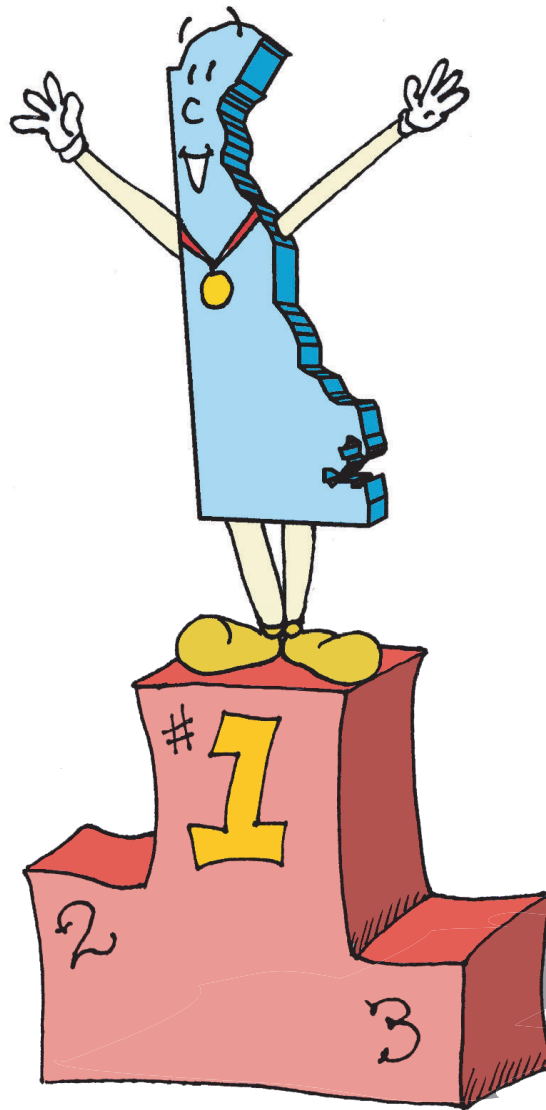


Keeping the First State First

The Alternative Bank Franchise Tax as an Economic Development Tool

by
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This year saw important revisions to the Delaware bank franchise tax (the “Alternative Bank Franchise Tax”)¹ resulting from the enactment of Senate Bill No. 249². This latest amendment, the 23rd to the 31-year-old bank franchise tax statute, illustrates the propensity of the State to successfully utilize the bank franchise tax statute to serve two seemingly conflicting economic development goals: sheltering the indigenous banking community against competitive threats on the one hand, and attracting and growing the business of newly created Delaware bank subsidiaries of non-Delaware bank holding companies on the other. As such, the 2006 bank franchise tax revisions are both a metaphor for and an illustration of the creative use of tax policy by Delaware to foster one of the most favorable environments in the United States for the financial services industry.

The 2006 Revisions

Unlike many other states, Delaware imposes a separate tax on the income as defined of banks, trust companies, and savings banks: the remaining states simply include banks among all of the commercial entities that are subject to a general business gross receipts tax. Prior to 2006, the Delaware bank franchise tax differed from such business gross receipts taxes in one respect that is critical here: the Delaware bank franchise tax treated all of the income (with certain limited exceptions), of a Delaware bank or a national bank having its principal place

of business in Delaware as if that income were earned in Delaware, while gross receipts taxes apportion and then tax only that income which is sourced to the taxing state. This distinction was not historically consequential for Delaware, first because most of the income of Delaware’s indigenous banks was earned in Delaware, and second, because, in 1981, Delaware enacted a regressive franchise tax rate that was designed to mitigate the inclusion of all income in the Delaware tax base of the Delaware banking subsidiaries of non-Delaware bank holding companies, wherever sourced, by rewarding them with a diminishing marginal tax rate as their income grew.³ As a result, the bank franchise tax generated revenues to the State that reached a zenith in fiscal year 2003 of \$141.5 million.

This equipoise ended abruptly on June 29, 2005, when the largest bank in the United States, Bank of America, announced its acquisition of Delaware’s largest bank (and its largest private employer as well), MBNA America. The issue, of course, was whether Bank of America would keep MBNA in Delaware as its credit card bank subsidiary, or relocate the franchise to another state (perhaps Arizona or North Carolina), with the attendant loss of a significant portion of the workforce. To those of us who were closest to the situation, the answer to this query was not the right one for Delaware. An important bit of history will explain why.

In 2000, Bank of America and NationsBank agreed to merge. Both parties to the merger had credit card bank subsidiaries with assets of approximately \$9 billion each. The Bank of America subsidiary was located in a state with an apportioned gross receipts tax, Arizona, while the NationsBank subsidiary, NationsBank Delaware, was located in Delaware. The surviving parent bank holding company, which assumed the name of Bank of America, did not need two separate credit card bank franchises. When it came time to decide whether to merge the Arizona bank into the Delaware bank, or vice versa, the course for Bank of America was clear: eliminate the Delaware franchise by merging it into the Arizona franchise, and thereby save substantial state taxes. Without a change in the Delaware bank franchise tax to include the apportionment of income, there was every reason to believe that the past would be prologue with respect to the future of MBNA.

Governor Ruth Ann Minner wasted no time in confronting this economic threat. In addition to establishing a personal and direct line of communication with the Bank of America leadership, she also established a task force chaired by her Director of the Delaware Economic Development Office, Judy McKinney-Cherry, and composed of other senior Administration representatives and Delaware banking law and business specialists. The ostensible mission of the Task Force was to identify and offer the resources of the State to the Bank of America with the purpose of encouraging the Bank to maximize its Delaware workforce, but the internal focus from the first day of its meetings with Bank officials was whether and how to address the lack of an apportioned franchise tax.

The task was daunting, for a number of reasons: first, the Task Force did not know how much time it had before the Bank would make its decision regarding the location of the credit card bank franchise, but the assumption was “hardly enough;” second, the Bank, understandably, would not absolutely link the location of the credit card franchise with the retention or movement of jobs because of its need to consider other competitive factors; third, there did not appear to be any reliable methodology at the outset for estimating the possible collective loss of revenue attributable to the utilization of an apportioned tax scheme by the other credit card and non-indigenous banks with significant non-Delaware sourced income; fourth, there was no obvious reason why the indigenous banking community should support an income allocation formula, from which they would derive little or no benefit; and finally, it was unlikely that the Task Force could provide meaningful assurance to the General Assembly and the Governor that, if they enacted bank franchise tax reform, the issue might not come back and bite them if MBNA were to relocate anyway.

Fortunately, the Task Force found paths around each of these obstacles. With the expert assistance of a tax consultant, the Task Force developed a rough methodology for estimating the possible diminution in franchise tax revenue which might result if those banks with income sourced outside Delaware were to be taxed under differing apportionment formulae.⁴ But the Task Force also came up with a way to partially mitigate whatever loss in income might occur. The concept, which was entitled the “Location Benefit Tax,” requires that any bank electing to be taxed under the Alternative Franchise Tax pay, for the privilege of transacting a banking business in Delaware, an additional levy equal to the sum of \$2

million plus a regressive percentage of the aggregate Delaware assets of the bank. The Location Benefit Tax, which is codified at 5 Del. C. §1101A(d) went a long way toward calming concerns about a significant downturn in revenues from the bank franchise tax. And finally, the Task Force seized upon the economic benefit potential of offering an apportioned tax by marketing it to other non-Delaware banking institutions as an incentive to locate additional businesses in Delaware.

Another statutory innovation, coupled with strong lines of communication between the Task Force and the indigenous Delaware banking community through the Delaware Bankers Association, eliminated any controversy arising from the award of a possible competitive advantage to those banks with non-Delaware sourced income without any corresponding benefit to the indigenous banks. The solution? Rather than repeal the existing bank franchise tax, offer instead to every Delaware bank the opportunity to elect to be taxed under either the present scheme or the new Alternative Franchise Tax. By doing so, those banks whose income is principally sourced in Delaware could continue to take advantage of the 44% discount, the regressive tax rate, and the special exemptions available under the existing franchise tax scheme, while banks with significant non-Delaware sourced income could elect the Alternative Franchise Tax—a win-win outcome. This simple construct assured at least the neutrality of the indigenous banking community, and in turn, removed the other major stumbling block to passage of the Alternative Franchise Tax.

Although there still was no assurance from Bank of America that it would preserve the Delaware credit card charter if the Alternative Franchise Tax were adopted, or, even if it were, that the preponderance of Delaware jobs would remain here, the Task Force, in the course of advising Bank representatives of its direction, did not receive any signals that it had chosen the wrong course. Accordingly, the Task Force recommended to the Governor that the enabling legislation, the drafting of which was ably overseen by Joseph Schoell, the Governor’s Legal Counsel, should be introduced. The Governor agreed, and Senate Bill 249, with a majority of the members of the Senate and the House as its sponsors, was introduced on January 24, 2006, passed by both Houses and was signed into law on the same day.⁵

On February 2, 2006, Bank of America announced that MBNA would retain its Delaware charter, and that Delaware would continue as its headquarters and principal place of business. As of this writing, at least, all who worked and/or voted for the Alternative Franchise Tax stand in the winner’s circle, and the Bank of America is a highly prized new member of the Delaware financial services industry.

A Glimpse at the Past

While the 2006 amendments were dramatic, they follow closely in the footsteps of prior amendments to the Tax that were also prompted by economic development or protectionist motives. The following are illustrative.

- The bank franchise tax structure was first adopted in July of 1974.⁶ The original tax piggy-backed on a bank’s net income for federal tax purposes, and the rate of taxation was set at 7.2%. This

Bank Franchise Tax

(continued from p. 11)

structure remained in place until 1981, when Delaware began in earnest to utilize the bank franchise tax as an economic development tool.

- No piece of legislation better illustrates Delaware's creative use of tax policy to foster financial industry location and expansion in Delaware than the Financial Center Development Act of 1981.⁷ The Act seized upon the quest by large banks to escape the excessive costs and taxes in New York, and Delaware adopted as its tax policy a unique regressive tax structure upon income generated by banks in the State. Chase and JP Morgan promptly signed on, and the floodgates opened.

- In June of 1983, the Delaware General Assembly, in an attempt to foster international banking facilities in Delaware, enacted the International Banking Development Act, which amended the bank franchise tax to exempt international banking transactions and international banking facilities from taxation.⁸ As a result of the legislation, Chase and other banks with international credentials moved offshore operations and EDGE Act activity to Delaware.

- In 1987 and again in 1992, the General Assembly amended the bank franchise tax to encourage banks to locate non-bank operations in Delaware. In 1987, Delaware granted securities powers to banks and provided that 50% of the income derived by a subsidiary engaged in securities activities could be exempt from the bank franchise tax.⁹ In 1989, the legislature adopted the Bank and Trust

Company Insurance Powers Act to grant insurance powers to banks and encourage financial institutions to locate insurance operations in the State.¹⁰ This legislation allowed the insurance activities of banks to be taxed at the lower premium tax rate under Title 18 of the Delaware Code rather than the bank franchise tax rate. Citibank, Chase and PNC to name a few, seized upon the opportunity to locate insurance operations in the State.

- The bank franchise tax has not only been used as an economic development tool, it has also been used for protectionist purposes to help the State retain tax income and to assist the financial services industry from avoiding negative tax implications on the state and federal level. In 1983, the United States Supreme Court struck down a Tennessee provision that taxed the interest earned by banks on federal stocks, bonds and Treasury notes, but did not tax the interest income from obligations issued by Tennessee and its political subdivisions.¹¹ The Court held that the tax discriminated against federal obligations in favor of state and local securities in violation of federal law.

Prior to 1983, Delaware, like Tennessee, taxed the interest income earned by banks on its federal obligations. With the Supreme Court ruling in *Memphis Bank*, Delaware suddenly faced the loss of revenue derived from taxing federal obligations, and banks faced additional tax burdens if the state were to tax both state and local obligations. State officials and the Delaware banks convened to find a common solution to this problem, and in 1984, the Delaware General Assembly amended the bank franchise tax to provide for the taxation of interest income from both federal and state



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obligations, but, to avoid a painful landing for the banks, the legislation also provided that “net taxable income” would be discounted by 44% to determine each bank’s taxable base.¹²

This discount, which some attribute to the legendary Joe Moran, Executive Vice President of Wilmington Trust, was intended to make the new franchise tax “revenue neutral.” To be certain, however, and to give each bank time to adjust its investments, the legislation also provided for an adjustment “true up” over time for the two succeeding tax years, which mitigated any hardship occasioned by the reconfiguration of the tax base.

Conclusion

Delaware stands at the forefront of using creative tax policy to foster one of the most favorable environments in the United States for the financial services industry. From the enactment of the Financial Center Development Act in 1981 to the Alternative Bank Franchise Tax in 2006, Delaware has utilized tax policy to emerge as one of the major money market centers in this country.



Footnotes: ¹ 5 Del.C. §1101A. ² 75 Del.Laws c. 223. ³ 5 Del.C. §1105. ⁴ In the final analysis, the Task Force could, and did, represent with absolute confidence that the projected loss did not begin to approach the estimated loss of between \$35 and \$40 million should MBNA weigh anchor and move to another state. ⁵ 75 Del.Laws ch. 223. ⁶ 59 Del.Laws, c.434. ⁷ 63 Del.Laws, c. 2. ⁸ 64 Del.Laws, c. 160. ⁹ 66 Del.Laws, c.27. ¹⁰ 67 Del.Laws, c.223. ¹¹ *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983). ¹² 64 Del.Laws, c.461.



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Delaware State Bar Association. He is the principal draftsman of numerous Delaware banking laws, including the Bank and Trust Company Insurance Powers Act of 1989, the Delaware Interstate Banking Act, and the Foreign Banking Development Act. Most recently he served on the task force that helped in the restructuring of Delaware's Bank Franchise Tax. Mr. Swayze is a 1969 graduate of the University of Pennsylvania Law School, and received his A.B. in politics from Princeton University.



Christine P. Schiltz joined Parkowski, Guerke & Swayze as a shareholder in June 2003, concentrating in insurance and banking law, health care and government relations and regulatory matters. She has represented a variety of clients before the Delaware General Assembly and state administrative agencies. She is a member of the ABA's Business Law and Tort and Insurance Practices sections. She is also a member of the Delaware State Bar Association and recently completed her term on the

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