Statement of George W. Mitchell

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before the

Committee on Banking, Housing and Urban Affairs

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I appreciate this opportunity to testify on behalf of the Board of Governors on legislation clarifying the powers of the States to tax banks. Legislation 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. To accomplish these three broad objectives, the Board recommends enactment of the provisions incorporated in title II of H.R. 15656.

While I have mentioned three broad objectives, the recommendations in the Board's report to Congress, submitted May 4, 1971, were more detailed. Let me turn now to those recommendations and their relation to H. R. 15656.

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

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credit unions)." H. R. 15656 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 commercial banks, as H. R. 15656 would do.

Taxation of Intangibles

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 related 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

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has been diminishing, reflecting the fact that intangibles taxes are extremely difficult to enforce effectively and have strongly adverse economic impacts when they are enforced. In an authoritative study a few years ago of the economics of the property tax, Professor Dick Netzer of New York University observed that --

> The progressive withdrawal of particular classes of personal property from the scope of the general property tax represents a surrender to reality. The process of exemption has gone furthest for those classes which pose the greatest difficulties in regard to discovery and valuation of the assets and in regard to the economic consequences of uniform valuation and taxation even where these are possible.
>
> Intangibles present the extreme case, for they are either readily concealed or highly mobile (or both) and thus hard to locate on assessment day; moreover, the incentive to evade or avoid the assessor is substantial, since investment in the form of intangibles frequently yields considerably lower rates of return than comparable investment in tangible assets. Hence a uniform area-wide property tax rate is likely to absorb a substantially larger part of the (realized or imputed) return from intangibles than of the return from other assets, especially when one considers that the assessor cannot as readily underassess fixed value claims, such as bank deposits,as he can other assets. (Netzer, Economics of the Property Tax, 1966, pp. 140-41.)

Netzer went on to describe the large shifts of bank deposits out of Chicago banks just before the annual assessement date, April 1--shifts so large that they have a discernible impact on Treasury bill yields. These assessment-day disturbances in the

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money markets of Chicago were described again in the Wall Street Journal of July 18 this year: "April 1 is assessment day, and only that cash on deposit that day in Illinois banks is considered taxable by the state. Therefore, shortly before April 1, many big companies convert their cash balances into government securities, which are tax-exempt, or simply transfer their funds across the border and beyond the reach of the Illinois tax man."

If Public Law 91-156 had been in effect when he wrote, Netzer might have added that the difficulties that prevent effective enforcement as to nonbank businesses might not confront the tax assessor in applying these taxes to intangibles owned by 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, and would have undesirable economic effects. Virtually all the assets of banks are in the form of intangibles, whereas this class of property is much less important for non-financial 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.

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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 staff study submitted with the Board report included a section summarizing arguments against allowing States to tax bank-owned intangible assets. Because a full quotation would involve repetition of some of the points I have already presented, I shall simply submit that section of the report for the record, as follows:

> (1) The territorial immobility of banks and the fact that they are closely regulated probably would lead to considerably heavier taxation of their intangibles than of similar assets of nonfinancial corporations. Intangibles in nature and in form are mobile, and opportunities to choose the business situs of such assets on the basis of tax considerations ordinarily are available to most firms conducting dispersed operations. However equal they might be under the law, in practice banks and some other classes of financial institutions would be at a relative disadvantage compared to firms in nonfinancial business, especially large firms, if barriers to State taxation of intangibles were eliminated.

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(2) A general tax on intangibles would have a discriminatory impact against the process of intermediation as distinguished from direct market financing, since the layering of financial assets that is inherent in intermediation would expose savings that flow through intermediaries to double or multiple taxation, whereas those placed directly with borrowers would be taxed only once. Moreover, a tax on intangible assets would be easily enforceable against institutions but the holdings of individuals would largely escape assessment and taxation.

(3) Unless most intangibles are taxed practically everywhere and to all businesses, and with substantially equal effectiveness in all jurisdictions, the intangible personal property tax has distinctly unneutral effects upon geographic and inter-industry movements of capital. If the intangibles tax were imposed in only a few States, or if administration was more vigorous and effective in some States than in others, the taxed banks' market power to recoup the tax by obtaining higher interest rates on loans and securities would be severely limited. Banking capital would tend to migrate toward non-taxing States or low-rate States.

(4) An intangibles tax would fall more heavily on Federal Reserve member banks than non-member banks and would constitute an additional cost of membership. This is because member banks are required to hold all their legal reserves in a form that earns no interest (vault cash or balances at the Reserve banks), whereas non-member banks generally may hold their reserves in earning forms or in balances with other banks for which correspondent bank services are received. The nearly universal practice of determining assessments on a single predetermined date each year might enable member banks to mitigate this difference by acting to reduce reserves on the assessment date. However, such adjustments would not remain possible if pressures to minimize market disruptions and tax avoidance impelled States to assess on the basis of averages.

(5) Exclusion of tax-exempt obligations from the tax base means that an intangibles tax would apply unevenly to individual banks, rather than in a uniform relationship to the volume of their intangible assets. Moreover, a tax-induced preference for tax-exempt holdings might have incidental effects, such as a tendency to divert banks from helping to finance the private sector since this would involve acquisition of taxable assets. If a State taxed public debt instruments issued by other States and their subdivisions, this might narrow the market for out-of-State obligations while strengthening the market for home-State securities, since they are usually exempt.

(6) The possibility that intangibles might be subjected to taxation in States other than the home State of the bank—that is, by the State of the debtor—might create apprehensions and protective reactions on the part of banks. For example, concern about compliance burdens and uncertainty about potential increases in the rate or coverage of such taxes might lead to limitation of credit operations in the foreign taxing States; any such impediments to the interstate flow of credit and commerce would hamper the efficient utilization of resources.

(7) Denial of authority to tax bank intangibles would not be a major limitation on the States, or a major loss to them, for several reasons:

(*a*) They never have had this authority with respect to national banks and therefore have applied it only in rare instances to State banks. In calling for amendment of section 5219, States did not make a special point of this prohibition, as they did with respect to sales, documentary, and some other types of taxes.

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> (b) Many States exempt all personal property or all intangibles and the trend toward exemption is continuing. Some States exempt designated classes of intangibles and tax selected categories at special low rates in recognition of problems of double taxation, the confiscatory potentials of property tax rates when related to yields on intangibles, difficulties of enforcement and administration, and the geographic shifts of investment that might be induced by full-rate taxation. It is doubtful that taxes on intangibles other than bank deposits and shares currently contribute as much as one-third of 1 percent of all State-local tax revenues.
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> (c) In any event, a significant portion of bank-held intangibles is not available for State taxation because of the exclusion of Federal government obligations from the property tax base.
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> On balance, it appears that the prospective removal of the prohibition on taxing intangibles owned by national banks could have substantial effects, concentrated in that sector of the economy which is engaged in the basic economic function of financial intermediation. The interstate flow of credit and commerce might be hindered. In practice such a tax would be discriminatory against banks and other financial institutions, however equitable and even-handed the formulation of the State tax laws. (Part II of the Board report, pp. 54-5.)

Over the years the number of States retaining an intangibles tax has been diminishing, reflecting dissatisfaction with the tax as inequitable and difficult to enforce. This trend is continuing as indicated by the 1970 repeal of the ad valorem intangibles tax in Iowa, conversion from an ad valorem to a gross earnings tax in Kansas, and adoption of a constitutional amendment in Illinois providing for the elimination of all personal property taxation by 1979. It would be unfortunate if Public Law 91-156 should lead to a reversal of this trend by encouraging States to focus upon bank-owned assets simply because they are comparatively easy to assess.

Taxation by States other than the Home State

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

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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."

H. R. 15656 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.

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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.

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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.

Formulation of satisfactory uniform standards for multiple State taxation will be a time-consuming and difficult process, requiring a major coordinated effort by State tax authorities, in consultation with representatives of the banking industry. H. R. 15656 provides for a study by the Board of Governors to develop such

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standards. The Board is hopeful that this provision will be amended to place responsibility for the study in the Treasury Department or the Advisory Commission on Intergovernmental Relations. These two agencies are well qualified to deal with the technical complexities and the consultative aspects of the problem, and the Board is not.

Discriminatory Taxation

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 H. R. 15656, since it would authorize "doing business" taxes only in the domiciliary State. More broadly, H. R. 15656 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

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now incorporated in the Federal and State constitutions. Uniformity is not the answer, since some kinds of nominally 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. H. R. 15656 adopts this approach by authorizing taxation of insured banks only where the tax is imposed generally throughout the taxing jurisdiction on a nondiscriminatory basis.

Income on U. S. Obligations; Treatment of Coin and Currency

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

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institutions from Federal Government 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. However, the St Germain Subcommittee of the House Committee on Banking and Currency decided not to include provisions carrying out this recommendation in H. R. 15656. I understand that this decision reflects questions of committee jurisdiction.

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 H. R. 15656. 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.

Relative Tax Burdens

It may be useful to mention briefly a question that is sometimes raised in discussions of State taxation of banks. The question is whether banks pay their fair share of taxes, as compared

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with other businesses. This question was examined in detail in appendix 9 of the Board's report. For reasons summarized at pages 18 and 19 of Part II of the Board's report, the report does not include a comparison of tax treatment of banks with that of other businesses. We know of no way to make such comparisons in a meaningful and objective fashion on the basis of available data.

As far as the pending legislation is concerned, the relevant point is that H. R. 15656 would not take away any existing source of revenue nor would it impose significant Federal limits on future taxation. The continued prohibition of taxes on bank-owned intangible personal property would become important in terms of the revenues involved only if States were to reverse the long-continued trend away from taxation of intangibles. The provisions relating to taxation of out-of-State banks would not necessarily reduce total taxes below what they would otherwise be. In fact, they might produce the opposite result for reasons that were pointed out in the Board report:

> The aggregate of taxes paid by any individual bank or other depository institution probably would be reduced by multiple State taxation as compared with taxation confined to the headquarters State because applicable tax rates in the home State (especially in the major banking center States) may be higher than in other States, and some States may not tax the out-of-State institution. (Pages 4-5.)

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The importance of the multistate taxation issues lies in the fact, also noted in the Board report, that --

> in some instances the added costs of acquiring technical competence regarding the differing tax laws and procedures of all States where business is done, maintaining records needed to determine which taxes are applicable and the amount of liability, and preparing and filing returns in all affected States may be even greater than the taxes. (Page 5.)

The objective of H. R. 15656 is not to relieve banks of any taxes comparable to those borne by other enterprises, but rather to avoid excessive compliance costs and the erection of avoidable barriers to interstate credit flows. As the Board said in its report,

> Such barriers would be raised not only by the imposition of the tax itself but also if there ensued uncertainty, controversy, and litigation of the sort that for decades have characterized taxation of interstate mercantile and manufacturing businesses. Uncertainties about potential tax liabilities and concern about compliance burdens could become material factors in decisions to make particular loans or investments. (Page 5.)

<u>Summary: State Taxation of Banks</u>

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 H. R. 15656

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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.

Full Insurance of Public Deposits

The bulk of my statement has dealt with taxation of banks, since I had understood that would be the subject matter of the hearing. I have since been informed that the hearing would be broadened to cover two additional subjects incorporated in an amendment intended to be proposed by Senator Proxmire, introduced July 26. Title III of the Proxmire amendment provides that deposits by Federal, State, or local governments in institutions insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation shall be fully covered by deposit insurance, notwithstanding the $20,000 limit generally applicable to other deposits. The FDIC and the FSLIC would be authorized to limit the aggregate amount of such deposits in any individual institution on the basis of the size of the institution in terms of its assets. The Board recommends against enactment of title III.

Commercial banks invest heavily in Treasury and municipal securities. At the end of last year they held $160 billion

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of U. S. Treasury, Federal agency, and municipal securities. An estimated $70 billion of these were pledged as security against $59 billion in public deposits. Full insurance would eventually lead to removal of pledging requirements and reduce bank demands for these securities. Borrowing costs to the Treasury and to State and local governments would thereby be raised.

Moreover, if the principle of full insurance were later extended to cover private as well as public deposits, incentives for good bank management could be significantly weakened. Finally, the Board believes it would be unwise to divert active or short-term time deposits from banks to savings and loan associations, as could result if title III were enacted. Public deposits are made up of funds needed for operating purposes, and of temporary overruns or surpluses. Public policy should not encourage investment of funds of this kind in long-term illiquid assets such as mortgages.

Cashing of Government Checks

Title II of the Proxmire amendment would prohibit any institution insured by FDIC and FSLIC from refushing to cash a Government check upon presentation by the payee on the ground that he does not have an account at the institution, provided he furnishes adequate identification. It would also prohibit such institutions from charging the payee for cashing the check. The Treasury would prescribe regulations to carry out these provisions.

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Two elements of cost would be involved in providing such check-cashing services: losses on checks cashed for people who are not entitled to payment, and routine handling costs. Losses due to false identification could be minimized, but not entirely eliminated, if identification procedures were carefully worked out. Routine handling costs, however, cannot be readily absorbed, particularly if the identification procedures proved to be time-consuming. Financial institutions would have to absorb these costs or pass them on to their customers, unless some arrangements can be made for the Government to reimburse them for their added expense.

In an analogous situation, when business payrolls result in a large number of checks being presented for cash at local banks, employer firms maintain balances at the banks at levels that will compensate them for the check-cashing service. I understand that in a few instances compensation has taken the form of fees rather than maintenance of deposit balances--a practice that may become more widespread as cost accounting techniques are perfected.

If banks are required to cash Government checks free of charge, the impact will vary among individual banks; in some cases the added costs could be substantial. We would hope that arrangements could be made, including guarantees against liability where the Treasury's identification procedures are complied with, to avoid imposing unfair cost burdens on particular institutions.

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