Testimony of Walter Hellerstein

on

State Tax Implications of Full Interstate Branching

Before the

Subcommittee on Economic Stability

of the

Committee on Banking

United States House of Representatives

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I am Walter Hellerstein, Professor of Law at the University of Georgia and Of Counsel to the law firm of Morrison & Foerster. I have devoted most of my professional life to the study and practice of state and local taxation and, in particular, to the federal constitutional and statutory limitations on state taxation. For the Subcommittee's information, I have attached a resume, which summarizes my background and lists my publications. While I am appearing on behalf of the Financial Institutions State Tax Coalition, I can assure the Subcommittee that I would not be here today if the views I am about to express did not reflect my best professional judgment.

The principal question I wish to address is whether proposed federal legislation permitting state and national banks to establish branches in states in which they are not domiciled will curtail the states' existing power to tax the income from federal obligations. In my judgment, the answer to this question is "no."

Under existing law, there is one significant restraint on the states' power to tax income from federal obligations. Section 3124 of Title 31 of the United States Code provides:

Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both to be considered in computing a tax, except . . . a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation.

This provision by its terms permits the states to tax income from federal obligations so long as they do so by means of a
nondiscriminatory corporate franchise tax. There is nothing in
the proposed federal legislation authorizing interstate branching
that purports to limit the states' power to tax federal
obligations. Consequently, unless there is some implicit
prohibition on the states' imposition of nondiscriminatory
franchise taxes on nondomiciliary banks,\textsuperscript{1} the plain meaning of
the statute compels the conclusion that the states retain the
power to impose such taxes.\textsuperscript{2}

The contention that the repeal of the McFadden Act will
implicitly limit the states' power to tax the federal obligation
income of nondomiciliary banks is advanced in a paper by Sandra
McCray entitled "The Effect of the Repeal of the McFadden Act on

\textsuperscript{1}As of September 12, 1976, Congress terminated all
congressionally granted immunity of national banks from state
as amended by Pub. L. 93-495, Title I, § 114, Oct. 28, 1974, 88
Stat. 1507; Pub. L. 94-222, §§ 1, 4, Feb. 27, 1976, 90 Stat. 197,
198 (codified at 12 U.S.C. §548 (1988)). The only congressional
restriction on state taxation of national banks is that "a national
bank shall be treated as a bank organized and existing under the
laws of the State or other jurisdiction within which its principal
office is located." \textit{Id}. The United States Advisory Commission on
Intergovernmental Relations described the effect of this amendment
as follows, in a congressionally authorized study of state taxation
of out-of-state banks: "States other than the principal office
state will be in a position to tax out of-State national banks
which are engaged in the conduct of interstate banking transactions
under . . . franchise taxes measured by net income in the same
manner and to the same extent as any other foreign corporation."
U.S. Advisory Commission on Intergovernmental Relations, \textit{State and
Local "Doing Business" Taxes on Out-of-State Financial

\textsuperscript{2}The U.S. Supreme Court has instructed that when construing
federal statutory restraints on state taxation, "courts need not
look beyond the plain language of the federal statute to determine
whether a state statute that imposes such a tax is preempted."
Aloha Airlines, Inc. v. Director, Division of Taxation, 464 U.S.
State Tax Revenue." Her essential thesis is that "states may include federal obligations in the measure of their franchise tax only when the tax is on a domestic corporation or when states have granted a special privilege to the corporation being taxed."³ In her view, if the McFadden Act is repealed, banks will not need state permission to expand interstate; states will not be able to insist that out-of-state banks operate in the state through a locally-domiciled subsidiary; and, because the "states will not be the grantor of the privilege of interstate banking and the host state will not be the domiciliary state to the bank," the states will "no longer have the power to tax the income from federal obligations."⁴

Ms. McCray's thesis is based on the fundamentally misguided notion that the states' power to tax federal obligation income depends on the grant by the state of a "special privilege" that she equates with the power of a state to exclude the corporation from doing business in the state. Her argument reflects an antiquated and formalistic view of state taxing power that prevailed during the nineteenth century but which has been unequivocally repudiated by the U.S. Supreme Court in its modern


decisions.\textsuperscript{5} Thus the Court's modern decisions permit states to tax out-of-state corporations so long as the tax is applied to an activity that has a substantial nexus with the state, is fairly apportioned, is nondiscriminatory, and is fairly related to services provided by the state.\textsuperscript{6} State tax power does not depend, as Ms. McCray argues, on the states' power to exclude.

To be sure, with respect to state taxation of federal obligations, and, indeed, with regard to state taxation of the federal government and its instrumentalities generally, there is one formalism that remains. The states may not impose a tax "directly" on the federal government or its instrumentalities although they may do so "indirectly."\textsuperscript{7} The long-standing rule that the states may not impose a direct net income tax on the income from federal obligations but may impose an indirect franchise tax on such income reflects this formalism, and this rule is embodied in 31 U.S.C. § 3124.

But this formalistic rule---that the states may tax federal obligations (or the income therefrom) so long as the legal incidence of the tax falls on some taxable subject that is

\textsuperscript{5}See, e.g., Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) (overruling the doctrine that the states could not impose a "privilege" tax on an interstate business, because the states had no power to grant the "privilege" of doing interstate business); Western & Southern Life Ins. Co. v. State Bd. of Equalization, 451 U.S. 648 (1981) (overruling the doctrine that a state's power to exclude a foreign corporation justified a discriminatory tax for the "privilege" of conducting a local business in the state).


\textsuperscript{7}See, e.g., United States v. New Mexico, 455 U.S. 720 (1982).
distinct from the obligation (or the income) itself—is wholly consistent with state taxation of the federal obligations of out-of-state banks. Because the legal incidence of the typical state franchise tax falls on the privilege of doing business, owning property, maintaining employees, or conducting other specified activity in the state (rather than on the income itself), it may be applied to the federal obligation income of an out-of-state bank that engages in such activity.

Ms. McCray's argument is predicated on the premise that the only privilege for which states may impose a nondiscriminatory franchise tax is the power to exclude, and once this power has been wrested from the states by congressional repeal of the McFadden Act, the states will lack the power to impose such a tax. But this premise is false. In numerous cases, the Supreme Court has sustained state franchise taxes on "privileges" that are distinct from the power to exclude. Indeed, the very cases

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9This assumes, of course, that the federal obligation income is derived from a unitary business being conducted in the state. See Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980).

10See, e.g., Colonial Pipeline Co. v. Traigle, 421 U.S. 100 (1975) (corporate franchise tax as applied to nondomiciliary corporation validly predicated on the "privileges" of exercising a corporate charter in the state, owning or using property in the state, or doing business in the state in corporate form); Memphis Gas Co. v. Stone, 335 U.S. 80 (1948) (corporate franchise tax as applied to nondomiciliary corporation validly predicated on "privileges" of maintaining, keeping in repair, and otherwise manning facilities of an interstate pipeline); Coverdale v. Arkansas-Louisiana Pipe Line Co., 303 U.S. 604 (1938) (corporate franchise tax as applied to nondomiciliary corporation validly
that Ms. McCray cites for the proposition that the power to tax federal obligations was in some sense a quid pro quo for some "special privilege" granted by the state stand merely for the proposition that a state tax measured by federal obligations is valid when it is imposed on some taxable subject other than the federal obligations themselves.\textsuperscript{11} It is the hoary "direct"-"indirect" distinction that still controls states' power to tax federal obligations but is in no sense tied to the states' power to exclude the corporation that is subject to the "indirect" levy. Indeed, Professor Paul Hartman, who Ms. McCray characterizes as "a leading state tax scholar,"\textsuperscript{12} flatly declares that the validity of a state tax on federal obligations "turns on what the Court concludes is the statutorily styled subject of the tax, and not what gives value to the styled subject."\textsuperscript{13}

Perhaps the most telling refutation of Ms. McCray's thesis is that virtually all states with franchise taxes impose their levies on the federal obligation income from out-of-state

\textsuperscript{11}See, e.g., Pacific Co. v. Johnson, 285 U.S. 480, 490 (1932) (recognizing that a tax upon "a franchise" or "the privilege of doing business in corporate form" was distinct from a tax on federal obligations themselves); Educational Films Corp. v. Ward, 282 U.S. 379, 389-90 (1931) (recognizing that indirect "excise" tax on "corporate franchises" and other discrete subjects of taxation may be measured by federal obligations, "although the statutory measure of the tax included securities constitutionally immune from any form of direct taxation").

\textsuperscript{12}Reply of Sandra McCray, note 3 supra, at 2.

\textsuperscript{13}P. Hartman, Federal Limitations on State and Local Taxation 349 (1981).
corporations. If Ms. McCray's thesis were correct, there would be a serious constitutional problem with states taxing the federal obligation income of out-of-state general business corporation. Unlike out-of-state banks, which are granted a "special privilege" of conducting business in the state under the McFadden Act which allegedly justifies the states' taxing their federal obligations, the typical out-of-state corporation is granted no such privilege by the state because the Commerce Clause guarantees its right to conduct an interstate business without asking the state's permission. If the state's power to tax the federal obligation income earned by such corporations depended on the state's power to exclude such corporations from the state, the states would obviously be in constitutional difficulty in imposing such taxes.

Ms. McCray appears to recognize this problem in her response to a letter of William Collins, Deputy Commissioner and Counsel to the New York Department of Taxation and Finance. Mr. Collins took issue with her position that the Supreme Court's decisions did not permit states to include federal obligations in the franchise tax measure of a nondomiciliary corporation. He also observed that New York has taxed such income since at least 1944. In response, Ms. McCray declared:

If New York does indeed impose a franchise tax on the income from federal securities held by nondomiciliary general business corporations, it may be the only state to do so. For general business corporations, income from federal securities is "nonbusiness" investment income. Under the Uniform Division of Income for Tax Purposes
Act (UDITPA), such income is taxed solely by the state of domicile. Approximately 46 states use UDITPA or some variation thereof. Moreover, the U.S. Supreme Court has noted in connection with the unitary business principle that a state does not have jurisdiction to tax an apportioned share of the income from intangibles unless those intangibles are related to and an integral part of the business of the nondomiciliary corporation (i.e., the income from the intangibles must be business income). This reasoning may be applicable to the taxation of nonbusiness income of nondomiciliary general business corporations whether or not the state uses the unitary business principle. Thus, the New York practice with regard to the taxation of the nonbusiness income (from federal securities) may be questionable.\textsuperscript{14}

Ms. McCray is wrong on the facts and wrong on the law. Far from being the only state with a franchise tax to impose its levy on the income from federal securities earned by nondomiciliary corporations, New York enjoys the company of many of her sister states that impose such taxes. Thus California,\textsuperscript{15} Connecticut\textsuperscript{16}, Florida,\textsuperscript{17} Massachusetts,\textsuperscript{18} Minnesota,\textsuperscript{19} Montana,\textsuperscript{20} New Jersey.\textsuperscript{21}

\textsuperscript{14}See Reply of Sandra McCray, note 3 supra, at 3.


\textsuperscript{16}[1] Multistate Corporate Income Tax Guide (CCH) ¶ 2352.

\textsuperscript{17}Letter to CCH from Florida Department of Revenue, Corporate Income Tax Bureau, [1] Multistate Corporate Income Tax Guide (CCH) ¶ 303.27

\textsuperscript{18}[1] Multistate Corporate Income Tax Guide (CCH) ¶ 3108.02.

\textsuperscript{19}Minn. Stat. § 290.01.19c(2) (1990).

Oregon,\textsuperscript{22} Tennessee,\textsuperscript{23} Utah,\textsuperscript{24} and Wisconsin\textsuperscript{25} all impose their franchise taxes on the federal obligation income of nondomiciliary corporations.

Moreover, this widespread practice among the states of taxing the federal obligation income of nondomiciliary corporations is fully in accord with settled legal doctrine in this area. A leading treatise on state taxation states that "the immunity doctrine does not prevent the States from including in the measure of franchise or excise tax on the conduct of business in the State interest on federal securities."\textsuperscript{26}

Ms. McCray further errs when she asserts that, under the Uniform Division of Income for Tax Purposes Act (UDITPA), "[f]or general business corporations, income from federal securities is "nonbusiness" investment income."\textsuperscript{27} In fact, under UDITPA all


\textsuperscript{22}Pacific First Federal Savings Bank v. Department of Revenue, 308 Ore. 332, 779 P.2d 1033 (1989) (Oregon nondiscriminatory franchise tax properly applied to federal obligations of nondomiciliary federally-chartered stock savings bank doing business in Oregon); [1 Ore.] State Tax Rptr. (CCH) ¶ 10-305.

\textsuperscript{23}[1] Multistate Corporate Income Tax Guide ¶ 4152.


\textsuperscript{25}Wis. Corp. Franch. Tax Rule 2.65, reported in [1 Wis.] State Tax Rptr. (CCH) ¶ 14-639.

\textsuperscript{26}1 J. Hellerstein, State Taxation: Corporate Income and Franchise Taxes 265 (1983).

\textsuperscript{27}See text at note 14 supra.
"business income," which includes "income from . . . intangible property if the acquisition, management, and disposition of the property constitute integral part of the taxpayers' regular trade or business operations,\textsuperscript{28} is taxable in part by a nondomiciliary state. Not only is there no presumption, as Ms. McCray suggests, that income from federal securities constitutes "nonbusiness" investment income, but in fact the UBITPA regulations presume all "income of the taxpayer is business income unless clearly classifiable as nonbusiness income."\textsuperscript{29} The case law arising under UBITPA likewise reveals that the income from federal securities earned by nondomiciliary taxpayers doing business in a state is routinely taxable as apportionable business income.\textsuperscript{30}

Finally, it is worth noting that only a few years ago Ms. McCray herself squarely acknowledged the very proposition that she is now attacking: "As the law stands today, then, a state franchise tax measured by net income, including the income from federal obligations earned by a bank operating in interstate commerce, is valid if (1) the bank has, by means of regular and

\textsuperscript{28}UDITPA § 1(a) (emphasis supplied).


deliberate contacts with the state, earned income from sources therein, and (2) the tax is fairly apportioned and does not discriminate against banks operating in interstate commerce."\textsuperscript{31} There is not a hint of Ms. McCray's current thesis that a state franchise tax on an out-of-state bank is permissible only if the state has granted a "special privilege" to the corporation being taxed.

In closing, I wish to emphasize that I am not here either to support or oppose federal legislation authorizing interstate branch banking. My sole purpose is to assure that your deliberations on the merits of interstate branching not be distracted by disinformation regarding the imagined effect that such legislation would have on the states' power to tax federal obligations.

\textsuperscript{31}McCray, State Taxation of Interstate Banking, 21 Ga. L. Rev. 283, 326 (1986) (emphasis supplied).