a combined group in order to separate the general business income from the financial income. The separation is necessary because the formula used for general business corporations is different than that used for financial institutions. Phone conversation with Ben Miller.

¹⁵⁰ 12 U.S.C. 24 (1984).

¹⁵¹ 12 U.S.C. 1843(a) (1982).

¹⁵² It is true that State A could assess its tax on the income received by it from Company A's credit card activities. It is unlikely to do so, however, since one of the reasons for setting up credit card subsidiaries is to take advantage of low-tax or no-tax jurisdictions (originally, the primary reason for setting up credit card subsidiaries was to escape state usury ceilings).

¹⁵³ See McCray, "State Taxation of Interstate Banking."

¹⁵⁴ *Burger King v. Rudzewicz*, 471 U.S. 462, 476 (1985).

¹⁵⁵ 1985 New York Tax Law, sec. 1451 (a), sec. 1462 (f).

¹⁵⁶ Minnesota Stat. Ann., sec. 290.015. In addition to the four items listed, "solicitation" includes advertising in publications with their circulation primarily in Minnesota; advertising in regional or Minnesota editions of national publications; advertising in national publications sold over the counter or by subscription in Minnesota; direct telephone or other electronic solicitation in Minnesota.

¹⁵⁷ Ibid.

¹⁵⁸ See *First Family Mortgage v. Durham*, 528 A.2d 1288 (1987).

¹⁵⁹ Minnesota Stat. Ann., sec. 290.015, subd. 3(b).

¹⁶⁰ See Minnesota Stat. Ann., sec. 290.371.

¹⁶¹ New Jersey Stat. Ann., 14A:13-20(b). Another section of the statute has language which permits the offending corporation to cure the defect and regain access to the state's courts. New Jersey Stat. Ann., 14A: 13-20(a) provides that, "No foreign corporation carrying on any activity or owning or maintaining any property in this State which has not obtained a certificate of authority to do business in this State and disclaims liability for the corporation income tax shall maintain any action or proceeding in any State or Federal court in New Jersey, until such corporation shall have filed a timely notice of business activities report" (emphasis added). The Minnesota statute contains similar provisions.

¹⁶² 528 A.2d 1288 (1987).

**Advisory Commission on
Intergovernmental Relations
and
National Association of Tax Administrators***
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Appendix

State Bank Tax Survey and Findings

Taxation of Financial Institutions

1. Does your state tax banks using a franchise tax, net income tax, bank shares tax, gross receipts tax, or other tax?
2. If your state uses a franchise tax, is that tax measured by net income or some other method?
3. Does your state include the value of or income from federal and state obligations in the measure of the tax?
4. Does your state tax general (nonfinancial) business corporations in the same manner as it taxes banks (if no, explain the differences)?
5. Does your state tax savings and loan institutions in the same manner as it taxes banks (if no, explain the differences)?

State Constitutional Limits

6. Does your state constitution place any restrictions on state taxation of domestic banks or savings and loan institutions (if yes, what are the restrictions)?
7. Does your state constitution place any restrictions on state taxation of out-of-state banks or savings and loan institutions (if yes, what are the restrictions)?
8. Does your state constitution place any restrictions on state taxation of income from state or municipal obligations (if yes, what are the restrictions)?

Taxation of Income of Out-of-State Banks

9. Does your state tax any of the following interstate income-producing activities of out-of-state banks? For each activity, indicate whether taxation is by statute, regulation, or administrative practice:
 - a. interest income from credit cards issued to residents of the state by an out-of-state bank that has no office or employees in your state
 - b. interest income from loans solicited by in-state representatives of out-of-state banks
 - c. interest income from loans solicited at loan production offices located in your state but closed at the out-of-state home office of the soliciting bank
 - d. interest income from loans made to residents of your state by an out-of-state bank that has no office, employees, or representatives in your state and secured by personal property located in your state
 - e. interest income from loans made to residents of your state by an out-of-state bank that has no office, employees, or representatives in your state and secured by real property located in your state

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10. Does your state require an out-of-state bank that solicits loans or deposits in your state through a loan production office to register or apply for a license (if yes, what are the requirements)?
11. Does your state require an out-of-state bank that solicits loans or deposits in your state through an agent or representative to register or apply for a license (if yes, what are the requirements)?
12. Does your state require the agent or representative of an out-of-state bank who solicits loans or deposits in your state to register or apply for a license (if yes, what are the requirements)?

Apportionment of Taxable Income

13. Does your state bank tax law or department regulations contain an apportionment formula to measure the taxable income of banks (if yes, describe the formula)?

14. If your state does not have either a law or regulations governing the apportionment of bank income, do you use the three-factor UDITPA formula or some other formula to apportion that income (give a brief description of the formula)?

Future Plans

15. Does your state have any plans to broaden its jurisdictional rules in order to tax the income that out-of-state banks receive from banking transactions conducted with residents of your state solely by mail or through electronic means (if yes, indicate legislation, regulations, or administrative interpretations)?
16. Does your state have any plans to change the formula it currently uses to apportion the income of banks (if yes, indicate whether legislation, regulations, or administrative interpretations)?

Findings

Table 1
State Bank Taxes
 (Survey Questions 1 and 2)

State	Franchise	Net Income	Bank Shares	Gross Receipts	Other
Alabama*	X				
Alaska		X			
Arizona		X			
Arkansas	X	X			
California*	X				
Colorado		X			
Connecticut*	X				
Delaware*	X				
District of Columbia*	X				
Florida*	X				
Georgia		X		X	A
Hawaii*	X				B
Idaho		X			
Illinois		X			
Indiana		X	X	X	
Iowa*	X				
Kansas*	X				
Kentucky			X		
Louisiana	X	X	X		
Maine*	X				
Maryland*	X				
Massachusetts*	X				
Michigan					C
Minnesota*	X				
Mississippi	X	X	X		D
Missouri*	X				
Montana*	X				
Nebraska	X				
Nevada					E
New Hampshire		X	X		
New Jersey*	X				
New Mexico	X	X		X	
New York*	X				
North Carolina	X	X			
North Dakota*	X				
Ohio	X				
Oklahoma	X	X			
Oregon		X			
Pennsylvania			X		
Rhode Island*	X	X	X		F
South Carolina*	X				
South Dakota*	X				
Tennessee	X	X			G
Texas	X				
Utah*	X	X			
Vermont	X				
Virginia	X				
Washington				X	
West Virginia	X	X			
Wisconsin*	X				
Wyoming					E

* States that measure franchise tax by net income. Missouri also has a franchise tax measured by bank shares and surplus.

A—corporate net worth tax

B—use tax

C—single business tax

D—ad valorem property tax

E—real and tangible personal property tax only

F—excise tax on banks on the higher of 8 percent of net income or \$2.50 for each \$10,000 of authorized capital stock

G—annual assessment of 1/25 percent of bank assets

Table 2
**States Reporting Inclusion of Federal
or State Obligations in Bank Tax**
(Survey Question 3)

State	State Obligations	Federal Obligations	State	State Obligations	Federal Obligations
Alabama	X	X	Minnesota	X	X
Alaska	X		Missouri	X	X
California	X	X	Montana	X	X
Connecticut	X	X	New Jersey	X	X
Delaware	X	X	New York	X	X
District of Columbia	X		North Carolina	X	X
Florida	X	X	North Dakota	X	X
Georgia	X	X	Ohio	X	X
Hawaii	X	X	Pennsylvania	X	
Illinois	X		South Carolina	X	X
Iowa	X	X	South Dakota	X	X
Kansas	X	X	Tennessee	X	X
Kentucky	X		Utah	X	X
Maine	X	X	Virginia	X	X
Maryland	X	X	West Virginia	X	
Massachusetts	X	X	Wisconsin	X	X
Michigan	X				

Table 3
**States Reporting Taxing Banks and Other Corporations
in the Same Manner**
(Survey Questions 4 and 5)

State	General Business	Savings and Loans	State	General Business	Savings and Loans
Alabama		X	Montana	X	X
Alaska	X	X	Nebraska		X
Arizona	X	X	Nevada	X	X
Arkansas	X	X	New Hampshire		X
California		X	New Jersey	X	X
Colorado	X		New Mexico	X	
Connecticut	X	X	New York		X
District of Columbia	X	X	North Carolina	X	X
Florida	X	X	North Dakota		X
Georgia		X	Ohio		X
Hawaii		X	Oregon	X	X
Idaho	X	X	Rhode Island		X
Illinois		X	South Dakota		X
Iowa		X	Tennessee	X	X
Kansas		X	Texas	X	
Maine		X	Utah	X	X
Maryland		X	Vermont		X
Massachusetts		X	Washington	X	X
Michigan	X	X	West Virginia	X	X
Minnesota	X	X	Wisconsin	X	X
Mississippi	X	X	Wyoming		X
Missouri		X			

Table 4
States Reporting Constitutional Restrictions on Taxation
 (Survey Questions 6, 7, and 8)

State	Domestic Banks or S&Ls	Out-of-State Banks or S&Ls	Income from State/Municipal Obligations
Alabama		X	
Arizona			X
California	X	X	X
Kentucky			X
Ohio		X	
Oregon			X
West Virginia	X		

Table 5
States Reporting Taxation of Income of Out-of-State Banks, by Type of Income and Method
 (Survey Question 9)

State	Type of Income (Method)				
Alabama	C(P)				
Alaska	A(P)	B(P)	C(P)		
Arizona	A(P)	B(P)	D(P)	E(P)	
California	A(R)				
Connecticut	B(R)	C(R)			
District of Columbia	C(S)	D(R)	E(R)		
Florida	A(S)	C(S)	D(S)	E(S)	
Georgia	A(S)	B(S)	C(S)	D(S)	E(S)
Hawaii	C				
Idaho	B(S)	C(S)			
Indiana	B	C			
Louisiana	B(S)	C(S)			
Maine	C(R)				
Maryland	C(P)				
Minnesota	A(S)	B(S)	C(S)	D(S)	E(S)
Mississippi	B(S)	C(R)			
Missouri	B	C	D	E	
Nebraska	A(R)	B	C	D	E
New Hampshire	A(S)	B(S)	C(S)	D(S)	E(S)
New Mexico	A(S)	B(S)	C(S)	D	E(S)
North Carolina	B(R)	C(R)			
North Dakota	C	D	E		
Ohio	A(S)	B(R)	C(S)	D(S)	E(S)
Oregon	B(R)	C(R)	E(R)		
Rhode Island	C(P)				
South Carolina	B(P)	C(P)			
South Dakota	B(S)	C			
Tennessee	C				
Virginia	C				
West Virginia	B(P)	C(P)			
Wisconsin	C(S)				

Key:
 A – interest income from credit cards issued to state residents by an out-of-state bank with no office or employees in the state (e.g., issuance of credit cards through the mail)
 B – interest income from loans solicited by in-state representatives of out-of-state banks (call programs)
 C – interest income from loans solicited at loan production offices located in the state but closed at the out-of-state home office of the soliciting bank
 D – interest income from loans made by an out-of-state bank with no office, employees, or representatives in the state to a resident of the state and secured by personal property in the state
 E – interest income from loans to residents of the state made by an out-of-state bank with no office, employees, or representatives in the state and secured by real property located in the state
 P – administrative practice
 R – regulation
 S – statute

Table 6
States Reporting License or Registration Requirements for Loans and Deposits on Out-of-State Banks
 (Survey Questions 10, 11, and 12)

State	Solicit through Loan Production Office	Solicit through Agent or Representative	Have Agent or Representative	State	Solicit through Loan Production Office	Solicit through Agent or Representative	Have Agent or Representative
Alabama	X	X	X	Missouri	X	X	
Alaska	X			New Mexico	X	X	X
California	X	X		New York	X	X	
Colorado	X		X	North Dakota	X	X	
Delaware		X		Oklahoma	X		
District of Columbia	X	X	X	South Carolina	X	X	X
Hawaii	X			South Dakota	X		
Idaho	X	X	X	Texas	X	X	X
Illinois	X	X		Utah	X	X	
Indiana	X	X	X	Washington	X		X
Maryland	X			West Virginia	X	X	
Minnesota	X	X					

Table 7
States Reporting Apportionment Formulas to Measure Taxable Bank Income, by Method
 (Survey Question 13)

State	Law	Regulation	State	Law	Regulation
Alaska	X		New Jersey	X	X
California		X	New Mexico	X	
District of Columbia		X	New York	X	X
Florida	X		North Carolina	X	X
Georgia	X		North Dakota	X	X
Illinois	X		Ohio	X	
Kansas	X		Oklahoma	X	X
Louisiana	X		Oregon		X
Maine	X		South Dakota	X	
Maryland	X		Tennessee	X	X
Michigan	X		Washington	X	
Minnesota	X		West Virginia	X	X
Montana	X		Wisconsin		X

Table 8
States Reporting Apportionment Formulas, by Type

State	UDITPA	Other	State	UDITPA	Other
Alaska		X	Minnesota		X
Arizona	X		Montana	X	
California		X	Nebraska		X
Connecticut		X	New Jersey	X	
District of Columbia		X	New Mexico	X	
Florida		X	New York		X
Georgia		X	North Carolina		X
Hawaii		X	North Dakota		X
Idaho	X		Oregon	X	
Illinois		X	South Carolina		X
Indiana	X		South Dakota	X	
Iowa		X	Tennessee		X
Kansas	X		Utah	X	
Maine	X		Vermont		X
Maryland		X	West Virginia	X	
Michigan		X	Wisconsin		X

Table 9
States Reporting Plans for Bank Tax Changes
 (Survey Questions 15 and 16)

State	Broaden Jurisdictional Rules	Change Apportionment Formula	State	Broaden Jurisdictional Rules	Change Apportionment Formula
Alabama	X		Kansas	X	X
Arizona	X	X	Massachusetts		X
California		X	Michigan	X	X
Colorado		X	Montana	X	X
District of Columbia	X		Ohio	X	
Georgia		X	Oklahoma	X	X
Idaho	X	X	Pennsylvania	X	X
Indiana	X	X	Utah	X	X
Iowa		X			

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