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Statement of George W. Mitchell

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Bank Supervision and Insurance

of the

Committee on Banking and Currency

House of Representatives

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I appreciate this opportunity to testify on behalf of the Board of Governors on those provisions of the legislation before you which deal with State taxation of banks.

Legislation clarifying the powers of the States to tax banks is needed for three reasons. First, taxation of intangibles owned by banks should be prohibited. Second, the imposition outside the home State of taxes measured by net income, capital stock, or gross receipts, and other "doing business" taxes, should be deferred until such time as uniform and equitable methods may be devised to determine jurisdiction to tax and to divide the tax base among States. Third, discriminatory forms of taxation that might discourage interstate and interregional credit movements should be avoided. The committee print before you would accomplish these three broad objectives, and the Board recommends its enactment.

While I have mentioned three broad objectives, the recommendations in the Board's 1971 report to Congress, submitted May 4, 1971, were more detailed. Let me turn now to those recommendations and their relation to the legislation before you.

At the outset, the Board's report suggested that "it would be desirable that the restrictions proposed in our recommendations apply to all commercial banks (national and State) and all other depositary

institutions (savings banks, savings and loan associations, and credit unions)." The committee print now before you applies only to commercial banks insured by the Federal Deposit Insurance Corporation. The Board's recommendation of broader coverage was based on the premise that any statutory protections accorded to commercial banks should, as a matter of equity, be extended to their close competitors. I recognize, however, that in some cases these competitors have looked upon this suggestion as reflecting an intention to expose them to new tax burdens rather than protect them. Congress therefore may prefer to restrict this legislation to banks, as the committee print would do.

Regarding intangible personal property, the Board's report recommended that Congress make permanent "the present denial of authority for States and their subdivisions to impose taxes on intangible personal property owned by national banks and extend that denial to intangible personal property owned by State banks and other depositary institutions."

This recommendation relates to ad valorem taxation of intangible personal property owned by banks. It does not concern taxes on bank shares or deposits or franchise taxes on capital stock. The recommendation rests on grounds of equity and economic impact.

Ad valorem taxes on intangible property now yield little revenue to the States. The number of States imposing such taxes has been diminishing, reflecting the fact that intangibles taxes are extremely difficult to enforce effectively.

At first blush, it might seem that the difficulties that prevent effective application of intangibles taxes to nonbank businesses could be avoided in applying these taxes to banks. Banks cannot move their base of operations from one taxing jurisdiction to another; they are closely supervised, with published balance sheets; and tax assessors cannot readily undervalue the fixed claims that make up bank assets to the degree that they generally undervalue other types of assets.

But application of intangibles taxes to banks would be inequitable, with perverse economic effects. Virtually all the assets of banks are in the form of intangibles, whereas this class of property is much less important for nonfinancial businesses. So even though intangibles taxes were to be levied on all corporations they would bear far more heavily on banks than on general business firms.

Moreover, such a tax would tend to distort financial flows, with some consequent loss in economic efficiency. For example, banks might then invest less in taxable assets such as loans to businesses and consumers, and more in tax-exempt municipal bonds. Or flows

of savings might be diverted from banks in States that imposed such a tax and into banks in States that did not. The process of financial intermediation performed by banks and other depositary institutions is particularly vulnerable to an intangibles tax since the duplication of financial assets that is inherent in the flow of savings, first into deposits of these institutions and then into customer loans, would expose savings flowing through intermediaries to an additional layer of taxation. This extra exposure does not occur where funds flow directly from savers to ultimate borrowers.

The trend is away from intangibles taxes, which are difficult to administer and are not a major source of revenue at present. It would be unfortunate if Public Law 91-156 should lead to a reversal of this trend.

The second recommendation in the Board's report related to taxation outside the home State. The recommendation was to "limit the circumstances in which national banks, State banks, and other depositary institutions may be subject to State or 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."

For national banks, the law now in effect confers exclusive taxing authority on the domiciliary State. That limitation would terminate December 31, 1972, if the "permanent amendment" of section 5219 becomes effective, as it will unless Congress takes action at this session. Under the "permanent amendment" and under the Board's recommendation, the home State might be required to divide the tax base of its domiciliary banks, both State and national, with other States in which the banks are "doing business."

The committee print would continue the present exclusive jurisdiction in the domiciliary State and extend this Federal statutory provision to all insured commercial banks. The section on policy includes a declaration that "doing business" taxes outside the home State should be deferred until uniform and equitable methods may be developed for determining jurisdiction to tax and for dividing the tax base among States. We consider this a realistic approach to a complicated problem.

The Board report recognized that its recommendation presupposes the formulation of clear jurisdictional principles for determining when a State may tax an out-of-State bank and standard rules for measuring what part of the base is subject to tax in any given State. The underlying objective was "to forestall the development of significant impediments to . . . mobility [of funds] while safeguarding the authority

of the States to collect taxes in circumstances where an outside bank . . . has established a clear relationship to the taxing State . . . through a physical presence or a pattern of sustained and substantial operations." Mere occasional and transitory business activities in a State should not subject a bank to "doing business" taxes in that State. It seems prudent to suggest that if banks are now to be exposed for the first time to multistate taxation (as they would be under the "permanent amendment" in Public Law 91-156), they should from the very outset be given some degree of statutory protection from the kinds of unsettling diversities and uncertainties that characterize State taxation of interstate manufacturing and mercantile businesses.

There is at present no consensus among State taxing authorities or in the banking community about the precise methods for providing such protection, particularly as to rules for division of the tax base.

Equitable division requires either separate accounting or apportionment of the tax base by a standard formula. Separate accounting is a procedure for nominal separation of affiliated enterprises which the States generally have found difficult to police and evaluate. On the other hand, where States use a formula to apportion the tax base of nonbank businesses, they commonly use one or more of three basic factors: property, payrolls, and sales. These factors are not

particularly suited to the banking business. Moreover, as the Board report indicated, if interstate division of the taxable net income of banks were to conform closely to procedures applied to other businesses by most States, there would be--with present lending practices--comparatively little allocation of the tax base to States other than the home State of the banks. In a formal sense, virtually all business of commercial banks is conducted in the domiciliary State. Banking practices may change, of course. State allocation procedures also may change in a variety of ways unless Federal statutory limitations are enacted to assure uniformity.

The Board is not in a position to develop the needed criteria, principles, procedures, and rules for multiple State taxation. Formulation of satisfactory uniform standards will be a time-consuming process, requiring a major effort by State tax authorities. It is unlikely that they will undertake this effort until the potential revenue justifies it--a development that may or may not come about in the foreseeable future. In the interim, it seems reasonable to continue to allocate bank income and the base for any other "doing business" tax to the domiciliary State for tax purposes, as the committee print provides.

The third recommendation in the Board's report was to prohibit "imposition of discriminatory or more onerous license, privilege, or

other similar 'doing business' taxes upon out-of-state depositary institutions than would be imposed upon these institutions if chartered by the taxing State." This particular form of discriminatory taxation would not be allowed under the committee print, since it would authorize "doing business" taxes only in the domiciliary State. More broadly, the committee print would expressly prohibit discrimination against out-of-State banks in any form of taxation, and would require equal treatment of national banks and State banks.

It is difficult to frame a statutory prohibition against other forms of discrimination that would add substance to the protections now incorporated in the Federal and State constitutions. Uniformity is not the answer, since some kinds of uniform taxes, such as ad valorem taxes on intangibles, if applied equally to banks and nonbank businesses, would hit banks unduly hard. Therefore, as was pointed out in the staff study that accompanied the Board's report, "it may be necessary in the interests of equity and economic neutrality to classify banks and other financial institutions, particularly depositary institutions, separately from other businesses in order that tax provisions may be adjusted to their special characteristics." Accordingly, the Board recommends continuation of the general standard against discrimination established in Public Law 91-156, without the addition of specific

statutory standards intended to assure uniform treatment for banks and nonbank businesses. The committee print adopts this approach by authorizing taxation of insured banks only where the tax is imposed generally throughout the taxing jurisdiction on a nondiscriminatory basis.

The fourth and fifth recommendations in the Board's report involved narrower questions. Recommendation 4 was that States should be authorized "to include, in the measure of otherwise valid direct net income taxes, the income realized by banks and other depositary institutions from Federal Government obligations." The committee print would allocate bank income to the domiciliary State for tax purposes, and provides (in section 104, relating to home-State taxation) that if the home State chooses to impose a direct tax on net income, the tax will apply to interest on Treasury obligations. Under present law (31 U. S. C. 742), States may include such income in the tax base for a franchise or excise tax measured by net income, but not for a direct tax on income. There is no economic difference between these two types of taxes, and the present exemption restricts the choice domiciliary States should have in taxing bank income.

Recommendation 5 was that "coins and paper currency [should] be considered intangible personal property for State and local tax

purposes." This recommendation is incorporated in the definition of "intangible personal property" in the committee print. Cash and currency are treated as intangibles under section 5219 of the Revised Statutes as now in effect, but the specification would lapse at the end of 1972 if there were no further legislation.

Admittedly, the central questions involved in Federal legislation pertaining to State and local taxation of banks are quite technical and complex. But they are important for the industry and for some State and local governments. The Board's report and the staff studies which preceded it have been furnished to the House and Senate Committees. These documents explore the underlying issues in greater detail. The point that I would stress today is that the restraints on the taxing powers of the States incorporated in the proposal before you will not, in my judgment, cut off important potential sources of revenue, but they do offer assurance against imposition of taxes that might impair the ability of the banking system to contribute to the efficient allocation of the Nation's credit resources.