The Taxation of Financial Institutions in Maryland

Department of Fiscal Services
Annapolis, Maryland

April 1990

For information regarding content
or for copies of this report, contact:

Department of Fiscal Services
Division of Fiscal Research
90 State Circle
Annapolis, Maryland 21401

(301) 841-3710 (From Baltimore/Annapolis)
(301) 858-3710 (From Washington, D.C.)

DEPARTMENT OF FISCAL SERVICES

MARYLAND GENERAL ASSEMBLY
LEGISLATIVE SERVICES BUILDING
90 STATE CIRCLE
ANNAPOLIS, MARYLAND 21401-1991
841-3710

DIVISION of FISCAL RESEARCH
JOSEPH M. COBLE
DIRECTOR

WILLIAM S. RATCHFORD, II
DIRECTOR

April 12, 1990

Honorable Thomas V. Mike Miller, Jr.
President of the Senate

Honorable R. Clayton Mitchell, Jr.
Speaker of the House of Delegates

Honorable Members of the General Assembly

Ladies and Gentlemen:

This evaluation of Maryland's taxation of financial institutions has been prepared by the Department of Fiscal Services pursuant to ongoing legislative interest and a request from the State Commission on Taxes and Tax Structure. The Department agreed to conduct a study on the taxation of financial institutions for the Commission's use in analyzing the State's tax structure.

The report describes the current tax structure relating to financial institutions in Maryland and the changes occurring in the industry and other states. The report analyzes Maryland's financial institution franchise tax in light these changes and tax policy considerations.

This report was prepared by Mr. Michael Johansen, with the assistance and general guidance of Ms. Barbara A. Klein and Mr. Douglas Mann, with editorial advice from Mr. Joseph M. Coble, Director of the Division of Fiscal Research.

The Department of Fiscal Services appreciates the cooperation and assistance received from the Department of Assessments and Taxation, Department of Licensing and Regulation, Office of the Comptroller, representatives of the financial sector, and all interested parties who took time to comment on the report and its contents.

We trust the General Assembly and the State Commission on State Taxes and Tax Structure will find this document to be useful.

Sincerely,

William S. Ratchford, II
Director

TTY for deaf ANNAPOLIS: 841-3814 D.C. METRO: 858-3814

Table of Contents

THE TAXATION OF FINANCIAL INSTITUTIONS IN MARYLAND

Table of Contents (cont.)

SCHEDULES

TABLES

EXHIBITS

APPENDICES

Executive Summary

THE TAXATION OF FINANCIAL INSTITUTIONS IN MARYLAND

Introduction

The financial sector has undergone significant change in recent years: (1) technological advances have altered the types of services offered and the types of firms offering such services; (2) ongoing regulatory changes at both the federal and state levels have redefined permissible areas of activity; and (3) states have relaxed interstate restrictions resulting in increased multistate operations. These changes highlight the need for a reevaluation of Maryland's current system of financial institution taxation. In doing so, the effects of any tax law changes must be assessed as to their potential effect on Maryland's competitive business environment.

Taxation of Financial Institutions in Maryland Under Current Law

Financial Institution Franchise Tax:

Maryland's primary tax on financial institutions is the financial institution franchise tax. The tax yielded $54 million in FY 89, of which $44 million flowed to the State's general fund and $10 million was distributed to local subdivisions. It is similar to the corporate income tax, differing mainly due to the inclusion of interest derived from all federal, state, and local obligations in the tax base and the single factor method used to apportion income.

The tax applies to all depository and lending institutions having an office located in the State. Excluded from the tax are bank or savings and loan holding companies because they are subject to the State's corporate income tax. Credit unions are not subject to any business taxation in the State (but are subject to real property taxes).

The tax is calculated at the rate of 7% of the Maryland portion of adjusted net income (i.e., net taxable income). The adjusted net income of a financial institution is apportioned to Maryland based on the ratio of gross receipts derived from business done in Maryland to gross receipts from all sources during the taxable year. Schedule I (on page 21) and Exhibit I (on page 77) display the calculation of the franchise tax.

Savings and Loan Association Franchise Tax:

In addition to the financial institution franchise tax, federal and state chartered savings and loan associations pay another type of franchise tax which generated $2.5 million in FY 89 for the State's general fund. This tax, which applies to savings banks as well, is imposed at the rate of 0.013% on the value of deposits held by an institution in the State on December 31st. It was originally created in 1961 to generally offset the State's costs of regulating savings and loan associations.

Other State Taxes on Financial Institutions:

All financial institutions located in the State, including national banks, federally chartered savings and loan associations, federal credit unions, and bank holding companies, pay the State and local tax on real property. Financial institutions are exempt from personal property taxation, however, even though general business corporations and bank holding companies are not. Sales taxes are paid by all financial institutions except federal and state chartered credit unions, as they are exempt under federal and State law, respectively.

This report focuses on Maryland's financial institution franchise tax because of the relatively minimal revenues collected from the other State taxes and fees imposed directly on financial institutions. Also, sales and real property taxes paid by these institutions will not be discussed further because these are imposed on general business corporations, as well.

Federal Limitations on the State Taxation of Financial Institutions

Since 1976, states have been able to tax national banks under any tax method as long as their state chartered banks are taxed identically. State taxation of federal and state savings and loan associations is subject to the same requirement imposed on state taxation of national banks. On the other hand, federally chartered credit unions are exempt from state and local taxation except as to real and tangible personal property. In general, the taxation of interest from federal obligations is prohibited except where a franchise tax is imposed which also subjects the interest from state bonds to taxation.

Types of State Business Taxes

Generally, two types of business taxes are imposed by states: income and non-income based taxes. Of the latter, the capital tax or shares tax was the most widely used for the taxation of financial institutions through the mid 1900's. Deposits and gross receipts taxes are non-income based taxes that also have been used to tax financial institutions. Income based taxes, on the other hand, are now used by over 75% of the states for financial institutions and by nearly all states for general businesses. Maryland replaced its bank shares tax with a franchise tax measured by net income in 1968.

The prevalence of income based taxes can be attributed to the following factors:

- income based taxes are elastic and fluctuate with national and local economic conditions;

- income based taxes more closely match "ability to pay;"

- income based taxes can be apportioned relatively easily among jurisdictions for revenue distribution purposes;

- income based taxes allow for the similar treatment of the various types of entities comprising the financial services industry, thereby increasing tax fairness; and

- income based taxes can borrow heavily from well established tax principles and the experiences of the states and the federal government.

Source Based Taxes and Apportionment Methods

Generally, two bases are used to apportion the income of a financial institution: residence or source. The residence based method, where the state in which an entity is located taxes all of its income from whatever source, has been slowly replaced with the source based apportionment method for purposes of taxing financial institutions (the source based method predominates in the taxation of general business corporations, as well). Source based methods are aimed at attributing the income of a multistate corporation to the state in which the income was earned.

Maryland's financial institution franchise tax is a source based tax relying on formulary apportionment (i.e., a single factor gross receipts formula measuring receipts earned within the State compared to total receipts). However, since formulary apportionment is not permitted for taxpayers lacking an office in another state, even though they may conduct business there, it contains an element of a residence based tax. These taxpayers are taxed by Maryland on all of their income. Maryland's single factor receipts formula used to apportion income is similar to the formula used for service corporations under the State corporate income tax. However, Maryland's apportionment formula for financial institutions is not supported by detailed situs rules which guide taxpayers in attributing receipts to the State. This lack of situs rules results in the taxpayer having discretion to source income producing activities to the state in which the most favorable tax treatment is available.

Source based taxes are more compatible with multistate operations of corporations in that they attempt to attribute the source of income to the state in which it was earned. As such, source based taxes promote a level playing field among corporations because domiciliary and nondomiciliary corporations are generally treated similarly. In contrast, under a residence based tax scheme, nondomiciliary corporations have a competitive advantage over in-state corporations because they will not be subject to taxation in that state.

The key to source based taxes is the method used to source income to the taxing state (i.e., to apportion income to the state in which it was earned). Two methods have received general acceptance by the states:

- separate accounting, which attempts to specifically attribute the origin of income using conventional accounting by attributing revenue and expenses to geographic regions; and

- formulary apportionment, which is used by 32 states to apportion the income of financial institutions and which attributes income to a state by a formula designed to measure the business activities within a state compared to total activities.

Apportionment formulas contain several components, each affecting the amount of income attributed to a state's tax base. These components include:

- the factors used to measure business activity within a state, including the number, type, and weight of each factor;
- situs rules which determine whether an item is considered an in-state or out of state activity; and
- rules for valuing the items included in each factor.

Forty-five of the forty-six states imposing corporate income taxes have agreed on an apportionment formula comprised of three factors for the taxation of corporations. The factors are: payroll, property, and receipts. However, this formula was designed for apportioning the income of manufacturing corporations. Financial institutions were specifically excluded from its recommended applicability because the factors and situs rules do not account for intangibles which are the distinguishing element of the industry (e.g., loans and securities in the property factor). Further, some states use different apportionment formulas for different types of industries. For instance, whereas Maryland generally uses the three factor formula for corporate income tax purposes, it has recognized that service corporations are significantly different than manufacturing firms and uses a single factor gross receipts formula for service corporations.

In designing an apportionment formula, policy makers must balance goals that encourage a competitive business environment and that generate needed tax revenues from income that is fairly attributable to the state. Through the careful selection of factors, situs rules, definitions of terms, and valuation rules states can promote/dissuade specific economic activity. States can protect their in-state businesses from out of state competitors or can seek to maximize their state tax revenues. For example, weighting the receipts factor more heavily in a three factor formula is beneficial for in-state corporations (compared to out of state corporations) since their property and payroll in the state is not counted as heavily in the formula.

An apportionment formula consisting of one or several relevant factors provides some administrative burden but may reduce the opportunity for tax avoidance and create competitive equality between in-state and out of state firms. For example, with affiliated corporations located in many surrounding jurisdictions and the difficulty in establishing a tax situs for intangible property, it may be relatively easy for a financial institution to source receipts to a more favorable tax environment. States can counter these types of tax avoidance activities by establishing broad situs rules and by utilizing special throwback rules assuring that all income is taxed.

Recent Changes in Other States:

Market States-- Indiana and Minnesota: these states have recently established aggressive tax policies aimed at taxing the income of out of state financial institutions doing business with state residents. Based on the perception that they are market states (i.e., states where financial institutions are not heavily concentrated and that are net borrowers of capital) rather than money center states (i.e., states where financial institutions are heavily concentrated and that are net lenders of capital), both Indiana and Minnesota have chosen to attribute financial institution revenues to the place where the customer resides as opposed to the state from which the lending bank operates. These policies are expected to increase tax revenues to Indiana and Minnesota as out of state corporations will be required to attribute more earnings to those states. Each state selected a different apportionment formula to achieve this result, however.

Maryland is primarily a market state and thus situs rules sourcing income to the state of the customer's residence could increase Maryland's financial institution franchise tax revenues. However, market state situs rules could have a negative effect on the State's competitive environment and should be carefully considered.

Money Center State-- New York: in contrast to Indiana and Minnesota, New York can be considered a money state (i.e., state where financial institutions are heavily concentrated and that is a net lender of capital). Thus, New York's formula, in order to generate maximum revenues, reflects a lending state perspective. For example, situs rules for receipts attribute income to the location where receipts are processed, services are performed, or credit card loans are made (rather than where the customer or property is located). Deposits are sited to the branch where they are maintained as opposed to the state where the depositor resides.

The potential for overlapping taxation within source based systems exists. This is best illustrated by reference to the money center state versus market state conflict described above. Some income from the operations of a financial institution in both New York and Indiana or Minnesota is likely to be attributed to both states, and hence taxed twice. Through federal legislation or voluntary state compact, the possibility for multiple taxation could be limited by establishing uniform tax methods and apportionment formulas among the states. The Multistate Tax Commission is considering uniform rules for the attribution of financial institution income that primarily reflect market state theory. Also, the American Bar Association in 1982 proposed federal legislation that generally exhibited money center state principles.

Scope of State Tax Jurisdiction

Historically, states limited their taxation of financial institutions to those having a physical location in the state. Maryland still uses such a "brick and mortar" nexus (i.e., contacts) test. The financial institution franchise tax is imposed "on each financial institution existing or doing business in the State." This statutory provision appears to be broad enough to cover any purposeful business activity conducted by an out of state financial institution in the State, but in practice this provision is interpreted as imposing the tax on only those financial institutions having an office in the State. This rule applies regardless of the amount of business done in the State or income derived from Maryland residents by an out of state financial institution.

As a comparison, Maryland's corporate income tax is imposed on any corporation having income allocable to the State. Through regulations and administrative procedures adopted by the Office of the Comptroller, the

State asserts jurisdiction over out of state general business corporations to the extent allowed by the U.S. Constitution (due process and commerce clauses) and federal statutory law (P.L. 86-272).

A physical presence tax jurisdiction rule does not cover all those financial institutions that are doing business within the State. An economic presence test, based on whether a corporation is deriving financial benefit from within a state, is more capable of covering all financial corporations doing business in the State. State tax jurisdiction over the out of state financial institution which has an economic presence, but not a physical presence, in the state rests on whether the institution "purposefully avails itself of the privilege of conducting business" within the state (i.e., whether it directs its activities toward a state's residents and derives business therefrom). In Burger King v. Rudzewicz (1985), the Supreme Court has expressly agreed that today's technological achievements have obviated the need for a physical presence in a state before jurisdiction attaches.

The Multistate Tax Commission's draft proposed jurisdiction rules, released July 1987 with amendments proposed March 1989 (not an official position of the Commission), impose financial institution taxes on financial institutions that: (1) have a place of business in the state; (2) have employees, representatives, or independent contractors in the state that conduct business on their behalf; or (3) engage in regular solicitation resulting in the creation of a depository or debtor/creditor relationship with customers in the state. Both Indiana and Minnesota, which recently revised their tax jurisdiction rules, follow this "economic presence" approach.

On the other hand, New York follows a physical presence test for tax jurisdiction and only taxes those financial institutions maintaining an office in the state. Along these same lines, the American Bar Association's proposed federal legislation would have prohibited states from taxing a financial institution which did not maintain a "business location" in the state.

Thus, in light of today's multistate business environment, states need to determine the tax implications of moving beyond requiring physical presence to establish taxable nexus. States should evaluate the need to modernize their tax jurisdiction regulations or statutes for financial institutions just as they have modernized nexus rules for the taxation of general business corporations due to the growth in multistate activities.

Maryland's statutory tax jurisdiction rule ("a financial institution existing or doing business in the State") is broader than the rule used in practice ("a financial institution having an office in the State"). The State should expand the application of the financial institution franchise tax to the doing business test (economic presence) embodied in the statute. Such an expansion of the tax base would promote competitive equality among those institutions deriving business from customers within the State.

Defining "Financial Institution" for Tax Purposes

Providers of financial services not only include banks, savings and loan associations, and credit unions but also include car manufacturers, consumer lenders, mortgage lenders, investment companies, brokerage firms, mutual funds, credit card issuers, and arguably, even insurance companies. Further, as banks and savings and loan associations are empowered to expand into real estate investment, insurance, and securities activities, traditional industry boundaries become more blurred. Regulatory definitions of a financial institution based on deposit taking and lending functions no longer accurately describe the scope of competitors in the financial industry and may result in differing tax treatments for those competitors.

A fair tax system should strive to tax industry participants similarly. Since corporations falling under the definition of a financial institution in Maryland are taxed on their earnings from federal and State obligations, it is important that a definition of "financial institution" be used which taxes all corporations deriving significant income from government obligations similarly.

For purposes of the financial institution franchise tax, Maryland defines "financial institution" broadly to include all banks and savings and loan associations, as well as international banking facilities, and credit, mortgage, finance, loan, safe-deposit, and trust companies. A catch-all provision includes any "company that substantially competes with national banks in the State." This provision has not been applied to include any other types of firms other than those specifically listed, since the provision has been interpreted as applying only to firms that accept deposits or make loans in the traditional sense. Credit unions are exempt from a franchise or an income tax by statutory provision.

In other states, holding companies of financial institutions are specifically included within the definition of "financial institution." They are not included in Maryland's definition and are therefore subject to the State's corporate income tax.

Both Indiana and Minnesota include holding companies within their financial institution taxes. Their definitions contain general provisions covering any firm conducting the business of a financial institution, as well as specific guidelines for determining which corporations conducting both financial and non-financial activities are subject to the tax.

Analysis

In general, Maryland's taxation of financial institutions is basically similar to financial institution taxation in many other states. Moreover, it is similar to Maryland's taxation of general business corporations. The franchise tax is income based and uses formulary apportionment to source income to the State. Indiana, which just revised its bank tax laws during its 1989 legislative session, chose the same single factor receipts formula Maryland developed in 1968.

Maryland's financial institution franchise tax is founded on solid principles. The franchise tax based on net income is widely used among states. Further, this tax is the only type of tax which can be imposed on the interest earnings of federal obligations. These obligations comprise a significant portion of the earnings within the industry and should be taxed to maintain fairness among the financial sector. Income apportionment is subject to a single factor gross receipts formula. This aspect of the tax is also widely accepted among the states. As a source based tax, it reasonably relates to the amount of business conducted in the state by an institution.

As described above, the basic elements of the State's financial institution tax are sound. However, the following changes should be considered:

- to promote competitive equality among in-state and out of state financial institutions and among competing types of financial and nonfinancial business entities, taxable jurisdiction should apply to out of state financial institutions conducting a significant business in the State regardless of whether they have an office in the State (i.e., tax jurisdiction should be determined by an economic presence rather than a physical presence);

- tax administrators should establish and promulgate situs rules to define and describe current administrative practice regarding the attribution of income within and without the State and explore the effects of implementing market state situs rules;

- consideration should be given to including holding companies of financial institutions in the definition of "financial institution" for franchise tax purposes; and

- repealing the exemption from local personal property taxes currently enjoyed by financial institutions and credit unions;

Other areas of the tax structure relating to financial institutions that deserve further exploration include:

- reviewing the definition of "financial institution" to ensure that all types of businesses deriving significant interest earnings from federal and State obligations are taxed similarly; and

- transferring administration of the financial institution franchise tax from the State Department of Assessments and Taxation to the Office of the Comptroller (the Comptroller's Office administers the corporate income tax).

Chapter One

THE BANKING ENVIRONMENT

I. National Experience

Few sectors of today's economy can escape the revolutionary advances and forces of technology. The age of the computer is wielding swift and massive changes upon society. High-tech computers coupled with information processing and complex telecommunication networks are quickening the pace of change for information based firms. One of the industries most affected by this new age of technology is that of banking and financial services. Consider an example: artificial intelligence can now analyze a customer's financial statements and recommend how to structure a loan. Known as "expert systems," these computer programs have the knowledge and reasoning capacities of an expert loan officer with the ability to judge the state of the borrower's industry and the strengths and weaknesses of its management.[1]

This high-tech environment has changed the scope and nature of industry competition by enabling an array of new and expanded bank products and services. Automatic teller machines, for example, have become widespread and could be used as "branchless banks" by out of state competitors offering their services to in-state customers (subject to state laws).

Moreover, electronic systems are making it advantageous for banks to offer non-traditional products and services. Presently, banks are allowed: (1) in 17 states, to engage in insurance underwriting or to act as an agent or broker; (2) in 26 states, to invest in and develop real estate or act as a broker; and (3) in 25 states, to undertake securities activities. Alternatively, there are firms that are generally not regulated to the same extent as "financial institutions," but that are able to offer bank-type services: department stores that offer credit cards, car dealers that offer financing, and securities dealers that hold and invest cash.[2]

Even within the industry, relatively recent trends are changing the competition. State statutes in effect as of April 1989 will authorize interstate banking in 29 states by 1992. Another 16 states and the District of Columbia allow regional reciprocal banking with no trigger to nationwide status.[3] Furthermore, savings and loan associations became full fledged industry competitors in the early 1980's when they were empowered to make commercial loans, offer checking accounts, and provide for investment in money market funds.

What do all of these changes mean? For one, the financial sector is coming under increased scrutiny. It has become increasingly difficult for auditors and regulators to assure customers, creditors, and investors of an institution's financial stability. Records are no longer available in the "hard form" of past years. Mismanagement by some institutions leading to bailouts by states and the federal government has once again lessened public confidence and increased the need to reestablish fiscal integrity within the industry.

Secondly, the new environment has distorted the traditional demarcation between financial institutions and other industries. New services, new products, new technology, and nearly indistinguishable industries mean that the role and scope of state tax and regulatory structures should be reevaluated. This paper addresses the structure of Maryland's tax on financial institutions and the related policy considerations in light of this new environment.

II. Trends in Interstate Banking

This section describes the history of federal limitations on interstate and intrastate branching, the devices used by banks and bank holding companies to expand nationally without direct state authorization, and the effect of these changes on the composition of financial institutions operating within the State.

A. Background:

Under current federal law, direct interstate branching of banks is left to the discretion of states. However, banks or bank holding companies may do business in any state through entities known as nonbank banks and nonbank subsidiary corporations. Prior to 1927, the National Bank Act prohibited national banks from engaging in either interstate or intrastate branching.[4] State-chartered banks were only limited by their own state laws concerning intrastate banking, and could operate in other states with their approval. In 1927, Congress amended the National Bank Act to permit national banks to branch within their home states (**intrastate branching**) if permitted by state law.[5] The McFadden Act, as this amendment became known, applied equally to state banks which were members of the Federal Reserve System. The Act did not authorize national banks to engage in **interstate** branching, however. It did allow banks to engage in business within other states' borders through separately incorporated nonbank subsidiaries.

Therefore, **interstate** banking activities were most easily conducted through the establishment of bank holding companies that could: (1) acquire an existing bank in any state; (2) perform bank related services through subsidiary corporations in any state; or (3) establish a separately chartered and capitalized bank in any state. A bank holding company is a corporation that controls all or a substantial majority of a bank's or related corporation's shares. Consequently, the McFadden Act's ban on **interstate** branching by national banks did little to eliminate the growth in multistate financial industry operations because of the use of bank holding companies.

The bank holding company loophole to the McFadden Act's ban on interstate branching by national banks was closed by the Bank Holding Company Act of 1956.[6] The Bank Holding Company Act requires approval of all bank acquisitions by a bank or bank holding company by the Board of Governors of the Federal Reserve System. The Douglas Amendment[7] provides that an application for acquisition of a bank located outside of the holding company's home state, will be disapproved unless the laws of the state in which the "acquiree" bank is located specifically permit the entry. But, even this rule is subject to possible circumvention. The Douglas Amendment only applies to interstate acquisitions of "banks."[8] Thus, holding companies may acquire "nonbank banks" (i.e., those which either accept deposits <u>or</u> make commercial loans but not both) without regard to state law or the provisions of the Act.

A **"nonbank bank"** differs from a **"nonbank subsidiary"** noted above in that the former operates under a bank charter and may even offer federally insured deposits, as long as it does not engage in both accepting deposits and making commercial loans. The latter, as discussed below, may be incorporated without need for a banking charter and may provide banking related services such as consumer and commercial lending, credit cards, leasing, and data processing. The establishment of new nonbank banks has been prohibited by the Competitive Equality in Banking Act of 1987.[9]

The Bank Holding Company Act permits bank holding companies to own and control separately incorporated subsidiaries engaged in activities closely related to banking. Such subsidiaries do not constitute "banks" and may be operated across state lines without federal restriction. The Act does limit the activities of these "nonbank subsidiaries" by prohibiting bank holding companies from owning or controlling them unless they conduct specific activities.[10] Generally these activities are limited to those closely related to banking or the management and control of banks, such as: bookkeeping or data processing services, issuing traveler's checks, operating industrial banks, issuing credit cards, lending through finance companies, and mortgage lending.

Thrift institutions were also subject to federal limitations on interstate operations. Through regulation and general policy, the Federal Home Loan Bank Board disallowed interstate branching or offices. Beginning in 1981, however, the Board began allowing interstate mergers when the institution to be acquired was in danger of failing. The Garn-St. Germain Act of 1982 established guidelines for these types of mergers or acquisitions. Finally, the Federal Home Loan Bank Board promulgated regulations in 1986 allowing interstate acquisitions for thrifts parallel to those for commercial banks mentioned above.

B. <u>Impact in Maryland</u>:

As of May 1989, all but three states had enacted some form of interstate banking legislation. Twenty-one (including the District of Columbia) permit national entry in their state. Maryland, like most states, currently allows regional entry on a reciprocal basis (i.e., the state in which the bank is chartered must allow Maryland banks to enter that state). Maryland's region currently includes Washington, D.C. and 14 states: Alabama, Arkansas, Delaware, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, Pennsylvania, South Carolina, Tennessee, Virginia, and West Virginia.[11] As a result of Maryland's law, eleven banks and one savings and loan association were acquired by out of state banks or bank holding companies. Maryland banks or bank holding companies, on the other hand, acquired eight banks located in states within the reciprocal region.[12]

In addition to direct branching, acquiring, or merging of Maryland banks or savings and loan associations by out of state financial institutions, financial services are provided in Maryland by subsidiaries of bank holding companies from throughout the nation. As noted above, these corporations provide services related to banking and may be established or acquired in the state by out of state holding companies. The number of banking offices in Maryland controlled by out of state domestic bank holding companies is 293. For comparison, there are 378 such offices in Pennsylvania and 110 in Virginia. Offices of nonbank subsidiaries number 71 in Maryland, 435 in Pennsylvania, and 238 in Virginia.[13]

Given the multistate nature of these activities in Maryland, the State's tax base is comprised of income earned by financial institutions operating solely within the State and others operating in multiple states. In 1987, of the State's 294 financial institution taxpayers, 128 or 44% indicated that they conducted business activities in at least one state other than Maryland. The State's taxation of financial institutions will be analyzed in regard to the significance of multistate activity occurring in the State.

C. <u>Summary</u>:

A significant aspect of the evolving financial services industry is the multistate and international activity conducted by industry participants. The relaxation of interstate banking restrictions among the states and the variety of entities providing traditional banking services typify the changes in the industry.

In Maryland, the law allows regional reciprocal interstate banking with 14 states and Washington, D.C. Recent attempts to expand the region and to authorize national reciprocal banking have not been enacted.

In summary, direct interstate branching by banks throughout the nation is regulated by each state's laws. Currently, only 21 jurisdictions allow direct entry by banks from all states. However, a bank or bank holding company(BHC) may expand anywhere in the country through the use of a "nonbank subsidiary" (i.e., a corporation providing banking related services such as data processing support, consumer lending, credit card operations, or loan production support, that is owned or controlled by a bank or BHC). Further, bank holding companies may acquire "nonbank banks" without regard to state restrictions imposed on the acquisitions of regular banks. "Nonbank banks" are corporations operating under a bank charter which either accept deposits <u>or</u> make commercial loans, but that do not do both. Another potential avenue for entry into a state by a bank or bank holding company is a "stakeout." In this case, a share of an in-state bank is acquired and held for a period of time allowing the bank or BHC the opportunity to gain future control as allowed by state banking laws. For savings and loan associations, rules for interstate acquisitions and branches parallel those for commercial banks. In effect, even without state laws authorizing national interstate banking, various types of entities have evolved to effect a vastly expanded financial services sector.

III. Federal and State Regulation of the Financial Industry

This section reviews the types of corporations making up the financial industry and their regulating bodies.

A. Industry Participants:

Commercial banks, savings and loan associations, and thrift institutions, including mutual savings banks, are the most familiar types of financial institutions. Lending institutions of all types, including both consumer and commercial lending companies, make up a large portion of the industry. Investment banks specializing in securities transactions and state and federal government lenders round out the roster of the traditional financial industry. However, industry competition has broadened as nontraditional entities have added bank-type financial services to their operations. These competitors, including insurance companies and securities firms, are relatively new entrants in the banking sector and generally are not subject to the same regulations and taxes as the traditional participants, such as depository and lending institutions.

B. Industry Regulators:

Historically, regulation of the banking industry began as the U.S. government entered the field. The first Bank of the United States was granted a 20 year charter in 1791. It was organized to accept deposits from private as well as public sources and to administer the government's cash flow. The bank's charter was not renewed in 1811 leading to its eventual dissolution. The government's funding needs for the War of 1812 precipitated the chartering of the Second Bank of the United States. Its 20 year charter also expired without extension in 1836, as President Andrew Jackson vetoed legislation aimed at renewing it.

The inconsistency of participation at the federal level left the chartering of financial institutions to the states. Congress eventually reentered the field through the National Banking Act of 1864.[14] The Act established a national banking system for the purposes of financing Civil War needs and eliminating the proliferation of state bank paper money certificates. Passage of the Act created the dual banking system which continues today: (1) a small number of large national banks chartered by the U.S. government; and (2) a large number of banks of various sizes chartered by the states.

The national banking system inevitably led to the creation of federal regulators. The Federal Reserve Board was charged by Congress with regulating bank holding companies, monitoring the undue concentration of commercial banking resources, operating a check or bank note clearing system, and conducting examinations.[15] The Comptroller of the Currency was charged with supervising national banks and regulating the national currency. Supervision of federal savings institutions has been delegated to the Federal Home Loan Bank Board. The Federal Deposit Insurance Corporation also contributes to the federal regulatory oversight of these financial institutions.[16]

Maryland regulatory control is centered in the Department of Licensing and Regulation. The State Bank Commissioner, part of the Department's division of Financial Regulation, has general supervisory powers over all banking institutions doing business in the State except national banks.[17] The Bank Commissioner conducts financial examinations of every bank, trust company, and mutual savings bank.[18] The Commissioner approves the creation of new banks, new branches (including automated teller machines), bank holding companies, and mergers/acquisitions of existing State banks. State chartered credit unions are also subject to the Bank Commissioner's supervision.[19] In addition to State chartered banks, trusts, credit unions, and bank holding companies, the Commissioner also has supervisory powers over: issuers of travelers checks and money orders, and the Maryland Higher Education Loan Corporation. Oversight responsibility for mortgage brokers and mortgage bankers was transferred from the State Bank Commissioner to the Commissioner of Consumer Credit during the 1989 legislative Session.[20]

State chartered savings and loan associations are supervised by the Division of Savings and Loan Associations within the Department of Licensing and Regulation.[21] Following recent events in the savings and loan industry, there are only 9 State chartered associations remaining. Further, 3 of these have applied for federal charters. All, however, are already federally insured. The Division conducts financial examinations and supervises the creation, operation, expansion, and merger/acquisition of State chartered savings and loan associations.

In addition to regulating State chartered depository institutions, Maryland supervises the activities of consumer lending companies through the Commissioner of Consumer Credit.[22] The Commissioner licenses and audits all consumer lending institutions, as well as investigates consumer complaints. Lending institutions include: consumer loan companies, sales finance companies, mortgage lenders and brokers, and installment loan lenders.

State regulation also extends to other industry competitors, such as securities firms (Office of the Attorney General) and insurance companies (Department of Licensing and Regulation). Most of the State regulatory functions mentioned above are aimed at protecting consumers. Therefore, commercial lending corporations are not subject to any regulatory or financial supervision in the State. Further, State regulation only extends to corporations establishing a physical presence in the State. Thus, for example, credit card activities conducted through the mail by out of state firms are not subject to the Commissioner of Consumer Credit's oversight.

The State Department of Assessments and Taxation and the Office of the Comptroller administer the State taxes imposed on financial institutions and holding companies. In addition, several different forms of business and license fees are imposed by the regulators mentioned above and other State agencies. These taxes and fees are discussed in the section which follows.

C. Summary:

The financial services industry has been heavily regulated by both federal and state bodies. Regulation has often restricted the geographical operations of financial institutions. Relaxation of these boundaries through changes in state and federal interstate banking laws has altered the nature of institutions which states are permitted to tax. For example, state tax jurisdiction may extend to financial institutions located outside the state. Tax laws and policies created during periods when banks were not allowed to operate outside their home state should be reevaluated in light of today's multistate environment. Moreover, regulatory expansion of permissible financial institution services and activities calls for states to reconsider the tax policies originally drafted for an industry primarily engaged in accepting deposits and making loans.

In summary, federal regulatory oversight of the banking industry primarily resides in the Federal Reserve and Federal Home Loan Bank Boards, in addition to the Comptroller of the Currency. State regulatory supervision is provided by various agencies within the Maryland Department of Licensing and Regulation, including the State Bank Commissioner, the Division of Savings and Loans, and the Commissioner of Consumer Credit.

Chapter One: Endnotes

1 Paula H.J. Cholmondeley, "Seeking the Future: A Game of Tag," Journal of Accountancy (October 1988) pp. 89-94, at p. 89.

2 Sandra B. McCray, State Taxation of Banks: Issues and Options, Advisory Commission on Intergovernmental Relations, M-168 (December 1989) p. 11.

3 Report of the Maryland State Bank Commissioner to the General Assembly on the Effects of Regional Reciprocal Interstate Banking and Emergency Interstate Acquisitions, Maryland Department of Licensing and Regulation (October 1, 1989) p. 32.

4 13 **Stat.** 101 (1864).

5 McFadden Act, 44 **Stat.** 1225, 1228 (1927).

6 70 **Stat.** 133 (1956).

7 12 **U.S.C.** § 1842(d) (1982).

8 The Act defines a "bank" as a company that accepts demand deposits and makes commercial loans. 12 **U.S.C.** § 1841(c) (1982).

9 Competitive Equality in Banking Act (1987). The Act prohibits granting new charters to nonbank banks but 166 of them were permitted to continue to exist (credit card banks and pure trust companies may still be chartered). Nonbank subsidiary corporations may still be freely created subject to the restrictions of the Bank Holding Company Act.

10 12 U.S.C. § 1843 (c)(8) (1982).

11 Mississippi does not include Maryland in its reciprocal region and therefore banks from that state are not at this time permitted to enter Maryland.

12 Interstate Banking in Maryland, Department of Fiscal Services (Annapolis, Maryland) November 1989.

13 King, Tschinkel, and Whitehead, "Interstate Banking Developments in the 1980's," Atlanta Federal Reserve Bank Economic Review(May/June 1989) pp. 32-51, at pp. 40-41.

14 13 **Stat.** 99.

15 Federal Revenue Act, 38 **Stat.** 251 (1913). The Act created Federal Reserve Banks, the Federal Reserve System, and gave state banks the option of becoming members of the federal system.

16 The Banking Act of 1933, 48 **Stat.** 162. The role of the Federal Savings and Loan Insurance Corporation has declined over the years.

17 The office was created by Chapter 219, **Md. Laws** 1910; current duties, powers, and functions are codified in **Md. Code Ann.**, Financial Institutions Art., Titles 2 through 5 (1985 Repl. Vol. and 1989 Cum.

Supp.).

18 Currently, only one state chartered mutual savings bank exists in Maryland (a savings and loan association converted to a mutual savings bank charter in 1989).

19 **Md. Code Ann.**, Financial Institutions Art., Titles 6 and 7 (1986 Repl. Vol. and 1989 Cum. Supp.).

20 Chapter 476, **Md. Laws** 1989.

21 The Division was originally the Department of Building, Savings and Loan Associations. Chapter 205, **Md. Laws** 1961. Current statutory provisions are set out in **Md. Code Ann.**, Financial Institutions Art., Titles 8 & 9 (1986 Repl. Vol. and 1989 Cum. Supp.).

22 The office can be traced back to the Administrator of Loan Laws created in 1941. Chapter 289, **Md. Laws** 1941. Current provisions are located in **Md. Code Ann.**, Financial Institutions Art., Title 11 (1986 Repl. Vol. and 1989 Cum. Supp.).

Chapter Two

TAXATION OF FINANCIAL INSTITUTIONS IN MARYLAND

This section first describes the current methods used to tax financial institutions in Maryland and the revenue collections from these tax sources. Then, an overview of the history of Maryland's taxation of financial institutions follows.

I. Current Tax Structure

Like many other states, Maryland has taxed banks, savings and loan associations, credit unions, and other financial institutions under various methods over the years. Often, the incidence and degree of the State's taxation has varied among types of financial institutions. The differing tax treatments can be largely explained by the history of federal limitations on the state taxation of national banks and the evolution of the banking industry.

A. Financial Institution Franchise Tax:

Maryland's primary tax on financial institutions is the financial institution franchise tax. The tax yielded $54 million in FY 89, of which $44 million flowed to the State's general fund and $10 million was distributed to local subdivisions. It is similar to the corporate income tax, differing mainly due to the inclusion of interest derived from all federal, state, and local obligations in the tax base and the method used to apportion the tax base.

1. Entities Subject to the Tax--

The franchise tax is imposed on each "financial institution existing or doing business in the State." The "existing or doing business in the State" requirement is satisfied if the taxpayer is a regulated financial institution, subject to the supervision of the Department of Licensing and Regulation, and if the taxpayer maintains a business office in the State.

The Annotated Code of Maryland broadly defines "financial institution" to include: a commercial bank, credit company, finance company, loan company, mortgage company, safe-deposit company, trust company, savings bank, savings and loan association, international banking facility, or any company which substantially competes with national banks in the State.

The definition specifically excludes: (1) a subchapter S corporation; (2) a finance company that makes loans only to farmers for agricultural purposes; and (3) a company licensed under the federal Small Business Investment Act of 1958. Also excluded are bank or savings and loan holding companies because they are subject to the State's corporate income tax. Credit unions are not subject to any business taxation in the State (but are subject to real property taxes).

2. Tax Rate and Taxable Base--

The financial institution franchise tax is calculated at the rate of 7% of the Maryland portion of adjusted net income (i.e., net taxable income). As mentioned previously, net taxable income under the franchise tax parallels that computed for the corporate income tax in that the starting point is federal taxable income as reported on the federal return. Certain additions and subtractions are then made to determine adjusted net income. All interest income derived from U.S., state, and local government obligations is included in adjusted net income for financial institutions even though interest from U.S. and Maryland (State and local) obligations is excluded from the corporate income tax. Special provisions are included in the Code for computing the net earnings of certain international banking facilities (no international banking facilities are currently eligible under these provisions).

3. Apportionment of Net Income to Maryland--

The adjusted net income of a financial institution is apportioned to Maryland based on the ratio of gross receipts derived from business done in Maryland to gross receipts from all sources during the taxable year. By departmental rule, net income may not be apportioned to another state unless the financial institution has an office located in that state and the state imposes a tax on that income.

4. Schedule of Tax Computation--

Schedule I outlines the structure of the financial institution franchise tax, displaying the components of adjusted net income, the apportionment of income to Maryland, and application of the tax rate using tax year 1987 data. Exhibit I at the end of this report contains a more detailed schedule of the franchise tax computation.

Schedule I. Calculation of Financial Institution Franchise Tax
Tax Year 1987 ($ in millions)

	Banks	Finance Corps.	S & L Assoc.	All
Federal Taxable Income	**$ 306**	**$ 1980**	**$ 172**	**$ 2458**
Addition Modifications:				
- State & Local Income Taxes	120	120	19	259
- Interest from State and Local Obligations	291	24	14	329
Total Addition Modifications	**411**	**144**	**33**	**588**
Subtraction Modification:				
- Federal Unallowable Interest Expense	(40)	0	(1)	(41)
Total Adjusted Net Income	**$ 677**	**$ 2124**	**$ 205**	**$ 3006**
Gross Receipts Apportionment Factor*	**x 59%**	**x 4%**	**x 65%**	**x 21%**
MD Portion of Net Income	**401**	**93**	**134**	**628**
Franchise Tax Rate	**x 7%**	**x 7%**	**x 7%**	**x 7%**
MD Franchise Tax Liability	**$ 28**	**$ 6.5**	**$ 9.4**	**$ 43.9**

* The single gross receipts factor measures business done in the State to business from all sources.

Note: These figures are calculated on a taxable year basis and do not match the fiscal year revenue collections shown in Table 1 on page 22.

5. Payment Dates, Fines, Penalties, and Interest--

A taxpayer must file a franchise tax return with the Department of Assessments and Taxation by March 15th if filing on a calendar year basis (or by the 15th day of the third month after close of the taxpayer's fiscal year). Taxpayers estimating a tax liability of $1000 or more must file and pay an estimated tax of at least 50% by June 1st (or the 1st day of the sixth month of the fiscal year). Interest and penalties at various rates are imposed on taxpayers for the following activities: underestimating taxes, failing to pay tax when due, failing to file and pay tax within 30 days after notice of demand for return is made, filing a false return or failing to file with intent to evade, and paying with a check which is subsequently dishonored.

6. Administration and Distribution of the Tax--

The State Department of Assessments and Taxation administers the financial institution franchise tax and collects the revenue. Except for the franchise tax paid by savings banks and savings and loan associations, financial institution franchise tax revenues are deposited into the State's general fund. Since 1966, franchise tax revenues paid by savings banks and savings and loan associations (less an administrative fee) are held in a special fund and have been distributed to the subdivisions based on the relative amount of deposits or share accounts held in each subdivision. Branch office activity is credited to the subdivision in which the branch is located. Table 1 below shows the revenue history of this tax. Exhibit II displays the distribution of these revenues to the counties and Baltimore City for FY 85 to FY 89.

Table 1. Financial Institution Franchise Tax
Revenues History ($ in millions)

Fiscal Year	General Fund	Special Fund*	Total	% Annual Increase/Decrease
1970	$ 6.9	$ 1.2	$ 8.1	--
1975	8.0	2.4	10.4	5.6%
1980	17.7	5.0	22.7	23.6%
1985	23.7	8.6	31.3	7.6%
1986	24.4	5.8	30.2	-3.5%
1987	25.0	6.7	31.7	5.0%
1988**	40.9	13.1	54.0	70.3%
1989	44.3	9.6	53.9	-0.2%

* Distributed to subdivisions after deduction of an administrative fee.

** The Department of Assessments and Taxation indicates that the significant increase in general fund franchise tax revenues in this year resulted from increased activity which appears to have been sustained in the most recent year. Also, the special fund revenues reflect additional collections from the first year that estimated tax payments were required for savings and loan associations and savings banks.

B. Savings and Loan Association Franchise Tax:

In addition to the financial institution franchise tax, federal and state chartered savings and loan associations pay another type of franchise tax which generated $2.5 million in FY 89 for the State's general fund. This tax, which applies to savings banks as well, is imposed at the rate of 0.013% on the value of deposits held by an institution in the State on December 31st. This franchise tax was created in 1961 to offset the costs of regulating the State savings and loan industry. A credit is granted to a savings and loan association which is subject to a tax in another state on its deposits held in Maryland. The tax is administered and collected by the Office of the Comptroller. A revenue history is shown in Table 2.

Table 2. Savings and Loan Association Franchise Tax Revenues History ($ in millions)

Fiscal Year	Total General Fund	% Annual Increase/Decrease
1970	$ 0.3	--
1975	0.7	18.5%
1980	1.1	9.5%
1985	2.2	19.8%
1986	1.9	-12.3%
1987	2.7	39.5%
1988	2.4	-11.1%
1989	2.5	6.5%

Chevy Chase Savings Bank filed suit June 15, 1989 against the State Comptroller in Maryland Tax Court (Misc. Appeal No. 667) challenging the imposition of the savings and loan association franchise tax. Chevy Chase is arguing that federal savings institutions (Chevy Chase is a federal savings bank) should not be subject to the tax since since they derive no benefit from the regulatory services of the State. Also, they question whether this "regulatory" tax should be reduced to more closely match the actual expenses of state regulation of savings and loan associations. The case is scheduled to be heard sometime during the Summer of 1990.

C. Supervisory Assessments and Other State Fees:

It should be noted that while banks and other financial institutions do not pay a franchise tax in addition to the financial institution franchise tax, they are required to pay supervisory assessments and license fees to the State Bank Commissioner to help defray the State regulatory expenditures related to State supervision of the industry. Supervisory assessments and other fees collected by the Bank Commissioner's Office reached $2.0 million in FY 88. The Commissioner of Consumer Credit collected $0.6 million from regulated lending corporations. In addition to the above, all corporations (financial institutions and general business) are required to pay annually to the Department of Assessments and Taxation corporate filing fees. These revenues totalled $3.6 million in FY 89.

D. Other State Taxes on Financial Institutions:

All financial institutions located in the State, including national banks, federally chartered savings and loan associations, federal credit unions, and bank holding companies, pay the State and local tax on real property. Financial institutions are exempt from personal property taxation, however, even though general business corporations and bank holding companies are not. Sales taxes on purchases are paid by all financial institutions except federal and state chartered credit unions, as they are exempt under federal and State law, respectively.

This report will focus on the financial institution franchise tax because of the relatively minimal revenues collected from the other State taxes and fees imposed directly on financial institutions. For example, financial institutions (including State chartered credit unions until July 1, 1990) are subject to State and local transfer and recordation taxes, as well as motor vehicle excise taxes. The revenues collected from these levies are minimal in comparison to the franchise tax and can be categorized as a cost of doing business. Further, sales and real property taxes paid by these institutions will not be discussed further in this report because these are imposed on general business corporations, as well.

II. Historical Overview of Maryland Taxation

A. Overview:

In general, the state taxation of banks and other financial institutions has been influenced by federal restrictions on the state taxation of national banks. In particular, those limits imposed by Congress on the state taxation of national banks largely set the upper bounds for the taxation of state chartered banks. To maintain tax parity, states devised tax systems where the level of tax burden imposed on state banks was limited to that imposed on national banks.

A brief history of the taxation of financial institutions in Maryland follows in this section. Appendix I contains a chronology of laws, cases, and events related to the State's taxation of financial institutions.

B. Maryland Historical Perspective-- A Summary:

The most direct example of federal involvement in the state taxation of banks was the Supreme Court's decision in McCulloch v. Maryland (1819), which gave birth to the doctrine of federal tax immunity. The case established the principle that the states could only tax national banks with the express approval of Congress. In this case, the Court found Maryland's stamp tax on notes of the Bank of the United States to be unconstitutional, because express authority had not been granted by Congress to tax an instrumentality of the federal government.

In 1841, Maryland imposed a shares tax on national and state chartered banks. This was followed in 1847 by an added tax on deposits held by savings banks in the State (a tax later defined to be a franchise tax). Beginning in 1888, the revenues from the deposits tax were shared with the local jurisdictions, divided 1/4 to the State and 3/4 to the jurisdictions in which the savings banks were located. The shares and deposits taxes remained largely unchanged over the next 100 years, with the only major change relating to the type of entity on the which the taxes were levied. Modifications to the tax rates were made in 1953 in response to recommendations of the Maryland Tax Survey Commission of 1949.

Not until 1965 did a wholesale restructuring of Maryland's taxation of financial institutions occur. The tax on the deposits of savings banks was replaced by a franchise tax on the net earnings of savings banks and savings and loan associations. The net revenues were fully distributed to the subdivisions based on the relative amounts of deposits held in each subdivision. Jurisdictions were expressly prohibited from taxing these savings institutions, except for a local real property tax levy. The shares tax on finance corporations, trust companies, and national and state banks was replaced with a net earnings tax in 1968. Due to the existence of federal limitations and because capital stock included the value of personal property under the shares tax, financial institutions had been exempt from local personal property taxes. This exemption was continued for financial institutions under the net earnings tax.

The base used for the net earnings taxes was very similar to that which exists today since net earnings were measured by corporate net income plus all interest from federal, state, and local obligations. Income was apportioned similarly to the corporate income tax on the proportion of business occurring within and without the State, subject to the discretion of the Director of the Department of Assessments and Taxation or the Comptroller's Office.

It should be observed that although Maryland did not undertake a major revision of its financial institutions taxes until the 1960's, Congress had enacted legislation in the 1920's liberalizing the types of state taxes that could be imposed on national banks. Notably, Congress authorized the states to levy income based taxes, such as the franchise tax, on bank earnings. (Until 1923, the shares tax was the only permissible direct tax on national banks.) However, while all 48 states levied a shares tax on national banks prior to 1923, progress was slow among the states in restructuring their tax systems, as evidenced by the number of states which continued to levy the shares tax (rather than an income based tax) in recent years---in 1934, thirty-seven states, and in 1970, twenty-one.

Under federal legislation effective in 1976, Congress substantially altered its role in the control of state taxation of national banks. Instead of promulgating a list of acceptable taxes, Congress authorized any method of state taxation as long as state and national banks were taxed uniformly. This expansion of state authority and changes in the composition of the financial industry should lead to a "sorting out" of the implications for Maryland and the other states. Those implications for Maryland are analyzed in this report following a discussion of federal limitations, types of state taxes, methods of apportioning income among states, and tax jurisdiction.

Chapter Two: Endnotes

1 **Md. Code Ann.**, Tax-General Art., § 8-202(a) (1988).

2 **Md. Code Ann.**, Tax-General Art., § 8-101(c) (1988).

3 The Code refers to the apportionment of income based on the "gross volume of transactions" occurring inside and outside the State. **Md. Code Ann.**, Tax-General Art., § 8-206(a) (1988).

4 **Md. Code Ann.**, Tax-General Art., § 8-301 (1988).

5 McCulloch v. Maryland, 17 **U.S.** (4 Wheat.) 315 (1819).

6 Symons and Strauss, Taxation of Financial Institutions in Washington State: A Study of the Legal and Fiscal Issues, Center for Public Financial Management: Carnegie Mellon Univ. (July 1, 1987) p. 4.

Chapter Three

FEDERAL LIMITATIONS ON THE STATE TAXATION OF FINANCIAL INSTITUTIONS

I. Current Federal Limits on the States

The current limitations on the state taxation of national banks, federal savings and loan associations, and federal credit unions are described below.

A. State and National Banks:

In addition to the general requirement that national and state banks be taxed identically, other federal statutory and case law had an impact on the method of taxation chosen by states for financial institutions. In 1969, Congress passed a measure that required states to tax national banks located within the state no differently than state chartered banks. This provision, which became effective in 1976, imposed a nondiscrimination requirement only with respect to state banks, rather than regular business corporations or "other moneyed capital." Thus, states are free to tax banks (national and state) differently than other corporations.[1]

Further, a general prohibition on the taxation of interest from federal obligations still exists. Congress has allowed exceptions based on the type of tax levied. "The exemption [from state taxation for interest from federal obligations] 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:** (1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and (2) an estate or inheritance tax."[2] Thus by using a franchise tax, the interest from federal obligations can be taxed (unlike a direct income tax where such interest earnings cannot be taxed).

B. Savings and Loan Associations:

State taxation of federal and state savings and loan associations is subject to the same requirement imposed on the state taxation of national banks: "a state may not tax a federal association greater than it taxes state associations." This rule was specifically prescribed by Congress in 1933,[3] without the same tortuous process encountered in states' attempts to tax national banks. States are free to select any method of taxation. Federal income taxes could not be imposed on savings and loan associations until the Revenue Act of 1951 redefined "bank" to include a savings and loan association.

C. Credit Unions:

Federally chartered credit unions are exempt from state and local taxation except as to real and tangible personal property.[4] States are free, therefore, to tax state chartered credit unions under any method of taxation without regard to the federal limits. Maryland has exempted state chartered credit unions from most state and local taxes except the tax on real property.[5] Federally chartered credit unions only pay the State and local levy on real property, as well.

D. Summary-- Current Federal Limits

The Supreme Court's decision in First Agricultural National Bank v. State Tax Commission,[6] led to Congressional changes resulting in the current limitations imposed on the state taxation of national banks. In 1969, Congress required states to tax national banks located within the state no differently than state banks. While this amendment did not become effective until 1976, Congress had assured the states a relatively free hand in taxing national banks, as long as they were nondiscriminatory (i.e., for tax purposes, a national bank is to be treated as if it were a state bank). Since 1976, states have been able to tax national banks and savings institutions under any tax method as long as its state chartered institutions are taxed identically.

II. History of Federal Limitations

A. Birth of the Federal Tax-Immunity Doctrine:

Maryland can be credited with, or perhaps held accountable for, the establishment of specific federal limitations on the state taxation of banks and other financial institutions. McCulloch v. Maryland[7] dealt with a Maryland tax on bank notes issued by any bank or branch which was not chartered by the State of Maryland. At that time, Maryland had no similar tax on notes issued by State chartered banks.[8] The Supreme Court, in an opinion written by Chief Justice John Marshall, declared that Maryland could not enforce its tax against a branch of the Second Bank of the United States because the bank was an instrumentality of the federal government. In so doing, the Court established a broad prohibition on the taxation of federal instrumentalities and created the federal tax-immunity doctrine. In McCulloch, Chief Justice Marshall pronounced that the "power to tax involves the power to destroy."[9] It is not surprising that with such a beginning, the federal tax-immunity doctrine has been closely safeguarded by the Supreme Court and Congress.

Another case to reach the Supreme Court involved a bank shares tax imposed by the City of Charleston, South Carolina on the shares of a national bank held by its residents.[10] Again, the Supreme Court held that the taxation of a federal instrumentality was unconstitutional citing the fact that the property tax did not apply to any stock issued by South Carolina corporations, including banks chartered by that state.[11] This is not to imply that the Supreme Court forbade all taxation of national banks or their operations. In fact, the McCulloch decision specifically left to the states the opportunity to tax bank real estate and bank shares.[12] Rather, the recurring theme in the development of federal control over state taxation of federal instrumentalities is a complete prohibition on the taxation of U.S. property or entities which results in a favorable tax environment for state property or entities.

B. The Role of Congress:

The Supreme Court cases did make it clear that Congress controlled the tax status of national banks and other federal instrumentalities---Congress could prescribe the types and extent of state taxes on federal institutions. Specific Congressional limits were enacted during the Civil War as the United States borrowed heavily for its war operations. Two Acts were passed:

- **Currency Act of 1862** -- exempted from state taxation all "stocks, bonds, and other securities of the United States held by individuals, corporations or associations within the United States;"[13] and

- **National Currency Act of 1864** -- in addition to permitting states to tax the real property of national banks, Section 41 of the Act authorized states to tax the value of capital stock shares of a national bank located within a state's borders.[14]

Congress permitted bank shares taxation under the notion that it was a tax on the holders of the shares, even though they permitted states to assess and collect the tax directly from the banks. The 1864 Act imposed a significant limitation on the rate of a state's bank shares tax. Tax rates were to be the lower of: (1) the rate imposed on the shares of state chartered banks; or (2) the rate imposed on "other moneyed capital." While the former was capable of easy identification and exhibited Congress' concern for non-discriminatory treatment, the latter generated much litigation precisely because it was subject to much manipulation by states seeking to maximize tax revenues and by banks seeking to avoid them.[15] The cases did not provide any real concrete guidance to states or national banks in determining the limits intended by Congress, however.

Congress enacted significant changes in 1923.[16] The first change attempted to narrow the definition of "other moneyed capital" to more clearly identify discriminatory taxation. The second change was the creation of two alternative methods for the state taxation of national banks. One was an income tax at a rate no greater than that applicable to the state's other corporations. The other was a tax on dividends in the hands of shareholders at a rate no higher than that imposed upon net income from "other moneyed capital." A final alternative to the shares tax was added in 1926.[17] This Act permitted the states to levy a franchise tax measured by the entire net income of a national bank, including income earned on federal obligations. The rate for the franchise tax was limited to that applicable to corporations under the state's income tax.

These changes also permitted states to assess more than one of the taxes concurrently. For example, a tax on dividends could be imposed concurrently with either the direct income tax or the franchise tax, as long as dividends from other corporations within the state were similarly taxed. A tax on dividends could not be imposed, however, if a state also employed a shares tax on national banks. From 1926 through 1969, Congressional authorization of the state taxation of national banks can be summarized as follows:

- states could tax domiciliary national banks only;

- permissible taxes included a direct income tax, a franchise tax measured by income, a shares tax on capital stock, and a tax on the dividends received by holders of a bank's stock;

- a tax on dividends was allowed in addition to an income or excise tax;

- interest from federal obligations could only be taxed through the use of a nondiscriminatory franchise tax measured by income;

- the tax rates for the income or excise taxes was limited to that imposed by a state on its other corporations; and

- states were still free to tax the real estate of national banks to the same extent as other real property in the state.

The changes made by Congress during the 1920's were a significant departure from prior policy but they too, suffered from various interpretations and applications among the states. For instance, some states used higher nominal tax rates on bank income than on regular corporate income because ordinary corporations paid other types of taxes such as personal property or sales taxes in addition to income taxes. Litigation continued as a result but the courts were lenient in their interpretation of comparable tax rates.

The Supreme Court's decision in First Agricultural National Bank v. State Tax Commission(1968),[18] led to Congressional changes resulting in the current limitations imposed on the state taxation of national banks. Prior limitations, designed to protect national banks from overly burdensome taxation at the hands of the states, had created situations where states could levy varying taxes on national banks, state chartered banks, savings institutions, and finance corporations. In this case, the Court declared impermissible a state's sales tax on a national bank's purchase of tangible personal property. The Court reasoned that a sales tax was not specifically permitted by Congress under the Acts governing taxation of national banks.

Proponents for change at this time argued that not only had the Congressional limitations ensured that national banks would not be discriminatorily taxed, the limitations created a tax environment favoring national banks. In addition to the issue of tax exemptions for national banks from general state taxation, national banks benefited from a requirement that states may only tax those national banks located within their borders. In 1959, restrictions on the state taxation of the interstate operations of nondomiciliary corporations were eased.[19] States were then able to attach jurisdiction to out of state corporations for tax purposes. This meant that a state could tax the operations of a nondomiciliary state bank but not those of a nondomiciliary national bank.

The Congressional solution took a straightforward approach. In 1969, the following amendment was enacted, not effective until 1976:

> **For the purpose 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.[20]

This simplification of prior limitations removed the technical guidelines concerning which taxes a state may use and replaced them with a statement of Congress' underlying theme, that of proscribing discriminatory taxation against national banks. As of 1976, states have been able to tax national banks under any method as long as its state chartered banks were taxed identically. This same rule applies today.

Chapter Three: Endnotes

1 It is not clear whether a challenge could be made by a national bank objecting to discriminatory tax treatment as compared to savings and loan associations or other corporations directly competing with national banks.

2 31 **U.S.C.** Section 3124(a) (1982) (emphasis added).

3 Home Owner's Loan Act of 1933, 12 **U.S.C.** 1464(h).

4 12 **U.S.C.A.** section 1768 (1982).

5 Various court cases have held that State chartered credit unions do not enjoy a broad exemption from all State and local taxes. Therefore, State chartered credit unions have been required to pay transfer taxes on property, local recordation taxes, and the State's motor vehicle excise tax. House Bill 599 of the 1990 Session passed the General Assembly on the final day of the legislative session. It purports to grant a broad tax exemption to State chartered credit unions except for real and tangible personal property taxes.

Md. Code Ann., Financial Institutions Art., § 6-103 (1986 Repl. Vol. as amended by House Bill 599 of the 1990 Session) (state chartered credit unions are exempt from all state and local taxation except on their real and personal property to the same extent that federal credit unions are exempt from federal taxation); Tax-General Art., § 11-204(a)(2) (1989 Vol.) (sales tax does not apply to State or federally chartered credit unions); and Tax-Property Art., § 7-228 (1986 Vol. and 1989 Cum. Supp.) (personal property owned by a credit union is not subject to valuation or property tax).

6 392 **U.S.** 339 (1968).

7 17 U.S. (4 Wheat.) 415 (1819).

8 For a history of state taxes on banks and financial institutions in Maryland, see Appendix I.

9 17 **U.S.** at 429.

10 <u>Weston v. Charleston</u>, 27 **U.S.** 448 (1829).

11 <u>Weston</u>, 27 **U.S.** at 469.

12 <u>McCulloch</u>, 17 **U.S.** at 435.

13 12 **Stat.** 346.

14 13 **Stat.** 112.

15 For a discussion of the litigation challenging the calculation of comparable tax rates and the meaning of the term "other moneyed capital," see Sandra B. McCray, <u>State Taxation of Banks: Issues and Options</u>, Advisory Commission on Intergovernmental Relations, M-168 (December 1989). The limitation on a state's tax rate to that imposed on its own banks was removed by amendment in 1868. 15 **Stat.** 34.

16 42 **Stat.** 1499.

17 44 **Stat.** 223.

18 392 **U.S.** 339 (1968).

19 Northwestern States Portland Cement Co. v. Minnesota and Williams v. Stockham Valves & Fittings, Inc., 358 **U.S.** 450 (1959) (Commerce Clause does not prohibit a state from imposing a direct net income tax--as opposed to a franchise tax measured by net income--on a corporation engaged exclusively in interstate business within the taxing state).

20 12 **U.S.C.** 548 (1982). Congress delayed the effective date of this new provision until January 1, 1973 to allow the Federal Reserve Board time to conduct a study on its effects. Another extension, P.L.93-100, delayed the effective date until 1976 pending a study by the Advisory Commission on Intergovernmental Relations. The ACIR study made several recommendations, but Congress failed to act and the 1968 provision became law without amendment. Advisory Commission on Intergovernmental Relations, 94th Cong., 1st Sess., Report of a Study under Public Law 93-100, State and Local "Doing Business" Taxes on Out-of-State Financial Depositories, Before the Senate Comm. on Banking, Housing, and Urban Affairs (Comm.Print 1975).

Chapter Four

TYPES OF STATE BUSINESS TAXES

I. Overview of Non-Income v. Income Based Taxes

A. In General:

Two types of state taxes are in use today: income and non-income based taxes. Income based taxes are used by a majority of the states and the federal government to tax individuals and most types of businesses, including financial institutions. Franchise taxes measured by net income, as well as direct net income taxes, are included in the category of income based taxes. Non-income based taxes, include capital (e.g., shares tax), deposits, and gross receipts taxes. Each of these taxes and their use in the taxation of financial institutions is described below.

B. Maryland:

While Maryland levies a minimal franchise tax ($2.5 million in FY 89) on the deposits of savings banks and savings and loan associations, the State has recognized the advantages of net income based taxes and uses the net income based franchise tax as its primary tax on financial institutions ($54 million in FY 89).

II. Non-Income Based Taxes

A. Taxes on Capital (Bank Shares):

Taxes on capital are imposed at a specific rate on some measure of a corporation's assets. The most widely used methods are real property taxes and taxes on the value of capital stock (a shares tax). Only seven states still levy a tax on bank shares. Bank shares taxes (in addition to real property taxes) were the only permissible method of taxing national banks until 1923 prompting all 48 states existing at that time to enact them. As Congress subsequently authorized alternative methods of taxation, including income based taxes, and eventually removed nearly all restrictions on the state taxation of national banks, most states replaced their bank shares tax with a tax based on net income. A 1983 Supreme Court decision which found that a Texas bank shares tax violated federal law by including the value of federal obligations in the tax base, further precipitated state action to replace bank shares taxes.[1]

Capital based taxes are a remnant of taxes on real property and personal property, both tangible and intangible. They were utilized at a time when most business taxation was conducted at the local level and the shares tax fit well with tax systems designed to assess and collect taxes on property. Prior to federal authorization of state income based taxes on financial institutions, taxes on the capital stock of a corporation were thought to be a good measure of the corporation's net worth and its holdings of intangible personal property. Shares taxes were also usually imposed at the same rates as state and local property taxes. Today, with other forms of taxation available to the states, capital based taxes suffer from the general criticism that they are not related to a taxpayer's ability to pay. The tax base is not economically elastic to reflect strong growth during good economic times or decline during poor economic times. Also, federal law restricts the inclusion of the value of federal obligations in the tax base for shares taxes without at least a pro rata exclusion from the tax equal to the percent of assets held as federal obligations.[2]

Capital based taxes rate poorly in today's climate of interstate activity. Attributing capital, especially intangibles, to a specific location is difficult. Thus, many states simply taxed domiciliary institutions on the full amount of their capital and did not tax nondomiciliary institutions at all. This residence based tax leads to a disadvantageous environment for a state's domiciliary institutions competing in the state with out of state financial institutions.

Maryland replaced its tax on the shares of banks and financial corporations with a tax on net earnings in 1968.[3] Prior to that time, the value of shares was determined by considering three factors: (1) the market value of shares; (2) the net earnings of a corporation; and (3) the net value of corporate assets. The value of shares of financial corporations other than banks was apportioned to the State based on the proportion of business done within and without the State.

B. Taxes on Deposits:

Taxes on deposits are imposed at a specific rate on the amount of deposits held by a bank or savings institution within the state. As noted, Maryland levies a tax on the deposits of savings banks and savings and loan associations to raise revenues ($2.5 million in FY 89) to generally offset the State's regulatory costs. Deposits may be an accurate measure of the traditional banking activities of accepting deposits and making short term consumer and commercial loans, but these practices are not reflective of the scope of present day financial institution practices. Real estate investment, securities transactions, and insurance activities are all modern day financial services. A tax on one small portion of the industry's operations, such as deposits, is inequitable and targets those institutions doing a substantial deposits business. Thus, deposits taxes are lacking in fairness among participants within the same industry. Further, deposits taxes, like capital taxes, do not reflect the taxpayer's ability to pay.

C. Taxes on Gross Receipts:

A tax on gross receipts is an excise tax imposed at a specific rate on the total amount of a firm's receipts or revenues. Gross receipts taxes have also received much criticism. One observer calls sales, use and gross receipts taxes useful in consumer or industrial sales contexts but concludes they are economically inelastic in the financial services context.[4] A survey prepared by the Advisory Commission on Intergovernmental Relations reports that four states still use a gross receipts tax for banks.[5] Gross receipts are a good measure of economic activity in a state but are not as sensitive to "ability to pay" as net income based taxes.

III. Net Income Based Taxes

Income based taxes can be classified into two types: direct net income taxes and franchise taxes measured by net income. Thirty-nine states, including Maryland, tax financial institutions on some measure of net income. Due to the federal limitations on the state taxation of interest from federal obligations, a franchise tax measured by net income has two advantages over a direct net income tax: (1) it promotes fairness by including federal obligation earnings in a financial institution's income, otherwise a significant portion of the income of this industry would be exempt; and (2) it is capable of producing greater tax revenues.

A. Direct Net Income Tax:

Direct net income taxes are imposed at a specific rate on the net income of a business. Because of federal limitations which prohibit the inclusion of interest income in a direct net income tax, twenty-two states use the franchise tax method rather than a direct net income tax. The seventeen states imposing direct net income taxes on financial institutions, generally do so in conjunction with or similarly to their taxation of general business corporations.

B. Franchise Tax Measured by Net Income:

Franchise taxes are generally imposed on corporations for the privilege of doing business in a state or for the granting of or power to exercise a corporate charter in a state. The tax is imposed on one of these events, regardless of the actual conduct of business in the state by a corporation (e.g., making a sale or earning income within the state). Maryland and 21 other states levy this type of tax on financial institutions. Minnesota imposes a franchise tax measured by net income on all of its corporations, including financial institutions.

Federal law allows inclusion of the interest from U.S. government obligations in the tax base of a nondiscriminatory franchise tax or other nonproperty tax. The "nondiscriminatory" requirement is satisfied by including interest earned from a state's own obligations in the tax base whenever federal obligations are included.[6] A state may not create a tax which discriminates in favor of its own instruments and against those of the United States. With this Congressional authorization, states can fashion franchise taxes that include a financial institution's interest earnings from federal obligations. Because these earnings represent a significant portion of the income of depository financial institutions, tax fairness and competitive tax equality are better achieved through the use of a franchise tax rather than a direct net income tax. One research report notes that the value of, and/or income from, federal obligations ranges from 10% to 60% of a bank's income.[7]

IV. Tax Policy Considerations-- Non-Income v. Income Based Taxes

Taxes based on the net income of a corporation do not suffer from the weaknesses generally associated with non-income based taxes. In general, income based taxes:

- are elastic and fluctuate with national and local economic conditions;

- can be structured to impose graduated tax rates[8] and more closely match "ability to pay;"

- can be apportioned relatively easily among jurisdictions for revenue distribution purposes;

- allow for the similar treatment of the various types of entities comprising the financial services industry, thereby increasing tax fairness. For example, depository institutions such as banks and savings and loans can be taxed similarly to lending companies, securities firms, and insurance companies; and

- can borrow heavily from well established tax principles and the experiences of the states and the federal government. Over 75% of the states tax banks and financial institutions based on some measure of their net income. Since similar taxes are used for income based taxes which are largely tied to computations for federal purposes, this contributes to uniformity, reduces compliance burdens, and assists both taxpayers and tax administrators.

Chapter Four: Endnotes

1 American Bank & Trust Co. v. Dallas County, 463 **U.S.** 855 (1983).

2 First National Bank of Atlanta v. Bartow County Board of Tax Assessors, 105 **S. Ct.** 1516 (1985).

3 Chapter 452, **Md. Laws** 1968. For a more complete history of the taxation of financial institutions in Maryland, see Appendix I attached to this report.

4 Judson and Duffy, " State and Local Taxation of Financial Institutions: An Opportunity for Reform," 39 Vanderbilt L.R. 1057, 1077 (May 1986).

5 Kincaid and McCray, "State Bank Taxation and the Rise of Interstate Banking: A Survey of States," 14 Intergovernmental Perspective 18, 19 (Fall 1988).

6 Memphis Bank and Trust v. Garner, 459 **U.S.** 392 (1983).

7 Kincaid and McCray, "State Bank Taxation and the Rise of Interstate Banking: A Survey of States," 14 Intergovernmental Perspective 18, 19 (Fall 1988).

8 Currently, 13 states use graduated tax rates for corporate income tax purposes.

Chapter Five

DIVISION OF INCOME AMONG THE STATES

I. Overview of Residence Based v. Source Based Taxes

A. In General:

Industry changes regarding interstate banking and technological developments have dramatically increased the multistate operations of financial institutions. These changes warrant the review of state tax policies and their effects. Of primary concern is the need to apportion or divide the income of a financial institution among the states in which it conducts business. The objective is to determine that portion of income attributable to a state for tax purposes.

Generally, two methods are used to apportion income, either residence based or source based. The residence based method, where the state in which the entity is located taxes all of the income from whatever source, has been largely replaced with the source based apportionment method for purposes of taxing general business corporations. In part due to past federal limitations and other restrictions on the multistate activities of financial institutions, states have been slow to move to source based taxes for financial institutions. Source based methods are aimed at attributing the income of a multistate corporation to the state in which it was earned.

B. Maryland:

Maryland's financial institution franchise tax is a source based tax relying on formulary apportionment (i.e., a single factor gross receipts formula measuring receipts earned within the State compared to total receipts). However, since formulary apportionment is not allowed for taxpayers lacking an office in another state, even though they may conduct business there, it contains an element of a residence based tax. These taxpayers are taxed on all of their income.

II. Residence Based Taxes

A residence based income tax is premised on the simple rule that a state taxes all of the income of domiciliary (in-state) corporations while taxing none of the income of nondomiciliary (out of state) corporations. This method of taxation is not used by states to tax general business corporations as it was recognized early on that the multistate operations of corporations could not be properly accounted for under such a system. For banks, however, a residence based tax matched the regulatory limitations on branching and prohibitions against operating in other states. These conditions have of course changed, making residence based taxes a poor measure of economic activity within a state and resulting in a lack of tax parity among out of state and in-state institutions.

Criticism of residence based taxes are several. First, since a pure residence based tax is imposed on a corporation's entire net income wherever earned, source based taxation in other states may subject the business to overlapping and multiple taxation. This is due to the differences among the state tax systems. For example, a multistate corporation subject to 100% taxation in a residence based tax state may still be subject to taxation in the other states in which it does business to the extent they use source based taxes. The predominance of source based taxes used by the states (only 18 do not apportion) indicates the prevailing sentiment that residence based taxes are an overly burdensome option. Residence based taxes may also be subject to constitutional challenges as a hindrance to interstate commerce because corporations engaging in interstate commerce may be subject to a greater tax burden than single state corporations.

Second, residence based taxes are a disincentive for multistate corporations to locate within a particular state. Under residence based taxes, the tax is computed by the home state on the entire income of the taxpayer, regardless of where it was earned. However, states can offset the harshness of taxing 100% of the corporation's income by granting tax credits for taxes paid to other states. Third, residence based taxes can lead to competitive tax inequality. For instance, an out of state lending company taxed under source principles by its home state would have an advantage competing in a state which taxes its banks under a residence based theory. Further, differing rates among states taxing businesses on residence based principles would favor a bank from a low tax rate state competing against a bank in a high tax rate state. Residence based taxes imposed on certain types of corporations within a state and not others creates inequity among those competitors within the same industry. Fourth, in this multistate age of business operations residence based taxes are not designed to tax the income of all entities doing business in the state, resulting in what could be a substantial amount of escaped state revenues.

III. Source Based Taxes

Source based taxes are more compatible with the multistate operations of corporations in that they attempt to attribute the source of income to the state in which it was earned. Source based taxes promote a level playing field among corporations because distinctions are not generally made between domiciliary (in-state) and nondomiciliary (out of state) corporations.

The key to source based taxes is the method used to source income to the taxing state (i.e., to apportion income to the state in which it was earned). Two methods have received general acceptance by the states. The first attempts to specifically attribute the origin of income using conventional accounting. This method, called separate accounting, can be administratively cumbersome and complex. The second method, called formulary apportionment, is used in some form by all 32 states which apportion the income of financial institutions. Formulary apportionment attributes income to a state according to a formula designed to measure levels of economic activity within a state compared to other states. In essence, the formula is applied to total income of a multistate business to determine how much income was earned within the state. Each is described below.

A. Separate Accounting:

Under separate accounting, the taxpayer is put to the task of attempting to separately account for the revenue generated and expenses incurred by the firm within each geographic region. This is a major administrative burden and is not practical for large multistate operations or for tax administrators charged with ensuring compliance with state tax laws. So, estimates of income and expense attributable to operations within a state may be relied upon instead. Further complicating matters are the difficulties in estimating expenses and income from transactions between a subsidiary and its out of state parent or between two subsidiaries. Thus, separate accounting is not a preferred method for determining the source of corporate income. In fact, no state relies on separate accounting as the sole method for attributing income even though it is used as an alternate method by some states when feasible. For example, Maryland employs formulary apportionment methods in the taxation of financial institutions and general corporations but does allow, if practicable, separate accounting to be used by corporations subject to the corporate income tax.

B. Formulary Apportionment:

The formulary apportionment method is the most widely used among the states for all types of business taxation, with 32 states using the method for financial institutions. Maryland uses it for the taxation of both general business corporations and financial institutions.

This method applies a mathematical formula to calculate the amount of income attributable to a particular state based on the proportion of in-state activities to total activities. This is less complex than separate accounting and if logically structured, can generate reasonable and fairly accurate results. However due to different formulas employed by various states, the potential exists to yield overlapping taxation. Multiple taxation in this case is not as objectionable on constitutional grounds as it is under residence based taxation as long as the state's formula fairly represents the business done by a corporation in the state. Residence based taxes make no effort to apportion tax liability based on the level of business activity in a state and thus may unfairly burden businesses engaging in interstate commerce.

The factors and situs rules which comprise apportionment formulas are the determinants of how much income is attributable to a state. For example, 45 of the 46 states imposing corporate income taxes have agreed on a formula comprised of three factors. The factors were codified in the Uniform Division of Income for Tax Purposes Act (UDITPA)[1] and they are: payroll, property, and receipts. While the general formula is widely accepted by the states, there is little actual uniformity because states weight each of the factors differently, include different items in each of the three factors, and value the items that are included differently. Modifications are made by states in order to accomplish specific economic policies, such as: (1) providing favorable tax treatment to a state's domiciliary corporations (e.g., by decreasing the weight of the payroll and property factors relative to receipts); and/or (2) increasing revenue raising ability (e.g., by increasing property and payroll factors relative to the receipts factor in a state in which corporations export most of their goods).

The UDITPA formula was designed for apportioning the income of manufacturing corporations. Financial institutions were specifically excluded from its recommended applicability because the factors and situs rules do not account for intangibles which are the distinguishing element of the industry (e.g., loans and securities in the property factor). Further, some states use different apportionment formulas for other types of industries. For instance, Maryland has recognized that service corporations are significantly different than manufacturing firms and under the corporate income tax uses a single factor gross receipts formula for service companies and the UDITPA three factor formula (with the factors equally weighted) for other businesses.

An apportionment formula consisting of one or several relevant factors provides some complexity and administrative burden but may reduce the opportunity for tax avoidance and create competitive equality between in-state and out of state firms. For example, with affiliated corporations located in many surrounding jurisdictions and the difficulty in establishing a tax situs for intangible property, it may be relatively easy for a financial institution to channel "receipts" activities to a favorable tax environment in another state. States can counter these types of tax avoidance activities by establishing broad situs rules (as discussed in Chapter Six) and by utilizing throwback rules (to capture revenues escaping tax) as discussed below.

C. Throwback Provisions:

One drawback to source based taxation is that it provides no guarantee that all income of a multistate corporation will be taxed. Source based taxation is designed to attribute income to a state based on some measure of its business activity within the state without regard to how a neighboring state treats the income of the corporation. The varying apportionment formulas, situs rules, and jurisdiction rules used by the states can lead to overlapping taxation or undertaxation of income. Overlapping taxation occurs when more than 100% of net income is taxed (i.e., more than one state stakes a claim to the same income) and undertaxation occurs when less than 100% of net income is taxed in aggregate by all the states (i.e., some portion of income is not claimed by any state). Throwback provisions limit the opportunities for multistate businesses to engage in tax avoidance behavior designed to take advantage of tax methods creating undertaxation.

One version of a throwback rule is used in formulary apportionment. If a taxing state attributes to itself 60% of a corporation's multistate income, then theoretically 40% of the corporation's income would be subject to taxation by some other state or states. When the other state or states either: (1) lack jurisdiction to tax the income of the corporation, or (2) do not use apportionment formulas which attribute any of the income to those states, then the taxing state can "throwback" or attribute that 40% of income to its taxable portion. Thus, the taxing state will tax the corporation based on 100% of its income even though its apportionment formula estimated that only 60% of the corporation's income was derived within the state. Throwback provisions can promote neutrality in source based tax systems by ensuring that corporations competing against single state firms are fully taxed on their earnings.

Another related throwback-type adjustment is used for tax systems that tax all of a resident corporation's income and provide a credit for taxes paid to other states. This is really a residence based tax but the credit signifies the state's recognition that income is earned in other jurisdictions and is taxable therein. Thus it is a modified source based approach. The home state can avoid unfairly reducing the multistate corporation's tax burden as compared to other home state taxpayers by limiting the credit to an amount based on what would have been paid if the home state had taxed 100% of the corporation's income (i.e., the credit should not exceed the home state's tax rate times the out of state portion of income).

Under each of these throwback adjustments, the multistate corporation's combined tax bill in all states will be at least what it would have been had the home state taxed 100% of its income. This enables the state to protect the competitive environment within its borders between multistate corporations and those corporations operating solely within the state. However, throwback provisions do add complexity to the tax system. Throwback provisions do not attempt to prevent overlapping taxation caused by variances in state apportionment formulas, situs rules, and jurisdictional requirements. Problems with source based taxes in regard to overlapping taxation are discussed in Section V below.

IV. Tax Policy Considerations-- Residence v. Source Based Taxes

In summary, while residence based taxes are administratively simple, the earnings of out of state corporations can largely escape taxation. Source based methods promote competitive equality and fairness among corporations doing business in several states and those operating in their state of domicile only. Some of the complexity inherent in source based systems is needed to achieve tax equity. Differences in tax methods among the states can give rise to overlapping taxation, however. Given Congress' protection of corporations engaging in interstate commerce, source based taxes are less subject to constitutional challenges regarding multiple taxation than are residence based taxes. Since residence based taxes are levied on all earnings (rather than that portion earned within a state), they are open to criticism as unfairly burdening interstate commerce in violation of Congress' powers under the commerce clause of the U.S. Constitution.

In addition to the possibilities of overlapping taxation, a pure source based tax method may allow for the undertaxation of income. Throwback rules can counter undertaxation of income. They are designed to ensure that a multistate corporation's combined tax bill in all states will be at least what it would have been had the home state taxed 100% of its income. As the implementation of a throwback rule by a state may cause certain corporations' tax liabilities to increase, it may have some effect on a corporation's desire to locate or conduct business within the state.

Maryland's financial institution franchise tax is a source based tax. As such, it is fairly related to the amount of business conducted in the State by a financial institution. However, the tax retains an element of a residence based tax as a multistate financial institution may not apportion income to another state unless it has an office in that state and the state taxes the financial institution on part of its income. This rule is similar to a throwback rule and helps to ensure that a financial institution is paying tax on at least 100% of its income. This rule should be modified, however, to recognize a situation where a financial institution may be required to apportion part of its income to a state even though it does not have an office there. (Administrative adjustments for taxpayers in this situation have been allowed in some circumstances.) Such a rule only entitles a financial institution to use the apportionment method for determining Maryland taxable income and does not dictate how much of a financial institution's income will be attributed to the other state in which it conducts business. Apportionment is the subject of the following section.

V. Issues in Apportioning Multistate Income

A. In General:

Apportionment formulas are used to "apportion" among the states the income of multistate financial institutions in at least 32 states. Sixteen of these states, responding to a survey conducted by ACIR, expected changes to be made in their apportionment formulas in the near future.[2] Apportionment formulas contain several key components, each having an effect on the amount of income attributed to a state. These components include:

- the factors used to measure business activity within a state, including the number, type, and weight of each factor;
- situs rules (including the definition of terms) which determine whether an item is considered an in-state or out of state activity; and
- rules for valuing the items included in each factor.

Policy makers must balance goals that encourage a competitive business environment and that generate needed tax revenues from income that is fairly attributable to the state. The apportionment formulas used by the states vary in many of these items, as each state's tax policy objectives mold the formula.

The most common apportionment formula--the UDITPA approach which is used by eleven states for financial institution taxation and 45 states for general business taxation--consists of three factors: payroll, property and receipts. Each factor is calculated as the amount of in-state business divided by business in all states. The factors are combined to compute the formula as follows:

$$\text{Apportionment Formula} = \left[\frac{\text{receipts in-state}}{\text{total receipts}} + \frac{\text{property in-state}}{\text{total property}} + \frac{\text{payroll in-state}}{\text{total property}}\right] \div 3$$

Other states use one, two, three, or four factor formulas and apply varying weights to each factor (as opposed to the equal weights given to each of the UDITPA factors). The factors are supposed to be representative of the source of income and of the benefits provided to the taxpayer by the state. This is why it is important that these formulas are reviewed in light of changes in business activity. For instance, states using source based taxes may choose and weight factors on whether their state is a customer state (i.e., a state where banks and financial institutions are not heavily concentrated and that is a net borrower of capital), such as Indiana and Minnesota, or a lender state (i.e., a state where banks and financial institutions are heavily concentrated and that is a net lender of capital), such as New York. Formulas can be designed which use varying weights for certain factors to benefit in-state over out of state banks. Such formulas coupled with situs rules that specify how to source particular items in-state or out of state could also be designed to decrease tax avoidance behavior.

B. Maryland:

For the financial institution franchise tax, Maryland uses a single factor formula to determine the amount of business done in the State compared to business done in all states by a firm. The apportionment formula equals the gross receipts derived from transactions in Maryland divided by total gross receipts. Unlike some states, Maryland's apportionment formula is not supported by detailed rules for siting receipts to the State or for defining the types of receipts to include in the factor. Partly because Maryland has a relatively simple method of apportioning income, many detailed rules may not be as necessary as for a state that uses a multiple factor formula.

C. Apportionment Formula Components:

State apportionment formulas are made up of one or more of the following factors: receipts, payroll, property, and deposits. Each factor is designed to measure levels of business activity from which income can be sourced to the state. Situs rules and definitional or valuation considerations are mentioned within the discussion of each factor where appropriate.

- Property Factor the property factor measures property located in the state to property located in all states. It can include real, tangible personal property (such as equipment and inventory), or intangible personal property (such as loans, receivables, or securities). If intangible property were not included in the factor for financial institutions, income attributable to the state would be understated since this property comprises most of the holdings of a financial institution.

  Real and tangible personal property is generally sited to the state where it is located or operated. Difficulty arises in determining the situs of intangible personal property because the physical location of the document constituting the loan or security can be held anywhere. Situs rules can attribute an intangible, like a loan or security, to the state of the creditor's domicile, the state of the debtor's domicile, or the state in which it has a business situs (e.g., where the loan was booked or where the property securing the loan is located). Also, rules can be used to determine the situs of such items as leased property and inventory in transit.

Valuation of property should also be specified by rule or regulation. For example, property can be valued according to its book value, depreciated value, or the value recognized for federal income tax purposes.

Situs rules for a property factor are obviously important considerations since they can increase or decrease the size of the factor and ultimately, the amount of income apportioned to the state.

- Payroll Factor - the payroll factor measures compensation paid in the state to compensation paid in all states. Payroll can be sited to the state where an employee's office is located or to the state where services are performed. Compensation should be defined to include/exclude fringe benefit expenses or fees paid to independent contractors for clarity.

- Deposits Factor - the deposits factor measures the amount of deposits held in the state compared to all states. For certain financial institutions, accepting deposits is a primary function and therefore, may be a good indicator of economic activity within the state. However, deposits can be attributed to either the state of the depositor or the state where the deposits are held. Using the state of the depositor as situs (as opposed to the state where the deposits are held), may decrease the opportunities for tax avoidance by a financial institution. Also, deposits can comprise a separate factor or they can be included within the definition of intangible personal property for purposes of the property factor.

- Receipts Factor - the receipts factor measures receipts attributable to the state compared to total receipts from all sources. The receipts factor may be the most important apportionment factor because it is the only one that is included in every state apportionment formula and the only one which is used singularly by states to apportion income. Maryland, for example, uses only the gross receipts factor in apportioning the income of financial institutions. Receipts broadly includes all gross income. At times, business income is distinguished from non-business income (e.g., gain from the extraordinary sale of an asset). Non-business income may be allocated to a specific state and may not be subject to apportionment through the receipts factor.

Situs rules for three specific types of income should be considered. They are income or receipts from loans, services performed, or credit card accounts. Here, situs rules can attribute income either to the state of the lender or to the state of the customer. The rule that is chosen can affect the amount of income of a multistate corporation that is deemed attributable to the state. This is particularly important for the market states and money center states which are discussed below.

In general, the customer state v. the lender state decision for situs rules highlights some of the most important issues to be faced by states in reviewing their taxes on financial institutions.

D. Trends among the States:

Maryland uses a single factor receipts formula. It is similar to the formula used by the State to tax service corporations for purposes of the corporate income tax. Maryland's apportionment formula is not backed up by detailed situs rules for determining when receipts are attributable to the State. Therefore, it is largely left to taxpayer discretion to source income among states.

Maryland limits the use of an apportionment formula to those financial institutions which maintain offices in other states. This implies that a corporation taxed by a state in which it has no office would be denied the opportunity to apportion income or receive an offsetting credit for taxes paid to the other state. However, administrative adjustments for taxpayers in this situation have apparently been allowed in some circumstances. It has been recommended in Section IV of this Chapter that this rule be modified to clearly allow use of the apportionment formula when a financial institution is subject to taxation in another state even though it lacks an office there.

Market States-- Indiana and Minnesota: these states have recently established aggressive tax policies aimed at taxing the income of out of state financial institutions doing business with state residents. Based on the perception that they are market states (financial institutions are not heavily concentrated in the states and the states are net borrowers of capital) rather than money center states (financial institutions are heavily concentrated in the state and the state is a net lender of capital), both Indiana and Minnesota, in order to generate increased revenues, have chosen to attribute financial institution earnings to the place where the customer resides as opposed to the state from which the lending bank operates. These policies are expected to increase tax revenues to Indiana and Minnesota as out of state corporations will be required to attribute more earnings to those states. Each state selected a different formula to achieve this result, however.

Indiana selected a single factor gross receipts formula for its non-resident taxpayers. Resident taxpayers, those corporations located and chartered in the state, are taxed on all their income from all state operations and granted a limited credit for taxes paid to other states. The situs rules for gross receipts of non-resident taxpayers attribute income to the residence of the customer. For example, interest and fee income from credit card accounts are sited to Indiana if the charges are regularly billed there.

Minnesota chose a weighted three factor formula of receipts(70%), property including intangibles(15%), and payroll(15%). Receipts are sited to the residence of the borrower or where the property securing the loan is located. Income from services is sited to the place of consumption, not the place of performance. Property is attributed to the state where located with intangible assets sited to the location of the borrower. Payroll is attributed to Minnesota if the employee is employed within the state, actually working there, or is accountable to an office within the state.

Money Center State-- New York: in contrast to Indiana and Minnesota, New York can be considered a money center state (i.e., state where financial institutions are heavily concentrated and the state is a net lender capital). Thus, New York's formula, in order to generate maximum revenues, reflects a lending state perspective. The state uses a weighted three factor formula of receipts(40%), deposits(40%), and payroll(20%). Situs rules for receipts attribute income to the location where receipts are processed, services are performed, or credit card loans are made. Deposits are sited to the branch where they are maintained as opposed to the state where the depositor resides. Moreover, the payroll factor is specially modified by including only 80% of the in-state payroll in the numerator. This may encourage financial institutions to locate employees within the state.

Proposals for Uniformity: the potential for overlapping taxation within source based systems is best illustrated by reference to the money center state v. market state conflict described above. Income from the operations of a financial institution in both New York and Indiana or Minnesota is likely to be attributed to both states, and hence taxed twice. Through federal legislation or voluntary state compact, the possibility for multiple taxation could be limited by the creation of uniform apportionment rules among the states. The Multistate Tax Commission, which has been somewhat successful in encouraging states to apply uniform rules regarding manufacturing firms, is considering uniform rules for the attribution of financial institution income. Also, the American Bar Association in 1982 proposed federal legislation aimed at limiting the amount of a multistate corporation's income subject to taxation by a state.

These proposals roughly follow the money center state/market state conflict with the Multistate Tax Commission proposal displaying more elements of a market state system (it was used by Minnesota and Indiana as a starting point for their recent changes) and with the American Bar Association proposal favoring money center state theory (e.g., sourcing loan receipts to state of loan origination, and services receipts to state of performance rather than consumption). Appendix II summarizes the tax structures of surrounding states and those discussed in this section, including the American Bar Association proposal and Multistate Tax Commission draft proposal.

E. <u>Combined Reporting and the Unitary Business Principle</u>:

Another issue related to apportionment concerns the unitary business principle. The unitary business principle, through combined reporting, combines the income of all members of a unitary group that are engaged in an integrated or single business. A state's apportionment formula is applied to the entire net income of the group instead of just to the income of a subsidiary doing business in the state. Taxation under the unitary business principle is based on the premise that, in a multistate business comprised of affiliated companies, income is not generated at one specific location (e.g., where the loans are processed). The Supreme Court has recognized the use of the unitary business principle as a valid method of apportionment.[3] The unitary business principle enjoys widespread use among the states for general business corporations and financial institutions (over 20 states allow some type of unitary combination for tax purposes). Further, combined reporting, an essential component of unitary taxation, is used by corporations for purposes of the federal income tax.

Unitary taxation is only imposed when affiliated corporations constitute a "unitary business." Much disagreement exists over the definition of this term. Three criteria have been developed by California and followed by many other states. They are called the "three unities" and are comprised of the following:

- **unity of ownership**--established when a parent holds in excess of 50% ownership in a subsidiary;

- **unity of use**--established where centralized staff functions are applied to all units of the organization; and

- **unity of operation**--established by evidence of a general system of operation and a centralized executive group.[4]

The unitary business principle helps states attribute a share of the income of a multistate operation to the state when the in-state activities of the group may not be credited with a significant share of the operation's income. It is a method of preventing tax avoidance. For example, suppose a banking firm in state A processes and approves loans which are marketed in state B by a loan production office subsidiary. If state A has a higher tax rate than state B, the income from the loans is likely to be attributed to the subsidiary in state B. Conversely, the income can be attributed to the state A parent company if tax rates are lower in A compared to state B. Under the unitary tax, the receipts and expenses of each affiliated corporation would be combined and state A's apportionment formula applied to combined net income, and state B's formula applied to combined net income.

Success of the unitary business principle and combined reporting depends on the degree to which the members of the unitary group are conducting a related business. In the financial services industry, this is practically assumed due to federal law which prohibits banks, bank holding companies, and their subsidiaries from engaging in a business unrelated to that of banking. Because of the large portion of a financial institution's earnings that are derived from federal obligations and the mobility of these intangible assets, states may benefit from the tax avoidance limitations created by the use of the unitary business principle for the taxation of financial institutions.

The benefits resulting from unitary taxation should be considered in conjunction with the considerable administrative burdens imposed by such a tax. Further, since the tax may subject large multistate corporations to additional compliance and tax burdens, the effect on a corporation's decision to do business in the state should be considered.

F. Tax Policy Considerations-- Apportionment Methods:

Through the careful selection of factors, situs rules, definitions, and valuation rules states can promote/dissuade specific economic activity. Also, states can protect their in-state businesses from out of state competitors or seek to maximize their state tax revenues. Other formula variations include weighting factors differently. For example, it is generally believed that weighting the receipts factor more heavily than others is beneficial for in-state corporations compared to out of state corporations since their property and payroll in the state is not counted as heavily in the formula. Selecting a number of factors instead of a single factor formula adds to administrative complexity but may limit the opportunities for tax avoidance behavior.

Maryland uses a single factor receipts formula. It rates high in terms of simplicity but is not supported by situs rules to guide the taxpayer in determining which portion of the taxpayer's income is attributable to the State. Without these guidelines, Maryland's apportionment method follows neither the market state nor the money center state approach. As the State is more like a market state, situs rules that attribute receipts to the state of the customer may increase franchise tax revenues and the consequences of establishing situs rules based on market state principles should be considered. Tax administrators should, at a minimum, establish and promulgate situs rules to define and describe current administrative practice for the benefit of the taxpayers' understanding and for tax compliance.

Chapter Five: Endnotes

1 UDITPA was drafted by the National Conference of Commissioners on Uniform State Laws in the 1950's. The Act proposed uniform apportionment rules for general business corporations. Financial instititions were specifically exempted from its provisions. Most likely, this was because federal limitations on the taxation of national banks were in place at the time and the interstate operations of financial institutions were relatively minimal .

2 Kincaid and McCray, "State Bank Taxation and the Rise of Interstate Banking: A Survey of States," 18 Intergovernmental Perspective 18-22, 22 (Fall 1988).

3 Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983).

4 James John Jurinski, "Taxpayer Strategies in a Unitary Tax Audit," Journal of Accountancy (January 1986) pp. 91-102, at p. 98.

Chapter Six

STATE TAX JURISDICTION AND DEFINING FINANCIAL INSTITUTION FOR TAX PURPOSES

I. Jurisdiction to Tax

A. State Tax Jurisdiction:

Financial institutions, like their general business corporation counterparts, are generally no longer limited by geographical state or national boundaries. They frequently conduct multistate and multinational income producing activities. The remaining restrictions on interstate branch banking do little to impede bank holding companies in establishing separately chartered bank subsidiaries. Further, financial institutions physically located in only one state have always been able to derive income from a neighboring state in the form of: deposits from out of state residents, loans to out of state residents and commercial enterprises, and loans for transactions involving property located in another state.

Historically, states limited their taxation of financial institutions to corporations having a physical location in the state. This matched well with the banking environment that existed before the creation of multistate bank holding companies, other new types of bank entities, and high technology information processing and communications equipment. Maryland, for example, still uses such a "brick and mortar" nexus (i.e., contacts) test taxing only those financial institutions having an office located in the State. This rule applies regardless of the amount of business done in the State or the amount of income derived from Maryland residents.

The limits on state tax jurisdiction over out of state financial institutions are likely to be tested by states which have aggressively expanded their scope of taxation (e.g., Indiana and Minnesota discussed below). It is just as likely that the courts will continue to uphold fairly apportioned, nondiscriminatory taxes on an out of state taxpayer who establishes a physical or economic presence within the state. As long as some purposeful exploitation of the market is found, even banking activities conducted through the mail or wire services may support state tax jurisdiction.

B. Federal Limits on State Tax Jurisdiction:

State taxation of multistate corporations cannot be implemented without limitations. First, the due process clause of the 14th Amendment to the U.S. Constitution requires "some definite link, some minimum connection, between [the state and] the person...it seeks to tax."[1] This requirement has been interpreted as permitting state taxation as to any corporation which conducts regular and purposeful economic activity within the state. The second limitation is tied to Congress' power under the Commerce Clause of the U.S. Constitution. The Supreme Court has described the limitations arising under the Commerce Clause as: (1) the corporate activity taxed must have a "substantial nexus" to the state; (2) the tax must be fairly apportioned; (3) the tax must not discriminate against interstate activity; and (4) the tax must be fairly related to the services provided by the state.[2] Each of these is generally aimed at preventing an undue burden on interstate commerce.

Finally, for corporations deriving income from the sale of tangible personal property, Congress has specifically prohibited state taxation of an out of state corporation whose in-state activities consist of soliciting orders only.[3] This federal statute, P.L. 86-272, is not a direct limitation on the state taxation of multistate financial institutions since it does not apply to the sale of services or intangible personal property, but it does provide some guidance as to Congress' intent in this area.

Taken together, the due process and commerce clause limitations impose restrictions on who can be taxed and the extent of the tax burden. As to who can be taxed, the due process requirement of minimum contacts is considered to be roughly equivalent to the commerce clause requirements of substantial nexus and maintaining a fair relation between taxation and services. Thus, a business must have some "adequate" connections to a state before the state may impose a tax. Regarding the tax burden limits (or "how" a state may tax a business once it has obtained jurisdiction), it is fairly clear that the state may not impose a tax which discriminates against out of state businesses as compared to businesses domiciled within the state. Also, the state may not apportion to itself a share of the out of state income which bears no relation to in-state activity or the amount of services provided by the taxing state.

C. When are Contacts Sufficient to Establish Nexus? Examples:

The court's concept of "nexus" or "minimum contacts" sufficient to establish state tax jurisdiction over nondomiciliary businesses, has shifted from a **physical presence test** to an **economic presence test** focusing on a taxpayer's regular and systematic exploitation of a state's market. Several types of financial institution activities are evaluated below to determine whether the contacts with a state are sufficient to satisfy taxable nexus.

1. Business Location in the State (The Physical Presence of a Business Office):

An out of state financial institution can engage in a substantial loan making business in a state without setting up a formal bank, branch or subsidiary operation. Through a loan production office or an automated teller machine (ATM), a financial institution provides access to customers for loans that are technically made, approved, and derived from the out of state financial operation. While this lending across state lines may raise questions as to "how" to apportion the loan income, determining that the out of state financial institution has created a sufficient nexus with the host state is clear from the fact that it has established a physical presence within the state. The Supreme Court has made it clear that it will continue to uphold state tax jurisdiction over an out of state corporation which establishes an in-state business location (i.e., a physical presence), such as a branch or a loan production office.[4]

Multistate financial activities have recently been expanded through the use of electronic fund transfer systems. The most visible form of the new age of banking is the automated teller machine(ATM). Whether a state may tax the income producing activities of an out of state financial institution which makes loans or accepts deposits through an ATM may depend on whether the ATM constitutes a physical presence within the state. One distinction which can be made is between an ATM established or built by an out of state institution and one which is a shared use terminal established by a financial network (e.g., MOST) or an unrelated financial institution. The former may be considered a branch subject to both state regulation and taxation. The latter, a "branchless bank" having no office in the state, may not constitute a physical presence. Business activities not constituting an actual physical presence, such as those conducted through the mail or telephone, are addressed below.

2. <u>Solicitation by Employees in the State (The Physical Presence of Employees)</u>:

The regular solicitation of loans by employees of an out of state financial institution is sufficient to satisfy the minimum contacts requirement of state tax jurisdiction. Financial institutions have regularly marketed their loans in other states through "call programs." Call programs consist of employees or independent contractors soliciting loans from residents of a host state for processing and approval by the home office much the same way that loan production offices operate. Any regular presence by such employees or independent contractors in the host state, beyond a casual or isolated sale, appears sufficient to satisfy taxable nexus.[5]

3. <u>Activities Constituting Only an Economic Presence</u>:

State tax jurisdiction over the out of state financial institution which does not establish a physical presence in the state rests on whether the institution "purposefully avails itself of the privilege of conducting business" within the host state (i.e., whether it directs its activities toward a state's residents and derives business therefrom).[6] This activity triggers the provision of state protection and services to the out of state corporation because of its economic presence.

For example, if an out of state bank solicits and issues a credit card to a host state resident solely through the mail, the contacts surrounding the use of the credit card by the resident are many. First, use of the card by the resident creates a loan with all its attendant obligations and rights. The host state will most likely be the only state in which the bank can enforce its agreement in court. Thus, the host state provides the protection of its laws to the out of state bank. Second, a purchase by the resident from a host state merchant requires some agreement between the merchant and the bank for reimbursement. Again, the bank would seek the protection of the host state's laws to enforce its agreement with the merchant. Third, it could be argued that the bank has property in the host state since the card remains the property of the issuer.

The Supreme Court has expressly agreed that today's technological achievements have obviated the need for a physical presence in a state before jurisdiction attaches. In Burger King v. Rudzewicz(1985), the Court stated:

> [I]t is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted. So long as a commercial actor's efforts are 'purposefully directed' toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there.[7]

D. Jurisdiction Rules in Maryland and Other States and Other Proposals:

The following summarizes jurisdiction rules in several states including a proposal by the American Bar Association and a draft proposal by the Multistate Tax Commission, which was used as the foundation for jurisdiction rules in Indiana and Minnesota.

Maryland-- the financial institution franchise tax is imposed "on each financial institution existing or doing business in the State."[8] This statutory provision appears to be broad enough to cover each of the activities analyzed above, but in practice this provision is interpreted as imposing the tax on only those financial institutions that have an office located in the State. For banks and savings and loan associations, the "brick and mortar" test parallels the State's regulatory requirements.

As a comparison, Maryland's corporate income tax is imposed on any corporation having income allocable to the State.[9] Through regulations and administrative procedures adopted by the Office of the Comptroller, the State asserts jurisdiction over out of state general business corporations to the extent allowed by the U.S. Constitution (due process and commerce clauses) and federal statutory law (P.L. 86-272).

Indiana-- the newly created franchise tax on financial institutions is imposed on each taxpayer "transacting the business of a financial institution" in the state.[10] The following activities are considered transacting business:

- maintaining an office in the state;
- conducting business through an employee, representative or independent contractor in the state;
- regularly selling products and services to Indiana customers which are consumed in the state;
- regularly soliciting business in the state;

- regularly performing services outside Indiana which are consumed within the state;

- regularly engaging in transactions with Indiana customers that involve intangible property and loans resulting in receipts flowing to the taxpayer from within the state;

- owning or leasing tangible personal or real property in the state; or

- regularly soliciting and receiving deposits from Indiana customers.

"Regular solicitation" of business is presumed if the above activities are conducted with twenty or more Indiana residents or the sum of the taxpayer's assets and deposits attributable to Indiana equal at least $5 million.

Minnesota-- the tax is imposed on the use of the corporate franchise to engage in income producing activities in Minnesota. In addition to those financial institutions having a physical presence in the state, the tax applies to corporations which regularly solicit or obtain business in the state. Regular solicitation is presumed under the same standard used by Indiana (above).

New York-- the franchise tax is imposed on all corporations doing a banking business in the state. "Doing business" is determined according to the brick and mortar physical presence test and includes the operation of a branch, loan production office, representative office, or bona fide office.

American Bar Association-- proposed federal legislation (adopted as an official position by the Association in 1982) prohibits states from taxing any depository financial institution which did not have a business location within the state.[11] As proposed, a depository institution would have a business location in the state if it: (1) maintains an office in the state: (2) has an employee who maintains a regular presence in the state; or (3) leases tangible property to others in the state or owns or leases tangible property for its own use in the state. An employee is deemed to have a regular presence in a state if a majority of his/her services are conducted there. Solicitation of loans which are approved outside the state is not considered in determining whether an employee has a regular presence in the state. Finally, the proposal contained a "**de minimis** exception" which provided that even if a business location was found, a depository institution could not be taxed by a state unless it had more than $1 million of either payroll or receipts attributable to the state.

Multistate Tax Commission-- a draft proposal released March 1989 (not an official position of the Commission), would impose financial institution taxes on those: (1) having a place of business in the state; (2) having employees, representatives, or independent contractors conducting business in the state on their behalf; or (3) engaging in regular solicitation resulting in the creation of a depository or debtor/creditor relationship with a customer in the state. Regular solicitation is presumed if the total of the relationships created above are with 100 or more residents or if the taxpayer has $5 million or more of assets attributable to sources in the state.[12]

E. Tax Policy Considerations-- Tax Jurisdiction:

In light of today's multistate business environment, states need to determine the tax implications of moving beyond requiring physical presence to establish tax nexus. Many corporations, both general business and financial institutions, have an economic presence in the state (but not necessarily a physical presence) yielding potential tax opportunity. This opportunity can be used to promote tax fairness, neutrality, and increased tax revenues. By clearly identifying which entities and activities are subject to the tax compliance burdens are lessened and uniformity is increased. Tax avoidance activities (such as sourcing activities to lower taxing states) can be limited, promoting competitive equality between in-state and out of state firms. Moreover, greater tax parity can be achieved by establishing tax jurisdiction policies similar to those for general businesses paying the corporate income tax. States should evaluate the need to modernize their tax jurisdiction statutes for financial institutions just as they have modernized nexus rules for the taxation of general business corporations due to the growth in multistate activities.

Determining "who" can be taxed rests on the existence of minimum contacts or nexus between the out of state corporation and the taxing state. Without doubt, the operation of a branch office in the taxing state satisfies the nexus requirement (i.e., establishment of a physical presence). It is becoming just as clear that economic presence (without physical presence) can constitute taxable nexus.

State tax laws/regulations should be clear as to tax incidence by delineating the types of activities that will result in creating taxable nexus and making an out of state financial institution subject to state taxation. Any regular and purposeful economic activity directed at a state's residents provides a state with a sufficient nexus to assert its tax jurisdiction. Clearly delineating which entities and activities are subject to tax lessens compliance burdens and increases uniformity by simplifying the tax for both taxpayer and tax administrator. Tax avoidance activities (such as sourcing activities to lower taxing states) can also be limited, producing competitive equality among in-state and out of state firms. Further, since most states have already expanded their tax jurisdiction rules for general business corporations, similar modifications for financial institution taxation will provide greater tax parity among types of businesses.

Maryland's statutory tax jurisdiction rule ("a financial institution existing or doing business in the State") is broader than the rule used in practice ("a financial institution having an office in the State"). The State should expand the application of the financial institution franchise tax to the doing business test (economic presence) embodied in the statute. Such an expansion of the tax base would promote competitive equality among those institutions deriving business from customers within the State.

II. Defining a Financial Institution for Tax Purposes

A. In General:

As noted throughout this report, the financial services industry has undergone many changes. Providers of financial services not only include banks, savings and loans, and credit unions but also consist of car manufacturers, consumer lenders, mortgage lenders, investment companies, brokerage firms, mutual funds, credit card issuers, and arguably, even insurance companies offering interest bearing whole life accounts. Further, as banks and savings and loans expand into real estate investment, insurance, and securities, traditional industry boundaries become more blurred. Maryland's State Bank Commissioner has the authority to expand the financial, fiduciary, and insurance activities of a state chartered bank through the use of an affiliated corporation. These activities are limited to those that are permitted under federal law for national banks. National banks have the power to:

- act as an agent in the sale of title insurance incidental to the bank's authority to make loans;
- underwrite title insurance by an operating subsidiary in connection with another subsidiary's mortgage lending;
- enter into percentage leases with insurance agents, but not in the form of a joint venture;
- offer credit life insurance to its borrowers
- broker variable annuity contracts on the grounds that they constitute the sale or purchase of securities on behalf of a customer; and
- issue standby credits for municipal loans.

Regulatory definitions of a financial institution based on deposit taking and lending functions no longer accurately describe the scope of competitors in the financial industry. Using regulatory definitions for tax purposes may result in differing tax treatments for today's industry competitors.

B. Maryland:

Maryland's definition of financial institution for tax purposes, while containing a provision making it applicable to all businesses competing with national banks, generally only applies to deposit taking or lending institutions. As such, brokerage firms, insurance companies, securities firms, mutual funds, and holding companies are not included within the term "financial institution." Therefore, these corporations are not taxed on the same basis as their competitors in Maryland (i.e., they are taxed as corporations or insurance companies rather than financial institutions). Additionally, Maryland banks are currently limited to conducting most insurance, real estate, and securities activities through affiliated corporations (only upon approval of the Bank Commissioner). These subsidiaries are not considered financial institutions in Maryland for tax purposes and therefore, are currently taxed as general business corporations. If banks are permitted to directly engage in these activities, the distinctions between the industries would become increasingly blurred and the reasons for taxing banks and the businesses engaged in insurance, real estate, and securities differently would become more artificial.

C. Defining "Financial Institution"-- Examples:

Maryland-- for purposes of the financial institution franchise tax, Maryland defines "financial institution" broadly to include all banks and savings and loan associations, as well as international banking facilities, and credit, mortgage, finance, loan, safe-deposit, and trust companies. A catch-all provision includes any "company that substantially competes with national banks in the State."[13] This provision has not been applied to include any other types of firms other than those listed, however. It appears that the acts of accepting deposits or making loans in the traditional sense are contemplated by the current definition. Credit unions are exempted from an income or franchise tax by statutory provision.[14] Specifically excluded are: subchapter S corporations, finance companies making loans only to farmers for agricultural purposes, and companies licensed under the federal Small Business Investment Act of 1958.

In other states, holding companies of financial institutions are specifically included within the definition of "financial institution." They are not included in Maryland's definition and are therefore subject to the State's corporate income tax.

Indiana-- the newly enacted franchise tax is imposed on any corporation conducting the business of a financial institution. This includes banks, savings and loan associations, bank holding companies, or any subsidiary thereof. Also, the tax applies to any other corporation deriving 80% or more of its gross income from the making or servicing of loans or the operation of a credit card business.

Minnesota-- for purposes of applying its special apportionment formula, Minnesota defines "financial institution" as including-- a holding company, a regulated financial corporation, or any other corporation carrying on the business of a financial institution. This broad definition includes any corporation deriving more than 50% of its gross income from lending activities in substantial competition with regulated financial corporations, such as national and state banks.

D. Tax Policy Considerations-- Definition of a Financial Institution:

A fair tax system should strive to tax industry participants similarly to promote a competitively equal business environment. As most states have adopted taxes based on net income which are either identical or similar to the taxes imposed on general business corporations, the need to accurately define "financial institution" for uniformity of tax treatment has somewhat diminished.

Two important reasons for carefully considering the scope of the term "financial institution" do remain. One depends on whether a state maintains separate tax systems for its financial institutions and general business corporations in order to tax the interest earned on government obligations through a permissible franchise tax. Obviously, "financial institution" will include the traditional depository institutions (i.e., banks, savings and loan associations, and other thrifts) which invest in government obligations. However, these financial institutions compete with some general business corporations that may also invest in government obligations but have interest earnings that are exempt under direct net income taxes. The equity of such treatment should be questioned. Of course, a state could avoid the need for defining a financial institution in this matter by imposing a franchise tax measured by net income on all of its corporations and include interest from federal, state, and local obligations in the taxable basis.

The other justification for accurately defining a "financial institution" centers not on "who" to tax but on "how." Whether a state has a single tax on all of its businesses or separate taxes for financial institutions versus ordinary business entities, different apportionment methods may be used. The factors and situs rules comprising an apportionment formula used for manufacturing companies may be different than those used for financial institutions. Here, "financial institution" should be broadly defined to include all those entities that regularly deal in intangibles, such as loans and securities. Thus, any depository institution, lending company, or other business conducting a deposit taking or lending activity should be included as a "financial institution."

In summary, states that use similar methods to tax financial and general business corporations should develop a definition of "financial institution" that identifies which institutions are subject to an apportionment method specifically designed for financial institutions. In contrast, states that tax financial institutions differently than general business entities (e.g., including/excluding interest from federal obligations) should develop a clear definition that identifies which tax applies to which institutions.

Maryland taxes financial institutions differently than it taxes general business corporations (i.e., interest from federal and Maryland obligations is included in a financial institution's net taxable income). Therefore, Maryland's definition of "financial institution" should clearly identify all those entities that are taxed on their interest earnings from federal and Maryland obligations. After making that distinction, the apportionment method should be determined based on whether the entity is a manufacturing corporation (three factor property, payroll and sales formula) versus a service corporation or financial institution (single factor receipts formula).

Chapter Six: Endnotes

1 National Geographic Society v. California Board of Equalization, 430 **U.S.** 551, 561 (1977)(quoting Miller Bros. Co. v. Maryland, 347 **U.S.** 340, 344-345 (1954)).

2 Complete Auto Transit, Inc. v. Brady, 430 **U.S.** 274, 279 (1977).

3 P.L. 86-272, 73 **Stat.** 555 (1959).

4 Northwestern States Portland Cement Co. v. Minnesota, 358 **U.S.** 450 (1959).

5 See, Brown-Forman Distillers Corporation v. Collector of Revenue, 234 **La.** 651 (1958), **cert. denied,** 359 **U.S.** 28 (1959) (solicitation of orders by employees for acceptance and shipment from out of state sufficient to support imposition of a tax); see also, Scripto, Inc. v. Carson, 362 **U.S.** 207(1960) (continuous solicitation by independent contractors in the taxing state sufficient to create taxable nexus).

6 Hanson v. Denckla, 357 **U.S.** 235, 253 (1958). This case involved the question of whether a Florida court had jurisdiction over a Delaware trustee for judicial and not tax purposes. However, it can be argued that both jurisdiction issues are closely related, if not identical, under due process and commerce clause analyses.

7 471 **U.S.** 462, 476 (1985).

8 **Md. Code Ann.** Tax-General Art., § 8-202(a) (1988).

9 **COMAR** Rule 03.04.03.03A (1989).

10 Created by House Bill 1625, **Laws of Indiana** 1989 (effective January 1, 1990).

11 2 **A.B.A Reports**, No. 1095 (1982); reproduced in Todres, "Multistate Taxation of Depositories: An Analysis of Legislation Proposed by the American Bar Association," 58 **St. John's L.R.** 443-475 (1984).

12 Multistate Tax Commission Review, volume 1989, number 1,(March 1989) pp. 17-21.

13 **Md. Code Ann.**, Tax-General Art., § 8-101(c)(1)(xi) (1988).

14 **Md. Code Ann.**, Financial Institutions Art., § 6-103 (1986 Repl. Vol.) (state credit unions exempt from tax on its income, capital, reserves, surpluses, and other funds); 12 **U.S.C.A.** section 1768 (1982) (federal credit unions exempt from all state taxes except those on real or personal property).

Chapter Seven

IMPLICATIONS FOR MARYLAND'S FINANCIAL INSTITUTION FRANCHISE TAX

I. Findings-- In General

Maryland's approach to the taxation of financial institutions, a franchise tax measured by net income, is used by twenty-one other states. Another seventeen states levy a direct net income tax. Since the tax is a franchise tax, the interest earnings from federal obligations may be included in the tax base.

In comparing Maryland's financial institution franchise tax to the corporate income tax, the inclusion of the interest from federal, state, and local obligations and the method of apportioning income mark the primary differences between the two taxes. An added distinction is that financial institutions are exempt from personal property taxation, whereas general businesses are not. As to similarities, under each tax structure the base is tied to federal taxable income (with certain modifications) and the tax rate is 7%. These similarities promote tax parity between the State's financial institutions and other businesses. The seven percent tax rate is considered "moderate" when compared to tax rates in other states. Of the twenty-one states levying a franchise tax measured by net income that includes interest from federal obligations, eleven have nominal tax rates exceeding seven percent.[1]

Overall, the basic structure of the financial institution franchise tax is sound and generally provides a rational basis for taxing the income of "financial institutions." The tax meets many of the goals of good tax policy--

- first, the net income based tax is related to "ability to pay," providing some vertical tax equity (i.e., tax liability is related to income). Although use of the 7% flat tax rate lacks progressivity, it promotes some horizontal tax equity since it is the same as that used for corporate taxpayers.

- second, since the tax base is coupled to federal taxable income the same as it is for corporations, administrative burdens are reduced for both taxpayer and tax administrator resulting in some uniformity and fairness among competing entities.

- third, the single factor apportionment formula, while not necessarily providing the best method of sourcing income (the "best method" is a subjective determination), is administratively simple requiring less complex tax rules. Moreover, by using a source based rather than residence based approach the tax is more equitable.

- fourth, by taxing the interest on federal and state obligations, it captures a significant source of income for financial institutions, which would otherwise escape taxation under a direct income tax. Because of this, the franchise tax is better able to promote fairness and competitive tax equality.

Thus, the financial institution franchise tax has a sound foundation and the basic method of taxation should be maintained.

However, there are some elements of the tax that could be adjusted in light of the evolving financial services industry. Two concerns, cited in this report, relate to changes in the industry: first, multistate operations of financial institutions have increased and second, types of financial services offered and the types of businesses offering them have expanded yielding a different set of industry competitors. Because of these changes, two issues must be addressed:

- the fair distribution of the tax burden among all taxpayers conducting business in the State, including out of state financial institutions; and

- the taxation of all financial sector competitors on a similar basis.

In summary, the historical reasons for taxing banks differently than general business corporations have changed (i.e., federal limitations have been lifted and the banking industry has evolved). Maryland's financial institution franchise tax measured by net income generally represents a sound approach to the continued taxation of financial institutions given its ability to tax interest earnings from federal obligations, its consistency with many of the goals of tax policy, and its basic similarity to the taxes imposed by other states on their financial institutions and by Maryland on its non-financial corporations. Revolving around changes in the banking industry--the increase in multistate activities and the expansion of services and industry competitors--some aspects of the tax structure could be modified, as discussed below.

II. Fairly Distributing the Tax Burden

A. Jurisdiction Over Out of State Financial Institutions:

Maryland's current tax jurisdiction rule requires the presence of an office in the State before tax jurisdiction attaches. This **physical presence test** allows some financial institutions to conduct business in the State without being subject to the State's taxation. This results in an unfavorable competitive environment for in-state financial institutions. Many other states use an **economic presence test** to determine tax jurisdiction. In fact, Maryland uses an economic presence test to determine whether out of state corporations are subject to the corporate income tax. Since the applicable provision of the Annotated Code of Maryland appears to permit an economic presence test (the tax is imposed on any financial institution "existing or doing business in the State"), **tax jurisdiction should be expanded, by regulation or otherwise, to include out of state financial institutions conducting a significant business in the State.**

Since the financial institution franchise tax only applies to financial institutions maintaining an office in the State, out of state consumer lenders (e.g., credit card and finance companies), mortgage lenders, and commercial lenders are able to conduct business with Maryland customers through the mail, phone, certain automated teller machines, or sales representatives without being subject to taxation by the State. By not using jurisdiction rules based on the **economic presence** of these entities, Maryland foregoes tax revenue. This yields a competitive disadvantage for Maryland institutions that pay tax on their income derived from Maryland customers. **To promote competitive equality among in-state and out of state financial institutions and among competing types of financial and nonfinancial business entities, the State should alleviate this disparity by broadening its jurisdiction rules for financial institutions through administrative regulation or through clarification of existing statutory law.**

This could have negative consequences for the State, however, as those out of state financial institutions currently receiving some degree of competitive advantage may choose to withdraw from the market in Maryland rather than face taxation by the State, particularly if their business in the State is limited or taxed by other means. This could lead to a decline in the availability of lending capital for Maryland consumers and businesses. **To limit the negative effects of expanding taxable jurisdiction, "de minimis" rules (such as those described below) should be adopted to exclude financial institutions which do not derive significant income from the Maryland market and who would be most likely either to not comply or to leave the Maryland market.**

Legal precedent for broad jurisdiction rules based on the economic presence of the taxpayer can be found in the administration of the State's corporate income tax. For general business corporations (including bank holding companies), the State's jurisdiction appears to extend to the limits of the Constitution (i.e., "minimum contacts" or "substantial nexus") and federal law. Indiana and Minnesota revised their bank tax laws to apply to financial institutions who either have a physical presence in the state <u>or</u> who regularly solicit business in the state. To provide clear guidelines as to when tax jurisdiction would attach under the "regular solicitation" standard, both states enacted **de minimis** exceptions--i.e., jurisdiction does not attach if solicitation activities result in fewer than 20 customers and less than $5 million in assets and deposits attributable to the State.

Broadening jurisdiction rules to include some out of state financial institutions not currently taxed by the State would promote competitive equality among in-state and out of state firms. Depending on the rate of compliance, broader tax jurisdiction rules would increase tax revenues. But, the amount of additional tax revenues would depend on the amount of income apportioned to the State not simply on the number of additional firms subject to the State's taxation. (Income apportionment is discussed in the next section).

An example concerning taxable nexus for financial institutions is the acquisition of loans in the secondary market having a connection to the State. Minnesota, for example, exempted purchasers of loans with a Minnesota situs (i.e., property securing the loan is located in Minnesota, or borrower is a Minnesota resident) from the normal tax jurisdiction provisions. Jurisdiction rules should specifically describe whether these types of "contacts" are sufficient to create taxable nexus.

B. <u>Apportioning the Income of Financial Institutions Conducting Multistate Activities</u>:

Currently, financial institutions subject to the State's franchise tax are required to apportion income to Maryland based on the amount of business done within the State compared to all business activity. Only those financial institutions maintaining an office outside the State may use the apportionment formula. The remainder are taxed on their entire income without credits for taxes paid to other states. (By administrative practice, some financial institutions lacking an office in another state have been allowed to adjust their tax for income that is apportioned to another state.) As other states expand their taxing powers over Maryland financial institutions doing business in those states (without an office), the disallowance of credits or the use of an apportionment method by those Maryland financial institutions could increase the incidence of multiple taxation. **A change permitting the use of the apportionment formula whenever a financial institution establishes that it is subject to tax in another state would decrease this burden on Maryland's financial institutions.** Some decline in franchise tax revenues would result.

When it is applied, the single factor receipts formula used by the State to apportion the income of financial institutions is a good starting point for sourcing the income of financial institutions. Similarly, a single factor sales formula is used by the State to tax service corporations (under the corporate income tax). Indiana, which revised its laws during its 1989 legislative session, selected a single factor receipts formula for its franchise tax on financial institutions.

Changing to a multiple factor formula, such as a three factor receipts, property and payroll formula, could be considered as an alternative for financial institutions. While increasing administrative complexity, a multifactor formula is widely accepted among the states. The Multistate Tax Commission is considering a three factor formula in its draft proposal of suggested "Uniform Attribution Rules for the Income of Financial Institutions." A formula including payroll and property factors is likely to result in a lesser tax burden on out of state financial institutions compared to a single factor receipts formula. Conversely, a multifactor formula may increase the tax burden on domiciliary corporations compared to the State's current single factor receipts formula (because the property and payroll factors give added weight to the activities of businesses located within the State). **While no data is available to analyze the benefits of changing Maryland's single factor formula, and since Indiana recently adopted this approach, no evidence exists to warrant a change in the single receipts factor method of apportioning income.**

One area that appears to warrant review by tax administrators is the lack of the use of situs rules. Situs rules supplement an apportionment formula by specifying how income is sourced: i.e. as an in-state or out of state activity. Under current Maryland law, siting receipts for purposes of the apportionment formula is largely left to the taxpayer's discretion. Formal rules or regulations have not been promulgated. While this provides for an administratively simple tax, the lack of situs rules provides the taxpayer with many tax avoidance opportunities. In establishing situs rules, the State should weigh administrative complexity, tax avoidance opportunities, and market state principles of apportionment.

For Maryland, implementing market state situs rules would likely increase tax collections from out of state financial institutions. On the other hand, such rules could decrease tax collections from the State's domiciliary corporations that conduct a multistate business. One variable which could influence either of these assumptions is the extent to which the lack of specific rules under current law, combined with the relatively low tax rate in Maryland, have influenced firms to source their earnings to Maryland. It is conceivable that the discretion left to taxpayers under the current law allows tax planning activities that may favor Maryland's revenue collections.

Implementing specific situs rules for financial institution taxation in Maryland could have negative implications. First, banking industry representatives have indicated that situs rules such as those being considered by the Multistate Tax Commission, could require large expenditures to implement, increase billing costs, and take several years to put in place. For example, rules which require information such as the state of domicile of the borrower could lead to equipment changes and new administrative procedures. Second, implementation of situs rules could have a negative effect on the State's ability to attract financial institutions to locate or conduct business within the State. For example, a credit card processing facility is expanding in Western Maryland and adding to the economic development of that area. Situs rules may make Maryland a less attractive business environment for these types of financial institutions.

An alternative which captures the benefits of using market state situs rules for out of state institutions while retaining the benefits of the current tax for domiciliary institutions is available. This approach contemplates taxing out of state financial institutions (such as credit card companies located in another state that solicit business from Maryland customers) on a formulary apportionment basis supplemented by market state rules (i.e., sourcing activity to the state of the customer). This could offer Maryland maximum revenue opportunities while promoting competitive equality with in-state institutions offering similar services to Maryland residents. For domiciliary institutions, Maryland could tax their entire net income while granting credits for taxes paid to the other states in which they conduct business. This also maximizes the State's revenue potential and limits tax avoidance opportunities. Indiana recently selected this two-tiered method for its revamped financial institution franchise tax structure. The approach represents a departure from current policy in Maryland for both financial institutions and general business corporations, and therefore should be carefully considered.

Tax administrators should explore the consequences of establishing market state situs rules. At a minimum, tax administrators should establish and promulgate situs rules to define and describe current administrative practice regarding the attribution of income within and without the State. Such rules would benefit taxpayers' understanding of the tax and assist administrators in ensuring tax compliance.

III. Similarly Taxing Competitors in the Expanding Financial Services Industry

Currently, only depository and lending institutions (exclusive of their holding companies) are taxed under the State's financial institution franchise tax. The other corporations, except for insurance companies which are taxed on their gross premiums, are subject to the corporate income tax. Thus for example, certain industry competitors such as brokerage, securities, and mutual fund firms and holding companies are subject to the corporate income tax. While both of these taxes are net income taxes and are computed similarly, only the franchise tax includes interest earnings from U.S. government and Maryland obligations.

Other differences in tax treatment among the State's businesses are the exemption of financial institutions from local personal property taxes (which are levied on the State's remaining businesses) and the favorable tax treatment enjoyed by credit unions. This section addresses these differences.

A. Income Based Taxes on Industry Competitors:

States are authorized to tax national banks and federal savings associations under any method as long as they are treated similarly to state-chartered institutions. Maryland taxes State and federal banks, savings and loan associations, and lending institutions using the financial institution franchise tax. A franchise tax, such as the financial institution franchise tax based on net income, is the only type of tax that may be levied on interest earnings from federal obligations.

Continuing to tax depository institutions on their interest earnings from government obligations is supported by the tax policy considerations of tax neutrality and fairness. Financial institutions, as an industry, deal heavily in federal, state and local obligations. Consequently, a significant portion of their earnings are derived from those sources. To exempt these interest earnings from taxation would decrease the tax burden on financial institutions relative to other corporations if the rates remained the same.

The question arises whether, in order to promote uniformity of taxation among all corporations, a franchise tax measured by net income that includes interest earnings from U.S. and Maryland obligations should be imposed on all corporate taxpayers. This would ensure tax equity among competitors. The negative impact of such an alternative is that in order to tax the interest from federal obligations, Maryland state and local bonds must also be taxed. Thus, the impact on the market for Maryland obligations needs to be assessed before a franchise tax could be considered as an alternative to the separate tax treatment of financial institutions and other businesses in Maryland. The alternative to a uniform tax on all of Maryland's corporations would be to exempt federal and state bond interest earnings from taxation, regardless of what type of corporation had earned it. Such an approach would decrease the tax base, reduce tax revenues, and violate the tax policy considerations noted. **The decision to impose a franchise tax on all types of business to tax government obligations would have to be made in the context of a larger analysis of business taxation in general.** For instance, the market for Maryland bonds would have to be assessed as part of a larger analysis. The issue is raised in this paper simply to note the difference in the State's treatment of interest income earnings from government obligations.

At a minimum, equity considerations suggest that those types of entites that derive significant interest from federal and State obligations should be taxed similarly. This could be accomplished by expanding the definition of "financial institution." A bank holding company is an example of an entity that could earn a significant amount of interest from government obligations wtihout being taxed on it, since holding companies are subject to the corporate income tax (not the financial institution franchise tax). The current definition of "financial institution" does not accomplish this. Also, lending institutions (commercial, consumer, mortgage, and credit card lenders located in the state) are taxed the same as banks and savings and loan associations, yet they may not derive more interest from government obligations than do insurance companies, securities firms, mutual funds, or manufacturing corporations(who are not taxed on earnings from these sources).

The types of businesses offering liquid-asset investment opportunities in today's market include mutual funds, insurance companies, and securities firms in addition to banks and thrift institutions. If banking activities further expand into securities, real estate investment, and insurance underwriting, the need for a uniform tax which can be applied across industries is heightened. **Competitive equality, neutrality, and fairness favor a tax which is uniformly applied to the taxation of competing businesses. Maryland's franchise tax measured by net income meets this objective and could be applied to all competitors in the financial sector.**

B. Other Competitive Equality Issues:

1. Local Personal Property Taxes--

Financial institutions subject to the franchise tax are exempt from the local taxes levied on tangible personal property. Personal property taxes levied on businesses represented about $330 million in FY 89 funds to local subdivisions. The exemption for financial institutions is largely a historical one dating back to the use of the bank shares tax. First, personal property taxes were not permitted by Congress to be levied on national banks. Second, allowing a tax on both bank shares and on personal property would have constituted double taxation. When the bank shares tax was replaced by the franchise tax in 1968, the federal restrictions had not yet been lifted. The exemption has remained in place even though federal law has changed and the imposition of a personal property tax in addition to a franchise tax would not constitute double taxation. **As the exemption from personal property taxation represents disparate treatment among the State's businesses, its imposition on financial institutions should be considered.**

Expansion of the personal property tax to include financial institutions represents an additional local revenue source. However, it would have a small effect on the State's franchise tax revenues. Since personal property taxes, like real property taxes, are a deduction from federal taxable income which flows through to Maryland, franchise tax revenues would decrease slightly as personal property taxes increase. For example, if $10 million in personal property taxes were paid by the State's financial institutions, Maryland taxable income would be reduced by the same amount resulting in a tax reduction of $700,000. Similarly, financial institutions paying federal corporate income taxes would realize a tax break of approximately $2,500,000 (assuming a 25% tax rate). Because of this tax offset at the federal level, personal property taxes may be an attractive alternative if an increase in business tax collections is needed. In the example above, Maryland subdivisions would realize $9.3 million (after subtracting the reduction in franchise tax revenues), with the federal government in effect subsidizing 25% or $2.5 million of that through the federal income tax deduction.

2. The Taxation of Bank Holding Companies--

Representative of the difficulty that arises when industry competitors are taxed differently is the State's treatment of bank and savings and loan holding companies. As current law does not recognize a holding company as a "financial institution" for tax purposes, holding companies are subject to the State's corporate income tax. As such, holding companies are subject to the jurisdiction, apportionment, and associated rules applicable to general business corporations (rather than those applicable to the financial institution which it owns and controls). Because of the current differences in the jurisdiction rules, for example, a bank holding company which maintains all offices outside this State may be subject to State tax jurisdiction for corporate income tax purposes whereas the bank which it owns is not subject to the franchise tax if it maintains all offices elsewhere. Likewise, a bank holding company can earn tax exempt interest from government obligations while interest from the same assets, if held by the subsidiary, would not be taxable. **Consideration should be given to including holding companies of financial institutions in the definition of "financial institution" for franchise tax purposes.**

3. The Credit Union Exemptions--

Federal law exempts federally chartered credit unions from all state and local taxes except those on real and tangible personal property. State law only authorizes the taxation of real property held by credit unions. The General Assembly (through House Bill 599 of the 1990 Session) recently passed legislation, the intent of which is to provide a general exemption for State-chartered credit unions from all State and local taxes except those levied on real property. In accepting deposits and making consumer loans, credit unions generally can be considered competitors with other financial institutions. In addition, if credit unions were authorized to engage in commercial lending, their competitive position in the industry would be strengthened.

A decision to tax State-chartered credit unions on their income (or retained earnings) would create a lack of tax parity between federal and State credit unions. An alternative would be to allow the taxation of personal property held by both State and federally chartered credit unions. This tax could be a substitute for an income based tax which cannot be levied on federal credit unions.

C. Administration of The Franchise Tax

While beyond the original scope of this study, **consideration should be given to transferring the administrative responsibilities of the financial institution franchise tax from the Department of Assessments and Taxation to the Office of the Comptroller.** It was observed that the resources devoted to administration of the tax within the Department were limited. The Comptroller's office is charged with administering the State's corporate income tax. Since the franchise tax is so similar, the resources of the Comptroller's office could be better utilized by administering the financial institution franchise tax, as well.

IV. Availability of Tax Data

To explore the fiscal implications of any change to the current financial institution franchise tax structure, a detailed survey of a sample of financial institutions and competing entities would have to be undertaken. The following information, which is not readily available at this time, would be helpful in determining the effects of change to the financial institution franchise tax:

- the amounts of taxable income derived from Maryland customers by out of state firms;
- the amounts of taxable income earned by firms domiciled in the State, sorted by the state of the customer;
- data that shows whether Maryland can be properly classified as a "market state;"
- data on alternative apportionment factors such as property, payroll, and deposits; and
- data on the amount of revenue to be generated by repealing the financial institutions' exemption from personal property taxes.

While some data is readily available from federal and State agencies, it is of limited usefulness in determining the effects of changes to the tax structure. Call reports provided by banks and savings and loan associations reflect "book income" accounting methods rather than taxable income methods. Also, the call reports include data for regulated entities only and thus cannot be used to compare all industry competitors. The Department of Licensing and Regulation issues annual reports which contain financial data as well. These figures primarily are derived from call reports and are subject to the same limitations noted above. State agency reports only reflect the activities of State institutions.

V. Summary

Maryland's financial institution franchise tax is founded on solid principles. The franchise tax based on net income is widely used by other states. Further, this tax is the only type of tax which can be imposed on the interest earnings of federal obligations. These obligations comprise a significant portion of the earnings within the industry and should be taxed to maintain fairness among the financial sector. Income apportionment is subject to a single factor gross receipts formula. This aspect of the tax is also widely accepted among the states. As a source based tax, it can reasonably relate the amount of business conducted by an institution in the state to all business activity.

As described above, the basic elements of the State's financial institution tax are sound. However, the following changes should be considered:

- to promote competitive equality among in-state and out of state financial institutions and among competing types of financial and nonfinancial business entities, taxable jurisdiction should apply to out of state financial institutions conducting a significant business in the State regardless of whether they have an office in the State (i.e., tax jurisdiction should be determined by an economic presence rather than a physical presence);

- tax administrators should establish and promulgate situs rules to define and describe current administrative practice regarding the attribution of income within and without the State and explore the effects of implementing market state situs rules;

- consideration should be given to including holding companies of financial institutions in the definition of "financial institution" for franchise tax purposes; and

- repealing the exemption from local personal property taxes currently enjoyed by financial institutions and credit unions;

Other areas of the tax structure relating to financial institutions that deserve further exploration include:

- reviewing the definition of "financial institution" to ensure that all types of businesses deriving significant interest earnings from federal and State obligations are taxed similarly; and

- transferring administration of the financial institution franchise tax from the State Department of Assessments and Taxation to the Office of the Comptroller (the Comptroller's Office administers the corporate income tax).

Chapter Seven: Endnotes

1 Delaware, included in the eleven, has a graduated tax rate starting at 8.7% and decreasing to 2.7% for net income exceeding $30 million. The District of Columbia, not included in the eleven, has a tax rate of 10.5% but does not include interest from federal obligations in the tax base.

CALCULATION OF FINANCIAL INSTITUTION FRANCHISE TAX

Maryland Modified Income:

Federal taxable income as shown on federal return (line 30) $$$

ADD (to the extent subtracted from federal income)--

1. Net capital loss carryback (I.R.C. s. 1212)
2. Any state or local income taxes
3. Interest and dividends from non-Maryland state or local obligations (net of expenses)
4. Federal tax exempt interest or dividends
5. Oil depletion allowance claimed under IRC s. 613 & 613A

Total of Addbacks of Federal Adjustments: + $

ADD--

1. Amount of Enterprise Zone Wage Credit claimed
2. Reforestation and Timber Stand modification
3. Net operating loss modification (amount which exceeds the actual loss in the loss year)

Total of State Adjustments: + $

SUBTRACT (to the extent included in federal income)--

1. Dividends received by domestic corporations claiming a foreign tax credit under IRC § 78
2. % of dividends received from an affiliated international sales corporation (IRC § 992(a))
3. Dividends received from foreign subsidiaries
4. Gross receipts less expenses subject to the public service company franchise tax
5. Interest attributable to a U.S obligation
6. Income derived from a security or obligation of the Development Credit Corporation of Maryland
7. Profit realized from the sale or exchange of a Maryland state or local bond
8. Payment from the State for relocation and assistance
9. Refund of any state or local income taxes
10. Dividend or interest attributable to a U.S. obligation distributed through a mutual fund
11. Conservation tillage equipment expenses
12. Double the expenses incurred on reforestation or timber stand
13. Wage expenses for targeted jobs not allowed under IRC § 280c(a)

Total of State subtractions from federal income: - $

TOTAL MARYLAND MODIFIED INCOME: $$$

(over)

TOTAL MARYLAND MODIFIED INCOME (from prior page):	$$$

Financial Institution Franchise Tax Adjustments:

ADD (even if subtracted above)--
1. Profit realized from sale or exchange of Maryland State or local bonds
2. Dividends received from foreign corporations and included in federal income (IRC § 78)
3. Interest derived from U.S. obligation
4. Interest attributable to a federal obligation received through a mutual fund
5. Federal exempt interest from all state or local bonds

Total of Franchise Tax Additions:	+ $
TOTAL ADJUSTED NET INCOME:	$$$$
Multiplied by Gross Receipts Factor-- (ratio of business within Maryland to total business)	x %
MARYLAND PORTION OF NET INCOME:	$$$$
Franchise Tax Rate (7%)	x .07
MARYLAND FRANCHISE TAX LIABILITY	$$$$

Source: Maryland Code Annotated, Tax-General Article, Titles 8 and 10 (1988 Vol. and 1989 Cum. Supp.)

Prepared by: Department of Fiscal Services (April 1990)

EXHIBIT II

DISTRIBUTION OF FRANCHISE TAX REVENUES* COLLECTED FROM SAVINGS & LOAN ASSOCIATIONS & SAVINGS BANKS

County	FY 1985	FY 1986	FY 1987	FY 1988**	FY 1989
Allegany	$ 119,724	$ 147,227	$ 166,819	$ 297,677	$ 1,106
Anne Arundel	486,082	288,212	494,233	839,632	587,929
Baltimore City	1,682,780	1,131,459	1,314,186	2,611,969	1,513,645
Baltimore Co.	2,062,994	1,908,225	2,282,183	4,404,650	2,834,854
Calvert	17,510	7,624	-114	00	142
Caroline	00	00	00	00	00
Carroll	72,011	51,635	52,017	109,392	77,127
Cecil	13,576	17,003	16,975	36,965	84,121
Charles	41,327	46,701	280,713	358,983	216,270
Dorchester	42,451	24,197	82,130	85,698	66,571
Frederick	49,761	53,588	54,226	131,119	42,578
Garrett	6,993	8,926	10,083	20,575	76
Harford	144,203	100,707	125,430	322,775	142,145
Howard	150,926	104,517	113,580	183,146	86,317
Kent	11,236	13,184	31,372	70,847	41,876
Montgomery	2,086,252	872,728	437,307	1,269,237	1,611,736
Prince George's	843,397	493,851	312,009	1,118,952	1,204,970
Queen Anne's	00	8,805	-944	954	1,282
St. Mary's	11,499	15,586	17,446	87,254	29,345
Somerset	00	00	00	00	00
Talbot	111,363	51,819	179,354	226,424	152,395
Washington	96,477	204,548	177,948	432,549	323,809
Wicomico	155,689	114,865	349,123	294,813	304,986
Worcester	117,970	48,875	163,032	146,164	191,849
Total Payments to Subdivisions	**$8,324,221**	**$5,714,282**	**$6,659,108**	**$13,049,775**	**$9,515,129**

* After adjusting for refunds from prior years and after deduction of an administrative fee.

** The 1988 revenues reflect increased collections resulting from the first year that estimated tax payments were required.

Source: State Department of Assessments and Taxation
Prepared by: Department of Fiscal Services (April 1990)

HISTORY OF THE TAXATION OF FINANCIAL INSTITUTIONS IN MARYLAND

1819

McCulloch v. Maryland, 17 U.S. (4 Wheat) 316: established the doctrine of federal tax immunity in declaring void a Maryland state tax on notes issued by the Second Bank of the United States.

1841

Chapter 23: imposed tax upon the capital stock of national and State chartered banks and corporations based on the par value of such stock. State tax collected at the rate of 19 cents per $100. Local taxes collected based on the value of stock apportioned among the counties according to the residence of the stockholder.

1847

Chapter 266: imposed a tax of 1/4 of 1% on the amount of interest bearing deposits held by a savings bank. A deduction from deposits for that portion invested in non-taxable securities was allowed.

1864

State v. Sterling, 20 Md. 502: upheld tax on deposits of savings banks under challenge to its constitutionality. Specifically upheld the propriety of allowing a deduction from deposits relating to the amount of investment in non-taxable securities.

1870

Chapter 394: mortgages are exempt from taxation.

1872

Chapter 90: tax on capital stock amended to be assessed according to its market value instead of its par value.

1874

Emory v. State, 41 Md. 38 (1874): The Monumental Fire Insurance Company of Baltimore was chartered among things to "purchase, improve, lease, hold and dispose of real and personal property, and to make mortgages and loans secured by property." They claimed that the value of their capital stock representing investment in mortgages should be exempt from taxation under Ch. 394, Acts of 1870. The Court of Appeals ruled that the General Assembly intended only to exempt the mortgage debt itself and not the portion of capital stock invested in mortgages.

Chapter 483: exemption from capital stock tax for all shares of building associations of which the funds are invested in mortgages on real property. (response to Emory case above).

1887

State v. Central Savings Bank, 67 **Md.** 292: Court of Appeals viewed the tax on deposits of savings banks as a franchise tax rather than a tax upon the property in which the deposits were invested.

1888

Chapter 242: tax on deposits of savings bank payable at the rate of one-fourth of one percent of total deposits (no deduction for non-taxable securities allowed) is the only tax on such deposits that may be assessed. Also, the tax on deposits was specifically labeled a franchise tax in response to Central Savings Bank. Savings banks must also pay tax on real property and its capital stock(if any). Deposits tax apportioned 1/4 to State, 3/4 to locals based on where the savings bank is located.

1890

Chapter 491: limitation imposed by Ch. 242 (1888) on the taxation of savings banks may not be interpreted as granting an exemption from taxation to the shares held by a bank by reason of its ownership by a savings bank.

1900

Westminster v. Westminster Savings Bank, 92 **Md.** 62 (1900): The City of Westminster levied property taxes on the real property , stocks, bond, and receivables of Westminster Savings Bank. The savings bank objected to the tax on its intangibles because it already paid to the State a franchise tax of the total amount of its deposits, which were used to purchase those intangibles. Court interpreted Ch. 491(1890) as requiring savings bank to pay the tax on the total amount of its deposits without a deduction for either the amount of deposits invested in non-taxable property or the amount of deposits represented by property on which others must pay tax on. Further, those holders of such property may not claim an exemption based on the payment of a tax on such property by the savings bank. This was previously held to be double taxation under Sterling's case and the Central Savings Bank case above. In this case, the intangibles purchased with the savings bank's deposits cannot be subject to further State, county or municipal taxation. Ironically, however, the City Westminster could have reached the value of these items if it had assessed the tax on the value of the capital stock held by this savings bank which it is liable to pay.

1904

Chapter 212: exempts from the franchise tax on deposits of savings banks those savings banks having capital stock of at least $20,000 which is subject to the shares tax provided that the savings bank "merely receives time deposits at at fixed rate and not weekly and monthly deposits."

1906

State v. German Savings Bank, 103 **Md.** 196 (1906): held Ch. 212 (1904) violated the Maryland Constitution because its title was misleading.

Fidelity Savings Bank v State, 103 **Md.** 206 (1906): reaffirmed that in the absence of a specific exemptions such as that proposed by Ch. 212 (1904), savings banks are liable to the State and locals on the taxation of their capital stock in addition to the franchise tax on its deposits paid to the State.

1929

Chapter 226: tax on the capital stock of banks and corporations expanded to include the stock of domestic finance corporations. Tax is imposed on the holder of the stock but may be paid by the corporations who may seek reimbursement from their shareholders.

1931

Chapter 254: franchise tax on the deposits of savings banks held as of January 1st, amended to be a franchise tax on the deposits of mutual savings banks held as of December 31st.

1939

Chapter 277: the State abolished the taxation of intangible personal property except for the shares tax on financial institutions and public utilities.

Chapter 387: enacted a shares tax on the capital stock of foreign finance corporations doing business in Maryland. The tax was imposed on the foreign corporation itself and not on the shareholders as the State's other shares taxes were assessed. The tax was attributed to the locality where its principal office was located. The other shares taxes are allocated among the locals according to the residence of the shareholder.

1940

The Report of the Maryland Tax Revision Commission of 1939 (William L. Rawls, Chairman) reviewed and summarized the taxation of financial institutions in Maryland effective in 1940. The **bonus tax** applied to all domestic corporations having capital stock except railroad corporations. It was levied on the amount of its initial stock at the time of incorporation and any additional stock thereafter authorized. The Commission recommended expanding the tax to corporations without capital stock and to building and homestead associations and credit unions at a $10 minimum tax rate.

The **shares tax** applied to national and state banks, trust companies, and domestic and foreign finance corporations. The Commission noted that the 2.5% **gross receipts** tax applied to safe deposit and trust companies but not to national and state banks even though the compete with them for safe deposit and trust business. A recommendation was made to place the incidence of the tax on the customer but have the company bear the responsibility of paying the tax. This would in effect bring the banks engaging in this business into the tax base.

The Commission noted that building and loan association were exempt from the bonus tax, the franchise tax, and the income tax. In addition, shares of building and loan associations representing an investment in mortgages were exempt from the shares tax regardless of who held them. The Commission recommended exempting these associations from the shares tax but subjecting their paid-in capital and deposits to a franchise tax of 1/4 of 1% as applied to mutual savings banks. This recommendation was extended to include a similar franchise tax on credit unions, as well.

1942

Seaboard Commercial Corp. v. State Tax Comm., 181 Md. 234(1942): upheld the tax on the capital stock of a foreign finance corporation whose only business in the State was the purchase of chattel paper from automobile dealers. All the accounts were subsequently serviced outside the State. The State Tax Commission apportioned the total value of capital stock of the corporation attributable to Maryland on the percentage of gross receipts in the State to total gross receipts. The Court ruled that the siting of the debts to Maryland was proper even though the contracts and physical evidence of the debts was located outside the State. The Court also approved of the imposition of the tax on the foreign corporation itself even though the shares tax on domestic corporations is technically a tax on shareholders.

1949

General Assembly created the Maryland Tax Survey Commission of 1949 charged to consider the franchise tax levied on deposits of savings banks for the purpose of determining whether such tax was inequitable and imposed an undue hardship on savings banks. This commission was chaired by Richard W. Case, and will hereafter be referred to as the Case Commission.

1950

As of 1950, the franchise tax on mutual savings banks applied to 9 Maryland savings banks, 8 of which were located in Baltimore City and 1 in Montgomery County. Based on deposits held as of 12/31/49, tax revenues to these jurisdictions split 25% to State, 75% to locals) were as follows:

State (1/4)	$248,407
Baltimore City	738,397
Montgomery County	6,834
Total	$993,638

1951

The Case Commission issued its report in March of 1951. The report summarized the State's current practice in the taxation of financial institutions. This information follows on the next page.

State and Local Taxes on Financial Institutions (1951)

	Real Property	Tangible Pers. Prop	Shares	Income Tax	Gross Receipts	Franchise Taxes
National Banks	S & L		S			
State Banks	S & L		S			
Trust Co.	S & L		S		S	
Building Assoc	S & L		S**			
Savings Banks	S & L					S(.25%)
Savings & Loans	S & L					S($10)
Credit Unions	S & L	S & L				S($10)*
Finance Co.	S & L		S	S		

State: S Local: L

* Federally chartered credit unions are exempt from state and local taxation under 12 U.S.C.A. § 1768 except as to real and tangible personal property.

** The shares of building and loan associations are exempt to the extent of their investment in mortgages.

Recommendations of the Case Commission were aimed at taxing savings and loan associations and savings banks on an identical or similar basis. Specifically, the Commission recommended:

(1) reducing the franchise tax on the deposits of mutual savings banks from 0.25% to 0.16% of deposits;

(2) impose a franchise tax on foreign and domestic savings and loan associations at the rate of $10 on the first $1 million of paid-in capital and 0.16% of paid-in capital in excess of $1 million(paid-in capital should be apportioned to fairly represent the business done in the State); and

(3) distribute the revenues to the State at 20% and to the locals at 80% to more closely match the distribution of bank shares tax revenues where the State taxes shares at 19 cents per $100 and the locals are limited to $1.00 per $100.

In addition, the Case Commission recommended repealing the gross receipts tax of 2.5% imposed on safe deposit and trust companies.

1953

Chapter 783: enacted a gradual reduction of the franchise tax on the deposits of mutual savings from 25 cents per $100 to: 22 cents for 1954, 19 cents for 1955, 16 cents for 1956, 13 cents for 1957, and 10 cents per $100 for each year thereafter. The bill as introduced would have altered the State/local split to 10% and 90% but that change was amended out of the Act before final passage.

1955

Chapter 563: clarified that a corporation doing a safe deposit and trust business must pay the gross receipts tax(2.5%) on that business in addition to any other taxes for which it is liable(e.g., bank shares tax).

1956

Household Finance Corp. v. State Tax Comm., 212 **Md.** 80 (1956): Household Finance Corporation (HFC), a foreign finance corporation, challenged the valuation and apportionment of its capital stock for purposes of the shares tax. During 1952, HFC made consumer loans out of 13 branch offices in the State. In calculating the portion of the value of capital stock as represents business done in the State, it is to be presumed that the business done within and without the state bears the same ratio as gross receipts or earnings in Maryland bears to total gross receipts or earnings. HFC claimed that the gross receipts fraction overestimated capital stock value to Maryland by not taking into account the capital stock value produced by its out of state headquarters or the value produced by its 10 subsidiaries operating out of state.

The Court upheld application of the gross receipts fraction with respect to the unitary business' out of state headquarters as that property contributed to the value of the Maryland operation through its supply of working capital and managerial ability. However, the Court ruled that the application of the factor representing the gross receipts in Maryland divided by the gross receipts of the parent company to the value of capital stock allocated too much of that value to Maryland. The Court indicated that a more appropriate formula would divide gross receipts in Maryland by the gross receipts of all subsidiaries plus the gross receipts (less intercompany transfers) of the parent company. The Court remanded the determination of the amount allocable to Maryland to the State Tax Commission.

1965

Chapter 183: replaced the tax on deposits of savings banks with a franchise tax on net earnings of savings banks and of building, saving and loan associations. The tax was imposed at the rate of 3/4 of 1% on that amount of net earnings which exceeded $100,000. Out of state savings banks and associations were allowed to apportion their net earnings based on the proportion of all loans made divided by those loans secured by Maryland properties. A credit for taxes paid to other states was provided. These tax collections were distributed to the subdivisions (after deduction of an administrative fee) based on the relative amounts of deposits in each subdivision. Finally, the Act prohibited the local subdivisions from imposing any tax other than the tax on real property on savings banks and savings & loan associations.

1966

American National Building & Loan Assoc. v. Baltimore City, 245 **Md.** 23: the Court held that the Savings and Loan Act of 1961, imposing the franchise tax on deposits, was regulatory and did not preempt the power of Baltimore City to impose a privilege tax for revenue purposes. Intent of the General Assembly was made clear by the creation of the net earnings tax on savings institutions in the prior year (see Chapter 183, Laws of 1965).

1967

Chapter 7: altered the definition of "net earnings" under the savings and loan net earning tax to not allow a deduction for dividends or interest paid to stockholders/depositors.

1968

Chapter 452: replace the bank shares tax with the financial institution franchise tax measured by net earnings. The tax applied to national and state banks, finance corporations, and trust companies. The tax rate was set at 7% and the taxable base included interest from federal obligations. Since the bank shares tax was repealed, dividends on bank stock received by individuals became taxable. To compensate the local subdivisions for the loss in bank shares tax revenues, special provisions were made. Also, the subdivisions were required to pay to their municipalities the FY 1968 amount of bank shares tax revenues.

1976

Chapter 407: required estimated tax payments for banks and finance companies subject to the financial institution franchise tax on net earnings.

1980

Chapter 856: allows a foreign savings and loan association to engage in certain investments (e.g., making loans on Maryland property) without establishing a taxable nexus with the State. Similar provision does not exist for other financial institutions. The Savings and Loan Law Committee, which sponsored the change, viewed the Act as being in the best economic interests of the State.

1981

Chapter 673: provided for the special treatment of certain international banking facilities.

1982

Chapter 615: limited the maximum tax payable by savings banks and savings and loan associations under the net earnings tax to the TY 1981 level.

1983

Chapter 358: provided for the gradual replacement of the savings and loan net earnings tax with the financial institution franchise tax. Thus, commercial banks, finance corporations, savings banks, and savings and loan associations would be hereafter subject to the same tax. The Act was phased-in so that all financial institutions would be similarly taxed by TY 1986.

1984

Chapter 176: repealed a retail sales tax exemption for sales to financial institutions as the provision only applied if and to the extent that federal law exempted national banks from state and local sales taxes.

1985

Chapter 282: transferred administration of the financial institution franchise tax to the Department of Assessments and Taxation since both net earnings taxes had been combined in 1983 (see Chapter 358 above).

1987

Chapter 581: provided for the payment of estimated taxes for savings banks and savings and loan associations and clarified the calculation of funds to be distributed to local subdivisions.

Chapter 582: replaced the apportionment formula for savings banks and savings and loan associations (based on loans made that are secured by Maryland properties) with a formula based on the gross volume of transactions. This made the apportionment formulas for commercial banks, savings and loans, and finance corporations uniform.

Chapter 583: charged the Department of Assessments and Taxation with the responsibility of calculating the franchise tax revenues distributed to the subdivisions (formerly performed by the Office of the Comptroller).

Chapter 688: clarified that the savings and loan association franchise tax (deposits tax) applied to federal savings banks chartered by the Federal Home Loan Bank Board.

Department of Assessments and Taxation v. Maryland National Bank, 310 **Md.** 664: held that interest earnings from Federal Home Loan Bank Board bonds could be taxed under the State's nondiscriminatory financial institution franchise tax.

1990

House Bill 599: reaffirmed the General Assembly's intent that State chartered credit unions are generally exempt from State and local taxes except for taxes on real property.

SUMMARY OF TAXES IMPOSED ON FINANCIAL INSTITUTIONS BY SELECTED STATES

California

Type and Taxpayer: Bank and Corporation franchise tax on all banks and financial corporations (excludes leasing companies).

Jurisdiction Rule: applies to corporations "doing business" in the State, which includes actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. Does not include banks lacking an office in the State which limit their activities to making/securing loans and arranging for their security.

Tax Rate: up to 2% higher than corporate tax rate of 9.6%. The tax rate is adjusted upward for banks and financial corporations to account for an exemption from personal property taxation granted to them.

Taxable Basis: apportion the net income of the unitary group. Start with federal taxable income but treat capital gains as ordinary income and disallow net operating losses.

Federal Obligations Included

Apportionment Method: these factor property, payroll, and receipts formula. Loans as property and receipts from loans are attributed to state where loan was booked. Thus, a California bank can book loans in its out-of-state loan production office.

Other Information: have special provisions for international banking facilities and alternative minimum taxes.

Delaware

Type and Taxpayer: Franchise Tax on banking organizations and building and loan associations doing business in Delaware, including state banks and national banks maintaining their principal office in the state.

Jurisdiction Rule: physical presence "brick and mortar" test.

Tax Rate: building and loan associations - 8.7% of net earnings; banking organizations - 8.7% of taxable income up to $20 million, 6.7% up to $25 million, 4.7% up to $30 million, and the remainder at 2.7%.

Taxable Basis: for banking organizations - 0.56 multiplied by the amount equalling net operating income plus securities gains, minus securities losses, minus net income of subsidiaries already subject to tax by any state. For building and loan associations, taxable net earnings less all interest and dividends paid to creditors.
Federal Obligations: included.

Apportionment Method: banking organization income is not apportioned other than above. Net earnings of foreign building and loan associations doing business in the state apportioned based on the ratio of loans secured by property located within/without the state. (Note: this latter provision is similar to the apportionment method existing in Maryland for savings, buildings, and loan associations prior to 1987.)

Credits: credits are granted to corporations which establish a new business facility in the state.

Other Information: corporations maintaining a statutory corporate office in Delaware but not doing business in the state are exempt from tax.

District of Columbia

Type and Taxpayer: Franchise Tax on all foreign and domestic corporations including financial institutions engaged in business in the District.

Jurisdiction Rule: tax does not apply to foreign financial corporations with no office in the District whose activities are limited to making mortgage loans on District property and protecting investments. (Note: Maryland has an identical provision for foreign savings and loan associations doing a mortgage business in the State. Md. Code Ann., Financial Institutions Article, Section 9-804.)

Tax Rate: 10% on apportioned net income plus a 2.5% surcharge.

Taxable Basis: federal gross income plus other State/local obligations, less D.C. and federal obligations, ordinary and necessary business expenses, other federal deductions, and federal net operating losses. Bank holding companies are not taxed on the dividends received by a subsidiary subject to the tax.

Federal Obligations: excluded.

Apportionment Method: non-business income is allocated; business income is apportioned according to three factor property, payroll, and receipts.

Other Information: has special provisions for international banking facilities and an alternative minimum tax. Also, financial institutions pay a tax on personal property as do general business corporations.

Indiana

Type and Taxpayer: Financial Institution Franchise Tax on any taxpayer transacting the business of a financial institution. Includes bank holding companies, regulated financial corporations, subsidiaries, and corporations deriving 80% or more of their gross income from the making or servicing of loans or the operation of a credit card business.

Jurisdiction Rule: applies to taxpayers "transacting business" in the state.

Tax Rate: 8.5% of net income.

Taxable Basis: adjusted gross income or apportioned income less apportioned net operating loss deduction, and less apportioned net capital losses.

Federal Obligations: included.

Apportionment Method: resident taxpayers pay tax on all adjusted gross income and receive a limited credit for taxes paid to other states; non-resident taxpayers apportion their income based on a single factor gross receipts formula where receipts are sited to Indiana if -- lease receipts to Indiana when property located in the state, loan interest if Indiana property is security for it, consumer loan interest to place of residence, commercial loan interest to state where proceeds used, credit card interest and fees to state where billed, and service fees to Indiana if consumed there.

Credits: non-resident taxpayers who apportion income get a credit for loan interest attributed to more than one state if the size of the loan is greater than $2 million.

Other Information: special provisions for taxing the unitary group, consolidated reporting, and international banking facilities; banks and financial institutions are subject to personal property taxation; and this new tax is effective January 1, 1990.

Maryland

Type and Taxpayer: Financial Institution Franchise Tax on all financial institutions existing or doing business in the State (does not include bank holding companies).

Jurisdiction Rule: applies only to those financial institutions maintaining an office in the state; "brick and mortar" test.

Tax Rate: 7% of taxable net earnings.

Taxable Basis: federal taxable income plus interest from federal/state/local obligations, and plus all state and local income taxes paid.

Federal Obligations: included.

Apportionment Method: single factor gross receipts formula representing business done within/without the state. No formal situs rules, subject to taxpayer determination. Apportionment is not allowed if the taxpayer does not maintain an office out-of-state.

Credits: provision granting a credit for taxes paid to other states by savings and loan institutions is not used in light of apportionment method.

Other Information: financial institutions are exempt from personal property taxation applicable to general business corporations; special provisions exist for international banking facilities; and bank holding companies are taxed under corporate income tax.

Minnesota

Type and Taxpayer: Franchise Tax measured by net income imposed on all corporations including financial institutions.

Jurisdiction Rule: any person conducting a trade or business in the state, including -- (1) maintaining an office, (2) regularly having employees or independent contractors in the state, (3) owns or leases real or tangible property in the state, or (4) regularly soliciting or obtaining business in the state. Regular solicitation is presumed if conducted with 20 or more residents or the sum of the assets and deposits attributable to Minnesota exceeds $5 million.

Tax Rate: 9.5% of net income.

Taxable Basis: federal taxable income plus -- interest from federal/state/local obligations, state and local income taxes, dividends received from foreign corporations; minus -- interest expenses, capital loss carryforwards, state and local income tax refunds, net operating loss carryforwards, 80% of dividends received from a corporation in which the taxpayer has at least a 20% controlling interest, and for thrifts on amount equal to dividends or interest paid to their members.

Federal Obligations: included.

Apportionment Method: three factor formula weighted 70%-sales, 15%-property, and 15%-payroll. Income and fees from services are sited to the state if consumed there. Loan receipts are sited to Minnesota based on customer's residence or where security property is located. Payroll is attributed to the state if the employee is employed within the state, actually works there, or is accountable to an office there.

Other Information: entire net income of unitary business is subject to apportionment.

New Jersey

Type and Taxpayer: (1) Corporation Business Franchise Tax imposed on all domestic and foreign corporations, including financial corporations and banks; (2) Savings Institution Income Tax on state/federal building and loans, savings and loans, and savings banks in lieu of a tax on personal property; and (3) Financial Business Excise Tax on all non-corporate business enterprises which are in competition with national banks in lieu of franchise or personal property tax.

Jurisdiction Rule: (1) applies to corporations having a physical presence in the state -- i.e., an office or property; (2) applies to savings institutions maintaining an office in the state; and (3) applies to all business enterprises having a physical presence in the state.

Tax Rate: (1) 9% of allocable net income plus 2% of allocable net worth; (2) 3% of allocable net income; and (3) 1.5% of allocable net worth.

Taxable Basis: (1) taxable federal income before net operating loss or special deductions, less any dividends received by a parent from a subsidiary (80% or more ownership), less 50% of dividends otherwise included in federal taxable income, less a net operating loss carryforward; (2) same as above; (3) net worth less the value of stock held which is otherwise taxed, less assessed value of taxpayer's equity in real property located in New Jersey -- the same net worth basis is used for corporations and banks under (1) above.

Federal Obligations: included.

Apportionment Method: (1) for the net income tax, a three factor property, receipts, and payroll formula; for the net worth tax, the same three factor formula or a single factor assets formula (includes intangibles); (2) no apportionment method; and (3) net worth is allocated as in (1) above. Apportionment is only allowed if taxpayer maintains a place of business outside the state.

Other Information: special provisions for international banking facilities.

New York

Type and Taxpayer: Franchise Tax imposed on all corporations conducting a banking business or who are owned 65% or more by a bank or bank holding company.

Jurisdiction Rule: applies to corporations doing business in the state which includes -- operating a branch, loan production office, representative office, or bona fide office.

Tax Rate: 9% of net income plus a surcharge.

Taxable Basis: federal taxable income plus all dividend or interest income deducted at federal level, plus 77.5% of all interest from federal/state/local obligation, plus federal net operating loss deduction, plus state and local income taxes.

Federal Obligations: included.

Apportionment Method: three factor payroll, double weighted receipts, double weighted deposits. The numerator of the payroll factor is 80% of in-state payroll. Loan receipts sited to location where processed, credit card receipts to state of domicile of holder, and services receipts to place of performance not consumption. Deposits sited to branch where maintained.

Other Information: require consolidated returns.

Pennsylvania

Type and Taxpayer: (1) bank shares tax on all national and state banks located in the state; and (2) net income tax on savings banks, savings and loans, building and loans, and other mutual thrifts.

Jurisdiction Rule: applies to those financial institutions maintaining an office in the state.

Tax Rates: (1) 10.77% of value of shares averaged over previous 6 years; (2) 20% of net income, subject to reduction.

Taxable Basis: (1) value is determined by adding book value of capital stock paid in, plus the book value of surplus and undivided profits, then reducing by the proportion of assets held as federal obligations to total assets; (2) net income is federal taxable income less interest earned from federal obligations.

Federal Obligations: excluded.

Apportionment Method: none.

Credits: limited credit allowed for mutual thrifts paying tax to other states; credit is granted to "new banks" establishing in the state.

Other Information: previous shares tax which did not grant a deduction for assets held as federal obligations was declared unconstitutional by the Supreme Court of Pennsylvania in First Federal Savings and Loan Association of Philadelphia (1987); First National Bank of Fredericksburg (1989) also sheds light on the issue.

Virginia

Type and Taxpayer: (1) Tax on Net Capital of banks and trust companies; (2) corporate income tax imposed on savings and loan associations.

Jurisdiction Rule: (1) only applies for banks located in the state; (2) applies to state and federal savings and loans having an office in the state.

Tax Rate: (1) combined state and local tax rate is limited to $1 per $100; and (2) corporate tax rate of 6% (plus local tax up to 1%).

Taxable Basis: (1) net capital equals -- capital, surplus, and undivided profits less, the assessed value of real estate, less the book value of tangible personal property that is held for lease, less the pro rata share of federal obligations, less the capital accounts of subsidiaries, and less reserves; (2) net income equals federal taxable income plus bad debt allowance, interest from other states' obligations, and state/local income taxes, less interest from federal or Virginia obligations, refunds of state/local taxes, foreign dividends received, dividends received by a subsidiary (50% or more ownership), and less bad debt allowance as if computed under pre-TRA of 1986 federal law.

Federal Obligations: excluded.

Apportionment Method: (1) none for banks and trust companies; (2) special rule for financial corporations based on business income within/without the state. Business within Virginia is based on cost of performance in the state over the cost of performance everywhere.

Credits: credits for all business to 50% of investment in approved neighborhood assistance programs.

Other Information: consolidated returns are allowed.

West Virginia

Type and Taxpayer: Shares Tax on Financial Institutions.

Jurisdiction Rule: applies to financial institutions located in the state.

Tax Rate: is the general property tax rate.

Taxable Basis: value of shares less the amount of real property on which taxes are already paid.

Federal Obligations: excluded.

Apportionment Method: proportion of capital stock representing the property owned and used in the State.

Other Information: all domestic foreign building and loan associations pay a license tax in an amount based on the proportion of loans made in the State instead of on the proportion of capital stock representing the property owned and used in the State.

MULTISTATE TAX COMMISSION DRAFT PROPOSAL (MARCH 1989)

Type and Taxpayer: Franchise Tax on "financial institutions -- includes a bank holding company, regulated financial corporation, or any corporation which is carrying on the business of a financial institution. Specifically includes any corporation deriving more than 50% of its gross income from lending activities in competition with banks.

Jurisdiction Rule: applies to financial institutions (1) having a place of business in the state, (2) having employees, representatives, or independent contractors conducting business in its behalf, or (3) engaging in regular solicitation resulting in the creation of a depository or debtor/creditor relationship. Regular solicitation is presumed if relationships created above are with 100 or more residents or if taxpayer has $5 million or more of assets attributable to sources in the state.

Tax Rate: N/A

Taxable Basis: net income.

Federal/State Obligations: included.

Apportionment Method: three factor receipts, property, and payroll. Property includes intangible personal property and is valued according to its federal income tax basis. Value of rental property is eight times its net annual rental rate. Receipts from loans are sited to the state where security property is located, if any, or to the state of the debtor. Credit card receipts to the state where such charges are billed. Receipts from services to the state where performed or if related to a loan, then to the state of the borrower. All receipts attributed to a state without jurisdiction to tax are excluded from both the numerator and denominator.

Credits: N/A.

Other Information: This is a summary of the Commission's "Draft" proposal which does not purport to represent the official position of the body.

Source: <u>Multistate Tax Commission Review</u>, volume 1989; number 1, pp. 17-21 (March 1989).

AMERICAN BAR ASSOCIATION PROPOSED FEDERAL LEGISLATION

Type and Taxpayer: Doing Business tax on depositories (i.e., any bank or thrift engaged in the business of receiving deposits).

Jurisdiction Rule: applies to depositories having a "business location" in the state which includes -- (1) having an office in the state, (2) keeping an employee with a regular presence in the state, or (3) owning tangible property located in the state. Employee is allowed to solicit loans, deposits, or services without creating nexus. Employee can also make credit investigations, appraise property, and collector service loans without creating a regular presence. Finally, in no case does a state acquire nexus unless the out-of-state depository has more than $1 million of either payroll or receipts attributable to the state.

Tax Rate: N/A.

Taxable Basis: can use shares tax, deposits tax, gross receipts tax, or tax measured by net income.

Federal Obligations: included.

Apportionment Method: two factor payroll and receipts formula. Payroll is sited to the state where the employee has a regular presence (i.e., spends most of his time). Receipts from loans secured by real property are sited to the state in which such property is located. Other loan receipts are sited to the state of loan origination. Receipts from services are sited to the state of performance. Lease receipts are sited to state in which property is located. Credit card interest or fee income is sited to state where card holder is domiciled. Interest, dividends, and gains from securities are sited to the state in which they are held as assets according to the depository's books or records. Receipts and wages which are attributable to a state not having jurisdiction to tax are excluded from both the numerator and denominator.

Credits: N/A.

Other Information: The proposed federal law places a limit on the amount of income as state may apportion to itself. It has special provisions to determine such limits when combined or consolidated returns are contemplated.

Source: Todres, "Multistate Taxation of Depositories: An Analysis of Legislation Proposed by the American Bar Association," 58 St. John's Law Review 443-475 (Spring 1984); originally published as an adopted recommendation of the American Bar Association in 2 A.B.A. Reports, No. 105 (1982).

4256