Income Taxation of Commercial Banks

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Commercial banks are subject to a variety of taxes, including income or profits taxes, property taxes, taxes on the ownership of bank shares or capital, franchise taxes, and an assortment of other miscellaneous taxes. Of these, income taxes are clearly the most important. In 1974, the most recent date for which figures are available, income taxes amounted to $1.8 billion and are estimated to account for three-fourths of all taxes paid by commercial banks. Federal income taxes comprised 77 per cent of this amount, and state and local income taxes comprised 23 per cent.

In view of the importance of income taxation to commercial banks, this article examines the extent to which the income tax burden of banks has changed in recent years. Attention is given to the impact of tax code modifications on the tax burden and the various approaches commercial banks have taken to minimize their tax burdens. Also examined is the differential burden imposed by Federal income taxes and state and local income taxes on banks in the nation, the Tenth Federal Reserve District, and on banks of varying deposit sizes.

FEDERAL INCOME TAXATION OF BANKS

Federal income taxes for banks are computed by first determining net taxable income. In general. the base for taxable income represents income from operating transactions, such as interest on loans and securities (excluding interest on municipal securities), trust department income, service charges, etc., less allowable operating expenses, including wages, interest paid on deposits and borrowed money, occupancy expense of bank premises, etc. This figure is then adjusted to make allowance for net loan losses or recoveries, net securities gains or losses, and for a variety of other modifications to income.

Federal Tax Burden

The average tax burden for commercial banks has fallen significantly between 1961 and 1974.[1]

1/Throughout this article the tax burden, or effective tax rate. of commercial banks is measured by dividing "provision for income taxes" by net income or profits. Rovision for income taxes, as reponed annually to the FDIC, includes estimated income taxes related to the current years' operations but docs not reflect adjustments (refunds or additional taxes paid) for previous years. Net income as used in measuring the tax burden is equivalent to gross profits before taxes. It is not taxable income. but rather total income less normal operating expenses. More specifically, net income includes such items as interest earned on state and local government securities. net long-term capital gains. etc.

This ratio is, of course, potentially subject to certain distortions. For example. a bank's provision for income taxes in a given year may differ significantly from the bank's actual income tax liability. A systematic bias in the figures for all banks though is unlikely. No adjustment has been made for the fact that the interest yield on tax-exempt securities is generally less than on taxable issues. thus imposing an implicit tax burden on investors in tax-exempts. Also net income could be biased by the timing of realizing loan losses and long-term capital gains or losses as well as changes in depreciation methods, etc. The importance of most of these possible biases cannot be determined, but none is likely to result in a regular distortion over time.

Since bank reporting procedures were modified in 1969, the figures have been adjusted to maintain comparability over the 1961-74 period. Some slight variations, however, still exist. A complete description of the 1%9 changes in reporting procedures appeared in the *Federal Reserve Bulletin*, July 1970. pp. 564-72. For the 1961-68 period. net profits and recoveries (or net losses and charge-offs) on loans. securities. and other transactions were added to (subtracted from) net current operating earnings to obtain the pretax net income figures used in this article. For the 1969-74 period, interest paid on capital notes and debentures. which was reported by banks as an operating expense in the latest period but included with dividends on referred siock in the 1961-68 period, was added to the FDIC figure; for income before taxes and securities gains or losses. In addition, gross securities gains (losses) d gross extraordinary credits (charges) were added to (deducted from) net operating ic to obtain the 1969-74 net income figures.

Table 1 indicates that the ratio of Federal income taxes to net income for all insured commercial banks over this period moved from 34.8 per cent to 14.5 per cent, a drop of 20.3 percentage points. Similarly, the effective tax rate at Tenth District banks declined 17.7 percentage points to 18.6 per cent over the same interval.

Banks of all sizes generally experienced a reduced tax burden between 1961 and 1974. The sharpest declines, however, were experienced by the largest banks. The effective tax rate for banks with deposits under $10 million dropped by only one-fifth or 5.2 percentage points, but banks with deposits over $100 million cut their effective tax rates by two-thirds or 23.3 percentage points. As a result, the effective tax rate in 1974 generally declined as bank size increased, giving the overall tax structure the appearance of regressivity. U. S. banks with deposits under $10 million, for example, paid Federal taxes equal to 23.4 per cent of net income, compared with 16.3 per cent for banks with deposits between $10 and $100 million and 13.0 per cent for larger banks. Effective tax rates for banks of different sizes in the Tenth District were somewhat greater than the national averages, but exhibited the same general trends.

The shifts in effective tax rates reflect both modifications in tax laws and bank efficiency in exercising legal tax shelters. Federal income tax rates applicable to commercial banks generally fell from 1961 to 1965, but tended to rise thereafter. Specifically, between 1961 and 1965 the tax rate on the first $25,000 of taxable income was reduced from 30 per cent to 22 per cent and on income over $25,000 from 52 per cent to 48 per cent. In 1969 and the first quarter of 1970, a 10 per cent surtax was imposed on all taxable income. Also, in 1969 banks were required for the first time to treat net long-term capital gains on securities as ordinary income. The tax rate for long-term capital gains on securities taken during a transitional period after 1969 and the tax rate on other long-term gains were raised. These tax law modifications suggest that reductions in tax rates contributed importantly to the sharp drop in the Federal tax burden experienced by commercial banks between 1961 and 1965. The remainder of the drop during this period, however, and that which has occurred since then is primarily attributable to bank utilization of tax shelters.

Table 1
FEDERAL TAX BURDENS AT INSURED COMMERCIAL BANKS
UNITED STATES AND TENTH DISTRICT
(In per cent)

	Ratio of Federal income taxes paid to net income				Changer in effective tax rates
	1961	1965	1969	1974	1961-74
All banks:					
United States	34.8	23.5	20.4	14.5	−20.3
Tenth District	36.3	27.0	25.7	18.6	−17.7
By deposit size:					
Less than $10 million					
United States	28.6	21.5	19.7	23.4	−5.2
Tenth District	30.1	22.5	21.9	23.6	-6.5
$10 to $100 million					
United States	33.6	25.7	22.2	16.3	−17.3
Tenth District	36.3	27.1	24.3	18.2	−18.1
$100 million and over					
United States	36.3	23.0	19.7	13.0	−23.3
Tenth District	41.6	30.8	30.3	16.0	−25.6

NOTE: Data for 1961-68 are not strictly comparable with data lor 1969-74.
SOURCE, Reports of Income, Federal Deposit Insurance Corporation.

Tax Shelters

A number of provisions in the tax laws permit banks to reduce their tax liabilities. Two of these options are investing in state and local government obligations, the interest from which is wholly tax exempt at the Federal level, and transferring funds to bad debt reserves to allow for future losses on loans. Tax benefits are also realized by banks engaged in lease financing and foreign operations. Banks leasing equipment are able to realize tax savings from the investment tax credit and from deductions for depreciation. Banks with foreign operations are permitted deductions for most taxes paid to foreign governments, or, alternatively, foreign income taxes may be claimed as a tax credit rather than a deduction. During the 1960's, the differential treatment of long-term capital gains and losses on securities also served to reduce the tax burden of commercial banks.

Table 2
SELECTED TAX ADVANTAGES OF ALL INSURED COMMERCIAL BANKS, 1972

Description of tax advantage	Income deduction or tax credit claimed in 1972	Estimated tax benefit	Percentage increase in total tax if no benefit
	(In millions of dollars)		
Interest on state and local obligations	3.489	1,675	129.9
Net transfers to bad debt reserves deduction	485	233	18.1
Gross depreciation deduction*	1,389	667	51.7
Investment tax credit †	90	90	7.0
Foreign tax credit?	221	221	17.1
Federal income taxes paid	1,289	2.886	223.9

Depreciation deductions cannot be separated between depreciation for ordinary bank assets and depreciation for leased assets. In addition, the depreciation deduction figure includes the deduction taken by noninsured commercial banks and mutual savings bonks.
† Tax credits include those taken by noninsured commercial banks and mutual savings bonks.

Each of these tax code features will be discussed in detail subsequently, but their relative importance for commercial banks in 1972 has been estimated in Table 2.[2] As can be seen, sizable tax benefits were realized from the interest exemption on state and local government securities and the net transfers to bad debt reserves. Gross depreciation also resulted in a sizable tax saving, but the significance of this figure must be heavily discounted. Available data do not permit the segregation of depreciation on leased assets from that on assets used directly in bank operations. Depreciation on regular plant and equipment is an expense of doing business, while depreciation benefits realized through leasing operations reflect, at least in part, a tax shelter.[3] Finally, the investment and foreign tax credits resulted in small, but noteworthy, tax savings. On balance, if these features had all been eliminated, the tax liability of commercial banks in 1972 would have more than doubled. These tax shelters have clearly been very important to the profitability of commercial banks.

Bank Investment in Municipal Securities. The largest single tax saving for commercial banks, as shown above, is derived from investing in state and local government securities. While bank holdings of state and local obligations have a slight tendency to fluctuate inversely with the demand for loans, Chart 1 indicates that the relative importance of these securities in banks' earn-

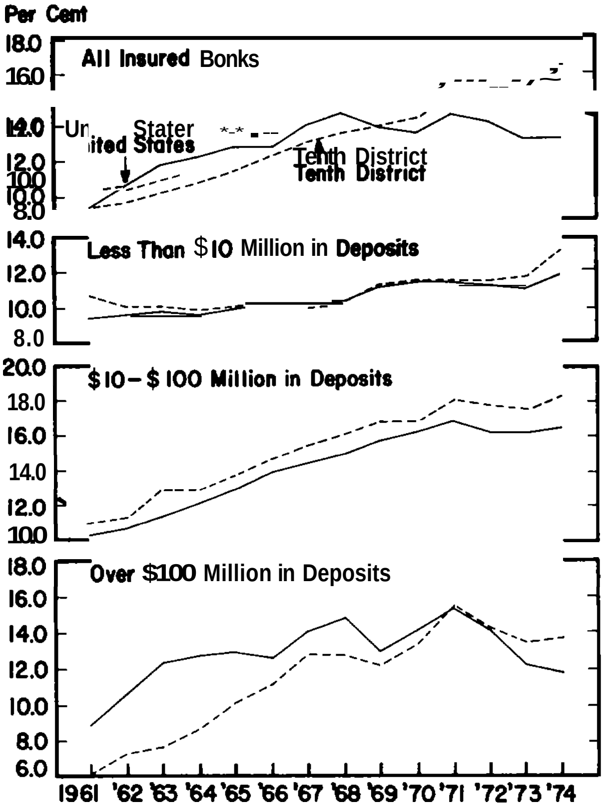
2/The figures in the first column of Table 2 are for 1972. the most recent year for which comprehensive figures arc available, and were supplied by the Internal Revenue Service and the Federal Deposit Insurance Corporation. While the magnitude of individual entries has almost certainly changed since 1972. tax regulations have not experienced any major revisions. suggesting that the relative importance of the individual entries is probably the same.

In examining the figures, a number of data limitations must be remembered. The calculation of tax benefits assumes a marginal tax rate of 48 per cent applicable to all banks. Insofar as some banks would have been subject to lower tax rates, the tax benefits shown in the table would be overestimates. Also, as explained in the text. the inability to isolate depreciation and the tax credit associated with leasing operations results in an overstatement of the tax benefits. On the other band, data arc not available for estimating the tax saving involved on long-term capital gains on securities. Banks realizing such gains on securities acquired prior to July 11, 1969, would have received a tax benefit. In addition, foreign taxes taken as a deduction from income rather than as a tax credit arc not shown. In this sense, the table underestimates possible tax savings. Unfortunately it is impossible with present data to determine the extent of these potential biases.

3/The tax benefits realized by banks engaged in leasing operations vary with the nature of the lease and the degree to which these tax benefits may be passed on to renters. Regulations governing bank holding companies require that leases must be the functional equivalent of loans and that the holding company must recover both the full acquisition cost of the equipment and the estimated cost of financing the property during the period covered by the lease. These costs may be realized through a combination of rental payments, estimated tax benefits (investment tax credit, gain from tax deferral from accelerated depreciation, and other tax benefits with a similar effect). and estimated residual values of the property at the time the lease expires. Banks generally follow these same rules, and similar regulations have recently been proposed for national banks.

The potential benefits from leasing can be seen from an example. If a bank makes a loan for the purchase of equipment. the borrower is able to deduct interest paid on the loan and depreciation on the quipment as expenses in computing taxable income; the bank receives no special tax advantage. However, if the bank were to lease the equipment to the customer, the customer is able to deduct rental payments to the bank which are equivalent to interest on the loan plus the repayment of principal (less any scrap value of the quipment). The bank is able to deduct depreciation on the quipment and may utilize the investment tax credit. In effect. therefore, the bank is allowed a deduction or tax credit for the functional equivalent of the principal of a loan. If the bank uses an accelerated depreciation schedule. additional benefits would be received through tax deferrals. Normal lease arrangements permit both the lessee and lessor to realize a portion of these tax savings but which of the two receives the majority of the tax benefit cannot be determined.

Chart 1
STATE AND LOCAL GOVERNMENT SECURITY HOLDINGS AS A PER CENT OF EARNING ASSETS



ing asset portfolios has increased for all groups of banks since 1961. The largest rise, however, has-been experienced by banks with deposits over $10 million. Banks with deposits under $10 million had only a slight increase in the fraction of earning assets invested in municipals. The chart also shows that in recent years Tenth District banks have had a slightly higher proportion of their portfolios invested in municipals than all U. S. banks generally.[4]

The different behavior of large and small banks regarding holdings of municipals probably is due to the fact that the tax advantages of municipals are considerably greater for banks with larger net taxable incomes. A bank in the 22 per cent tax bracket would receive a higher return from investing in taxable securities if the pretax yield on these securities is more than 1.28 times the return on tax-exempts. Similarly, a bank in the 48 per cent tax bracket would require a minimum return on a taxable security of 1.92 times the return on a tax-exempt issue to benefit from investing in a taxable security.[5] A comparison of interest rates on intermediate-term U. S. Government issues with the rates on state and local Aaa securities during 1961-74 reveals that banks in the 48 per cent tax bracket were always ahead to invest in tax-exempts. Banks in the lower tax bracket, on the other hand, were often able to earn the highest after-tax return by selecting taxable issues.[6] Smaller banks, which must rely mainly on their security holdings for a liquidity reserve, may also have been deterred from acquiring large amounts of municipals from a concern about their marketability during periods of strong loan demand.

Transfers to Bad **Debt Reserves.** Tax regulations permit banks to use one of two methods in handling loan losses. Under the direct charge-off method, recoveries or losses would be an addition to or deduction from taxable income in the year they occurred. Under the reserve method, a bank is allowed to build up a reserve for anticipated loan losses. Actual recoveries or losses during the year are charged to the reserve rather than to income. For tax purposes, however, allowable transfers to bad debt reserves are treated as an operating expense and thus serve to reduce net income subject to taxes.

4/Although Tenth District banks have a higher ratio of municipal securities to earning assets than U. S. banks, the District tax burden is higher. This reflects, in pan, the greater use of other tax shelters by U. S. banks than by Tenth District banks and other factors affecting bank taxes and earnings which are not explicitly discussed here.

5/For a taxable security to be more profitable than a tax-exempt security, the following must hold true: (yield on taxable security) (1 -tax rate) >(yield on tax-exempt security) or (yield on taxable security)/(yield on tax-exempt security) $> 1/(1 - \text{tax rate})$. Assuming a yield of 8 per cent on a taxable security and a rate of 6 per cent on a tax-exempt security, investment in the taxable security will be more profitable for a bank in the 22 per cent tax bracket since: $8\%/6\% = 1.33 > 1/(1-.22) = 1.28$. A bank in the 48 per cent bracket will benefit more by investing in the tax-exempt security since: $8\%/6\% = 1.33 < 1/(1-.48) = 1.92$.

6/This analysis assumes that the bank is making the purchase for the interest return only and does not take into consideration the tax effect of a capital gain or loss.

The tax treatment of bad debt reserves has been modified over time.[7] From 1954 to 1964, banks were permitted to base tax free reserves on an average experience factor derived from any 20 consecutive years after 1927. This period, however, included the Depression years of the 1930's when loan losses were unusually high. Consequently, many banks were able to transfer substantially larger amounts to bad debt reserves than were needed to cover current losses. Banks not in existence during the 1930's, though, were at a disadvantage in using this method. To equalize the deductions among banks, the rules for computing bad debt reserves were modified in 1965. Under the change banks were allowed to build up reserves totaling 2.4 per cent of eligible loans outstanding at the close of the taxable year. Or, they were given the alternative of basing reserves on a probable experience method derived from the ratio of net bad debts during the most current 6 years to the sum of loans outstanding at the close of those years.

Under the 1969 Tax Reform Act, banks were further limited in the size of additions to bad debt reserves. The law provided an 18-year transitional period during which banks could claim additions to reserves by the greater of a percentage method or an experience method. The experience method is similar to the procedure used during the 1965-69 period. Until 1976, the percentage method allows a tax free reserve up to 1.8 per cent of eligible loans outstanding at the end of the taxable year. This percentage will be further reduced to 1.2 per cent from 1976 to 1981 and to 0.6 per cent from 1982 to 1987. Beginning in 1988, the average actual loss experience will be the only allowable method for computing bad debt reserves.

Although the allowable percentage of loans that may be held as tax free bad debt reserves has been reduced in recent years, the dollar volume of reserves has continued to grow with loan volume and additions to these reserves in some years have been quite large. For example, in 1974, U. S. banks had net transfers to bad debt reserves of 9.4 per cent of pretax net income. Moreover, the ratio of bad debt reserves to loans outstanding at U. S. banks tends to rise as bank size increases. This is a partial reflection of the fact that larger banks mainly tend to utilize the reserve method of accounting for loan losses, whereas smaller banks frequently charge off loan losses only when realized and, consequently, have no bad debt reserve. Thus, bad debt reserve deductions result in a greater tax reduction for larger banks. In 1974, had there been no allowable tax free transfers to bad debt reserves, the total effective tax rate[8] would have been 3.1 per cent higher for U. S. banks with more than $100 million in deposits, 2.2 per cent greater for banks with deposits of $10 to $100 million, and only 1.2 per cent greater for banks with deposits under $10 million.

Security Swaps. Prior to 1969, commercial banks were able to obtain important tax savings by controlling the timing of realizing capital gains and losses on securities. Rules in effect at the time required that banks first offset any long-term capital losses with long-term gains. Beyond that, however, net losses could be deducted from regular income without limit, producing roughly a 50 per cent tax absorption of any loss for banks in the highest tax bracket. Long-term gains, on the other hand, were taxed at a maximum rate of 25 per cent. Under these circumstances, banks could realize the greatest tax benefit by taking capital losses one year and capital gains another. If gains and losses of the same magnitude were both realized in the same year, no tax saving would occur. But if the capital loss were taken one year and the gain in another, the bank would realize a tax saving of about 25 per cent of the loss. One justification for the preferential capital loss treatment was that banks were often forced to sell bonds at capital losses during business cycle expansions to acquire funds to meet loan demands.

The Tax Reform Act of 1969 modified the tax treatment of capital gains by requiring banks to

7/To prevent banks from concentrating transfers to bad debt reserves in years of extremely high income, certain limitations are placed on the amount that can be added to the reserve in any one year.

8/The effect of these transfers could not be separated between the effect on Federal income tax burdens and the effect on state and local income tax burdens. Thus, figures for the effect on the total income tax burden are given.

treat gains or losses on securities acquired after July 11, 1969, as ordinary income. The change considerably reduced the advantage to banks of alternating years of gains and losses, but did not remove all incentive for undertaking security swaps. If a bank realizes a loss on the sale of a security and subsequently invests in a higher yielding bond, the bank would experience increased interest income. In addition, the bank could benefit by reduced taxes in the year of the loss and the postponement of the potential capital gains tax on the new securities until future years.[9] In any event, security swaps have been utilized by banks to moderate fluctuations in net income. Banks have tended to take large security losses in years of sharply rising incomes and to boost income by realizing gains during periods of declining profitability. The 1969 revisions did not alter this tendency.

Investment and Foreign Tax Credits. Although the dollar impact has been comparatively small, both the investment tax credit and the foreign tax credit have reduced the domestic tax payments of commercial banks. A tax credit, of course, reduces the dollar amount of taxes paid by the amount of the credit. The investment tax credit was initiated in 1962 to spur economic growth and allowed a deduction from taxes up to 7 per cent of the cost of a qualified investment in new or used property for the first year that the property is placed in service. The credit has remained in effect except for two brief periods of suspension from October 1966 to March 1967 and from April 1969 to December 1970. Just recently, moreover, the investment tax credit was raised to 10 per cent for the period from January 22, 1975, through December 31, 1976.

Commercial banks have been able to utilize the investment tax credit on purchases such as computers used by the banks themselves and on purchases made for their lease financing operations. Normal depreciation on bank leased assets further serves to reduce tax payments.[10] Finally, if the equipment is ultimately sold for more than its depreciated value, additional tax savings are experienced. In bank leasing operations, tax benefits are often passed along to customers in the form of lower leasing costs. However, since banks are able to realize significant tax benefits which would not be possible if a loan had been made to purchase the equipment, leasing operations have frequently been viewed as a major tax shelter for commercial banks. These tax savings are undoubtedly responsible in large measure for the substantial growth in leasing operations by both banks and bank holding companies. Nonetheless, it should be recognized that, in periods of strong inflation, these benefits are inadequate to allow for full replacement costs. Some observers feel these tax features should be further liberalized to reduce the potential real capital shortage the country may face over the coming decade.

The foreign tax credit has also been called a tax shelter, but this observation is not fully justified. The credit was introduced to limit double taxation of income by both the United States and foreign countries. Before 1962, banks paid taxes on foreign income only when it was repatriated to U. S. shareholders through dividend distributions. However, since the Revenue Act of 1962 was passed, domestic corporations have been taxed according to their share of income from foreign subsidiaries. Banks have had the options of either deducting foreign taxes from net income, or claiming a credit for foreign income taxes paid or accrued during the taxable year. The latter method usually yields the greatest tax advantage, but the former is easier to compute.[11]

The sharp rise in foreign operations of large banks since the mid-1960's and the temporary suspensions of the investment tax credit are jointly

9/For a description of the potential benefits, see Paul S. Nadler, "Are Tax Swaps Dead?" Bankers Monthly, August 15, 1972, pp. 15-16.
10/See footnote 3.

11/The foreign tax credit is subject to a "per country" limitation or to an "overall" limitation. Under the per country limitation, the credit as a proponion of the U. S. tax cannot exceed the ratio of taxable income from the foreign country to total taxable income. Under the overall limitation, the proponion of all foreign taxes paid to the U. S. tax cannot exceed the ratio of the bank's taxable income from all foreign sources to all taxable income. Cenain canyover and carryback provisions also apply to the use of the two limitation methods to adjust for variations in tax years between the United States and other countries and differences in the timing of including income or deductions in calculating the tax base. Also, the 1963 law provides for "grossing up" income from developed countries by the amount of the taxes paid when a tax credit is claimed.

responsible for the more rapid growth of foreign tax credits than investment tax credits. As might be expected, though, the investment tax credit has been more important for smaller banks and the foreign tax credit more important for larger banks. Large banks initiated a significant expansion of their foreign operations in the mid-1960's when the Voluntary Foreign Credit Restraint (VFCR) program restricted loans to foreigners. By lending through foreign branches which were not subject to VFCR guidelines, these banks were able to meet the growing credit needs of multinational corporations whose overseas operations were expanding.

Minimum Tax on Tax Preference Items. One feature of the Tax Reform Act of 1969 which has resulted in greater equalization of tax burdens between large and small banks is the Minimum Tax on Tax Preference Items. A preference item is essentially a provision in the tax codes which allows a bank to reduce its tax liability. The "minimum tax" imposes an additional 10 per cent tax on some items of preference after an exemption of $30,000 and applicable Federal income taxes. Preference items of major interest to banks are contributions to bad debt reserves in excess of experience, accelerated depreciation on certain assets, and long-term capital gains. In general only the largest banks pay this tax. If this tax were eliminated, the disparity between the tax burdens of large and small banks would be even greater.

STATE AND LOCAL INCOME TAXATION OF BANKS

While states govern the types of taxes imposed on state chartered banks, the states must follow Federal statutes regarding taxation of nationally chartered banks. Until recent years, states were quite restricted in imposing taxes on national banks; states could tax bank shares, the dividends of owners, or the bank's net income. Interest received on U. S. Government obligations was not taxable under a direct income tax, but net income from all sources could be taxed under an excise or franchise tax. Only one of these methods of taxation could be used, and a state could only tax national banks if the head office was within the state. In addition, states or localities were permitted to levy real property taxes on national banks. Although states were free to impose any tax on state chartered banks, competition between national and state chartered banks and equity considerations prompted most states to treat the two groups of banks equally.

In December 1969, Congress liberalized the laws regarding state taxation of banks. States were allowed to levy any tax, except an intangible personal property tax, on a national bank having its main office in the state. States also were allowed to impose sales or use taxes, real property or occupancy taxes, documentary taxes, tangible personal property taxes, and license, registration, transfer, or other taxes on a national bank not having its main office in the state if those types of taxes were generally imposed on a nondiscriminatory basis. Subsequently a permanent amendment, passed in 1973, allowed states to treat national banks as state banks for tax purposes. The amendment further permitted the imposition of intangible taxes but retained limits on state taxation of nondomiciliary banks' income.

Tax Burden

Income taxes are the most important single tax levied by state and local governments.[12] Between 1961 and 1974, the burden of state and local income taxes nearly doubled at all U. S. banks, rising from 2.3 per cent of net income to 4.3 per cent. (See Table 3.) This rise reflects both the upward movement of tax rates over the period and the imposition of income taxes in some states which had previously not taxed bank profits. By comparison, the average burden of state income taxes for Tenth District banks rose only slightly over the period from 2.3 to 2.6 per cent. The lower effective tax rate for Tenth District banks than for banks in the nation reflects the smaller tax burden of District banks with deposits of $100 million and over. These banks had a tax burden of 2.5 per cent in 1974, compared with 5.3 per cent for U. S. banks of sim-

12/Banks also pay property taxes. sales taxes. documentary taxes. and other miscellaneous taxes to state and local governments. Although current data on the volume of these taxes are unavailable, a 1969 study by the Board of Governors of the Federal Reserve System revealed that these taxes accounted for 62 per cent of all taxes paid to state and local governments while income taxes accounted for 38 per cent.

Table 3
STATE AND LOCAL INCOME TAX BURDENS OF BANKS UNITED STATES AND TENTH DISTRICT
(In per cent)

	Ratio of state and local income taxes paid to net income				Changes in effective tax rates
	1961	1965	1969	1974	1961-74
All banks:					
United States	2.3	2.6	3.4	4.3	+2.0
Tenth District	2.3	2.4	2.9	2.6	+0.3
By deposit size:					
Less than $10 million					
United States	1.4	1.7	1.7	2.5	+1.1
Tenth District	1.6	2.2	2.1	2.5	+0.9
$10 to $100 million					
United States	1.5	1.5	1.9	2.4	+0.9
Tenth District	2.2	2.7	2.8	2.8'	+0.6
$100 million and over					
United States	2.8	3.1	4.3	5.3	+2.5
Tenth District	3.1	2.2	3.5	2.5	−0.6

NOTE: Data for 1961-68 are not strictly comparable with data for 1969-74.
SOURCE, Reports of Income, Federal Deposit Insurance Corporation.

ilar size. On the other hand, Tenth District[13] banks with deposits under $100 million had effective tax rates equal to or above the national averages.

The slight change in the average tax burden for Tenth District banks between 1961 and 1974 tends to mask the underlying shifts that have occurred among the individual states. Over the period, banks in Colorado, Missouri, and Oklahoma generally experienced a reduced tax burden which was more than offset by the imposition of income taxes by Kansas (1964), Nebraska (1969), and New Mexico (1969). (See Table 4.) Wyoming remains the only Tenth District state which does not impose an income tax on banks.

Differences in income tax burdens among states tend to reflect in part alternative definitions of taxable income. In general, taxable income in most District states is based on the Federal definition, but with certain additions or subtractions. The most important differences result from the treatment of income from Federal and municipal government securities and the allowable deductions for bad debt reserves and Federal taxes paid. Among Tenth District states, Kansas, New Mexico, and Missouri require adjustments to Federal taxable income to include interest income from state and local obligations, while Colorado and Oklahoma include interest from out-of-state municipal securities. Colorado also allows banks to deduct interest income from Federal obligations from taxable income and Missouri allows a deduction for Federal income taxes paid. Missouri, however, permits banks to claim only actual net bad debt charge-offs as a deduction rather than additions to bad debt reserves as allowed on the Federal form.

Differences in income tax burdens among Tenth District states also reflect variations in tax rates among the states. Banks in Kansas and New Mexico, which reported the highest ratios of state and local income taxes to net income, have relatively high tax rates. Tax burdens for these two states were above the national average. Tax burdens for banks in Colorado and Missouri were close to the District average as adjustments to the tax base partly offset their comparatively high tax rates. For banks in Nebraska and Oklahoma, the ratios of state and local income taxes to net income were as low as 1.7 per cent and 1.9 per cent, respectively, in 1974, reflecting in part that these two states have two of the lowest income tax rates in the nation.

In Colorado, Kansas, and Missouri, small banks paid the lowest effective income tax rates. In Nebraska and Oklahoma, however, where only minor adjustments are made to the Federal tax base in computing taxable state income, large banks—i.e., with deposits over $100 million—had the smallest tax burdens. The tax burden of the Federal income tax structure, it will be recalled, also was smallest for the largest size banks. In New Mexico, banks of all sizes had nearly equal state income tax burdens.

CONCLUDING REMARKS

Between 1961 and 1974 the effective Federal tax burden on commercial banks dropped about 60 per cent, with large banks generally realizing the sharpest declines. Reductions in tax rates account for a portion of the decline, but the largest share has resulted from bank utilization of legal tax shelters. The more important of these include invest-

13/Colorado, Kansas. Nebraska, Wyoming, 43 western Missouri counties, northern New Mexico, and most of Oklahoma.

Table 4

STATE AND LOCAL INCOME TAX BURDENS OF BANKS
TENTH DISTRICT STATES, BY DEPOSIT SIZE

States by deposit size	Ratio of state and local income taxes paid to net income (In per cent)		State tax rates applicable to banks' net income
	1961	1974	1974
Colorado	6.4	2.5	5%
Less than $10 million	6.5	1.9	
$10 to $100 million	6.6	2.5	
$100 million and over	6.2	2.8	
Kansas	—	4.4	5% on income < $25,000 7.25% on income > $25,000
Less than $10 million	—	3.7	
$10 to $100 million	—	4.6	
$100 million and over	—	5.0	
Missouri*	2.9	2.4	7%
Less than $10 million	1.5	1.7	
$10 to $100 million	1.7	2.6	
$100 million and over	4.1	2.3	
Nebraska	—	1.7	2.75%
Less than $10 million	—	1.8	
$10 to $100 million	—	1.9	
$100 million and over	—	1.1	
New Mexico'	—	5.1	6%
Less than $10 million	—	5.3	
$10 to $100 million	—	5.1	
$100 million and over	—	5.1	
Oklahoma*	2.7	1.9	4%
Less than $10 million	3.1	2.5	
$10 to $100 million	2.6	2.0	
$100 million ond over	2.6	1.4	
Wyoming	—	—	0

* Banks in Tenth District portion of state.
SOURCE: Reports of Income, Federal Deposit Insurance Corporation.

ments in state and local government securities, creation of reserves for bad debts substantially in excess of actual losses, and the development of equipment leasing operations. Banks in the Tenth Federal Reserve District generally experienced similar trends, but over the period were subject to an effective Federal tax burden above the national average. In 1974, for example, the Federal tax burden was 18.6 per cent for Tenth District banks, compared with 14.5 per cent for all banks in the nation. On the other hand, the state and local income tax burden of Tenth District banks was somewhat below the national average. On balance, Tenth District banks averaged a total income tax burden of 21.2 per cent, compared with 18.8 per cent for U. S. banks.