STATEMENT OF SANDRA B. MCCRAY

ON

THE EFFECT OF THE REPEAL OF THE MCFADDEN ACT
ON STATE TAX REVENUES

BEFORE THE HOUSE SUBCOMMITTEE ON
ECONOMIC STABILIZATION
OF THE
HOUSE COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

MAY 15, 1991
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My name is Sandra McCray, and I am a lawyer who has worked with and written on state tax issues for several years. In addition to my work with states, I teach tax and communications law at the University of Colorado. I appreciate the opportunity to speak to the Committee to present my view on the effects of geographic deregulation on state tax revenues.

As requested by Committee Chairman Carper I will consider the following issues in my testimony:

1. What are the specific results of my analysis on the repeal of the McFadden Act on state tax revenues?

2. From what legal bases are my conclusions derived?

3. Based on my analysis, what states would be adversely affected by the repeal of the McFadden Act? How significant is taxation of federal obligations to a state's tax base?

4. How could legislation be drafted to clarify that states may impose a franchise tax with respect to Federal obligations regardless of the domicile of the entity subject to such tax? Am I aware of any current legislative proposals which adequately address this issue?

In addition I wish to address the following question:

5. What effect will geographic deregulation have on state apportionment formulas?
1. The Effect of the Repeal of the McFadden Act on State Tax Revenue

I believe that the members of the Committee have a copy of a report that I wrote for the Conference of State Bank Supervisors. The title of that report is "The Effect of the Repeal of the McFadden Act on State Tax Revenue." In that report I examine in some detail the four federal laws, legislative history, and case law that control state taxation of federal obligations. My analysis of the case law, federal statutes, and relevant legislative history leads me to the following conclusion: state taxation of federal obligations is limited to franchise taxes on domiciliary banks or on banks that are granted a special privilege by the taxing state. Because a repeal of the McFadden Act and Douglas Amendment to the Bank Holding Company Act would remove state control over the entry of out-of-state banks, states may lose their ability to tax federal obligations of nondomiciliary banks. Other consequences flow from the loss of the ability to tax federal obligations held by nondomiciliary banks. I discuss those consequences in my answer to question 4.

2. The Legal Bases for My Conclusions

The primary federal statute governing state taxation of federal obligations is found in 12 U.S.C. section 3124(a), which currently provides that:

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 ...."

To understand fully the effect of this law on state taxation of the federal obligations held by banks, one must examine the entire federal statutory scheme, including the following four related laws: Section 3124(a) quoted above; Section 548 of the U.S. Code (National Bank Act); the McFadden Act; and the Bank Holding Company Act (including the Douglas Amendment). The legislative and judicial history of these laws illustrate how they operate in concert to allow states to tax the income from federal obligations held by a national bank only if they impose a franchise tax either on a domiciliary bank or on a nondomiciliary bank to whom they have granted a special privilege.
The Legislative and Judicial History of Section 3124(a).

In 1829, the U.S. Supreme Court found in Weston v. Charleston that a property tax imposed by Charleston, South Carolina on stock issued by the Bank of the United States violated the borrowing clause of the Constitution. Later, in 1862 Congress codified the Supreme Court's holding in Weston by enacting a law exempting from state taxation "all stocks, bonds and other securities" of the federal government.

The total prohibition against state taxation of federal obligations did not last long, however. In 1867, the Supreme Court considered the validity of a Connecticut statute that levied a tax on the deposits of state-chartered savings banks. One Connecticut bank challenged the tax, claiming that it violated the federal law prohibiting state taxation of U.S. government securities because some of the bank's deposits were invested in federal securities. Connecticut countered that its tax was levied on the franchise of a corporation created by the state legislature and was therefore valid. The Court agreed with the state, upholding the tax as a valid franchise tax. According to the Court:

Nothing can be more certain in legal decision than that the privileges and franchises of a private corporation ... may be taxed by a State for the support of the State government. Authority to that effect resides in the State independent of the Federal government, and is wholly unaffected by the fact that the corporation ... has or has not made investment in Federal securities.

In 1899, however, the Supreme Court struck down a similar state franchise tax levied on a national bank. Unlike the situation with state-chartered banks, states do not have the power to grant charters to national banks; therefore, they have no independent power to impose a franchise tax without permission from Congress. Congress gave states permission in 1926 when it amended the National Bank Act allowing states to levy a franchise tax measured by net income on national banks. Members of the House explained the purpose of the amendment as follows:

In the States which now apply the net income tax method to corporations generally and denominate it an excise or a franchise tax, the practice is to include income from all sources, including income from tax-exempt securities, in arriving at the measure of the tax based on the net income. Therefore, it is desirable, in order to establish complete taxing parity, to remove any question as to the inclusion of the income from tax-exempt securities as part of the measure of the tax based on the net income of national-banking associations; so that the same basis of measuring the tax
according to net income for corporations generally may be applied to national-banking associations by the taxing State.

The taxing parity created by Congress in 1926 allowed states to tax the income of national banks under the same conditions and to the same extent as they taxed the income of state banks. In 1926, state franchise taxes on state banks and private corporations were deemed valid only if they were imposed on domestic banks and corporations, or in some cases, on foreign corporations receiving special privileges from the taxing state. According to the above legislative history, Congress required that same conditions applied to state franchise taxation of national banks.

In my article, I cite several decisions in which the U.S. Supreme Court addressed the issue of state franchise taxation of the income from federal securities. In each case the Court upheld state franchise taxes on the federal obligations held by banks and other entities if the entity being taxed was either a domiciliary bank or corporation or a nondomiciliary corporation that received a special privilege from the taxing state.

Establishing which state is the domiciliary state of a bank is thus one of the two alternative critical elements for state taxation of federal obligations. The task is straightforward with regard to state banks. The state of domicile of a state bank is the state in which the bank is chartered. The state of domicile of a national bank, on the other hand, is determined by federal law -- 12 U.S.C. section 548.

The Legislative and Judicial History of Section 548.

In 1819, the U.S. Supreme Court ruled in McCulloch v. Maryland that the Supremacy and Necessary and Proper Clauses of the U.S. Constitution prohibit state taxation of national banks without the express permission of Congress. In 1864 Congress passed the National Currency Act, which codified the holding in McCulloch v. Maryland by limiting state taxation of national banks to bank real estate and shares, the two methods left to states in McCulloch. Over the next century, Congress amended the law on several occasions to allow states to tax a national bank by means of (1) a bank shares tax; (2) a tax on the dividends received by the owners; (3) a net income tax and (4) a franchise tax measured by net income. Finally, in 1976, Congress amended the law once again, removing the listing of specific permissible bank taxes. Currently, section 12 U.S.C. 548 provides that:

[f]or purposes of any tax law enacted under authority of the United States or any State, 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.
Section 548 thus establishes the rule determining the domiciliary state of a national bank -- the state in which its principal office is located. Unlike state banks, which are chartered by one state and are deemed to be domiciled in their chartering state, national banks are chartered under federal law. For each charter, the national bank must designate where its principal office will be located. According to section 548 that state then becomes the sole domicile of the national bank even if the bank has authorized branches in other states.

If Congress were to repeal the laws granting states control over interstate banking, many if not most national banks would likely do business through branches rather than through separately-chartered subsidiaries. Section 548 would place the legal domicile of a national bank in only one state -- the state of location of the bank's principal office as designated in its charter. Contrary to the present situation, national banks would not have a separate charter and separate domicile in each state in which they do business. Instead, a national bank could do business in 49 other states without either (1) becoming domiciled there, or (2) receiving state permission for the privilege of entering. Under these circumstances, only one state, the domiciliary state, would have the power to tax the federal obligations of that national bank.

To create a level playing field between their state-chartered banks and nondomiciliary national bank branches and between their domiciliary national banks and nondomiciliary national bank branches, states would likely choose to exempt from taxation (1) the federal securities of their domiciliary banks in order to create a level playing field between domiciliary and nondomiciliary banks (i.e., not disadvantage their domiciliary banks), and (2) the state securities of their domiciliary banks in order create a level playing field between state securities and federal securities (i.e., not disadvantage their securities).

The McFadden Act and the Douglas Amendment

Current federal law allows states to bestow the necessary privilege by controlling whether and when banks may operate interstate. The McFadden Act, passed in 1927, defers to state law in connection with intrastate branch banking and prohibits interstate branch banking. The Bank Holding Company Act requires the Board of Governors of the Federal Reserve to approve all bank acquisitions by a bank or a bank holding company. The Douglas Amendment proscribes the Board of Governors from approving the acquisition of a subsidiary bank outside the holding company's principal state of operation unless the laws of the state in which the bank is to be acquired or established expressly allow such entry.
The Bank Holding Company Act permits a state to enact laws requiring the parent bank holding company to apply for and receive permission to establish or acquire banks. States can grant or deny the privilege of entry to all banks indiscriminately or to some banks selectively. Because entry through a bank holding company gives a state maximum regulatory control over the bank, the vast majority of states have laws allowing interstate banking only through the bank holding company mechanism.

Without the McFadden Act and Douglas Amendment, the constitutional doctrine set forth in McCulloch would prevent states from exercising the power to grant or deny the privilege of interstate branch banking to a national bank. Thus it is only by virtue of these two federal laws -- the McFadden Act and the Douglas Amendment -- that states have the power to bestow the privilege of interstate branch banking on banks, thereby satisfying the second of the two alternative conditions necessary to the imposition of a franchise tax on federal obligations.

3. The States Affected and The Significance of Federal Obligations to a State's Tax Base.

Approximately 27 states currently tax the income from or value of federal obligations. According to a 1988 survey conducted by the Advisory Commission on Intergovernmental Relations (ACIR) those states are:

- Alabama
- California
- Connecticut
- Delaware
- Florida
- Georgia
- Hawaii
- Indiana
- Iowa
- Kansas
- Maine
- Maryland
- Massachusetts
- Minnesota
- Missouri
- Montana
- New Jersey
- New York
- North Carolina
- North Dakota
- Ohio
- South Carolina
- South Dakota
- Tennessee
- Utah
- Virginia
- Wisconsin

According to FDIC statistics for 11 representative states, federal and state obligations make up from 4 to 34 percent of bank assets and 5 to 33 percent of interest income. In some states these percentages are much higher. For example, a 1989 survey by the Nevada Bankers Association showed that federal obligations alone made up 11 percent of the assets and 23 percent of the net income of the state's largest 3 banks and 4 percent of the assets and 63 percent of the net income of the remaining 12 banks that responded to the survey.
Approximately 24 states do not use franchise taxes to tax the income from federal obligations. Because the income from federal obligations is a substantial portion of bank income, the large banks engaged in interstate banking will have an incentive to locate in one of the states that do not use a franchise tax. Currently, states can control how these large multistate banks can conduct their interstate banking business. Therefore, this potential for tax avoidance has not become a widespread problem, although anecdotal evidence indicates that some large banks have placed a substantial fraction of their federal obligations in separate subsidiaries located in states that do not use a franchise tax.

With the repeal of the McFadden Act and the Douglas Amendment, the potential for tax avoidance could become a reality. If so, the approximately 27 states that use franchise taxes will suffer a substantial reduction in their state bank tax base. The smaller states are likely to suffer a greater impact because the large national banks are likely to choose one of the money center states as their domiciliary state.

Another consequence of the repeal of state control over interstate branch banking is the unequal (non neutral) tax treatment of large multistate and small community-based banks. As described, the former banks can locate in one of the approximately 24 states that do not have a franchise tax and thereby shelter a significant fraction of their income from state tax. The small, community-based banks cannot reap the same tax advantages. These small banks may thus be taxed on a much broader base than that of their large multistate bank competitors.

The ability of large multistate banks to escape state taxation of a significant fraction of their interest income in virtually every state in which they do a banking business also places small non-banking businesses at a disadvantage. To the extent that a state faces a revenue shortfall because of the loss of a substantial fraction of its bank tax base, it may increase taxes on other local business corporations.


Drafting Federal Legislation

If Congress decides to repeal the McFadden Act and the Douglas Amendment, states will lose their ability to impose their franchise taxes on nondomiciliary banks and face a substantial reduction in
their tax base. Congress could, however, draft a law that would solve the problem of state taxation of federal obligations and yet allow banks to branch interstate. States must be permitted under the new law to grant the privilege of entry (whether through a bank holding company subsidiary or through a branch) to nondomiciliary banks. To assure that states can impose their franchise taxes on federal obligations, states must have the right to withhold the privilege of entry if a nondomiciliary bank does not comply with entry requirements. For example, a law with provisions similar to the following might accomplish both purposes:

a. Filing requirements. A state may impose filing requirements on nondomiciliary banks similar to those imposed on general business corporations.

b. Effect of filing: Method of Entry. Nondomiciliary banks that comply with such filing requirements would be permitted to enter the state either through a bank holding company subsidiary or branch.

c. Effect of filing: Compliance with State Laws. The effect of entering through the filing mechanism would be to create a level playing field between domiciliary and nondomiciliary banks with respect to state laws, including state franchise taxes.

d. Failure to File. A state may refuse entry to a nondomiciliary bank that fails to comply with state filing requirements.

e. Limited Visitation Rights. Lawfully authorized state auditors and examiners may review the records of a branch or principal office of a national bank located within the state solely to ensure compliance with filing requirements, etc.

The Adequacy of Current Federal Proposals

I have not had the opportunity to read all of the pending federal proposals. I have read and will address the pertinent provisions in H.R. 1505 and H.R. 624.

H.R. 1505 would repeal the McFadden Act effective immediately after passage and the Douglas Amendment three years after passage. The bill would add compensatory language allowing a host state to require any national banking association establishing a branch within the host state to comply with such filing requirements as are otherwise imposed on a foreign (nondomiciliary) corporation seeking to do business in the host state. This filing requirement
is close to the provisions that I recommend above. In its present form, however, it is not completely satisfactory for several reasons.

* First, the legal basis for state laws requiring foreign corporations to file specified documents with the appropriate state officer is the general right of states to deny entry to foreign corporations. Without specific permission from Congress, however, states do not have the right to deny entry to national banks. Because the entire legal basis for state power over foreign corporations is different than for state power over national banks, it is unclear how courts would interpret the general filing requirement language in H.R. 1505. For example, would courts find that Congress meant to give states the same power over national banks that they have over other foreign corporations? Would a court determine instead that Congress just meant to give states the bare right to require national banks to file certain documents with no effect?

* Second, the mere requirement to file documents with the appropriate officer of the host state will not satisfy the constitutional standard for state taxation of federal obligations -- i.e., that the host state grant a special privilege to the foreign corporation.

* Third, virtually all states recognize that filing alone is not sufficient. Therefore, the state foreign corporation laws contain provisions specifying the effect of filing and receiving a certificate of authority. Typically a statute will have the following or similar language:

   **Effect of Certificate of Authority**

   (a) A certificate of authority authorizes the foreign corporation ... to transact business in this state subject, however, to the right of the state to revoke the certificate as provided in this Act.

   (b) A foreign corporation with a valid certificate of authority has the same but no greater rights and has the same but no greater privileges as, and except as otherwise provided by this Act is subject to the same duties, restrictions, penalties, and liabilities now or later imposed on a domestic corporation of like character.

* Although there is much uniformity among state filing requirements, some states exempt banks from those requirements and other states ask for information some banks may find burdensome. A quick review of the foreign corporation statutes of several states revealed the following. In Indiana
banks are exempt from the general foreign corporation filing requirements. Instead, nondomiciliary banks are subject to a special rule that requires them to receive a certificate from both the secretary of state and the banking department and to deposit $100,000 with the state. In Illinois, a foreign corporation must provide the secretary of state with "an estimate, expressed in dollars, of the value of all property to be owned by it for the following year, wherever located, and an estimate of the value of the property to be located within this state during such year, and an estimate, expressed in dollars, of the gross amount of business which will be transacted by it during such year and an estimate of the gross amount thereof which will be transacted by it at or from places of business in this state during such year."

The provisions in H.R. 1505 allowing states the right to impose filing requirements on national banks are a good start toward a solution to the problem of state taxation of federal obligations in the absence of the McFadden Act and the Douglas Amendment. It should not be difficult to build on this foundation and draft suitable language (following the model described above) for filing requirements that are specifically tailored to national banks.

H.R. 624 would repeal the McFadden Act and the Douglas Amendment. Host states could, however, elect to deny national banks the right to operate a branch within the host state by enacting a statute prohibiting or limiting such branch. In my view, this option is less desirable that the option in H.R. 1505. A state should not have to choose between (a) allowing branching but losing tax revenue, and (b) maintaining their tax base but losing the right to allow branching.

5. The Effect of Geographic Deregulation on State Apportionment Formulas.

Since the early 20th century states have apportioned the income of a multistate corporation among the various states in which it operates. Under this method of taxation, known as formulary apportionment, each state taxes the fraction of income that is attributed to it. For this purpose, states use an apportionment formula. The apportionment formula is designed to measure the fraction of a multistate taxpayer's income that should be attributed to a given state by comparing the taxpayer's in-state income-producing activities with its activities everywhere. The particular formula chosen must reflect how and where the taxpayer earns its income. The use of a formula requires states to choose factors and situs rules.

The factors used in the formula represent how the taxpayer
generates its income. Most states use a 3-factor formula to apportion the income of a multistate general business corporation. The factors used are payroll, real and tangible property, and sales. The formula compares the taxpayer's in-state payroll, property, and sales (numerator) to its payroll, property, and sales everywhere (denominator).

While the factors represent how the income of a multistate entity is earned, the situs rules attempt to locate where that income is earned. Typically, situs rules locate income either in the headquarter state (origin rules) or in the market state (destination rules). Thus, situs rules control the numerators of the factors in the state's apportionment formula. Both headquarter state and market state situs rules are currently in use by states.

Headquarter state situs rules "locate" the in-state property, payroll, sales (and any other factors chosen) in the numerators of the factors of the state of the taxpayer's corporate domicile. Market State (destination state) Situs Rules.

Market state situs rules "locate" the in-state property, payroll, and sales in the numerators of the factors of the state into which sales/loans are made or from which deposits are collected.

Some observers predict that if Congress passes a bill that (a) eliminates the ability of states to control the activities of state-chartered banks and the entry of nondomiciliary banks, (b) reduces the limit on deposit insurance, and (c) formalizes the too-big-to-fail doctrine, the U.S. banking will become more concentrated and the dual banking system will die. Although I have no opinion on the likelihood of such a scenario, I am sure that if the banking needs of many states are served in the future through branches of banks domiciled elsewhere states will have to amend their apportionment formulas to maintain their present tax base. For example, a host state that is served solely or primarily by branches of a bank domiciled elsewhere will see a drastic drop in its revenue if it uses headquarter state situs rules because such rules will "locate" all receipts and property in the headquarter state. Because states seldom voluntarily choose to give up revenue to another state, host states will likely amend their laws and adopt market state situs rules.

Conclusion

The proposed repeal of the McFadden Act would have a severe impact on state revenues. This issue must be specifically addressed in any branching legislation being considered for passage. If the tax problems are not solved, then it will be up to the courts to decide.

I commend you Mr. Chairman for holding these hearings and
appreciate the opportunity to testify. I would be happy to answer any questions you may have. Thank you.