

# STATE TAXATION OF BANKS\*

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This paper deals with the problem of taxing national banks and their competitors within the framework of the limitations of section 5219, Revised Statutes,<sup>1</sup> which defines the power of states and their subdivisions to tax national banking associations.

\* This article is based on a talk before the American Bankers Association National Workshop on State Banking Laws, Chicago, Illinois, May 12, 1966.

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<sup>1</sup> 12 U.S.C. § 548 (1964):

*"State taxation.*

"The legislature of each State may determine and direct, subject to the provisions of this section, the manner and place of taxing all the shares of national banking associations located within its limits. The several States may (1) tax said shares, or (2) include dividends derived therefrom in the taxable income of an owner or holder thereof, or (3) tax such associations on their net income, or (4) according to or measured by their net income, provided the following conditions are complied with:

1. (a) The imposition by any State of any one of the above four forms of taxation shall be in lieu of the others, except as hereinafter provided in subdivision (c) of this clause.

(b) In the case of a tax on said shares the tax imposed shall not be at a greater rate 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 within the meaning of this section.

(c) In case of a tax on or according to or measured by the net income of an association, the taxing State may, except in case of a tax on net income, include the entire net income received from all sources, but the rate shall not be higher than the rate assessed upon other financial corporations nor higher than the highest of the rates assessed by the taxing State upon mercantile, manufacturing, and business corporations doing business within its limits: *Provided, however*, That a State which imposes a tax on or according to or measured by the net income of, or a franchise or excise tax on, financial, mercantile, manufacturing, and business corporations organized under its own laws or laws of other States and also imposes a tax upon the income of individuals, may include in such individual income dividends from national banking associations located within the State on condition that it also includes dividends from domestic corporations and may likewise include dividends from national banking associations located without the State on condition that it also includes dividends from foreign corporations, but at no higher rate than is imposed on dividends from such other corporations.

(d) In case the dividends derived from the said shares are taxed, the tax shall not be at a greater rate than is assessed upon the net income from other moneyed capital.

2. The shares of any national banking association owned by nonresidents of any State shall be taxed by the taxing district or by the State where the association is located and not elsewhere; and such association shall make return of such shares and pay the tax thereon as agent of such nonresident shareholders.

3. Nothing herein shall be construed to exempt the real property of associations from taxation in any State or in any subdivision thereof, to the same extent, according to its value, as other real property is taxed.

4. The provisions of section 5219 of the Revised Statutes of the United States as in force

As we shall see, the meaning of the restrictions imposed by section 5219 is not entirely clear. A well-rounded investigation requires a generous dose of legal expertise, something I lack. My interest is that of an economist who has worked with two tax commissions in Maryland. The reform program jointly recommended by these commissions was far-reaching, detailed, carefully worked out, and narrowly defeated, at least in the first instance, by the Maryland General Assembly. Bank taxation was only one of hundreds of matters with which the commissions dealt, but no part was more complex. This paper draws on the Maryland experience to illustrate concretely the problems of selecting from among alternative approaches to taxation of banks.

Although the stress here is on economic considerations, the legal intricacies of bank taxation tend always to obscure the economics. These legal intricacies constitute a major impediment to reform of bank taxes, partly because they impose restrictions on the ways national banks can be taxed and partly because the law is unclear so that it is difficult to know, in advance, whether a particular tax will stand up to a court test.

## I

### A SHORT HISTORY OF SECTION 5219<sup>2</sup>

Section 5219 originated in the 1864 revision of the National Banking Act of 1863.<sup>3</sup> Provision was made for the states to enact taxes upon the shares of national banks "at the place where such bank is located, and not elsewhere, but not at a greater rate than is assessed upon other moneyed capital in the hands of individual citizens of such state . . . [or] upon the shares in any of the banks organized under authority of the State where such association is located."<sup>4</sup> Repeated court tests have since upheld the federal government's power to prescribe what taxes, if any, states can levy on national banks.<sup>5</sup>

In 1868, the law was amended, primarily to allow shares of stockholders residing in the state in which a national bank's head office was located to be taxed by the local jurisdiction (city, county, special district) of residence of the owner, rather than by the local jurisdiction in which the head office itself was located.<sup>6</sup> In addition, however, the prohibition of discriminatory taxes was shortened by dropping the reference to state-chartered banks.

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prior to March 25, 1926, shall not prevent the legalizing, ratifying, or confirming by the States of any tax heretofore paid, levied, or assessed upon the shares of national banks, or the collecting thereof, to the extent that such tax would be valid under said section."

<sup>2</sup> This section draws heavily on Myers, *Bank Taxation*, in *TAXATION IN MINNESOTA* 277 (R. G. Blakey ed. 1932), and R. B. WELCH, *STATE AND LOCAL TAXATION OF BANKS IN THE UNITED STATES* (Special Report No. 7 of the State Tax Comm'n, State of New York, 1934).

<sup>3</sup> Act of June 3, 1864, ch. 106, § 41, 13 Stat. 111.

<sup>4</sup> *Id.* at 112.

<sup>5</sup> *E.g.*, *First Nat'l Bank of Guthrie Center v. Anderson*, 269 U.S. 341 (1926); *Des Moines Nat'l Bank v. Fairweather*, 263 U.S. 103 (1923); *Liberty Nat'l Bank v. Buscaglia*, 270 N.Y.S.2d 871 (App. Div. 1966); *Irvine v. Spaeth*, 210 Minn. 489, 299 N.W. 204 (1941).

<sup>6</sup> Act of Feb. 10, 1868, ch. 7, 15 Stat. 34.

The prescription laid down in 1864 and amended in 1868 produced a remarkable uniformity of state taxes on banks. Nearly all states applied identical share taxes to national banks and state-chartered banks and trust companies.

However, trouble was brewing. Inability to enforce taxation of intangibles at general property tax rates led many states to adopt classified systems that applied special low-rate taxes to most intangibles, in the justified hope of averting wholesale evasion. But bank shares were generally not classified for low-rate taxation, since evasion was not a problem and revenue from the share taxes was substantial. Did this constitute illegal discrimination against national banks? Did "other moneyed capital" mean only shares of state-chartered commercial banks, or did the term embrace a wide range of intangible personal property, including that classified for low-rate taxes? The legislative history of the 1868 amendment, and the wording of the statute itself, left the matter very uncertain. This invited recurring litigation, which culminated in the Supreme Court's 1921 *Richmond* decision.<sup>7</sup> The Court adopted a broad interpretation of "other moneyed capital" and found that favored taxation of interest-bearing securities in the hands of individuals under a classified property tax did discriminate against national banks.

The *Richmond* decision invalidated or called into serious question state taxes on national bank shares in at least twenty states. The potential revenue losses were great. Pressure for amendment of section 5219 brought results in 1923. The first change altered the antidiscrimination clause relating to share taxes to read as follows:

. . . shall not be at a greater rate 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 within the meaning of this section.<sup>8</sup>

Even with this proviso, however, the meaning of "other moneyed capital" was interpreted rather broadly in a number of subsequent cases,<sup>9</sup> and agitation for further amendment continued.

The second major change in 1923 was provision for alternative bank taxes.<sup>10</sup> Henceforth, a state could levy either of two taxes in lieu of the share tax. The first was a tax on net income of national banks at a rate no higher than that assessed on "other financial corporations nor higher than the highest of the rates assessed . . . upon the net income of mercantile, manufacturing, and business corporations." The

<sup>7</sup> *Merchants' Nat'l Bank v. City of Richmond*, 256 U.S. 635 (1921).

<sup>8</sup> Act of March 4, 1923, ch. 267, 42 Stat. 1499.

<sup>9</sup> *E.g.*, *First Nat'l Bank of Hartford v. City of Hartford*, 273 U.S. 548 (1927); *First Nat'l Bank of Guthrie Center v. Anderson*, 269 U.S. 341 (1926); *Knowles v. First Nat'l Bank of Shenandoah*, 58 F.2d 232 (8th Cir. 1932); *People ex rel. Morris Plan Co. v. Burke*, 253 N.Y. 85, 170 N.E. 502 (1930).

<sup>10</sup> Act of March 4, 1923, ch. 267, 42 Stat. 1499.

second was a tax on dividends in the hands of shareholders, at rates no higher than those imposed upon net income from "other moneyed capital."

Neither the tax on dividends nor the income tax on banks was an acceptable substitute for the old share tax, because neither would produce sufficient yields while still meeting the restrictions relating to discrimination. Interest on federal and most state and local obligations is exempt from state income taxes but figures importantly in the operating revenues of commercial banks. Thus the law was amended again in 1926 to permit still another method—an excise tax according to net income "from all sources" (with the same discrimination safeguard as was provided for taxes on net income in the 1923 amendment)—and also to permit use of the tax on dividends concurrently with either the income or the excise tax (but not with the share tax) as long as other corporate dividends were similarly taxed.<sup>11</sup> The excise tax base could include income from federal, state, and local securities because it was not a "direct" tax on this income but merely an excise tax "measured by" it.

And so the statute stands today. Under section 5219, the states may tax banks and their shareholders (1) on the value of shares, (2) on net income, (3) according to net income from all sources, and (4) on dividends. Method (4) may be used with methods (2) or (3), but otherwise the methods are mutually exclusive. In addition, section 5219 provides that banks may be taxed on real estate at the same rates applied to real estate in general. The meaning of provisions regarding discrimination against national banks, both with respect to share taxes and with respect to excise and income taxes, remains obscure, and this obscurity stands in the way of improvement of present bank taxes. We shall return to this problem later, in a discussion of Maryland's problems with bank taxation.

## II

### BANK TAXES IN 1966

The accompanying table (pages 154-55) summarizes present state taxes on banks under section 5219. Twenty-seven states still use the share tax, twenty employ the excise levied according to net income, two—South Carolina and Wisconsin—levy direct taxes on net income, and one—Washington—has no special bank taxes.<sup>12</sup>

The table reveals certain patterns. Excise and income taxes are largely confined to states that tax individual and corporate incomes. All but one of the twenty-two states that levy income or excise taxes also tax incomes of ordinary corporations, and nineteen tax individual incomes. On the other hand, only sixteen of the twenty-seven

<sup>11</sup> Act of March 25, 1926, ch. 88, 44 Stat. 223.

<sup>12</sup> At least as far as I can tell from a reading of the state tax services. The tax on bank shares was repealed in 1935 when Washington first imposed an income tax on banks and corporations. The income tax was later declared unconstitutional, and the bank share tax was restored, only to be declared inoperative by the Attorney General, apparently because it violated other provisions of Washington law.

share-tax states tax corporate incomes, and fifteen tax individual incomes. The latter states may not tax dividends on national bank stock, and typically the exemption is also accorded to dividends of state banks.

Among the twenty-one states that levy excise or income taxes on banks and also levy general corporation income taxes, the relation between bank tax rates and rates paid by ordinary business corporations is highly variable. In several states the bank tax rate is higher than the general income tax rates. In a few it is lower. In some cases the rates are identical, and in two states, flat rates applied to banks are bracketed by the high and low ends of the graduated rates paid by ordinary corporations.

Deduction of federal income taxes paid in calculating net income is allowed in about half of the income-tax and excise-tax states. Such deductibility lowers the effective rate on net income before taxes. For example, if a bank's federal tax is thirty per cent of net income, and the state tax rate is ten per cent, the "effective rate" is only seven per cent after deduction of federal tax paid.

About half of the states that impose excise taxes on banks also levy excise (or franchise) taxes measured by net income on ordinary business corporations. The rest tax corporate incomes directly. This point is potentially important, for reasons that will be discussed later.

Among the share-tax states, the rates of tax applied to bank shares, and the assessment methods, vary widely. Some states apply the general property tax rate to shares, but many have special limited rates. Interstate comparisons of property taxation are extremely difficult, because property tax laws and administration vary widely. Furthermore, within the same state, there may be thousands of different tax rates that could apply to bank shares, depending on the location of the bank and its shareholders, the number of taxing jurisdictions, and the degree of overlapping of jurisdictions.

In many states, state-chartered banks pay taxes that cannot be imposed on national banks. At least one state (Montana) subjects state banks to both the bank share tax and the corporation excise tax (measured by net income from all sources) and taxes dividends on state bank stock under the individual income tax as well. National banks pay only the share tax.

In general, one may conclude that if there is one "best" way to tax banks, most states do not employ it.

### III

#### THE PROBLEM IN MARYLAND: CASE STUDY OF A COMPLICATED CHOICE

With this background, let us consider the concrete case of Maryland to draw out the implications involved in the choice among alternative bank taxes and to illustrate the difficulties of making and implementing such a choice.

## STATE TAXES ON BANKS

1966

	Rate of Tax on Bank Shares	Rate of Corporation Income Tax	Individual Income Tax State?
<i>I. Share Taxes</i>			
Arkansas	General property tax rate on assessed value	1-5%*	Yes
Delaware	1/5 of 1% of true value	5	Yes
Florida	1 mill per \$1 on full cash value	None	No
Georgia	5 mills per \$1 plus local levies on market value	5	Yes
Illinois	General property tax rate on assessed value	None	No
Indiana	25¢ per \$100 on actual value	2	Yes
Iowa	6 mills per \$1 on assessed value	3	Yes
Kansas <sup>b</sup>	5 mills per \$1 on value	4.5	Yes
Kentucky	50¢ per \$100 plus local levies on cash value	5-7*	Yes
Louisiana	General property tax rate on 50% of value	4	Yes
Maine	15 mills per \$1 of assessed value <sup>c</sup>	None	No
Maryland	State rate plus local tax of \$1 per \$100 of assessed value	5	Yes
Michigan	5.5 mills per \$1 of capital	None	No
Mississippi	General property tax rate on assessed value	2-3*	Yes
Montana	General property tax rate on 30% of true value	5.25	Yes
Nebraska	8 mills per \$1 on actual value	None	No
Nevada	General property tax rate on 35% of cash value	None	No
New Hampshire	1% of par value <sup>c</sup>	None	No
New Jersey	3/4 of 1% of true value	1.75 <sup>d</sup>	Yes
New Mexico	General property tax rate on actual value	3	Yes
Ohio	2 mills per \$1 on book value	None	No
Pennsylvania	8 mills per \$1 on actual value	6	No
Tennessee	General property tax rate on actual cash value	4	No
Texas	General property tax rate on actual cash value	None	No
Virginia	10 mills per \$1 plus local levies on actual value	5	Yes
West Virginia	General property tax rate on actual value	None	Yes
Wyoming	General property tax rate on par value	None	No

\*Graduated.

<sup>a</sup>Typically, the assessed value of real estate is deducted from the value of shares to arrive at the share-tax base. The value is frequently determined by adding together the amount of capital, surplus, and undivided profits. In other cases, market value, capitalized earnings, and miscellaneous other approaches are employed.

<sup>b</sup>Kansas imposes a 5% excise tax on net income in lieu of the share tax.

<sup>c</sup>Applies to national banks. No mention of tax on state-chartered commercial banks is made in CCH STATE TAX GUIDE.

<sup>d</sup>Plus net worth or assets tax.

## A. Current Practice in Maryland

Maryland taxes the shares of its forty-six national banks, seventy-two state-chartered commercial banks, and domestic and foreign finance companies at a limited rate of \$1 per \$100 of assessed value for local purposes and at the general property tax rate (\$0.15 per \$100 in 1967) for state purposes. The \$1 local tax is distributed to the jurisdiction of residence of the shareholder, except that the tax on shares belonging to out-of-state residents goes to the jurisdiction where the head office of the bank is located. Shares are assessed at market value less the assessed value of real estate subject to the general property tax.

The share tax produced \$4.9 million in fiscal 1964, roughly one-half of one per cent of total state and local tax revenue. Of this, \$4.2 million was paid on bank shares; the rest was tax on shares of finance companies.

Maryland's only other tax on intangible property is a tax on shares of domestic public utilities, levied at the full state and local general property tax rates. All other intangibles taxes were abolished in 1937 when the individual and corporation income

STATE TAXES ON BANKS—Continued  
1966

	Rate of Bank Tax	Federal Income Tax Deductible?	Rate of Corporation Income Tax	Federal Income Tax Deductible?	Individual Income Tax State?
<b>II. Excise Taxes</b>					
<b>A. States with Direct Taxes on Net Income of Ordinary Corporations</b>					
Alabama	6%	Yes	5%	Yes	Yes
Alaska	2	No	18% of federal income tax	No	Yes
Arizona	5	Yes	1.3-6.6*	Yes	Yes
Colorado	6	No	5	No	Yes
Hawaii	11.7	No	5.85-6.435*	No	Yes
Missouri	7	Yes	2	Yes	Yes
North Carolina	4.5	No	6	No	Yes
North Dakota	4	Yes	3-5*	Yes	Yes
Oklahoma	4	Yes	4	Yes	Yes
Rhode Island	6 <sup>c</sup>	No	6 <sup>c</sup>	No	No
<b>B. States with Excise Taxes According to Net Income of Ordinary Corporations</b>					
California	9.5 <sup>f</sup>	No	5.5	No	Yes
Connecticut	5.25 <sup>e</sup>	No	5.25 <sup>e</sup>	No	No
Idaho	6	No	6+\$10 excise	No	Yes
Massachusetts	8(max.) <sup>g</sup>	No	6.765 <sup>e</sup>	No	Yes
Minnesota	12.54	Yes	10.23	Yes	Yes
New York	4.5	No	5.5 <sup>e</sup>	No	Yes
Oregon	8	No	6	No	Yes
Utah	6 <sup>e</sup>	Yes	6 <sup>e</sup>	Yes	Yes
Vermont	5	No	5	No	Yes
<b>C. State with Excise Tax on Net Income of Banks and No Excise or Income Taxes on Income of Ordinary Corporations</b>					
South Dakota	4.5	Yes	None	—	No
<b>III. Direct Income Taxes</b>					
South Carolina	4.5%	No	5%	No	Yes
Wisconsin	2-7*	Yes <sup>h</sup>	2-7*	Yes <sup>h</sup>	Yes

\*Graduated.

<sup>c</sup>Or alternative tax, whichever is greater.<sup>f</sup>Rate for 1965; the rate is determined annually.<sup>g</sup>Determined annually.<sup>h</sup>Wisconsin limits the deduction to 10% of net income before federal tax.

Note: Washington imposes no share, excise, or income taxes on banks.

Source: CCH STATE TAX GUIDE.

taxes were enacted.

All banks and finance companies are exempt from state and local tangible personal property taxes, and dividends on their stocks are exempt from the state individual income tax. Thus the required exemption of national banks and their dividends from these taxes is extended to state banks and finance companies. State banks and finance companies are, however, subject to the state general sales tax on their pur-

chases of taxable items. And finance companies must pay the corporation income tax, though national and state banks are exempt.

Savings and loan associations and mutual savings banks in Maryland are taxed at a low rate on gross income from investments. Ordinary business corporations are taxed five per cent on net income allocable to Maryland (without deductibility of federal income tax). Ordinary business corporations and unincorporated businesses, like banks, are subject to tax on real property. Unlike banks, they are taxed on tangible personal property, and these taxes, which are highly variable because of differing local exemptions, are, in the aggregate, substantial. In addition, ordinary businesses, like state banks, but unlike national banks, are subject to sales tax on their purchases of machinery, equipment, and certain supplies. This summary serves to indicate some of the complexities of business taxation in Maryland, although it ignores many complications that are not relevant to the problem of bank taxation.

#### B. Tax Reform and the Banks: The Finding of Overtaxation

In 1962 the Governor of Maryland appointed a special commission to study the State's fiscal problems. Early in 1965 this commission delivered a comprehensive plan of fiscal reform.

A Special Legislative Commission was named to study this plan and recommend legislation to the 1966 General Assembly. For the most part, the Special Legislative Commission accepted the guidelines that had been laid down by the Governor's Commission. The two commissions were not pleased with business taxation as they found it. In general, their recommended changes in business taxes reflect a belief that the taxes are now both too high and too diverse. The proposals envisaged a reduction or elimination of several special taxes on businesses, an expanded scope for the corporation income tax, and elimination of local taxes on business tangible personal property, to be replaced by a uniform low-rate state tax on this property. The over-all tax program extended far beyond reforms of business taxation and aimed at greater reliance on individual and corporate income taxes as opposed to property and miscellaneous levies.

As for the tax on bank shares, the Governor's Commission had concluded that banks are overtaxed and are probably taxed by the wrong method. Under Maryland law, bank shares are assessed at book value, market value, or net earnings after federal taxes capitalized at ten per cent, whichever is highest. In the case of all large banks, market value dominates; it produces a tax base about twenty-five per cent higher than the capitalization method. At \$1.15 per \$100, the share tax amounts, on the average, to about fourteen per cent of net income after federal taxes, and about ten per cent of net income before federal taxes. The ordinary business corporation, it will be recalled, pays state income tax of five per cent of net income before federal taxes, but also pays other taxes not paid by banks.

These figures indicated to the Commission that banks are overtaxed. The banks,



needless to say, were not alarmed by this conclusion. Indeed, they had complained about their taxes from time to time, although they had not made any concerted effort to get the law changed or to call the problem to the attention of either commission.

After publication of the original (Governor's) Commission report, the Maryland Bankers Association (MBA) appointed a committee to make specific recommendations to the Legislative Commission, which had to develop a concrete plan of reform. In a statement published in the summer of 1965, the MBA committee recommended that the state either revise the share-tax assessment method—assessing all shares at ten times earnings after federal taxes—or enact an excise tax based on net income from all sources without deduction of federal taxes. The rate of the latter, the MBA committee advised, should be lower than the five per cent rate paid by ordinary corporations, so as to reduce or eliminate the possibility that the excise tax, whose base includes income that is ordinarily tax-exempt, would be found to discriminate against national banks.

The Legislative Commission then turned to making up its own mind. The Commission's goals were easily stated: to tax national and state banks uniformly; to tax competing financial institutions as banks were taxed; to tax financial institutions in general no more heavily, or more lightly, than business in general.

### C. Excise Tax vs. Direct Income Tax

The first question was whether a shift from taxation of shares to either the income tax or the excise tax was appropriate. This led to consideration, first, of the relative merits of the two "income tax" approaches.

Because banks hold a large proportion of their total assets in federal and state and local government bonds, the base of a direct income tax on banks is probably less than half as large as that of an excise tax on net earnings from all sources.<sup>13</sup> One would not want to choose the excise tax simply because its base is larger. Thinking of this sort has led to such monstrosities as the turnover taxes still used by some nations and states. The question is whether the exemptions are merited.

Federal exemption of interest on state and local bonds has for years been contro-

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<sup>13</sup> Revenue from interest on federal, state, and local government securities is, for many—probably most—banks, as great as or greater than net income before federal income taxes. The most useful data available to the Maryland Commission were the summary tables of income of insured commercial banks in the United States and in Maryland published in the 1964 FDIC ANN. REP. 194-215. In 1964, FDIC data show that aggregate income from government bonds of all insured commercial banks in Maryland amounted to nearly 80% of net income before federal income taxes. It is clear from this aggregate data that exclusion of this income in calculating taxable income would, in a great many cases, reduce the tax base to zero. Only calculation on a bank-to-bank basis can indicate the precise size of the tax base. Moreover, income data reported to the FDIC are not identical with the data on which income taxes are based. (If deduction of federal income taxes were allowed in the determination of taxable income for state purposes, the state income tax base would probably be zero in all but a few cases. Maryland does not allow deduction of federal taxes under the individual or ordinary corporation income taxes, however.) The erosion of the tax base due to tax-exempt interest income could be reduced if allowable deductions were also reduced. Thus, the state might disallow interest and operating costs allocable to the tax-exempt bond portfolio. Despite the logic of this approach, the fact that the federal government does not follow it casts considerable doubt on its feasibility for Maryland.

versial. Defenders argue that exemption protects the sovereignty of the states and saves them money. Opponents stress that loss of tax revenue to the federal government exceeds the interest saving to state and local governments; that exemption permits individual taxpayers in the highest brackets to avoid much of the bite of federal income taxes into investment income; and that the exemption discourages wealthy investors from committing their funds to higher-priority private undertakings.<sup>14</sup>

Whatever are the merits of the dispute over exemption of interest on municipals from federal tax, it is hard to imagine that a state today would confer exemption on interest from federal obligations out of solicitude for the strength of the federal establishment or its fiscal problems. Thus the Commission had no trouble deciding that an excise tax on income from federal bonds was acceptable.

What about interest on the state's own bonds and those of its subdivisions? Exemption presumably lowers the cost of selling municipals, and revenue gains from a tax on interest must be weighted against the higher interest cost that results from the tax.

It turns out that the gains exceed the cost. To demonstrate this point, we start by supposing that *all* state and local bonds are sold to commercial banks within the state. In this case, given the after-tax net yield that will induce banks to hold the entire supply of bonds issued, the pretax yield must be high enough to cover any tax on the interest. For example, with a five per cent tax, the bank keeps 0.95 of interest earned, and an issue that could be placed at three per cent if tax exempt would have to return three per cent  $\div .95$ , or 3.158 per cent, to yield three per cent after tax.

But this example ignores an important point: commercial banks pay federal income tax. In arriving at federal taxable income, they deduct state and local taxes paid. Imposition of state taxes on interest from municipals reduces the federal tax base.

For a bank facing the top-bracket forty-eight per cent federal corporation income tax rate—and most taxable bank income does fall in this bracket—payments of state taxes cost, net, only fifty-two cents on the dollar. Thus, a pretax yield of 3.08 per cent on a state bond, taxed at five per cent by the state, would produce a net yield after both state and federal taxes of three per cent. Denial of exemption, then, would raise the state's interest cost by eight cents per year per \$100 of debt, but tax revenue would increase by  $\$3.08 \times .05$ , or 15.4 cents.

Beyond this consideration, not all state and local bonds are sold to banks within the issuing state. In fact, nationally, only about one-third of all municipals are held by banks, and some of those are held by banks outside the state of issue. This means that removal of tax exemption for only the banks within the state will not necessitate a fully compensating increase in pretax yield because as the yield rises, other non-

<sup>14</sup> A taxpayer facing the top (70%) marginal rate would net, after tax, as much from a 3% municipal bond as he would from a taxable investment yielding 10%.

taxable investors—nonbank investors within and outside the state, and banks outside the state—will absorb a larger portion of the total debt. Banks will have to settle for a lower after-tax yield and will presumably hold a lower share of the total debt.

Thus, exemption of interest on its own bonds held by banks *costs* the state money, and not an insignificant amount.<sup>15</sup> The interest cost argument must therefore be dismissed.

But more fundamentally, is it equitable and conducive to efficiency to exempt bank income derived from state, local, and federal bonds? The Commission felt it was not and the MBA agreed. Consider what happens with exemption. The ratio of government bond income to net income before income taxes varies greatly from bank to bank. A direct tax on income will produce a much smaller yield than an excise tax at the same rate; it will also produce a different distribution of the total burden. The differences are substantial. For example, nationally, FDIC figures for 1965 show that only banks in size groups over \$100 million total deposits had, in the aggregate, net income before income taxes in excess of income from government bonds.<sup>16</sup> Thus, nearly all of the burden of an income tax would fall on very large banks. Many—perhaps most—banks would pay zero tax. Even among banks of the same size, and in similar regions, there are substantial differences in holdings of government securities relative to private loans.

It is hard to see why it is either equitable or conducive to efficiency to confer complete exemption to banks that specialize in government securities when other businesses, including banks that make substantial business, consumer, and mortgage loans, pay substantial amounts. It would be easier to make a case for precisely the opposite policy. The Maryland Legislative Commission did not, therefore, seriously consider recommending the direct income tax.

#### D. Excise Tax vs. Share Tax

The relevant comparison, then, was between the share tax, with modifications, and the excise tax. To begin this comparison, assume that the assessed value of shares bears some fixed relation—say ten times—to net earnings before federal taxes. Then the share tax for any bank will have the same yield as an excise tax at a rate one-tenth as high. But states levying the share tax cannot tax dividends to holders of national bank stocks, and most (perhaps all) states, like Maryland, grant parallel treatment to state-bank stockholders. In 1964, net income before income taxes of all insured commercial banks in Maryland was \$45.3 million, and dividends were \$10.8 million.<sup>17</sup> The added revenue from the individual income tax on dividends would be substantial

<sup>15</sup> It should be noted, however, that an intergovernmental transfer, in favor of the state and against its subdivisions, occurs because the tax is paid to the state but the higher interest costs are partly paid by the subdivisions.

<sup>16</sup> 1965 FDIC ANN. REP. 160.

<sup>17</sup> Nationally, dividends are higher—about one-third of net income before income taxes in 1964.

—about one-fourth of the bank tax yield if individuals pay tax on dividends at the same rate banks pay under an excise tax.<sup>18</sup>

The assumption of a given capitalization rate applied to the current year's income is not realistic. Presumably states are free to adopt laws requiring assessment according to a statutory capitalization rate, but few, if any, do. If market values, book values, or other considerations enter into the assessment, the percentage that net income bears to the share-tax base will differ from bank to bank and from time to time.

Should a bank be taxed on its actual income or on the capitalized value of its expected income as reflected in the market value of its shares? The difference will be substantial even if total tax yields under the alternative methods are the same. New banks may have much future promise but little present income. Growing banks will, presumably, have higher price-earnings ratios than stable or declining banks.

Should new banks or growing banks pay higher taxes in relation to current income? Should movements of the capitalization ratio over time, either as a trend, or as a reflection of cycles in bank income, change the level of taxes in relation to income? If capital values are superior to net income for *bank* taxes, so should they be for all other business taxes. The Maryland Commission showed no interest in moving business taxation toward a capital value base. Rather, it was trying to move in the opposite direction. Uniform treatment of banks and other businesses led logically to rejection of a share tax based on the market value of bank stock.

This left the choice between an excise tax and a modified share tax with share values to be established by capitalization of annual net income at a specified uniform rate. The two approaches could not be made precisely equivalent because of the dividend exemption under the share tax required by section 5219. But the rate of tax on shares could be made high enough to produce a yield that would be the equivalent of the total yield of an excise tax and the tax on dividends to individuals. The equivalence would not be precise, because the ratio of dividends to net income varies among banks. Low-dividend banks would be disadvantaged, and high-dividend banks would be advantaged, by the share-tax approach. Moreover, with a graduated individual income tax, which the Commission was also recommending, high-bracket bank stockholders would be given an advantage at the expense of low-bracket stockholders by the "equivalent" share-tax approach.

Still another important consideration argued for the excise tax. The Commission had decided to recommend elimination of the tax on shares of public utilities and to subject utilities instead to the corporation income tax, from which they are now

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<sup>18</sup> The prohibition of dividend taxes in share-tax states seems to be based on the notion that taxation both of the value of shares and of dividends received by shareholders would constitute "double taxation." The share tax is conceived as a tax on the shareholder, not on the bank. In the eyes of the law—or at least in the eyes of § 5219—the bank merely serves as collecting agent.

The same double-taxation argument applies, logically, to an excise tax based on net income—or to any corporation income tax. If a state taxes income of ordinary corporations, and also taxes dividends as individual income, it is already "double taxing." It is hard to see why the state should avoid "double taxation" of bank income but not of income of ordinary corporations.

exempt. Removal of the bank share tax would eliminate the last vestige of intangibles taxes from the system.

Unification and simplification of the tax structure have many advantages, not the least of which is that they make the tax system easier to understand. The enormous complexity of state fiscal systems is largely senseless, and it constitutes an important barrier to informed policy decisions. Legislators, to say nothing of the citizenry, have enough trouble educating themselves without having to deal with endless technicalities that are the legacy of historical accident.

#### E. The Uncertain Status of an Excise Tax

For these reasons, the Legislative Commission decided in favor of the excise tax. The decision was tentative because it was not entirely clear that an excise tax levied at a rate high enough to avoid discriminating in *favor* of banks relative to other businesses would stand up to a court test under the discrimination provisions of section 5219. Paradoxically, a shift to an excise tax that lowers the tax burden on banks raises the risk of violating section 5219.

It is important to note that this risk arose despite the fact that the Commission did not propose to tax bank income under the excise tax at a rate *higher* than the rate levied on the income of ordinary business corporations. A glance at the table of state taxes on banks will show that nearly half of the twenty excise tax states impose higher rates on banks than on income of ordinary corporations. In two states—California and Massachusetts—the bank tax rate is set annually. California taxes banks at the basic 5.5 per cent rate applied to ordinary corporations and imposes an additional tax, up to a maximum of four per cent, determined annually to reflect the total of other taxes paid by ordinary corporations from which banks are exempt. It is noteworthy that the maximum additional rate of four per cent has been imposed in recent years.

The Commission did not favor the California approach. There is no reason to believe that ordinary business corporations are affected in the same way by, say, a tangible personal property tax that happens, after the fact, to be equal to one, or five, or eight per cent of its net income as they are by an income tax at the same rate. The same applies to sales taxes and other miscellaneous levies imposed on businesses. It is simply not correct to assert that all taxes deemed legally to be paid by corporations are equivalent to taxes based on net income. It is perfectly possible that all such taxes taken together might exceed 100 per cent of net income. That fact would not call for a 100 per cent tax on bank net income.

The California approach has the added defect of using *average* taxes for other businesses to determine bank taxes (up to the four per cent maximum). If the other business taxes are *appropriate* taxes, the *appropriate* bank tax would be, not an average of what other businesses pay in relation to net income, but rather the taxes

the *individual* bank would pay on the same bases—tangible personal property, purchases subject to sales tax, and so forth.

Even though the bogus precision of the California tax must be rejected, there remains a case for imposing an excise tax on banks at a rate somewhat higher than the rate of income tax on ordinary corporations, in recognition of the fact that banks are to some undetermined degree advantaged by exemption from other state and local taxes.

This idea has some appeal, but its application is hazardous. The situation is complicated, not only by uncertainty about the “advantages” of banks, but also by uncertainty concerning the amount of income corporations receive from tax-exempt government securities. Equity and section 5219 both demand that attempts to equalize taxes on banks and other businesses recognize not only that banks escape some taxes paid by other businesses but also that other businesses may escape some taxes paid by banks. Moreover, comparisons of tax burdens must be made against a common base.

In this respect, Maryland’s situation differs from that of about half of the twenty states that now levy excise taxes on banks. These states, shown as Group II-B in the table of state taxes on banks, also tax ordinary corporations under excise taxes based on income “from all sources” rather than under direct taxes on income. In this case, one could be fairly certain that a bank excise tax moderately higher than the ordinary corporation excise tax would stand up in court, since it would need to be shown only that, in addition to the excise tax based on net income, ordinary business corporations pay other taxes from which banks are exempt.

But Maryland, like many other states, levies a direct tax on net income of ordinary corporations. Adoption of the bank excise tax, at the same rate as the income tax on ordinary corporations, would raise the question of discrimination in favor of ordinary corporations. The advantage of tax-exempt interest to ordinary corporations would have to be weighed against the advantage to banks of exemption from some taxes, most notably the tangible personal property tax, paid by ordinary corporations.

The guiding consideration is the *Oklahoma* decision of 1940.<sup>19</sup> In that decision, which is the law today, the Supreme Court held that “discrimination is not shown merely because a few individual corporations, out of a class of several thousand which ordinarily bear the same or a heavier tax burden, may sustain a lighter tax than that imposed on national banking associations.”<sup>20</sup> Banks in Oklahoma paid an excise tax measured by net income of six per cent and ordinary corporations paid a six per cent direct tax on net income. In comparing tax burdens, the Court considered the fact that some nonbank corporations held tax-exempt government securities. It determined, however, that they also paid a corporation franchise tax not

<sup>19</sup> *Tradesmens Nat’l Bank v. Oklahoma Tax Comm’n*, 309 U.S. 560 (1940).

<sup>20</sup> *Id.* at 568.

imposed on national banks, in an amount greater than the tax that would have been due had government bond interest been taxed.

Thus the view of the Court in the *Oklahoma* decision seemed to be that total taxes would be compared on the basis of the broader definition of "income from all sources." If the comparison were made on the narrower definition (income excluding interest on tax-exempts), the *Oklahoma* decision surely would have gone the other way, since many banks that paid excise taxes would have had zero or negative tax bases under the narrow definition.

The *Oklahoma* decision did not mention tangible personal property or sales taxes in its comparisons of tax burdens on national banks and ordinary business corporations. These are the major taxes from which national banks are exempt under section 5219. Before deciding where to set the bank excise tax rate, the Maryland Legislative Commission needed legal advice on the meaning of the law. In particular, the Commission needed to know whether the excise tax rate could be set higher than the corporation income tax rate. A firm from outside the state, known for its expertise on section 5219, was retained. Counsel was fairly reassuring that the broad definition used by the Court in the *Oklahoma* comparisons would also be made in any court test of the proposed Maryland excise tax. But the attorneys could not give assurance that an excise tax levied at a rate higher than the ordinary corporate tax rate would stand up. Such assurance, if it were forthcoming at all, would have to be based on a detailed and costly study of individual business firms' tax payments, a study the Commission was in no position to make in the limited time available.

In fact, the Commission never could establish with *certainty* that an excise tax levied at the *same* rate as the ordinary corporation income tax would stand a court test. Despite the *Oklahoma* decision, there remained a possibility that the court would compare tax burdens in relation to income excluding tax-exempt interest. This uncertainty could not be dispelled despite the fact that several states shown in Group II-A of the table of state taxes on banks impose bank excise taxes at rates equal to or greater than the rates imposed on income of ordinary corporations that enjoy exemption of government bond interest. After consultation with representatives of the Maryland Bankers Association and with the Attorney General's office, and in the light of the opinion of out-of-state counsel, a decision was finally made to recommend abandonment of the present share tax in favor of an excise tax on banks and finance companies at the same rate as the income tax on ordinary corporations.

#### F. Problems of Uniform Taxation

Abolition of the Maryland share tax would remove the exemption of state banks and finance companies from tax on their tangible personal property, since, under Maryland law, this exemption is predicated on payment of the share tax. National banks, as we have noted, cannot be required to pay this tax. The Commission there-

fore recommended specific exemption of tangible personal property of state banks and finance companies. It did not, however, recommend exemption of state banks and finance companies from retail sales tax on purchases of equipment, furniture, and supplies, even though national banks do not pay the tax. The Maryland sales tax is already riddled with exemptions, which greatly complicates administration of the tax. The Commission was loath to make matters worse.<sup>21</sup>

The end result was that the proposed taxation of state and national banks would remain about as close to uniform as it is under the share tax, with national banks still slightly favored; but the discrimination against finance companies, which pay both share taxes and income taxes, would be removed. The major gain would be that the discrimination against banks and finance companies vis-à-vis ordinary corporations would be removed. Final pronouncements about the matter are not easily made, but, in my view, the proposed system, if it discriminated at all, discriminated in favor of banks and finance companies.

In terms of its own goals, then, the Commission's recommendations can be given a high score if we recognize the handicaps imposed by section 5219. Bank taxes would be lower, sales finance companies would no longer be taxed twice, and the elimination of the bank share tax would complete the process of simplifying the tax structure by erasing the last vestige of intangible personal property taxation. Without the restrictions of section 5219, of course, the Commission could have done better.

### G. The Cooperative Institutions

There remained unsolved one problem—the taxation of cooperative financial institutions. There is no question that Maryland taxes discriminate against banks and finance companies vis-à-vis mutual savings banks and savings and loan associations. These institutions pay a much lighter tax, which is based on gross investment income.

To date, the courts have not forced the issue in other states, as far as I know. Apparently share capital of savings and loan associations is not considered "other moneyed capital" coming into substantial competition with banks. The archaic precedent based on the quaint view of savings and loans as cooperative bands of poor persons who finance one another's modest homes apparently persists in the courts.<sup>22</sup> It is hard to believe that this will continue.

Notwithstanding the absence of legal compulsion, the Maryland Commission perhaps would have been inclined to explore the present taxation of savings and loans

<sup>21</sup> It also was loath to make them better. The only major recommendation of the original Governor's Commission that was rejected entirely by the Legislative Commission was a controversial proposed revamping of the sales tax.

<sup>22</sup> See, e.g., *Michigan Nat'l Bank v. Department of Revenue*, 358 Mich. 611, 627-39, 101 N.W.2d 245, 253-59 (1960), *aff'd sub nom. Michigan Nat'l Bank v. Michigan*, 365 U.S. 467 (1961); *Hoenig v. Huntington Nat'l Bank*, 59 F.2d 479, 482 (6th Cir.), *cert. denied*, 287 U.S. 648 (1932). *But see* the dissenting opinion of Mr. Justice Whittaker in *Michigan Nat'l Bank v. Michigan*, *supra* at 483.



and mutual savings banks had the legislature not already been through a battle in its 1965 session to enact the present taxes on these institutions.

Since this is clearly a proper subject of further study in Maryland and many other states, let us consider what might be the general findings of a future Maryland commission that considered this problem.

First, the commission would discover that practices among the states vary so widely as to defy description. Second, if the share tax on banks is still in use by the state, the commission will have to decide whether shares of S & Ls are the equivalent of shares of capital stock of commercial banks. What about time deposits of mutual savings banks? Are they the equivalent of commercial bank time deposits? Are S & L shares and mutual savings bank deposits equivalent? The difference these decisions will make is, of course, enormous. If shares are deemed to be the equivalent of commercial time deposits, what is the equivalent of commercial bank capital? Reserves and undivided capital of shareholders? Undivided capital of shareholders but not reserves?

Or if the state is levying an excise tax on banks, can the same tax be used for S & Ls and mutual savings banks? What is net income of a cooperative? Total net income before dividends to shareholders? Net income after dividend distributions—*i.e.*, additions to undivided capital? Net income after distributions plus additions to reserves?

I hazard the guess that such a commission would look favorably on retention of the present tax on gross income from investments, levied at a rate that produces a yield closer to the tax that would be paid if net income after dividend distributions were taxed at the same rate as bank net income from all sources, than to the tax that would be paid if the bank rate were applied to net income of the cooperatives before distributions. The commission might *wish* that it could recommend a tax on gross investment income of *all* financial institutions, corporate and cooperative. That approach would merit careful study, except that it cannot be applied to national banks.

Section 5219 will surely give such a future commission as much trouble as it has given past ones.

#### IV

#### CONCLUDING REMARKS

Up to this point, the lessons of Maryland's experience with bank tax reform seem fairly clear and inspire a reasonable degree of optimism. Revision of bank taxes is no easy matter, primarily because of section 5219. Since national banks cannot be made to pay all of the taxes normally levied on ordinary businesses, complete uniformity is impossible. But substantial progress toward this goal is possible. In states that tax incomes of ordinary corporations, the excise tax on banks seems superior to the alternatives permitted under section 5219. The case for rates under the excise tax that

are either higher or lower than those applied to net income of ordinary corporations is hard to make.

A curious fact is that section 5219 provides banks with more protection against discrimination under income and excise taxes than under the share tax. The provision that the tax be no "higher than the highest of the rates" imposed on ordinary business corporations applies only to the income and excise taxes. The share tax burden *can* be higher, so long as it does not violate the "other moneyed capital coming into competition" provision. Thus the Maryland Commission's recommendation, even though it aimed at eliminating overtaxation under the share tax, raised the risk—probably not very great—of an adverse court decision in the event that a national bank contested the excise tax.

No two states will be entirely alike, because no two states have exactly the same approach to business taxation. But in any state, attempts to develop a more rational system of bank taxation probably require more analytical study, expert counsel, and data of the kind that is not likely to be readily available, than almost any other specific problem of tax reform. At all times, it seems, the major difficulty is to keep the economic considerations from being submerged in a sea of legal confusion. But given persistence, the end result may be fortunate.

## V

### AN EPILOGUE

But then it may not. The Maryland tax reform program of 1966 failed, mostly because it called for a controversial new system of state aid to local government that would have funneled money from the high-income suburban areas into the City of Baltimore and the poorer counties. But before the program was voted down by a narrow margin, the new bank tax proposal was amended.

On March 15, two weeks before the end of the 1966 session of the General Assembly of Maryland, and at a time when political lines had hardened and rational consideration of the issues was nearly impossible, the State Treasurer sent a letter to the Chairman of the Legislative Commission opposing the new bank tax. This letter, and attached memoranda based on discussion with state bond counsel and some unnamed investment bankers, made the following statements:

[I]f the State includes State and municipal bonds . . . as a basis for measuring the franchise tax on financial institutions, it could hardly argue with very much conviction that the Federal government should not also eliminate the tax exemption and tax them the same as other corporate securities. As you know, a number of attempts have been made to do just that. It is estimated that to subject State bonds to the Federal income tax would have the effect of increasing the rate by approximately 1-¾% to 2%. This would also add a substantial burden to the taxpayer in the additional cost of financing State of Maryland, county and municipal bond issues at the higher rate necessary to sell non-tax exempt bonds.

. . . [T]he effect of such a franchise tax . . . is not restricted to just the financial institutions but would have a psychological and actual effect on the other purchasers, who might figure that due to this change in the status of financial institutions the market for resale . . . of State of Maryland bonds would be adversely affected with the loss of the present ready market furnished by financial institutions in the State of Maryland.

Due to the present very difficult market situation for bonds of any type, the Treasurer's Office will soon announce the policy of accepting pledges of State of Maryland bonds by Maryland banks to protect deposits in those banks with the thought that this will encourage the purchase of Maryland bonds by financial institutions and thereby, through improvement of the market, decrease the cost to the State of Maryland bond issues. The possible adverse effect of eliminating the tax exempt status under this franchise tax will instead, of course, have the effect of decreasing the marketability.

It is entirely possible that the additional revenue earned by this section of the proposed Bill by including the interest received from State, county and municipal obligations within the definition of net earnings rather than continuing the present exemption, when considering the very large issues of tax exempt bonds of the counties and municipalities as well as the State, may be more costly in the long run than the revenue produced by it would be worth.

This was an unthinking attack. First, twenty states already use the excise tax. I presume that they do not feel inhibited in arguing against federal taxation of state bonds. It is hard, in any event, to believe that the larger issue would turn on Maryland's decision to adopt a tax expressly permitted by section 5219.

Second, and most important, the share tax at present does not exempt state and local bonds. The prospect that denying a tax exemption that does not exist for banks in the first place would cause all this harm is remote. But the advice of bond counsel is not easy to ignore. At this late date, in the midst of all the confusion surrounding legislative consideration of a wide-ranging program, it did not seem that this advice could be effectively met. So, in the interest of saving the larger bill, the Commission retreated to its second choice, an excise tax on bank capital assessed at ten times earnings, at a rate sufficient to produce the same revenue as the combined excise tax and tax on bank dividends distributed to individuals. Interest on government bonds was, by the way, to be included in net income for capitalization purposes. Bond counsel seemed not to mind that.

As I have noted, the bill failed in any event. But in 1967, the General Assembly passed a bill that represents the first instalment in the over-all reform of Maryland's fiscal system. The 1967 bill dealt with all aspects of reform except business taxation. That thorny problem is on the agenda of the 1968 session. Bank taxes will doubtless cause as much trouble in 1968 as they did two years earlier. If the lessons of 1966 are remembered, perhaps the farcical episode touched off by the Treasurer will not be repeated.