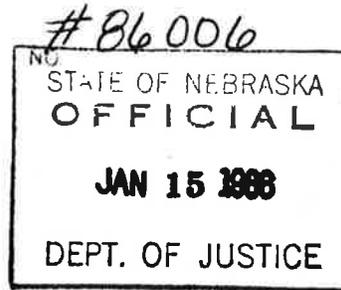


DEPARTMENT OF JUSTICE

STATE OF NEBRASKA

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DATE: January 15, 1986

SUBJECT: Proposed Financial Institutions Tax Legislation

REQUESTED BY: Senator Vard R. Johnson
Nebraska State Legislature

WRITTEN BY: Robert M. Spire, Attorney General
L. Jay Bartel, Assistant Attorney General

In your letter dated December 3, 1985, you have requested our opinion on four questions relating to legislation designed to provide for the taxation of financial institutions. Generally, this legislation provides for the imposition of a franchise tax measured by deposits on financial institutions doing business in Nebraska, subject to a limitation that the tax imposed on any financial institution will not exceed a specified percentage of the institution's net financial income.

1. Initially, you have asked us to consider whether the legislation, which imposes a tax based on deposits, not to exceed a percentage of the financial net income of a financial institution, would constitute a property tax. Article VIII, Section 1A of the Nebraska Constitution specifically prohibits the levying of any property tax for state purposes.

Generally, taxes on bank or savings deposits, measured by the amount of deposits of the institution, have been held to be franchise taxes, on the theory that the deposits represent the amount of business done by the institution and the value of the franchise. Society for Savings v. Coite, 73 U.S. (6 Wall.) 594 (1868); Robinson v. Fidelity Trust Company, 140 Me. 302, 37 A.2d 273 (1944); Provident Institution for Savings v. Commonwealth, 259 Mass. 124, 66 N.E. 36 (1927); State v. Bradford Savings Bank & Trust Company, 71 Vt. 234, 44 A. 349 (1899); see, Clement National Bank v. Vermont, 231 U.S. 720 (1913); First Federal Savings & Loan Association of Boston v. State Tax Commission, 372 Mass. 478, 364 N.E.2d 374 (1977); see, generally, Annot. 103 A.L.R. 18, 61-63 (1936).

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The rationale behind the view that taxes on deposits represent franchise taxes, not property taxes, is perhaps best explained in the following language from the opinion of the Supreme Court of Vermont in State v. Bradford Savings Bank & Trust Co., supra:

In the case at bar the tax is levied directly by an act of the legislature, and is payable into the state treasury. It is not levied upon the property of the bank, which must consist of chattels, money, notes, stocks, bonds, and other evidences of indebtedness or real estate. The amount of its deposits shows the indebtedness of the corporation to its depositors, and does not necessarily bear any relation to the actual value of its taxable property. There is no assessment of property to ascertain its value and compare it with the value of other taxable property in the community. The amount of the tax is determined solely by the extent of the business of the corporation, as measured by the average amount of its deposits for the time for which the tax is assessed, after making the deductions specified. On authority and reason, it is clear that it is a franchise tax. . . .

71 Vt. at 238-239, 44 A. at 351.

Based on the foregoing authority, we conclude the deposits tax proposed under this legislation would not constitute a property tax, but would be considered a franchise tax imposed on financial institutions for the privilege of doing business in the state. While the tax is based on the average amount of deposits in the institution, this simply represents a means to measure the extent of the business done by the institution, and the value of the franchise granted to the institution. Section 2 of the bill in fact characterizes the tax as a franchise tax, imposed on financial institutions for the privilege of doing business in this state.

2. Your second question concerns whether the legislation would be construed as imposing a nondiscriminatory franchise tax, in conformance with the requirements of 31 U.S.C. §3124(a) (1982). Section 3124(a) provides, in pertinent part:

Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except--

(1) a nondiscriminatory franchise tax or other nonproperty tax instead of a franchise tax, imposed on a corporation; and

(2) an estate or inheritance tax. (Emphasis added).

In Memphis Bank and Trust Company v. Garner, 459 U.S. 392 (1983), the U.S. Supreme Court held invalid a Tennessee bank tax which imposed a tax on the net earnings of banks doing business in the state, which defined net earnings to include interest from obligations of the United States and its instrumentalities, but excluded from taxation the interest earned on obligations of the state and its political subdivisions. The Court found the state bank tax could not be characterized as nondiscriminatory under the statutory exception for nondiscriminatory franchise taxes under 31 U.S.C. §742 (now 31 U.S.C. §3124(a)), because the tax impermissibly discriminated in favor of securities issued by the state and its political subdivisions by including in the tax base income from federal obligations while excluding income from comparable state and local obligations. Following the U.S. Supreme Court decision in Memphis Bank, the Nebraska Supreme Court held a portion of Nebraska's corporate franchise tax, Neb.Rev.Stat. §77-2734(2) (Cum.Supp. 1982) (repealed 1984), which resulted in a franchise tax with a base that excluded interest from state and local obligations but included interest on federal obligations, constituted an invalid, discriminatory franchise tax prohibited under federal law. State ex rel. Douglas v. Karnes, 216 Neb. 750, 346 N.W.2d 231 (1984).

In American Bank and Trust Company v. Dallas County, 463 U.S. 855 (1983), the U.S. Supreme Court held invalid a Texas property tax on bank shares computed on the "equity capital formula," which involved determining the basis of the bank's net assets without any deduction for federal obligations held by the bank. The Court concluded the Texas bank shares tax was calculated with consideration of federal obligations and, therefore, violated the provisions of Rev. Stat. §3701, 31 U.S.C. §742 (now 31 U.S.C. §3124(a)). While holding invalid the property tax on bank shares in American Bank, the Court recognized the specific, express exceptions for franchise and estate and inheritance taxes permitted under §3701. Id. at 862-864.

These cases establish that, in order for the proposed tax on financial institutions to avoid the proscription against state taxation of federal obligations contained in 31 U.S.C. §3124(a), the tax imposed must fall within the stated exception as a "nondiscriminatory franchise tax."

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In our response to your first question, we cited a number of cases which have held that taxes on bank or savings deposits, measured by the amount of deposits of the institution, constitute franchise taxes. We concluded that the deposits tax imposed on financial institutions under the proposed legislation would therefore be regarded as a franchise tax, and not a tax on property.

Furthermore, we believe that the deposits tax provided under this legislation would avoid the discrimination against federal obligations which resulted in the invalidation of the taxing schemes involved in the Memphis Bank and State ex rel. Douglas v. Karnes cases. The imposition of a tax based on deposits would not result in any difference in treatment between federal obligations and state and local obligations, as no consideration is given to the federal or state and local obligations in the calculation of the tax. Accordingly, there is no prohibited discrimination in contravention of 31 U.S.C. §3124(a).

3. Your third question concerns whether, in instances where the income cap operates for individual institutions to limit the amount of tax liability, there exists any unconstitutional impairment of contract obligations by virtue of language in Nebraska statutes providing certain bonds and the income from such bonds shall be exempt from taxation, since no adjustment or deduction is made in the cap base for income from state or local obligations of this nature. Your concern relates to whether, in situations where the tax liability of the institution is limited by the income cap, the basic nature of the tax imposed remains a franchise tax based on deposits.

Our research reveals no case law specifically addressing an issue of this nature. To our knowledge, the only state which has adopted a similar scheme for taxing financial institutions is Vermont, which imposes a tax on deposits not to exceed a limitation consisting of the institution's federal taxable income (before net operating losses) plus income from municipal and state obligations. VT. STAT. ANN. Tit. 32, §5836 (Supp. 1985).

A review of the proposed legislation leads us to conclude that the inclusion of the income cap provision, creating a limitation on the tax liability of an institution, does not alter the basic form and nature of the franchise tax imposed as measured by the deposits of the institution. The income cap provision does not constitute an alternative tax, but only establishes a means to potentially limit the amount of franchise tax liability of the financial institution. On its face, the legislation does not demonstrate the establishment of a scheme of taxation designed to tax indirectly income from state and local

obligations which are, by statute, granted immunity from direct taxation.

In a previous opinion, our office addressed a similar question regarding the potential unconstitutional impairment of contractual obligations presented by a proposed tax based on the financial net income of financial institutions. Attorney General Opinion No. 90, May 31, 1985. In this opinion, we discussed the case of Macallen Co. v. Massachusetts, 279 U.S. 620 (1929), in which the U.S. Supreme Court held a state excise tax imposed on corporations measured by net income, which included interest on tax exempt obligations, operated to impose a tax on county and municipal bonds and, therefore, was void as impairing the obligation of the statutory contract of the state by which such bonds were exempted from state taxation. The court in Macallen Co. distinguished the tax imposed from those involved in earlier decisions upholding the validity of franchise taxes measured by net income, including income from tax exempt obligations, by stating:

The distinction pointed out in these cases is between an attempt to tax the property or income as such and to measure a legitimate tax upon the privileges involved in the use thereof. It is implicit in all that the thing taxed in form was in fact and reality the subject aimed at, and that any burden put upon the nontaxable subject by its use as a measure of value was fortuitous and incidental.

Id. at 628.

In our previous opinion, we noted that, in a case subsequent to the decision in Macallen Co., the U.S. Supreme Court held a California franchise tax did not unconstitutionally impair the obligation of contract by adopting as a basis for the tax the entire net income of corporations, including income from tax exempt municipal bonds. Pacific Co. v. Johnson, 285 U.S. 480 (1932). In upholding the validity of the California franchise tax, the Court in Pacific Co. distinguished the tax from what it characterized as the discriminatory tax invalidated in Macallen Co., by stating:

. . . [T]he present act must be judged by its operation rather than by the motives which inspired it. As it operates to measure the tax on the corporate franchise by the entire net income of the corporation, without any discrimination between income which is exempt and that which is not, there is no infringement of any constitutional immunity.

285 U.S. at 496.

In several other cases, the U.S. Supreme Court has recognized the distinction between a tax laid directly on governmental obligations and the income derived therefrom, and an excise tax imposed upon corporate franchises, even though the corporate property or income utilized to measure the tax includes tax exempt obligations or the income earned on such obligations. Educational Films Corporation of America v. Ward, 282 U.S. 379 (1931); Flint v. Stone Tracy Co., 220 U.S. 107 (1911); See Werner Machine Co. v. Director of Division of Taxation, 350 U.S. 492 (1956).

Furthermore, in Tradesmens National Bank v. Oklahoma Tax Commission, 309 U.S. 560 (1940), the Court, construing a federal statutory provision permitting states to tax the net income of national banks, held a state statute which imposed a net income tax on national banks, measured by net income including tax exempt income on federal securities, was not invalid as imposing an unconstitutional tax on the tax exempt income itself. The Court, citing its ruling in Pacific Co., found the statute did not involve the discrimination which resulted in the invalidation of the tax statute in the Macallen Co. case. The Court further noted that it was unnecessary to consider under what circumstances a situation would fall within the scope of the Macallen Co. decision, "assuming that case still has vitality." 309 U.S. at 566. On the basis of the Supreme Court's decisions in Pacific Co. and Tradesmens National Bank, the status of the Macallen Co. case as authority would seem to be subject to doubt.

Based on the foregoing, it would appear that, in determining whether the tax imposed under the proposed legislation constitutes a valid franchise tax measured by deposits, the crucial inquiry involves whether the income cap provision operates in such a manner as to constitute an unconstitutional impairment of contractual obligations by virtue of discriminating between exempt and nonexempt income. In this regard, we believe the legislation does not operate to provide for any such prohibited discrimination, and that no unconstitutional impairment of contractual obligations results by virtue of the fact that no adjustment or deduction is made from the income cap base for income from state or local obligations.

4. Your final question concerns whether, pursuant to subsection (4)(b) of Section 1 of the legislation, the state can legally define and tax "nonbank banks" in the same manner as other financial institutions.

The term "nonbank bank" refers to entities which do not fall within the definition of "bank" under the Bank Holding Company

Act of 1956 (as amended), 12 U.S.C. §1841 et seq. Under the Act, the term "bank" is defined as any institution that: (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans. 12 U.S.C. §1841(c). Subdivision (b) of subsection (4) of Section 1 of the proposed tax legislation includes within the definition of financial institutions subject to the tax imposed "[a]ny institution listed in subdivision (a) of this subdivision which is not chartered to do business in this state but maintains a permanent place of business in this state and actively solicits deposits from residents of this state."

The principle questions involved in determining the validity of the state's power to tax "nonbank banks" in the manner proposed appear to center around the extent of the state's power to tax such foreign or interstate business entities consistent with the provisions of the due process and commerce clauses of the federal Constitution. The doctrine which has developed with regard to the reach of a state's taxing power in this area blends the concerns of both constitutional provisions. See Norfolk and W. R. Company v. Tax Commission, 390 U.S. 317, 325 n. 5 (1968). Generally, a state's power to tax a foreign corporation under the due process and commerce clauses depends on the existence of "a 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" Container Corp. v. Franchise Tax Board, 463 U.S. 159, 165-66 (1983) (Citations omitted).

Applying this analysis to the provision for the taxation of "nonbank banks" under the proposed legislation, it appears the first prong of the test, requiring sufficient "minimal connections" or "nexus" between the out-of-state business and the state, would be satisfied. It is our understanding that such "nonbank banks" maintain physical facilities within the State of Nebraska, and have employees or agents at such facilities within the state. In addition, we understand these entities actively seek and solicit deposits from Nebraska residents, although the actual acceptance of such deposits occurs outside the State of Nebraska.

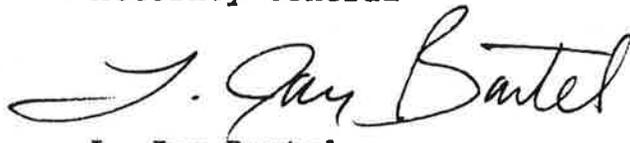
Even if "nonbank banks" have a sufficient minimal connection to the state to justify imposition of a tax, any tax levy must bear a "rational relationship . . . [to] the intrastate values of the enterprise." Container Corp., supra, 463 U.S. at 166. The question of whether this second prong is satisfied would rest on a factual determination regarding whether the measure and operation of the franchise tax imposed bears a reasonable relationship to the privileges granted by virtue of permitting such entities to conduct business in Nebraska. While it would

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appear the application of the tax does not, on its face, violate this requirement, we cannot, in the absence of any facts regarding the reasonableness of the measure in actual application, state unequivocally that this requirement is satisfied with respect to the operation of the tax on "nonbank bank" activities.

Very truly yours,

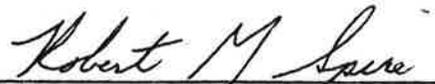
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