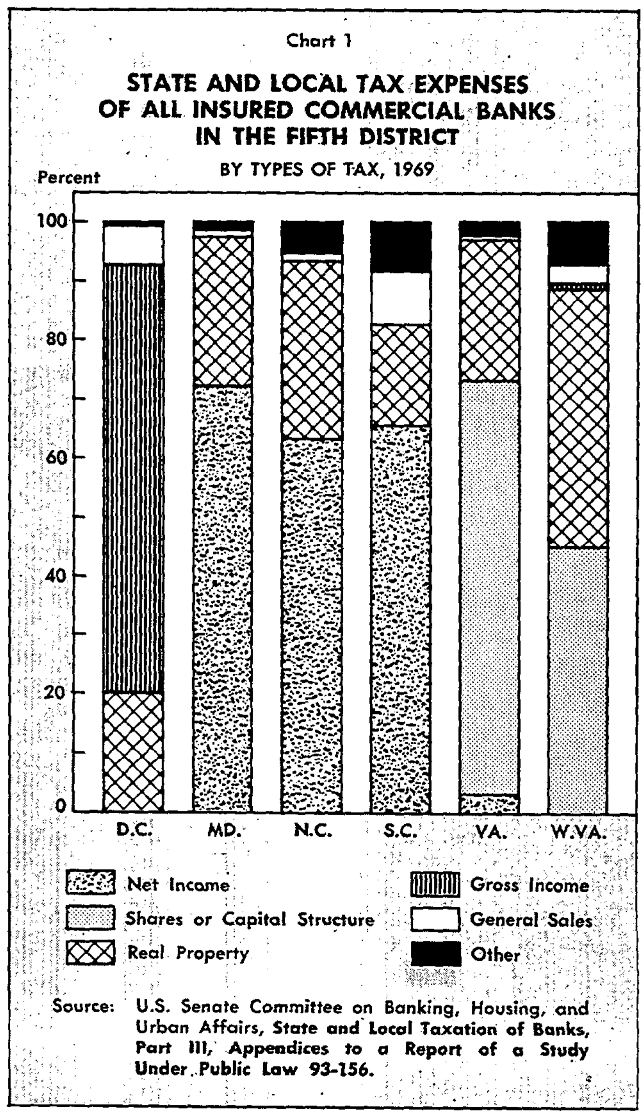
State Taxation of Fifth District Banks

Until recently, the powers of the states to tax banks have been narrowly restricted by Federal statutes. Most important among these laws was the famous Section 5219, U. S. Revised Statutes, 12 U.S.C. (hereafter: "Section 5219"), which limited the types of taxes that states could levy on national banks. The restrictions of Section 5219 date back to the 19th century, to the days when national banks had currency-issuing and fiscal agency functions and could legitimately be considered "instrumentalities of the Federal Government." The Federal Reserve System long ago took over these functions, thereby rendering Section 5219 obsolete. Recognizing the obsolescence of the law, Congress in 1969 moved to revise it by means of a "temporary amendment," which allowed states to apply most types of taxes to national banks. Moreover, a "permanent amendment," initially scheduled to become effective in 1972 but subsequently deferred until January 1, 1973, went further and completely rewrote Section 5219 to specify that national banks could henceforth be taxed in the same manner as state banks. This article, focusing on the Fifth District, discusses in turn the major types of taxes paid by banks under the old Section 5219, the changes in state tax treatment of banks following enactment of the "temporary" and "permanent" amendments, and the possibilities for further change now that the "permanent amendment" is in force.

Major Forms of Bank Taxation The original Section 5219, enacted as part of the National Banking Act of 1864, allowed states and their political subdivisions to levy real estate and shares (capital stock) taxes on the newly created national banks.[1] As amended in the 1920's, Section 5219 permitted the states to substitute either an income tax or an excise tax "according to or measured by" net income for the shares tax, if they wished. No other form of taxation could be applied to national banks. Nothing in Federal law prevented other types of taxes from being applied exclusively to state-chartered banks. Such instances of discriminatory taxation, however, have been rare in recent years, at least in the Fifth District. As Chart 1 demonstrates, more than 80 percent of the taxes paid by all banks to state and local governments (with the exception of the District of Columbia)[2] in 1969, the last year under "old" Section 5219, were of the types applicable to national banks. Most of the remaining taxes, such as the sales tax in South Carolina and the tax on bank deposits in North Carolina, were officially levied on state banks and paid "voluntarily" by national banks. The "voluntary" tax arrangement effectively skirted the restrictions of Section 5219. As might seem obvious, however, no major

[1] Not only were these common types of taxes; but they had been specifically designated as permissible, if applied by a state to the Bank of the United States, by Chief Justice John Marshall in his famous decision in the McCulloch vs Maryland decision, 4 Wheat. 316 (1819). The legacy of that decision was undoubtedly a factor responsible for the restrictions of Section 5219 in the first place.

[2] The District of Columbia was never subject to Section 5219. Instead, Congress imposed a gross receipts tax of 7 percent on banks operating in the District. The District sales tax has also applied to purchases made by national banks.



amounts of revenue were collected from banks in this manner.

Of the three major modes of bank taxation, one, the tax on real property, is almost exclusively within the province of the local city, town, or county governments. It exists everywhere, but presents no novel features when applied to banks, so little more need be said about it here. State governments, for their part, were left to choose between the shares tax and the income tax.

Shares Taxes In thirteen states, including Virginia and West Virginia, banks pay a shares tax rather than an income tax. Originally, the shares tax derived from the general property tax; and it still retains much of the character of a property tax in West Virginia, where the tax is paid on the basis of "true and actual value" of bank shares, minus a deduction for real property taxes. The assessments are made by the individual counties, which also set the rates. Virginia's tax, on the other hand, is a flat tax on bank capital, surplus, and undivided profits, minus a deduction for the assessed value of real property. The rate is 10 mills (1¢) per dollar value. The state collects the tax; but half the revenues are shared with the cities and towns, which can, additionally, levy their own shares tax if they wish, at rates up to 8 mills per dollar value. In such cases the local tax is credited against the state tax. Both states levy the tax officially on the shareholder; but it is, in practice, collected and paid by the bank.

For a long time the shares tax was the most popular tax levied on banks, even after the 1920's amendments to Section 5219 permitted income taxes. The shares tax fit well into the general tax structure of most states, was relatively high-yielding, and did not rise and fall with bank income—a virtue, perhaps, from the point of view of the states seeking revenue in the unstable banking era that lasted until 1933. The tax does have notable disadvantages. In some states the vagaries of local assessment procedures probably resulted in uneven and discriminatory levies. The tax, additionally, falls on capital and thus provides some incentive to minimize the amount of capital held. Most bankers have come to view the income tax as a fairer tax, and most states, in a period of high and rising bank income, have seen it as a more lucrative source of revenue. Accordingly, thirty-seven states have switched to the income tax since 1926, and none has switched back. For all that, the shares tax does not seem to be distinctly inferior to the income tax, which has some disadvantages of its own.

Income Taxes States that first switched to the income tax in the 1920's did so by simply making banks subject to existing state corporation income taxes. As such, they found an income tax on banks to be a disappointing source of revenue, because Federal debt statutes prohibit state taxation, under a direct income tax, of that part of income consisting of interest from U. S. Government securities. For the purpose of taxing most types of businesses, this provision hardly matters, but banks are a special case. Because of their large holdings of various U. S. Government securities, a significant portion of their income is exempt from taxation under state income tax laws. Furthermore, states had no way to compensate for this shortfall, because Section 5219 and constitutional law prohibited either raising tax rates on national banks alone or introducing other taxes to compensate. Another avenue was open, however. By designating the tax a "franchise" or "excise" tax, "measured by or according to" net income, the states could, in fact, bring interest income from Federal securities under the income tax. This redefinition involved no essential change in the nature of the tax, other than one of wording. In a 1926 amendment to Section 5219, Congress sanctioned the application of this "excise" income tax to national banks. More recently, the "excise" income tax has become widely applicable. Nearly all of the state income taxes paid by banks, including the bank income taxes of Maryland, North Carolina (until this year), and South Carolina have been of this variety. The rates in these states are 7 percent, 6 percent, and 4½ percent, respectively.[3]

The "excise" income tax has been popular both with the state governments and, generally but not universally, with bankers. The former view it as a lucrative source of revenue, especially when rates are as high as 6 percent; the latter see it as a fair tax, covering a broad but easily definable tax base that varies roughly with ability-to-pay, i.e., with net income. Nevertheless, the "excise" income tax does have some deficiencies as a form of taxation. First, the incidence of the tax, as for all corporate income taxes, is not known for sure; it could be, for example, that the tax falls on capital as much as does the shares tax. Secondly, as is better known, the "excise" income tax has some portfolio-distorting effects. Because the tax falls on U. S. Government securities

[3] These are, of course, nominal rates. The effective rates of tax could only be determined by examining in detail the various specific definitions of the tax base, allowable deductions, etc. No attempt to do so will be made here. For a description of the major feature of the tax in each state, see Commerce Clearing House, *State Tax Guide*, 1973. Some indication of the effective rates of tax may be found in the interstate comparison of tax burdens, discussed later in the article.

but generally not on in-state municipal securities, the effective yield of the former to the banks is reduced relative to that of the latter. Banks end up buying more municipals and fewer Governments than otherwise, and perhaps, their total *after-tax* yields are lower than they might be if another type of tax were in effect. Of course, the magnitude of this distortion may be small if it exists at all and is in any case dwarfed by a far larger distortion caused by similar rules involved in determining the *Federal* income tax base. Future efforts at tax reform in the "excise" income states may, however, center around this distortion factor, especially since other tax alternatives, under the "new" Section 5219, are now available to the states.

A Comparison of Interstate Tax "Burdens" Attempts to measure the extent of corporate tax burdens are always hampered by a host of formidable problems. For one thing, the incidence of different taxes is often difficult to detect and still more often difficult to measure. Moreover, even if the incidence problem is ignored, measures of tax burden, which are ratios comparing total taxes paid to some indicator meant to represent taxable capacity, are necessarily arbitrary, since no one yet has devised a reliable measure of taxable capacity, or, for that matter, a precise definition of what taxable capacity really means.

Subject to these caveats, Table I compares the amounts of taxes paid by banks in each Fifth District state and the District of Columbia. Although four different measures of taxpaying capacity are used, it appears that the comparative results are virtually the same in each case. The results, not surprisingly, mirror the effects of varying tax *rates* on income or share taxes, although all taxes are included. The apparent implication is that high tax *rates*, rather than the type of taxes imposed, are the important factors making for relatively higher tax burdens.

The figures in Table I are for 1969, the last year for which such data are available. As will be shown in the following section, however, the effects of changes in tax rules since 1969 on the Table I figures are not difficult to estimate.

Changes Since 1969 The "temporary amendment" to Section 5219 significantly liberalized the rules. After 1969, states were restricted only from taxing national banks on the basis of intangible personal property and from levying certain types of taxes on out-of-state banks. The lingering ban on intangible property taxation was removed when the "permanent amendment" came into effect in 1973. These new regulations led the legislatures in the Fifth District states to reassess their tax treatment of banks. Varying degrees of change resulted.

In most cases the changes were relatively minor. Sales and use taxes on purchases of equipment and other material items were made applicable to both national and state banks in each state or were made compulsory where they had been "voluntary." National banks became subject to documentary taxes, license taxes, motor vehicle registration taxes, and any other such general category from which Section 5219 had exempted them. Figures showing the re-

Table I

STATE AND LOCAL TAX EXPENSES OF FIFTH DISTRICT BANKS: RATIOS TO SELECTED INCOME STATEMENT AND BALANCE SHEET ITEMS, 1969

		Ratios of ALL taxes to:			
State	Principal tax on banks	Gross Operating Revenue	Net Income Before Taxes	Net Income After Taxes	Equity
District of Columbia	7%, Gross Income	2.4	7.5	14.5	1.9
Maryland	7%, Net Income	2.1	7.4	13.3	1.6
North Carolina	6%, Net Income	1.2	5.8	9.2	1.1
South Carolina	4½%, Net Income	1.3	4.7	7.3	1.0
Virginia	10 mills per $1 value of capital, surplus, undivided profits	1.3	5.8	9.1	1.1
West Virginia	Value of bank shares (rates vary by county)	1.2	4.5	6.8	0.7

Source: U. S. Senate Committee on Banking, Housing, and Urban Affairs, State and Local Taxation of Banks, Part III, Appendices to a Report of a Study Under Public Law 91-156 (Washington, D. C.: Government Printing Office, 1972) pp. 15-16, 53-54.

sulting differences in bank revenues are not available; but a fair guess would be in the range of 5 to 10 percent, depending on the types of taxes and the rates of tax, which vary among the states.

An additional more substantive change took place in West Virginia, where banks became subject in 1971 to the state's "business and occupation tax," a tax on gross receipts of 1.15 percent. It may be recalled from Table I that bank tax burdens in West Virginia were the lowest of all the Fifth District states in 1969. The gross receipts tax is likely to redress the balance.

The most drastic changes in the Fifth District took place in North Carolina, during the 1974 legislative session. The excise (income) tax was repealed, along with a series of *in lieu* provisions that had exempted banks from certain other state taxes paid by North Carolina corporations. Under the new tax law the banks instead became subject to the latter categories of taxes, which include (1) a corporate income tax, with income from U. S. Government securities exempted; (2) a corporate franchise tax; (3) taxes on tangible personal property, as levied by local governments; and (4) an "intangibles" tax, to be paid on the basis of total vault cash as of December 31 of each year. As it was estimated that the revenues from this new batch of taxes would not completely compensate for the revenue loss resulting from repeal of the existing law, a fifth tax was added. This additional levy, a state "privilege license tax," consists of a lump sum payment of $30 for each $1 million, or fractional part, of total assets. For tax purposes, "total assets" for any year consist of the average of total assets at the end of each quarter. As a partial offset to this state tax, local governments are henceforth prohibited from levying such "privilege" taxes of their own, as many have done since 1969.

The chief purpose of the North Carolina tax changes appears to be uniformity in the tax structure. Taxing banks in the same manner as other corporations, to the maximum extent possible, was seen as a goal in itself—a goal that was clearly impossible under the old Section 5219. The new law is not meant either to increase or decrease bank tax burdens. It is, of course, too early to tell whether this effect has been achieved. In all probability, however, deviations in either direction will be of no great magnitude.

Under the Permanent Amendment: The Scope for Further Change There has not been any tendency among other Fifth District states to emulate North Carolina by completely revising the tax laws affecting banks. Nor do any such changes appear to be in the offing. All changes, great and small, that *have* taken place do, however, follow that same general pattern: greater uniformity of tax treatment of banks and other corporations. Few of the new taxes affecting banks have applied to banks, or to financial institutions, alone, but rather to businesses generally. It is obvious that absolute uniformity cannot be achieved—not, at any rate, without serious inequities. A major portion of business taxes in nearly all states derives from the corporation income tax, under which banks generally pay less than other corporations under an ordinary income tax, owing to the mandatory exemption of interest from U. S. Government securities. Whatever the desire for tax uniformity, state governments will always find it in their interest to make up the inherent revenue shortfall, either by applying an "excise" income tax, by taxing banks on the basis of shares or gross receipts instead of income, by a lump sum or "privilege" tax (as in North Carolina), or by some combination of these alternatives.

On the other hand, there has been no tendency to subject banks to heavy taxation in light of removal of the Section 5219 restriction, or to levy taxes which, even if applied to all businesses, might fall disproportionately on banks. One such tax would be a general tax on "intangible" property. Most bank assets are intangible property. During the hearings preceding the amendments of 1969 and 1973, some observers expressed fears that states might impose "intangible" property taxes that would apply to loans, vault cash, and perhaps even (for member banks) required reserves held on deposit at Federal Reserve Banks. In a 1971 study prepared for Congress, the Board of Governors cited the dangers of intangible taxes: the incentive to evade would be great; assets subject to tax would be transferred to holding companies, or to subsidiaries, or out of state; banks would switch their assets from taxable to nontaxable form; loan customers would have incentive to apply out of state, or to avoid the banking system altogether; general inefficiency and waste would result. As we have seen, a ban on intangibles taxation was inserted into the temporary amendment, but not into the permanent amendment. It would seem, however, that the imposition of such taxes will remain unlikely. Intangibles taxation has become unpopular among the states. The general tendency during the last few decades has been to repeal such taxes, not to enact them. Where this form of taxation still exists, as in North Carolina (noted above), it is in an extremely restricted form and unlikely to have any dire effects.

State and local revenue needs are not as pressing at the present time as they were a few years ago, so additional taxes on Fifth District banks do not seem likely in the immediate future. Any future tax initiatives—barring an overhaul similar to North Carolina's—would, in all probability, take the form of higher rates on existing taxes, rather than new forms of taxation. It is even less likely that a disproportionate share of any increased taxation would fall on banks, even with the shield of Section 5219 removed.

Sources of Bank Taxation: The Question of Out-of-State Banks States have not ordinarily levied taxes on banks domiciled in other states, but the permanent amendment, in theory, gives them the power to do so. Taxation of out-of-state banks, however, might prove to be a complicated matter, owing to the difficulties likely to arise from any attempt to apportion the tax base and the limits to taxation of interstate commerce imposed by constitutional law. For example, if a bank in State A made a loan to a customer in State B, it is not easy to see how State B could subject the bank to, say, income taxes on the interest income from that loan, without imposing unfair, and possibly unconstitutional, double taxation (if the bank already pays tax to State A). The inherent possibilities for ambiguous interpretations of tax laws and arbitrary interstate taxation of banks, with the distortion of capital mobility that would inevitably result, led the Board of Governors to recommend in the above-mentioned report that limitations on interstate taxation of banks be continued under the permanent amendment, at least until uniform, equitable, national standards for such taxation could be developed. The recommendation was not adopted, but Public Law 93-100, enacted in August of 1973, imposed a new ban, lasting until January 1, 1976. Meanwhile, the Advisory Commission on Intergovernmental Relations was directed to prepare a study of the whole question, with a completion date of December 31, 1974. Presumably Congress will again take up the matter in 1975. A future relaxation of the current prohibition, which is not altogether inconceivable, would undoubtedly lead to a corresponding change in state tax policies.

Conclusion It would seem that the tax changes induced by the alterations in Section 5219 have not been far-reaching, at least as far as revenues and tax burdens are concerned, and that further substantial changes are unlikely in the near future. The implication is that the "old" Section 5219 was not so restrictive, after all. Even so, there is no doubt that the changes in the law were desirable. First, the amendments to Section 5219 resulted in the removal of some completely unnecessary prohibitions (the sales tax being the most obvious example), which is sufficient justification. Second, as the example of North Carolina illustrates, the changes leave individual states free to handle the issues of bank taxation in whatever manner seems most appropriate. The changes have not, as yet at least, resulted in any adverse effects.

Daniel A. Karp