



Bauerle's Bank Notes

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Laboratory of Democracy

With little public fanfare, Pennsylvania recently enacted a series of changes to state business tax laws. Included are a variety of loophole-closing measures that defeat tactics like the so-called 89-11 strategy for dodging real estate transfer taxes or placing intellectual property in Delaware holding companies to reduce corporate tax liability. Effective January 1, 2014, a number of significant revisions to the bank shares tax also take effect in response to changing industry conditions.

Most importantly, the bank shares tax will now apply to all banks doing business in Pennsylvania. Previously, only banks that had a physical presence in Pennsylvania paid the tax. Since Internet-based banks can make loans to, and take deposits from, Pennsylvanians without having any physical presence in the Commonwealth, the competitive disadvantage for Pennsylvania-based banks was obvious.

Another notable change is reduction of the tax rate from 1.25% to .89%. The bank shares tax dates to 1861 and its rate has been changed many times. As a practical matter, the economic effect of the rate reduction is likely to be less than it appears. Bank regulators are raising the levels of capital banks must maintain to be classified as well capitalized. This in turn will increase the book value of banks' shares, which is the benchmark to which the bank shares tax is applied. Bankers today also maintain larger capital cushions due to capital and liquidity issues caused by the Panic of 2008. So hypothetically, a 15% increase in book value occasioned by keeping additional capital would offset approximately a third of economic benefit of the tax rate reduction.

More technical changes to the tax structure include calculating the value of banks' shares on a one year valuation formula rather than a six year average, as well as replacing a three component apportionment scheme (payroll, deposits and receipts) with a single receipts factor based on receipts from Pennsylvania customers. The one year valuation formula is a legislative response to a Pennsylvania Superior Court decision a few years ago that invalidated the six year averaging method as applied in the case of bank mergers.

Another change in the law will require banks to file petitions seeking refunds of bank shares tax assessments within six months of the assessment being levied. Formerly, banks had two years after payment of the tax to initiate refund claims. Refund petitions will now be handled under the Department of Revenue's general appellate procedure for corporate taxes rather than the bank shares tax-specific procedure previously used.

By January 2015, the Department of Revenue in consultation with the Department of Banking and Securities and the banking industry must prepare a report for the legislature identifying how the changes in the bank shares tax are serving the twin and somewhat contradictory purposes of raising sufficient tax revenue while keeping Pennsylvania banks competitive. Also called for are recommendations on the tax rate and apportionment formula. The timing of this requirement conveniently puts any reconsideration of the law past the next general election. So the industry should use 2014 as a year to build consensus around further changes in the shares tax needed to account for changes in business and consumer banking behavior. In our view, the focus of this consensus building should be threefold.

- Tweaking the bank shares tax will not halt the onslaught of nontraditional providers; stronger measures are needed. Banking by smart phone is poised to take off the way cell phone use did 25 years ago. So the expansion of the bank shares tax's applicability to banks doing business in Pennsylvania (rather than only those that have physical presence in the state) is a smart move to level the playing field and blunt the erosion of tax revenue due to banks locating elsewhere. The battle for survival of Pennsylvania and other regional banks, however, is far from over. The Pittsburgh Post-Gazette for Sunday, November 17, carried a ¼ page advertisement on the business page for a two year time deposit account offered by GE Capital Retail Bank that pays 1.15%. Branded as the "Optimizer+" account, it is available via a website titled, "myoptimizerplus.com." The good news is GE Capital is now subject to the Pennsylvania bank shares tax, just like Pennsylvania banks. The bad news is GE Capital's 90 day commercial paper funding costs remain 15 basis points below the Federal Funds rate. The upshot is that the objective of keeping Pennsylvania-based banks competitive will require more than adjusting the rate of the bank shares tax.
- Broader based tax without effective enforcement will not achieve desired outcome. General Electric's prominence as a taxpayer means it is unlikely to escape paying the bank shares tax due on its banking business in Pennsylvania. The same cannot be said, however, of the multitude of banks that will travel under the radar of the Department of Revenue while doing business in Pennsylvania. Worse, credit unions and non-bank financial services providers are not subject to the tax (although some of them may be subject to the corporate net income tax instead). This is particularly true of technology platform companies that as a functional matter are engaged in bank-like activities even though they do not hold bank charters. eBay and peer-to-peer loan providers like Prosper come to mind. For the Department of Revenue to report in January 2015 that bank shares tax collections have not taken a dive due to the rate reduction recently enacted will require stepped up enforcement effort against those providers that are unaware of, or ignore, the law. Likely, further legislative action will be needed to tailor the application of the tax to those enterprises whose operations are "financial in nature" (in the phrase of the federal Gramm-Leach-Bliley Act) without holding bank charters.

- Fundamental reexamination is warranted. Thirty years ago, Thomas Storrs and other Southerners engineered the Southeastern Regional Banking Compact. Storrs' belief was that large and strong regional banks were needed to bring the South to economic parity with Northeast and Midwest states and protect Southern banks from being acquired by money center institutions. Storrs' North Carolina National Bank (now Bank of America) and other Southeastern regional banks became the capital engines that fed the Southern economic miracle of the last 30 years. New York and New Jersey have in other ways famously protected their banks from out of state interests, even in the face of interstate banking.

In our view, banks that depend on their local and regional economies for success are better stewards of the public interest than those that lack those ties. Exhibit A is the recent series of settlements by Wall Street banks for, variously, price fixing, deceit and market manipulation. Lest one think the problem is confined to New York City, Exhibit B is Comerica, formerly Manufacturers National Bank. Chartered by Edsel Ford in 1933 as part of the carefully orchestrated plan to end the national banking crisis of that era (General Motors simultaneously capitalized the National Bank of Detroit), Manufacturers was a bulwark of the Midwest economy. Its abandonment of that economy by relocating to Dallas in 2007 deepened the economic crisis that continues to grip Detroit and Michigan.

This year's revisions to the Pennsylvania bank shares tax reflect a recognition that the state must keep up with new business developments and be sensitive to competitive disadvantages time-worn laws create for Pennsylvania banks and businesses. The greater challenge will be to continue to adapt to changing ways and means of business and banking. Supreme Court Justice Louis Brandeis's observation that states are the laboratories of democracy is no less true today than when he said it in 1932.^[1] Tax policy is an essential tool for shaping local and regional economies. The eBays and Prospers of the world will work tirelessly to avoid becoming subject to bank shares tax or other obligations under which legacy businesses now labor. It is up to those legacy businesses, including especially Pennsylvania-based banks, to mount an offensive capable of preserving the value of their franchises in the face of intensifying competition.

^[1] New State Ice Co. v. Liebmann, 285 U.S. 262 (1932)(Brandeis, J., dissenting).[A]dvances in the exact sciences and the achievements in invention remind us that the seemingly impossible sometimes happens. . . . The discoveries in physical science, the triumphs in invention, attest the value of the process of trial and error. In large measure, these advances have been due to experimentation. . . . There must be power in the states and the nation to remold, through experimentation, our economic practices and institutions to meet changing social and economic needs. I cannot believe that the framers of the Fourteenth Amendment, or the states which ratified it, intended to deprive us of the power to correct the evils of technological unemployment and excess productive capacity which have attended progress in the useful arts.

To stay experimentation in things social and economic is a grave responsibility. Denial of the right to experiment may be fraught with serious consequences to the nation. It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country. This Court has the power to prevent an experiment. . . . But, in the exercise of this high power, we must be ever on our guard, lest we erect our prejudices into legal principles. If we would guide by the light of reason, we must let our minds be bold. Id. at 310-11.