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Recent Changes In The Bank And Corporation Franchise Tax Act

II.

The first instalment of this article described the 1933 amendments to the Bank and Corporation Franchise Tax Act involving the tax rate on banks. It is the purpose of these amendments to obtain from banks a fair and equitable tax within the restrictions imposed by section 5219 of the United States Revised Statutes. The present instalment analyzes the validity, in relation both to section 5219 and to the California Constitution, of these amendments, and outlines the problems involved in the classifications made under the Act for taxation purposes.

There are two grounds upon which the validity of the Act as amended might be questioned: (1) The fact that it imposes a higher arithmetical rate upon banks than upon manufacturing, mercantile and business corporations, and (2) the fact that, while imposing the same arithmetical rate on "financial corporations" as it imposes upon banks, it simultaneously provides that such corporations may offset against the tax, the amount of personal property taxes paid locally (limited, however, by the condition that the tax shall not be less than two per

1 For the first instalment of this article, see (1933) 21 CALIF. L. REV. 543.

California, in concert with other states, has been attempting for several years to secure liberalization of the federal limitations on state taxation of national banks. In this connection a bill to amend section 5219 (H. R. 9045) was introduced by Mr. Steagall on April 10, 1934, and at the time of this writing had reached the House Union Calendar. It proposes to amend section 5219 to read as follows:

"Sec. 5219. The legislature of each State may determine and direct the manner and place of taxing national banking associations located within its limits, provided such taxation shall not be at a greater rate than is imposed upon the shares, business income, and/or property of State banks. State banks shall mean and include all persons and corporations engaged in the business of commercial banking.

"In case of a tax on shares, the shares of any national banking association owned by nonresidents of any State shall be taxed by the district or by the State where the association is located and not elsewhere; and such association shall make return of such shares and pay the tax thereon as agent of such nonresident shareholders."

The comparison herein made of the tax on national banks with that on "state banks" would be a sensible and long desired improvement on the present stringent and obscure provisions of section 5219. The bill, however, raises a number of questions. For instance, does the proviso in the bill, that "such taxation shall not be at a greater rate than is imposed upon the ... business income ... of state banks" limit the States to a tax "upon" as distinguished from "according to or measured by" income so that they may not reach tax-exempt income of national banks? In the event of a negative answer to that question, would the qualification "business" income contemplate a distinction which would prevent the states from reaching such income? Finally, does "income" include gross income?
cent of their net income, i.e., the rate applicable to mercantile, manufacturing and business corporations).

Are these provisions consistent with the conditions of section 5219 that (1) "the rate [on national banks] shall not be higher than the rate assessed upon other financial corporations" and (2) "nor higher than the highest of the rates assessed by the taxing State upon mercantile, manufacturing, and business corporations doing business within its limits"? The answer hinges upon the purpose and meaning of these conditions. Similar conditions obtained for the share method of bank taxation, and the courts' interpretation of them under that method will have an important, if not a controlling, influence upon their interpretation under the income methods of taxation.

"Rate" Means "Burden"

Under the share tax method of national bank taxation, the "tax imposed shall not be at a greater rate than is assessed upon other moneyed capital" in the hands of individual citizens. In a long line of decisions, the United States Supreme Court has sanctioned the application of different methods of taxation to national bank shares and to "other moneyed capital" provided the ultimate tax burden on "other moneyed capital," translated into the kind of tax imposed upon national bank shares, did not discriminate against such shares. Mr. Justice Miller forcefully states the law on this point in Davenport National Bank v. Board of Equalization:

"It has never been held by this court that the States should abandon systems of taxation of their own banks, or of money in the hands of their other corporations, which they may think the most wise and efficient modes of taxing their own corporate organizations, in order to make that taxation conform to the system of taxing the national banks upon the shares of their stock in the hands of their owners. All that has ever been held to be necessary is, that the system of state taxation of its own citizens, of its own banks, and of its own corporations shall not work a discrimination unfavorable to the holders of the shares of the national banks."

In Amoskeag Savings Bank v. Purdy, the Court, speaking of People v. Weaver, declared:

"This court held that the clause in Section 5219,—"that the taxation shall not be at a greater rate than is assessed upon other moneyed capital,' etc., meant that the taxation upon shares should not be greater than on other moneyed capital, taking into consideration both the rate of assessment and the valuation. In other words, that the restriction contained in the act of Congress had to do with the actual incidence and practical burden of the tax upon the taxpayer."

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2 Note (1929) 59 A. L. R. 10, 16.
3 (1887) 123 U. S. 83, 85.
5 (1879) 100 U. S. 539.
The judicial history of the word "rate" clearly identifies it, under the share tax method, not with the arithmetical percentage, but with the actual incidence and practical burden of the tax upon the taxpayer. Such an interpretation was designed to make possible the imposition of equitable burdens without disturbing existing state tax systems. There is therefore every reason for applying it to the income methods of taxation which were incorporated into section 5219 to facilitate further the imposition of equitable burdens.\(^6\)

If the Court then construes the words of the condition attached to the income method of national bank taxation, namely, "the rate shall not be higher," as it has construed the words of the condition attached to the share tax method, "the tax shall not be at a greater rate," it follows that the state may tax national banks on a net income basis, without taxing state banks or other corporations on the same basis, provided the ultimate tax burden of national banks is not higher than that of other financial corporations nor higher than the highest burden imposed upon mercantile, manufacturing or business corporations.\(^7\)

Thus, for example, the state may tax corporations according to or measured by their gross receipts, and at the same time tax their personal property. There will be no discriminatory burden on national banks if the gross receipts tax plus the personal property tax paid by corporations, translated into a tax in terms of their net income, equals or exceeds the burden on banks. Similarly, there can be no discriminatory burden on national banks if the net income tax on corporations, plus their personal property taxes, translated into a tax in terms of net income, equals or exceeds the burden on banks.\(^8\)

**RATE ON BANKS MUST NOT BE HIGHER THAN HIGHEST OF THE RATES ON MERCANTILE, MANUFACTURING AND BUSINESS CORPORATIONS**

Neither section 5219 nor the California statute defines the characteristics of a "mercantile", "manufacturing", or "business" corporation.

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\(^6\) See (1926) 67 Cong. Rec. 5822, 6083.


\(^8\) Banks are taxable upon their real property in the same manner and to the same extent as corporations. In so far as real property taxes are concerned, there is no necessity to resort to a higher franchise tax on banks than upon corporations in an effort to impose upon banks a burden comparable to that imposed upon corporations, and for that reason the percentage of net income of corporations paid in real property taxes does not enter into the determination of the bank tax rate.
It is not likely, however, that an interpretation of these terms will present serious difficulties. The courts, in construing the terms “mercantile” and “manufacturing” in various statutes, seem pretty well agreed that a “mercantile” corporation is one that has to do with trade or the buying and selling of merchandise habitually as a business, and not occasionally or incidentally; and that a “manufacturing” corporation is one engaged in the business of working raw materials into new articles for the purpose of sale. The greatest difficulty will probably arise in the definition of “business” corporation and its differentiation from “mercantile” and “manufacturing” corporations. Numerous cases support the view that any corporation whose purpose is that of pecuniary gain to its members is a business corporation. This definition obviously covers not only mercantile or manufacturing corporations, but other corporations as well. Mercantile, manufacturing and financial corporations are business corporations in the same sense that cats, dogs and horses are animals. Had Congress been called upon to define these corporations in detail, it would no doubt have perceived their evident overlapping. In the absence of contrary evidence, one may suppose that, while “other financial corporations” are arbitrarily placed in another clause because of their resemblance to banks, “mercantile” and “manufacturing” constitute an unnecessary detailing of “business” corporations within the same clause.

*What is the “highest rate”?*—It is inherent in the phrasing “highest of the rates” that the rates on corporations may vary; else why the qualifying “highest” and the plural “rates”? National banks may, accordingly, be taxed only at that highest rate, or at any rate below it. The obscurities of the “mercantile, manufacturing and business corporations” clause, however, raise the problem of locating the highest rate which is to determine the maximum rate imposable upon banks. Is it the rate on the individual corporation—mercantile, manufacturing or business—sustaining the highest tax burden? For example, if a regulatory high rate were levied upon a single liquor corporation, could the same rate be extended to banks? In such a case an exceptional rate on an individual corporation, justified by circumstances peculiar to that

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corporation, would be extended to banks operating under different circumstances, provided it were simultaneously extended to financial corporations. Would such a rate be consistent with the purpose of section 5219 to protect national banks from undue discrimination? If the financial corporations, under such circumstances, could not claim undue discrimination, would the banks be able to make such a claim? Precisely the same questions arise under the hypothesis that the "highest rate" is that on the subclassification,\(^{12}\) in any of these groups, sustaining the highest burden.

The obscurities create even greater difficulty if one supposes the "highest rate" to be that average rate of the group—mercantile, manufacturing or business—which sustains the highest average tax burden. In such case, will the "business" group cover only those corporations not specifically listed as mercantile, manufacturing or financial? Or will the business group cover mercantile, manufacturing and all other corporations except financial corporations? It is evident that "highest rate" would probably be different in each instance. Here again, however, the banks have a final limited protection in that whatever maximum rate is finally determined on, if extended to them it must simultaneously be extended to financial corporations. It is evident also that any of these group comparisons would be more favorable to national banks than a comparison with the highest rate on an individual corporation or subclassification of corporations.

One clear fact emerges from these obscurities. Wherever the "highest rate" is located, banks can never sustain a tax burden higher than that rate. The California Act meets this condition, and its validity on that score remains unimpaired regardless of which basis of comparison is used. Under it the tax burden on mercantile, manufacturing and business corporations determines the burden imposed by the Act upon banks. It is evident that the burden on these corporations as a group will at least equal that on banks.\(^{13}\) If a comparison is to be made between banks as a class and mercantile corporations as a class, manufacturing corporations as a class, or business corporations as a class, the burden on at least one of these classes of corporations must equal

\(^{12}\) E. g., incorporated druggists, grocers, or department stores would constitute subclassifications of mercantile corporations.

\(^{13}\) Actually the tax burden on banks is considerably less than that on mercantile, manufacturing and business corporations, inasmuch as corporations are subjected to various taxes, such as city licenses, the tax on gross receipts for the privilege of making sales at retail, etc., to which banks are not subjected, and which are not taken into consideration in determining the burden of taxation on corporations in arriving at the bank tax rate. Furthermore, in no event can the bank tax rate exceed 6%, whereas data compiled by the Franchise Tax Commissioner indicate that the franchise tax plus the personal property taxes paid by corporations are in excess of 6% of their net income.
or exceed the burden on banks. If the burden on each class is equal, any single class will sustain a burden at least equal to that of banks. If one of these classes sustains a heavier burden than the others, its burden must be higher than the average burden of the whole group, and therefore necessarily higher than the burden on banks. Under no circumstances, therefore, can banks sustain a higher burden than the highest burden imposed upon the classes of corporations mentioned. If the comparison is made between an individual bank and an individual mercantile, manufacturing, or business corporation, the same conclusion follows. If an individual corporation is found with a lower tax burden than a bank, it must be because some other corporation or corporations sustain a heavier burden than corporations as a group, and necessarily, therefore, a higher burden than that imposed on banks.

**Rate on Banks Must Not Be Higher Than Rate on Financial Corporations**

The Act classifies financial corporations with banks, and not with mercantile, manufacturing and business corporations in order to insure, through a common rate, that their burdens will at least equal that on banks. Had they been classified as mercantile, manufacturing and business corporations, they would have paid a lower franchise tax, and their tax burden would have equalled that of banks only when they paid sufficient personal property taxes, when translated into percentages of net income, to make up the difference. It is evident that such equality would not obtain universally. Even had it existed at the time the Act was amended, there would still have remained the constant possibility of downward fluctuations in personal property taxes, and a corresponding favorable burden as compared with banks. Such fluctuations present no problem under the present classification, since a common rate compels not only the group as a whole, but each individual financial corporation to sustain a burden, in terms of net income, at least equal to that of banks.

In order to prevent, on the other hand, undue discrimination against financial corporations, they are permitted to offset against their franchise tax personal property taxes paid locally. If they sustained franchise taxes at the same rate as banks and received no offset for personal property taxes, they would suffer discrimination as compared both with banks and with other corporations. As compared with banks, they would be subject to the same franchise tax rate and would pay in addition personal property taxes which banks do not pay. As compared with mercantile, manufacturing and business corporations, they would be subject to a higher franchise tax rate and would likewise pay personal property taxes. If, however, they were permitted to offset their franchise tax to
the full extent of their personal property taxes, many financial corporations with net income might pay no franchise tax at all, a privilege not enjoyed by mercantile, manufacturing or business corporations possessing net income. In order, therefore, not to discriminate unduly against financial corporations nor to place them in a more favored class than mercantile, manufacturing and business corporations they are allowed an offset, but the Act provides that their franchise tax, after the allowance of offset, shall not be less than two per cent of their net income, i.e., the rate imposed upon mercantile, manufacturing and business corporations. To the extent, however, that they are permitted only a limited offset on their personal property taxes, they are possibly discriminated against as compared with banks.14

EXEMPTION OF NATIONAL BANKS FROM PERSONAL PROPERTY TAXES DOES NOT AFFECT VALIDITY OF BANK TAX RATE

Their personal property tax exemption confers other benefits upon banks, in addition to their advantageous position over other financial corporations. Banks without net income are not required to pay any taxes other than real property taxes, regardless of the amount of personal property they may own. Under section 4a of the Act, limiting their maximum franchise tax to 6% of their net income, they also benefit from their exemption whenever a mercantile, manufacturing or business corporation pays personal property taxes and franchise taxes totalling a higher comparable ratio.15 They benefit, too, whenever the latter's ratio is at or within 6%, and it has a smaller amount of personal property than banks.16

14 Financial corporations must always pay at least 2% of their net income in addition to their personal property taxes. Suppose the bank tax rate were 6% and that a financial corporation paid 6% of its net income in personal property taxes. It would pay in addition a franchise tax, after offset, of 2%, and would sustain, in terms of net income, a total franchise and personal property tax burden of 8%. Discrimination against a financial corporation increases in direct proportion with the excess of its personal property taxes over the difference between 2% and the bank tax rate.

15 Suppose a mercantile, manufacturing or business corporation pays a 4% ad valorem tax on personal property assessed at $200,000 and a 2% franchise tax measured by its net income of $100,000. Its total tax burden is $10,000, or 10% of its net income. A bank with exempt personal property and a similar net income would pay only a 6% franchise tax, measured by its net income, or $6,000. It thus pays less than it would pay if its tax were on its personal property and measured by its net income in the same way as for other corporations.

16 Suppose a mercantile, manufacturing or business corporation pays a 4% ad valorem tax on personal property assessed at $100,000 and a 2% franchise tax measured by its net income of $100,000. In this case its total tax burden is $6,000 or 6% of its net income. A bank with exempt personal property of $200,000 and a similar net income would pay only a 6% franchise tax measured by its net income, or $6,000. It again pays less than it would pay if its tax were on its personal property and measured by its net income in the same way as for other corporations.
When other corporations have the same or larger amounts of personal property, and their total tax burden does not exceed 6% of their net income,17 however, banks receive no benefit from their exemption.18 It is proper to determine, therefore, whether this situation presents any analogy to that in National Life Insurance Co. v. United States.19 In determining the net income tax on life insurance companies deductions were allowed for (1) income from tax-exempt securities, and (2) a sum equal to 4% of the company's legal reserve, less the amount of the first deduction. As the tax-exempt income increased up to 4% of the reserves, therefore, the tax burden on the company's total net income, including its tax-exempt income, increased.20 The Court invalid

17 See supra note 15.
18 Suppose a mercantile, manufacturing or business corporation pays a 4% ad valorem tax on personal property assessed at $100,000 and a 2% franchise tax measured by its net income of $100,000. Its total tax burden is $6,000, or 6% of its net income. A bank with exempt personal property of $100,000 and a net income of $100,000 would pay $6,000, or 6% of its net income. It thus pays the same as it would pay if its tax were on its personal property and measured by its net income in the same way as for other corporations.

Suppose again that the bank has a net income of $100,000, but that its exempt personal property amounts to only $50,000. It would still pay $6,000, or more than it would pay if its tax were on its personal property and measured by its net income in the same way as for other corporations. In these cases the bank sustains no higher burden upon its net income than that upon the net income of other corporations, and therefore suffers no discrimination under the net income tax method of taxation allowed by section 5219. It receives no positive advantage, however, from its personal property tax exemption.

The bank tax rate now calculated from the ratio of the total franchise and personal property tax burden of other corporations to their net income accordingly varies as the net income and personal property of other corporations vary. The question then arises whether it would have been more equitable to calculate the bank tax rate on the basis of the franchise rate on corporations, plus an additional percentage of the net income of banks equal to what they would have paid if their personal property had been taxable. Under such a method, however, whenever banks had a greater amount of personal property in proportion to their net income than corporations, they would sustain a greater burden in terms of net income than corporations, in clear violation of section 5219. It would further be a difficult, if not impossible task to ascertain each year the amount of personal property owned by banks, its situs for purposes of taxation, the amounts for which it would be assessed by the various city and county assessors, and the different rates of taxation, city, county and district, which would be applicable thereto.


20 Suppose a company with $100,000 reserves, which was allowed a deduction of 4% thereof or $4,000. If it had no tax-exempt income, and its total net income were $10,000, it accordingly paid taxes on only $6,000. A company with the same reserves and the same net income, which included, however, tax-exempt income, would pay taxes exactly as if it held no such tax-exempt income, since the amount of its second deduction under the statute was reduced by the amount of tax-exempt income it held. Exempt income amounting to 4% or over of the reserves therefore operated to prevent any realization of a tax deduction. Any exempt income amounting to less than 4% of the reserves likewise prevented a full realization of this deduction.
dated the condition attached to the second deduction, declaring that "one may not be subjected to greater burdens upon his taxable property solely because he owns some that is free."

Certain circumstances distinguish this statute from the California Act. Once the bank tax rate here is determined, it applies equally to all banks, and the tax they pay varies only with their net income and not with the amount of personal property they own. A bank with a large amount of personal property is required to pay no greater tax than a bank with a similar amount of net income which owns little or no personal property. Thus, there is no relation between the amount of personal property a bank owns and the amount of taxes it is required to pay. Consequently, it cannot be said that banks are subjected to a greater burden measured by their net income solely because they own personal property that is free, or that the Act has the effect of taxing the personal property of banks.

While section 5219 impliedly prevents the direct taxation of personal property of national banks, it specifically provides that they may be taxed according to or measured by their net income. There is nothing in this section or in its judicial history to indicate that the personal property tax exemption of banks should entitle them to pay a franchise tax lower in amount than the combined franchise tax and personal property tax of other corporations. The purpose of the limitation in section 5219 was not to protect the exemption accorded personal property of national banks but to prevent discrimination against national banks in favor of other corporations. Its conditions are met by any franchise tax that does not impose a higher actual burden upon national banks in terms of net income than that imposed upon other corporations, and the California Act more than meets those conditions by limiting the maximum franchise rate imposable on banks to 6%.

A basically similar situation was involved in Capital National Bank v. City of Jackson. For the purposes of its Depositor's Protection Fund, the state there required all state banks to pay a guaranty assessment on their surplus in lieu of all taxation thereon, allowed a deduction of such exempt surplus from the valuation of the shares of such banks for taxation, and granted national banks the right voluntarily to pay a corresponding assessment on their surplus with a corresponding deduction from the valuation of their shares. The plaintiff bank, electing not to pay the guaranty assessment, complained that the valuation of its property without the deduction of surplus allowed state banks

21 See supra note 18.
22 (1932) 162 Miss. 658, 139 So. 163, cert. den., (1932) 286 U. S. 550.
23 The assessment complained of was against the appellant in its corporate capacity and not on the shares of its capital stock, but the appellant disclaimed any objection to the assessment on that ground.
was in violation of section 5219. The Court upheld the tax, declaring:

"It is manifest that the legislature did not intend to discriminate against national banks... but was attempting to exercise its undoubted power to regulate the state banks in such a way as to place such banks and national banks on a parity, in so far as it exacted money from them for public purposes. In so far as the national banking act is concerned... the state could have exacted the same ad valorem tax from state and national banks... Instead of taking that course, it assessed the surplus of state banks directly... in lieu of ad valorem taxes thereon, and granted to the national banks the right voluntarily to pay the same per cent on their surplus as assessed against state banks in lieu of ad valorem taxes thereon. Both methods impose the same burden and reach the same end, and it is difficult to see why national banks can complain of the one but could not of the other."21

Similarly, in California it is manifest that the legislature intended no discrimination against national banks. In so far as section 5219 is concerned, the state could have exacted the same franchise tax from banks and corporations by imposing upon both an identical tax rate and exempting corporations as well as banks from taxation upon their personal property. The advantages of this exemption to banks would thus have been completely negated by the extension of the same exemption to other corporations. Another method was chosen imposing the same burden and reaching the same end, with the difference that banks here retain many of the advantages of their exemption. Since the tax in the *Capital National Bank* case is valid, the tax imposed by the California Act is *a fortiori* valid.

Finally, the contention may be advanced that the validity of the Act must be determined solely from its own provisions, and that the law may not take cognizance of the fact that other taxes are imposed by other Acts upon corporations, which are not imposed upon banks. This contention is effectively answered by the opinion of the Court in *Gregg Dyeing Co. v. Query*.25 South Carolina imposed a tax on gasoline brought into the state for use or consumption and kept in the state for twenty-four hours after it lost its character as a shipment in interstate commerce. The tax was not applicable to gasoline paying the license tax imposed by other statutes. The Court held that the tax statute did not discriminate against interstate commerce, since all gasoline bought in the state was taxed by other acts at a rate equal to that imposed by the statute in question. It declared:

"But appellants question the right to invoke other statutes to support the validity of the Act assailed. To stand the test of constitutionality, they say, the Act must be constitutional 'within its four corners,' that is, considered by itself. This argument is without merit. The question of constitutional validity is not to be determined by artificial standards. What is required is that state action, whether through one agency or another, or

25 (1932) 286 U.S. 472.
through one enactment or more than one, shall be consistent with the restrictions of the Federal Constitution. There is no demand in that Constitution that the State shall put its requirements in any one statute. It may distribute them as it sees fit, if the result, taken in its totality, is within the State's constitutional power.”

WHAT ARE FINANCIAL CORPORATIONS?

The classification of financial corporations for rate purposes involves their definition. The term is not defined in the Act. It seems clear, however, that the legislature intended to tax at a different rate from the rate imposed on mercantile, manufacturing and business corporations, only those corporations which are financial corporations within the meaning of section 5219. Whatever the reasons, Congress refrained from defining the term in section 5219, and the term as therein used has not been interpreted by the courts. The legislature thus faced two alternatives. It could undertake a definition which might later be inconsistent with decisions of the federal courts interpreting the term. Any such legislative error of divination would then have to wait upon the following legislative session for correction. Or it could refrain from definition, thus throwing the burden of divination upon the Franchise Tax Commissioner.

The latter alternative was chosen, since it allowed of more flexibility in examining and resolving each situation as it arose. Any error of divination by the commissioner may be corrected immediately and simply by complying with the court decisions as rendered. Even though some corporation not listed as a financial corporation paid a smaller tax than banks, and the courts subsequently decided that it was a financial corporation and that the bank tax was therefore invalid, the situation would automatically remedy itself. The Franchise Tax Commissioner would then re-list the corporation as financial and tax it accordingly, thereby removing the discrimination against banks. This was

26 Ibid. at 479-480.
27 Although it is conceivable that the legislature might have intended a broader meaning than that contemplated by Congress and imposed the bank tax upon financial corporations for reasons independent of the restrictions of section 5219, the history of the Act, its purpose to facilitate compliance with section 5219, and the uncommon nature of the classification lead to the conclusion that the classification was made solely because of the different requirements of that section regarding the rate of tax on financial corporations on the one hand, and mercantile, manufacturing and business corporations on the other. final report california tax commission (1929) 247-291; summary report of california tax research bureau (1932) 73-91; see also section 1 of the Act which provides “The State is hereby adopting the method numbered (4) authorized by the Act of March 25, 1926, amending Section 5219 of the Revised Statutes of the United States.” cal. stats. 1933, p. 869.
28 If a financial corporation were taxed at a lower rate than banks the cause would lie not in the Act but in the classification by the commissioner. Should the court then reduce the tax on banks below the rate provided by the Act, or should it hold the bank tax valid on the theory that the remedy for the discrimination is to impose the rate provided by the Act on the corporations erroneously classified?
the only practical way of circumventing the difficulties raised by the unfortunate wording of section 5219 bearing upon classification.

Since Congress itself has not defined "financial corporations," one

The first alternative finds some support in Sioux City Bridge Co. v. Dakota County (1923) 260 U. S. 441; Cumberland Coal Co. v. Board of Revision of Tax Assessments (1931) 284 U. S. 23; and Iowa-Des Moines Nat. Bank v. Bennett (1931) 284 U. S. 239. These cases hold that although property is not assessed at a larger amount than the statute provides, a discriminatory assessment thereon is invalid even though the discrimination arises from the under-assessment of other property in violation of the statute. They involved, however, not errors of judgment but intentional discrimination, a distinction specifically drawn in the Sioux City Bridge case. In Iowa-Des Moines Bank v. Bennett, the Court intimates, at p. 247, that there would be no cause to complain if the state had corrected the under-assessment immediately upon the discovery of the intentional discrimination. Any discrimination under the Act caused by an error of judgment may be corrected at any time before the expiration of the period of limitations on additional assessments. There would therefore be no reason to invalidate the bank tax on the basis of an error which may be corrected by reclassification.

Should the court, however, adopt the alternative of reducing the bank tax, section 4a of the Act provides that, "If it be judicially determined that the rate of tax on any bank or corporation is higher than is authorized by law such bank or corporation shall be relieved of liability for any tax imposed by this act only to the extent of the excess beyond that legally authorized." Cal. Stats. 1933, p. 872. It is clear from this provision, and probably independently of this provision (see (1929) 17 CALIF. L. REV. at 465, n. 29), that the rate on banks should not, in any event be reduced below 2%, the rate imposed upon mercantile, manufacturing and business corporations. The rate could be reduced to 2% only if the financial corporations erroneously classified as nonfinancial were required to pay no personal property taxes. If they did pay personal property taxes the percentage of their net income so paid would be added to the 2% franchise tax rate and the bank tax rate could be reduced only to the percentages so obtained. Thus if they were required to pay personal property taxes in amounts equal to 3% of their net income, the bank tax rate would be reduced only to 5%. If the personal property taxes should amount to 4% of their net income, there would be no discrimination and hence no reason for reducing the bank tax rate.

A reduction in the tax rate on national banks would not necessitate a corresponding reduction for state banks under section 5219 or the Constitution of the United States. Union Bank & Trust Co. v. Phelps (1933) 288 U. S. 181. The question arises, however, whether such a reduction would be necessitated under article XIII, § 16 of the California Constitution. Paragraph 1 (a) provides for a tax measured by net income at a rate of 4% on all banks. Paragraph 3 empowers the legislature to change the rates of tax but makes no intimation that the changed rates must be the same for all banks. Paragraph 1 (b) empowers the legislature to change the form of taxation from that set forth in paragraph 1 (a), "provided, that such forms of taxation shall apply to all banks located within the limits of this state." It might be contended that the phrase "form of taxation" covers not only the method but also the rate of taxation, and that while this interpretation does not expressly apply to the method of taxation provided in paragraph 1 (a) a similar interpretation is already implied in that paragraph by the provision for the 4% rate on all banks. Such a contention attributes to "form of taxation" a broadness of meaning which may not have been intended, and overlooks the unqualified authority given the legislature to change rates. It also reads into paragraph 1 (a) a requirement that the same tax rate shall apply to all banks. A similar contention was repudiated in Union Bank & Trust Co. v. Phelps, supra.
may find a possible clue in the construction placed upon the analogous provision in section 5219 that national bank shares shall not be taxed at a greater rate than other moneyed capital. It has been held that the term "other moneyed capital" includes only capital "which is employed in such way as to bring it into substantial competition with the business of national banks." The Supreme Court has stated that the purpose of this limitation of the term was designed to "render it impossible for any state, in taxing the shares, to create and foster an unequal and unfriendly competition with national banks, by favoring shareholders in state banks or individuals interested in private banking or engaged in operations and investments normally common to the business of banking." The income methods, like the share method, are subject to restrictions with the objective of preventing discrimination against national banks. Since these restrictions are separately applied to mercantile, manufacturing and business corporations on the one hand, and to financial corporations on the other, one must locate that characteristic which at once differentiates financial corporations from mercantile, manufacturing and business corporations, and unites them in the same classification with banks. Competition with banks was the characteristic which subjected "other moneyed capital" to burdens at least equivalent to those of national banks. Since amendments to section 5219 have merely sanctioned additional methods of taxation, in accord with the purpose of the section, it is reasonable to assume that the phrase "other financial corporations" under the income methods is to be given the same general interpretation as the phrase "other moneyed capital," with the intentional difference of here limiting that interpretation to corporations. The same reason which led the Court to adopt a purposive classification of "other moneyed capital" continues with equal force in the case of "other financial corporations." The phrase "moneyed capital" was effectively limited by the courts to mean competing moneyed capital, on the theory that the possibility of discrimination against national banks inhere only in those situations where moneyed capital came into competition with banks. Any extension of the phrase to non-competing moneyed capital would have exceeded the purpose of preventing actual discrimination against banks, and would have caused an unnecessary hardship upon non-competitors. Only by the limitation could the phrase fulfil the purpose of section 5219 without possible injustice to non-competitors outside the scope of that purpose. Only by a similar limitation can the phrase "other financial corporations" similarly fulfil that continuing purpose.

If this analysis is correct, it follows that a "financial" corporation, for the purpose of classification necessitated by section 5219, means any corporation the activities of which come into substantial competition with the business of national banks. Corporations whose financial activities do not compete with those of banks must be classified as business corporations. There is no reason for supposing that Congress intended that corporations which under a purely literal rather than purposive interpretation might be considered financial but which do not compete with national banks, should be taxed as high as such banks when other non-competitive corporations could be taxed at a lower rate.

It thus becomes necessary to define competition. There is general agreement that it involves the use of moneyed capital on an extensive scale, irrespective of whether that moneyed capital accrued from competitive or non-competitive activities, substantially as in the loan and investment features of banking. The problem is complicated, however, by wide variations in the nature and scale of activities within each generic type of corporation. There is little homogeneity,


34 Further complications arise when corporations are engaged partly in competitive and partly in non-competitive activities. Ordinarily it would seem that the predominating activities of a corporation would determine its classification. Thus, when a corporation is engaged primarily in substantial competition with national banks the fact that it is engaged in some non-competitive activities would hardly preclude its classification as a financial corporation. On the other hand, where the non-competitive activities predominate, it would seem that the corporation should be classified as nonfinancial. It may be, however, that the competitive activities, although constituting a small part of the corporation's business, are of such character and extent as to bring it into substantial competition with national banks. To classify such a corporation as financial would mean that it would be subject to a tax, at the same rate as banks, measured by all of its net income, even though most of such income were derived from non-competitive activities—a result which goes beyond any needs of national banks for protection. To classify it as nonfinancial would mean that income from competitive activities would be used as the measure of the tax at a lower rate than that imposed upon banks—a result which might invalidate the bank tax. An equitable solution of cases of this character may be to measure the tax (a) at the same rate as upon banks by income from competitive activities and (b) at the corporation rate by income from other activities. Such a solution, however, finds no support in the Act, presents serious accounting and administrative problems and is probably not permitted by section 5219. Pending judicial guidance on this question it would seem that the commissioner would be justified in classifying corporations of this kind as financial and applying the bank tax rate to the entire net income.
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for example, amongst building and loan associations, personal loan companies, automobile finance companies or mortgage companies. In such instances, a judgment as to their competitive nature must wait upon a factual analysis occasioned by a legal test. Another difficulty arises from the disagreement as to whether the use of moneyed capital, to be competitive, must be in fields in which banks actually operate, in fields in which they might operate were it not for the competition, or in fields in which they may conceivably but not necessarily operate. The Act accordingly makes possible flexible classifications, subject to alteration in accord with changes in the sources of competition, as well as in its definition. Any final classification is precluded by the changes, not only in "other financial corporations", but in the banks themselves.

A flexible classification obviates the necessity of including corporations which are potential competitors only, since it may include them, with greater accuracy, if and when they become real competitors. The

35 The first and strictest of these interpretations was adopted in First Nat. Bank of Shreveport v. Louisiana Tax Comm., supra note 7. The lower court stated that "the discrimination is of no importance unless it is in favor of moneyed capital invested in a line of business which the national banks engage in, or which they might engage in but for the competition." The Supreme Court, in holding that the banks had failed to sustain the burden of proving competition, stated at p. 64: "...It is necessary to prove not only that the plaintiffs were empowered by law and authorized by their stockholders to engage in a competitive line of business, but that, during the tax year, moneys of these national banks were in fact employed in substantial amount in some line of business which was carried on, during the year, by less heavily taxed nonbanking concerns. It is as necessary to prove that the bank's capital was so employed as it is to prove that moneyed capital was actually employed by others in substantial competition with banks." (Italics added). This statement, in itself clear, is obscured by the subsequent words of the Court: "It is argued that national banks might conceivably be prevented from engaging in actual competition with other moneyed capital by reason of the very features complained of in the taxing statutes. Compare People ex rel. Pratt v. Goldfogle, 242 N. E. 277, 302; 151 N. E. 452. But no suggestion is made that such was the situation in the case at bar." Ibid. at 65.

This leaves a doubt as to whether or not the Court would hold a tax on national bank shares invalid, if the banks were later to prove that their capital would have been engaged in certain fields held it not been for the competition. One might reason that the competition in such an event, by stopping all banking operations in that field, would be more severe than in a situation where the banks continued their operations, but on a lesser scale. Cf. First Nat. Bank of Hartford v. Hartford, supra note 33, which held that competition was established when other moneyed capital and national banks "engage in seeking and securing in the same locality capital investments of the class now under consideration, which are substantial in amount." See Minnesota v. First Nat. Bank of St. Paul, supra note 33.

In People ex rel. Pratt v. Goldfogle (1926) 242 N. Y. 277, 151 N. E. 452, the court held that competition arises, not only with actual transactions being conducted by a bank, but also when moneyed capital, as a primary and characteristic purpose, "engages in business which such a bank is authorized to conduct." Public Nat. Bank v. Keating (C. C. A. 2d, 1931) 47 F. (2d) 561, aff'd, 284 U. S. 587, held competitive all substantial amounts of moneyed capital engaged in loans and investments similar to those of banks. See Note (1932) 41 YALE L. J. 609.
same reasoning applies to borderline corporations, if and when they become demonstrably real competitors. In the latter situation, such a classification augments the possibility of imposing dissimilar burdens on similar enterprises; this possibility, however, is negated by the fact that both section 5219 and the Bank and Corporation Franchise Tax Act protect national banks from burdens exceeding those on financial corporations, and the banks, if necessary, may automatically seek legal redress. Even pending redress, the banks would still enjoy the partial protection offered by the mercantile, manufacturing and business corporation clause of section 5219.

A flexible classification specifically listing current competitive corporations, therefore, not only causes no harm by augmenting the possibility of temporarily imposing dissimilar burdens on similar enterprises, but serves the purpose of equitable taxation by reducing the possibility of imposing similar burdens on enterprises which are possibly dissimilar, a possibility against which no redress comparable to that of the banks is available. Neither section 5219 nor the Act grants financial corporations a comparable protection in their competitive activities, and it is an open question if they would have any redress when their tax burden exceeded that on banks. Some of them have in the past enjoyed certain exemptions on the basis of public policy, but these are being increasingly challenged where actual competition exists, while the protection to banks remains intact. The banks, therefore, are in the favorable position of being protected, not only from burdens higher than those on other financial corporations, but also, on occasion, from burdens as high as those on such corporations. Since other financial corporations are thus at a disadvantage as compared with banks, it is important to classify as financial only those corporations which are clearly competitive, and not to impose upon a non-competitive one the burdens of a financial corporation, by which the maximum burden of banks is determined. The banks themselves should not object to such a limitation, since it implies a scrupulous examination of where actual competition exists, and a consequent subjection of such competition to burdens at least equaling those of banks.

In view of the limitation to competitive financial corporations and the great increase of activities, and therefore of possible competition, amongst both banks and other corporations engaged in financial activities, it becomes necessary to analyze the outstanding possible sources of competition.\(^{36}\)

\(^{36}\) Since there has never been any doubt about the competitive nature of commercial banks they will not be considered here. Federal Reserve Banks (38 STAT. (1913) 258, 40 STAT. (1919) 1314, 12 U.S.C. (1926) § 531), Federal Land Banks, National Farm Loan Associations (39 STAT. (1916) 380, 12 U.S.C. (1926) §§ 931,
(1) Savings Banks.—It was once generally held, following the decision in Bank of Redemption v. Boston, that savings banks, as servitors of the public policy to encourage thrift, did not enter into competition with national banks, and were therefore deserving of a privileged position in the matter of tax-exemptions. In view of the extensive development of savings banks from depositories of small deposits into large scale financial corporations, it is probable that this authority will be increasingly challenged. The savings departments of national banks, as well as of trust companies, compete with state savings banks for real estate mortgages, and they in turn compete with the national banks and trust companies for collateral loans. As with the trust companies, the savings banks encroach increasingly on the business of national banks; simultaneously, as their own business ramifies, it is in turn encroached upon by national banks. This was recognized in National Bank of Commerce v. King County, and in Yakima National Bank v. Yakima County, where the national banks succeeded in establishing, for taxation purposes, the competitive nature of mutual savings banks as well as of certain other financial corporations.

(2) Trust Companies.—Trust companies, like savings banks, enjoyed tax exemptions long after the reasons for those exemptions disappeared. Their activities parallel closely those of commercial banks; at an early stage, they not only developed their own particular activities, but encroached substantially upon those of banks. Nevertheless, they enjoyed a lighter tax burden because they were not incorporated in Joint Stock Land Banks (whose shares are taxable subject to limitations of section 5219 with reference to national banks, 39 Stat. (1916) 380, 12 U. S. C. (Supp. 1933) § 932) are now in process of liquidation and prohibited from making loans except such as are necessary and incidental to the refinancing of existing loans on bond issues or sale of real estate owned or hereafter acquired by such banks. 48 Stat. (1933) 46, 12 U. S. C. A. (Supp. 1933) § 810.

37 Hitchcock, How Should Banks Be Taxed? (1930) 8 Tax Mag. 410.
39 (1929) 153 Wash. 300, 280 Pac. 16.
40 (1929) 153 Wash. 495, 280 Pac. 25.
under the laws which created the banks, even though they subsequently exercised every function of a bank except that of issue.\textsuperscript{41}

As the trust companies continued to be competitors of national banks in substance if not in form, the states gradually brought them under the laws applicable to banks. In most states they are now subject to the same tax laws and their business is becoming increasingly interchangeable with that of national banks.\textsuperscript{42} The effects of their original advantage have continued and, as one writer concludes, "The phenomenal growth of the trust company is attributable to antiquated tax laws and laxity of enforcement."\textsuperscript{43}

(3) Building and Loan Associations.—Building and loan associations, on grounds of public policy,\textsuperscript{44} have enjoyed a series of exemptions under federal tax laws.\textsuperscript{45} Certain external differences from banks\textsuperscript{46}

\textsuperscript{41}Mercantile Nat. Bank v. New York, supra note 30. For a critical analysis of this case see Bell, \textit{A Study in the Early Methods of Taxation of Trust Companies} (1929) 14 \textit{Nat. Tax Ass'n Bull.} 199-206.

\textsuperscript{42}In Jenkins v. Neff (1902) 186 U. S. 230, it was claimed that, although the laws of New York did not permit trust companies to engage in the banking business, they were in fact doing such business. The Court held that, even admitting that trust companies were in fact doing a banking business, it would presume that the state would not show bad faith by permitting them to continue such operations, and that investments in trust companies were not competitive with national banking capital, even though such companies did temporarily compete because of their illegal acts. This holding was expressly repudiated by the Court in First Nat. Bank of Hartford v. Hartford, supra note 33: "The question [of competition within the meaning of section 5219] is thus a mixed one of law and fact, and in dealing with it we may review the facts in order correctly to apply the law. [Citations omitted] The opposite view expressed in Jenkins v. Neff, must be considered discarded by the later cases." 273 U. S. 548, 552. By dictum in Amoskeag Sav. Bank v. Purdy, supra note 4, trust companies were assumed to be competing with national banks. From these dicta it seems safe to assume that investments in trust companies exercising the powers admittedly exercised by the companies in Jenkins v. Neff would now be considered "other moneyed capital" and the companies themselves would be held to be "financial corporations" within the meaning of section 5219. It is important to note that national banks are now permitted to do a trust business, subject to certain statutory limitations. Federal Reserve Act of 1913, 38 Stat. (1913) 251, 262, 12 U. S. C. (1926) § 248. The Supreme Court, in upholding the Statute, gave as one of its reasons for the decision the fact that trust companies actually compete with the business of national banks. First Nat. Bank of Bay City v. Fellows (1917) 244 U. S. 416, 425; see Missouri ex rel. Burnes Nat. Bank v. Duncan (1924) 265 U. S. 17.

\textsuperscript{43}Bell, \textit{loc. cit. supra} note 41.

\textsuperscript{44}In their earliest form, they devoted themselves chiefly to the financing of small homes through long-term amortized loans, so issued as to make the borrower also a shareholder on a mutual basis, thus serving what was generally regarded as the public interest.

\textsuperscript{45}For a brief history of federal exemptions, see Bodfish (editor), \textit{History of Building and Loan in the United States} (1931) 188-209, 222-226; Bullock, \textit{Exempt Corporations under the Federal Income Tax Laws} (1926) 4 \textit{Nat. Income Tax Mag.} 380-381.

\textsuperscript{46}While building and loan associations now frequently do business with non-members, they point to the higher risk and therefore higher interest paid on loans,
have fortuitously enabled them to enjoy, within the limits of section 5219, similar exemptions under state laws on the tenuous authority of the decisions exempting early savings banks on grounds of public policy. Even though the great qualitative, as well as quantitative, extension of the financial activities of these associations, beyond the confines of their originally mutual forms, has occasioned legal tests of their competitive nature, the courts have generally sanctioned their exemptions on the basis of a traditional public policy, the present applicability of which they assumed without analysis.

The accompanying higher risk and therefore higher interest paid on deposits, the limitations on deposit withdrawals, the small cash reserves, and the concentration on long-term amortized real estate loans. They argue, accordingly, that irrespective of the scale of their operations, they serve different needs and a different market from that served by banks. It is not necessary, however, that activities be identical to be competitive. First Nat. Bank of Hartford v. Hartford, supra note 33.

See Hearings before the Committee on Banking and Currency, U. S. Sen., 70th Cong. 1st Sess., on S. 1572, pp. 118-125. As one writer observes: "The total assets [of building and loan associations] have increased from about $1,769,000,000 in 1917 to $7,000,000,000 in 1928. The number of persons who are investors has increased from 4 of each 100 in 1917 to 10 of each 100 in 1928... The commercial banks have shown a relatively much slower growth... The building and loan associations owe a part of their growth, perhaps a large part, to their preferential position with regard to taxation... On their business as such, in most states, they pay practically no taxes. Moreover, they pay practically no federal taxes... The gain that has accrued to patrons of building and loan associations, whether investors or borrowers, has been more than offset to the patrons of commercial banks by reason of the heavy taxes which they pay." Jensen, Economic Aspects of Bank Taxation (1930) 23 NAT. TAX Ass'N PROCEEDINGS 297, 299-300. The fact that the depression since 1928 has handicapped these associations in the course of its general severe effects on business in no way detracts from the force of this statement.

This has been true even where the investments of the building and loan associations bulked so large, in fields so similar to those in which banks operate, as to seem seriously competitive. Thus, the majority in Hoenig v. Huntington Nat. Bank, supra note 47, held that no competition arose from the fact that banks issued money upon the security of real estate mortgages, or that building associations invested in Liberty bonds and, to a limited extent, in collateral loans or so-called "straight mortgages." Nor could they see competition in the "mere facts that money is loaned by building associations upon promissory notes, at interest and to be repaid in money, and that national banks take the ownership of real estate in consideration in passing upon the credit standing of borrowers." Mr. Justice Tuttle, dissenting, pointed out that the extensive evidence of the use of the moneymed capital after it was obtained, indicated clear and substantial competition with national banks. The evidence reviewed in his opinion lends conviction to his dissent. The majority, on
In view of the present unsettled state of the law, such an assumption becomes increasingly precarious, as specific evidence on the financial activities of these associations accumulates. Their present privileged position cannot obscure the many possibilities on which they could be held to compete with national banks. Any realistic classification, therefore, under the Bank and Corporation Franchise Tax Act, within the limitations of section 5219, would list as financial corporations all building and loan associations whose present characteristic activities are competitive with those of national banks. To be exempt from such a classification, an association should be required to prove, not merely that its historical forerunners were exempted on grounds of public policy, but also that its own activities are limited to fields serving that public policy and not encroaching upon the field of normal banking operations. One may note that the recent entrance of the federal government into the field of building and loan associations heightens the difficulty of predicting their development.

(4) Finance, Mortgage and Investment Companies: Dealers in Commercial Paper.—The Supreme Court has repeatedly held, under

the basis of traditional cases, assigned as a reason for the “finding of want of competition” the “fundamental and substantial differences between commercial institutions, such as national banks, and institutions of the insurance company, savings bank and building association types.” By this tour de force, they sanctioned exemptions of clearly competitive activities, unrelated to any public policy, on the grounds that those activities were carried on by groups which had in their first stages of development enjoyed similar exemptions by virtue of their limited and non-competitive activities justifying protection on the basis of public policy. See Merchants’ Nat. Bank of Glendive v. Dawson County, supra note 47.

Compare Commercial Nat. Bank v. Franklin County (S. D. Ohio 1930) 45 F. (2d) 213, which was reversed in Hoening v. Huntington Nat. Bank, supra note 47, where the court, in holding invalid a tax on national bank shares at a higher rate than other moneyed capital, such as that invested in building and loan associations, mortgage companies and finance companies, observed at p. 220: “The mortgage loan company and the finance company of today are the creations of the modern business activities in very recent years. The building and loan associations, with all the appointments of up-to-date financial institutions, are altogether different concerns from the old community mutual building and loan association such as was dealt with in the case of Mercantile National Bank v. Hubbard (C. C.) 98 F. 465.” Cf., also, National Bank v. Custer County (1926) 76 Mont. 62, 245 Pac. 259, rev’d, (1927) 275 U. S. 502; Public Nat. Bank v. Keating, supra note 35; Boise City Nat. Bank v. Ada County (D. Idaho 1930) 37 F. (2d) 947, (D. Idaho 1931) 48 F. (2d) 220; National Bank of Commerce v. King County, supra note 39; (1932) 81 U. S. L. Rev. 230.

See supra note 35.

the share tax methods, that all individuals and corporations who made substantial loans or investments in notes, bonds, mortgages and other securities in which banking capital could be appropriately employed, were competitive within the intent of section 5219. Under the income methods, corporations engaged principally in making such loans and investments would likewise seem clearly to be financial corporations within the intent of section 5219. While they may make certain loans and investments with fewer restrictions than banks, this does not alter the fact of competition between them where they both engage in the same field on a substantial scale. Where the difference in restrictions compels different methods of operating in the same field, however, the question arises as to whether that dissimilarity destroys competition by destroying its directness and immediacy, or whether it intensifies it by allowing other corporations, through their very differences of methods, advantageously to increase the total employment of their own capital, and therefore decrease that of banks, in the general loan and investment field in which both operate. There arises, also, the coincident question as to the effects of dissimilarity caused by restrictions voluntarily assumed by the banks.


53 National banks "are given authority, in addition to loaning money, to exercise all such 'incidental powers' as shall be necessary to carry on the business of banking 'by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt.' ... They are authorized, with certain limitations, to loan money on real estate mortgages.... Here plaintiff is shown to have investments in real estate mortgages and to be engaged in selling them. The sale of mortgages and 'other evidences of debt' acquired by way of loan or discount with a view to reinvestment is, we think, within the recognized limits of the incidental powers of national banks.... To that extent the business of acquiring and selling such mortgages and evidences of debt, carried on by numerous individuals, firms, and corporations in Wisconsin, comes into competition with this incidental business of national banks. That the exercise of this incidental power has become of great importance in the business of national banks appears from the Report of the Comptroller of the Currency for 1924, 44 et seq., showing that approximately one-third of the investments of national banks consist of Government, railroad, public service corporation and other bonds and 'collateral trust and other corporation notes.'" First Nat. Bank of Hartford v. Hartford, supra note 33, at 559-560.

54 Supra text, pp. 512-513, and note 35.

55 In First Nat. Bank of Shreveport v. Louisiana Tax Comm., supra note 7, the banks contended that their loans of money on real estate brought them into competition with other corporations in substantially the same field. The Supreme Court held, however, that not only the field, but the methods of operation must be similar. Similarly in Hoenig v. Huntington Nat. Bank, supra note 47, the majority held that because of different methods of operation, no competition arose from the fact that banks made substantial straight loans secured by mortgages, sometimes on a long-term basis, and made substantial investments similar to those of finance companies, in automobile and other commercial paper.

Cf. People ex rel. Title & Mortgage Co. v. Burke (1930) 253 N.Y. 85, 170 N.E.
Since there is general agreement that competition need not be with all phases of banking, it would seem that corporations engaging extensively in the loan and investment field open to banks would be competitive, even where their activities were highly specialized. Despite frequent exemptions of such highly specialized companies, the more recent tendency seems to be to hold them competitive.

(5) **Insurance Companies.**—Insurance companies, like building and loan associations, have enjoyed a number of exemptions under federal and state laws, and these have usually been upheld on grounds of public policy, or because the reserves of the companies were

605, involving a company which specialized in bond and mortgage loans which banks could also make, on a more restricted basis, though they did not actually do so. The difference in method arising out of these restrictions was held to intensify rather than diminish competition. In *People ex rel. Pratt v. Goldfogle* (1926) 242 N. Y. 277, 151 N. E. 452, the court held that the test of competition was potential business rather than actual transactions, in the general field of loans and investments, and that competition arose whenever moneyed capital was regularly employed in operations which had for their primary and characteristic purpose the transaction of some business which could be carried on by national banks, and was not diminished by the fact that banks were subject to certain restrictions not imposed upon the other moneyed capital. See also Nelson v. First Nat. Bank (1930) 42 F. (2d) 30; Voran v. Wright (1930) 129 Kan. 601, 284 Pac. 807, *rehol'd aff'd* (1929) 129 Kan. 1, 281 Pac. 938; Stevenson v. Metsker (1930) 130 Kan. 251, 236 Pac. 673; Citizens Bank of Galena v. Tax Comm. of Kansas (1931) 132 Kan. 5, 294 Pac. 940; Bonaparte v. American First Nat. Bank (1929) 139 Okla. 189, 281 Pac. 958; National Bank of Commerce v. King County, *supra* note 39; Ward v. First Nat. Bank (1932) 225 Ala. 10, 142 So. 93.


57 On the basis of their heavy loans and investments, Boise City Nat. Bank v. Ada County, *supra* note 49, held competitive, investment houses, savings and loan associations, building and loan companies, insurance companies, real estate mortgage loan companies, and even finance companies handling exclusively automobile and similar commercial paper. The legislature, however, subsequently made a new classification, which was sustained in *State ex rel. Bank of Eagle v. Leonardson*, *supra* note 47. *People ex rel. Pratt v. Goldfogle*, *supra* note 35, made regular, continuous and characteristic activity, including highly specialized activities in some banking field, a condition of competition.

*Public Nat. Bank v. Keating*, *supra* note 35, on the authority of *First Nat. Bank of Hartford v. Hartford* and *Minnesota v. First Nat. Bank of St. Paul*, both *supra* note 33, held that competition arose from the fact that "billions of dollars were employed by thousands of brokers, private bankers, bond dealers, individual investors of surplus funds, firms and corporations ... in investing and re-investing, dealing in bonds, notes, commercial paper, acceptances, real estate mortgages and other securities and evidences of debt, lending money on call or on time, with or without security, discounting commercial paper, and making loans or advances to customers upon collateral security ... in substantially the same manner as did national banks." 47 F. (2d) at 565.

58 Bullock, *op. cit.* *supra* note 45, at 380-400.

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held to constitute debts owing by the insurer to the insured.60 Their heavy investments nevertheless raise a question as to whether or not they may be regarded as competitors of national banks. Some cases have held them non-competitive on the ground that, while engaged in the general investment field, their actual methods and markets differed from those of national banks.61 If the view held in People ex rel. Pratt v. Goldfogle62 that competition occurs in a general field rather than in specific transactions gains ground, however, there will undoubtedly be a corresponding tendency to regard insurance companies as competitive, and there is already some evidence to that effect.63 Nevertheless, their peculiar financial organization will make it difficult under the income tax methods to levy equal burdens upon them and upon banks,64 and the problem of discrimination may become one of accounting as well as of law.65


61 “The loans made by life insurance companies... were longer time loans than a national bank would make... Their business was such as the national banks would never handle or desire to handle.” First Nat. Bank of Shreveport v. Louisiana Tax Comm., supra note 7, 195 La. at 139, 145 So. at 29. See Merchants’ Nat. Bank of Glendive v. Dawson County, supra note 47.

62 Supra note 35.


64 “...Since national banks were authorized to lend money on real estate mortgages and to act as trustees, the insurance companies, particularly life insurance companies,... must now be held to be competitors of banks... Such companies are great reservoirs of capital which is placed constantly in various ways and in all sections of the country in competition with the business of banking. Peculiarities of this group... requiring the setting-up of statutory reserves, together with other reasons, render the income tax measuring-rod entirely unsuitable as a means of comparing the tax burdens of such companies with the burden imposed upon any other group of taxpayers. What becomes of this so-called protective principle, insisted upon by banking interests, if comparison of the burden is not to be made or cannot be made by the use of [the net income-tax] measuring-rod with this class of corporations which furnishes such aggressive competition with the business of banking?...” Blodgett, Weighing the National Tax Burden by Comparatives (1930) 23 NAT. TAX ASS’N PROCEEDINGS 283, 293.

65 Section 14 (b) of article XIII of the California Constitution provides that insurance companies shall be taxed upon their gross premiums from business done in this state which tax “shall be in lieu of all other taxes and licenses, state, county and municipal, upon the property of such companies, except county and municipal taxes on real estate.” This section further authorizes a deduction of county and municipal real estate taxes paid by such companies from the tax on gross premiums. Since the Bank and Corporation Franchise Tax Act applies only to corporations subject to taxation under section 14 (d) of article XIII, and since that section imposes a property tax (Miller & Lux v. Richardson (1920) 182 Cal. 115, 187 Pac.
(6) Small Loan Corporations.—Small loan corporations and individuals, such as pawnbrokers, extending credit for the purchase of furniture, clothing, jewelry, or making general small loans at high rates of interest have been regarded as serving a market not generally sought by banks. Their tremendous growth, however, and the large

(411), it becomes necessary to determine whether all insurance companies would enjoy a constitutional exemption from taxation under the Act. It is clear that insurance companies exclusively engaged in insurance business would be exempt. Since, in any event, their restricted activities would remove them from competition with national banks, and therefore from classification as financial corporations, no question could here arise concerning the validity of the bank tax. See supra note 27.

The question arises, however, whether insurance companies, which engage in additional activities competitive with those of national banks, are taxable under the Act. See supra notes 34 and 35. Such companies could constitutionally be held taxable under the Act only if they were taxable under section 14 (d). Since the in lieu provision of section 14 (b) makes no distinction between property used in the insurance business and property used by insurance companies in other activities, it may be contended that the gross premiums tax is in lieu of other taxes, except real property taxes, upon all the property of insurance companies, irrespective of its use, and that consequently the franchises of such companies are not taxable under section 14 (d). This would amount to a virtual exemption from taxation of all property of insurance companies, other than real property, not used in the insurance business. It is doubtful that section 14 (b) intended such a result. The court could prevent such a result (a) by holding that the gross premiums tax is in lieu only of taxes upon property used in the insurance business, and that property otherwise used is taxable to the same extent and in the same manner as other property (Title Guaranty Trust Co. v. Johnson (1928) No. 33,060, Dept. 2, Superior Court, Sacramento County, Calif.); (b) by holding that the gross premiums tax ceases to apply to insurance companies which cease to do an exclusively insurance business, and that such companies and their property become taxable to the same extent and in the same manner as other corporations and their property. See Nelson v. St. Paul Title Ins. & Trust Co. (1896) 64 Minn. 101, 66 N. W. 206.

Under either of these alternatives, insurance companies extending their activities beyond an insurance business would be taxable under section 14 (d), and therefore taxable under the Act. If these activities competed with those of national banks, the companies would be taxed as financial corporations. If not, they would be taxed as business corporations. In the event that such companies were held not taxable under the Act, the tax on national banks would nevertheless be valid, unless the tax on gross premiums, after the deduction of real estate taxes, were to equal a smaller percentage of the net income of insurance companies than the rate on banks.

66... The small loan companies... make loans not exceeding $300... and are allowed to charge interest at the rate of 3½% per month. The loans, as a rule, are secured by chattel mortgages... The business of the small loan companies, the same as that of the pawnbrokers, is not in any class of business done by national banks, and is not in competition with any of the business done by national banks.” First Nat. Bank of Shreveport v. Louisiana Tax Comm., supra note 7, at 66. While the plaintiff banks in that case sometimes conducted small loan departments, the Supreme Court declared that “there was evidence to indicate that those to whom the banks granted such loans differed as a class from those who borrowed from the institutions alleged to be competing.” See Welfare Loan Soc. v. Des Moines (1928) 205 Iowa 400, 219 N. W. 534; Universal Loan Corp. v. Board of Review (1928) 205 Iowa 391, 219 N. W. 536; Boise City Nat. Bank v. Ada County, supra note 49; Bank of Fairfield v. Spokane County (1933) 173 Wash. 145, 22 P. (2d) 646.
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amounts of capital thus made available to them for reinvestment in exclusively financial activities, raise a question as to whether they are not substantial, even if indirect, competitors of national banks, and they have on occasion been so declared. While their methods would be neither appropriate nor acceptable to banks, the fact remains that they do operate exclusively in loan and investment transactions, often causing thereby an indirect diversion of capital from the corresponding transactions of banks. Unlike the capital employed by certain corporations for long term credit, not generally extended by banks, and serving an essential economic purpose, the capital here involved could not claim exemption on grounds of public policy.

While the banks in the past have not sought the market served by small loan corporations, the recent tendency to open small loan departments of their own indicates that they now consider the field open and appropriate to them. Although the tendency is so recent as to justify the conclusion of the Court in First National Bank v. Louisiana Tax Commission that the borrowers now differed as a class, it is likely that any increase of banking activities in this field will involve an encroachment on the existing business of these small loan corporations, and that competition will therefore result between the two for the same loans. In the absence of convincing proof that national banks do not seek the same business as small loan corporations the commissioner would be justified in classifying such corporations as financial.

(7) Labor Banks.—The possibility of competition from so-called

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67 In People ex rel. Morris Plan Co. v. Burke (1929) 216 App. Div. 258, 234 N. Y. Supp. 608, the company occasionally made loans up to $5,000, though the bulk of the loans were small, at rates much in excess of those charged by national banks. The court nevertheless regarded those facts immaterial, holding that since the company was engaged in discounting evidences of debt, and lending money on personal credit in the same quality, though not in the same quantity, as national banks, it was competitive within the meaning of the statute. The New York Court of Appeals, in (1930) 253 N. Y. 85, 170 N. E. 502, in affirming this decision, relied upon the authority of First Nat. Bank of Hartford v. Hartford, supra note 33, and declared: "...The principal underlying fact remains: that the company is in the business of lending its capital to borrowers, on collateral, notes, bonds, stocks or certificates of investment, for profit, and that upon payment of the loans, it re-invests the moneys. Thus, moneyed capital of the Morris Plan comes into competition with the business of National banks. That the money may be repaid in instalments and advanced on light security may be an attractive feature to the borrower, intensifying the competition; that the State may permit the company to make more than 6% on its loans is an incident of business which may attract capital to these companies for capital investment and divert it from the stock of National banks... The business of the Morris Plan and that of National banks is making money out of loans on notes and collateral security, with some advantage in favor of the Morris Plan, because of the appeal to small borrowers." 253 N. Y. at 92, 170 N. E. at 504. See National Bank of Commerce v. King County, supra note 39; Collins v. First Industrial Bank (1929) 85 Colo. 458, 276 Pac. 988.

68 See supra note 7.
"labor banks" is likewise remote, in view of their limited activities.\textsuperscript{69} While there has been an occasional tendency to break away from their strictly co-operative principles, this has little significance in view of the fact that these corporations have been contracting rather than expanding their activities in recent years.\textsuperscript{70}

(8) Credit Unions.—Credit unions, operating in some thirty-eight states, and serving, on a strictly mutual basis,\textsuperscript{71} the needs of small borrowers not served by commercial banking, have usually enjoyed tax-exemptions under federal and state laws on grounds of public policy\textsuperscript{72} as well as of their clearly non-competitive activities.\textsuperscript{73} In California the Credit Union Act of 1927\textsuperscript{74} defines a credit union as a corporation organized to promote thrift among its members and to create a source of credit for them at legitimate rates of interest, for provident purposes. In 1930, the Attorney General Webb ruled that credit unions in this state could not receive moneys on deposit subject to withdrawals, or otherwise engage in the banking business in the state.\textsuperscript{75} It would therefore

\begin{itemize}
\item \textsuperscript{69} The first labor bank was established in Washington, D. C., in 1920. They are usually owned or controlled by trade union members, and are characterized by such co-operative features as the limitation of the number of shares to be held by each person or organization, limitation of dividends, control of market price of stock, and profit-sharing with depositors. They have used their funds largely in the extension of small loans to their members, in somewhat the same manner as credit unions. See \textit{The Labor Banking Movement in the United States} (Princeton Univ. Study, Industrial Relations Section, 1929).
\item \textsuperscript{70} Carter, \textit{Future of Labor Banking}, Barron's, Nov. 3, 1930, at 11.
\item \textsuperscript{71} They are usually organized in each community, within laws sponsored by the Credit Union National Extension Bureau, for loans to members from low-income groups, such as postal employees. The loan fund is built up by the members themselves, through small fees or savings in the form of shares. About twenty per cent of net earnings goes into a guaranty or reserve fund to meet bad debts, and if any profit accrues, it is distributed to the members. Loans on first and second mortgages are sometimes authorized, but any investments other than loans are usually limited to those legal for trust funds or for savings banks. \textit{Berencren, Credit Union} (1931); \textit{Moen, Rural Credit Unions in the United States} (1931).
\item \textsuperscript{72} The present unions, like the original ones organized by Edward A. Filene in Boston in 1909, are designed to meet serious emergency needs of small borrowers at interest rates considerably lower than those usually charged by commercial small loan corporations.
\item \textsuperscript{73} Unlike the commercial small loan corporations, credit unions are strictly limited in both the amount and character of their loans and investments. Far from competing with commercial banks, therefore, they are generally regarded as useful adjuncts to them. Moen, \textit{op. cit. supra} note 71, at 37, writes that: "City banks that have understood what credit unions are... have been eager to secure their business. Like building and loan associations, each credit union selects a depository for its idle funds... American experience has proved that the credit unions are of assistance to the banks selected as depositories in bringing in savings."
\item \textsuperscript{74} Cal. Stats. 1927, p. 51.
\item \textsuperscript{75} See ruling of Attorney General Webb printed in Commercial and Financial-Chronicle, August 23, 1930, v. 131, p. 1207.
\end{itemize}
seem that credit unions in this state are clearly outside the classification of financial corporations.

The above discussion illustrates the difficulty of determining, for classification purposes, what constitutes a competitive, and therefore financial corporation. There is general agreement that competition with national banks involves substantial activity in the loan and investment fields in which banks operate. The problem lies in determining the degree at which such activity becomes substantial. It varies according to the locality in which banks operate, and also according to the nature and extent of their operations which, like those of other corporations, are subject to change. It thus becomes evident that only a flexible classification, on the basis suggested at the beginning of this discussion, can meet such changes as they arise, and thus obviate the inequalities inherent in a fixed classification.

(TO BE CONCLUDED)

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