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# The Taxation of National Banks\*

[A memorandum on certain political and economic issues involved in the problem of the taxation of national banks, with some reference to the new California Bank Tax]

THERE are at least three, and possibly more, points of view from which every tax may be considered: the political, the legal and the economic.

Dr. Traynor's interesting articles in the CALIFORNIA LAW REVIEW<sup>1</sup> set forth very learnedly the legal tangles which at present enmesh the taxation of banks. They stimulate us to make a brief memorandum on some of the political and economic factors which are pertinent.

This memorandum is confined to three points.

*The first* is the strange political *impasse* in which (1) the state taxing officials, (2) Congress and (3) the banks, represented by the American Bankers' Association, have gotten themselves in the legislation relating to the taxation of banks. This may serve to an understanding of the origin of the present deluge of litigation and of statute writing regarding bank taxation.

*The second* relates to the "substance behind the form" in certain phases of the older law relating to the taxation of banks. It is an inquiry into the nature, as an economist sees it, of the so-called "exemption" of mortgages, stocks, bonds and other kinds of "intangible" property.

*The third* involves an examination of the contract between the government and the holders of tax-exempt public bonds with a view to ascertaining whether the considerations therein are good and sufficient. It seems inevitable that this point will loom large in litigation in the near future.

## I. "THE LEGISLATURE ACTS UPON ITS CONSTITUENTS"

The paramount political issue with regard to the taxation of banks has its origin in the anxiety of Congress to protect its creatures, the national banks, from destruction by hostile and voracious taxation at the hands of the state legislatures. As a war measure designed to promote the sale of war bonds the national bank had a peculiar right of way. At the very inception of the national banking system Congress itself had used "the power of taxation to destroy" the note circulation

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\* The last installment of the article, "National Bank Taxation in California," by Roger J. Traynor, will appear in the July issue of the REVIEW.

<sup>1</sup> Traynor, *National Bank Taxation in California* (1929) 17 CALIFORNIA L. REV. 83, 232.

of the state banks in order to make room for the national bank notes. So it was natural to fear reprisals. However, Congress very soon conceded to the states the right to tax the shareholders in national banks. But it did so under limitations which are more fully set forth in Dr. Traynor's articles.

Nearly half a century before the establishment of the national banks, in the case of *McCulloch v. Maryland*,<sup>2</sup> Chief Justice Marshall had stepped outside the boundaries of the law to discuss the political safeguards against turning taxes into destructive tribute. Representative government in the form which the great Chief Justice was then helping to establish and to interpret was in many ways a new thing in the world, and his interpretation has become authoritative. To refresh our memories let us reread the well-known argument:

"To carry it [taxation] to the excess of destruction, would be an abuse, to presume which, would banish that confidence which is essential to government"; and "The only security against abuse of this power is found in the structure of the government itself. In imposing a tax, *the legislature acts upon its constituents*. . . . This is in general a sufficient security."<sup>3</sup> (Italics added.)

For over half a century, namely from 1864 to 1923, Congress may be said to have relied successfully on this principle for the safeguarding of national banks. For by the "other moneyed capital" clause, which was attached to the grant of power to tax shares in national banks, it was necessary for a state legislature to act upon its own constituents, more particularly its own bank constituents, in a manner substantially the same as it might act on Congress' constituents, or creatures, the national banks.

One result of this was that *all* banks came, in course of time, to be placed by most of the states in a class by themselves for purposes of taxation. The taxes on this class came to be fixed somewhat rigidly in the mold Congress had provided for national bank taxes. That mold was the general property tax as it existed about the middle of the nineteenth century.

With the passage of some sixty years, however, the tax systems of the states underwent many changes. New theories as to the proper political functions and activities of government arose. These new activities of government and the expansion of the older activities became very expensive. The taxes required increased both in absolute amount and relatively to the revenues of the governed. Many new forms of wealth came into being and still more new forms of holding wealth

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<sup>2</sup> (1819) 17 U. S. (4 Wheat.) 316.

<sup>3</sup> 17 U. S. (4 Wheat.) 431, 428.

were devised. New economic and political doctrines as to the appropriate measures for the apportionment of the tax burden came into vogue to meet the condition of a "progressive" age. Triumphant social democracy modified representative government and the legislature's "constituents" acted on themselves.

Taxes multiplied in form. The old *general* property tax changed in character and broke up into separate kinds of property taxes. One of these changes is of particular interest in our present study. That was the imposition on the corporations *per se* of all taxes on property held by corporations, the shareholders being disregarded.

Congress had fixed the form and the base of bank taxes, but not the rate. The thought was that the rates would take care of themselves being the same as the rates on other property or taxpayers. In fact Congress practically so said and so prescribed. So long as the old general property tax continued in the same form as it was when Congress established the national banks the tax rate on the banks in any state could be quite easily compared with the tax rate paid by others. Equality was automatically achieved.

But as time passed, held fast in the mold created by Congress, the banks were; in a sense, left behind in a class by themselves. Other peoples' taxes changed in form. The old comparison was no longer easy, if, indeed, it was at all possible. Thus in many cases the banks were the only corporations taxed on the basis of shares; all others were taxed on the basis of the property owned by the corporation and the shareholders were disregarded. It was, of course, easy to argue that the value of the shares equals the value of the property and hence it is indifferent which be chosen as the base, provided, always, that one or the other, not both, be taxed. But the moment a different base was used the suspicion of discrimination also arose.

This suspicion received support from a growing realization, finding expression in new tax forms, that all properties are not alike in tax-bearing capacity. It would take us too far afield from our present subject, which is the political aspect of bank taxation, to attempt an elucidation of these differences in the taxable quality of different kinds of properties. Suffice it to say, dogmatically, that there are essential differences in quality, making a merely quantitative measure of property for taxation unjust and unequal. These qualitative differences could not be taken into consideration in the taxation of banks, held in the older form of the general property tax by a federal law sixty years old, but were being considered in the case of other peoples' taxes.

With the increase in complexity of state taxes came administrative changes. The township assessors or listers gave way to State Tax Com-

missioners, many of whom have a broad knowledge of tax problems. These commissions began to press for changes in the taxation of banks.

Meanwhile the American Bankers' Association became fearful that, since the banks were all in a class by themselves, all of them, state and national alike, might be subjected to excessive tax burdens. Taxes on banks were rising alarmingly. It was no longer possible to find a standard of measurement applicable to the burden on banks and at the same time to the burden on others. The political protection afforded by the principle quoted as the heading of this section seemed lost. Are banks, or for that matter any other soulless corporations, among the constituents a legislator recognizes?

There is also an economic feature of the present bank taxes, which while not wholly in place in this section, has an important bearing on the great political activity of the American Bankers' Association. It is this. One of the changes in the general tax systems of the states is a recognition of the fact that shares of stock and other intangibles derive their value solely from other properties which they stand for and represent. They are, as it were, mirrors; the values they present to the eye are mere reflected images. Hence the tendency is to push all the taxes back to the tangible property and let the intangibles go. But bank shares represent the bank's properties, and among them are again many intangibles, which in turn merely represent taxed tangibles. The values seen in bank shares are partly reflected from other mirrors. Hence it is very likely that a considerable element of double taxation creeps into a tax on bank shares. To whatsoever extent this is the case the banks have ground for complaint.

In addition to the changes which have come about in the political and economic features of state taxation our people are beginning to think of income as a good measure for testing equality in taxation. Twenty-five years ago the present writer called the income tax "un-American" in the sense that at that time there was not an income tax of the slightest consequence anywhere in the United States. Today the income tax is quite fashionably "American." Our popular thinking on this idea is still very crude. This is so partly because the so-called federal income tax is one on many other things as well as on income. Like all new ideas the concept of income as a possible basis of taxation is supposed to be very simple. As a matter of fact it is an exceedingly complex idea. There are many kinds of income, many forms of wages, interest and rent, and each represents a different taxable capacity. Several of the states have adopted some sort of an income tax.

The people of the United States believe today in three different political theories of taxation. The oldest is that every one should pay

taxes in proportion to his estate. This held very nearly complete control until after the Civil War. Since then this old theory has been greatly modified by the more practical or expedient system of taxing tangible property wherever it may be found regardless of the owners. But remnants of the old theory still persist, as for example in the attempts to put a small tax on intangibles. Finally there is coming into the popular mind the theory of income taxation.

Beginning about 1920 pronounced dissatisfaction with the old method of taxing banks arose which found expression through State Tax Commissions and the bankers. The result was an amendment of section 5219 of the federal statutes<sup>4</sup> relating to the taxation of national banks which can be properly characterized as a nightmare. While apparently giving the states the option of using any one of the three theories above listed, it hedges each about in such manner that none can be logically carried into effect.

The political tangle can be unravelled only by further action of Congress. That it will be untangled in that way seems highly probable. The states need the money, Congress represents the states. It is difficult to say how many of the voters have in the last decade become owners of bank stock. It may be enough to make the bankers feel safe once more in relying on the principle that "the legislature acts on its constituents."

## II. "OTHER MONEYED CAPITAL"

The provision on which Congress originally relied to protect the national banks from destructive taxation read that the taxation of shares of national banks to the shareowners shall not be at a greater rate "than is assessed upon *other moneyed capital* in the hands of individual citizens of such state."<sup>5</sup> (Italics added.) This came to be construed to mean other taxable moneyed capital competing with bank capital. At the time this was enacted the prevailing theory was that all shares of stock in corporations were assessed to the shareholders. But experience taught that shares of stock other than bank stock were hard to find. They might even be owned outside the taxing state. It was obviously much simpler to assess to the corporation all the property it held at rates high enough to cover all the value and then to give up the vain pursuit of the shareholders. Such was, however, the tenacity with which the older theory of the property tax was held that this change was brought about administratively without statutory sanction possibly

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<sup>4</sup> 13 STAT. 99 (1864); U. S. REV. STAT. § 5219; amended 1923 — 42 STAT. 1499 (1923), 12 U. S. C. § 548 (1926).

<sup>5</sup> 13 STAT. 99 (1864), 12 U. S. C. § 548 (1926).

more often than by statutory direction, and often directly in the face of the statutory provisions.

The law often required double taxation. The assessors refused to apply it. In a meeting of the National Tax Association the Honorable Oscar Leser, Judge of the Appeal Tax Court, Baltimore, said:

"No assessor with a heart and with a desire to continue to live in his own neighborhood would undertake to list and to value at their full value the intangible investments of his own people, knowing that only a very small fraction was being reached, and knowing that it was practical confiscation."

He expressed only what every assessor feels and on which most of them act.

The Political Code of California contains a section (3608) dating from 1881, directing that "all property belonging to corporations shall be assessed and taxed, but no assessment shall be made of shares of stock, nor shall any holder thereof be taxed therefor." This was one of the earliest expressions of the new theory of property taxation recorded in the country.

This section contains also an exegesis, by way of preface, which reads: "Shares of stock in corporations possess no intrinsic value over and above the actual value of the property of the corporation which they stand for and represent, and the assessment and taxation of such shares, and also of the corporate property, would be double taxation." This doctrine is economically sound. From 1881 to 1910 the attempt was made to apply it to banks in California. But owing to administrative weakness the effort was a failure.

By the first decade of the twentieth century, half a century after the first federal bank tax act, the general practice of the states with regard to corporations other than banks was to ignore the shares of stock and to tax the property to the corporations. The old doctrine, however, died hard and sporadic attempts to "classify" intangibles and subject them to some light tax continue even to the present day.

Until quite recently, then, bank shares were taxed but there was no tax on the property of the banks. Other shares of stock were not taxed but the property of the corporations was taxed. The question whether this invalidated the tax on banks was raised, and was in a general way answered in the negative.

But like Banquo's ghost the question would not down, and came walking in through a new door.

The new door was opened in this way. National banks, which had long been regarded as strictly commercial banks, and as such had had little dealings in long time loans desired to enter new pastures. Con-

gress, therefore, permitted them to hold mortgages. But in many states mortgages as documents, intangible property, in the hands of the mortgagees, were not taxed, or if taxed bore only a very light tax. So it was alleged that mortgages were "exempt." The following syllogism states the argument which was then set up.

1. Shares of stock in banks are moneyed capital and may not be taxed at a higher rate than other moneyed capital.

2. Mortgages are "other moneyed capital," and are "exempt."

Hence shares of stock in banks must be exempted.

The chief fallacy in this syllogism lies in the premise that mortgages are "exempt." Every mortgagor is well aware that his mortgage is taxed for *he* pays the tax. Although there are two parties, the mortgagor and the mortgagee, there is only one property or one value involved. If all the property is taxed, all value is taxed. This is clearly expressed in the California constitution which says<sup>6</sup>: "All property . . . shall be taxed in proportion to its value, *provided* that a mortgage . . . shall not be considered property subject to taxation." (Italics added.) The genesis of this provision was that it took the place of one which required that the tax on the hypothecated property be divided between mortgagor and mortgagee. Not a cent of taxes was remitted by the change. It is logical to put the tax on the mortgagor for he has the property in possession and in full use and enjoyment. The mortgagee has only an unmatured claim, on maturity of which, whether by foreclosure or payment, the mortgage ceases to exist.

A minor, yet vital, fallacy crept into the syllogism by way of the older interpretation by the courts of the term "other moneyed capital." It had been defined as other taxable moneyed capital competing with bank capital. It was now urged that private persons investing in mortgages competed with banks doing the same thing. Be it observed, however, that the banks volunteered to enter into this competition, and hence could not have feared it very much. Moreover, so far as taxation is concerned, they compete on equal terms.

If the fallacies pointed out are truly fallacies the decisions based on them are erroneous.

But experience and observation of many years has taught us that a series of court decisions all in the same line, even when the logic on which they are based seems decidedly and obviously faulty, may have been based on a conviction that there was or is a real grievance to be corrected.

It appears to us that in the case of the bank taxes there may be a sound reason for the protest of the banks against taxes running as high

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<sup>6</sup> CAL. CONST. Art. XIII, § 1.



as, say, one per cent or more on the book value of the stock. That reason is in a measure the same as the reasoning used above where it was proven that the taxation of both the mortgagor and the mortgagee, or of both the stock and the property of a corporation is objectionable double taxation. If any considerable part of the paper in a bank's portfolio consists of mortgages the tax on which is paid by the mortgagor, or securities the tax on which is paid by the tax on the corporation issuing them, then to that extent the bank stock derives its value from the securities so held, and is merely an ownership twice removed from the actual wealth or tangible property. Thus (1) the taxed farm has value, (2) the mortgage reflects a part of that value, (3) the stock of the bank which holds the mortgage reflects the mortgage which has no taxable value since the farm is taxed.

In some museums one may enter a room which on first sight seems crowded with people. On closer observation he becomes aware that he is the only person there and that his own image reflected, and re-reflected in a cleverly arranged series of mirrors appears many times multiplied. Similarly by a series of securities, stocks, bonds, and mortgages a single valuable piece of property may be multiplied in appearance but in reality is but one.

Why was it that for fifty years or more this grievance was not felt? The answer is twofold. *First*, it existed but to a small extent. The enormous output of securities is a product of a comparatively recent development. It is essentially a twentieth century product. When bank loans were mainly on commercial transactions untaxed in themselves the banks could easily afford to pay the taxes on their stock, there being none on the basic transactions below. *Second*, until recently the tax rate was small, and the effect of any error in choosing or evaluating the base was not magnified as it is when the tax rate is high.

### III. TAX EXEMPT SECURITIES. PUBLIC BONDS

One of the new features of the federal statute relating to the taxation of national banks is the permission to impose on such banks taxes: (1) on the net income; or (2) according to or measured by the net income.<sup>7</sup> The difference between the two so far as set forth in the statute is that in the second case, *i. e.*, when the tax is "according to or measured by" net income, the net income considered may "include the entire net income received from all sources." The language of the section is not as perspicuous as might be desired, but it is fairly clear that when the tax is "*on* net income" the clause permitting the inclu-

<sup>7</sup> These are methods (3) and (4) as set forth in Sec. 5219 of the federal statutes. See *supra* n. 4.

sion of net income from all sources does not apply. What is *not* to be included in the first case, but which *may be* included in the second is not specified. But in the interpretation reliance is placed on a statement made to Congress when the bill was pending that "from all sources" was intended to permit the inclusion of interest from tax-exempt bonds, federal, state and municipal in the "net income."

Using a 4% tax rate, the two methods would work out as follows: in the case of a bank having \$100,000 of net income from all sources including \$5,000 in interest from tax exempt securities:

	METHOD ONE	METHOD TWO
Net income all sources . . . .	\$100,000	\$100,000
Less tax exempt interest . . . .	5,000	No deduction
	<hr/>	<hr/>
Taxable net income . . . .	\$ 95,000	\$100,000
Tax . . . . .	\$ 3,800	\$ 4,000

If the entire net income were tax-exempt interest, the tax by the first method would be nil, and by the second \$4,000.

It will doubtless appear to the taxpayer, as it certainly does to the economist, that the extra \$200 in the second instance is a tax *on* the tax-exempt interest. As such it is a flagrant breach of contract and otherwise bad public policy. It is difficult to conceive of any method of taxation by which a tax could be so directly and obviously aimed at the "interest from tax-exempt bonds," and which would be so effective in reaching the avowed goal. The only more direct way would be to withhold the tax when the interest is paid.

Whether the smoke screen of phrases like: "according to or measured by," or "for the privilege of exercising its corporate franchises," or the change of "*on*" into "*upon*" found in the recent California statute,<sup>8</sup> will prevent the courts from discovering the piratical plundering of the bondholders remains to be seen.

Whether legal or not it is a very curious thing that Congress could get into a frame of mind permitting the passage of such a statute.

Why are there "tax-exempt" public bonds? Are they truly "exempt"? What are the mutual considerations in the contract of "exemption"? What will be the effect on public revenues and expenses of breaking that contract, or of not issuing any more "tax-exempt" bonds?

A vast amount of nonsense has been written and said about "tax-exempt" securities and about the wickedness of avoiding taxation by

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<sup>8</sup> Cal. Stat. (1929) c. 13, § 2 (Approved by the Governor, March 1, 1929).

owning tax-exempt bonds. This nonsense does not emanate solely from persons who "see red" by reason of envy of wealth.<sup>9</sup>

The government issues tax exempt bonds, because the easiest and most certain way to tax public bonds is to sell them with the estimated or foreseeable taxes prepaid or commuted, or as more commonly expressed to sell them "tax-exempt."<sup>10</sup> In short it is simpler to pay the interest *net less the tax* than to pay a rate of interest high enough to include the net interest which is necessary to sell the bonds plus the tax. The government does not then have to levy a tax to collect back the money it has already paid out in interest.

While the term tax-exempt is a fairly useful description of the contract, some such term as tax-prepaid, tax-commuted or as the Britishers say tax-redeemed would be more accurate.

An illustration from another tax-exempt contract will be helpful.

<sup>9</sup> While this memorandum was in preparation there appeared in a syndicated newspaper article in the finance section of a daily paper the statement that the issuance of such bonds "deprived the cities of the taxes which might be collected thereon."

<sup>10</sup> The term "tax-exempt" as applied to public bonds properly construed means that the taxes so far as can be foreseen have been commuted by the payment to the government when the bond is issued of a sum which together with the interest thereon would pay the taxes on the property or income involved, during the life of the bond.

It is fairly well known that if the government were to issue bonds subject to taxation imposed in a manner which could not be avoided or evaded, it would have to pay in interest 5% to 6% according to the state of the market. But if it issues them tax-exempt it has to pay only 4½% or thereabouts.

The price or market value of a bond varies in inverse ratio to the interest or discount rate. That is, it is higher the lower the interest rate. To illustrate: A 4½% twenty year government bond par value \$1,000 is merely a promise to pay \$22.50 every six months for twenty years and at maturity \$1,000. The selling value of that bond untaxed is the sum of the discounted or present values of each of the forty interest payments plus the discounted or present worth of \$1,000 payable twenty years hence. If the prevailing or market discount rate is 6% such a bond would sell for \$826.60, at 5% \$937.20, at 4½% \$1,000.

Suppose now that such a bond is subject to taxation and that to make sure of collecting the tax the government takes the amount of the tax out of the interest every six months.

We are here stating the basic theory. We are well aware that by concealment the bond holder may escape taxation in whole or in part. The assumption in the illustration is that the tax is actually enforced. The analysis applies to whatsoever extent it is anticipated that a tax may be enforced.

Suppose then that the tax amounts to \$5.00 per annum. The bond holder now receives only \$20.00 every six months and such a bond is worth in a 6% market \$768.90, at 5% \$874.50, at 4½% \$934.50.

The difference between the second set of values and the first is in each case exactly that sum which together with interest at the specified rates would pay all the taxes during the life of the bond.

In short by paying \$1,000 instead of \$934.50 the bondholder has put up in advance the capital equivalent of the taxes. He has bought his "exemption."

In 1797, after a series of wars which had been very expensive, Great Britain found herself burdened with an exceedingly heavy debt. To obtain money in order to reduce the principal of this debt Parliament offered the landowners a contract to the effect that if they would pay into the treasury a sum equal to the capitalized value of the land taxes, which were then fixed annual charges, they would be allowed to hold this land tax free ever thereafter. Not all but eventually a large part of the land owners accepted the offer and *redeemed* their lands. The debt was correspondingly reduced by this fund.

The economic considerations in the contract between the government and the holder of a tax-exempt bond are mutual and equal in value as nearly as may be. On the side of the government the consideration is the receipt in advance of a sum of money in excess of the price which would prevail if the bond were sold subject to taxation. On the side of the purchaser the consideration is relief from the obligation to pay a tax.

It is, moreover, a great convenience to both parties, in that the government does not have to assess and collect the tax every year, and the bondholder does not worry about paying it.

If objection be raised that it is only the estimated or probable taxes that are commuted, and that the calculation is based on an uncertain figure, the answer is that the market for public bonds is so wide and so many men, well advised as to the probable burden of taxation, are competing one with another for small margins of profit that the result is certainly very close to the true figure.

The only excuse that the government might frame for laying a tax on the bond *in addition* to the one already prepaid, commuted or redeemed is to argue that the prepayment received by it was only to cover the then anticipated taxes, and then to urge that the new tax is to be considered as wholly unforeseen and hence beyond the original contract. But there is never any such contingency contemplated in the tax-exempt contracts as written.

We have stated above that the taxation of tax-exempt interest is dishonest and contrary to public policy. Obviously, dishonesty, especially on the part of government, is in and of itself always poor policy. But it is bad public policy in another way, namely that it wastes the public funds. Of course, all the money that can be stolen by the government from any of the holders of bonds at present outstanding over the expenses of collection is clear gain. But what about the future? It is obvious that the price obtainable for future bond issues is bound to be less by at least the capitalized value of the tax. But that "least" is bound to be more for two reasons. One is the well known fact that the

costs (annoyance) the tax payer is put to will be added by him to the tax which in this case he retains capital to cover. The other is that the credit of the government is injured by its own breach of faith and the risk of further breaches of faith has to be paid for.

It may be argued that the new California 4% tax falls on tax-exempt interest only when that interest is received by a bank or some other corporation, and that private individuals may still enjoy it tax-exempt. This is true. But the individual investor will argue somewhat as follows: "Since banks and other corporations cannot hold these bonds free of taxation the *demand* is lessened. Since such corporations will probably dump public bonds on the market the *supply* will be increased. And finally, what assurance have I, as an owner, that the government having broken faith once may not do so again?" It seems inevitable that the government will hereafter pay more for every dollar it borrows than it would have had to pay if it had been honest, and it should not be overlooked that the amount of extra interest it thus pays out will far exceed what it can recover in the taxes, thereon, levied on bonds held by banks and corporations.

Finally we may not overlook the effect on different branches of government and on the tax payers thereof when such a tax is levied by one branch only. The first practical effect of the passage last November of the constitutional amendment permitting the state to tax tax-exempt interest when received by the banks, was that San Francisco found difficulty in selling 4¼% bonds at par. Even though, as the market rate of interest fluctuates, these bonds may eventually be worked off at par, a possible premium, or part of such a premium, is lost to the city.<sup>11</sup> How much the state may ever collect by the tax on the interest of these particular bonds is problematical. Probably it will be very little. But the very threat thereof increased the cost of borrowing to San Francisco and that burden falls on the tax payers of the city. So, for the sake of a very problematical state revenue, the taxes in San Francisco are to be increased. Similarly, the state itself just now goes to market with some 4½% bonds, which are depressed in value for the same reason. That is, to collect a small sum by the new tax the state has to raise in taxes a much larger sum. It seems poor business all round.

Of course, there is force to the argument that many of the bonds will be marketable outside the state where the present tax will not pursue them. This will make it difficult to calculate how much the "might have been" loss actually is. But the outside investor will be "dumb"

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<sup>11</sup> Even if we assume that the bond market was at that time so depressed that a 4½% per cent bond would not have sold at par, it nevertheless remains true that the price was still further depressed by the considerations stated in the text.

indeed if he does not take advantage of the opportunity to drive a good bargain, at the expense of a dishonest government and its tax payers.

In conclusion it may be pointed out that once the sanctity of these contracts is torn down there is no knowing how far the taxation of "tax-exempts" may go. In the public hearings before the legislature it was urged that this is a "relatively slight and insignificant tax." But little taxes like little babies may grow.

It was really a pity to repeal, even in a small degree, section 13 $\frac{1}{4}$  of Article XIII of the constitution, which reads:

"All bonds hereafter issued by the State of California, or by any county, city and county, municipal corporation or district within said State, shall be free and exempt from taxation."

It is apparently within the power of the legislature to restore the exemption of interest on public bonds. But the menace permitting it in the amendment adopted last November remains and the blot on our escutcheon placed there by the breach of contract can never be erased.

#### IV. A CONSTRUCTIVE SUGGESTION

The foregoing discussion contains much destructive criticism of our present bank taxes. Such criticism is not of much value unless it opens the way to a constructive suggestion. It would appear from Dr. Traynor's articles that legally the bank taxes are tied in a Gordian knot and that the only thing to do is to cut it.

A constructive plan might recognize the following considerations:

1. Congress and the banks will presumably resist any attempt to throw the door wide open to the legislatures to tax national banks as they please. Confusion and lack of uniformity would undoubtedly result.

2. Congress has the power to create national banks and to protect them. The integrity of our monetary and financial system is dependent on central or federal control of the Federal Reserve and national banking systems, and *uniformity of taxation thereof throughout the country* is, to that end, highly desirable.

3. The states have had for a long time considerable revenues from taxes on national banks and depend on the continuance of such revenues.

4. In view of the great increase in multiple forms of ownership, or as it is sometimes described, the increase in intangibles, and of the changes in the forms and methods of taxation the comparison between bank taxes and other people's taxes *is no longer practical* as a basis for safeguarding the banks.

5. The attempt to establish such a basis of comparison inevitably

leads to dictation by Congress of part, and an increasingly important part, of the tax systems of the states. This is highly undesirable.

Consideration number 2, above, is paramount to every other consideration.

To absolutely control the taxation of national banks by the states, Congress must fix not only the form and base of the tax but also the tax rate, or at least the maximum.

Granting that protection is desirable and uniformity throughout the country equally so, this absolute control seems logical.

What should be the base? Property as a base is out of the question, because the evaluation of the notes and securities in a bank's portfolio, involving as it must a differentiation for tax-exempt and other tax-prepaid holdings, is too complicated. Income as a base is likewise unsatisfactory for some banks make little or no income and again the differential treatment of income from tax-exempt interest and tax-prepaid dividends is not practical. All that is left is a license or privilege tax or one of that general form. Congress permitting, such a tax is presumably legal, the name or form being immaterial. The simplest base is capital, measured by paid in capital, surplus and undivided profits. The rate would have to be quite arbitrary. Possibly a maximum of one-half of one per cent is for the present adequate.

To carry out this idea Section 5219 would be amended to read somewhat as follows:

"The legislature of each state may levy a tax on national banking associations located within its limits. Said tax shall not exceed one-half of one per cent upon the sum of the paid in capital stock together with the surplus and undivided profits, and shall be in lieu of all other taxes and licenses, state and local, except taxes on real estate."

#### ADDENDUM

A friendly critic, on reading the manuscript of this memorandum, raised the question whether so simple a provision as this would not open the door to favoritism of state and private banks by permitting the legislatures to tax them at rates even lower than is proposed for national banks. This is a question quite natural in view of the origin and history of the problem involved.

We doubt, however, whether any such contingency is to be feared for the following obvious reasons: *First*, the state constitutions almost universally require uniformity of taxation on all subjects of state taxation. Hence the latitude for exemption or favoritism possessed by the legislatures is slight. *Second*, the states all need the revenues which

bank taxes afford. *Third*, the political appeal of a proposal to exempt or favor state banks is exceedingly weak.

Far more probable would it be in our opinion that the taxes on state banks would tend to be equated with those on national banks. This would be a most fortunate outcome if we are right in our conviction that uniformity of taxation for all banking throughout the country is desirable.

But it seems to us a wholly sufficient answer to this criticism to point out that the rate of the tax (as well as the grant of any tax) is wholly within the control of Congress. Obviously any general tendency of the states to discriminate in favor of state banks could be immediately corrected by an Act of Congress reducing the rate of taxation permitted on national banks. In view of such a penalty, so costly in state revenues, it is scarcely conceivable that the legislatures would misbehave.

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