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Statement by

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before the

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of the

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I am pleased to appear before this Subcommittee, on behalf of the Federal Reserve Board, to present the Board's views regarding the application of State and local "doing business" taxes to out-of-State financial depositories. In so doing, I will comment on the recommendations to the Congress of the Advisory Commission on Intergovernmental Relations, which Committee Print No. 1 seeks to implement.

As the Subcommittee is aware, the ACIR recommendations grew out of a study, conducted in response to Public Law 93-100, in which the Congress invited the Commission to submit specific and detailed proposals relating to the application of State "doing business" taxes to out-of-State depositories. This request had been prompted by certain Federal Reserve recommendations on these matters submitted to the Congress in 1971, when the Board completed a study requested earlier by the Congress on the possible economic and financial effects of a major shift in Congressional policy regarding taxation of national banks.

In 1969, the Congress acted to remove all previous restrictions on State and local taxation of national banks and substitute a simple requirement that these banks be accorded the same tax treatment as State-chartered banks. This revision was incorporated in a "permanent amendment" scheduled to become effective in early 1972. One of the major effects of this legislation was to remove the historical requirement which had confined authority to tax national banks (except for real

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property taxes) to the State in which the bank's principal office was located. Because of the umbrella effect of this requirement, States generally had confined their taxation of State-chartered banks and other depositories as well to home-State institutions.

In its 1971 report to the Congress, one of the Board's principal recommendations was that legislation be enacted before the "permanent amendment" became effective to "(L)imit the circumstances in which national banks, State banks, and other depository institutions may be subject to State and local government taxes on or measured by net income, gross receipts, or capital stock, or to other "doing business" taxes in a State other than the State of the principal office, and prescribe rules for such taxation." The Board's recommendations also covered two related matters--the possibility of discrimination in State and local taxation of out-of-State depositories and the tax treatment of interest on Federal obligations in a direct tax on net income. The areas covered by these recommendations constitute the major focus of the comprehensive staff study incorporated in the ACIR Report.

Although the "permanent amendment" did take effect on January 1, 1973, the Congress has acted on two occasions since that time to provide a moratorium on the exercise of the new authority for State and local application of "doing business" taxes to Federally

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insured out-of-State depositories. The last of these extensions, enacted this past February in Public Law 94-222, extended the moratorium to September 12, 1976. The purpose of these extensions has been to allow time for the ACIR to complete its study and for the Congress to take whatever legislative action seems desirable before the authority is made available for States to apply "doing business" taxes to out-of-State depositories.

The Board believes, as it did when preparing its earlier recommendations to the Congress, that Federal legislative policy regarding the taxation of interstate business of banks and other depository institutions must be carefully formulated to minimize the emergence of tax and compliance barriers to the free mobility of credit and monetary flows. This Nation's depository institutions constitute a highly efficient and sensitive mechanism for gathering available savings from all sectors of the economy and channeling them to creditworthy users--governments, businesses, and consumers--wherever they may be. These institutions typically operate on fairly narrow margins, and their choices as to sources as well as uses of funds often are influenced by relatively small interest rate and cost differentials. Under our present system, vast amounts of funds have moved across State lines and within and among regions. The vigorous growth of these institutions over the years has contributed

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greatly to the efficiency of our economy and to the economic benefit of both depositors and borrowers.

In providing new authority for State and local governments to levy income and other "doing business" taxes on out-of-State national banks--and, in effect, on other depositories--the Board continues to urge that the Congress establish adequate safeguards to assure that interstate and interregional mobility of funds not be put in jeopardy. Experience over the decades with multistate taxation of manufacturing, public utility, and mercantile enterprises suggests that, in the absence of effective safeguards, multistate taxation as applied to the quite dissimilar interstate operations of depositories could have damaging economic effects. Under these circumstances, multistate taxation would tend not only to impede credit mobility, but also to divert financing into channels that would be both less efficient and potentially injurious to many community interests, particularly in agricultural and other credit deficit areas. In certain areas, the availability of many established interstate financial activities, such as correspondent banking, loan pooling, and deposit-related services would be reduced, loan rates increased, and competition weakened.

With such taxation, the tax itself would enter as a consideration to be weighed in every credit, deposit, or service transaction with a customer in a nondomiciliary taxing State. Moreover, the wide differences

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that exist in tax structures and allocation rules--State to State and locality to locality--might give rise in many cases to a compliance burden which, by itself, would render the performance of credit or other depository services unprofitable, particularly where the volume of transactions is small. Depositories would need to acquire technical knowledge regarding the tax laws and regulations of every taxing State in which they do business, maintain separate records, and file separate tax returns. Under such circumstances, as is frequently pointed out, the compliance cost could exceed the amount of the tax. Additional deterrents to out-of-State activity would include the uncertainty, controversy, and litigation involved in determining whether or not the depository is subject to taxation in a particular State and what its tax liability is in that State; the possibility that more than 100 per cent of the tax base might be subject to taxation; and the costs and inconvenience of efforts to develop new ways to meet the financing needs of out-of-State borrowers while avoiding the incidence of the new taxes.

To minimize these barriers to the interstate mobility of funds while at the same time recognizing the desire of the Congress to minimize constraints on State taxing powers, the Board's 1971 Report recommended that the legislation to govern the application of State and local "doing business" taxes to out-of-State depositories should address itself to three major areas. Such legislation would need to (1) specify the

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circumstances and conditions under which a State may assert jurisdiction to tax an out-of-State depository, (2) establish rules and procedures to govern the division of an institution's tax base among the various States having jurisdiction to tax, and (3) establish rules to guide the States in their administrative procedures. Any rules and standards in these areas that are developed for State taxation should be applicable to local government levies as well. As indicated earlier, the Board's Report also included recommendations relating to discriminatory taxation and tax treatment of interest on Federal obligations. With respect to each of these five areas I should now like to outline the Board's conclusions, as stated in its 1971 Report, and then summarize and appraise the related ACIR recommendations against that background.

With respect to permissible circumstances for taxation of out-of-State depositories, the Board stated that the Federal statute should establish clearly defined uniform criteria for determining when a State or its subdivisions may exercise jurisdiction to tax a bank or other depository which has its principal office or is chartered in another State. The intent of such legislation would be to safeguard the authority of the States to collect taxes in circumstances where an out-of-State institution has "established a clear relationship to the taxing State or political subdivision through a physical presence or a pattern of sustained and substantial operations." At the same time,

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the Board believed "that the overriding objectives should be to avoid creation of tax impediments to the continued free flow of credit across State lines and uneconomic changes in the procedures that now govern the overwhelming bulk of interstate lending by depository institutions."

Like the present Federal statute that applies to income tax on interstate sales of tangible personal property (Public Law 86-272), the statute relating to depository institutions might provide that certain activities do not constitute a sufficient connection with the State to establish jurisdiction to tax (e.g., mere solicitation of prospective borrowers by a depository institution or its representatives, the loans being approved or rejected outside the State; the holding of security interests in property located in a State; or enforcement of obligations in the courts of a State).

The related ACIR recommendation, while stated in negative form, calls for legislation that would deny authority to a State or local govenrment to impose an income or other "doing business" tax on an out-of State depository unless that depository has a "substantial physical presence within the State" in the form of a regular office location, the regular presence of depository employees or agents, or the ownership or use of tangible property within the State, including property involved in lease-financing operations. The ACIR also recommends

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that activities within a State relating to enforcement or protection of a security interest in case of default should not, by themselves, provide a basis for imposing a tax.

While the proposed ACIR standard appears broadly consistent with the Board's recommendations, we do not believe that the standard is sufficiently specific to make a definitive judgment. For example, the "regular presence of depository employees or agents" could be interpreted to include periodic visits by a loan officer from an out-of-State bank or participations by an out-of-State bank in local credits through a local correspondent bank. Such an interpretation clearly would not satisfy the Board's concern that existing procedures governing the overwhelming bulk of interstate lending not be jeopardized through inadequate restraint on State and local taxation of depositories. To safeguard such procedures, the legislation might incorporate an adaptation for depositories of the jurisdictional standard in Public Law 86-272, as suggested by the Board in 1971.

The lack of specificity of the ACIR standard incurs the additional risk of creating substantial uncertainty among many depositories doing business across State lines regarding their potential tax liability in the various States. The resulting compliance burden and risk of confusion and litigation alone could be substantial impediments to interstate flows of credit and other depository services. Customers in non-domiciliary States would be placed at a disadvantage not only through the reduction in competitive alternatives, but also in some

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cases due to the resulting higher interest rates on borrowed funds and higher costs of other depository services. Smaller firms, which do not have access to the money and capital markets, would be affected the most.

Regarding interstate division of the tax base, the Board recommended enactment of legislation that would prescribe standard principles and procedures to govern apportionment for each applicable tax base. States would not be limited in their choice of tax base, but a formula for apportioning the base, definitions of the various factors used in the formula, and rules governing the application of those factors clearly would be needed. In the Board's view, the legislation should safeguard against the use of inappropriate allocation factors, provide assurance that the sum of the taxable base on which two or more States levy a tax not exceed 100 per cent of the actual base, and avoid the difficulties of complying with widely varying procedures and requirements among the various States.

The ACIR recommends enactment of legislation providing simply that the applicable tax be applied on a "fairly apportioned or attributed part of the entire. . . tax base," and that there be no Congressional action requiring States to adopt a standardized definition of taxable income for purposes of taxing out-of-State depositories. To limit aggregate tax payments and provide assurance that all of the tax base is attributed to an area having jurisdiction to tax, the ACIR recommends that legislation permit the domiciliary

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State to apply its tax to the entire tax base of home-State depositories but then require the domiciliary State to allow the taxpayer a credit against such tax liability for similar taxes paid to other States. However, such credit need not exceed the lesser of the actual tax paid to nondomiciliary jurisdictions or the amount that would be fairly apportioned to such jurisdictions under the laws and rules of the domiciliary State.

These recommendations clearly do not provide the standard principles and procedures to govern interstate division of the tax base that the Board recommendation had contemplated. Substantial diversity of practice still exists among the States with respect to apportionment of taxes on interstate sales of tangible personal property, notwithstanding extensive efforts by the States to promote uniformity and reduce compliance burdens. There is considerable risk that efforts to adapt these varying nonfinancial business allocation procedures to the noncomparable interstate operations of depositories, or to develop new apportionment measures for such institutions, would be a source of uncertainty and prolonged litigation unless the statutory guidelines are very specific. These difficulties, together with compliance problems associated with the complex and widely varying State and local apportionment laws, rules, and procedures that likely would develop in the absence of such guidelines, could cause many depositories to withdraw from out-of-State markets and seriously impede credit mobility.

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Moreover, providing complete discretion for States to develop and apply their own apportionment formulas would open the door for adoption of factors that might allocate to an individual State a share of the tax base determined mainly by the volume of loans outstanding to, or the volume of deposits received from, customers in that State. Such a tax structure could lead to a marked reduction in the flow of credit to particular States and seriously affect the local economy, particularly in States where local supplies of credit are inadequate to meet existing needs.

The ACIR indicates that its proposed requirement for tax credits, together with its proposed "fair share" apportionment requirement, would meet the potential problem of overlapping taxation or taxation of more than 100 per cent of the tax base of an individual depository. But we do not see how such protection could be assured under the ACIR apportionment standard, where the States would be free to adopt varying definitions of the tax base and apportionment formulas that would allocate that base through what undoubtedly would prove to be widely varying combinations of factors and averaging procedures. It might be noted also that under this crediting arrangmeent, the taxes actually paid by a depository on its income apportioned to nondomiciliary States would not in all cases be governed by the tax rates applicable in those States as would be the case under a strict apportionment-of-base arrangement. If the tax rate in the nondomiciliary State is lower than in the home State, the credit allowed the depository would be limited

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to the actual tax paid in the foreign State. Yet all its income, including the amount apportioned to the foreign State, would be subject to taxation in the home State at its higher rate.

In its 1971 recommendations, the Board also expressed concern about the burden on out-of-State taxpayers associated with the need to comply with widely varying administrative procedures among the States. Accordingly, the Board recommended enactment of legislation to establish rules that would guide the States in their administrative procedures, such as the application of a unitary business concept, requirements regarding use of consolidated or combined tax returns from related or affiliated corporations, and audits of out-of-State corporations. The Board also suggested the designation of a Federal administrative agency to provide regulations and interpretations.

The ACIR, in recommending against Federal prescription of a standardized definition of taxable income for taxation of out-of-State depositories, in effect is recommending also that the States be free to apply their own administrative, accounting, and reporting procedures in apportioning and collecting the tax. Moreover, the ACIR proposes that Federal legislation concerning the application of "doing business" taxes to out-of-State depositories omit reference to procedures and mechanisms for adjudication of disagreements between States and taxpayers. This would leave the resolution of such problems to customary administrative agencies and procedures established by the States and to applicable judicial proceedings in State and Federal courts.

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The Board remains concerned about the barriers to credit flows that could be associated with the need to comply with widely varying and complex administrative procedures in the various States. Because the application of "doing business" taxes to out-of-State banks and other depositories opens a new area in interstate taxation for which established or customary procedures do not now exist, wide differences in treatment are likely. There would appear to be significant advantages, to the tax collector as well as the taxpayer, if such taxation were introduced on the basis of uniform administrative procedures to be provided for by Federal statute. We believe that the Congress should designate a Federal administrative agency, such as the Treasury Department, to develop appropriate regulations and issue interpretations.

I can be very brief regarding the remaining two issues on which the Board and the ACIR recommendations overlap--those dealing with discriminatory taxation and taxation of interest on Federal obligations--since the recommendations contained in both reports are essentially identical. Because of uncertainties regarding the possibility that States might discriminate against out-of-State depositories in favor of those within the State, the Commission recommends enactment of legislation specifying that out-of-State depositories shall not be subject to heavier taxes than would be imposed if they were domestic

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corporations chartered or domiciled in the taxing State. The Commission also recommends that the Federal public debt statute be amended to authorize States to include, in the measure of otherwise valid direct net income taxes, the interest income realized by financial depositories from Federal government obligations. States now may tax such interest only through a franchise or excise tax "according to or measured by" net income, not by a direct income tax, although the two types of taxes are identical in all other essential characteristics. The recommended legislation would enable some States to simplify their tax structures and provide additional flexibility for States in adapting their choice of tax to their individual needs. The Board recommends enactment of both proposals.

In concluding my statement, I should like to remind the Subcommittee that the issues before you in these legislative recommendations are of substantial economic importance to the Nation. To meet the needs of governments, businesses, and individuals for an efficient monetary and credit system, and to promote effective utilization of the Nation's resources, a very large and complex system of interstate and interregional flows of funds through depository institutions has developed. It is essential that these flows not be placed in jeopardy as the out-of-State activities of these depositories are exposed, in many cases for the first time, to non-domiciliary State and local taxation. Accordingly, the Board's 1971 study concluded that the grant of authority to tax must be accompanied by certain safeguards, a conclusion to which we still subscribe.

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It is the Board's view, based on this study and on the later ACIR study, and my own view, influenced in part by my banking experience, that the bill in Committee Print No. 1 now before you does not provide adequate safeguards. We, therefore, recommend that the Congress develop a legislative approach that will establish appropriate and uniform jurisdictional, apportionment, and administrative guidelines and procedures and thus avoid the risks of damage to our economy that might otherwise arise.

The Board appreciates that this is a difficult and complex undertaking and that viable answers might not be found quickly. If the necessary legislative and administrative action cannot be completed before the present moratorium expires on September 12, the Board reluctantly concludes that the moratorium should be further extended.

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